MONETARY AND FINANCIAL CONDITIONS

INTERNATIONAL MONETARY AND FINANCIAL CONDITIONS

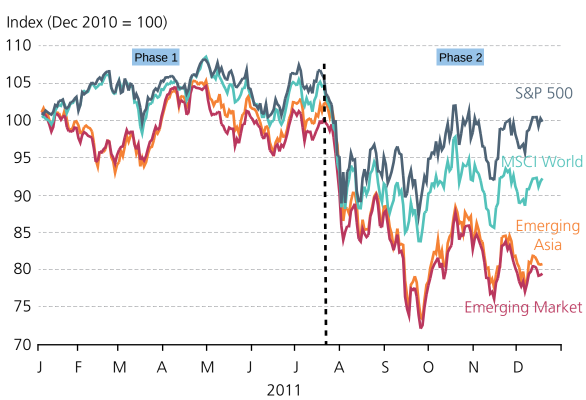
Developments in international monetary and financial conditions broadly followed two distinct phases in 2011. In the first half of the year, global financial markets were trending upwards due to positive sentiments driven by expectations of better prospects for global economic growth. At the same time, the emergence of inflationary pressures and risks of financial imbalances arising from a prolonged period of low global interest rates prompted central banks in emerging economies to adjust upwards their interest rates. This period coincided with episodes of large and sustained capital inflows into emerging economies. In the second half of the year, global financial conditions deteriorated significantly. Financial market volatility intensified in the advanced economies following the escalation of the European debt crisis and heightened fiscal uncertainties in the US. There was also increasing uncertainty over the strength of the recovery in the advanced economies amid structural weaknesses prevailing in these economies. Despite the introduction of additional extraordinary policy measures by authorities in the advanced economies, risk aversion remained high. Asset repatriation by European investors resulted in capital outflows from emerging economies.

Global financial markets started the year on an upward trend, notwithstanding the temporary disruption caused by geopolitical unrest in the Middle East and North Africa, and the earthquake in Japan. Positive news on economic activity and higher than expected corporate profits contributed to increases in equity prices. The IMF revised upwards its estimate for world growth to 4.4% in January, from 4.2% in October 2010. In advanced economies, there were emerging signs of a self-sustaining recovery, with private sector demand holding up well despite the waning effects of fiscal stimulus. Credit conditions in the major advanced economies, including in the euro area, were slowly improving after a prolonged period of incremental tightening. In emerging economies, growth was seen as being more firmly entrenched, with concerns increasingly focused on strong credit expansion and rising demand pressures in these economies.

Global financial markets entered the year on a strong note building on the positive momentum from end-2010

Chart 2.1

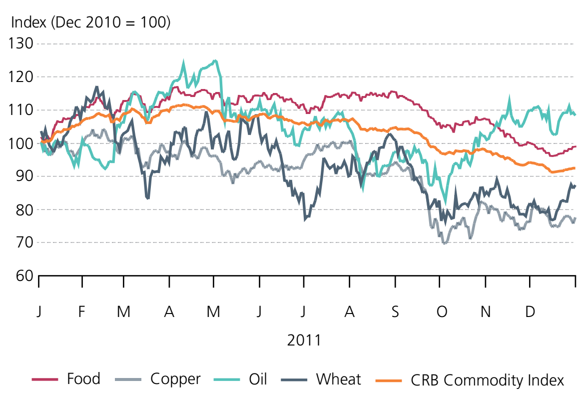
Selected Equity Market Indices



Source: Bloomberg

Chart 2.2

Commodity Prices



Source: Bloomberg

At the same time, inflationary pressures increased, mainly in response to higher global food and energy prices. The rise in global energy prices towards the end of 2010 was amplified by supply disruptions due to the geopolitical tensions in the Middle East and North Africa. Global food supplies were affected by adverse weather conditions and the low stockpiles, especially for wheat and corn. This exerted upward pressure on prices in both the advanced and emerging economies. The multi-speed growth in the global economy, however, meant that demand pressures were uneven. Narrowing output gaps and higher capacity utilisation made emerging economies generally more vulnerable to demand pressures and second-round inflationary effects. In the advanced economies, however, demand pressures remained subdued with the prevailing high unemployment, high debt, deleveraging and weak sentiments.

With signs of the global economic outlook improving, central banks shifted the focus of policy towards gradually removing the degree of monetary policy accommodation. In advanced economies, the expected timing of interest rate increases was brought forward. In February, implied forward rates indicated that policy tightening for the UK and euro area was expected towards the middle of 2011, compared to expectations at end-2010 that such increases would only occur in 2012. For emerging economies, rising inflationary concerns strengthened the case for policy normalisation. A significant number of countries, including PR China, Brazil and India increased policy interest rates in response to higher inflationary pressures. The perceived widening growth and interest differentials amidst a situation of excess global liquidity added to the attractiveness of emerging economies as a destination for capital inflows. In June, the Institute of International Finance estimated that net private capital flows to emerging economies could rise to USD1.04 trillion in 2011, from USD990 billion in 2010. Faced with significant capital inflows and the consequent risks of the build-up of financial imbalances, countries such as Brazil, Korea and Indonesia responded by implementing macro-prudential and capital account measures to preserve financial stability.

Despite the positive outlook for global growth, fundamental issues in the advanced economies remained unresolved. First, governments remain heavily indebted. The sustainability of the fiscal position in the US, Japan and peripheral euro area countries continued to remain a concern. In April, Portugal became the third euro area country forced into seeking financial assistance from the EU-IMF, while doubts lingered over Greece's solvency and its ability to implement fiscal reform. Second, the health of financial institutions had not recovered in tandem with the overall economy and confidence in the banking systems of many advanced economies had not been fully restored. Third, the high level of unemployment, weak household balance sheets and legacy mortgage problems in the US continued to have a negative effect on consumption.

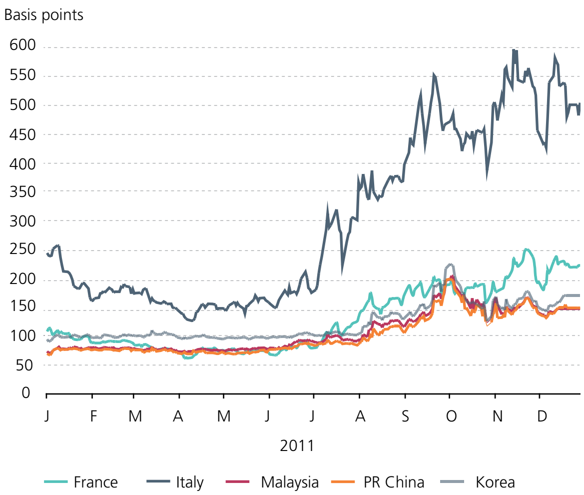
Financial market volatility increased in the second half of 2011 as the downside risks to the global economy became more apparent with the escalation of the European sovereign debt crisis

In the second half of 2011, the escalation of the European sovereign debt crisis and fears of its attendant contagion caused significant volatility in international financial markets. Concerns over the ability of Greece to service its debt and the implications on European banks exposed to Greek debt led to tighter liquidity conditions and stress in the eurozone money markets. The euro LIBOR-OIS spread, a measure of interbank liquidity conditions, increased by 60 basis points from July to September. There was also speculation on the possibility of Greece abandoning the euro in favour of its own national currency. Amid several rating downgrades, bond yields across the euro area increased significantly. In Italy, the 10-year yield breached the critical 7% level, widely viewed as the threshold where the debt would become unsustainable. In addition, the core European countries were also not spared, with credit default swap spreads for France rising above those of lower-rated emerging economies. These concerns were further compounded by the impasse in the US over its debt ceiling and the downgrade of its AAA sovereign rating by Standard and Poor's in August.

Signs of slowing global growth further weighed on investor sentiments and contributed to the

Chart 2.3

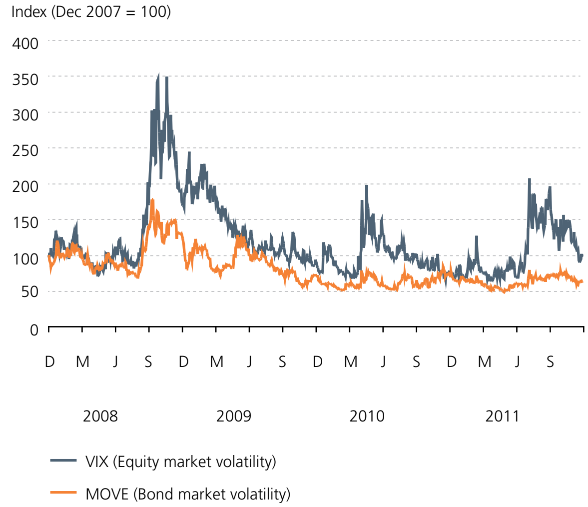
5-year Credit Default Swaps (CDS)



Source: Bloomberg

Chart 2.4

Measures of Volatility



Source: Bloomberg

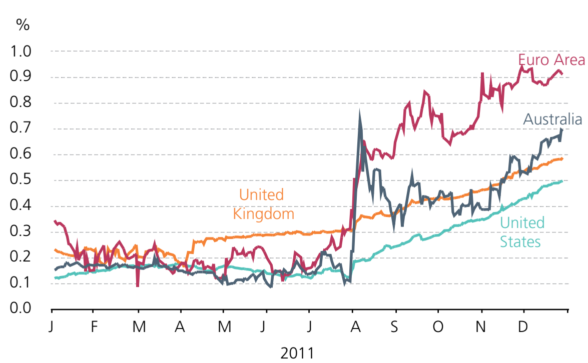
uncertainty in financial markets. The threat of a double-dip recession resurfaced following the release of negative economic reports in the US, on-going disruptions to the global supply chain from the earthquake in Japan and the likely drag on growth from fiscal consolidation in the advanced economies. For emerging economies, despite the rebalancing of growth towards domestic demand and intra-regional trade, developments in advanced economies would still have an impact both directly and indirectly on emerging economies through the financial market and trade channels. Signs of slowing economic activity in most emerging economies became more evident in the third quarter of 2011, following the slowing of exports caused by deteriorating external demand.

During the period, risk aversion increased, while market sentiments deteriorated considerably. The VIX index, a gauge of investors' risk aversion increased to levels not seen since the collapse of Lehman Brothers in 2008. Investors withdrew funds from emerging market assets in favour of highly liquid US dollar denominated assets such as US Treasuries and precious metals such as gold, causing the 10-year US Treasury yield to decline to a record low of 1.72% and gold prices to reach a new record high of USD1900 per ounce. In addition, some countries which are considered as safe haven currencies such as the Swiss franc instituted measures to limit currency appreciation.

Several advanced economies, especially in the euro area, being the epicenter of events, were badly affected. Measures introduced to improve sentiments and calm markets, such as the leveraging and expansion of the European Financial Stability Fund from €440 billion to €1 trillion, the voluntary write-down of Greece's debt held by private investors, the recapitalisation of European banks and sovereign bond purchases by the ECB had only limited impact and provided temporary relief to markets. Although global investor risk

Chart 2.5

3-Month LIBOR less OIS



Source: Bloomberg

aversion had subsided and sovereign bond yields declined following the announcement of these measures at the EU summit on 26 October and the coordinated swap arrangement by six major central banks on 30 November, the interbank liquidity conditions remained tight and volatility continued to remain high.

Emerging economies were not insulated from the effects of the turmoil. Market sentiments were adversely affected by developments in the advanced economies. Heightened risk aversion and asset repatriation by European investors facing difficulties with short-term funding resulted in a sharp reversal of capital flows from emerging economies. Between 29 July to 5 October, the MSCI Asia (ex-Japan) index declined by 27.2%, erasing the gains since June 2010. This in turn led to a depreciation of emerging market currencies, reversing the appreciating trend earlier in the year. The tightness in US dollar funding also led to a decline in the supply of US dollar credit from euro area banks to emerging economies, although banking and credit conditions in general remained stable.

Against a backdrop of significant downside risks, the monetary policy focus in the latter part of 2011 broadly shifted towards an accommodative bias. The lack of fiscal space in the advanced economies, coupled with weak economic and financial conditions called for a more supportive role for monetary policy. Policy measures ranged from a reduction in interest rates by the ECB and the Reserve Bank of Australia, a commitment by the US Federal Reserve to maintain interest rates at close to zero till mid-2013, and additional bond purchases by the ECB, BOE, BOJ and the US Federal Reserve aimed at lowering long-term interest rates and injecting liquidity directly into the economy. Emerging economies, however, faced a tradeoff between a slowing external sector and the still robust domestic demand conditions. Several major emerging economies such as Brazil, Indonesia and PR China reduced interest rates, or reduced reserve requirements. Others paused the process of policy normalisation to evaluate the balance of risks and the potential for further negative spillover effects should conditions in the advanced economies worsen.

Despite some tentative signs of improvement in the US economic data towards the end of the year, it was clear that the balance of risks had tilted towards the downside. In the advanced economies, prevailing issues of high debt levels and fragility of financial institutions remain unresolved, while the ability to sustain the growth momentum without policy support remains uncertain. As a result, emerging economies could face significant external headwinds from slowing external demand and financial contagion. With the global outlook clouded with significant uncertainties, there was a significant likelihood that authorities would introduce additional monetary stimulus going forward. This additional liquidity, coupled with volatile financial market conditions was likely to result in sharp surges and swings in capital flows to emerging economies. Moving forward, such an environment will continue to pose policy challenges for both financial and monetary stability in emerging economies.

DOMESTIC MONETARY AND FINANCIAL CONDITIONS

Exchange Rate

As in the previous year, ringgit developments in 2011 were heavily influenced by significant two-way flows of portfolio investment arising primarily from external factors. Reflecting the volatile developments in international financial markets, ringgit movements during the year followed two noticeable trends. Between early January and July 2011, the ringgit strengthened due to significant portfolio inflows. Strengthening fundamentals and positive investor sentiments continued to attract such short-term capital flows towards regional markets. In August and September, however, heightened risk aversion and asset repatriation by some European investors resulted in the reversal of portfolio flows and contributed to the depreciation of most regional currencies, including ringgit. The respite following the positive outcomes of the EU summit in October was brief, as capital outflows and ringgit volatility increased towards the end of 2011 amidst unresolved market concerns over the sovereign debt crisis in Europe. Ringgit ended the year at RM3.1770 against the US dollar, a depreciation of 2.9%.

The broad appreciating trend of the ringgit in 2010 carried forward into the first half of 2011 as the combination of regional ``pull´´ and global ``push´´ factors continued to attract international investors towards regional financial assets. Economic growth in the region remained resilient, averaging 7.9% in the first half of 2011 (2010 1H: 10.5%)[1], underpinned by sustained domestic demand and intra-regional trade. Rising price pressures in emerging market economies

[1] Bank Negara Malaysia's estimates of EA-9 countries' growth (PR China, Chinese Taipei, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand)

during the first half of 2011 also raised investor expectations for further interest rates increases and currency appreciation across the region to contain inflation. Meanwhile, the continued weakness and expectation of a prolonged low interest rate environment in the advanced economies also served to push investors interest towards emerging economies. These factors contributed to the increase in demand for regional financial assets and resulted in net portfolio inflows of RM56.4 billion into Malaysia in the first half of 2011 (2010 1H: RM26.7 billion). Against this backdrop, the ringgit reached RM2.9385 against the US dollar on 27 July 2011, which was the strongest level since the introduction of the managed float system in July 2005.

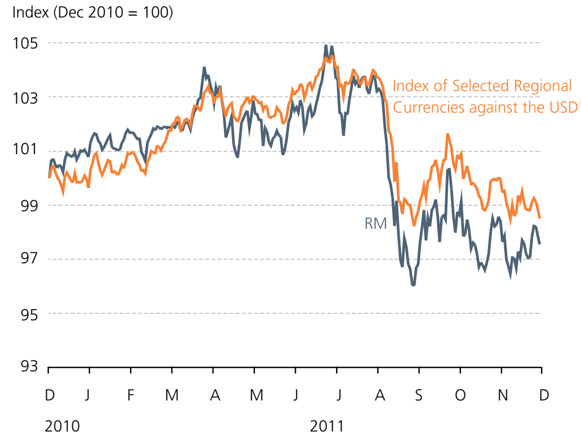
The performance of the ringgit during the year was influenced by volatility in international financial markets

The appreciating trend of the ringgit and other regional currencies was, however, reversed in August and September 2011 as investor risk aversion rose sharply following heightened uncertainty surrounding the global growth outlook and renewed concerns over the sovereign debt crisis in Europe. During this period, investor sentiments deteriorated and caused large portfolio outflows from regional financial markets including Malaysia. Investors began to shift investment preferences towards more liquid US dollar assets during this period of heightened uncertainty. Portfolio outflows were further exacerbated by asset repatriation by some European investors facing potential short-term funding shortages in their home countries. As a result, regional currencies broadly depreciated against the US dollar. For Malaysia, outflows in the third quarter amounted to RM23.4 billion, the highest quarterly outflow since the fourth quarter of 2008. The depreciation briefly abated in October, but volatility remained elevated throughout the remainder of 2011 as financial markets reacted to developments in the euro area.

Against other major currencies, the ringgit depreciated against the Japanese yen (-7.6%), pound sterling (-2.3%) and the euro (-0.8%). The sizeable depreciation against the Japanese yen was in line with the regional trend as the Japanese currency strengthened across the board. The ringgit also broadly depreciated against regional currencies, with the exception of the Thai baht, against which the ringgit appreciated by 2.2%. The ringgit's weaker performance in 2011 only partially reversed the ringgit's relatively strong performance against regional currencies

Chart 2.6

Exchange Rate of the Malaysian Ringgit (RM) and Selected Regional Currencies Against the US Dollar



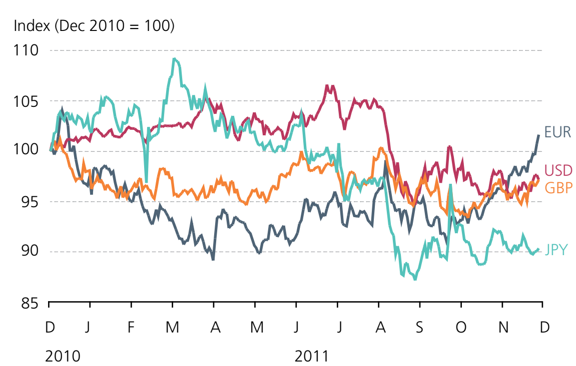
[1] Regional currencies: Chinese renminbi, Indonesian rupiah, Korean won, Philippine peso, Singapore dollar, New Taiwanese dollar and Thai baht. Each currency carries equal weight

Note: An increase in the index represents an appreciation of the ringgit or of selected regional currencies against the US dollar

Source: Bank Negara Malaysia

Chart 2.7

Exchange Rate of the Malaysian Ringgit (RM) Against Major Currencies

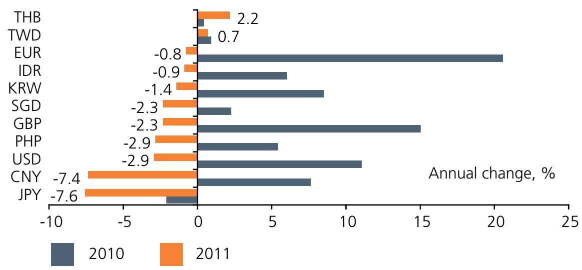


Note: An increase in the index indicates an appreciation of ringgit against the currency

Source: Bank Negara Malaysia

Chart 2.8

Summary of Malaysian Ringgit Performance against Major and Regional Currencies



Note: (+) indicates an appreciation of the ringgit against foreign currency
Source: Bank Negara Malaysia

in 2010. For the year as a whole, the ringgit's Nominal Effective Exchange Rate (NEER), a measure of ringgit's performance against the currencies of Malaysia's major trading partners, depreciated by 2.8% (2010: +6.4%).

During periods of heightened uncertainty, the policy stance was to ensure that ringgit adjustments remained orderly. Given that Malaysia is a small and highly open economy, avoiding large and excessive exchange rate swings is vital to avoid significant disruptions in the market that could result in dislocations in the real sector. It is therefore important for movements of the currency to be gradual to allow for the corresponding adjustments in the real economy to take place. Consistent with this policy stance, the Bank will continue to ensure that sudden surges in capital flows do not create destabilising conditions in the foreign exchange market. Over the medium to long-term, as the global risk aversion subsides, portfolio flows are expected to return to emerging economies, as fundamental factors such as positive growth and rates of return differentials that favour emerging economies will continue to draw global investors.

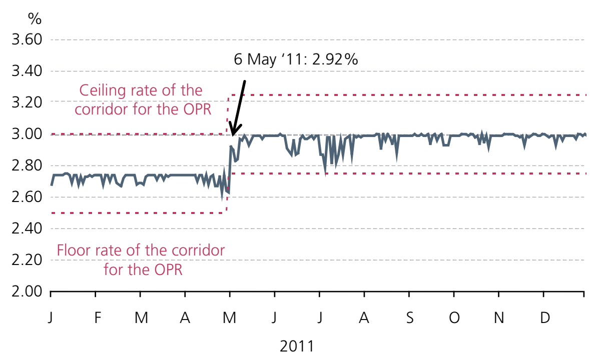
Interest rates, bond yields and equity prices

Interest rates rose in 2011 following the Monetary Policy Committee's (MPC) decision to raise the Overnight Policy Rate (OPR) by 25 basis points to 3.00% in May 2011. Taking into account the OPR increases in 2010, the policy rate has since been raised by a cumulative 100 basis points, only partially reversing the 150 basis points OPR reduction following the 2008 financial crisis in the advanced economies. Despite the increase in borrowing costs following the rise in the OPR, monetary conditions therefore continue to remain accommodative, ensuring an environment that continues to be supportive of economic activity.

The transmission of the OPR normalisation in May 2011 to the wholesale and retail markets was rapid and sizeable. Money market rates adjusted immediately following the May OPR increase; the average overnight interbank rate rose from 2.63% on 5 May 2011 to 2.92% on 6 May 2011 and has since remained stable. Interbank rates of other tenures also increased. Kuala Lumpur Interbank Offered Rates (KLIBOR) and interest rate swap (IRS) rates rose in tandem with other money market rates, and continued to increase slightly after the OPR normalisation

Chart 2.9

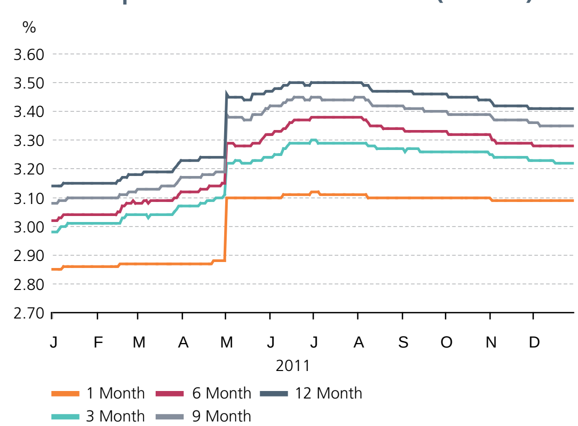
Average Overnight Interbank Rate



Source: Bank Negara Malaysia

Chart 2.10

Kuala Lumpur Interbank Offered Rate (KLIBOR)



Source: Bloomberg

in May, reflecting market expectations of further OPR increases. KLIBOR and IRS rates subsequently moderated beginning August 2011 as market expectations of further OPR increases were tempered given the uncertainties surrounding global growth and its implications for the Malaysian economy.

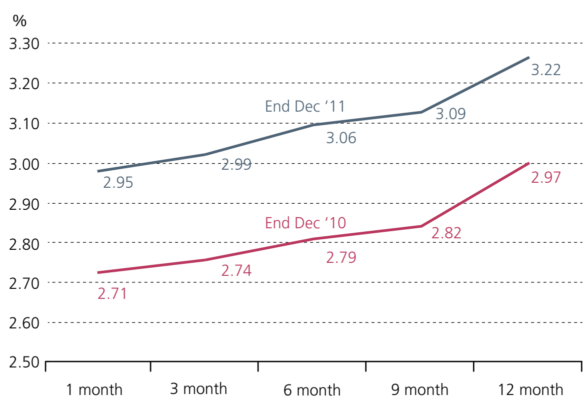
Interest rates have increased following the normalisation of the OPR, but continue to remain supportive of economic activity

The rise in the OPR resulted in an upward revision in retail deposit rates. Interest rates on fixed deposits rose by 24 to 27 basis points across tenures. The adjustment of fixed deposit rates was undertaken quickly, within ten days of the OPR increase in May.

Given the high OPR pass-through to money market interest rates, retail lending rates also adjusted upwards to reflect the higher cost of funds. The benchmark lending rate, as measured by the average base lending rate (BLR) increased by 27 basis points to 6.54% as at end-May 2011. Compared to previous adjustments, the magnitude of increase was 2 basis points higher than the OPR increase to also take into account the higher cost of financial intermediation following the increase in the Statutory Reserve Requirement (SRR). All domestic commercial banks adjusted their BLRs within eight days of the OPR increase.

Chart 2.11

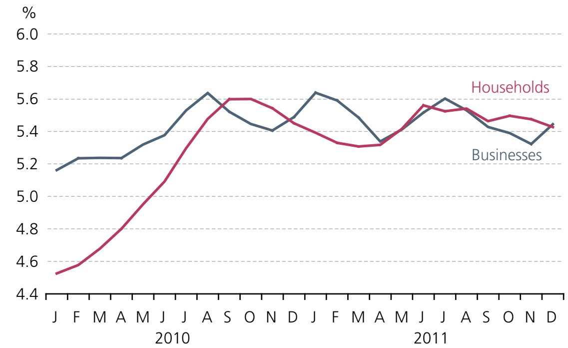
Fixed Deposit Rates



Source: Bank Negara Malaysia

Chart 2.12

ALR on New Loans Approved (3-month moving average)



Source: Bank Negara Malaysia

The impact on lending rates was uneven, with the size of the adjustment varying across loans by different purpose and sector. The average lending rate (ALR) on new loans for the purchase of residential properties, securities and personal use increased by 14, 11 and 27 basis points respectively from end-April to end-May 2011. In contrast, lending rates on hire purchase loans actually moderated during the year. However, this was mainly due to the moderation in the benchmark IRS rates, which is used to price hire purchase loans. Lending rates to businesses also experienced a smaller degree of pass-through, with the ALR on new business loans rising by 7 basis points, from 5.34% to 5.41% during the same period. This was the outcome of the strong competition in the loans market.

Movements in Malaysian Government Securities (MGS) yields in 2011 were primarily driven by external factors. In the first four months of the year, MGS yields trended upwards across all maturities. This was largely attributed to a combination of stronger growth prospects, higher inflationary pressures due to the surge in global commodity prices and expectations of an increase in the policy rate. From January to April 2011, the 5-year MGS yield increased by 15 basis points.

In the subsequent eight months of the year, however, bond yields reversed the upward trend on strong non-resident portfolio inflows into the bond market. The share of non-resident holdings of MGS to total outstanding MGS

Chart 2.13

MGS Yields

Source: Bank Negara Malaysia

increased to 36.9% in December 2011 from 28.3% in December 2010. As in the previous year, the high demand for MGS was driven by international portfolio funds searching for yield in an environment of surplus liquidity. Favourable growth and interest differentials, expectations of currency appreciation and the depth of the Malaysian bond market were key factors attracting these funds to Malaysia. Reduced market expectations of any increase in the policy rate in the second half of 2011, amid signs of slowing global growth and receeding inflationary pressures, also supported lower yields.

The downward trend in the yields was punctuated by two temporary episodes of rising yields. In May, short-term yields rose briefly in response to the increase in the OPR, with the 1-year MGS rising 12 basis points from 5 May to 11 May. There was also a brief upward surge in yields in September as heightened global risk aversion prompted a shift in non-resident portfolio flows towards more liquid, US dollar-denominated assets.

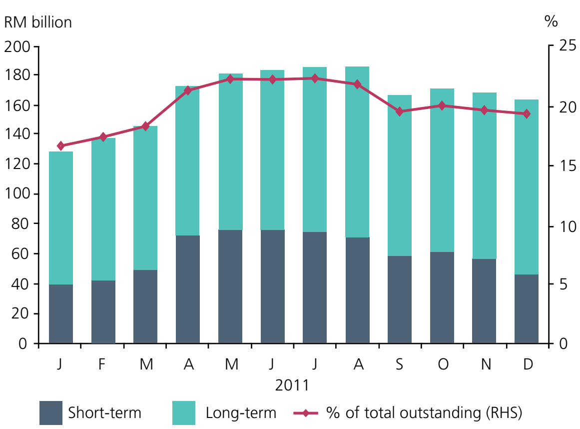
MGS yields remained low following strong external demand amid positive domestic growth prospects

This resulted in non-resident holdings of MGS declining from RM100.9 billion as at 24 August to RM92.7 billion as at end-September. The portfolio outflows were, however, temporary as measures taken by governments in the advanced economies to calm markets and restore confidence resulted in a resumption of portfolio inflows into emerging economies. This resulted in inflows into the domestic bond market. Overall, for the year, MGS yields declined by between 4 to 34 basis points. A larger decline was recorded for bonds of longer tenures, resulting in a further flattening of the benchmark yield curve in 2011.

Despite the volatility and stress in the international financial and credit markets, conditions in the

Chart 2.14

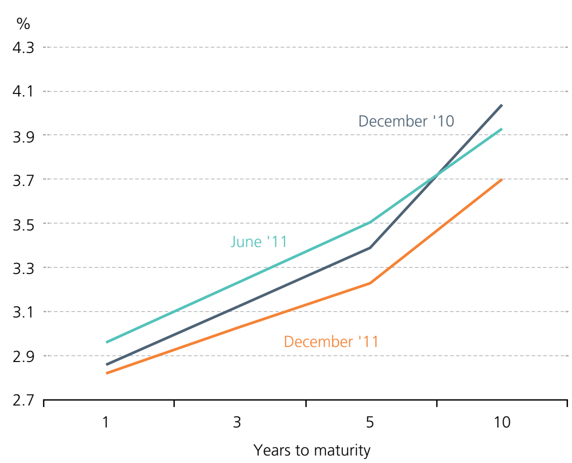
Outstanding Debt Securities Held by Non-Residents



Source: RENTAS, Bank Negara Malaysia

Chart 2.15

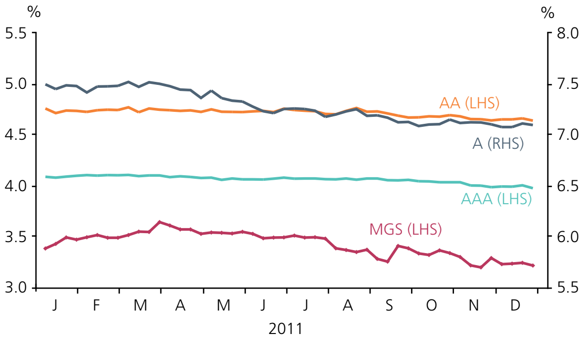
MGS Benchmark Yield Curve



Source: Bank Negara Malaysia

Chart 2.16

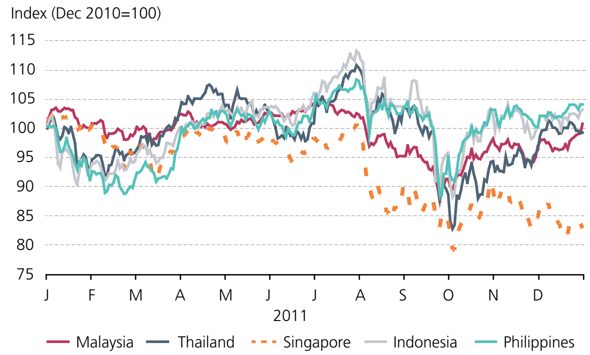
5-year MGS and 5-year PDS Yields



Source: Bank Negara Malaysia

Chart 2.17

Regional Equity Indices



Source: Bloomberg

domestic private debt securities (PDS) market remained robust. PDS yields were largely stable in 2011, with yields on the 5-year AAA and AA-rated papers recording a marginal decline of 9 basis points. As the size of non-resident holdings relative to the total size of the PDS market was small, PDS yields were mostly unaffected by the portfolio outflows experienced in the second half of 2011. Yields on lower-rated PDS, namely the 5-year A-rated paper, declined by 42 basis points, as domestic credit conditions improved, as reflected by the substantial decline in the number of negative rating actions during the year from 106 in 2010 to 51 in 2011.

Conditions in the PDS market were largely unaffected by the turmoil in international financial markets

Liquidity in the PDS market improved further, with total turnover in the PDS market increasing to RM112.3 billion in 2011 from RM89.3 billion in 2010. Of note, turnover in the second half of 2011 was higher than that in the first half, as there was a larger amount of new PDS issuances during the period. New PDS issuances increased to RM69.6 billion in 2011, from RM52.1 billion in 2010, reflecting the higher demand for financing arising from the Economic Transformation Programme (ETP) and infrastructure projects.

The FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) increased by 0.8% in 2011 (2010: 19.3%) to close at 1,530.7. Domestic equity prices rose in the first half of 2011 on strong domestic fundamentals. However, the upward trend was periodically interrupted by negative sentiments following unexpected geopolitical tensions and natural disasters in other regions. The disruption to the supply chain caused by these events proved, however, to be temporary, and the FBM KLCI recovered, recording an increase of 4% in the first half of 2011. In June, the FBM KLCI was upgraded from the Secondary Emerging Markets to Advanced Emerging Markets series for the FTSE Global Equity Index Series. The upgrade provided further support to the FBM KLCI as it recorded a new closing high of 1,594.7 on 8 July 2011.

Shifting investor sentiments and deleveraging contributed to volatility in regional equity markets

In the second half of the year, domestic equity prices were affected by concerns regarding developments in advanced economies.
The US debt-ceiling crisis led to a downgrade in its sovereign ratings, a first in history, which triggered a spike in global risk aversion and a large sell-off in global equities. This was followed by a further deterioration in the sovereign debt crisis in Europe that added downward pressure on equities. Increased investor uncertainty arising from these developments was reflected in the higher volatility of FBM KLCI returns in the second half of the year relative to the first half. The FBM KLCI bottomed in late-September before it tracked a slow recovery as investors reacted

Chart 2.18

Global Risk Aversion and Volatility of KLCI Returns

[1] Refers to VIX Index
[2] Refers to 30-day rolling standard deviation of daily returns

positively to measures taken in advanced economies to stabilise markets. Overall, the FBM KLCI declined by 3.1% in the second half of 2011.

For the first three quarters of the year, equity prices were supported by finance-related stocks as favourable domestic conditions continued to support growth in this sector. The last quarter of the year saw stocks of plantation companies experiencing a boost due to improving global commodity prices. The high turnover in the FBM KLCI reflected sustained interest in the domestic equity market. Continued Government efforts to liberalise certain sectors and divest its stake in government-linked companies (GLCs) further supported interest in the domestic equity market.

Liquidity and Monetary Aggregates

Liquidity conditions in the banking system remained ample throughout 2011. Private sector liquidity expanded strongly on account of sizeable capital inflows in the first half of 2011. Despite the episodes of large capital outflows in the second half of 2011, a net expansion in liquidity was recorded for the year as a whole. Consequently, Bank Negara Malaysia's monetary operations were focused on offsetting the impact of the flows on domestic liquidity and maintaining relatively stable domestic monetary conditions.

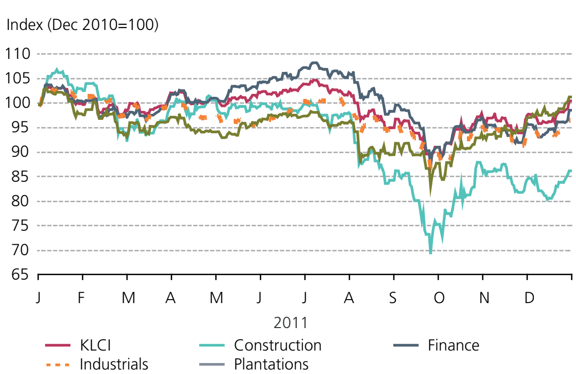
In the banking system, ample liquidity conditions prevailed at both the institutional and system-wide levels. Surplus liquidity placed with Bank Negara Malaysia increased by 18.8% in 2011, due mainly to the unprecedented scale of foreign inflows into the Malaysian financial system.

Bank Negara Malaysia conducted operations in the money market to manage the growth of liquidity arising from the inflows. The concern was that if not managed, the excessive build-up of liquidity could give rise to financial distortions including over-extension of credit to the private sector, mis-pricing of risk, and excessive risk-taking; all of which could result in excessive growth of leverage and the misalignment of asset prices. Accordingly, the inflows were sterilised through a wide range of instruments including direct borrowing, repurchase agreements (repos) and Bank Negara Malaysia bills. The Statutory Reserve Requirement (SRR) was also raised three times between January and May, from 1.00% to 4.00%, to provide longer term sterilisation of the liquidity.

Private sector liquidity, as measured by broad money or M3, exhibited a stronger growth of 14.4% during the year. The main impetus for

Chart 2.19

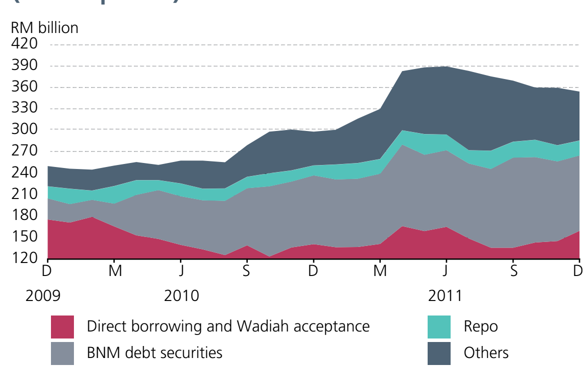
KLCI and Bursa Malaysia Sectoral Indices



Source: Bloomberg

Chart 2.20

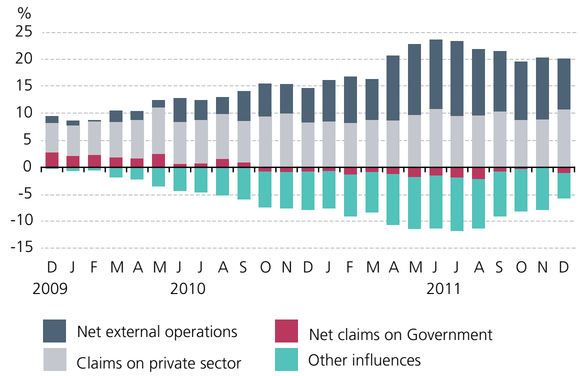
Outstanding Liquidity Placed with BNM (at end-period)



Source: Bank Negara Malaysia

Chart 2.21

Contribution to M3 Growth



Source: Bank Negara Malaysia

Chart 2.22

Broad Money, M3

Source: Bank Negara Malaysia

the increase in broad money was the significant capital inflows in the first half of the year. Broad money also increased throughout the year following higher credit extension by the banking system. The expansion in M3, however, was in part contained by Bank Negara Malaysia's sterilisation operations. This was reflected in the contraction of ``*other influences*´´. Capital outflows in the second half of the year also had a moderating impact on broad money growth.

FINANCING OF THE ECONOMY

Financing conditions remained supportive of economic activity in 2011. The reasonable cost of borrowing and ample liquidity conditions in the financial system sustained financing to all segments of the economy.

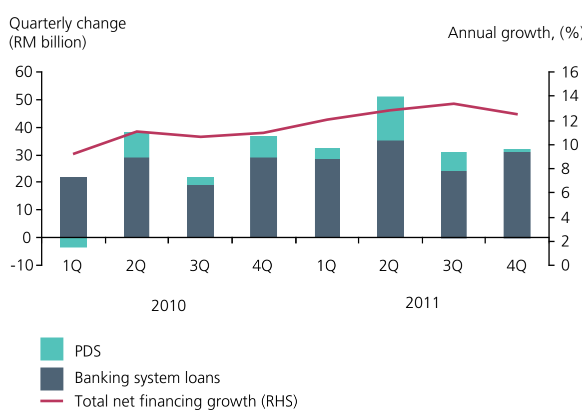
Private sector financing growth has trended upward since 2010 in line with the improved economic growth. For the year as a whole, net financing raised by the private sector through the banking system and the capital market expanded at a faster annual pace of 12.5% (2010: 10.9%). Robust private consumption, underpinned by the continued resilience of the domestic economy, contributed towards sustained demand for financing from both businesses and households.

Financing for consumption and investment supported the domestic economy

During the year, total financing extended through financial institutions and the capital market to the business sector recorded a marked improvement, growing by 11.5% (2010: 7.7%). Financing was extended mainly to the *finance, insurance and business services*; *real estate*; *manufacturing* and *wholesale, retail, restaurants and hotels* sectors. The increase in financing to businesses was driven by improved retail sales and higher investment activity in response to strong domestic demand. The expansion in banking system loans to businesses (2011: 13.5%; 2010: 9.4%) reflected the broad based increase in loans disbursed to finance the investment and working capital needs

Chart 2.23

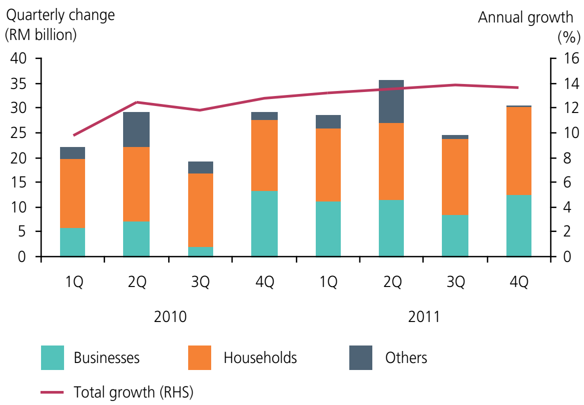
Total Net Financing to the Private Sector through Banking System Loans and PDS Issuances



Source: Bank Negara Malaysia

Chart 2.24

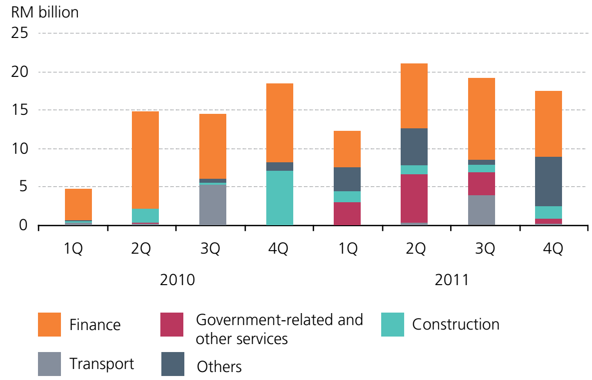
Loans Outstanding by Customers



Source: Bank Negara Malaysia

Chart 2.25

Gross PDS Issued by Sector



Note : Data excludes Cagamas bonds and issuances by non-residents

Source: Bank Negara Malaysia

of businesses, especially in the *manufacturing*; *real estate*; *wholesale, retail*, *restaurants and hotels*; and *transport*, *storage and communication* sectors. Despite the moderation in loan applications from the *manufacturing*; *wholesale, retail, restaurants and hotels* and *transport*, *storage and communication* sectors in the fourth quarter of 2011 following the more uncertain outlook for global growth, the overall demand for loans by businesses remained strong.

Business demand for funds from the capital market was also higher, with new issuances of private debt securities (PDS) amounting to RM69.6 billion in 2011 (2010: RM52.1 billion). The increase was due to several large-scale issuances, mainly by the *finance, insurance, real estate and business services* and *government-related and other services* sectors to fund working capital requirements and refinance debt. Financing via the equity market, however, declined to RM12.6 billion (2010: RM32.1 billion) as turbulent market conditions globally affected market sentiments domestically.

The demand for household loans was also sustained, with outstanding loans increasing by 12.9% in 2011 (2010: 13.4%), driven mainly by loans for the *purchase of residential and non-residential properties* and for *personal use*. The expansion in household loans reflected growing household consumption expenditure amid favourable income growth, positive employment prospects and improved consumer sentiments. Loan growth for the *purchase of passenger cars*, however, moderated to 6.0% in 2011 (2010: 7.3%) reflecting lower car sales during the year following supply disruptions stemming from the impact of natural disasters in Japan and Thailand.

Although the overall level of household debt and credit growth remained manageable, the Bank nevertheless adopted a pre-emptive approach in dealing with potential vulnerabilities and risks to macroeconomic stability. Several pre-emptive measures were instituted since end-2010 to ensure prudent levels of household debt and to mitigate potential risks of financial imbalances. Among the measures implemented were the maximum loan-to-value (LTV) ratio of 70% on third and subsequent housing loan facility taken out by borrowers, the new measures on credit cards to promote prudent financial management, introduction of the Financial Capability Programme by the Credit Counselling and Debt Management Agency (AKPK) to raise the level of financial literacy and new lending guidelines for financial institutions to promote prudent, responsible and transparent retail financing practices.

New Malaysian Currency Series

Introduction

The introduction of the third series of Malaysian coins and the fourth series of Malaysian banknotes marks yet another significant milestone for Bank Negara Malaysia as the sole currency issuing authority in Malaysia. Each of the banknote and coin series showcases the unique and distinctive aspects of the country. The latest banknote and coin series also incorporates numerous innovations and security features that are more technologically advanced than in the previous issuance of the coin series in 1989 and the banknote series in 1996.

The Third Series of Malaysian Coins

The third series of Malaysian coins was launched on 25 July 2011 and has been introduced into general circulation since 16 January 2012. The new coins, in denominations of 50 sen, 20 sen, 10 sen and 5 sen, will gradually replace the existing series, which has been in circulation since 1989. Themed 'Distinctively Malaysia', the new coins reflect the diversity and richness of Malaysia's national identity. The obverse side of all coins features fourteen dots to represent the thirteen states and the Federal Territory, while the five horizontal lines represent the five principles of the 'Rukun Negara' (national pillars), with exception of the 50 sen coin. The fine lines in the motif background of the new 50 sen coin are part of the security features. The different motifs featured on the reverse side of the respective denominations are as follows:

Denomination	Icon
50 sen	Pea tendrils motif
20 sen	Jasmine flower
10 sen	'Orang Asli' motif
5 sen	*Destar Siga*

50 sen

10 sen

20 sen

5 sen

In general, the new coins are smaller, lighter and more user-friendly. The new series of coins has been introduced in two colours – yellow and silver, with different features at the edge for easy recognition and differentiation. This design has been adopted bearing in mind the difficulties faced by the visually challenged.

The new coin series also embodies the latest minting technology that integrates improved anti-counterfeiting security features. The latest security features such as the latent image and indentions have been included in the new 50 sen coins to prevent counterfeiting and also to make authentication easier. The public will be able to see the lettering of the denomination "50" and "SEN" when the coin is tilted slightly. At the same time, the use of new metal alloys will extend the lifespan of the coins, with enhanced protection against wear and corrosion. The technical specifications of the new coin series are as follows:

Denomination	50 sen	20 sen	10 sen	5 sen
Alloy	Nickel Brass Clad Copper	Nickel Brass	Stainless Steel	Stainless Steel
Diameter (mm)	22.65	20.60	18.80	17.78
Thickness (mm)	1.92	1.75	1.50	1.12
Weight (gram)	5.66	4.18	2.98	1.72
Shape	Round with 9 indents	Round	Round	Round
Edge	Plain	Coarse	Milled	Plain
Colour	Yellow	Yellow	Silver	Silver

The Fourth Series of Malaysian Banknotes

The fourth series of Malaysian banknotes was officially launched by YAB Dato' Seri Mohd Najib Tun Haji Abdul Razak, the Prime Minister of Malaysia, on 21 December 2011. Similar to the third series of Malaysian coins, the latest series of Malaysian banknotes has been inspired by features that are distinctively Malaysia. The banknotes feature traditional expressions in art and craft, natural wonders, flora and fauna, the economy and the nation's traditions.

On the obverse side, all denominations of the new banknotes retain the portrait of the First Seri Paduka Baginda Yang di-Pertuan Agong, Tuanku Abdul Rahman ibni Tuanku Muhammad, the national flower *Rosa-sinensis* hibiscus (known locally as the 'Bunga Raya') and patterns of traditional woven fabric, the 'songket'. The different motifs featured on the reverse side of the banknotes are as follows:

Denomination	Icon
RM100	Kinabalu Park, Sabah and pinnacles rock formations of Gunung Api Valley, Sarawak
RM50	Oil Palm & Biotechnology
RM20	Hawksbill Turtle and Leatherback Turtle
RM10	*Rafflesia Azlanii* flower
RM5	Rhinoceros Hornbill bird
RM1	Moon Kite

The RM20 banknote has been re-introduced in this new series, after its first appearance in the second series in 1982, to serve as an intermediary denomination between RM10 and RM50 for greater convenience in making payments. The old RM20 was discontinued in the third series of the Malaysian banknotes.

The new security features that have been incorporated in the new banknote series include a pixel watermark portrait with a highlight numeral, micro lens thread and iridescent patch. For familiarity and easy identification, the Bank has also retained the existing security features which have proven to be effective, including the shadow image, clear window, colour-shifting security thread, perfect see-through registration, invisible fluorescent elements, intaglio printing and micro printing. The banknotes are printed in durable substrates to maintain a high level of durability and quality while in circulation. The technical specifications of the new banknotes are as below:

Denomination	Substrate	Size (mm)	Predominant Colour
RM100	Paper	150 x 69	Purple
RM50	Paper	145 x 69	Green-blue
RM20	Paper	145 x 65	Orange
RM10	Paper	140 x 65	Red
RM5	Polymer	135 x 65	Green
RM1	Polymer	120 x 65	Blue

The banknotes retain their existing sizes and predominant colours to facilitate easy handling of the new banknotes by the public. For the visually impaired, Braille features have also been retained.

The fourth series of Malaysian banknotes will be available for circulation in the second half of 2012. The RM50 banknote became the first denomination in the series to be introduced into circulation when it was launched on 21 December 2007, in conjunction with the 50th Anniversary of Malaysia's Independence.

Conclusion

Currency usually reflects the identity of a nation, showcasing its unique cultures, natural endowments and historical heritage. In keeping with its responsibility to provide high quality currency and ensure public confidence in the Malaysian currency, Bank Negara Malaysia has incorporated the latest technologies and enhanced the technical specifications of the currency to ensure longevity and higher quality. While counterfeiting has never been a significant issue, newer and better security features have been introduced, from time to time, as a pre-emptive measure to enhance the integrity of Malaysia's currency notes and coins.

The new currency series is legal tender and will co-circulate with the earlier series until the gradual process of phasing out of the older series is completed.