

ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE FOURTH QUARTER OF 2010

OVERVIEW

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The Malaysian economy registered a growth of 4.8% in the fourth quarter of 2010. Higher private and public sector spending contributed to the expansion in domestic demand. The slower growth in the global economy, however, had led to weaker growth in external demand. On the supply side, all economic sectors, with the exception of the primary sectors, continued to expand further during the quarter. For the year as a whole, the Malaysian economy registered a growth of 7.2% (2009:-1.7%).

Domestic demand strengthened by 5.7% in the fourth quarter (3Q 10: 5%), due mostly to the strong expansion in private consumption and capital spending. Private consumption increased by 6.5% (3Q 10: 7.1%) supported by favourable labour market conditions, positive consumer confidence and higher income levels. Public consumption, on the other hand, declined by 0.3% (3Q 10: -10.2%), arising from lower expenditure on supplies and services. Gross fixed capital formation increased by 9.2% (3Q 10: 9.8%) driven by both public and private capital spending. Private sector capital spending was led by the expansion in the production of domestic-oriented industries amid high levels of capacity utilisation. Public sector capital investment rose as a result of higher development expenditure mainly in the education and transportation sectors.

On the supply side, all economic sectors, with the exception of the primary sectors, continued to expand further in the fourth quarter. Growth in the services sector was higher at 6.2% (3Q 10: 5.4%) with expansion in all sub-sectors,

supported mainly by domestic economic activity. The construction sector also registered higher growth of 5.6% (3Q 10: 2.8%), reflecting expansion in the non-residential and civil engineering sub-sectors. The manufacturing sector expanded at a more moderate pace of 6.2% (3Q 10: 7.5%) mostly on account of the weaker external demand. The agriculture sector, however, registered a contraction of 4.3% (3Q 10: 2.7%) attributed to the decrease in palm oil output. The mining sector contracted further (-1.3%; 3Q 10: -1%) due to continued decline in production of crude oil.

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI), increased by 2% on an annual basis in the fourth quarter (3Q 10: 1.9%). The increase in inflation was attributable mainly to higher price of *food and non-alcoholic beverages* which rose by 2.9% and *transport* (4Q 10: 2.5%, 3Q 10: 2.1%) reflecting the further removal of fuel subsidies by the Government which resulted in an upward adjustment of 5 sen/litre for RON95 petrol and diesel prices.

In the external sector, the trade surplus widened to RM25.5 billion in the fourth quarter (3Q 10: RM22.3 billion). Both gross exports and imports increased at a more moderate pace of 3.7% and 10.1% respectively (3Q 10: 10.4% and 16.5% respectively), in line with the moderation of the global economy. The slower growth in exports was due mainly to the lower exports of manufactured products, reflecting the softening global demand for electronics. The moderation in gross imports reflected mainly lower intermediate imports while imports of capital and consumption goods were sustained amidst strengthening domestic demand.

On a cash basis, gross inflows of foreign direct investment (FDI)* were higher at RM11.8 billion in the fourth quarter (3Q 10: +RM8.5 billion), reflecting mainly larger inflows of equity capital. After adjusting for gross outflows due to repayment of inter-company loans, net FDI increased to RM8.3 billion (3Q 10: +RM4.4 billion). FDI was channelled mainly into the services, manufacturing and mining sectors. Investments in the services sector were primarily undertaken by companies in the finance, insurance and business services, as well as wholesale and retail trade sub-sectors. In the manufacturing sector, the FDI was channelled into the electrical and electronics as well as petroleum-related industries. Direct investment abroad (DIA)* by Malaysian companies recorded a lower net outflow of RM3.2 billion in the fourth quarter (3Q 10: -RM5.4 billion) due to lower net extensions of inter-company loans to subsidiaries abroad. These investments were undertaken by the services sector, particularly in the finance, insurance and business services, and wholesale and retail trade sub-sectors. There were also sizeable investments in the oil and gas and the agriculture sectors. Portfolio investment registered a smaller net inflow of RM2.8 billion in the fourth quarter (3Q 10: +RM9.8 billion), due partly to net foreign liquidation of debt securities in November as investors reacted to the sovereign debt concerns in the eurozone. Nevertheless, steady growth in the domestic economy has continued to attract inflows of foreign funds into the domestic equity and bond markets.

The international reserves of Bank Negara Malaysia amounted to RM328.6 billion (equivalent to USD106.5 billion) as at 31 December 2010. This level of reserves has taken into account the quarterly adjustment for foreign exchange revaluation gain, following the strengthening of most major currencies against the ringgit during the quarter. As at 31 January 2011, the reserves position amounted to RM333.5 billion (equivalent to

USD108.1 billion), sufficient to finance 8.7 months of retained imports and is 4.2 times the short-term external debt.

Monetary policy is supportive of economic activity

The Overnight Policy Rate (OPR) was left unchanged at 2.75% in the fourth quarter of 2010 and also at the MPC meeting held on 27 January 2011. At the prevailing level, the OPR remains accommodative and is considered to be appropriate and consistent with the assessment of growth and inflation prospects.

Reflecting the unchanged OPR, the average overnight interbank rate was stable. In terms of the commercial banks' lending rates, the average lending rate edged lower following a foreign currency loan issued at a lower lending rate by a foreign banking institution. The average fixed deposit (FD) rates were unchanged.

Financing conditions remained supportive of economic activity. The demand for financing from both the public and private sectors was supported by continued access to financing, the reasonably low cost of borrowing and ample liquidity in the financial system. Total gross financing raised by the private sector through the banking system and capital market increased to RM220.9 billion in the fourth quarter (3Q 10: RM189.4 billion). On a net basis, banking system loans and PDS outstanding rose by an annual rate of 11.4% as at end-December (3Q 10: 10.9%). Major loan indicators remained strong in the fourth quarter.

Net funds raised in the capital market by both the public and private sectors amounted to RM30.5 billion (3Q 10: RM16.8 billion). In the private sector, fund raising activity was mainly from the bond market. In the public sector, funds were raised through issuances of Malaysian Government Securities (MGS) and Government Investment Issues (GI).

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

Monetary aggregates continued to grow at a sustained pace in the fourth quarter. M3, or broad money, expanded at an annual growth rate of 7% as at end-December 2010 (3Q 10: 8.5%).

During the quarter, the ringgit appreciated marginally (+0.1%) against the US dollar. The appreciation of the ringgit towards the end of the year following renewed optimism on the growth outlook for Asia roughly offset its earlier depreciation in October and November amid higher risk aversion following concerns over the European sovereign debt problems and tensions in the Korean Peninsula. The ringgit also appreciated against the euro (+2.9%), pound sterling (+2.2%) but depreciated against the Japanese yen (-2.4%). Against regional currencies, the ringgit broadly depreciated in the range -0.1% to -1.7% as country specific factors led to the strengthening of these currencies against the ringgit. The ringgit, however, strengthened by 0.7% against the Indonesian rupiah.

Financial stability preserved

Financial stability was maintained throughout the fourth quarter, supported by sound financial institutions and orderly financial markets which provided continued support for financial intermediation in the domestic economy.

On 3 November 2010, the Bank introduced the maximum limit on loan-to-value (LTV) ratio of 70% for the third house financing facility taken by a borrower. The implementation of the LTV ratio is aimed at promoting a stable and sustainable property market, and ensuring the continued affordability of homes for the general public.

The banking sector remained financially resilient, with strong capital buffers of more than RM60 billion. Profitability was sustained amidst continued growth in lending activity with average returns on assets and equity at 1.5% and 16.5% respectively. Financing was broad-based, with financing to households and SME's accounting for about 70% of

total outstanding financing. Capitalisation was strong with risk-weighted capital ratio of 14.6% and core capital ratio of 12.8%. Meanwhile, the level of net non-performing loans (including impaired financing) improved slightly to account for 2% of total loans. The loan loss coverage strengthened further to 99.5% providing additional buffer to the banking sector.

The capital adequacy ratio for the insurance industry was 225.7% (3Q 10: 222.7%). For the year as a whole, profits of insurance and takaful operators improved to RM16.3 billion (2009: RM14.6 billion) due mainly to improved investment performance, more favourable claims experience in the general business segment and continued business expansion.

Recovery to remain uneven across different regions

Going forward, the global economic recovery is expected to remain uneven across the different regions. While short-term prospects for the advanced economies have improved recently, uncertainties remain over weak fiscal positions, high unemployment and constrained lending conditions. In contrast, the growth outlook for Asia remains favourable, supported by robust domestic demand. The regional economies are, however, confronted with the challenges of rising inflationary pressures, particularly from high commodity and fuel prices, and the large and volatile capital flows.

The pace of growth of the Malaysian economy will be affected by the environment of moderating external demand. Growth will, nevertheless, be supported by continued firm expansion in domestic demand. Private consumption spending will continue to benefit from the favourable labour market conditions, firm commodity prices and access to financing. The roll-out of construction and infrastructure activities and the implementation of the economic transformation programme by the Government are likely to provide significant support to the growth momentum in private investment.