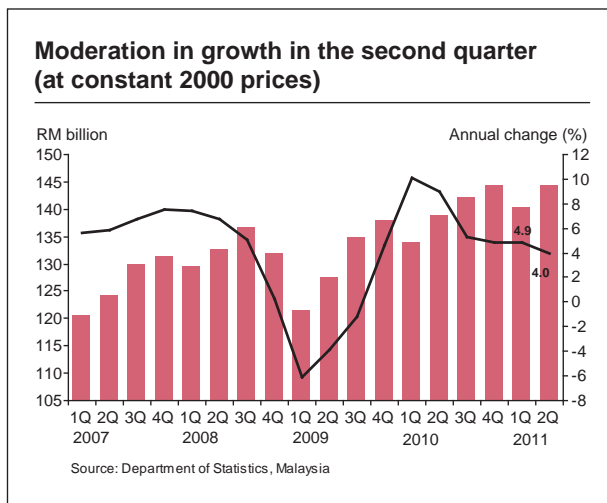


ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE SECOND QUARTER OF 2011

OVERVIEW

Growth moderated in the second quarter

The pace of growth of the Malaysian economy moderated in the second quarter (4.0%; 1Q 11: 4.9%) following a weaker external environment. The overall weakness in the advanced economies and the disruptions in the global manufacturing supply chain stemming from the disaster in Japan, were reflected in the slowdown in the manufacturing sector. Nevertheless, overall growth continued to be underpinned by the sustained expansion of private domestic demand. This was further supported by the strong exports of commodities and resource-based products given the favourable regional demand and high commodity prices.



Domestic demand increased by 5.2% (1Q 11: 6.9%), supported mainly by sustained growth in private sector spending. Private consumption increased by 6.4% (1Q 11: 6.7%). Sustained expenditure on emoluments and supplies and services supported the growth in public consumption (4.0%; 1Q 11: 8.9%). Growth in gross fixed capital formation moderated to 3.2% (1Q 11: 6.5%), due mainly to lower public investment. Private capital spending, however, was sustained by expansion in production capacity and investment in new growth areas in the manufacturing sector as well as exploration and development activity in the oil and gas

sector. During the quarter, Federal Government development expenditure was lower, and was focussed on the education, transportation and trade and industry sectors.

On the supply side, growth in most economic sectors moderated during the quarter. The manufacturing sector slowed to 2.1% (1Q 11: 5.5%) due mainly to the weaker global environment and the production disruptions following the disaster in Japan in March. Nevertheless, the services sector was sustained at 6.3% (1Q 11: 6.4%), supported by continued domestic private sector spending. The agriculture sector turned around to expand by 6.9% (1Q 11: -0.2%), due mainly to higher output of both crude palm oil and natural rubber following an improvement in weather conditions. Meanwhile, growth in the construction sector moderated to 0.6% (1Q 11: 3.8%) due to delays in the implementation of infrastructure projects. The mining sector continued to contract (-9.2%; 1Q 11: -4.2%), reflecting the lower production of crude oil following the shutdown of production facilities for maintenance.

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI), rose to 3.3% on an annual basis during the quarter (1Q 11: 2.8%), driven by supply factors. The increase in consumer prices was reflected mainly in the food and non-alcoholic beverages category, which rose by 4.7% (1Q 11: 4.3%). Prices in the transport category also registered an increase of 5.7% (1Q 11: 4.4%), due to the upward adjustments in the price of RON97 petrol in April and May following higher global crude oil prices.

The external sector recorded a trade surplus of RM27.1 billion in the second quarter (1Q 11: RM31.8 billion). Gross exports expanded by 8.3%, while import growth moderated to 7.1% (1Q 11: 4.8% and 12.4% respectively). Export growth was supported by the continued expansion in the exports of commodities and non-E&E products, due mainly to the firm commodity prices and robust regional demand.

Meanwhile, exports of E&E registered a contraction as exports of computer and parts remained weak. Growth in gross imports was weighed down by lower imports of intermediate goods, which were affected by the global supply disruptions. The import of capital goods moderated due mainly to lower imports of machineries, while the import of consumption goods continued to expand.

On a cash basis, both gross and net inflows of foreign direct investment* were higher at RM13.4 billion and RM6.2 billion respectively (1Q 11: +RM7.6 billion and +RM4 billion respectively). The inflows were broad-based and channelled mainly into the finance, insurance and business services sub-sector, manufacturing and oil and gas sectors. Direct investment abroad* by Malaysian companies recorded a larger net outflow of RM9.4 billion (1Q 11: -RM3.7 billion). These investments were largely undertaken by companies in the finance and insurance, business services and communications sub-sectors. Net inflows of portfolio investment also increased to RM37.6 billion (1Q 11: +RM8.1 billion), reflecting the strong foreign interests in the domestic capital market, particularly the debt securities markets.

The international reserves of Bank Negara Malaysia amounted to RM406.3 billion (equivalent to USD134.3 billion) as at 30 June 2011. The reserves level has taken into account the quarterly adjustment for foreign exchange revaluation. As at 29 July 2011, the reserves position amounted to RM409.6 billion (equivalent to USD135.4 billion), sufficient to finance 9.6 months of retained imports and is 4.4 times the short-term external debt.

Monetary policy is supportive of economic activity

On 5 May 2011, the Monetary Policy Committee (MPC) raised the Overnight Policy Rate (OPR) by 25 basis points to 3.00%. The degree of monetary accommodation was adjusted as a pre-emptive move to prevent a build-up of financial imbalances. At the July meeting,

the MPC decided to pause the normalisation and leave the OPR unchanged due to the heightened uncertainties arising from global developments which had created greater downside risks to growth.

Following the increase in the OPR in May, the average overnight interbank rate traded higher and interbank rates of other maturities rose accordingly. In terms of the commercial banks' lending rates, both the average base lending rate and the average lending rate were revised upwards. The average fixed deposit (FD) rate also increased in tandem.

Financing conditions remained supportive of economic activity during the quarter, with financing continuing to remain available to all segments of the economy. Total gross financing raised by the private sector through the banking system and the capital market increased to RM225.6 billion (1Q 11: RM202 billion). On a net basis, banking system loans and private debt securities (PDS) outstanding rose by an annual rate of 12.9% as at end-June (end-March 11: 12.1%). The major loan indicators also remained strong in the second quarter.

Net funds raised in the capital market amounted to RM20.8 billion (1Q 11: RM29.7 billion), of which, 83%, or RM17.3 billion was raised by the private sector, mainly via PDS. Meanwhile, net funds raised by the public sector amounted to RM3.5 billion during the quarter.

Private sector liquidity, as measured by broad money (M3), expanded at a higher annual rate of 12.4% as at end-June (end-March 11: 8.0%), reflecting the higher extension of credit to the private sector by the banking system and increased non-resident inflows.

The ringgit's appreciating trend against the US dollar in the first quarter of 2011 continued into the beginning of the second quarter, as the favourable growth outlook in Asia relative to the advanced economies continued to attract investors towards the regional financial markets. For the quarter as a whole, the ringgit

* Excludes retained earnings.

appreciated marginally by 0.2% against the US dollar. Against other major currencies, the ringgit appreciated against the pound sterling (0.1%), but depreciated against the euro (-2.4%) and the Japanese yen (-2.5%). Against the regional currencies, the ringgit strengthened against the Thai baht (1.7%), but depreciated against the Chinese renminbi (-1.2%), Indonesian rupiah (-1.2%), Singapore dollar (-2.4%) and Korean won (-2.8%). The ringgit remained unchanged against the Philippine peso. During the period between 1 July and 15 August 2011, the ringgit appreciated against the US dollar (1.2%), euro (2.7%) and pound sterling (0.1%), but depreciated against the Japanese yen (-3.4%). Against regional currencies, the ringgit strengthened against the Korean won (2.2%), Indonesian rupiah (0.6%) and Chinese renminbi (0.1%) but depreciated against the Singapore dollar (-0.6%), Philippine peso (-0.9%) and Thai baht (-1.5%).

Financial stability remained intact

Domestic financial system stability was maintained, underpinned by sound financial system and institutions and orderly financial markets which continue to support efficient financial intermediation and sustained public confidence in the financial system. The level of risk exposures of the financial sector continued to be manageable during the quarter. The resilience of the financial sector was evident in the sound capitalisation, firm profitability and stable quality of assets. Core capital ratio and risk-weighted capital ratio remained strong at 12.3% and 13.9% respectively. As for the insurance and takaful sector, the capital position remained strong with capital adequacy ratio of

224.1% and excess capital of RM19.5 billion. Liquidity remained ample to meet the demand for deposit withdrawals and other liquidity obligations.

Growth of the domestic economy to improve in the second half

While the moderation in the global growth in the second quarter was mainly due to temporary factors arising from global supply chain disruptions and high commodity prices, fiscal and debt conditions in several of the advanced economies had also contributed to increased uncertainties and heightened financial market volatilities which affected overall confidence. Going forward, global growth is expected to remain positive, supported by economic activity in most of the emerging economies and the improvement in the global supply chain. The overall global recovery, however, will continue to be constrained by the structural weakness in the advanced economies. In addition, prolonged uncertainty in the financial markets could also weigh down on real economic activity.

In Malaysia, while the global supply disruptions affected production and trade in the second quarter, the underlying strength of the domestic economy remained intact as domestic demand continued to support growth. Going forward, the downside risks to external demand have increased following heightened uncertainties in the external environment. Nevertheless, domestic demand is expected to remain resilient and support growth amidst sustained private consumption, strong private investment and faster pace of implementation of public sector projects in the second half of the year.

DEVELOPMENTS IN THE SECOND QUARTER OF 2011

INTERNATIONAL ECONOMIC ENVIRONMENT

Global growth moderated amidst heightened uncertainties in the international financial markets

Global economic activity experienced a slower expansion in the second quarter of 2011, amidst increased uncertainties over global growth prospects. The moderation in growth was due partly to a slowdown in global manufacturing and trade activities following the natural disasters in Japan that led to significant disruptions in the global supply chain. In addition, high commodity prices also weighed in on private consumption in most economies. In the advanced economies, growth momentum slowed as the economies continued to face headwinds from slower improvements in labour market conditions, elevated fuel prices and rising concerns over fiscal sustainability. This had spillover effects on external trade and affected growth in the emerging economies. Conditions in the international financial markets deteriorated during the quarter due mainly to fiscal issues in the US and the euro area. Concerns over the European sovereign debt crisis intensified following increased possibility of a debt default by Greece. The slow progress in official agreement to address the issue further strained market confidence. Concerns over Portugal's fiscal sustainability came into the spotlight which eventually resulted in a bailout package of €78 billion in May. The crisis triggered rating downgrades for several economies. In the US, the government was hit by the possibility of a shutdown in April and subsequently, possible default if the debt ceiling is not raised by 2 August. Notwithstanding these uncertainties, monetary authorities, particularly in the emerging economies, continued to tighten policy interest rates during the quarter to contain inflationary pressures, driven mainly by elevated food and energy prices.

In July and August, financial market conditions became increasingly volatile following heightened concerns over the sovereign debt issues in the advanced economies and possibility of a weaker global economic recovery. On 21 July, European leaders managed to agree on several

measures to contain the Greek crisis, including a planned €109 billion new bailout package as well as involvement of the private sector on a voluntary basis. Despite the move, the crisis worsened, following market perception of the uncertainty in the adequacy of the new measures to address Greece's solvency issue and lack of concrete details on some of the measures being outlined. The crisis spread to Italy and Spain, precipitating an increase in sovereign yields in these economies. In the US, the government averted a potential debt default following Congress' approval to raise the debt ceiling but the deficit reduction plan was deemed insufficient to achieve medium-term fiscal sustainability. On 5 August, S&P downgraded the US sovereign debt rating to AA+ and maintained a negative outlook. The decision exerted further stress on an already fragile market confidence amid renewed concerns over the potential risk of a double-dip recession, following the release of weak economic indicators in the US. On 7 August, policymakers from the G7 economies pledged to jointly introduce necessary measures to maintain confidence and preserve financial market stability. In addition, the ECB announced that it would actively implement its Securities Market Programme to stem contagion.

The **US** economy grew at a modest pace of 1.3% in the second quarter (1Q 11: 0.4%) due to a moderate expansion in domestic demand. On an annual basis, the economy expanded at a slower pace of 1.6% (1Q 11: 2.2%). Consumption recorded a broad-based slowdown largely due to a contraction in motor vehicles and parts. The global supply chain disruption had resulted in lower auto production and subsequently, higher automobile prices and removal of discounts. In addition, consumer confidence deteriorated due to high gasoline prices, slower improvement in job market conditions and volatile equity market performance. However, private fixed investment grew at a faster rate of 5.8% (1Q 11: 1.2%), following a rebound in construction activity and modest growth in capital spending on equipment and software. Government spending

declined as fiscally-constrained state and local governments continued to cut spending and employment. Inflation rose at a faster rate of 3.4% (1Q 11: 2.1%) due mainly to higher energy and food prices.

The **euro area** economy expanded at a slower pace during the quarter, following the waning of temporary factors which boosted growth in the previous quarter. The moderation in growth was also attributed to a slower improvement in both domestic and external demand. Growth in private consumption was affected by higher inflation and weaker sentiment following an escalation of the sovereign debt crisis due mainly to mounting investors' concerns over a potential restructuring of Greek debt. In the peripheral economies, domestic demand continued to be weighed down by fiscal austerity measures. On the inflation front, consumer prices rose at a faster pace of 2.7% (1Q 11: 2.5%), due mainly to higher energy and commodity prices.

In the **UK**, real GDP growth slowed to 0.2% in the second quarter (1Q 11: 0.5%). On an annual basis, the economy expanded at a slower pace of 0.7% (1Q 11: 1.6%). The moderation in growth was due partly to temporary factors including an additional bank holiday in April and the after effects of the Japanese tsunami which affected production activity during the quarter. Domestic demand continued to be weighed down by fiscal austerity measures, weak sentiments and higher consumer prices. Inflation increased at a faster rate of 4.4% during the quarter (1Q 11: 4.1%), driven by higher commodity prices and the increase in the value-added tax in January 2011.

The **Japanese** economy continued to decline by 1.3% on an annualised basis (1Q 11: -3.6%) in the second quarter, resulting from the supply-side shocks and a decline in exports caused by the natural disasters in March. On an annual basis, the economy contracted by 1.0% (1Q 11: -1.0%). In April, power shortages continued to disrupt production activity, resulting in slower exports. However, the rate of decline eased in May reflecting a gradual recovery in production capacity. During the quarter, exports declined by 5.3% year-on-year (1Q 11: +6.5%). On the domestic front, household spending continued

to fall although there were signs of some improvements in consumer sentiment. Towards the latter part of the quarter, gradual recovery in production activity led to improving household and business sentiments. As a result, consumer spending declined at a slower rate of 0.6% (1Q 11: -1.0%), reflecting increased consumer willingness to spend. On the inflation front, core consumer prices (excluding fresh food) rose by 0.5% (1Q 11: -0.2%) due to increase in energy prices.

Advanced Economies: Real GDP Growth

	2010		2011		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
US ¹	3.8	3.9	0.4	1.3 ^a	1.1
UK	1.5	0.6	1.6	0.7 ^p	1.2
Japan ¹	-0.5	6.2	-3.6	-1.3 ^p	-2.8

¹ Annualised basis
^a Advance estimate
^p Preliminary

Source: National authorities

Monetary policy in the advanced economies remained accommodative. In the US, the **Federal Reserve** (Fed) maintained the federal funds rate at 0-0.25% during the quarter. The Fed also completed its purchases of USD600 billion of long-term Treasury securities under the QE2 programme at the end of June but would maintain its existing policy of reinvesting principal payments from its securities holdings. During the quarter, the **European Central Bank** (ECB) increased its key policy rate by 25 basis points to 1.25% in April and signalled that it would continue to raise interest rates to counter rising inflationary pressures. Subsequently, on 7 July, the ECB raised its policy rate by a further 25 basis points to 1.5%. However, on 4 August, the ECB announced that it will restore its provision of 6-month loans, to address renewed tensions in financial markets. In contrast, balancing between higher inflation and a fragile economic recovery, the **Bank of England** decided to leave its policy rate unchanged at 0.5% and maintained the size of its asset purchase programme at £200 billion. The **Bank of Japan** (BoJ) maintained its overnight policy rate at a range of 0 - 0.1%. In response to the natural disasters, BoJ introduced a one-year

¥1 trillion lending programme at a rate of 0.1% to assist companies in the affected areas and established a ¥500 billion fund for banks for equity investments and lending purposes. In August, the BoJ expanded its asset purchase programme by ¥5 trillion to ¥15 trillion to further support the recovery of the economy. The fixed-rate lending program, which was established in December 2009, was also raised by ¥5 trillion to ¥35 trillion. Meanwhile, the Swiss National Bank cut its interest rate target range to between 0–0.25% from 0–0.75% in an unscheduled emergency meeting in August. The move was to counter the strong pressure on the Swiss franc as a safe haven currency following the debt crisis in Europe and the U.S.

	2010		2011		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
PR China	10.3	11.1	9.7	9.5	9.6
Indonesia	6.1	5.9	6.5	6.5	6.5
Hong Kong SAR	6.7	7.4	7.5	5.1 ^P	6.3
Chinese Taipei	12.9	13.2	6.5	4.9 ^A	5.7
Korea	7.5	8.0	4.2	3.4 ^A	3.8
Singapore	19.4	17.9	9.3	0.9	5.1

^P Preliminary
^A Advance estimate

Source: National authorities

After a robust growth in the first quarter, economic activity in **Asia** moderated in the second quarter. Growth in the region was mainly affected by the global supply chain disruptions following production interruptions in Japan. This was reflected in the slower expansion in production and exports. Nevertheless, sustained domestic demand continued to underpin growth in most regional economies. Private consumption remained resilient, supported by continued access to financing, favourable labour market conditions and rising wages. In **PR China**, growth moderated to 9.5% (1Q 11: 9.7%) following slower expansion in the agriculture and manufacturing sectors. In **Hong Kong SAR**, the economic expansion slowed to 5.1% (1Q 11: 7.5%), attributable to moderation in exports and government expenditure. In **Chinese Taipei**, GDP growth moderated to 4.9% (1Q 11: 6.5%)

due to a slower growth in private consumption and lower contribution from net exports. In **Korea**, the economy expanded at a slower rate of 3.4% (1Q 11: 4.2%) due to moderation in exports amid continued weakness in investment activity. **Singapore**'s economy recorded a weaker-than-expected growth of 0.9% in the second quarter (1Q 11: 9.3%), due mainly to a deceleration in the manufacturing sector, primarily reflecting the decline in the volatile biomedical manufacturing cluster. **Indonesia**'s economic growth was sustained at 6.5% (1Q 11: 6.5%), supported by continued expansion in domestic consumption, investment and exports.

Headline inflation remained elevated in the regional economies due to higher food and energy prices. An uptrend in core inflation in some regional economies during the quarter also indicated increasing demand pressures. Amidst sustained economic growth and elevated inflationary pressures, several regional central banks continued to normalise or tighten their policy interest rates. The **People's Bank of China** raised its benchmark interest rates by 25 basis points each in April and July, bringing the 1-year lending rate to 6.56% and increased major banks' reserve requirement ratio by a cumulative 150 basis points to 21.5% in the second quarter. The **Bank of Thailand** increased its 1-day repurchase rate by 25 basis points each in April, June and July to 3.25% to contain inflation expectations amidst robust domestic demand. Similarly, **Bangko Sentral ng Pilipinas** (BSP) raised its overnight reverse repurchase rate by 25 basis points to 4.50% in May. The BSP also raised banks' reserve requirement by 50 basis points each in June and July to contain excess liquidity condition from leading to upward price pressures. The **Reserve Bank of India** increased its repurchase rate by a total of 125 basis points in May and June to 8.00%. The **Bank of Korea** (BoK) also hiked its base rate by 25 basis points to 3.25% in June on expectations of further price pressures from sustained economic growth and higher inflation expectations. As part of its move to mitigate the impact of volatile capital flows, the BoK introduced additional macro-prudential measures to restrict financial institutions from investing in locally-issued foreign currency-denominated bonds. In August, BoK decided to maintain its policy rate at 3.25% for a second

month as the US sovereign rating downgrade and European debt crisis heightened concerns over the global economic recovery. In addition, Korea's Financial Services Commission decided to ban short-selling of shares for three months starting on 10 August to maintain market stability following a 17% loss in the equity market over six trading days.

Crude oil prices¹ remained elevated with a higher quarterly average of USD102 per barrel in the second quarter of 2011 (1Q 11: USD94 per barrel), despite corrections in the last two months of the quarter. After rising to USD113.9 per barrel at the end of April, the highest level since September 2008, the upward trend in oil prices began to reverse in May. Oil prices recorded a significant decline in the first week of May as a result of a huge sell-off due to a number of weaker-than-expected economic releases, pointing towards expectations of slowing oil demand from the US. Oil prices declined further to a four-month low of USD91 per barrel following an announcement by the International Energy Agency on 23 June of its release of 60 million barrels from the strategic petroleum reserves, with half of the amount to be contributed by the US. However, the impact was temporary, and towards the end of the quarter, oil prices rose again, ending the quarter at USD95.4 per barrel.

In the **foreign exchange markets**, most major currencies appreciated against the US dollar in the early part of the quarter. The euro, in particular, strengthened in April following the

policy rate hike by the ECB. However, the trend reversed in May as increasing concerns over the sovereign debt crisis in Europe and signs of weaker global growth prospects led to heightened global risk aversion. The euro and the pound sterling ended the quarter lower against the US dollar. The yen continued to strengthen against the US dollar in the quarter, benefiting from its role as a safe haven currency amid heightened investor risk aversion in the global financial market. In August, Japan decided to intervene unilaterally in the currency market to ease the pressure on yen. The yen fell by 4.1% against the dollar following the intervention, surpassing the 3.9% drop at the previous joint intervention with G-7 on March 18. Regional currencies, on the other hand, were supported by continued capital inflows and a relatively stronger growth outlook during the quarter. However, the pace of appreciation was limited by the increase in global risk aversion since May. On 1 August, the Singapore dollar traded at a new record high of SGD1.2015 per US dollar, while the Chinese yuan rose to a 17-year high of 6.3940 per US dollar on 12 August.

Going forward, global growth is expected to remain positive supported by economic activity in most of the emerging economies and the improvement in the global supply chain. The overall global recovery, however, will continue to be constrained by the structural weakness in the advanced economies. In addition, prolonged uncertainty in the financial markets could also weigh down on real economic activity.

¹ Refers to West Texas Intermediate one-month futures on NYMEX

DEVELOPMENTS IN THE MALAYSIAN ECONOMY

Growth moderated in the second quarter

The pace of growth of the Malaysian economy moderated in the second quarter (4.0%; 1Q 11: 4.9%) following a weaker external environment. The overall weakness in the advanced economies and the disruptions in the global manufacturing supply chain stemming from the disaster in Japan, were reflected in the slowdown in the manufacturing sector. Nevertheless, overall growth continued to be underpinned by the sustained expansion of private domestic demand. This was further supported by the strong exports of commodities and resource-based products given the favourable regional demand and high commodity prices.

Sustained domestic demand

Domestic demand was sustained at 5.2% in the second quarter (1Q 11: 6.9%). Growth was supported mainly by private consumption and private investment.

Private consumption grew by 6.4% in the second quarter (1Q 11: 6.7%). Overall spending was supported by continued income growth and favourable labour market conditions. Continued high commodity prices also provided further impetus to spending in the rural areas. Major consumption indicators such as manufacturing sales of food and beverages, credit card spending and imports of consumption goods, registered improvements during the quarter. However, real private consumption was affected by higher food and fuel prices, with headline inflation averaging 3.3% in the second quarter (1Q 11: 2.8%). Higher inflation also affected consumer sentiments, as reflected by a slight drop in the MIER Consumer Sentiments Index to 107.9 points in the second quarter (1Q 11: 108.2 points). These factors resulted in more cautious spending on discretionary items during the quarter.

Public consumption continued to expand, albeit at a more moderate rate of 4.0% (1Q 11:

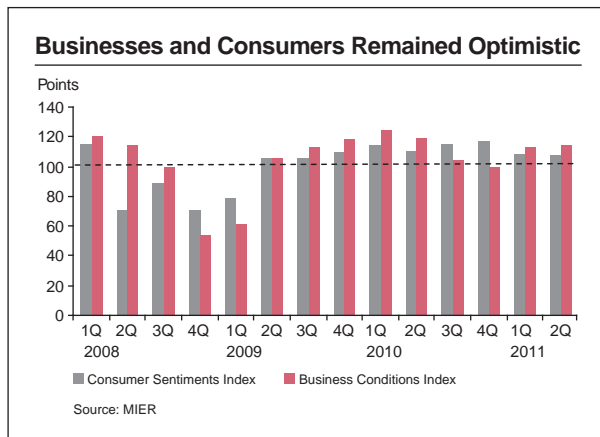
GDP by Expenditure Components (at constant 2000 prices)

	2010		2011		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Aggregate Domestic Demand (excluding stocks)	9.1	7.3	6.9	5.2	6.1
Consumption	7.8	6.6	7.1	5.9	6.5
<i>Private sector</i>	7.9	6.5	6.7	6.4	6.6
<i>Public sector</i>	7.3	7.0	8.9	4.0	6.3
Gross Fixed Capital Formation	12.9	9.5	6.5	3.2	4.7
Net Exports	-41.7	-25.9	-39.6	17.2	-21.4
<i>Exports of Goods and Services</i>	14.0	16.5	1.4	4.1	2.8
<i>Imports of Goods and Services</i>	22.6	25.0	8.4	3.2	5.7
GDP	9.0	9.5	4.9	4.0	4.4

Source: Department of Statistics, Malaysia

8.9%), due to expenditure on emoluments as well as supplies and services.

Gross fixed capital formation moderated to 3.2% (1Q 11: 6.5%), due mainly to lower public investment. Private investment, however, was sustained during the quarter. High capacity utilisation rates in the manufacturing sector led firms to expand their production capacity, while continued high crude oil prices underpinned increased exploration and development activity in the oil and gas sector. Capital spending was also supported by investments in new growth areas, namely solar, advanced E&E and medical equipment industries. There was continued growth in most major investment indicators, namely bank lending to businesses, production and sales of construction-related materials and sales of commercial vehicles. Importantly, business confidence improved, as evidenced by the increase in the MIER Business Conditions Index to 114.0 points in the second quarter (1Q 11: 113.3 points). Public investment was supported by continued high capital spending by non-financial public enterprises as Federal Government development expenditure declined during the quarter. The bulk of development expenditure by the Federal Government was focussed on the education, transportation, as well as trade and industry sectors.



supply disruptions on trade-related activities. Nonetheless, growth in the services sector was sustained by domestic-driven activities. The construction sector moderated due to delays in the implementation of infrastructure projects, while the performance of the commodities sector was mixed.

Value-added growth in the **manufacturing sector** slowed to 2.1% (1Q 11: 5.5%), as production of both the export-oriented and domestic-oriented industries recorded a more moderate growth. In the **export-oriented industries**, output of E&E continued to decline, dragged down by weaker performance of computers and semiconductors. In addition, there was a sharp fall in production of refined petroleum products, attributed to shutdowns in several crude oil production facilities for maintenance purposes. On the other hand, the continued expansion in **domestic-oriented industries** was supported by the robust performance of the construction-related cluster, which continued to benefit from domestic residential construction activity. However, the consumer-related cluster was affected by the disruption in the automotive supply chain following developments in Japan, with the production of transport equipment, particularly motor vehicles and its related parts, declining sharply.

GDP by Economic Activity (at constant 2000 prices)

	2010		2011		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Agriculture	2.8	4.9	-0.2	6.9	3.4
Mining	1.5	1.2	-4.2	-9.2	-6.6
Manufacturing	16.0	16.5	5.5	2.1	3.8
Construction	4.1	6.2	3.8	0.6	2.1
Services	7.4	8.0	6.4	6.3	6.4
Real GDP (Annual Change)	9.0	9.5	4.9	4.0	4.4
Real GDP (Preceding Change)	3.8	0.0	-2.8	2.8	-0.6

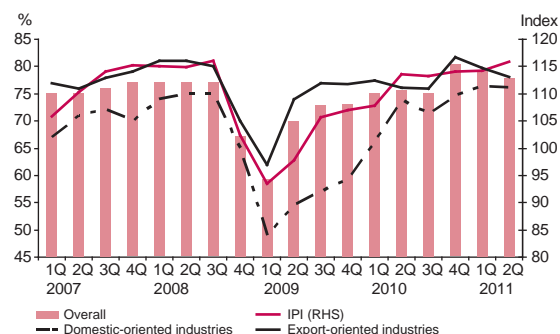
Source: Department of Statistics, Malaysia

Moderate growth in most economic sectors

On the supply side, growth in most economic sectors moderated in the second quarter. The growth of manufacturing sector slowed, reflecting mainly the weaker global economic performance and the effect of the global

Overall capacity utilisation rate in the manufacturing sector moderated marginally (78%; 1Q 11: 79%), reflecting the softer production growth in the sector. Export- and domestic-oriented industries operated at 78% and 76% of total capacity respectively during the quarter (1Q 11: 80% and 76% respectively).

Capacity utilisation rate in the manufacturing sector*



* Beginning 2009, the capacity utilisation rate in the manufacturing sector has been rebased from value-add in year 2004 to value-add in year 2006

Source: Bank Negara Malaysia & Department of Statistics, Malaysia

In the **services sector**, the growth in the **wholesale and retail trade** sub-sector was higher at 7.3% (1Q 11: 6.8%), as growth in the wholesale and retail segment remained resilient, supported by sustained income growth given the favourable labour market conditions. However, the motor vehicle segment declined, reflecting the lower sales of new motor vehicles due to the global supply disruptions. The continued increases in domestic private sector spending also supported the higher growth in the **accommodation and restaurant** sub-sector. The **finance and insurance** sub-sector expanded by 5.6% (1Q 11: 6.8%), led by the continued growth in net interest and fee-based income arising from favourable loan growth. Strong capital market-related activity also drove the sustained growth in the **real estate and business services** sub-sector (7.6%; 1Q 11: 8.8%).

Performance of the Manufacturing Sector

	2010		2011		
	2Q	1H	1Q	2Q	1H
	Annual Change (%)				
Value Added (at constant 2000 prices)	16.0	16.5	5.5	2.1	3.8
Overall Production¹	16.1	15.7	6.0	2.1	4.0
Export-oriented industries	14.4	14.4	5.1	1.6	3.3
Electronics and electrical products cluster	30.4	33.1	-5.3	-6.9	-6.1
<i>Of which:</i>					
Electronics	19.3	21.5	-18.1	-14.9	-16.5
Electrical products	52.3	58.4	17.9	5.5	11.3
Primary-related industry cluster	6.4	5.5	11.4	6.7	9.0
<i>Of which:</i>					
Chemicals and chemical products	10.4	17.0	5.5	6.6	6.0
Petroleum products	-0.8	-12.3	26.0	2.2	13.6
Rubber products	19.1	27.7	12.4	21.2	16.8
Off-estate processing	0.2	2.2	-7.4	17.6	5.3
Domestic-oriented industries	21.9	20.0	8.9	3.7	6.2
Construction-related cluster	23.1	22.5	22.1	17.6	19.7
<i>Of which:</i>					
Construction-related materials	26.5	26.8	15.3	15.4	15.3
Fabricated metal products	19.0	17.1	32.0	20.6	25.8
Consumer-related cluster	20.9	18.3	-0.3	-6.6	-3.5
<i>Of which:</i>					
Transport equipment	38.6	39.5	-3.9	-15.2	-9.7
Food, beverage & tobacco products	12.2	7.3	6.7	1.8	4.1

¹ Industrial Production Index (2005=100)

Source: Department of Statistics, Malaysia

Performance of the Services Sector (value added at constant 2000 prices)

	Share 2010 (%)	2010		2011		
		2Q	1H	1Q	2Q	1H
		Annual change (%)				
Intermediate Services	43.7	7.3	8.0	6.8	6.0	6.4
Finance & insurance	20.3	8.7	7.9	6.8	5.6	6.2
Real estate & business services	9.5	2.8	8.2	8.8	7.6	8.2
Transport & storage	6.6	9.0	8.5	4.3	4.7	4.5
Communication	7.4	8.3	7.5	6.4	6.5	6.5
Final Services	56.3	7.4	8.0	6.1	6.5	6.3
Wholesale & retail trade	23.6	8.8	9.2	6.8	7.3	7.1
Accommodation & restaurant	4.2	5.9	5.7	4.0	5.9	4.9
Utilities	5.2	9.0	12.7	1.3	2.4	1.8
Government services	13.0	8.0	7.8	9.4	8.6	9.0
Other services	10.2	3.6	4.1	3.9	4.6	4.3
Total Services	100.0	7.4	8.0	6.4	6.3	6.4

Source: Department of Statistics, Malaysia

Selected Quarterly Indicators in the Services Sector

	2010				2011	
	1Q	2Q	3Q	4Q	1Q	2Q
	Index					
MIER Consumer Sentiments Index	114.2	110.4	115.8	117.2	108.2	107.9
MIER Retail Trade Index	106.9	134.1	140.0	132.0	99.1	124.8
MIER Tourism Market Index	120.5	118.2	118.8	124.6	113.1	125.4
	Annual change (%)					
Tourist arrivals	5.3	3.9	5.6	1.2	-3.7	n.a.
Total passenger traffic at all airports	20.3	14.1	10.0	6.3	11.8	13.4
Total consumption credit outstanding	9.5	10.6	10.7	9.8	9.5	8.7
Loans outstanding to the wholesale & retail trade, hotels & restaurants	4.5	8.6	7.3	7.5	7.2	6.8
Imports of consumption goods	18.5	13.3	3.2	6.9	5.3	16.8
Total sales of motor vehicles	22.7	17.4	3.7	9.3	7.5	-9.7
Container cargo handled (Port Klang and PTP)	22.5	21.3	10.9	9.6	14.4	9.6

Source: Various sources

The expansion in the **construction sector** moderated to 0.6% (1Q 11: 3.8%) as the slow implementation of infrastructure projects contributed to the contraction in the civil engineering segment. The residential sub-sector expanded further, underpinned by positive sentiments amidst favourable employment and financing conditions, while the ongoing construction of commercial properties, especially office and retail space, continued to support the non-residential sub-sector.

Indicators for the Construction Sector

	2010		2011		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
New sales and advertising permits	14.9	22.1	25.1	11.6	17.7
Housing approvals	8.9	11.1	31.6	14.1	22.1
Production ¹ of construction-related materials	23.1	22.5	22.1	17.6	19.7
Loans approved for construction	43.7	42.2	29.3	31.8	30.7
Imports of construction materials and mineral products	28.3	40.0	-1.8	22.5	10.4

¹ Industrial Production Index (2005=100)

Source: Ministry of Housing and Local Government, Department of Statistics, Malaysia and Bank Negara Malaysia.

In the commodities sector, value-added growth of the **agriculture sector** turned around to expand by 6.9% (1Q 11: -0.2%), reflecting mainly the increase in the output of both crude palm oil and natural rubber following the improvement in weather conditions. Conversely, the **mining sector** contracted by 9.2% (1Q 11: -4.2%), as production of crude oil declined further due to the shutdown of production facilities for maintenance.

Performance of the Agriculture Sector

	2010		2011		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (at constant 2000 prices)	2.8	4.9	-0.2	6.9	3.4
Industrial Crops	-3.3	2.1	-8.3	9.9	0.9
Food Crops	10.2	8.2	8.9	3.5	6.1
Production					
<i>Of which:</i>					
Crude palm oil	-0.4	0.7	-7.7	22.2	7.7
Rubber	0.0	17.4	2.5	16.2	8.3
Fish	4.5	1.1	2.0	-1.4	0.2
Livestock	2.4	4.9	-6.3	6.7	0.2

Source: Malaysian Palm Oil Board (MPOB)
Malaysian Rubber Board (MRB)
Fisheries Department, Malaysia
Department of Veterinary Services, Malaysia
Department of Statistics, Malaysia

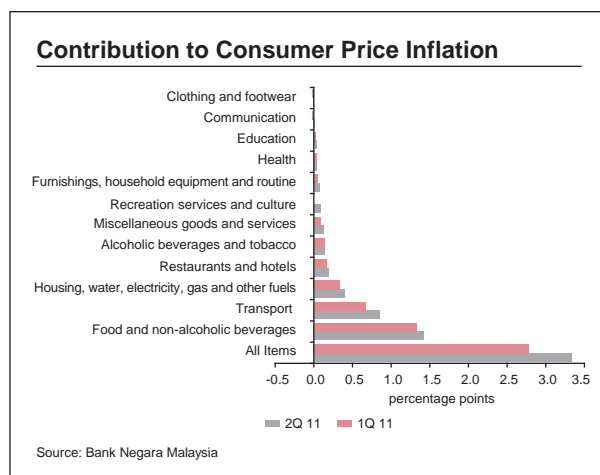
Performance of the Mining Sector

	2010		2011		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (at constant 2000 prices)	1.5	1.2	-4.2	-9.2	-6.6
Production					
<i>Of which:</i>					
Crude oil and condensates	-1.6	-1.3	-7.3	-17.8	-12.5
Natural gas	0.4	1.4	-0.9	2.7	0.8

Source: PETRONAS
Department of Statistics, Malaysia

Inflation increased in the second quarter

Headline inflation, as measured by the change in the Consumer Price Index (CPI), rose to 3.3% on an annual basis in the second quarter (1Q 11: 2.8%), driven by supply factors. The increase in consumer prices was reflected mainly in the *food and non-alcoholic beverages* category, which rose by 4.7% (1Q 11: 4.3%). The increase in food prices was mainly the result of higher prices in the *meat and fish and seafood* sub-categories, which increased by 8.2% and 5.2% respectively (1Q 11: 5.5% and 3.5% respectively). The prices of fish and seafood rose due to supply disruptions. Prices in the *transport* category registered an increase of 5.7% (1Q 11: 4.4%), reflecting the upward adjustments in the price of RON97 petrol in April and May following higher global crude oil prices. These price increases, however, were partially mitigated by declining prices in the *clothing and footwear* category. The increase in electricity tariffs in June had minimal direct impact on the CPI, given that its impact is limited to households with electricity usage of more than 300kWh.

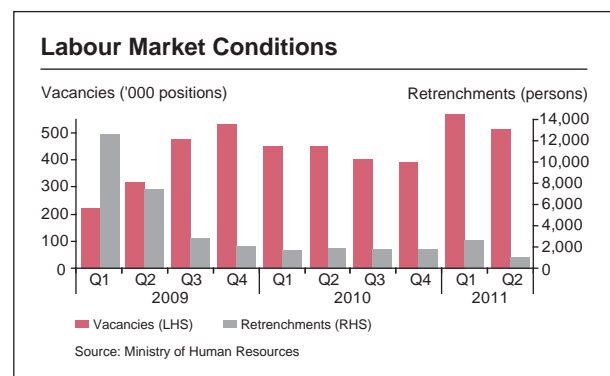


The Producer Price Index (PPI) increased at a higher rate of 10.2% on an annual basis during the quarter (1Q 11: 7.4%). The prices of commodity-related components were higher by 27.1% (1Q 11: 19.5%), while the prices of non-commodity-related components registered an increase of 2.3% (1Q 11: 1.7%). In terms of composition, prices in the imported components of the PPI recorded an increase of 2.8% (1Q 11: 1.8%), while prices in the local components rose by 13.6% (1Q 11: 9.9%).

Labour market conditions remained positive

Conditions in the labour market improved in the second quarter as the number of retrenchments declined by more than half from the preceding quarter to 1,105 persons (1Q 11: 2,621 persons). Most major sectors registered fewer layoffs, with the manufacturing sector recording a notable improvement (370 persons; 1Q 11: 1,822 persons) following fewer layoffs particularly in the E&E, wood, rubber and plastics industries. The services sector, however, recorded marginally higher retrenchments (656 persons; 1Q 11: 644 persons), accounted for mainly by the higher layoffs in the social and private services sub-sectors.

Labour demand during the quarter remained strong, as evidenced by the sustained high number of job vacancies posted on the JobsMalaysia Portal (514,189 positions; 1Q 11: 568,717 positions). During the quarter, the number of job openings was notably higher in the manufacturing, construction and mining sectors. In tandem with these positive developments, the overall unemployment rate improved to 3% during the first two months of the quarter (1Q 11: 3.1%). Nevertheless, real wages in the manufacturing sector expanded at a higher pace (4.8%; 1Q 11: 3.9%).



Exports expanded while imports increased moderately

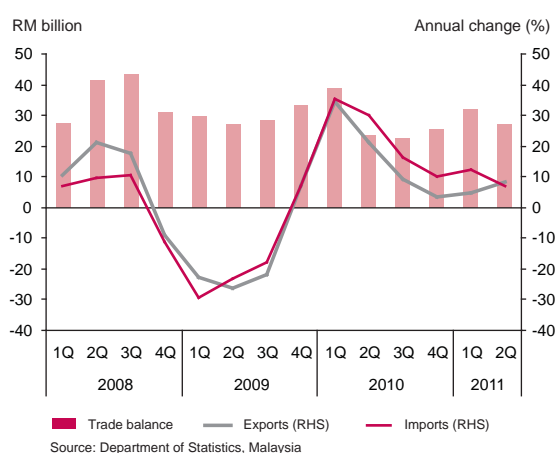
The **trade surplus** amounted to RM27.1 billion during the quarter (1Q 11: RM31.8 billion). Gross exports expanded by 8.3% (1Q 11: 4.8%), led mainly by the exports of commodities and non-E&E products. Gross imports recorded a moderate growth of 7.1% (1Q 11: 12.4%), due mainly to the lower imports of intermediate and capital goods.

Growth in **gross exports** was supported by the stronger growth in commodity exports (28.8%; 1Q 11: 20.1%) and a small expansion in manufactured exports (1.2%; 1Q 11: -0.8%). The continued expansion in the exports of commodities and non-E&E products (9.1%;

1Q 11: 7.2%) was supported by higher commodity prices and stronger regional demand, particularly Japan's post-earthquake demand for energy generation capacity and reconstruction. Meanwhile, E&E exports continued to record a contraction as exports of computers and parts remained weak.

Growth in **gross imports** moderated as imports of capital and intermediate goods grew at a more moderate pace in the second quarter. The former was due mainly to lower imports of machineries, while the latter reflected the lower imports of parts and accessories of machineries, in tandem with the disruption in global production following the disasters in Japan. Nonetheless, the imports of consumption goods expanded strongly in the second quarter, reflecting sustained private consumption and higher prices for food and beverages.

External Trade Performance



Trade Account

	2010		2011		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Gross Exports	21.2	27.5	4.8	8.3	6.6
Manufactured	16.9	24.5	-0.8	1.2	0.2
E&E	16.1	25.4	-7.5	-5.5	-6.5
Non-E&E	17.9	23.4	7.2	9.1	8.2
Commodities	38.7	39.4	20.1	28.8	24.4
Agriculture	22.1	33.2	25.1	42.1	33.4
Minerals	52.6	43.8	16.7	19.9	18.3
Gross Imports	30.2	32.7	12.4	7.1	9.6
Capital goods	26.5	18.1	9.3	3.5	6.2
Intermediate goods	30.5	33.9	13.9	4.8	9.0
Consumption goods	13.3	15.8	5.3	16.8	11.1
Trade balance (RM billion)	23.4	62.4	31.8	27.1	58.9

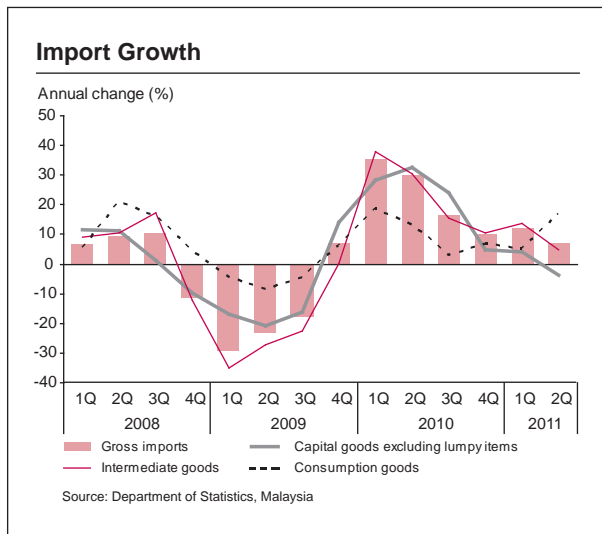
Source: MATRADE and Department of Statistics, Malaysia

Malaysia: Direction of Exports

	2010		2011			2010		2011		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
	Annual change (%)					Share of total exports (%)				
United States	5.1	7.8	-8.0	-7.4	-7.7	10.0	9.7	8.3	8.5	8.4
European Union (EU)	22.4	25.7	5.5	2.4	3.9	10.8	10.7	10.7	10.2	10.4
Selected ASEAN countries¹	17.0	27.3	-0.3	5.9	2.7	25.2	25.6	24.6	24.6	24.6
North East Asia	27.8	41.2	2.2	8.8	5.4	24.5	24.8	24.4	24.6	24.5
People's Republic of China	27.7	45.6	3.2	9.0	6.0	12.4	12.8	12.9	12.5	12.7
Hong Kong SAR	22.6	29.0	-1.7	-4.7	-3.3	5.4	5.1	4.6	4.7	4.6
Chinese Taipei	48.9	60.8	18.0	15.3	16.6	3.1	3.0	3.2	3.3	3.2
Korea	20.8	32.3	-6.9	22.6	6.4	3.6	3.9	3.8	4.0	3.9
West Asia	-0.3	7.3	17.6	6.8	12.0	3.6	3.4	3.7	3.5	3.6
India	14.5	18.0	23.7	45.2	33.9	3.0	3.2	3.9	4.1	4.0
Total exports	21.2	27.5	4.8	8.3	6.6	100.0	100.0	100.0	100.0	100.0

¹Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam and Vietnam

Source: Department of Statistics, Malaysia



Higher inflows of FDI and portfolio investment

On a cash basis, gross inflows of **foreign direct investment (FDI)*** were higher at RM13.4 billion in the second quarter (1Q 11: +RM7.6 billion), on account of higher inflows of equity capital and drawdowns of inter-company loans. After adjusting for gross outflows due mainly to repayments of inter-company loans, net FDI was also higher at RM6.2 billion (1Q 11: +RM4 billion). During the quarter, the bulk of FDI inflows was undertaken mainly by companies in the finance, insurance and business services sub-sector. FDI in the manufacturing and oil and gas sectors remained sizeable.

Net outflows of **direct investment abroad (DIA)*** by Malaysian companies increased to RM9.4 billion (1Q 11: -RM3.7 billion), reflecting largely higher outflows of equity capital and net extensions of inter-company loans to subsidiaries abroad. Investment abroad by Malaysian companies was channelled mainly into the services sector, particularly the finance and insurance, business services and communications sub-sectors.

Portfolio investment recorded a larger net inflow of RM37.6 billion (1Q 11: +RM8.1 billion). The significantly higher inflows reflected mainly purchases of debt securities, particularly central

bank and government securities by non-residents. There were also sizeable inflows of funds into the equity market. Despite heightened concerns on the global growth outlook and the European sovereign debt crisis, inflows of portfolio funds continued to be buoyed by the strong fundamentals and favourable growth prospects of the domestic economy.

External debt remained manageable

Malaysia's **total external debt** amounted to RM241.7 billion or USD79.1 billion as at end-June 2011 (end-Mar: RM233.5 billion or USD76.4 billion), equivalent to 30% of GNI.

The **medium- and long-term external debt** increased to RM149.5 billion (end-Mar: RM142.3 billion), reflecting mainly the net borrowing position of the private sector due to higher borrowings by both the bank and non-bank sectors. The public sector, however, recorded a net repayment position following loan repayments by several NFPEs during the quarter.

As at end-June, the **short-term external debt** amounted to RM92.2 billion or USD30.2 billion (end-Mar: RM91.1 billion), reflecting mainly higher interbank borrowings. Short-term external debt accounted for 38.1% of total external debt. The latest international reserves position as at 29 July 2011 is able to cover 4.4 times the short-term external debt.

	2010		2011	
	end-June ^P		end-Mar ^P	
	RM billion			
Medium- and long-term debt	149.9	142.3	149.5	
Public sector	85.4	77.2	77.5	
Private sector	64.6	65.1	72.0	
Short-term debt ¹	72.2	91.1	92.2	
Total external debt	222.2	233.5	241.7	
USD billion equivalent	67.3	76.4	79.1	
External debt/GNI	30.0	29.0	30.0	
Reserves/Short-term external debt	4.3	3.8	4.4 ²	

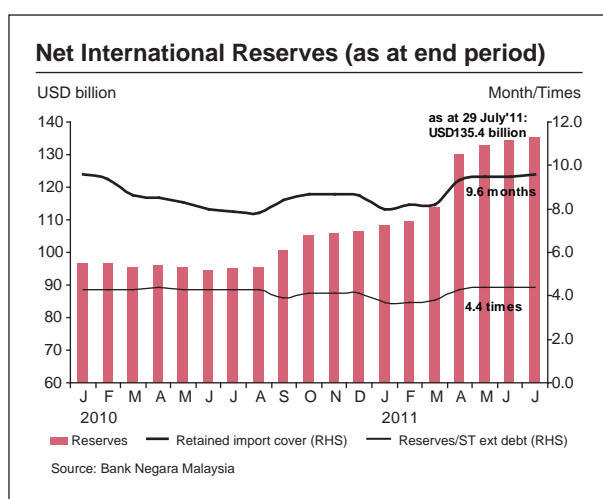
¹ Excludes currency and deposits held by non-residents with resident banking institutions
² Based on reserves as at 29 July 2011
^P Preliminary

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

* The statistics for FDI and DIA on a cash basis does not include retained earnings.

International reserves remained high

The international reserves of Bank Negara Malaysia amounted to RM406.3 billion (equivalent to USD134.3 billion) as at 30 June 2011. The reserves level has taken into account the quarterly adjustment for foreign exchange revaluation gain following the strengthening of some major currencies against the ringgit during the quarter. As at 29 July 2011, the reserves position amounted to RM409.6 billion (equivalent to USD135.4 billion), sufficient to finance 9.6 months of retained imports and is 4.4 times the short-term external debt.



Improved fiscal position on higher revenue collection

The Federal Government recorded a small fiscal surplus of 0.4% of GDP in the second quarter. Total revenue grew at 18.3%, contributed mainly by higher petroleum and individual income taxes. In terms of expenditure, the increase was due largely to higher operating expenditure from the payment of subsidies, and supplies and services. As at end-June 2011, total outstanding debt of the Federal Government amounted to RM437.2 billion or 52.7% of GDP.

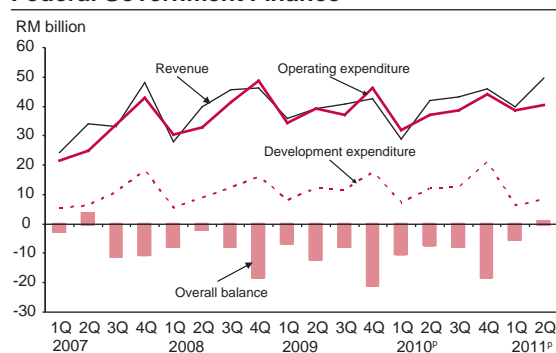
Federal Government Finance^P

	2010		2011		
	2Q	1H	1Q	2Q	1H
RM billion					
Revenue	42.0	70.7	39.8	49.6	89.4
% growth	6.6	-6.0	38.4	18.3	26.4
Operating expenditure	37.1	69.0	38.7	40.6	79.2
% growth	-5.8	-6.4	21.2	9.5	14.9
Current account	4.9	1.7	1.1	9.1	10.2
% of GDP	2.6	0.5	0.5	4.3	2.5
Gross development expenditure	12.1	19.4	6.4	8.3	14.8
% growth	0.1	-4.5	-12.0	-31.3	-24.0
Overall balance	-7.1	-17.3	-5.2	0.8	-4.4
% of GDP	-3.8	-4.7	-2.6	0.4	-1.1
Memo item:					
Total gross expenditure	49.2	88.4	45.1	48.9	94.0
% growth	-4.4	-6.0	15.0	-0.5	6.4
Total Federal Government debt (as at end-period)	388.1	388.1	430.2	437.2	437.2
% of GDP	50.7	50.7	51.8	52.7	52.7
Domestic debt	371.0	371.0	414.2	421.0	421.0
% of GDP	48.4	48.4	49.9	50.7	50.7
External debt	17.1	17.1	15.9	16.2	16.2
% of GDP	2.2	2.2	1.9	1.9	1.9

^P Preliminary

Source: Ministry of Finance

Federal Government Finance



MONETARY AND FINANCIAL DEVELOPMENTS

Interest rates adjusted upwards in response to the increase in the OPR

On 5 May 2011, the Monetary Policy Committee (MPC) raised the Overnight Policy Rate (OPR) by 25 basis points to 3.00%. The degree of monetary accommodation was adjusted as a pre-emptive move to prevent a build-up of financial imbalances. At the July meeting, the MPC decided to pause the normalisation and leave the OPR unchanged due to the heightened uncertainties arising from global developments which had created greater downside risks to growth.

The daily weighted average overnight interbank rate (AOIR) traded higher in the second quarter, to reflect the increase in the OPR. From the period 1 April to 28 April 2011, the AOIR moved within the range of 2.67% to 2.74%. The interbank rates of other maturities were stable during the period. Following the increase in the OPR from 2.75% to 3.00% on 5 May, the AOIR traded higher within the range of 2.83% to 3.00% from 6 May to 30 June 2011. Interbank rates of other maturities also rose accordingly. Overall, market conditions remained orderly as financial institutions transitioned to the new interest rate level.

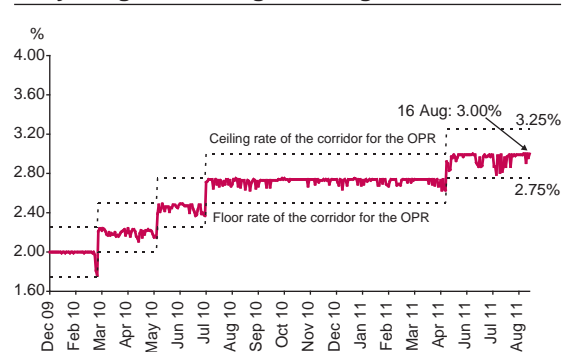
The 1-year interest rate swap (IRS) rose to an average of 3.52% during the quarter (1Q 11: 3.375%), in line with the increase in the OPR. However, this was not reflected in the other maturities, with the 3-year IRS remaining relatively stable at 3.78%, while the 5-year and 10-year IRS declined, with the latter declining to 4.285% (1Q 11: 4.665%), amidst higher portfolio inflows.

Interest Rates

	2010	2011	
	2Q	1Q	2Q
At end-period (%)			
Overnight Policy Rate (OPR)	2.50	2.75	3.00
Interbank rates			
Overnight	2.43	2.74	2.97
1-month	2.71	2.79	3.08
Base lending rates (BLR)			
Commercial banks	6.02	6.27	6.54
Average lending rates (ALR)			
Commercial banks	5.05	5.06	5.07
Fixed deposit rates			
Commercial banks			
3-month	2.51	2.74	2.99
12-month	2.82	2.98	3.23

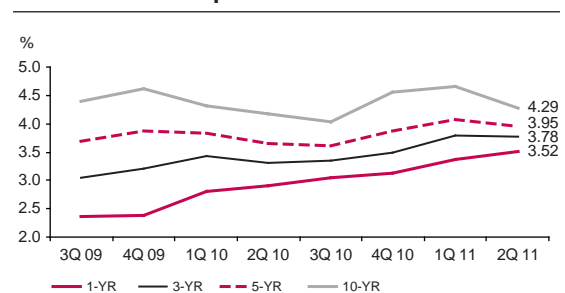
Source: Bank Negara Malaysia

Daily Weighted Average Overnight Interbank Rate



Source: Bank Negara Malaysia

Interest Rate Swap: Rates

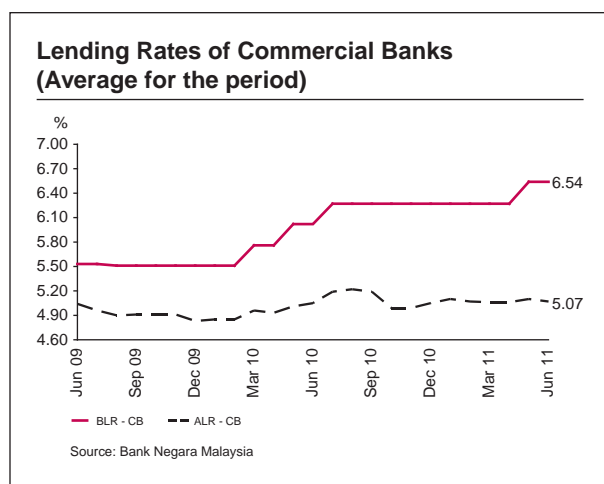
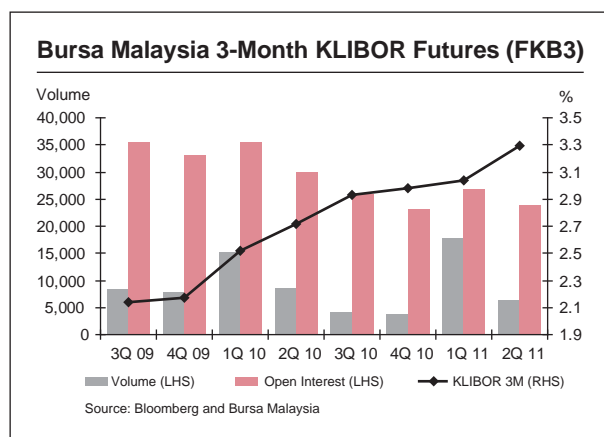


Source: Bloomberg

The Bursa Malaysia KLIBOR 3-month futures (FKB3) also rose to 3.29% at end-June (end-March: 3.04%). With the expectations for no additional OPR adjustments in the short-term, some traders unwound their positions in the market.

Depositors were also compensated by a higher rate of return on their savings following the increase in the OPR. The average quoted fixed deposit (FD) rates rose between 24 to 28 basis points to a higher range of 2.95% and 3.23% as at end-June. In particular, the 12-month FD rate saw a sizeable 25-basis point pass-through following the OPR increase.

Similarly, retail lending rates were revised upwards. The average base lending rate (BLR) of commercial banks increased by 27 basis points to 6.54%. All domestic commercial banks adjusted their respective BLRs by 30 basis points. The weighted-average lending rate on loans outstanding also trended higher to 5.71% as at end-June (end-March: 5.64%). The cost of borrowing to businesses and households remained below pre-crisis levels.



Higher liquidity in the private sector and banking system

Private sector liquidity, as measured by broad money (M3), expanded at a higher annual rate of 12.4% as at end-June 2011 (end-March: 8.0%). On a quarter-on-quarter basis, M3 increased by RM45 billion, reflecting the higher extension of credit to the private sector by the banking system and increased non-resident inflows. Higher credit was underpinned by an increase in loans of RM35.6 billion, as well as higher holdings of private debt securities by banks. Liquidity expanded following non-resident inflows but was partially offset by drawdown of deposits by the private sector to finance the purchases of Bank Negara Monetary Notes (BNMNs). This was captured by the moderation in the other influences category. The repayment of debt by the Government also helped to offset the expansion of broad money.

Liquidity in the banking system also increased during the quarter, due mainly to the higher non-resident inflows, especially in April 2011. Nevertheless, these inflows were sterilised by Bank Negara Malaysia through the use of various instruments to avoid excessively expansionary monetary conditions. The instruments used included the Statutory Reserve Requirement (SRR) ratio which was raised by 100 basis points in May, and a further 100 basis points to 4% in July 2011. The decision to raise the SRR was undertaken as a measure to manage the significant build-up in liquidity, which may result in financial imbalances and create risks to financial stability.

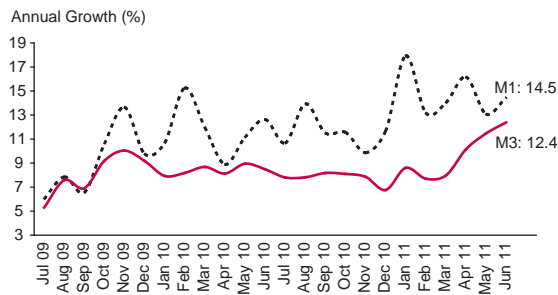
Determinants of Broad Money, M3

	Change during the period				
	2010		2011		
	2Q	1H	1Q	2Q	1H
	RM billion				
M3	-0.4	14.2	28.0	45.0	73.0
Net claims on Govt	-5.1	-7.4	-3.7	-11.5	-15.2
Claims on private sector	16.6	33.2	22.8	41.2	63.9
Loans	26.4	46.2	26.5	29.3	55.8
Securities	-9.9	-12.9	-3.7	11.9	8.2
Net foreign assets ¹	18.3	29.9	25.1	69.0	94.1
BNM	6.4	7.7	15.7	61.7	77.4
Banking System	11.8	22.2	9.3	7.3	16.7
Other influences	-30.1	-41.5	-16.1	-53.7	-69.8

¹ Pre-revaluation

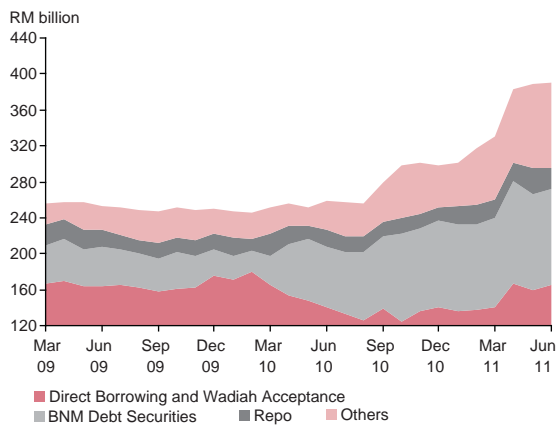
Source: Bank Negara Malaysia

Monetary Aggregates



Source: Bank Negara Malaysia

Outstanding Liquidity Placed with Bank Negara Malaysia (At end-period, RM billion)



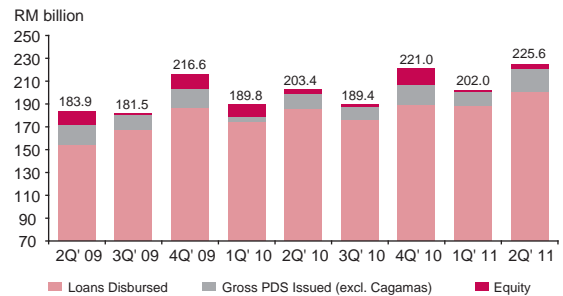
Source: Bank Negara Malaysia

Private sector financing activity strengthened in the second quarter

Financing conditions remained supportive of economic activity in the second quarter, with financing continuing to remain available to all

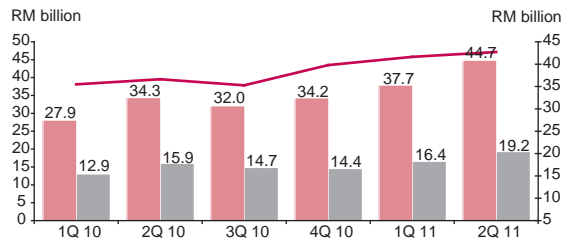
segments of the economy. Total gross financing raised by the private sector through the banking system and the capital market increased to RM225.6 billion (1Q 11: RM202 billion). The higher financing reflected increased bank loan disbursements and private debt securities (PDS) issuances during the quarter. On a net basis, banking system loans and PDS outstanding rose by an annual rate of 12.9% as at end-June (end-March: 12.1%).

Gross Private Sector Financing through Banking System and Capital Market



Source: Bank Negara Malaysia

Bank Lending to SMEs



Source: Bank Negara Malaysia

Financing of the Private Sector through Banking System and Capital Market

	During the period (RM billion)					Annual growth (%)				
	2010		2011			2010		2011		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
Gross total financing	203.4	393.2	202.0	225.6	427.5	10.6	15.2	6.4	10.9	8.7
Loans disbursed	185.3	359.6	188.6	200.8	389.5	20.0	18.8	8.2	8.4	8.3
Gross PDS (excl. Cagamas)	13.9	18.3	12.2	20.9	33.1	-23.0	-32.3	174.8	50.6	80.7
Equity	4.2	15.3	1.1	3.8	4.9	-63.2	31.0	-89.9	-9.7	-67.6
Net total financing (A)+(B)	38.5	57.2	33.4	52.2	85.5	11.1	11.1	12.1	12.9	12.9
Banking system	29.3	48.6	25.9	42.3	68.2	11.3	11.3	12.4	13.5	13.5
Loans outstanding (A)	29.2	51.4	28.8	35.6	64.4	12.4	12.4	13.2	13.5	13.5
Holding of PDS	0.1	-2.9	-2.8	6.7	3.9	-2.9	-2.9	2.1	13.4	13.4
PDS outstanding (B)	9.2	5.7	4.6	16.6	21.2	7.4	7.4	8.9	11.2	11.2
Memorandum item										
Gross PDS (incl. Cagamas)	14.7	19.4	12.2	20.9	33.1	-23.9	-32.2	161.3	42.0	70.8

Source: Bank Negara Malaysia

The major loan indicators remained strong during the quarter. For businesses, the increase in demand for new financing was mainly from the *real estate; transport, storage and communications; wholesale and retail, restaurants and hotels, and construction* sectors. The bulk of loan applications were to finance working capital requirements. Loan disbursements were higher, supporting the expansion of business loans outstanding to RM11.6 billion (1Q 11: +RM11.3 billion). On an annual basis, business loans outstanding rose at a higher rate of 12.1%

as at end-June (1Q 11: 10.9%). The increase in business loans outstanding was broad-based across all economic sectors.

Financing to the household sector also rose. Higher demand for loans was mainly for the *purchase of residential and non-residential properties, and personal use*. Accordingly, household loans outstanding expanded by RM15.4 billion during the quarter to increase at an annual growth rate of 12.8% as at end-June (1Q 11: 13.2%).

Loan Indicators	During the period (RM billion)					Annual growth (%)				
	2010		2011			2010		2011		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
Total										
Loan applications	158.7	291.5	168.5	199.2	367.6	15.8	19.2	26.8	25.5	26.1
Loan approvals	90.4	160.5	87.6	109.7	197.3	19.2	19.9	25.0	21.4	23.0
Loan disbursements	185.3	359.6	188.6	200.8	389.5	20.0	18.8	8.2	8.4	8.3
Loan repayments	161.8	316.3	168.1	173.8	341.9	8.7	10.2	8.8	7.4	8.1
Change in loans outstanding*	29.2	51.4	28.8	35.6	64.4	12.4	12.4	13.2	13.5	13.5
Of which:										
Business enterprises**										
Loan applications	71.6	131.6	79.6	96.6	176.1	11.4	13.1	32.6	34.8	33.8
Loan approvals	42.9	72.2	38.9	55.4	94.3	23.0	18.3	32.8	29.2	30.7
Loan disbursements	125.0	242.1	122.1	134.8	256.8	21.3	18.8	4.2	7.8	6.1
Loan repayments	111.3	216.5	109.8	116.9	226.7	8.3	10.3	4.3	5.0	4.7
Change in loans outstanding*	7.1	13.1	11.3	11.6	22.9	8.2	8.2	10.9	12.1	12.1
SMEs**										
Loan applications	34.3	62.2	37.7	44.7	82.4	30.9	34.1	35.0	30.6	32.6
Loan approvals	15.9	28.7	16.4	19.2	35.6	39.9	42.4	27.3	20.9	23.8
Loan disbursements	36.6	72.1	41.6	42.7	84.4	5.9	4.1	17.3	16.6	17.0
Loan repayments	32.4	65.8	37.2	36.6	73.9	0.8	2.2	11.4	13.1	12.2
Change in loans outstanding*	-6.7	-3.3	3.4	7.5	10.9	3.0	3.0	2.4	14.1	14.1
Large corporations										
Loan applications	37.4	69.4	41.9	51.8	93.7	-2.0	-0.7	30.5	38.8	34.9
Loan approvals	27.0	43.4	22.4	36.3	58.7	14.8	6.4	37.1	34.1	35.2
Loan disbursements	88.3	170.0	80.4	92.0	172.5	29.1	26.3	-1.5	4.2	1.4
Loan repayments	78.9	150.7	72.6	80.2	152.8	11.7	14.2	1.1	1.7	1.4
Change in loans outstanding*	13.8	16.4	7.9	4.1	12.0	11.8	11.8	17.0	10.8	10.8
Households										
Loan applications	87.1	159.9	88.9	102.6	191.5	19.6	24.7	22.0	17.8	19.8
Loan approvals	47.5	88.3	48.8	54.3	103.0	16.0	21.2	19.4	14.3	16.7
Loan disbursements	60.3	117.5	66.6	66.1	132.7	17.4	18.9	16.4	9.6	12.9
Loan repayments	50.5	99.7	58.3	57.0	115.3	9.6	10.1	18.4	12.8	15.6
Change in loans outstanding*	15.1	29.0	14.8	15.4	30.1	12.9	12.9	13.2	12.8	12.8

* The annual growth is for end-period.
** Include loans to individual businesses.

Source: Bank Negara Malaysia

Loans by Sector	Loans disbursed					Loans out-standing	
	During the period					Share of total	Share of total
	2Q 10	1H 10	1Q 11	2Q 11	1H 11	2Q 11	
	(RM billion)					(%)	
Business enterprises	125.0	242.1	122.1	134.8	256.8	67.1	45.2
<i>Large corporations</i>	86.3	170.0	80.4	92.0	172.5	45.8	30.5
<i>SMEs*</i>	36.6	72.1	41.6	42.7	84.4	21.3	14.7
<i>Selected sectors</i>							
Agriculture, hunting, forestry and fishing	5.4	14.6	5.6	5.9	11.5	2.9	2.2
Mining and quarrying	0.6	1.4	1.1	1.1	2.2	0.6	0.4
Manufacturing	37.6	71.0	41.2	42.0	83.3	20.9	9.5
Construction	10.5	19.6	10.3	10.1	20.3	5.0	4.1
Real estate	4.1	9.3	6.4	8.5	14.9	4.2	4.6
Electricity, gas and water supply	1.0	1.8	1.5	1.2	2.7	0.6	1.2
Wholesale, retail, restaurants and hotels	33.2	61.3	30.8	33.8	64.5	16.8	7.3
Transport, storage and communication	5.9	11.2	4.4	4.3	8.7	2.1	2.9
Finance, insurance and business services	15.1	28.6	14.9	18.7	33.6	9.3	7.6
Households	60.3	117.5	66.6	66.1	132.7	32.9	54.8
Purchase of residential properties	14.1	29.0	15.0	15.7	30.7	7.8	25.3
Consumption credit	37.9	71.4	40.1	40.9	81.0	20.3	20.1
Of which:							
<i>Credit cards</i>	20.1	38.5	23.3	24.2	47.4	12.0	3.2
<i>Purchase of passenger cars</i>	9.8	18.6	8.9	8.6	17.5	4.3	12.0
Others	8.2	17.1	11.4	9.5	21.0	4.7	9.5
Total	185.3	359.6	188.6	200.8	389.5	100.0	100.0

*Include loans to individual businesses.
Source: Bank Negara Malaysia

Fund raising in the capital market was driven by the private sector

Net funds raised in the capital market amounted to RM20.8 billion during the quarter (1Q 11: RM29.7 billion). Of this, 83%, or RM17.3 billion was raised by the private sector. As with the previous quarter, the bulk of funds was raised through private debt securities. New PDS issuances increased to RM20.9 billion (1Q 11: RM12.2 billion) which were mostly utilised for *new activity* and for *working capital and general corporate purposes*. Funds raised from the equity market increased to RM3.8 billion. The bulk of funds were raised through initial public offerings (RM2.9 billion), while the rest were raised via rights issues.

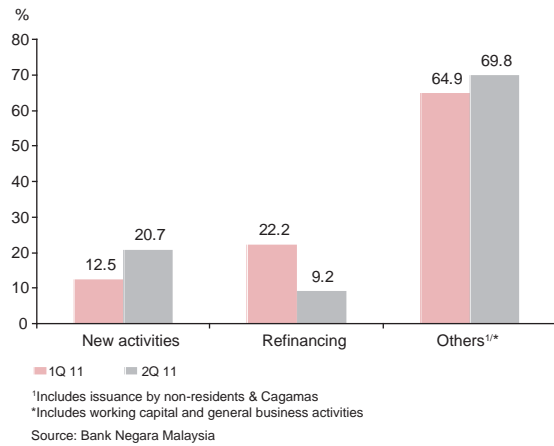
In the public sector, gross funds of RM26.7 billion were raised through the issuance of a 15-year and 20-year Malaysian Government Securities (MGS), a 10-year Government Investment Issues (GII), as well as the

re-opening of a 7-year and 10-year MGS, and a 5.5-year GII. After adjusting for redemptions, net funds raised by the public sector (including Merdeka Savings Bonds) amounted to RM3.5 billion in the second quarter.

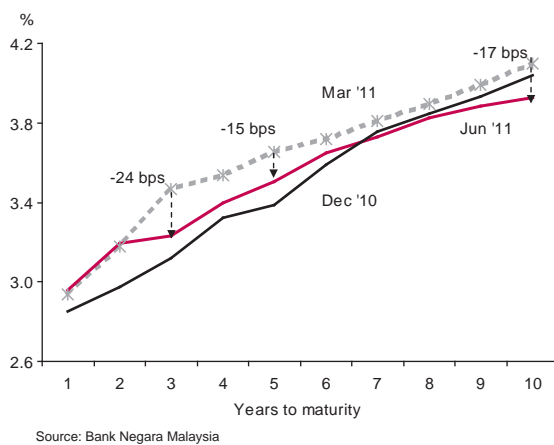
	2010		2011		
	2Q	1H	1Q	2Q	1H
	RM billion				
By Public Sector	5.5	21.0	24.6	3.5	28.1
Government securities, <i>net</i>	3.2	18.8	24.6	5.0	29.6
<i>Malaysian Government Securities</i>	8.6	21.1	15.1	16.7	31.8
<i>Government Investment Issues</i>	5.5	12.0	9.5	10.0	19.5
<i>Less: Redemptions</i>	10.9	14.4	-	21.8	21.8
Khazanah Bonds, <i>net</i>	-	-	-	-	-
Savings Bonds, <i>net</i>	2.3	2.3	(0.1)	(1.4)	(1.5)
By Private Sector	12.0	19.1	5.1	17.3	22.5
Shares	4.2	15.3	1.1	3.8	4.9
Debt securities, <i>net</i>	7.8	3.9	4.0	13.5	17.5
<i>Private Debt Securities</i>	14.7	19.4	12.2	20.9	33.1
<i>Less: Redemptions</i>	6.9	15.5	8.2	7.4	15.6
Total	17.6	40.2	29.7	20.8	50.6

Source: Bank Negara Malaysia and Bursa Malaysia

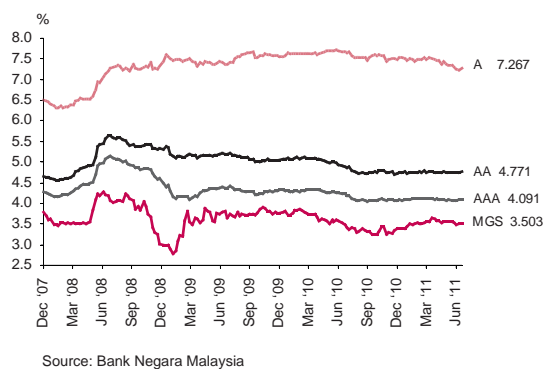
**Private Debt Securities Issued by Purpose
(% of total)**



Trend in MGS Yields



5-year MGS and 5-year Corporate Bond Yield



Bond prices increased in the second quarter

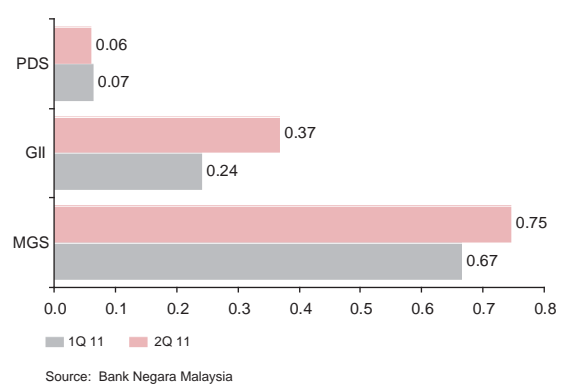
MGS yields trended lower in the second quarter. There was some initial upward pressure on yields following the increase in the OPR by 25 basis points. However, this was later offset by sustained demand from non-residents and concerns of slowing global growth. The decline was across the board, with the benchmark 3-year, 5-year and 10-year MGS recording a decline of 24, 15 and 17 basis points respectively.

In the PDS market, yields on the 5-year AAA-rated and AA-rated papers were largely unchanged. Yields on the 5-year A-rated issuances, however, recorded a decline of 24.8 bps, reflecting better credit conditions in the lower segment of the PDS market following the improved economic outlook.

Secondary trading in the bond market increased

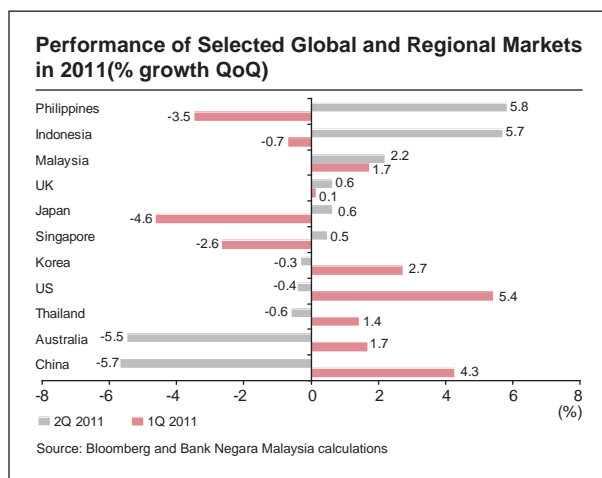
Total trading in the secondary market increased to RM256 billion during the quarter (1Q 11: RM222 billion). The increase was concentrated mainly in government securities, with both the MGS and GII segments registering higher liquidity ratios of 0.75 and 0.37 respectively. The liquidity ratio for the PDS segment declined slightly to 0.06.

Liquidity Ratio: Turnover/Outstanding



KLCI rose at a faster pace in the second quarter

The FBM (FTSE Bursa Malaysia) KLCI rose by 33.9 points, ending the quarter at 1,579 (end-March: 1545.1). The index increased 2.2% in the second quarter (1Q 11: 1.7%) as the market was buoyed by the initial public offerings (IPO) of 10 companies, which were met with strong demand from investors. As a result, market capitalisation increased to RM1.342 trillion at end-June (end-March:



RM1.31 trillion). However, the daily average turnover decreased to 1.04 billion units (1Q 11: 1.73 billion units). On 15 August 2011, the KLCI ended slightly lower at 1,499.7 points (since end-2Q 2011: -5.0%), with market capitalisation of RM1.287 trillion (since end-2Q 2011: -4.1%).

Bursa Malaysia: Selected Market Indicators

	2010		2011	
	As at end			
	June	Mar	June	
Price Indices				
Composite	1,314.0	1,545.1	1,579.1	
FBMEMAS ¹	8,863.4	10,612.5	10,842.3	
FTSE Second Board ²	-	-	-	
ACE Market ³	3,801.4	4,333.5	4,198.2	
Market capitalisation (RM billion)	1,044.4	1,311.0	1,342.2	
No. of companies listed	962	954	953	
	During the quarter			
	2Q	1Q	2Q	
Average daily turnover				
Volume (million units)	849.1	1,730.1	1,038.8	
Value (RM million)	1,287.6	2,233.9	1,638.7	

¹FBMEMAS stands for FTSE Bursa Malaysia EMAS Index

²From 3 August 2009, FTSE Second Board was merged with the Main board and renamed as Main Market

³From 3 August 2009, Mesdaq market was replaced with ACE Market

Source: Bursa Malaysia

Bursa Malaysia: Market Turnover

	2010				2011					
	2Q		1H		1Q		2Q		1H	
	Billion units	RM billion	Billion units	RM billion	Billion units	RM billion	Billion units	RM billion	Billion units	RM billion
Turnover	54.3	82.4	116.1	172.8	102.1	131.8	65.4	103.2	167.5	235.0
Of which:										
Main Board	45.3	80.2	97.7	168.3	84.1	128.4	49.5	100.0	133.6	228.4
Of which										
Consumer Products	3.1	3.9	5.9	7.6	4.0	5.4	4.0	5.0	8.1	10.4
Industrial Products	9.0	9.8	21.4	23.9	18.8	21.2	10.5	15.7	29.4	36.9
Construction	3.0	5.0	6.1	9.9	4.6	9.0	2.8	5.9	7.4	14.9
Trading/Services	13.9	28.9	30.0	57.7	33.5	46.2	17.2	36.5	50.6	82.6
Finance	4.4	18.7	8.6	39.5	4.4	24.6	4.7	20.9	9.1	45.5
Properties	6.6	3.5	13.0	7.3	12.8	9.6	6.3	7.2	19.0	16.9
Plantations	1.1	4.8	2.5	11.3	2.4	8.2	1.2	5.2	3.5	13.4
Infrastructure	1.0	1.9	2.1	3.6	1.1	2.4	0.7	2.1	1.8	4.5
Second Board ¹	-	-	-	-	-	-	-	-	-	-
Mesdaq ²	4.1	0.7	9.5	1.8	8.3	1.2	10.9	2.1	19.2	3.4

¹From 3 August 2009, FTSE Second Board was merged with the Main board and renamed as Main Market

²From 3 August 2009, Mesdaq market was replaced with ACE Market

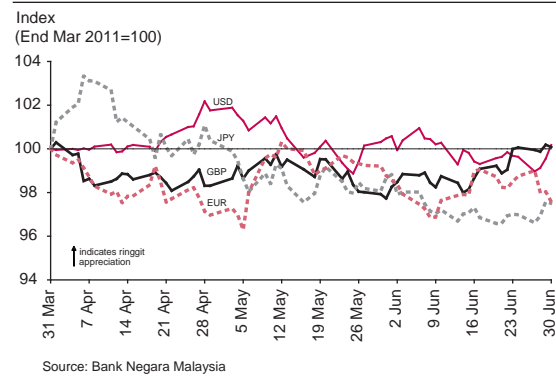
Source: Bursa Malaysia

Mixed performance of the ringgit against major currencies

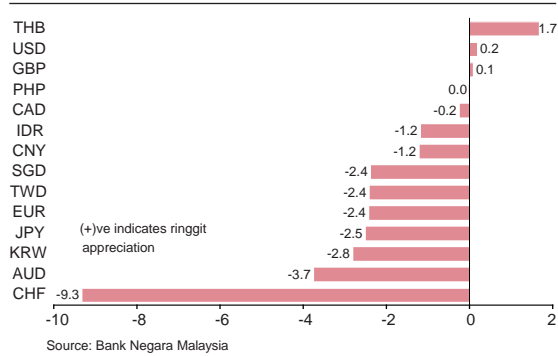
The ringgit's appreciating trend against the US dollar in the first quarter of 2011 continued into the beginning of the second quarter, as the favourable growth outlook in Asia relative to the advanced economies continued to attract investors towards the regional financial markets. This upward trend, however, experienced some downward pressure towards the end of the quarter. The trend was similar to most regional currencies, reflecting concerns over the worsening sovereign debt crisis in the eurozone and uncertainty on the US economic outlook. For the quarter as a whole, the ringgit appreciated marginally by 0.2% against the US dollar. Against other major currencies, the ringgit appreciated against the pound sterling (0.1%), but depreciated against the euro (-2.4%) and the Japanese yen (-2.5%). Against regional

currencies, the ringgit strengthened against the Thai baht (1.7%), but depreciated against the Chinese renminbi (-1.2%), Indonesian rupiah (-1.2%), Singapore dollar (-2.4%) and Korean won (-2.8%). The ringgit remained unchanged against the Philippine peso.

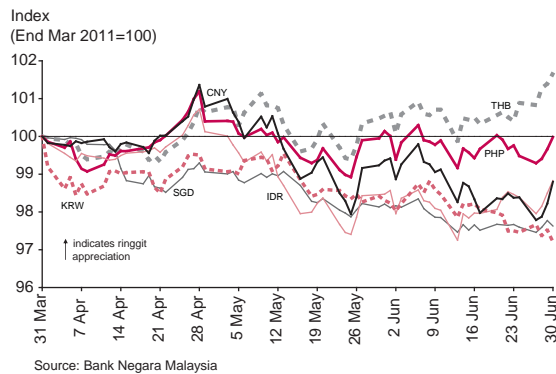
Ringgit Performance Against Major Currencies



Summary of Ringgit Performance Against Selected Currencies, Percent Change (1 April - 30 June 2011)



Ringgit Performance Against Regional Currencies



During the period between 1 July and 15 August 2011, the ringgit appreciated against the US dollar (1.2%), euro (2.7%) and pound sterling (0.1%), but depreciated against the Japanese yen (-3.4%). Against regional currencies, the

ringgit strengthened against the Korean won (2.2%), Indonesian rupiah (0.6%) and Chinese renminbi (0.1%) but depreciated against the Singapore dollar (-0.6%), Philippine peso (-0.9%) and Thai baht (-1.5%).

Performance of Ringgit Against Selected Currencies

RM per foreign currency	As at end				% change since*		
	21 Jul 05	2Q 10	1Q 11	2Q 11	21 Jul 05	2Q 10	1Q 11
US dollar	3.8000	3.2575	3.0259	3.0205	25.8	7.8	0.2
Euro	4.6212	3.9785	4.2762	4.3820	5.5	-9.2	-2.4
Pound sterling	6.6270	4.9069	4.8687	4.8648	36.2	0.9	0.1
100 Japanese yen	3.3745	3.6787	3.6602	3.7538	-10.1	-2.0	-2.5
Singapore dollar	2.2570	2.3242	2.3994	2.4577	-8.2	-5.4	-2.4
100 Thai baht	9.0681	10.040	9.9947	9.8308	-7.8	2.1	1.7
100 Philippine peso	6.8131	7.0144	6.9637	6.9649	-2.2	0.7	0.0
100 Indonesian rupiah	0.0386	0.0359	0.0347	0.0352	9.9	2.1	-1.2
100 Korean won	0.3665	0.2655	0.2747	0.2826	29.7	-6.0	-2.8
Chinese renminbi	0.4591	0.4797	0.4617	0.4673	-1.7	2.7	-1.2

* (+) indicates appreciation of ringgit against respective currency and (-) indicates depreciation.

Source: Bank Negara Malaysia

MANAGING RISKS TO FINANCIAL STABILITY

Financial stability remained intact

Financial system stability was maintained throughout the second quarter. This was underpinned by a sound financial system and institutions and orderly financial markets that continue to support efficient financial intermediation and sustained public confidence in the financial system.

Overall credit risk exposures of the financial sector remained manageable. Both impaired loans and loans in arrears improved to 2.0% of net loans (1Q 11: 2.2%) and 2.9% of gross loans (1Q 11: 3.2%) respectively. The level of household indebtedness rose by 2.8% for during the quarter to 77.0% (1Q 11: 76.5%). Total impaired loans improved to 2.0% of household loans (1Q 11: 2.2%). All categories of household loans had low levels of impairment. Household aggregate financial assets stood at more than twice the size of household debts.

Credit growth in the business sector continued to expand, amidst steady growth in revenue. Despite facing more challenging operating environment posed by rising commodity prices and higher electricity tariff, the risk of delinquency as measured by the Expected Default Frequency remained unchanged at 0.57%. Debt servicing capacity of businesses remained healthy with impairment levels

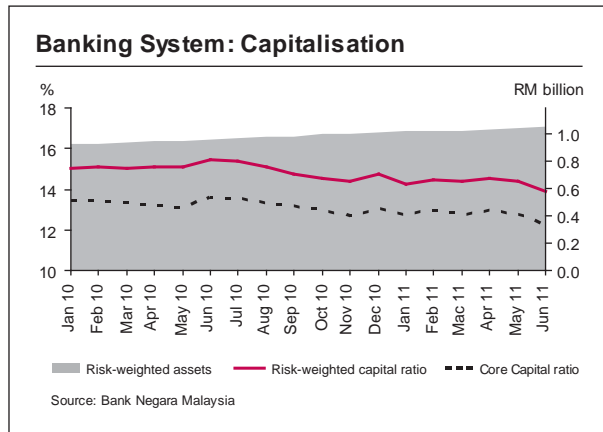
improving to 4.6% (1Q 11: 4.9%) of gross business loans and the repayment-to-disbursement ratio remaining stable at 90%. The credit risk outlook for businesses is neutral as commodity prices may remain elevated for a prolonged period.

Continued uncertainties over the fiscal position and sovereign debt concerns in some advanced economies have had no adverse impact on the domestic financial markets. Trading liquidity was favourable, whilst there was no significant increase in asset price volatility. Volatility in the FBM KLCI rose only slightly to average at 9.2% (1Q 11: 8.8%). The domestic financial markets continued to experience inflows of portfolio investment during the quarter. Despite the magnitude of flows, the financial markets remained orderly and exhibited the capacity to intermediate the financial flows effectively. No material changes in the risk-taking behaviours of financial institutions, has thus far been observed. The banking system's exposure to equity risk remained small at 1.3% of capital base as at end-June 2011 (1Q 11: 1.3%), whilst insurance and takaful sector's exposures to equity risk remained at 7.4% (1Q 11: 7.3%) of capital base.

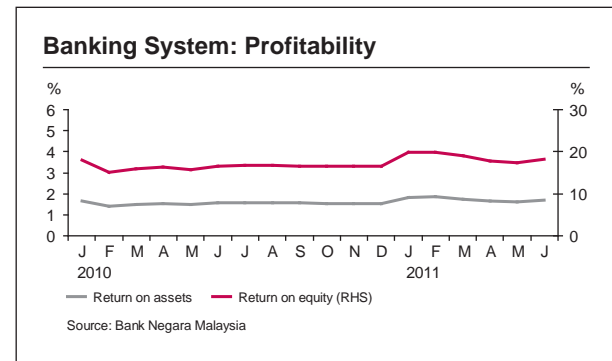
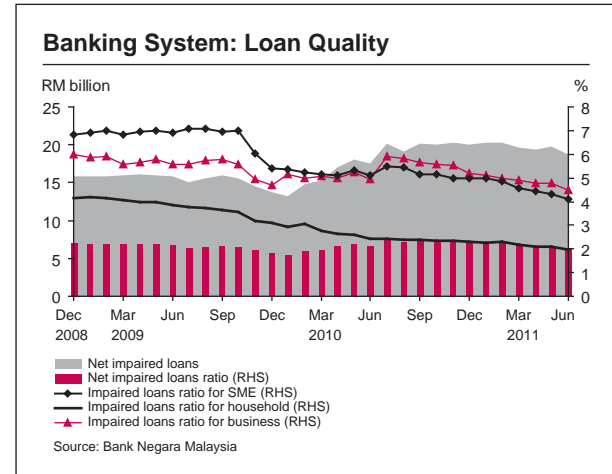
Interest rate risk remained low at 6.0% of capital base (1Q 11: 6.4%) for the banks and 3.3% (1Q 11: 3.3%) for the insurance and takaful sector.

The financial sector remained sound and supported the financial intermediation of domestic economic activity

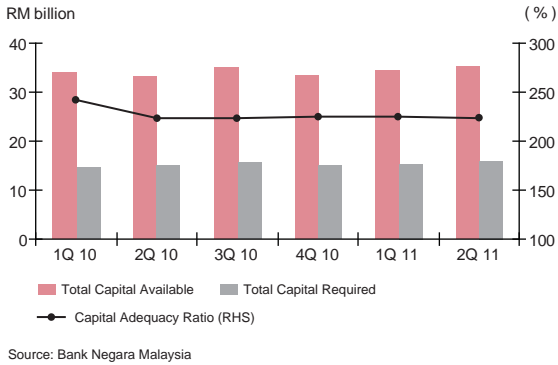
The domestic banking system remained well-capitalised with the core capital ratio and risk-weighted capital ratio remaining strong at 12.3% and 13.9% respectively. Financial buffers were sustained at a high level in excess of RM57 billion to absorb unexpected losses from any shocks while preserving the ability of the banking system to continue financing economic activity. The quality of capital continued to be supported by the high proportion of Tier 1 capital with common equity and reserves continuing to account for the bulk of banking



sector capital funds. As for the insurance and takaful sector, the capital position remained strong with a capital adequacy ratio of 224.1% and an excess capital of RM19.5 billion.



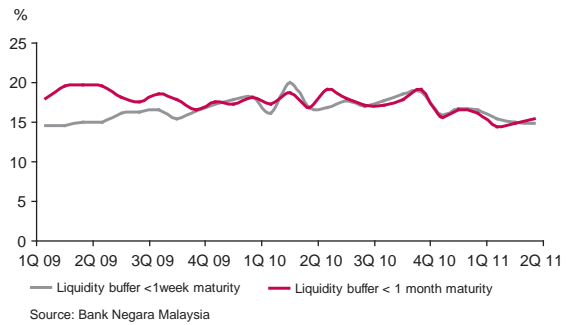
Insurance Sector: Capital Adequacy Ratio



Banks recorded pre-tax profits of RM6.6 billion (1Q 11: RM6.9 billion) on account of higher financing and net interest income. Returns on assets and equity stood at 1.7% and 18.2% respectively. Life insurance and family takaful recorded higher excess of income over outgo of RM3.8 billion (1Q 11: RM3.2 billion) driven by higher net premiums and investment income. Demand for investment-linked products continued to expand in tandem with favourable financial market conditions. Similarly, the general insurers and takaful operators registered higher operating profits (2Q 11: RM603.8 million, 1Q 11: RM526.5 million) contributed by higher investment income (+24.5%) of RM248.6 million (1Q 11: RM199.6 million).

Liquidity remained ample to meet the demand for deposit withdrawals and other liquidity obligations. The overall liquidity buffer of the banking system remained at comfortable levels and was well above the regulatory requirements. The loan-to-deposit ratio was almost unchanged at 81.8% (1Q 11: 82%).

Banking System: Liquidity Buffer to Total Deposit Ratio



Insurance and Takaful Sector: Indicators

	2010		2011		
	2Q	1H	1Q	2Q	
	RM million				
Life insurance & family takaful					
Excess of income over outgo	2,922.9	5,881.4	3,226.5	3,763.3	6,989.8
General insurance & general takaful					
Operating profit	574.9	1,099.8	526.5	603.8	1,130.3
Claims ratio (%)	62.1	62.1	61.4	62.7	62.7

Source: Bank Negara Malaysia

**8th Islamic Financial Services Board Summit :
Panel Session 2- Financial Stability: Regional and Global Cooperation
Luxembourg, 12 May 2011**

Speech by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

It is now more than three years since the onset of the global financial crisis. Yet, its repercussions continue to reverberate across the world. Efforts to return the global economy on a sustainable growth trajectory have been challenged by risks and uncertainties that continue to prevail in many parts of the world. Most of all, this crisis has demonstrated the greater degree of international interdependence arising from the increased international financial and economic integration. Global financial stability has therefore become a shared responsibility. In today's more interconnected financial systems and stronger economic interlinkages, the enormous challenge in securing effective and efficient functioning financial systems and financial stability will demand for unprecedented collective action and international cooperation.

It is my pleasure to be here in Luxembourg on this occasion of the 8th IFSB Summit on 'Enhancing Global Financial Stability: Challenges and Opportunities for Islamic Finance'. I am honoured to speak on the scope for international collaboration and cooperation in Islamic finance in our collective endeavor to safeguard financial stability.

The internationalisation of Islamic finance and its increased role in the international financial system

Since the turn of the millennium, the internationalisation of Islamic finance has accelerated. Its internationalisation is manifested by the increased presence of Islamic financial institutions in new jurisdictions, the increased international participation in Islamic financial markets and the increased cross border flows that are Shariah compliant. Today, there are more than 600 Islamic financial

institutions that operate in more than 75 countries. The sukuk market in particular, has evolved as a major contributing factor driving the internationalization of Islamic finance. It has become an important avenue for international fund raising and investment activities, generating significant cross-border flows. Following the return of investor confidence reflected by the strong performance of financial markets in 2010, activity in the sukuk market also gained momentum. Islamic finance has become the fastest growing segment in the international financial system. Moving forward, the international dimension of Islamic finance is set to become even more pronounced in this post crisis-era.

With the intensification of this globalization process, we need to be mindful of the important lessons from the recent global financial crisis of ensuring the quality and soundness of the financial integration process. Whilst the growing internationalization of Islamic finance essentially reflects its ability to be competitive and its ability to meet the changing demands of businesses, its resilience has been important in supporting this trend. This resilience is essentially underpinned by two inherent strengths of Islamic finance. First, is its strength that is derived from the emphasis on having a close linkage between Islamic financial transactions and economic activity and from having built-in checks and balances which inherently make Islamic finance a stable form of intermediation. Second, are the initiatives that have been taken to strengthen the international infrastructure of Islamic finance to promote the sound and orderly development of Islamic finance. Importantly, these initiatives are being taken while the Islamic financial institutions and Islamic financial markets are still at a relatively early stage of development.

With its internationalization, Islamic finance will contribute to the more efficient mobilization and allocation of funds across regions. This trend will also strengthen the international financial and economic interlinkages between jurisdictions, bringing with it mutually reinforcing gains. It also influenced the patterns of global financial and economic integration, in particular, facilitating the revival of financial and economic integration between Asia and the Middle East and between emerging economies and the more established financial markets, thereby contributing towards a more balanced growth in the global economy.

Initiatives to strengthen the cross-border financial stability framework

As Islamic finance increasingly expands beyond national boundaries, it has called for **developing the framework for cross-border financial stability** to further strengthen the resilience of Islamic financial system and to address cross-border challenges in an integrated manner. This recent decade has seen such international cooperation and collaboration to safeguard financial stability in the international Islamic financial system be taken to a new level. This is to ensure its orderly evolution as an integral component of the international financial system.

Strengthening international financial infrastructure

The focus of cooperation has been particularly significant in the area of the development of the international financial infrastructure relating to financial stability. A key development since the setting up of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in 1990 has been the establishment of the Islamic Financial Services Board (IFSB) as the international prudential standard setting body for the Islamic financial services industry in 2002. The important goal of strengthening the foundation of the global Islamic financial system was recently reinforced further following the recent global financial crisis, through the work of the IFSB-IDB Task Force of Islamic Finance and Global Financial Stability. In its report that was released in 2010, eight building blocks were identified to deal with the potential

risks and vulnerabilities to the Islamic system in this now more challenging international financial environment. These include steps that need to be taken for the implementation of the prudential standards; the development of a liquidity management infrastructure; the introduction of strong financial safety nets; the development of an effective crisis management and resolution framework; the development and implementation of accounting, auditing and disclosure standards; the formulation of an effective macro prudential framework; the development of credible credit rating institutions and processes; and finally, to strengthen efforts for capacity building and talent development for the Islamic financial services industry. Given the global dimension of these building blocks, international cooperation and collaboration is significantly vital to advance these important agendas.

Regulatory harmonization

Commanding the highest level of international cooperation is particularly vital in the implementation of common prudential standards to safeguard the stability of the Islamic financial system. This will contribute towards the harmonization of the regulatory and supervisory framework in Islamic financial systems across borders. Of importance is advancing the international standards and best practices that takes into account the distinct characteristics of Islamic finance. Such prudential regulation that considers the unique mix of risks associated with Shariah-compliant financial business would enhance the effectiveness of the regulatory outcomes intended for Islamic finance.

Much progress has already been made by the IFSB in promulgating an extensive set of prudential standards for the Islamic financial services industry since its establishment in 2002. The IFSB has already introduced standards for capital adequacy, risk management, corporate governance and Shariah governance. This important work has been significant in promoting international uniformity of regulatory frameworks and international best practices for the Islamic financial system in different jurisdictions. Its significant progress has benefited from the strong international cooperation and collective

support from its member countries and global institutions. Indeed, as an evolving global industry with varying stages of development across borders and various business structures and operating models used in the different markets, this close engagement has also allowed for the attainment of balanced views.

Whilst Islamic finance has demonstrated resilience during the recent crisis, the IFSB has moved quickly to review its existing capital standards for possible enhancements and to incorporate new liquidity measures in its ongoing work in developing liquidity standards for Islamic banking. This work is currently being addressed through the Working Groups for Capital Adequacy Standards and for Liquidity Risk Management. The overarching objective is to ensure that the salient features of Islamic finance are effectively and adequately addressed while taking into account the issues that had surfaced in the crisis in the conventional financial system.

The next stage is the **implementation of these standards in the different jurisdictions**, which is just as important as the development of the standards itself. This is an area in which global cooperation and collaborative action is critical so as to ensure the consistent implementation of the regulatory framework. The full adoption of IFSB standards will eliminate the opportunity for regulatory arbitrage, in particular, regulatory arbitrage due to cross-sectoral differences, cross-border differences and the differences between conventional and Islamic finance. The more consistent implementation of these standards will also ensure greater certainty in the regulatory treatment of Islamic financial transactions, thereby enabling comparability among institutions as well as surveillance by regulatory authorities. This harmonization will not only contribute towards global financial stability, but will also promote greater transparency across borders.

The application and enforcement of the international prudential standards promulgated by the IFSB will contribute towards achieving these objectives. Technical cooperation programmes can be developed and designed for both ex-ante and ex-post implementation of the IFSB standards. In the pre-implementation

period, structured technical programmes can be tailored to individual countries to enhance jurisdictional preparedness in adopting the standards if so required. Similarly in the post-implementation period, a framework for self-assessment can be developed to assess jurisdictional effectiveness in implementing the IFSB standards. These developments would potentially lead to the inclusion of the IFSB standards and rules for adherence and implementation across jurisdictions, along with the core principles and standards of the Basel Committee, IAIS and IOSCO within the context of the IMF-World Bank Financial Sector Assessment Program. This would further contribute towards the efforts of achieving global financial stability in the international financial system.

Cross-border supervisory cooperation

The increasing internationalisation of Islamic finance has a significant extent been facilitated by the expansion of the operations of Islamic financial institutions beyond their domestic borders, motivated by the search for new growth opportunities. In addition to the increased interconnectedness of Islamic financial markets, this trend calls for greater cooperation among supervisors to ensure financial stability of the Islamic financial system. The recent global financial crisis has in fact put to a test the strength of cross border supervisory cooperation. Challenged by information asymmetries due in part to the lack of arrangements for cooperation, supervisors faced the challenging task of understanding the extent of the systemic risk and its contagion across borders.

In the rapidly evolving world of Islamic finance, supervisors are also confronted with an even greater task, of keeping abreast with the pace of innovation, taking into account the uniqueness of Islamic financial contracts in addition to the universal scope of Islamic banking business. This warrants supervisors to recognise the different aspects of risk management in Islamic finance. Islamic financial institutions in most jurisdictions have evolved within the confines of the conventional system and have been accustomed to business practices in their respective jurisdictions. This could result in

distinctly different business and risk taking activities. Collaboration among supervisory authorities of such internationally active Islamic financial institutions thus needs to become part of the overall supervisory framework.

These efforts would require **regular engagement between home and host supervisors** to ensure alignment of the supervisory oversight. This will allow for a more holistic evaluation of risks and vulnerabilities for Islamic finance businesses that operate across borders. Effective sharing of surveillance information and assessments of other supervisory issues on Islamic financial institutions is already taking place through bilateral cooperation between supervisory authorities and other informal arrangements. Going forward, a more structured framework for collaboration among supervisors is needed so as to enhance supervisory informational efficiencies, and ultimately, contribute to an effective assessment and early detection of any cross-border risk-transmissions from the group-wide activities. The home-host information sharing can be facilitated through the supervisory college arrangement as an institutionalised mechanism for greater cooperation.

The recent financial crisis has also revealed the failure to understand the inter-relationship between financial and the broader sector, particularly in understanding the potential spill-over and second-round effects that are transmitted between sectors. Post-crisis regulatory efforts have focused on macro-prudential measures to complement micro-surveillance and supervision. This entails horizontal assessment of risks across institutions, sectors and national borders, as well as risks in asset markets across time. This is particularly relevant for the Islamic financial services sector. Given the **close ties of Islamic finance with the real economic sector** through the various modes of Islamic financing contracts, a complete understanding of the entire risk spectrum often encounters much difficulties. It is therefore important for the regulators to also establish **an integrated framework of macro surveillance for Islamic** financial activities across jurisdictions. The global database for prudential Islamic **finance statistics** to be initiated by the IFSB, would therefore need to go far beyond

ensuring standardised data collection among jurisdictions, but also to enable the generation of various macro and financial indicators, and global sharing of best practices in macro surveillance. The engagement by supervisors would also contribute towards the understanding of the systemic risk and its origins and would support the maintenance of timely and accurate economic and financial data. This would in turn contribute towards more effective surveillance and management of financial stability issues.

Indeed, developing an **integrated surveillance mechanism, identification and prevention of emerging risks** in the Islamic financial system, as well as the establishment of an **integrated crisis management and resolution framework**, are crucial to the maintenance of financial stability in the global Islamic financial system. This would allow for a comprehensive and prompt response to a financial stress, and thus increase the prospects for an early recovery. This was the basis behind the setting up of the Islamic Financial Stability Forum (IFSF) in 2010, as a platform to build closer cooperation among regulatory authorities. More specifically, the IFSF carries the mandate of promoting international dialogue, engagement and cooperation in the area of financial stability. It also aims to broaden the understanding on the external repercussions of policy action or inaction in a given country on other national financial systems, and in considering the merits for collective action. Whilst effective international cooperation requires a framework for shared commitments, important in this process is the recognition of the restraints of national autonomy given that financial regulation and intervention are subject to country-specific circumstances. This arrangement can contribute towards enhancing mutual understanding and prevent dilution of the commitment towards common objectives.

A concrete advancement in cooperation and collaboration that has paved the way for the development of yet another important international financial infrastructure is the establishment of the International Islamic Liquidity Management Corporation (IILM), in 2010. This landmark collaboration between 12 central banks and two multilateral development institutions represents a major breakthrough

in strengthening the liquidity arrangements for the international Islamic financial system. This liquidity infrastructure is vital for the efficient and well-functioning of the Islamic financial system. The creation of IILM with the mandate to issue Shariah compliant liquid instruments is an important step forward in promoting more efficient cross-border liquidity management by Islamic financial institutions. The IILM will also be well-equipped to serve as a platform of global engagement on liquidity management in the Islamic financial system and on addressing cross-border systemic liquidity issues.

Conclusion

Let me conclude my remarks. This decade has been a defining era in the evolution of Islamic finance. It has been characterized by rapid global expansion and increased internationalisation. Of importance is that these trends have been supported by significant actions taken to strengthen the foundations of the international Islamic financial system involving

the development of important international institutional arrangements and mechanisms. These tremendous achievements have been the outcome of strong cooperation and collaboration among the Central Banking community from both Islamic and non-Islamic countries.

Moving forward, it is essential for this strong cooperation to continue given the dynamic nature of the industry. In addition, the pace of internationalization can be expected to gain further momentum. As the international integration of Islamic finance intensifies, cross border financial flows and its associated challenges will also increase. This will call for an even greater degree of international cooperation and coordination. While this new decade beckons the prospect of immense opportunities in Islamic finance, our ability to realize this potential will be determined by the ability to recognize the shared responsibility it demands and to collectively advance forward the agenda of financial stability and resilience to achieve our ultimate goal of a shared prosperity.

**Langkawi International Dialogue 2011:
Innovative Financing for Transformation
Putrajaya, 19 June 2011**

Speech by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

The world is transforming. Our motivation for accelerating our own pace of transformation is to ensure that we will be able to effectively participate in this new economic and financial environment, and in the process, maximize our potential performance. Central to this is having a well functioning financial system and the right financial policies. The recent financial crisis in the developed world has shown that when things have gone wrong in the financial system, the consequences have been catastrophic. Instead of creating wealth - it destroys wealth, instead of generating employment - it results in job losses, instead of facilitating economic progress - it derails growth and development.

It is my great honour and pleasure to speak at this 2011 Langkawi International Dialogue on Innovative Financing for Transformation. The overarching objectives of economic transformation is surely to generate sustainable and balanced growth, to improve living standards, to create employment opportunities and to achieve a more inclusive development. This decade has however seen how innovative financing in several of the developed economies have fuelled excessive levels of leverage that have resulted in deeply indebted private and public sectors, which in turn have become highly destabilizing to their financial systems and to their economies. The challenge before us is how then should the financial system be developed and regulated so that these pitfalls will be avoided while at the same time remaining dynamic and innovative so that we can push our frontiers and gain the progress that we aspire.

While innovation remains essential to economic progress, it needs to be within the context of stronger governance and sound risk management practices. Positive innovation can make enormous contributions to economic performance. The financial system has to

deliver the essential financial services that would cater to the financial needs of all sectors of the economy - from households, small and medium enterprises, including to micro enterprises and to the corporate sector. The financial system also has to take into account the fundamental changes taking place in the global economy and the growing participation of emerging economies in the global economy. As we become more interlinked, financial systems also need to become more internationalized to facilitate and reinforce this trend.

The role of the financial system is essentially to effectively intermediate and to meaningfully mobilize funds including from across borders to be channeled to productive economic activity. Such intermediation must be firmly anchored and aligned to the objective of generating sustainable and balanced growth, raising the standards of living, creating employment and promoting development. With clarity in the role of the financial system and the importance of its link to the economy, the range of the financial solutions offered needs to meet these highly differentiated and changing requirements.

For the households, the financial system provides a means to optimally spread their income and consumption over their life cycle. Accumulating wealth via saving, investment and borrowing in the initial years, and de-accumulating of the wealth during the later years, such as through pension products and annuity schemes during retirement. This is particularly important as a population matures. The absence of these products will impose tremendous burdens to the government fiscal position and the overall standards of living.

The Malaysian experience has been to encourage diversity of financial product offerings to ensure that the needs of all segments of the

population are met. This includes, from having basic banking products at negligible cost for lower income groups, to the wider range of savings, investment and protection products for the middle income groups and for the higher income groups, wealth management and comprehensive advisory services.

In the area of financing, a key priority for any country is financing to promote home ownership. This is to meet an important basic need of society and to encourage wealth accumulation among households. Malaysia approached this by initially establishing Cagamas, a national mortgage corporation, which enables banks to source long-term funding to match long-term housing loans. The national mortgage corporation has continued to evolve to promote the secondary market for housing loans via securitization and mitigating risks in mortgage financing through the provision of mortgage insurance. A recent innovative arrangement introduced this year is the risk-sharing arrangements between the government and banks to provide opportunities for the lower income and younger segments of the population to own homes and thus accumulate wealth at an earlier age.

Another important form of wealth accumulation is the collective investment schemes such as unit trusts. The pooling of savings provides economies of scale, access to professional investment managers, as well as a diversified investment portfolio. In Malaysia, this was initially promoted through the establishment of government sponsored national savings scheme (Amanah Saham Nasional). Participation of the average household has now paved the way for the growth in the private unit trust industry. The formation of such national savings schemes has also contributed to the development of an institutional investor base in Malaysia that has been able to mobilize substantial volumes of savings. The mobilization of these funds provides the potential for funding of businesses and the corporate sector and for project financing including for infrastructure development.

As SMEs and micro enterprises form the majority of business enterprises in most countries, and as they contribute significantly

to GDP, employment and wealth creation, efficient access to finance is critical. The Malaysian experience to address this has been the establishment of the Credit Guarantee Corporation to assist viable SMEs with inadequate track record to access financing by providing guarantees and credit enhancements for SME financing. The credit evaluation is carried out by banks, and by the CGC. For countries where SME-credit evaluation skills are scarce, the centralisation of expertise using such an arrangement would be able to facilitate this as banks build their capacity. There have also been a wide range of innovative financial products and services to support this agenda.

A highly successful programme in Malaysia has been the RM2 billion SME Assistance Guarantee Scheme which was established in February 2009 to ensure that viable SMEs adversely impacted by the economic slowdown would have continued access to financing. Under this scheme, SMEs are able to obtain financing with an 80% guarantee cover provided by the Credit Guarantee Corporation. The cost of the guarantee was borne by the Central Bank. This scheme has assisted about 10,000 SMEs from all sectors of the economy in sustaining their businesses and preserving employment.

Venture capital and private equity funds are required to provide early stage financing for innovative SMEs. Due to the highly specialised focus of such funds, it is common for fund-of-funds to be established as a pooling mechanism for the purpose of risk diversification. However, the success of these forms of financing depend very much on the enabling environment in terms of availability of talent as well as deep and relatively well developed equity market for early stage investors to “exit”.

Finally, micro financing is important to provide access to funding for micro enterprises. There are now many highly innovative schemes to achieve outreach, including by mobile banking and agent banking. Critical to the success of such financing is pricing and accessibility. The world has seen different degrees of success of such financing. Critical to their success is the enabling environment of which equal attention has to be accorded. This includes the

institutional arrangements, the business model for such financing, the regulation and policies and the supervisory oversight. This will ensure its sustainability as a form of financing.

Another important segment of businesses is the corporate sector. Established corporates will require efficient sources of financing for expansion as well as advisory services to maximise enterprise value. A deep and liquid bond market with good information flow and modern infrastructure will allow for efficient pricing of corporate issuances - from short term commercial papers to support liquidity and working capital, to longer term bonds for project financing. Treasury services are also important to manage the funds of larger corporations to achieve higher returns as well as access to risk management and hedging instruments to manage foreign exchange, commodity price and other forms of market risk.

As economies develop, governments will need to increasingly shift from being a driver of growth towards having a facilitating role and to promote the private sector as the driver of growth. Malaysia has leveraged on the comparative advantage of the public and private sectors through Public Private Partnerships for infrastructure projects. The objective is to optimise on the cost efficiency and sustainability of the financing model, so as to enhance the financial viability of the infrastructure project. This is achieved as risks are transferred to parties that can best manage those risks. Hence, the public sector can provide the regulatory risk guarantees and incentives to ensure adequate demand, whilst the private sector will raise financing as well as technical expertise. This model was successfully implemented for the biggest highway concessionaire in Malaysia. PLUS operates and maintains 973km of expressways in Peninsular Malaysia, stretching from the border of Thailand to Singapore and linking all major cities on the west coast of Peninsular Malaysia.

Financing for infrastructure development is equally important as this has implications on the fiscal position. To structure the most competitive and efficient financing for each stage of the infrastructure project schedule, several options can be considered - including

direct funding from the budget, the issuance of long-term Government bonds, the issuance of long-term Government-guaranteed bonds, the securitization of works completed, and the issuance of long-term bonds backed by the Government's undertaking to make deferred payments. The actual funding mix adopted needs to be based on the Government's fiscal position and on economic conditions. By adopting a mix of strategies over the overall duration of the project, the Government can optimise on the funding costs.

Another major area of financing that has been a challenge both in the developed and emerging economies is for health care. The structure of healthcare provision requires a balanced socialised element to avoid both the market failure of a largely privately driven system (e.g. as experienced in US) and the inefficiencies of fully public systems (e.g. several European countries). Social health insurance schemes based on earnings contributions is a means by which such funding sources can become a complementary source of funding to public sector. Such an institutional arrangement should provide high quality basic healthcare for the population whilst private health insurance can have a complementary role in providing higher level care for those that have the means to absorb these costs.

In developing a financial sector that will deliver innovative financing for economic transformation throughout the different phases of development requires several supporting elements. These include:

- a. Having strong financial institutions that are resilient to withstand the economic cycle;
- b. Establishment of a credit information system;
- c. Development of a domestic bond market for financing large investments for both the public and private sectors. This includes the necessary infrastructure to facilitate the functioning of the bond market;
- d. Having the talent pool in the financial services industry;
- e. Financial literacy has to be advanced aggressively;
- f. Effective structure to ensure sufficient supervisory oversight to ensure soundness and stability of the financial system;

- g. Mechanism for resolution of debt problems including for public and private sector;
- h. Potential to leverage on technology. This in particular enhances distribution channel and outreach;
- i. Consumer protection framework needs to be in place; and
- j. Surveillance mechanism needs to be in place.

Finally, I would like to discuss the importance of Islamic finance as an important mode for financing economic transformation. Islamic finance requires financial transactions to be supported by an underlying productive economic activity that will generate legitimate income and wealth. This gives rise to a close link between financial transactions and productive flows. Therefore, the growth in Islamic financial assets is generally in line with the growth of underlying economic activities, thereby ensuring that the financial system is always grounded to the real economy. Other inherent features arising from risk sharing also contribute to the stability and integrity of Islamic finance. Thus, Islamic finance, embraced in its entirety, is supportive of sustainable economic growth.

Islamic finance offers an extensive range of innovative financial products and services from consumer financing, asset and wealth

management to Islamic insurance and capital markets. The sukuk market has become a highly competitive fundraising option for large scale projects and infrastructure development. With an annual growth rate of 40 percent, sukuk instruments are fast emerging as an attractive new asset class for investors, while evolving to become a preferred financing and capital raising option for issuers. In Malaysia, the sukuk market now accounts for more than fifty percent of our bond market, drawing the participation of not only our own corporates but also a wide range of international corporations and multilateral agencies. In Malaysia, a comprehensive Islamic financial system operates in parallel to the conventional financial system. This is now internationalized to enhance our interlinkages with other emerging economies and traditional markets.

The emerging economies will be the key drivers of economic transformation over the next decades, both within and across borders resulting in a more integrated global economy. It is therefore imperative that efforts are increased in ensuring collaboration and sharing of experience for the common good. The Langkawi International Dialogue continues to be an important platform for such exchanges and it is a great honour for me to have this opportunity to be here today.

**Official Monetary and Financial Institutions Forum (OMFIF)
World Banking Summit:
“Looking into the Crystal Ball: The New International Balance of Economic and
Financial Power and its Implications”
London, 30 June 2011**

Speech by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

We live in the most extraordinary of times. A major global transformation is taking place at an unprecedented scale and speed. The pervasive nature of this transformative change is the result of several mutually reinforcing global shifts – an economic shift, financial shift and monetary shift. The ramifications of these significant structural shifts will have widespread and far reaching implications. It will result in a realignment of the global economic and financial landscape, a realignment that will not be transitory but a structural transformation that will be of historical significance that will reshape the world.

It is my great pleasure to be here in London to speak at this OMFIF World Banking Summit. My remarks today will focus on the three global – and interconnected – structural shifts; the economic, financial and monetary shifts that are unfolding. While the world is currently confronted with wide-ranging challenges – sustaining growth that is accompanied by job creation, ensuring effective and efficient functioning financial systems, reining in rising inflation, dealing with fiscal imbalances and excessive indebtedness and living with volatile and destabilising cross border financial flows – it is also important to recognise the significance of these underlying shifts that are reshaping the future global landscape.

Economic Shift

The **economic shift** is resulting from the cumulative shifts in global consumption, investment and trade. For more than two centuries, the centre of global economic power has been with nations with less than twenty per cent of the world populationⁱ. But in these

recent two decades, the concurrent rise of the emerging economies is contributing towards a major realignment of the global landscape. Furthermore, this process has been further accelerated by the recent global financial crisis that is resulting in a global recovery that is uneven, with slow and fragile recovery in the developed world and robust and stronger growth in the emerging world.

The concurrent rise of the emerging economies is shifting the economic centre of the world towards a global environment in which the economic power is more dispersed – into a world that will become increasingly multi-polar. While the economic growth has been most visible in Asia, strong growth has in fact been experienced in most of the emerging world in this recent decade. The emerging economies today collectively contribute almost three-quarters of global growth, while their share of global economic output is projected to account for almost 60% of total world output by 2030ⁱⁱ.

Rising incomes, growing employment opportunities and the conscious policies to promote domestic demand is increasingly shifting the locus of global consumption from the advanced to the emerging economies. The emerging economies are already – on the average – adding 125 million people into the global middle class each year, equivalent to more than twice the population of the United Kingdom. This will about double the global middle class population to 3.2 billion by the conclusion of this decadeⁱⁱⁱ. Highly visible are the new consumer retail centres that are emerging in Asia, the Middle East and Latin America. By 2020, Asia alone is projected to comprise more than 50% of the global middle

class population, accounting for more than 40% of global consumption^{iv}. This is reinforced by a demographic structure that indicates a relatively young population with a relatively higher propensity to consume.

Other measures that have enhanced the potential for increased consumption are the social safety nets that are being put in place including for health and education, the improvements in public transportation, the institutional arrangements that are reducing the need for precautionary savings that involve the development of pension funds and insurance. And finally, the development of the domestic financial system has ensured the continued access to financing.

This geographical shift of global consumers is also transforming the patterns of international trade. As final demand increasingly originates from Asia, the Middle East and Latin America, the final destination of exports is also increasingly gravitating to the emerging economies. The direction of trade is therefore expected to shift as advanced economies will increasingly be exporting to the emerging economies. This in turn will contribute to the unwinding of the global imbalances and potentially even reversing the global balance of payments position.

Trade between the emerging economies is also increasing substantially. Not only will there be greater intra-regional trade within Asia, but trade between the various regions of the emerging world, in particular, between Asia and the Middle East and Latin America is also gaining importance. As the emerging economies transform from being global producers to becoming global consumers, the concentration of trade will also shift from comprising of intermediate manufactured inputs to that of final consumer goods. Indeed, these shifts in trade patterns are taking place. While world trade has expanded by almost four-fold, trade among the emerging economies has increased by more than ten times^v. Within the more recent decade, Asia has emerged as the largest trading partner for the Middle East, accounting for more than half of the total trade in the Middle East.

Alongside these profound changes is also the secular shift in investment flows into the emerging economies. Initial investment flows to the emerging world were prompted by the presence of resources, labour supply, the lower costs of doing business and the growing scale of the domestic market. These factors have produced vast investment opportunities in the emerging economies. In particular, in this recent two decades there has been a massive shift in the manufacturing capacity from the advanced economies to the emerging economies.

More recently however is the investment flows into the emerging economies originating from the emerging economies themselves. Today, more than one third of foreign direct investments (FDI) into the emerging economies originate from the emerging economies, and this share can be expected to increase further^{vi}. As firms in the emerging economies grow in size and strength, they can be expected to expand their operations to beyond their domestic borders to the region and other parts of the world, thus creating a new generation of global multinational companies. Importantly, the increasing regionalisation and internationalisation of such firms will not only provide capital to the other emerging economies, but also talent and expertise. Recent statistics indicate that the number of emerging market companies in the Fortune 500 have more than doubled in the recent four years^{vii}. The strengthening of trade links among the emerging economies also reinforces this cross-border corporate investment into the emerging economies.

This change in the direction of capital flows – from the advanced into the emerging economies, and among the emerging economies themselves – will contribute to reinforcing the growth potential of the emerging economies, and thus this global economic shift towards the emerging economies. Additionally, the increasing allocation of capital towards productive investment opportunities in emerging economies will contribute to the global rebalancing process, and thus towards achieving a more balanced global economy.

Financial Shift

Let me now turn to a more recent shift that is taking place in the global environment – the financial shift. As the world economy becomes more globalised and as economic activity and production becomes globally more dispersed, the distribution of financial centres will also become increasingly more dispersed. International financial centres are currently still dominated by financial centres in the developed world. There is still a high level of geographical concentration of financial centres that are dominated by cities in the advanced world. The global financial system is also characterised by a network of financial institutions that originate from such financial centres – mainly from the United States, Europe and Japan – that have presence in different parts of the world. Their international presence is largely to serve their clients that have international businesses and to finance international trade.

The future is likely to see the distribution of financial centres become more dispersed. Increasingly, new centres of financial activities will emerge to serve the new growth centres in the emerging economies and the new businesses that have operations in their respective regions and other parts of the world. This will also promote greater interlinkages between financial systems, especially among the emerging economies. This trend will be reinforced by the changes in the pattern of international trade and cross border investment activities to and among the emerging economies.

In addition, several features that are prevailing in most emerging economies will prompt greater intra-regional financial intermediation. Firstly, is the relatively higher savings rate in most emerging economies. This provides opportunities for more effective mobilisation of savings within and between regions to be efficiently channelled to productive investment opportunities across and between regions. Regions with surplus funds such as the Middle East have the opportunity to channel these funds to other regions that have investment opportunities. Secondly, is the trend for deregulation and financial reform that allows for greater flexibility and predictability in the

functioning of the financial system. Thirdly, is the trend towards greater liberalisation – both in terms of elimination of barriers to entry and that of capital account restrictions. These developments have been reinforced by the development of financial markets in emerging economies. These trends have cumulatively prompted greater regionalisation and internationalisation of financial systems in the emerging economies.

These trends will also be reinforced by the rapid growth and expansion of emerging market financial institutions that are increasingly operating beyond their national borders. Financial institutions from the emerging economies have grown significantly in size and strength over the recent decade, accounting now for almost half the worldwide financial industry market value. In fact, the world's two largest banks by assets are today held by emerging market financial institutions. Not only have financial institutions gained presence by way of establishing subsidiaries or branches in new jurisdictions, but there has also been increased cross border mergers and acquisitions. This trend has further facilitated cross border financial intermediation and has enhanced the economic interlinkages between emerging economies. With the development of the domestic financial markets and as these markets are internationalised, it enhances the interconnectedness of these markets and hence the potential of facilitating the optimal and efficient allocation of resources between economies. It will result in some part of the high savings within the region to be recycled into, investment activities in the region.

Another key trend in the international financial landscape is the internationalisation of Islamic finance and its role in contributing to supporting overall global economic growth and global financial stability. This recent decade has seen the expansion of Islamic finance as a competitive form of financial intermediation. With the internationalisation of Islamic finance, it will also enhance the economic interlinkages not only in Asia and the Middle East, but also with the rest of the world. While the regulatory framework for Islamic finance has been well established at the international level, there has also been meaningful progress in the

harmonisation of Shariah interpretations and the establishment of a mechanism for managing cross border liquidity. An area that has been identified for further work is on the development of a cross border crisis management framework. As evident in recent trends, the internationalisation of Islamic finance is facilitating the strengthening of trade and investment ties – especially between Asia and the Middle East, and thus deepening the economic and financial inter-linkages between the two dynamic growth regions.

Monetary Shift

The third global shift taking place is in the international monetary system. As the share of emerging economies in the global economy increases and as our participation in cross border transactions in trade and investment increases, the role of emerging economies in the international monetary system will also increase. The issue before us is how will the international financial system evolve amidst the global economic and financial shifts that are taking place. Will there be a corresponding shift in the international financial system?

When the Euro emerged as an international reserve currency, it was thought that three international reserve currencies would prevail in the international financial system – the US dollar, the Euro and the Japanese Yen. Given the degree of the internationalisation of the US dollar, the significant size and liquidity of its financial markets, the US dollar has dominated as an international reserve currency in the international financial system. Going forward, it is those currencies that can effectively perform as a medium of exchange for cross border transactions for trade and investment that will emerge as an international reserve currency. Three scenarios have been extensively discussed by the international community. Firstly, a single currency dominates; second, multi-currencies exist as international reserve currencies; and third, the emergence of a global currency such as the SDR. Key is the relative stability of the currency and its ability to withstand destabilising developments.

Prior to the sovereign debt crisis in Europe and the financial crisis in Japan, there was

ready acceptance of the Euro and the Yen as important reserve currencies. The recent developments in Europe should be viewed as a temporary setback. Following the resolution and restoration of stability, the trend of its role as an international reserve currency can be expected to resume. In addition, the emergence of China as a significant participant in the international financial system will enhance the prospects of the Renminbi as a reserve currency. China is already the largest trading partners to many countries. There are already settlements in Renminbi for bilateral trade. Increasingly, Central Banks and Sovereign Wealth Funds are also already investing in Renminbi denominated assets. This trend can be expected to increase.

The third scenario that has been discussed is the emergence of a global currency. The smaller emerging and developing economies that participate in international trade may consider the case for a global currency that represents a composite of a basket of currencies compelling. Being a composite of currencies, it would provide greater relative stability, a risk that a single currency is not able to avoid. Trade earnings would thus avoid being diminished by volatile currency movements.

The transition to any new monetary order will however be gradual given that the financial infrastructure and pre-conditions that need to be in place will need time. Historical experiences have shown that inertia exists in the internationalisation of currencies. As such, the internationalisation of the euro and Chinese renminbi as complementary reserve currencies to the US dollar can be expected to proceed gradually, with even occasional reversals towards the US dollar during periods of heightened risk aversion. Among the important pre-conditions is the strengthening of the depth and liquidity of the foreign exchange and other financial markets, to withstand the transition process as we transition into a multi-polar international reserve system.

Global Governance

As the emerging economies increasingly take centre-stage in the global economic and financial landscape, emerging economies need to be accorded with greater representation and

responsibility in the global governance process. Whilst the transition from the G7 to the G20 is recognised as a positive step forward that extends beyond the advanced economies, representation in the G20 remains limited by virtue of size of economies and not by the groups of countries. Importantly, small and medium-sized economies need to be a part of this global governance process and in the setting of international standards which have to sufficiently take into account the impact on the emerging economies.

Increasingly, regional blocs are undertaking their own surveillance and establishing facilities and mechanisms to safeguard stability. This does not diminish the role of existing international multilateral financial institutions. These efforts should be encouraged. The comparative advantage of the regional blocs should be leveraged upon to achieve the common agenda.

The higher degree of interconnectedness in the global economic, financial and monetary landscape also means that the global agenda for growth and financial stability is a shared responsibility. As the world is confronted with global challenges, there will be a greater need

for global solutions and global accountability. Policies can no longer be on only national considerations. The new global governance architecture will also need to take into consideration this greater interdependency of economies and the need to achieve greater international cooperation and coordination.

Conclusion

Allow me to conclude. The concurrent rise of the emerging economies is fundamentally transforming the global landscape. These developments that are unfolding, are having immense implications to the world. While we are currently in a period of transition, faced with the need to manage many major challenges, it is important to recognise the underlying structural shifts that are reshaping the world. As we head towards this 'new normal' that is being reinforced by a world in which there is greater economic and financial interconnectedness, it will necessitate a greater balance in global governance, as well as an intensification in global cooperation and coordination. The common agenda is to achieve a new world that is more balanced, more stable and more sustainable.

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- i OECD, Perspectives on Global Development 2010: Shifting Wealth (June 2010)
 - ii OECD, Perspectives on Global Development 2010: Shifting Wealth (June 2010)
 - iii OECD, The Emerging Middle Class in Developing Countries (January 2010)
 - iv OECD, The Emerging Middle Class in Developing Countries (January 2010)
 - v OECD, Perspectives on Global Development 2010: Shifting Wealth (June 2010)
 - vi World Bank, Global Development Horizons 2011: Multipolarity – The New Global Economy (May 2011)
 - vii McKinsey Quarterly, The Great Rebalancing (June 2010)

CALENDAR OF EVENTS

April – Jun 2011

20 April 2011

The Bank announced the reappointment of Dr. Zeti Akhtar Aziz as the Governor of Bank Negara Malaysia for another term of 5 years effective 1 May 2011. Dr Zeti has held the position of the Governor of the Bank since May 2000.

25 April 2011

The Bank and the People's Bank of China signed an agreement on the establishment of a representative office by the Bank in Beijing. The establishment of this representative office will further strengthen the bilateral cooperation between the two central banks. The office will also serve as an important liaison point with China's regulators and market players as well as to facilitate the conduct of market research on China's economic and financial developments. The Beijing representative office is the third overseas representative office established by the Bank, in addition to its offices in London and New York.

3 May 2011

The Bank announced measures to ensure that all motorists will obtain access to motor cover. Members of the public can obtain motor cover from all general insurers and their branches as well as at Pos Malaysia outlets nationwide. All general insurers are committed to provide motor cover to all motorists including those "displaced vehicles" comprising private vehicles exceeding 10 years old and motorcycles currently underwritten by the Malaysian Motor Insurance Pool. In ensuring the rights of consumers are protected, the Bank also prohibits insurers from compelling their customers to purchase non-motor products as a condition for the sale of a motor cover.

5 May 2011

At its third meeting for 2011, the Bank's Monetary Policy Committee (MPC) decided to raise the Overnight Policy Rate (OPR) by 25 basis points to 3.00%. With the assessment for the Malaysian economy to remain firmly on a steady growth path, the MPC decided to adjust the degree of monetary accommodation. At the new level, the monetary policy continued to remain supportive of economic growth. The Bank also announced the increase in the Statutory Reserve Requirement (SRR) Ratio from 2.00% to 3.00% effective 16 May 2011, as a pre-emptive measure to manage the significant build-up of liquidity which may result in financial imbalances and create risks to financial stability.

12 May 2011

In her speech at the 8th Islamic Financial Services Board (IFSB) Summit in Luxembourg entitled "Financial Stability: Regional and Global Cooperation", Governor Dr. Zeti highlighted that as Islamic finance becomes more internationalised, there is a need to develop a cross-border financial stability framework to further strengthen the resilience of Islamic financial system and to address cross-border challenges. She added that collaboration among supervisory authorities of Islamic financial institutions is vital to ensure the success of this initiative. In addition, Governor also proposed the establishment of an integrated framework of macro surveillance for Islamic finance activities, including efforts such as the IFSB's global database of Islamic finance statistics, which would help to identify and mitigate the emerging risks in the Islamic financial system across jurisdictions.

18 May 2011

The Bank announced that Malaysia has sustained its economic growth momentum in the first quarter of 2011 by registering a growth of 4.6%, led by expansion in domestic demand and higher private sector spending. On the supply side, all major economic sectors recorded positive growth led by strong growth in the manufacturing and services sectors, with the exception of the primary commodity sectors namely agriculture and mining. The headline inflation rate increased by 2.8% in the first quarter attributed mainly to higher global commodity and food prices.

On the same day, the Bank also announced the liberalisation of foreign exchange administration rules on direct investments abroad, inter-company loans and foreign currency trade financing with effect from 1 June 2011. Resident companies that meet the prudential requirements are now permitted to undertake any amount of direct investment abroad to support the expansion of their operations. They are also permitted to borrow any amount in ringgit or foreign currency from their resident and non-resident non-bank related companies to further enhance the efficient management of financial resources within a corporate group and to provide greater flexibility on sources of competitive financing. In addition, the RM5 million limit previously imposed on foreign currency trade financing obtained by residents from non-residents will no longer be applicable. In this regard, residents may obtain foreign currency borrowing, including foreign currency trade financing, up to the prevailing aggregate limit of RM100 million for companies on a corporate group basis and RM10 million for individuals. The liberalisation is part of the efforts to continuously increase business efficiency and enhance competitiveness of the economy.

23 May 2011

The Bank announced that a new series of Malaysian banknotes and coins will be issued for circulation in early 2012, an exercise that is undertaken periodically every twelve years. The theme of the design of the new currency series will include features that are distinctively Malaysia. It will also be enhanced with new security elements in line with the latest advancements in technology for currency notes. As part of the efforts to increase public awareness on the new currency series, the Bank will issue the commemorative coins set for the third series and unveil the new fourth series banknotes design in the third quarter of 2011.

15 June 2011

The Bank awarded a new international Islamic bank licence to Elaf Bank B.S.C (c) (Elaf Bank) of Bahrain to conduct a wide array of Islamic banking business in international currencies other than Malaysian ringgit. Elaf Bank's presence will further strengthen the economic and financial linkages between Malaysia and Bahrain and contribute further to the development of the Islamic financial system in Malaysia.

19 June 2011

At the Langkawi International Dialogue 2011 in Putrajaya, Governor Dr. Zeti delivered a speech entitled "Innovative Financing for Transformation". She highlighted that financial system has to deliver essential financial services that would cater to the financial needs of all sectors of the economy – from households, small and medium enterprises including micro enterprises and to the corporate sector. She also shared Malaysia's experience in developing a financial sector that would deliver innovative financing for economic transformation.

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The Bank announced the introduction of a new Islamic monetary instrument, the Bank Negara Monetary Notes-Istithmar (BNMN-Istithmar). The issuance of BNMN-Istithmar is based on the Istithmar (investment) concept which refers to portfolio investments into a combined structure of sale and lease-back of assets (Ijarah) and commodity mark-up sale transaction (Murabahah). The main objective of issuing BNMN-Istithmar is to increase efficiency and flexibility of liquidity management in the Islamic money market by expanding the Shariah concept used in the Bank's Islamic monetary instruments. BNMN-Istithmar will contribute towards expanding investment instruments and the investor base as well as promote greater liquidity in the Islamic money market.

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