Monetary and Financial Conditions

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OVERVIEW

Following the widespread fallout from the US sub-prime crisis and the collapse of Lehman Brothers in September 2008, global monetary and financial conditions deteriorated in the first quarter of 2009. In the advanced economies, the crisis reached its peak in March 2009 and contributed to the worst global recession since World War II. Economic and financial conditions only stabilised in the second half of 2009 following unprecedented large scale interventions by the authorities in the advanced economies to support their financial system and revive the economy. Emerging economies were also adversely affected given the significant financial and economic linkages with the advanced economies. However, prompt fiscal and monetary stimulus mitigated the impact of the external shocks on the emerging economies.

As with many regional economies, Malaysia was adversely affected by the large contraction in external demand and the sharp decline in domestic financial asset prices as the worldwide deleveraging by investors caused large outflows of portfolio funds. Nevertheless, the implementation of two fiscal stimulus programmes, together with the easing of monetary policy, provided support for domestic demand. Additional measures to facilitate access to financing ensured that the environment was supportive of domestic consumption and investment. Meanwhile, the existence of a strong financial sector continued to support financial intermediation and reinforced the expansionary fiscal and monetary influences on domestic demand.

INTERNATIONAL MONETARY AND FINANCIAL CONDITIONS

Developments in international monetary and financial conditions in 2009 broadly followed three distinct phases. The first quarter of the year was characterised by turbulent financial market conditions amidst a severe global recession. This was followed by the stabilisation phase in the second and third quarters of the year, as the unprecedented scale of policy measures undertaken earlier in the year began to take effect. By the fourth quarter, economic and financial conditions stabilised and the expansionary impact of large fiscal and monetary stimulus led to a revival of growth.

After a tumultuous first quarter, the global monetary and financial conditions stabilised by mid-year and improved following the large scale fiscal support and unprecedented monetary stimulus in the advanced economies

In early 2009, monetary and financial conditions continued to deteriorate in the aftermath of the collapse of Lehman Brothers and the continued fallout from the excessive leverage in the US financial system. The broad-based loss of confidence arising from the Lehman episode led to heightened risk aversion which continued into the first two months of 2009. In many countries, liquidity conditions tightened amid significant sell downs and volatilities in the equity and bond markets.

Chart 2.1
Measures of Volatility*

*Chicago Board of Exchange (CBOE) Implied Volatility Index (VIX) and Merrill Lynch Option Volatility Estimate (MOVE)

Source: Bloomberg

Financial conditions were particularly dire in the advanced economies. In the first two months of the year, the S&P 500 equity index declined by 21.1% while the 3-month LIBOR less OIS spread, which measures the level of liquidity and credit risk in the interbank market, continued to remain elevated at levels indicating failures of financial intermediation. The dysfunctioning interbank markets severely impaired the financial intermediation process which in turn disrupted credit flows to the broader economy. This had significant repercussion on economic activity. The real sector plunged into a deep recession amid contracting consumption, investment and trade activity. Most advanced economies experienced a sharp contraction in economic activity in the first quarter, with the growth outlook being very bleak. The IMF's forecast for growth in 2009 for advanced economies was downgraded from 0.5% in October 2008 to -2% in January 2009. Key economic indicators, including industrial production and labour market conditions continued to deteriorate significantly and at a faster pace. The strong feedback loops between the real and financial sector meant that weaknesses in economic activity further intensified financial sector dislocations and vice versa.

The intensity of the problems in the financial and real sectors prompted a wide range of government interventions. These interventions were designed to restore the functioning of the financial and financial institutions, and to provide support to the real economy. To stabilise financial conditions, various conventional and unorthodox measures were implemented

Chart 2.2
Selected Equity Market Indices

Source: Bloomberg

including government guarantees, purchases of private sector assets, recapitalisation programmes and quantitative easing. This was strongly reinforced by sizeable fiscal stimulus programmes of between 1% to 6% of GDP by authorities in advanced economies, and monetary policy easing to provide support to growth. These policies, however, took some time to gain traction given the severity of the financial conditions.

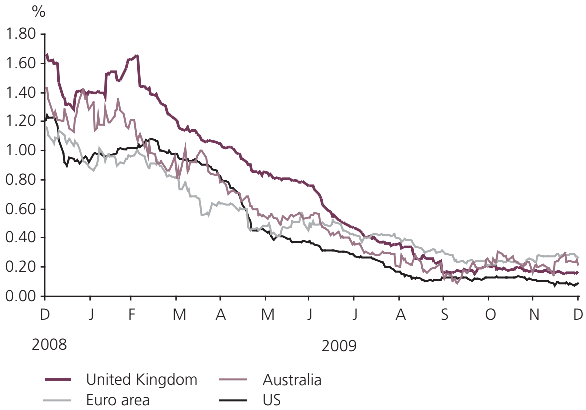
Meanwhile, despite minimal direct exposure to the sub-prime crisis and to the problems in the derivatives markets, financial markets in emerging economies were also significantly impacted given the financial inter-linkages with the major financial markets. The MSCI Emerging Index declined by 14.1% year-to-date in February as global deleveraging caused foreign investors to dispose their assets in emerging economies. As these funds were remitted back to the US, it resulted in large capital outflows causing the currencies of some emerging economies to depreciate by an average of 8.8% against the US dollar during the period.

Growth in open emerging economies was also impacted by the contraction in global trade following the collapse in external demand from advanced economies. Export growth for Hong Kong, Singapore and Malaysia fell by 21.1%, 20.7% and 15.7% year-on-year respectively at the end of the first quarter. In addition, the contraction in trade was intensified by a shortage of dollar liquidity in international financial markets, which affected trade financing.

Policy responses by authorities in emerging economies were rapid and generally aimed at mitigating the impact of the crisis from the advanced economies. The measures involved a combination of monetary and fiscal measures that included lowering interest rates to sub-normal low levels, improving access to financing and large fiscal spending. The strong overall initial conditions of emerging market economies as a group, their sound banking systems and fiscal flexibility, placed emerging economies in a better position to institute decisive and strong counter-cyclical measures in response to the crisis.

By the second quarter, there were visible signs of stabilisation in the financial markets coupled by some improvements in business and consumer sentiments. In the advanced economies, financial conditions began to show improvements as a result of the wide range of measures initiated by

Chart 2.3
Money Market Spreads*



* 3-month LIBOR less 3-month Overnight Index Swap (OIS)

Source: Bloomberg

the authorities. Interbank money market spreads declined considerably from the second quarter onwards, indicating that the additional liquidity provided to the financial markets were taking effect. The 3-month LIBOR less OIS spreads declined from an average of 101 basis points in the first quarter of 2009 to an average of 23 basis points in the third quarter of 2009.

The health of major financial institutions also improved as indicated by the positive results from the bank-wide stress tests to ascertain the solvency of financial institutions. The decline in credit default swaps of major banks in the US by almost one-third was a testament to the renewed confidence in the financial institutions. As conditions improved, financial markets rose steadily albeit at a cautious pace. Between March and May 2009, the S&P 500 index rose by 25.2%, recovering all of the losses incurred since the beginning of 2009. In the third quarter, volatility in the financial markets as proxied by the VIX index, dropped significantly and returned to levels prior to the collapse of Lehman Brothers.

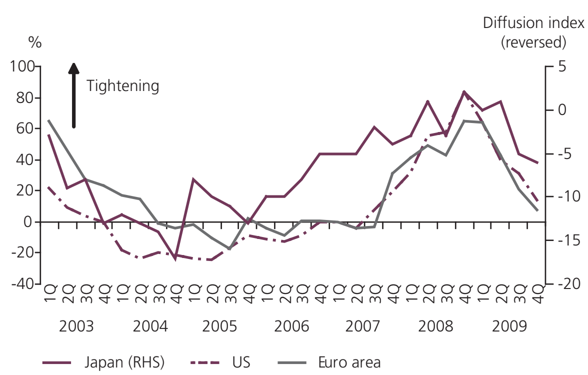
Though the measures had a positive effect on reducing stress in the financial markets and restoring the functioning of the markets, the underlying economic conditions in the advanced economies remained weak. Credit to the broader economy was still constrained as both lenders and borrowers remained cautious. Lending standards in major advanced economies remained tight. While key economic indicators were at depressed levels, there were however incipient signs that economic conditions were deteriorating at a slower pace. Nevertheless, as economic and financial conditions improved, questions lingered on the sustainability of the recovery given that the financial system remained impaired.

Emerging economies, in contrast, had shown firm indications of economic recovery by the second quarter of 2009. With stronger initial conditions and reinforced by comprehensive fiscal and monetary responses, emerging economies were able to recover at a faster pace. Given the strong signs of economic recovery, investors' risk appetites for emerging market financial assets rose. Equity markets in emerging economies rallied by an average of 61.6% compared to 36.2% in the advanced economies.

Chart 2.4
US Banks 5-year Credit Default Swaps (CDS)

Source: Bloomberg

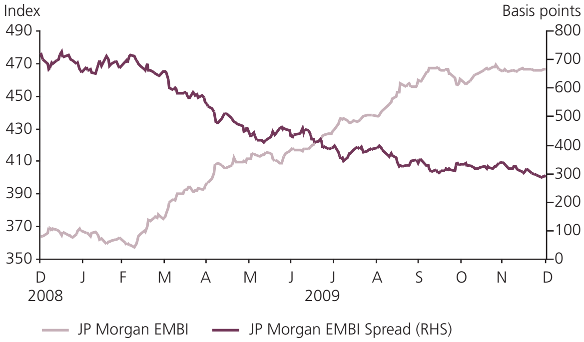
Chart 2.5
Bank Lending Conditions for Business*



*Based on Senior Loan Officer Survey conducted in selected countries

Source: Central Banks' Websites

Chart 2.6
Emerging Market Bond Index (EMBI) and Bond Spreads EMBI

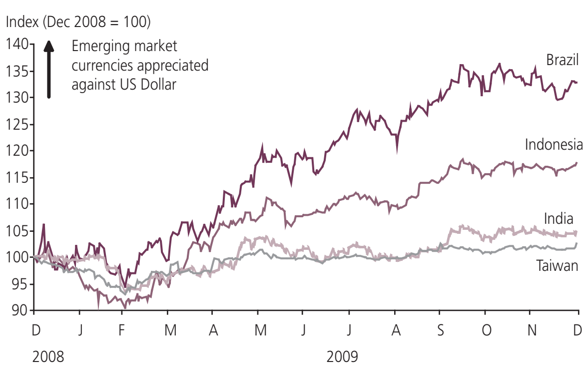


Source: Bloomberg

By the fourth quarter of the year, economic and financial conditions in both advanced and emerging economies showed visible and firm signs of recovery. This improved investor confidence and revived financial market trading activities globally. With the world awash with liquidity amid record-low interest rates globally, the search for yields led to a sharp increase in foreign portfolio inflows into emerging markets. As a result, emerging market currencies, in particular the Indonesian rupiah, Brazilian real and Korean won appreciated strongly by 17.7%, 33.0% and 10.0% respectively in 2009. Better recovery prospects and expectations of further currency appreciation also added to the interest towards emerging markets.

The surge in capital inflows, coupled with the uptrend in commodity and property prices, begun to raise concerns over the possible formation of asset price bubbles in emerging economies. Some emerging economies such as Brazil and Taiwan imposed restrictions on capital inflows to avoid undue volatility in the financial markets and to mitigate the impact on monetary conditions. These restrictions included a tax on flows into equity and fixed-income securities, as well as a ban on foreign investors placing their money in time deposits.

Chart 2.7
Emerging Market Currencies against the US Dollar



Source: Bloomberg

By the end of the year, stronger signs of recovery had emerged. This prompted discussions among policymakers on the need to review the policy stance. The exceptionally low interest rate environment implemented when the risk of a fundamental economic downturn was high needed to be realigned to avoid the risk of the build-up of financial imbalances. Thus, whilst remaining accommodative, a number of central banks including the Reserve Bank of Australia began to raise policy rates, with several others stated the intent to do so in the near future. The pace, timing and magnitude of policy rate adjustments would, however, differ across countries and regions given the disparities in economic and financial conditions across countries.

DOMESTIC MONETARY AND FINANCIAL CONDITIONS

The domestic monetary and financial conditions continued to remain favourable and supportive of economic activity in 2009 despite being subjected to adverse economic and financial shocks in the aftermath of the global financial crisis. Prompt policy response and the resilience of the banking sector and capital market ensured that the financial intermediation process functioned effectively and smoothly. Domestic conditions improved markedly towards year-end with firm indications of a sustainable recovery.

Exchange Rate

The ringgit performance during the year reflected the volatile developments in international financial markets. Early in the year, the ringgit and regional currencies faced intense depreciation pressure as the global financial and economic crisis were in full force. Nevertheless, the sell down of financial assets across the world eased by March 2009 following emerging signs of stabilisation in the international financial markets and in global economic activity.

The ringgit continued its depreciating trend into early-2009 as the full impact of the global financial crisis enveloped the global economy. Against the background of heightened market risk and as investors continued to deleverage to reduce their level of borrowings, assets in emerging economies were sold off. During this stressed financial environment, investor preference also shifted to holding cash to preserve capital. The consequent reversal of portfolio investments and the surge in the demand for US dollar as these funds were remitted to the US generated significant depreciation of currencies in the regional economies. The ringgit weakened to RM3.7255 against the US dollar on 2 March 2009, the lowest level since February 2006. The depreciation was, however, partly mitigated by the continued net trade surplus, which provided underlying support for the demand for ringgit. The strong international reserve position also instilled greater market confidence on the ability of Bank Negara Malaysia to maintain orderly market conditions despite the volatile global environment.

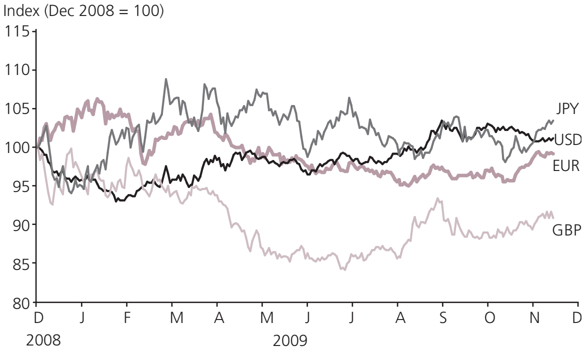
Despite the volatile global financial market conditions, the movement of the ringgit remained orderly and had an important role in absorbing external shocks to the domestic economy

The downward trend of the ringgit subsequently reversed in March 2009, following a confluence of external and domestic factors. The large scale expansionary measures undertaken by policymakers to arrest the global economic slide were instrumental in restoring confidence and stabilising global financial market conditions. These measures served to lift investor sentiment and risk appetite, and shifted their focus to the better outlook in the regional economies. The sound financial systems and stronger economic fundamentals amongst emerging economies point to prospects for an earlier and stronger recovery. These conditions attracted large portfolio flows into emerging markets and raised the demand for regional currencies including the ringgit. The ringgit also benefited from positive market reaction to the second stimulus package announced on 10 March. In addition, the accelerated implementation of the fiscal stimulus measures, the accommodative monetary conditions, the resilient financial system and the continued access to financing have further supported positive investor sentiments towards the domestic financial markets. Consequently, net portfolio inflows increased by RM13.3 billion in the second half of the year and the ringgit strengthened to RM3.3475 against the US dollar on 15 October, an appreciation of 11.3% from its lowest level recorded in early March 2009.

The ringgit, however, fluctuated within a broad downward trend from mid-October 2009 until the end of the year, amid greater market volatility arising from heightened and volatile global risk aversion. The imposition of capital controls in Brazil and Taiwan fuelled concerns that other central banks in the region could also move in the same policy direction, which dampened investors' risk appetite for regional markets. Market sentiments were also affected by concerns about the potential systemic impact of the debt crisis in Dubai and the sovereign debt issue in Greece. On balance, the ringgit ended the year at RM3.4245 against the US dollar, 1.2% stronger compared to the level at end-2008.

Against other major currencies, the ringgit appreciated against the Japanese yen (3.4%). The yen was particularly vulnerable to swings in carry trade activity. The ringgit ended the year marginally weaker against the euro (-0.9%) and more significantly against the pound sterling (-9.1%). To a large extent, the appreciation in

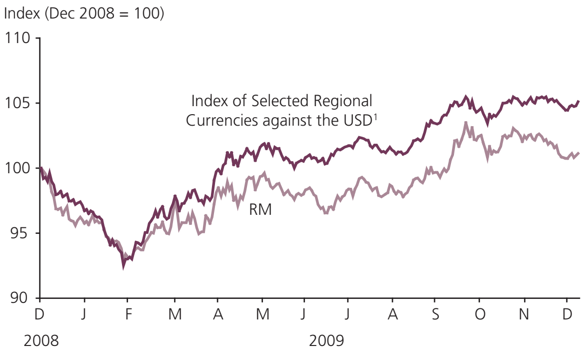
Chart 2.8
Exchange Rate of the Malaysian Ringgit (RM) Against Major Currencies



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

Source: Bank Negara Malaysia

Chart 2.9
Exchange Rate of the Malaysian Ringgit (RM) and Selected Regional Currencies Against the US Dollar

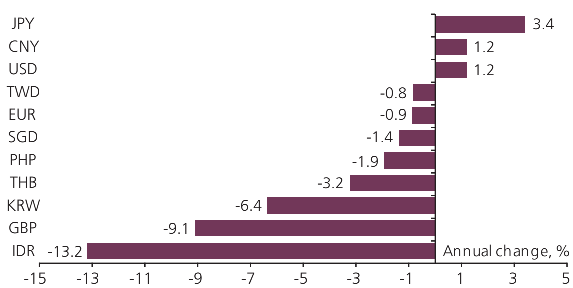


¹ Regional currencies: Chinese renminbi, Indonesian rupiah, Korean won, Philippine peso, Singapore dollar, New Taiwanese dollar and Thai baht. Each currency is of equal weight.

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 2.10
Summary of Malaysian Ringgit Performance Against Major and Regional Currencies in 2009



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

the pound sterling was a correction from the significant depreciation of the currency against most international currencies in 2008, after the UK economy was severely affected by the financial crisis.

In 2009, the ringgit was broadly weaker against regional currencies with this trend reversing in early 2010. Intra-regional exchange rate performance was differentiated by country-specific factors. In particular, the Korean won and the Indonesian rupiah strengthened significantly against most currencies, following positive market sentiments. Strong domestic demand contributed to Indonesia's relatively better economic performance. It also partly reflected recovery in both the Indonesian rupiah and Korean won from the large depreciation experienced in 2008. Between September 2008 and February 2009, the Indonesian rupiah and the Korean won had depreciated against the ringgit by 20.3% and 28.3% respectively. This provided greater appreciation potential for these currencies relative to other regional currencies when the global conditions improved.

The ringgit depreciated by 1% in Real Effective Exchange Rate (REER) terms during the year. The REER refers to the weighted average of the ringgit against the currencies of Malaysia's major trading partners, adjusted for differences in inflation rates. By and large, the depreciation of the REER during the year was due mainly to the broad depreciation of the Nominal Effective Exchange Rate (NEER), which also declined by 1% during the same period. Malaysia's prices relative to the major trading partners remained stable, as the pace of changes in prices of goods and services across countries decelerated in an almost synchronised manner amidst global disinflationary pressures.

The intensification of two-way movements of capital flows into emerging economies in an environment of an uncertain recovery of the global economy raised concerns of the potential risks to the trade sectors of these economies. In addition, strong financial inflows could become destabilising with the potential for a sudden reversal of these flows. To Malaysia's advantage, the country's capacity and resilience in managing these sizeable and volatile financial flows had been fortified in a number of ways. First, our economic fundamentals have remained healthy and the financial markets were more diversified and developed. This has enhanced the ability of the financial system to absorb capital inflows and outflows, thereby minimising disruptions while ensuring that the capital flows can be effectively intermediated. Second, the managed float regime accorded the necessary flexibility for the ringgit to adjust to changing conditions. Since exiting from the fixed exchange rate regime, the managed float regime has served the economy well by providing a good balance between flexibility and stability. Third, the ability to manage domestic liquidity has also improved significantly, supported by a wider range of instruments to conduct monetary operations and having in place better surveillance and information system. This ability to manage liquidity effectively meant that financial flows have limited impact on financial intermediation and the level of economic activity, including reducing the risk of the build-up of large imbalances in the economy.

Interest Rates, Bond Yields and Equity Prices
Interest rates in 2009 were lowered substantially to support a highly accommodative monetary policy. The thrust of monetary policy during the year was focused on mitigating the impact of the economic and financial crisis on domestic demand. In addition to the 25 basis points reduction in November 2008, the Overnight Policy Rate (OPR) was lowered by 75 basis points in January 2009, and a further 50 basis points in February 2009. To expedite the transmission of the policy rate reductions to retail rates, the Statutory Reserve Requirement (SRR) was also concurrently reduced from 4% to 1%. The monetary policy measures were transmitted quickly by the domestic financial system and had a material impact on the economy.

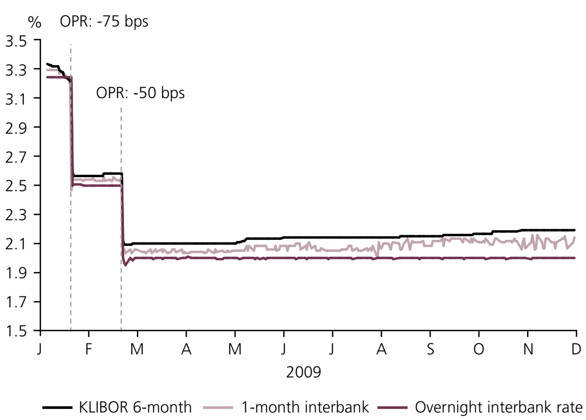
Sound financial institutions and stable liquidity conditions facilitated a rapid pass-through of the OPR reductions into lending rates

Following Bank Negara Malaysia's decision to reduce the OPR, the overnight interbank rate in the money market decreased from 3.25% on 1 January 2009 to 2.00% on 25 February with concurrent reductions in the interbank rates of other maturities. The high degree of pass-through from the OPR to the money market rates was supported by stable liquidity conditions in the interbank market. The sound financial institutions also underpinned orderly trading in the market, with little signs of market disruptions despite the volatile conditions in the global financial market. Accordingly, money market rates were stable and at historical lows during the year.

Reflecting the high pass-through of the OPR reduction to the money market interest rates, banks responded by lowering retail lending rates to households and businesses. The benchmark lending rate, as measured by the average base lending rate (BLR) of commercial banks, was reduced by 121 basis points, from 6.72% to 5.51%, by end-2009. This lowered the interest cost on variable rate loans pegged to the BLR, increasing the disposable income of borrowers. The adjustment in the BLR was transmitted quickly, with all banks lowering their respective BLRs within two weeks of the OPR adjustments.

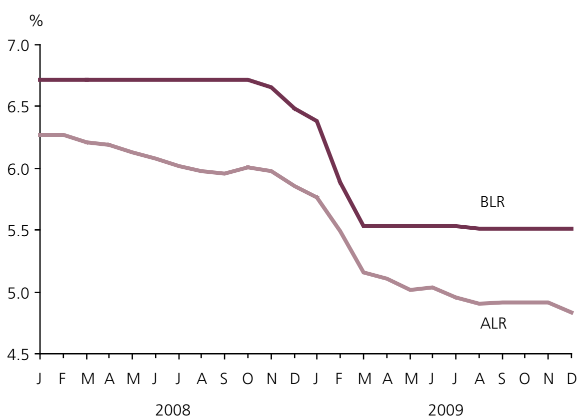
New borrowers also benefited from the low interest rate environment, as lending rates on new loans to both businesses and households were reduced. This was evidenced by the 127 basis points decline in the average lending rate (ALR) on new loans approved, from 6.17% in October 2008 to 4.90% in December 2009.

Chart 2.11
Money Market Rates



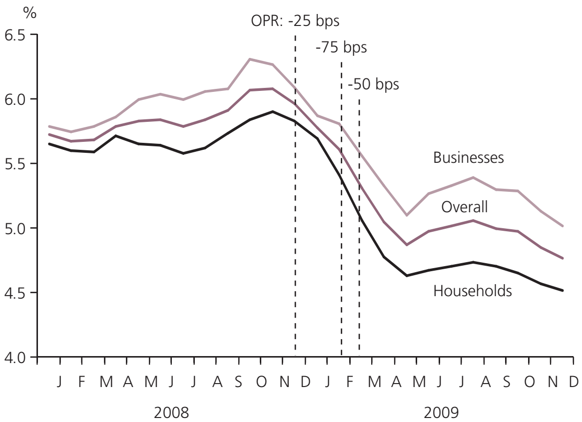
Source: Bank Negara Malaysia and Bloomberg

Chart 2.12
Commercial Banks' Lending Rates (at end-period)



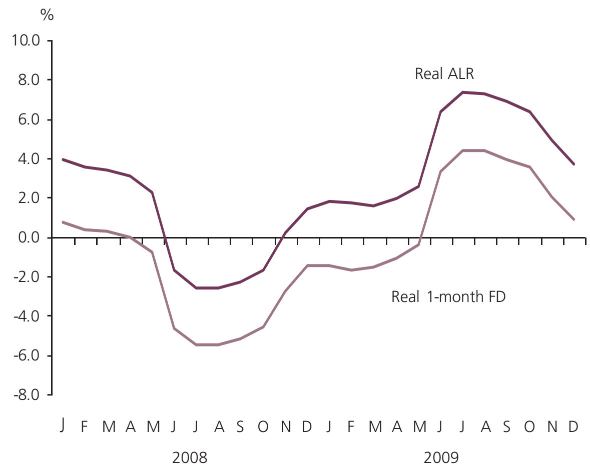
Source: Bank Negara Malaysia

Chart 2.13
ALR on New Loans Approved (3-month moving average)



Source: Bank Negara Malaysia

Chart 2.15
Real Deposit and Lending Rates

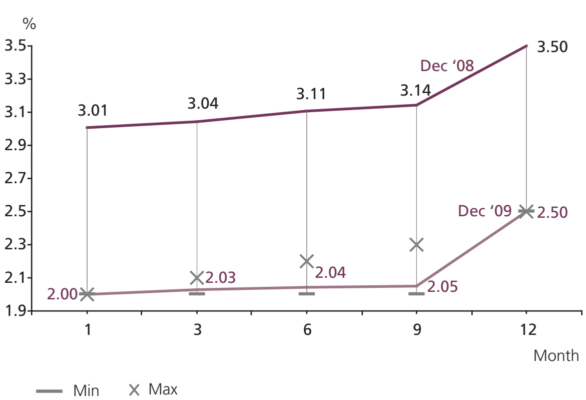


Source: Bank Negara Malaysia

The reduction in lending rates on new loans was broad based, with loans to all sectors of the economy registering lower interest rates after the OPR was reduced. With the re-pricing of new and existing loans, the ALR on loans outstanding stood at a historic low of 4.83% as at end-2009. The low interest rate environment, in turn, provided a supporting environment to financing activity.

Deposit rates were also adjusted downwards. Nevertheless, fixed deposit (FD) rates were supported by the floor imposed by Bank Negara Malaysia. As a result, the interest rates on FDs with tenures between 1 to 12 months ranged from 2.00% to 2.50%, at end-2009. Towards the middle of the year, depositors also received a positive real rate of return as inflation turned negative.

Chart 2.14
Commercial Banks' Fixed Deposit Rates



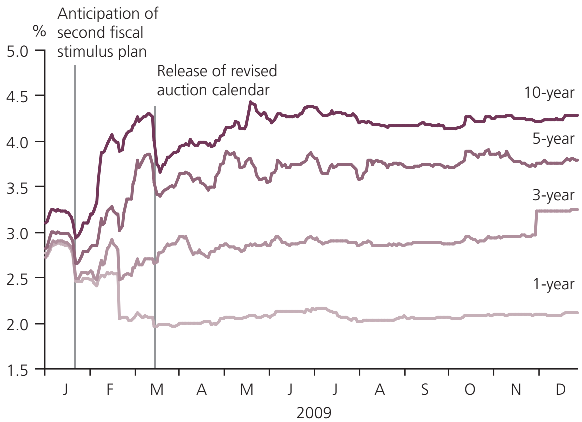
Source: Bank Negara Malaysia

Sovereign bond yields rose initially due to concerns on the large increase in the issuances of Government securities, but remained generally stable for the major part of the year as economic conditions improved amid a benign inflation outlook. Trading activity was mainly focused on the shorter end of the market, reflecting investors' cautious sentiments.

MGS yields were stable for most part of 2009

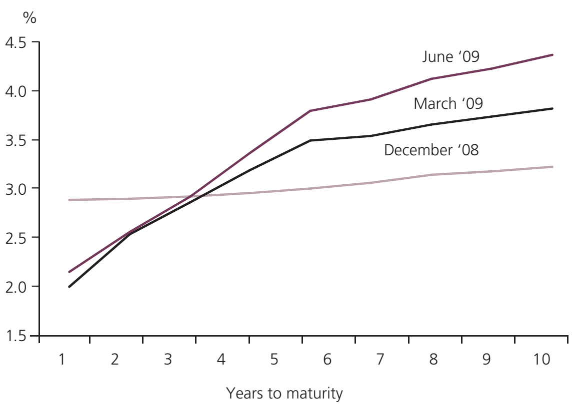
Yields on Malaysian Government Securities (MGS) were initially on a declining trend in early 2009 due to heightened risk aversion among investors as the outlook for the global economy deteriorated. The reduction in the OPR on 21 January added further impetus to the downward trend in MGS yields, amid expectations that inflation was moderating. The declining trend, nevertheless, reversed following the Government's announcement to introduce a second stimulus package. Market soon became anxious about the size of the stimulus and the potential additional issuances of Government securities. As these concerns mounted, MGS yields rose markedly, particularly those for the longer maturities. The 5-year and 10-year MGS increased by 106 and 116 basis

Chart 2.16
MGS Yields



Source: Bank Negara Malaysia

Chart 2.17
MGS Benchmark Yield Curve



Source: Bank Negara Malaysia

points respectively between end-January to mid-March. The reduction in the OPR in February provided only a temporary downward effect, as MGS yields continued to rise on concerns over the potential large size of new Government borrowings.

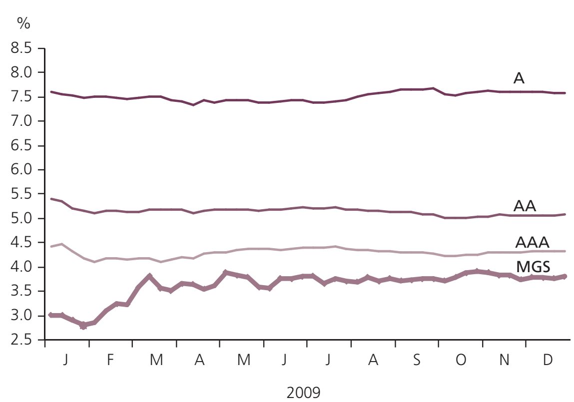
MGS yields fell by end-March as such anxieties dissipated following the release of a revised auction calendar for Government securities. Investors, nevertheless, remained broadly cautious given the continued uncertainty on the macroeconomic outlook and tended to focus on securities of shorter maturities. This led to the reduction of liquidity at the longer end of the MGS yield curve, thus exerting upward pressure on long-term yields. In turn, following the stronger interest in the shorter-tenure MGS, the 1 and 3-year MGS yields rose only marginally by 15 and 6 basis points respectively between end-March and end-June, resulting in a further steepening of the slope of the yield curve.

By end-June, market sentiments began to improve amid investors' easing concerns over the larger supply of Government securities. The upward pressure on long-term yields also began to ease. MGS yields across all maturities became more stable thereafter and through most of the second half of 2009. Towards year-end, MGS yields trended slightly higher on firmer expectations of an economic recovery driven by news of better economic data on trade and industrial production. In December, the 3-year MGS yields recorded an increase of 26 basis points following the issuance of the new 3.5-year MGS, which replaced the previous 3-year MGS as the new benchmark. The higher yields mainly reflected the slightly longer maturity of the new benchmark.

PDS yields affected by risk aversion

In the private debt securities (PDS) markets, yields were mainly affected by investors' increased risk aversion. Factors such as investor concerns over credit conditions significantly influenced the yields of lower-rated PDS. Concerns over deteriorating credit conditions were amplified by the rising number of negative rating actions, especially in the first half of 2009. The heightened risk aversion led to a low level of

Chart 2.18
MGS and PDS Yields (5-year)



Source: Bank Negara Malaysia

liquidity in the PDS market, which pushed the yields of lower-rated PDS higher.

Mirroring the trend in the MGS market, liquidity in the PDS market improved as sentiments became better towards end-July. The establishment of Danajamin Nasional Berhad, a financial guarantee institution that provides credit guarantees to selected issuers, also contributed to the improved sentiments in the bond market. Lower-rated PDS yields, however, registered only a marginal improvement towards the end of the year due to lingering credit concerns.

Credit spreads for PDS narrowed in 2009. This may initially have seemed counter-intuitive in an economic downturn. Nevertheless, further analysis revealed that earlier in the year, credit spreads narrowed following higher MGS yields, as markets anticipated more issuances by the Government. Subsequently, relative stability returned to both the PDS and sovereign markets as the economic and financial outlook improved. Credit spreads were generally stable in the second half of the year. For the year as a whole, credit spreads for higher-rated securities (5-year) fell by between 96 to 104 basis points.

Chart 2.19
Turnover of Corporate Debt Securities

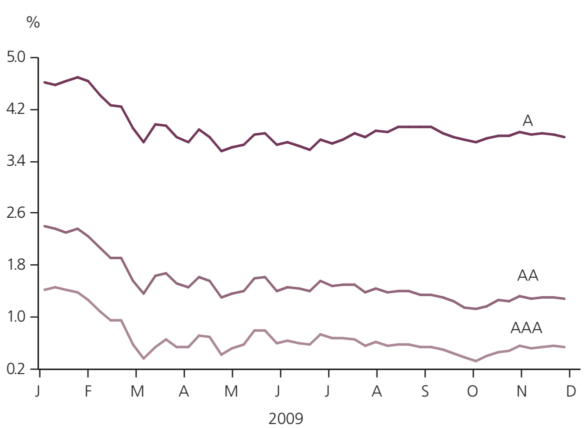
Source: Bank Negara Malaysia

Firmer signs of economic improvement spurred the equity market

In the early part of the year, the domestic equity market experienced bouts of volatility amid highly challenging domestic and global conditions. Subsequently, from the second quarter, equity markets around the world including Malaysia staged a strong rebound from the depressed levels in early 2009 as investors turned opportunistic amid highly accommodative monetary conditions and stabilising financial markets. Risk appetite improved further on the improving outlook for economic revival as the fiscal stimulus began to support economic activity.

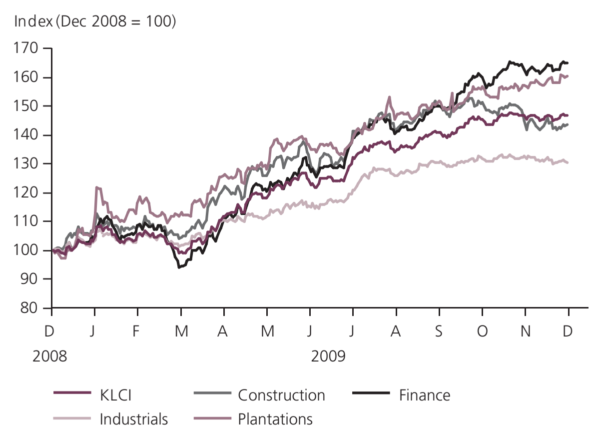
The domestic equity market experienced significant volatility in the early part of the year amid heightened uncertainties in the global

Chart 2.20
Corporate Credit Spread Against MGS (5-year)



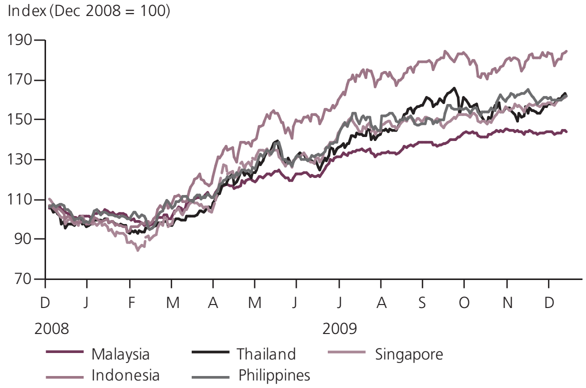
Source: Bank Negara Malaysia

Chart 2.21
KLCI and Bursa Malaysia Sectoral Indices



Source: Bloomberg

Chart 2.22
Regional Indices

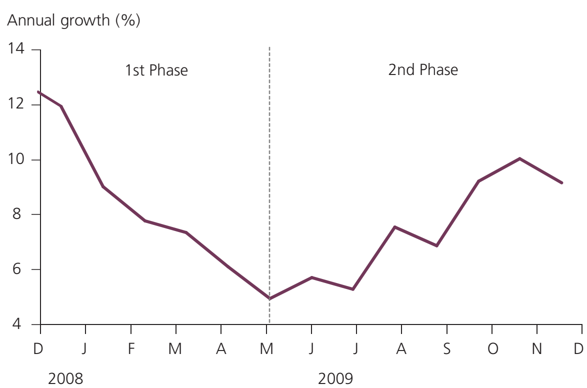


Source: Bloomberg

financial markets. The benchmark FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) reached a low of 838.4 points on 12 March but began rising, albeit modestly, from end-March 2009. This was supported by the rise in commodity prices which boosted the plantation and oil and gas-related stocks. In addition, domestic participation increased as market sentiment began to improve.

In the second half of 2009, regional equity markets including Bursa Malaysia was lifted further by the reallocation of global funds to emerging markets, including Asia, on optimism for a stronger pace of economic recovery. Equity prices were further boosted by improving corporate earnings outlook. The announcement by the Government of the liberalisation of the services and financial sectors and efforts to increase liquidity of the stock market by Bursa Malaysia also provided additional impetus to the market. For the year as a whole, the FBM KLCI rose by 45.2% (2008: -39.3%).

Chart 2.23
Broad Money, M3



Source: Bank Negara Malaysia

Liquidity and Monetary Aggregates

Liquidity conditions were ample throughout 2009 and supportive of economic activity. Private sector liquidity was affected by global and domestic credit conditions. This was largely due to the deleveraging activities of international financial institutions, which caused the outflow of funds from Malaysia. As such, private sector liquidity, as measured by broad money, exhibited two distinct stages in 2009.

Between January and May, lending by banks to businesses and households moderated, reflecting the slowdown in economic activity that affected the demand for credit. The impact of slower credit growth on broad money was compounded by the contractionary impact of net foreign outflows

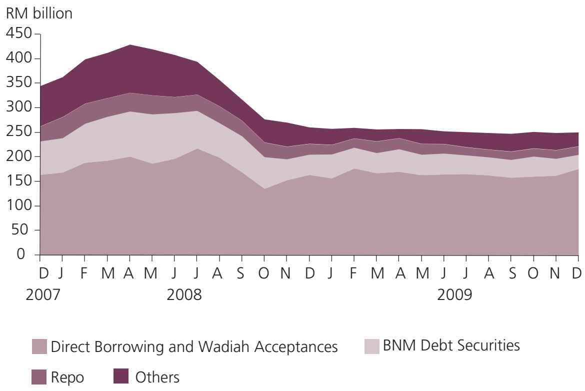
Table 2.1
Broad Money, M3

	Change (RM billion)	
	2009	
	1H	2H
M3	**18.6**	**66.5**
Currency in circulation	0.5	2.6
Demand Deposits	1.7	13.0
Broad Quasi-Money	16.5	51.0
Fixed deposits	*17.5*	*5.7*
Savings deposits	*5.7*	*4.4*
NIDs	*-1.2*	*-7.6*
Repos	*0.0*	*0.9*
FX deposits	*1.2*	*14.1*
Other deposits	*-6.7*	*33.5*
Determinants of M3		
Net claims on Government	11.5	14.2
Claims on the private sector	10.8	40.7
Loans	*12.3*	*34.7*
Securities	*-1.5*	*6.0*
Net foreign assets*	-0.4	12.1
*Bank Negara Malaysia**	*-6.0*	*2.7*
Banking system	*5.6*	*9.4*
Other influences	-3.3	-0.5

* Pre-revaluation of the international reserves

Source: Bank Negara Malaysia

Chart 2.24
Outstanding Liquidity Placed with Bank Negara Malaysia (at end-period)



Source: Bank Negara Malaysia

on domestic liquidity. These factors, however, were partially mitigated by the Government fiscal spending which supported broad money growth throughout the year. The expansion in broad money moderated in the first half of the year, growing at an annual pace of 5.7% in June.

Subsequently, the broad money trend reversed to grow at a faster annual pace. The turnaround in broad money reflected the improvement in the domestic and external economic and financial environment. Financing by the banking system to the private sector picked up, reflecting the recovery in economic activity and was supported by the low interest rate environment. In addition, broad money also expanded in the second half of the year due to net foreign inflows. Broad money ended the year with a higher rate of growth of 9.2% in December.

Bank Negara Malaysia conducted monetary operations in the domestic money market to ensure liquidity in the banking system remained ample. Compared to 2008, however, liquidity conditions in the interbank money market in 2009 were far more benign. Outflows of liquidity following foreign selling of domestic assets, which continued from 2008 into the first quarter of 2009, were offset by the release of liquidity absorbed by Bank Negara Malaysia. In this respect, the large interbank placements with the Bank acted as a liquidity buffer for the banking system. For the remainder of the year, liquidity in the interbank market was ample and relatively stable.

While the size of the surplus liquidity was reduced by foreign portfolio outflows, banking system liquidity, nonetheless, remained in surplus. This was evident from the loan-deposit ratio, which ranged between 77.7 in January and 77.9 in December. At the institution level, all banks operated from a position of surplus liquidity with net placements of funds with the Bank. The large number of institutions with surplus liquidity was one of the factors underpinning the resilience of the banking system as a whole.

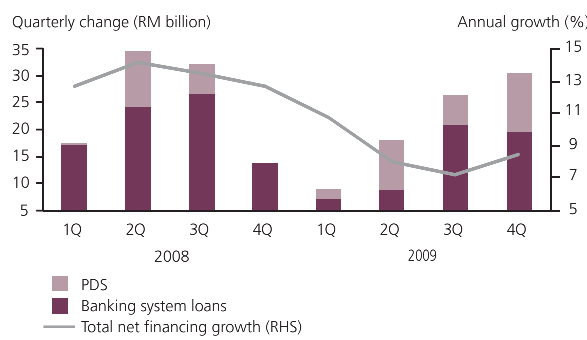
Bank Negara Malaysia also reduced the level of required reserves that banks hold against eligible liabilities from 4% to 1%. While this move increased the liquidity available to banks, Bank Negara Malaysia's main motivation for cutting the SRR was to reduce the cost of intermediation in the banking system. As a result, banks were able to pass on a larger share of the OPR reduction through reductions in their retail lending rates.

FINANCING OF THE ECONOMY

Financing conditions in 2009 remained conducive and supportive of economic activity. The sound banking system and functioning capital markets, coupled with historically low interest rates and ample liquidity, ensured that financing activity continued to expand.

Growth of private sector financing was slower in the early part of the year in tandem with the general weakness in the economy. Financing, nevertheless, gained momentum towards the second half of the year, supported by lower lending rates and extensive measures put in place to ensure continued access to funds for all sectors of the economy. In addition, the resumption

Chart 2.25
Total Net Financing to the Private Sector through Banking System Loans and PDS



Source: Bank Negara Malaysia

of growth in the fourth quarter of the year contributed to increased demand for financing. For the year as a whole, net financing to the private sector raised through banking system loans and PDS rose by 8.5% (2008: 12.7%).

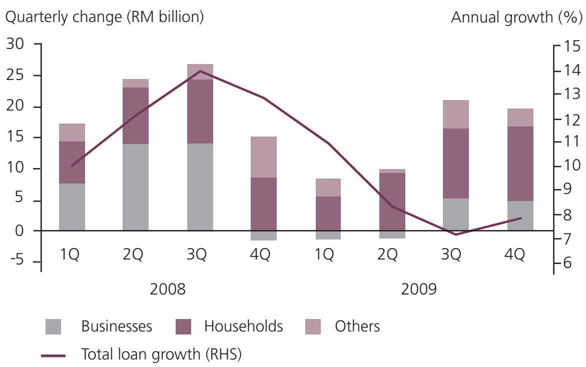
The lower cost of borrowing and continued availability of financing supported the financing requirements of businesses and households

During the year, higher loans extended to the household sector were underpinned by both the lower cost of borrowings and the availability of financing in a competitive environment. From the demand side, the lower interest rates provided the opportunity for households to refinance loans contracted earlier at higher rates, including housing, personal and credit card loans. For new housing loans, demand was also augmented by measures announced by the Government in the first and second stimulus packages to promote home ownership. These measures included a 50% stamp duty exemption extended to loan agreements for the purchase of houses up to RM250,000, as well as tax relief of up to RM10,000 a year for three years on interest paid on housing loans. Towards the second half of the year, households' financing were further supported by improvement in consumer sentiments and labour market conditions.

From the supply side perspective, banking institutions placed greater focus on the lending to households as economic slowdown clouded the outlook for businesses. Many banks offered more attractive packages for the refinancing of housing loans and promoted transfers of credit card balances. Banks also lowered rates on newly approved personal loans to an average of 6.31% (2008: 7.72%). As such, notwithstanding the moderation in economic activity, household loans outstanding rose by 9.8% in 2009 (2008: 9.7%), accounting for a higher share of total loans outstanding at 55.1% (end-2008: 54.1%). More loans were extended for the *purchase of residential* and *non-residential properties, personal use, purchase of passenger cars* and *purchase of securities.*

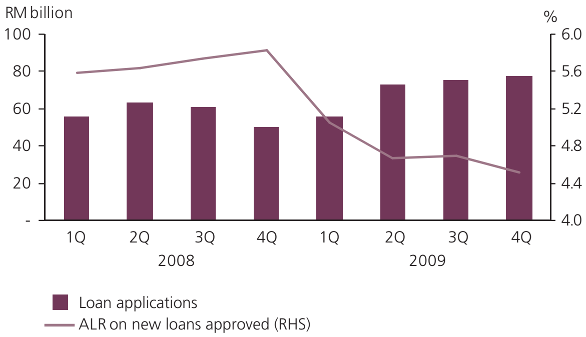
Loans extended to individuals for the *purchase of securities* expanded at a faster pace of 24.5%. This trend was in tandem with the rally in the stock market. However, the overall volume of loans

Chart 2.26
Loans Outstanding by Customers



Source: Bank Negara Malaysia

Chart 2.27
Households: Loan Applications and ALR on New Loans Approved*



* Exclude credit cards

Source: Bank Negara Malaysia

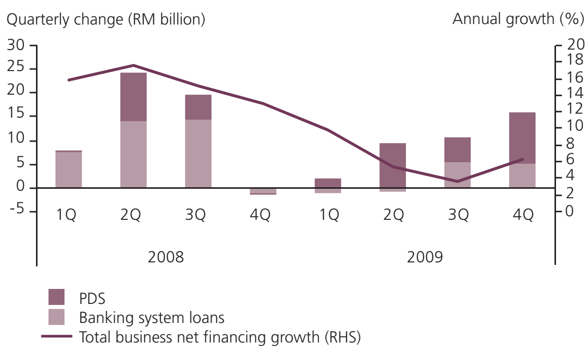
Chart 2.28
Households: Loans Outstanding for the Purchase of Securities and KLCI Index

Source: Bank Negara Malaysia and Bloomberg for the *purchase of securities* remained small, accounting for only 4.8% of household loans and 2.6% of total loans at end-2009.

Notwithstanding the increase in debt, the household sector's balance sheet improved as evidenced by the decline in household debt to liquid financial asset ratio. The ratio of non-performing households' loans over loans outstanding also remained low at 3.1% (end-2008: 4.1%). To ease the loan repayment burden of households, the banking institutions actively undertook debt restructuring and rescheduling. In addition, the Government announced in March 2009 a one-year moratorium on housing loans for retrenched workers.

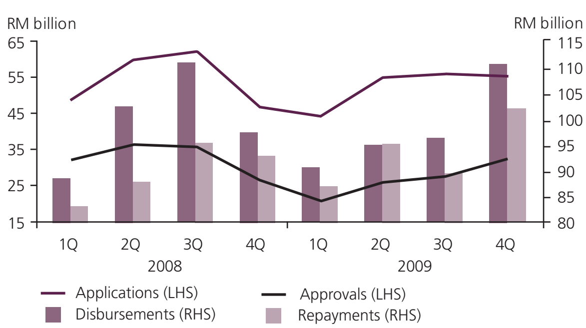
In contrast to the household sector, the growth in financing to the business sector was more moderate. Net financing extended to the business sector through the banking system and the PDS market increased by 6.3% (2008: 12.9%). The slowdown in global and domestic demand clearly affected business profitability. Consequently, some businesses scaled down their operational capacity and postponed their expansion plans, reducing their demand for financing for their working capital requirements and investment activities. As such, loan applications from the business sector contracted by 2.8% in 2009 (2008[1] : +0.8%).

Chart 2.29
Businesses: Net Financing through Banking System Loans and PDS



Source : Bank Negara Malaysia

Chart 2.30
Businesses : Loan Indicators



Source: Bank Negara Malaysia

For a brief period in the early part of the year, some businesses faced difficulty in accessing financing from the banking system and the capital market. This reflected the more cautious stance by both banks and investors in the PDS market due to the perception of the increased risk of borrowers due to the weaker economic conditions.

Recognising that access to financing is paramount to support the recovery process, the authorities intensified efforts to ensure the continued flow of financing to all segments of the economy. Towards this end, several measures were introduced by Bank Negara Malaysia and the Government, including the setting up of several special funds for the SMEs and the establishment of Danajamin Nasional Berhad to provide financial guarantees for the issuances of private debt securities and Sukuk by those companies assessed to be viable. The Bank continued to initiate active dialogues between the private sector and banking institutions to understand the development in the international and domestic environment. Avenues to seek help and redress established by the Bank and the Association of Banks in Malaysia (ABM)[2] also had a major role in enabling businesses and individuals to address enquiries relating to banking services and credit issues.

These measures yielded positive results. Financing conditions for the business sector improved from the second quarter onwards. In the third quarter, loans outstanding to businesses registered a quarterly expansion after three consecutive quarters of contraction. Higher loans were disbursed to

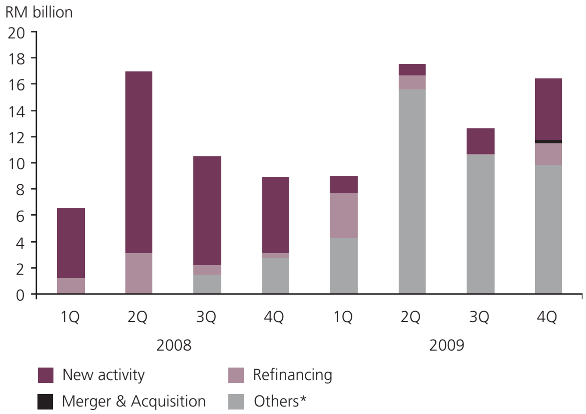
[1] The growth rate for 2008 excluded one large loan extended in 2007 for a privatisation activity

[2] Bank Negara Malaysia established the enhanced Integrated Contact Centre comprising BNM Link and BNM Telelink that includes the Complaints Management and Advisory section in July 2008. The Association of Banks in Malaysia (ABM) in collaboration with banking institutions also set up the *ABMConnect* Toll Free Channel in December 2008.

the *manufacturing, construction, wholesale and retail trade, restaurants and hotels* as well as the *agriculture* sectors. In the capital market, improved market sentiments also contributed to higher liquidity in both the PDS and equity markets.

The developed capital market provided a more diversified source of financing for the larger businesses. In 2009, fund-raising activity in the capital market was particularly active, accounting for 82.5% of total net financing raised by the business sector (including issuances of equity)

Chart 2.31
Gross PDS Issued by Purpose

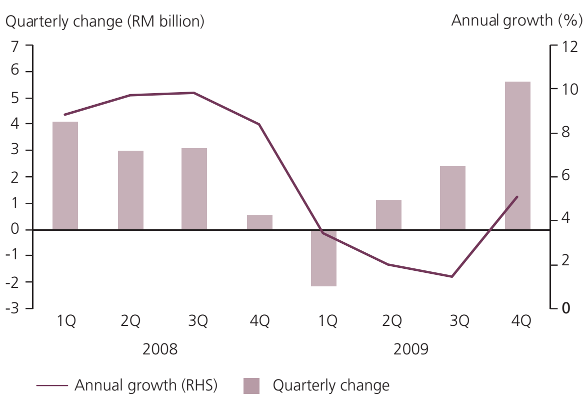


*Others include financing for working capital, equity investments and general business activities.

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

Source: Bank Negara Malaysia

Chart 2.32
SMEs Loans Outstanding*



* Adjusted to include the reclassification of SMEs to large corporations

Source: Bank Negara Malaysia

(2008: 37.9%). In the PDS market, gross issuances increased by 30.9% in 2009, coming mainly from large government-linked companies and financial institutions. The bulk of the PDS issued during the year were to fund working capital requirements, refinance debt and for equity investments. Meanwhile, funds raised in the equity market amounted to RM26 billion (2008: RM5.5 billion). The significantly larger funds raised reflected issuances of several large rights issues and initial public offerings (IPOs).

For the SMEs and micro enterprises, financing was primarily sourced from the banking institutions and development finance institutions (DFIs). In 2009, loans outstanding to the SMEs contracted slightly. This mainly reflected the exclusion of a number of companies from the SMEs classification as they have grown beyond the definition of SME. Without such exclusion, SMEs loans outstanding would have increased by 5.1% in 2009. As at end-2009, SMEs loans outstanding accounted for 39.6% of total business loans of the banking system and development finance institutions.

Financing to SMEs was augmented by special funds established by the Bank and the Government. During the year, there were a total of three new funds set up to facilitate SMEs' access to financing. Firstly, the SME Assistance Guarantee Scheme (SAGS) was established in February 2009 with an allocation of RM2 billion to provide access to financing for viable SMEs that were adversely impacted by the economic slowdown. The fund was fully utilised and closed to applications in September 2009 after benefiting more than 9,000 SMEs from various sectors. Meanwhile, the Working Capital Guarantee Scheme (WCGS) and the Industry Restructuring Loan Guarantee Scheme (IRLGS) were both established in March 2009, with an allocation of RM5 billion each. Subsequently, in September 2009, due to the overwhelming response from borrowers, the Government reallocated RM2 billion from the IRLGS to WCGS. The WCGS, which was closed for new applications in October 2009, has benefited 5,329 companies. As at 4 March 2010, a total of RM5.4 billion in loans had been disbursed to 4,339 companies under this scheme. The IRLGS will continue to remain open until end-2010 or until the fund has been fully utilised, whichever earlier. As at 4 March 2010, 190 companies have benefited from this scheme with RM815 million worth of loans being approved.

Table 2.2
Special Funds for SMEs Administered by Bank Negara Malaysia

	RM million				%
	Allocations	Approvals	Disbursements	Loans Outstanding	Utilisation Rate[1]
	As at end-2009				
Special Funds					
Fund For Food[2]	1,300.0	1,727.9	1,707.1	175.7	75.4[3]
New Entrepreneurs Fund 2	2,850.0	3,741.6	3,507.4	2,181.8	89.6
Fund for Small and Medium Industries 2	6,750.0	12,813.8	12,017.4	4,823.8	91.9
Bumiputera Entrepreneurs Project Fund[4]	300.0	946.7	903.4	54.6	82.4
Micro Enterprise Fund	200.0	79.6	71.2	66.9	38.9
Bumiputera Entrepreneurs Project Fund - Islamic	300.0	12.6	0.3	0.3	4.2
Total	**11,700.0**	**19,322.2**	**18,206.8**	**7,303.1**	**87.6**
Financial Assistance and Guarantee Schemes					
SME Assistance and Modernisation Facilities[5]	1,200.0	1,076.0	975.6	779.9	
SME Assistance Guarantee Scheme[6]	2,000.0	1,889.0	1,218.7	1,093.6	
Working Capital Guarantee Scheme[7, 8]	7,000.0	7,000.0	5,127.9	1,379.9	
Industry Restructuring Loan Guarantee Scheme[7]	3,000.0	779.7	210.6	46.3	
Total	**13,200.0**	**10,744.7**	**7,532.8**	**3,299.7**	
	Change during the year				
Special Funds					
Fund For Food[2]	-	-2.5	0.1	-80.0	
New Entrepreneurs Fund 2	-	197.1	155.9	-80.1	
Fund for Small and Medium Industries 2	-	880.0	1,123.8	-148.4	
Bumiputera Entrepreneurs Project Fund[4]	-	46.8	89.2	-24.9	
Micro Enterprise Fund	-	75.4	68.9	64.5	
Bumiputera Entrepreneurs Project Fund - Islamic	300.0	12.6	0.3	0.3	
Total	**300.0**	**1,209.4**	**1,438.1**	**-268.6**	
Financial Assistance and Guarantee Schemes					
SME Assistance and Modernisation Facilities[5]	-	-	734.6	564.1	
SME Assistance Guarantee Scheme[6]	2,000.0	1,889.0	1,218.7	1,093.6	
Working Capital Guarantee Scheme[7, 8]	7,000.0	7,000.0	5,127.9	1,379.9	
Industry Restructuring Loan Guarantee Scheme[7]	3,000.0	779.7	210.6	46.3	
Total	**12,000.0**	**9,668.7**	**7,291.8**	**3,083.9**	

1 Ratio of approvals over allocations and repayments.
2 Exclude funds allocated by the Government under the Ninth Malaysia Plan.
3 Exclude repayments of RM541 million that has been converted into Agrobank's equity.
4 Closed and replaced by the Bumiputera Entrepreneurs Project Fund - Islamic in July 2009.
5 Schemes were established in August 2008 and has been closed down in February 2009.
6 Scheme was established in February 2009 and was closed in end December 2009. The total approved amount is RM2 billion after accounting for applications that were processed after the closing date.
7 Schemes are administered by Syarikat Jaminan Pembiayaan Perniagaan Berhad (SJPP), a special purpose vehicle managed by Prokhas Sdn Bhd. Both SJPP and Prokhas are a wholly owned company of Minister of Finance Incorporated.
8 Scheme was closed in October 2009 as the limit has been met.

Source: Bank Negara Malaysia