

ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE SECOND QUARTER OF 2008

OVERVIEW

Sustained growth momentum in the Malaysian economy

The Malaysian economy registered a growth of 6.3% (1Q 08: 7.1%) in the second quarter of 2008. Growth was supported by strong external demand while domestic demand expanded at a more moderate pace.



Growth in domestic demand moderated but remained strong at 7.8% in the second quarter (1Q 08: 10%). Private consumption increased by 9% (1Q 08: 11.7%) in an environment of higher consumer prices and softer consumer sentiment. Higher expenditure on emoluments, defence, supplies and services supported the growth in public spending (7.1%; 1Q 08: 10.5%). Investment activity was sustained at 5.6% (1Q 08: 6%), supported by continued inflow of foreign direct investment, mainly into the services and manufacturing sectors, and higher development expenditure by the Government. While most investment indicators suggest continued expansion in capital spending, the higher cost of investment activities dampened investment spending in real terms.

All key sectors contributed positively to growth, except for mining. The services sector expanded by 7.6% (1Q 08: 7.9%), led by strong growth in the wholesale and retail trade, and favourable performance in the communication, transport and storage; and finance and insurance sub-sectors.

The manufacturing sector registered a 5.6% growth (1Q 08: 7%), led by domestic-oriented industries, particularly transport equipment, food and construction-related industries. Export-oriented industries grew at a more moderate rate due mainly to lower output in the computers and parts and decline in production of petroleum and chemical industries. Growth in the overall electronics and electrical (E&E) sector was sustained by external demand for electrical products and semiconductors. Meanwhile, selected resource-based industries such as off-estate processing and rubber products continued to lend support to export-oriented industries.

Growth in the agriculture sector (5.9%; 1Q 08: 6.3%) was underpinned by double-digit expansion in crude palm oil production. The construction sector grew at a moderate pace (3.9%; 1Q 08: 5.3%) amidst the rising cost of building materials. Meanwhile, the mining sector contracted slightly due to lower output of natural gas.

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI), rose to 4.8% in the second quarter (1Q 08: 2.6%). The higher inflation during the quarter reflected the higher retail prices for petrol and diesel following the subsidy restructuring on 4 June 2008, as well as higher food prices. Fuel and food prices rose on account of higher global prices for commodities and energy. Headline inflation is expected to remain at elevated levels from June 2008, before beginning to moderate towards the middle of 2009.

On the external front, the trade balance registered a record surplus of RM40.8 billion (1Q 08: RM26.8 billion) in the second quarter supported by strong commodities and resource-based manufacturing exports. Gross exports grew strongly by 20.8%, due mainly to continued strong growth in agriculture and mineral exports, benefiting mainly from higher commodity prices. At the same time, manufacturing exports were higher (+12.3%; 1Q 08: -1.9%), underpinned by higher prices in resource-based products and semiconductors.

Gross imports increased by 9.8% in the second quarter, reflecting stronger growth in all categories of imports. Intermediate imports increased by 10.2%, in line with higher manufactured exports. Continued investment activities led to higher demand for capital imports. Strong growth of 21.1% in consumption imports reflected mainly continued consumption activities and high prices for processed food and beverages.

In the financial account, gross inflows of foreign direct investment, as captured by Bank Negara Malaysia's Cash BOP System, increased to RM12.2 billion (1Q 08: RM7.1 billion). The FDI inflows were mainly directed into the services, manufacturing, and oil and gas sectors. After adjustment for gross outflows due mainly to repayments of short-term loans, net FDI increased to RM8.3 billion (1Q 08: RM2 billion). Overseas investment by Malaysian companies recorded a net outflow of RM3.5 billion (1Q 08: -RM6.6 billion) reflecting sustained investments in the manufacturing and services sectors. Meanwhile, portfolio investment registered a net outflow of RM31.8 billion (1Q 08: +RM1.5 billion) due to net liquidation of both bonds and equities by foreign investors. During the quarter, investor sentiment in Malaysia and in the Asian region was affected by concerns over impact of higher energy prices and US economic slowdown on growth prospects in the region.

The international reserves of Bank Negara Malaysia amounted to RM410.9 billion (equivalent to USD125.8 billion) as at 30 June 2008. The reserves amounted to RM403.9 billion (equivalent to USD123.7 billion) as at 15 August 2008. The reserves position is sufficient to finance 9.7 months

of retained imports and is 5 times the short-term external debt.

OPR was left unchanged

The Overnight Policy Rate (OPR) was left unchanged at 3.50% throughout the second quarter. The Bank is projecting inflation to remain elevated in the second-half of 2008 and into early next year before moderating towards mid-2009. The major restructuring of domestic energy prices in June is expected to have a deflationary effect on the economy in the second half of this year and into the early part of 2009.

With the OPR unchanged, interbank rates for all maturities were relatively stable during the quarter. In terms of lending rates, the average base lending rate (BLR) remained unchanged during the quarter, while the average lending rate (ALR) softened to 6.08% as at end-June. Deposit rates remained relatively stable during the period.

Financing activity in the second quarter remained strong and supported domestic economic activity. On a net basis, banking system loans and PDS outstanding expanded by 14.1% at end-June. Loans outstanding increased by 11.7% at end-June, reflecting increases for both the business and household sectors, with loans outstanding to these sectors expanding at 14.4% and 8.9% respectively. Loan applications, approvals and disbursements remained at relatively high levels, with continued broad-based financing to productive sectors of the economy.

Net funds raised in the capital market were significantly higher in the second quarter, amounting to RM27.7 billion. In the private sector, net funds raised through the PDS market were higher at RM15 billion, while net funds raised through the equity market amounted to RM1.7 billion. Net funds raised by the public sector amounted to RM11 billion.

M3, or broad money, expanded by RM16.1 billion during the quarter, increasing at an annual rate of 14.2% at end-June. The increase during the quarter was mainly due to higher lending to the private sector.

During the second quarter, the ringgit depreciated by 2.4% against the US dollar. The US dollar strengthened during this period on expectations for a pause in Fed Funds rate cuts. In addition, higher global fuel and food prices and prospects of moderation in growth dampened investor sentiments towards the region, prompting portfolio outflows, affecting the regional currencies, including the ringgit. The ringgit depreciated against the euro (-2.3%) and the pound sterling (-2.3%), but appreciated against the Japanese yen (3.8%). The ringgit exhibited a mixed performance against other regional currencies. During the period 1 July to 28 August 2008, the ringgit depreciated against the US dollar (-3.2%) and the Japanese yen (-0.5%), but appreciated against the euro (3.3%) and the pound sterling (5%). The ringgit depreciated against most regional currencies in the range of 1.4% to 4%, with the exception of the Singapore dollar and Korean won against which the ringgit appreciated by 0.4% and 0.3% respectively.

Banking system remained resilient

The banking system continued to exhibit resilience and is well-positioned to support the financing and financial services needs of the domestic economy. As at end-June 2008, the banking system remained well-capitalised with risk-weighted capital ratio (RWCR) and core capital ratio (CCR) of 13% and 10.1% respectively. The banking system recorded

a pre-tax profit (PBT) of RM5.2 billion during the quarter, with annualised average returns on assets and equity of 1.7% and 22% respectively. Meanwhile, net non-performing loans (NPL) based on 3-month classification declined further by 6.7% to RM17.8 billion to account for 2.7% of total net loans.

Growth going forward

Going forward, the international economic and financial environment is expected to be more challenging. Global growth is projected to weaken further with a more protracted slowdown in a number of the developed economies and some moderation in growth in the emerging economies. While commodity and energy prices have experienced some correction in response to signs of slower global growth, prices remain elevated. Meanwhile, the international financial markets continue to remain fragile.

The domestic economy will be affected by these external developments. In addition, the impact of rising commodity and fuel prices and costs will continue to have a deflationary impact on domestic demand, as well as affecting consumer and business sentiments. Despite signs of moderating growth, the underlying fundamental strength of the Malaysian economy and the resilient banking sector provide the potential of the Malaysian economy to resume its steady growth path.