Monetary and Financial Conditions

Monetary and Financial Conditions

Monetary and financial conditions remained favourable in 2007. Despite being subjected to bouts of volatility due to global financial markets developments, domestic financial markets demonstrated resilience and were supported by the robust macroeconomic fundamentals. Globalisation and financial integration has led to financial markets adjusting more rapidly to external events and has resulted in a stronger international co-movement of asset prices across countries. Thus, the increased volatility in financial markets due to external developments and their consequent impact on the economy creates a more challenging environment for macroeconomic management.

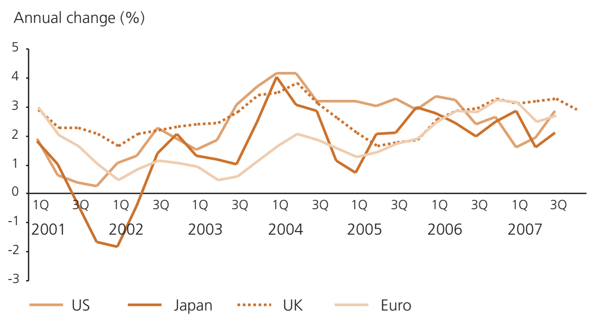
OVERVIEW OF INTERNATIONAL MONETARY AND FINANCIAL CONDITIONS

After several years of robust growth, 2007 signified a pivotal turning point in the global economic and financial environment. Financial market conditions turned disorderly as the unfolding sub-prime and credit crisis in the US spread across the major financial markets. This has been accompanied by the sustained depreciation of the US dollar vis-à-vis other major currencies, as well as the persistence of large global imbalances and surging food and commodity prices.

Global financial market conditions were mainly influenced by the unfolding US sub-prime crisis, sustained depreciation of the US dollar, as well as the persistence of large global imbalances and rising food and commodity prices

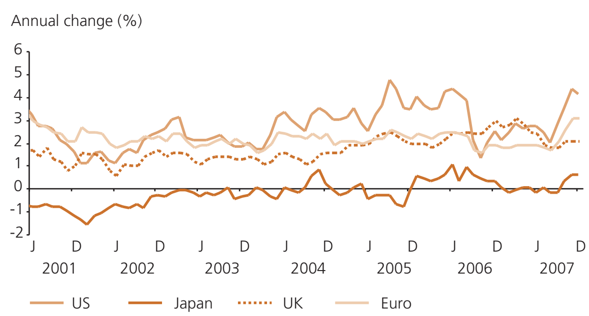
The year 2007 began favourably with global financial market conditions supported by a broadly positive global outlook. Major economies were expected to sustain their expansion, albeit at a slower growth rate, while growth in emerging market economies was expected to continue unabated. Despite rising inflationary pressures from high food prices, early signs of a slowing US housing market and geopolitical tensions in the Middle East, investor optimism was sustained in the early part of the year by the continued expansion of the global economy, the ample global liquidity conditions and orderly conditions in financial markets. As a result, equity markets turned in a robust performance in early 2007, with emerging market equities achieving new records. Sovereign yields rose in major bond markets, as expectations were for tighter future monetary policy, in light of favourable growth prospects amidst rising food and commodity prices. The positive outlook was also evident in the emerging markets, with risk premiums remaining low, as reflected by the continuous narrowing of spreads in the early months of 2007.

Chart 2.1
Gross Domestic Product Annual Change (Selected Industrialised Economies)



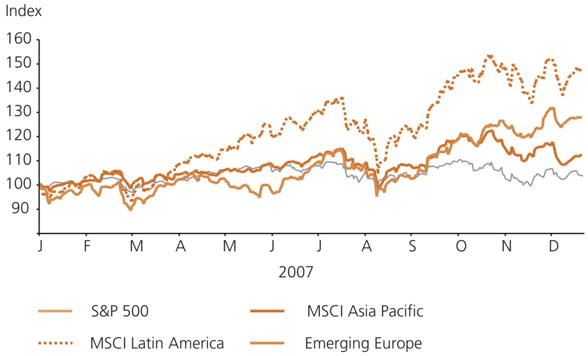
Source: Bloomberg

Chart 2.2
Consumer Price Index Annual Change (Selected Industrialised Economies)



Source: Bloomberg

Chart 2.3
Performance of Global Equity Markets



Source: Bloomberg

Chart 2.4
Emerging Market Bond Index and Bond Spreads (EMBI)

Source: Bloomberg

Against the background of expectations for steady expansion of the global economy supporting growth in employment and incomes amid diminishing spare capacity in most major economies, the balance-of-risks to price stability in the major economies in early 2007 was on the upside. While the US Federal Reserve kept its policy rate unchanged in the first-half of 2007, the FOMC statements during this period underscored its predominant monetary policy concern that inflation would persist for a longer period of time. Similar tightening biases were also expressed by both the Bank of England and the European Central Bank, which increased their key policy rates by 75 basis points and 50 basis points respectively, between January and July 2007.

Among the regional economies, the situation was somewhat more mixed. High capital inflows leading to a build-up of liquidity and faster money and credit expansion, contributed further to rising domestic inflationary pressures in several economies. In view of the high liquidity growth and its impact on the asset markets, the Bank of Korea took further tightening steps in 2007 by raising its policy rate and introducing other quantitative measures to curb the steady rise in asset prices. In addition to increasing the key policy rate, the People's Bank of China adopted supplementary measures, such as increases in reserve requirements, to contain inflation and rapid credit expansion. In Thailand and Indonesia, however, concerns on the downside risk to growth dominated monetary policy decisions. Inflationary pressures were deemed to be under control following previous monetary tightening that had been successful in mitigating the impact of high commodity prices on domestic prices. Therefore, monetary policy was eased in these countries in 2007 to stimulate domestic demand.

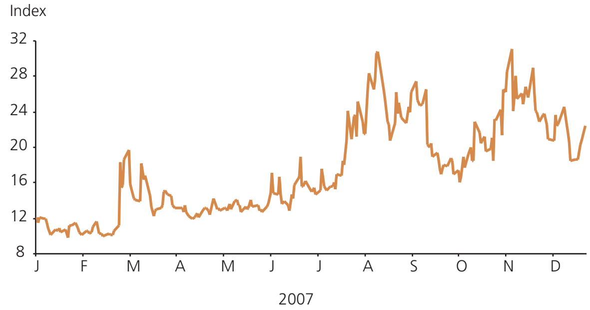
Concerns on the prospects of a protracted decline in US house prices and the implications on the US economy began to surface at the end of the first quarter of 2007. The outlook for the US mortgage market took a turn for the worst by mid-year, when risk premiums on the sub-prime mortgage market rose significantly and triggered widespread sharp downward ratings of financial assets amongst global investors and caused disruptions in the interbank markets. The loss of confidence in the valuation of structured credit products heightened uncertainty surrounding the extent and distribution of these losses across the financial system. As a result, liquidity demand increased dramatically, but was met with more risk averse lenders, leading to the surge in the cost of borrowing. Spreads rose sharply across the credit universe in tandem with the rise in interbank money market rates. Market volatility increased sharply and disorderly conditions prevailed, which at times, led to malfunctioning interbank markets in the major financial centres of the industrial world.

At the initial stage, the impact of the sub-prime turmoil was deemed to be confined within the financial markets. Against an

Chart 2.5
3-month LIBOR less 3-month Treasury Bill Yield

Source: Bloomberg

Chart 2.6
Chicago Board of Exchange (CBOE) Implied Volatility Index (VIX)



Source: Bloomberg

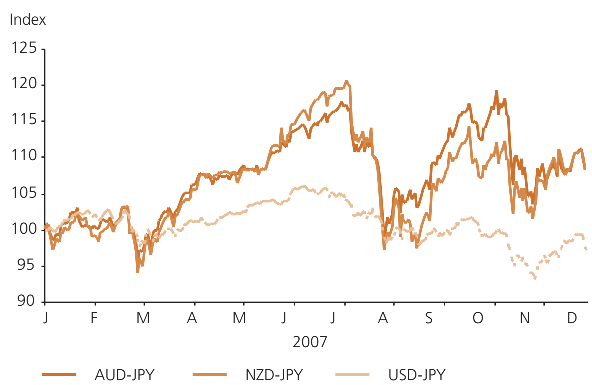
uncertain background of financial turbulence and potential systemic implications, major central banks responded with injections of liquidity into the tight interbank markets, as well as broadening the range of assets that were allowed to be discounted with the central banks. In addition, the US Federal Reserve undertook an immediate cut in its discount rate by 50 basis points on 17 August 2007 to promote the restoration of orderly conditions in financial markets.

While liquidity conditions in most emerging markets remained favourable given their limited exposure to the US sub-prime assets and asset- backed securities markets, the integration across financial markets and the ongoing repricing of risks, did lead to a sharp sell-off in equities and selected currencies in the region. Emerging markets equities, however, proved to be resilient, as the MSCI for emerging market recorded gains of about 36.5% for the year as a whole.

Nonetheless, on a broader scale, the sub-prime crisis initiated a holistic reassessment of risks globally. First, the low risk premiums environment that had prevailed for the recent three years came to an end. Concerns and uncertainty about the location and size of potential losses in the credit derivative markets led to the elevation of risk aversion, with investors returning to safe-haven assets, thus leading to the fall in yields of US Treasuries from 5.02% at end-June 2007 to 4.02% at end-December 2007. Volatility in the US equity market as measured by the VIX index, increased to 30.8 index points on 16 August 2007 from 16.2 index points on 1 July 2007.

Second, the sub-prime crisis also increased the volatility in the currency markets, due partly to the unwinding of carry trade positions. Carry trades or leveraged cross-currency positions were profitable as long as investors benefited from borrowing in a cheap funding currency to invest in higher earning foreign currency assets; with gains from interest rate differentials not expected to be overwhelmed by near-term exchange rate movements. With the sustained period of low policy interest rates and low perceived exchange rate risks in Japan and Switzerland, the yen and the Swiss franc have

Chart 2.7
Carry Trade Index (Cumulative Excess Return)



Source: Bloomberg

been used to fund carry trade activities into high yielding currencies and other financial instruments. However, these carry trade positions had retreated somewhat, given the heightened risk aversion following the greater uncertainty in the financial markets in the period after the sub-prime crisis.

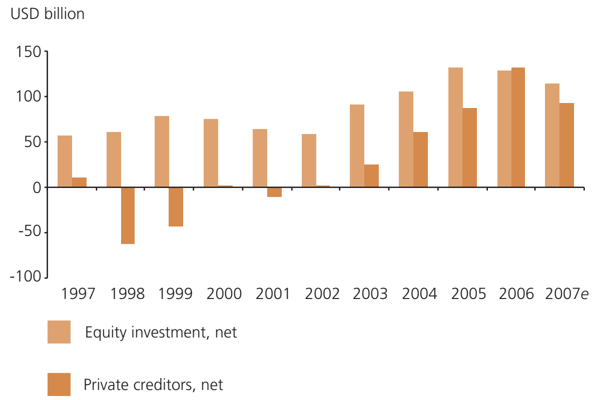
Third, the overriding concern arising from the sub-prime crisis was the extent to which the contraction and higher pricing of credit had repercussions on the real sector. As economic data continued to show deteriorating conditions in the US housing and job markets, the key policy challenge was to ascertain the extent of its spillover effects on the real economy. Given the greater trade and financial linkages between the major developed economies and the rest of the world, any protracted slowdown would inevitably have an impact on the external demand in these economies and thus on the global economic outlook.

Fourth, global commodity prices continued to scale new highs in 2007, driven by strong demand and a shift in asset allocation away from financial assets, and thereby contributing to the build-up of global inflationary pressures. As a result, the prospect of significantly slower global growth amidst a sustained increase in global commodity prices, has led to some concerns of possible stagflation in the developed economies. Nevertheless, the slowdown in the US and other developed economies would contain global demand, thus limiting the probability of such a scenario.

Chart 2.8
Commodities Index (CRB) and Gold Prices

Source: Bloomberg

Chart 2.9
Capital Flows to Emerging Asia



e Estimate
Source: Institute of International Finance

Overall, emerging markets have remained broadly resilient, but face critical challenges ahead. Sustained periods of strong private capital inflows to emerging markets and developing economies have supported growth and the positive developments in the domestic financial markets. Nonetheless, some economies have also experienced inflationary pressures, due to the rapid expansion of credit and liquidity. In addition, the risk of greater financial market volatility due to the impact of the unfolding sub-prime crisis, the prospect of slower global growth and reduced trade flows, as well as elevated inflationary pressures, would pose challenges to macroeconomic management.

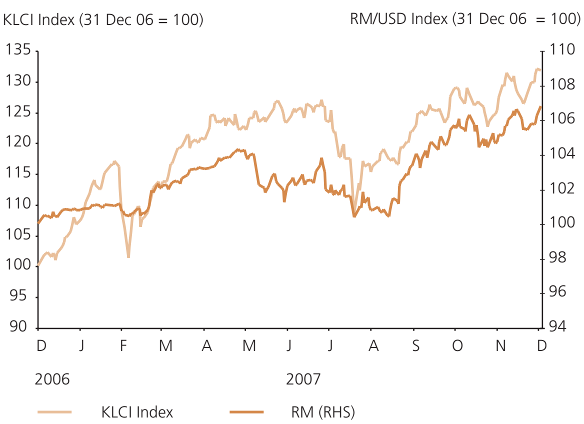
RINGGIT EXCHANGE RATE DEVELOPMENTS

Strong two-way trade and investment flows continued to influence ringgit performance against major and regional currencies during the year. Underlying demand for the ringgit was derived from the positive net trade balance, sustained inward foreign direct investment and substantial repatriation of profits and dividends by Malaysian companies with investments abroad. Ringgit demand was also augmented by significant portfolio inflows, as expectations of strong earnings growth and further currency appreciation contributed to the re-rating of Malaysian equities. This was reinforced by the generally optimistic investor sentiments towards the region and the broad weakness of the US dollar. The upward ringgit pressure was to a certain extent balanced by the demand for foreign currencies to fund larger outward direct and portfolio investments, repayment and prepayment of external loans by both the public and private sectors and the repatriation of profits and dividends by non-residents. The strengthening of the ringgit was also punctuated by several external events during the year, such as the global equity correction in the first quarter and the global financial disruptions following the developments in the US housing market in the third quarter, which had a restraining effect on regional currencies, including the ringgit.

Strong two-way trade and investment flows continued to influence ringgit performance against major and regional currencies during the year

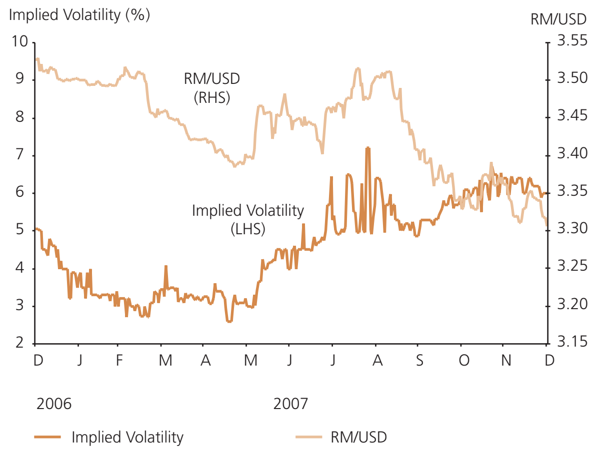
The strong demand for ringgit resulted in the continued appreciation against the US dollar in 2007. The upward trend in the ringgit was however disrupted by the withdrawals of funds from the region following the correction in the Shanghai equity market in February, and developments related to the US sub-prime mortgage market, particularly in the period June through September. The weakness of the ringgit in the June to September period was especially noteworthy because it corresponded with a marked increase in ringgit exchange rate volatility. These disruptions proved to be temporary as the ringgit resumed its appreciating trend, arising from the positive investor sentiment towards the Malaysian economy. The ringgit also reflected the general

Chart 2.10
Performance of the Kuala Lumpur Composite Index (KLCI) and the Malaysian Ringgit (RM) against the US Dollar



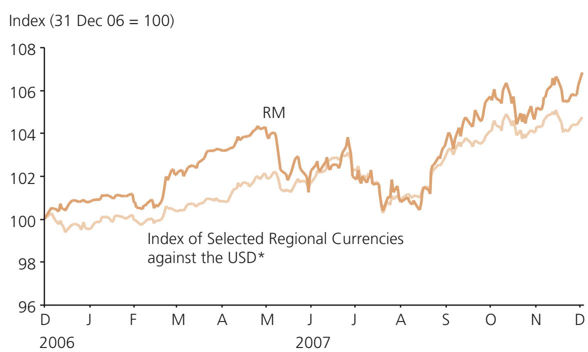
Source : Bursa Malaysia

Chart 2.11
Exchange Rate and Implied Volatility of the Malaysian Ringgit (RM) against the US Dollar



Source : Bloomberg

Chart 2.12
Exchange Rate of the Malaysian Ringgit (RM) and Selected Regional Currencies against the US Dollar



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

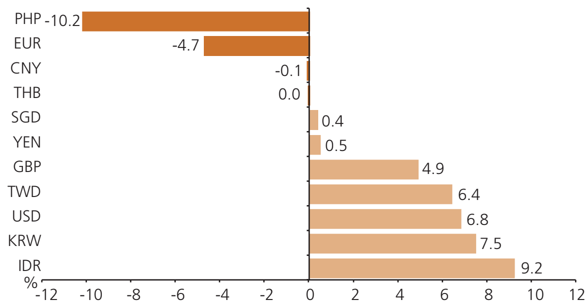
Note: An increase in the index represents an appreciation of the ringgit or of selected regional currencies against the US dollar.

improvement in investor sentiment following the monetary policy action by the US Federal Reserve to normalize market conditions and address the emerging risk of a broader US economic slowdown, as well as the efforts by the other major central banks to ease the tight liquidity conditions in financial markets. For the year as a whole, the ringgit appreciated by 6.8% against the US dollar to end the year at the dollar exchange rate of RM3.3065 (noon rate).

The ringgit also ended the year marginally higher by 0.5% against the Japanese yen. The ringgit was generally stronger against the yen in the first half of the year as the yen was the favoured short currency for carry trade activities. The substantial unwinding of these positions following the rise in global financial market volatility in the second half of the year, however, led to a significant appreciation of the yen relative to the ringgit. Nevertheless, the ringgit ended the year firmer versus the yen on renewed carry trades and concerns about the strength of growth of the Japanese economy. Conversely, the ringgit depreciated against the euro by 4.7%, following the marked strengthening of the euro against the major currencies. Key factors supporting the euro were market expectations for continued monetary policy tightening by the European Central Bank, the positive economic growth outlook for the euro zone, and the greater role of euro as a reserve currency.

Chart 2.14
Summary of Malaysian Ringgit (RM) Performance against Major and Regional Currencies

Percent change, 1 Jan - 31 Dec 2007



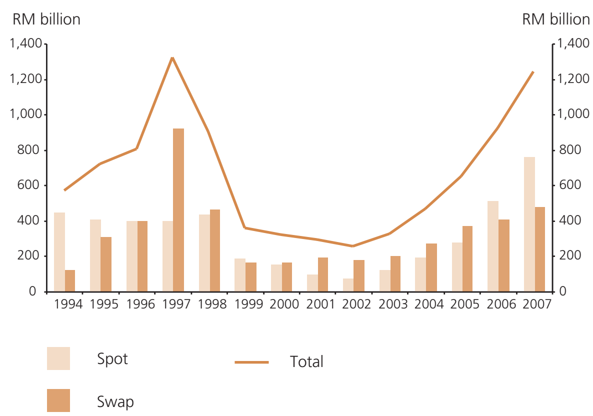
Note: (+) indicates an appreciation of the ringgit against the currency

The performance of the ringgit against the regional currencies was mixed. Although the underlying trend of the ringgit was broadly consistent with that of other currencies in the region, country-specific factors resulted in variations in performance between the regional currencies. In particular, the Philippine peso strengthened due to strong remittances and export receipts, and the relatively high interest rates of peso instruments. The Indonesian rupiah weakened as demand for foreign currency rose in line with import growth following stronger economic activity and the increase in world oil prices.

Chart 2.13
Exchange Rate of the Malaysian Ringgit (RM) against Major Currencies

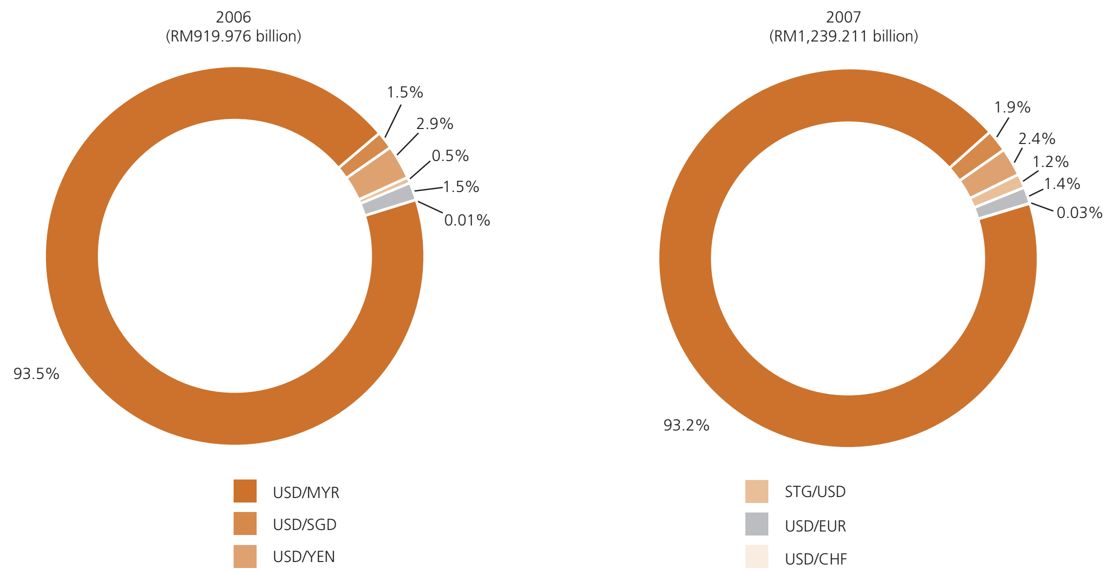
Note: (+) indicates an appreciation of ringgit against the currency

Chart 2.15
Volume of Interbank Transactions in the Kuala Lumpur Foreign Exchange Market



Note: Data from 2002 onwards is based on the new Ringgit Operations Monitoring System (ROMS), whereas observations for previous years are based on transactions of the eight Authorised Dealers.

Chart 2.16
Transactions in the Kuala Lumpur Foreign Exchange Market by Currency



The rapid expansion in the volume of interbank transactions in the Kuala Lumpur foreign exchange market continued in 2007. At current exchange rates, total volume increased by 34.7% (at constant 2006 exchange rates: 41.1%). The increase in turnover was driven mainly by the rise in spot transactions, which grew by 49.2% at current exchange rates (at constant 2006 exchange rates: 60.6%). For the recent two years, spot transactions had overtaken swap transactions as the dominant contributor to the overall volume, a reversal of the trend since 2000. This may in part be attributed to the increase in short-term financial flows into the region. It is noteworthy that the 34.7% increase in the average daily volume of spot and swap transactions in the Kuala Lumpur foreign exchange market is higher than the annualized global average growth of 20.2% over the 2005 – 2007 period covered by the Bank for International Settlements Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2007. This development reflects the larger two-way flows and the growing vibrancy of the Kuala Lumpur foreign exchange market.

LIQUIDITY AND MONEY SUPPLY

In 2007, monetary aggregates expanded as a consequence of both external and domestic factors. Broad money, or M3, exhibited a relatively stable growth trend in the first half of 2007, which subsequently moderated towards the second half of the year, and ended the year growing at an annual rate of 9.5% (end-2006: 13.0%).

Large external flows and higher lending activity contributed to sustained growth in monetary aggregates

Inflows from the current account surpluses, foreign direct investments and portfolio funds were the main drivers in the expansion of liquidity, albeit at a lesser extent compared to 2006. In particular, during the third quarter, net foreign assets exerted a contractionary impact on M3, reflecting to a large extent, the outflows from the heightened risk aversion amongst

Chart 2.17
Monetary Aggregates

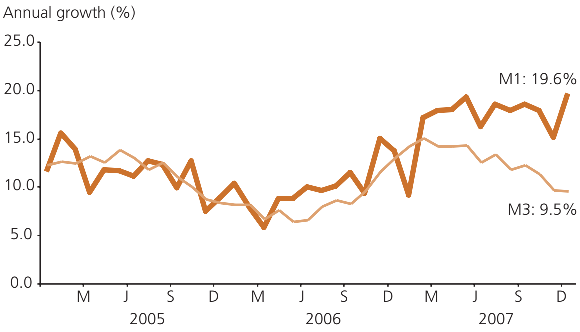
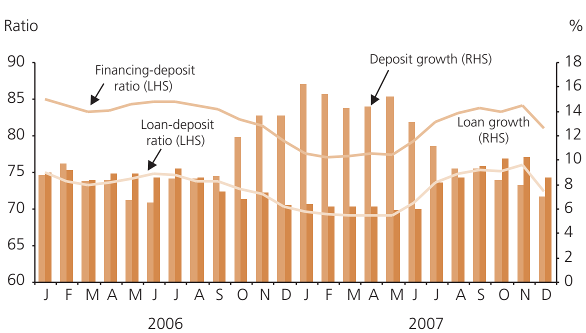


Table 2.1
Broad Money, M3

	Change (RM billion)	
	2006	2007
M3	87.5	72.5
Currency in circulation	3.4	2.8
Demand deposits	11.7	24.2
Broad Quasi-Money	72.4	45.5
Fixed deposits	*31.9*	*10.7*
Savings deposits	*5.2*	*8.7*
NIDs	*14.3*	*-15.3*
Repos	*11.8*	*-72.4*
FX deposits	*3.2*	*1.5*
Other deposits	*5.9*	*112.2*
Determinants of M3		
Net claims on Government	8.3	0.3
Claims on private sector	34.7	51.6
Loans	*36.8*	*48.5*
Securities	*-2.1*	*3.1*
Net external operations*	59.7	76.4
*Bank Negara Malaysia**	*32.1*	*50.9*
Banking system	*27.6*	*25.4*
Other influences	-15.3	-55.8

* Pre-revaluation of the international reserves

Chart 2.18
Financing-Deposit and Loan-Deposit Ratios



investors due to the US sub-prime crisis. Higher bank lending contributed significantly to M3 growth in the second half of the year, in tandem with the increased pace of economic activity.

Narrow money or M1, continued to record stronger growth throughout the year, evidenced by the annual growth of 19.6% at end-December (end-2006: 13.7%), as the private sector opted for higher transaction balances to undertake trading activities.

Meanwhile, banking system liquidity continued to remain ample, as evidenced by the financing-deposit and loan-deposit ratios. During the year, the banking system's lending to the private sector, as reflected by loans outstanding and holdings of private debt securities, expanded at a faster pace of 9.4%, compared with deposits growth of 7.0%. While this resulted in a higher financing-deposit and loan-deposit ratio to 80.8% and 72.2% respectively, liquidity remained ample to enable the banking institutions to undertake their lending activities.

FINANCIAL MARKET CONDITIONS

Apart from brief periods of corrections, the domestic financial markets proved resilient in the face of global financial market turbulence. In part, the resilience reflected strong macroeconomic performance, with sustained private sector-led growth. Nevertheless, given that global financial markets have become increasingly integrated, the domestic financial markets experienced larger and more volatile episodes of capital flows which coincided with the swings in risk appetite of the global investors.

In addition to the strong domestic fundamentals, domestic sentiments strengthened during the year following the announcements of several projects under the Ninth Malaysia Plan and the economic corridors. Sentiments were further lifted by other initiatives including the transformation program for the Government-linked companies (GLCs) and the Government's incentive package for the property market. The incentive package for the property sector included the relaxation of rules on foreign property purchases, the exemption of the real property gains tax and increased commitment for a more efficient public delivery system such as a faster approval process. These measures were complemented by the further liberalisation of the capital account transactions.

Interest Rate Developments

With the Overnight Policy Rate (OPR) held at 3.50% throughout the year, changes in the domestic money market and retail interest rates were driven primarily by market factors.

Money market and deposit rates were generally stable. Lending rates, however, softened due to strong competition between banks

In the money market, the average overnight interest rate remained close to the OPR throughout the year, trading in a tight range between 3.48% and 3.51%. The interbank rates of the one-week and one-month maturities were also relatively stable, with spreads against the overnight rate narrowing as the year progressed. The narrowing spread between the various tenures may be attributed to market participants paring down their expectations of adjustment to the OPR.

The lending rates of commercial banks on the other hand, moderated in 2007. While the base lending rate was unchanged at 6.72%, the average lending rate (ALR) on outstanding loans trended lower by 28 basis points to 6.29% as at end-December 2007. Compared to 2006, more banks had their ALRs in the 6-7% range, down from the 7-9% range, providing further evidence of the downward trend in lending rates. The average lending rates on new loans approved also trended lower. The declining trend in lending rates reflected the ample supply of

Chart 2.19
Interbank Rates

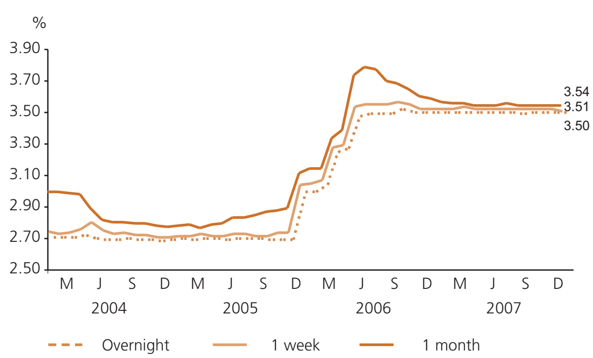


Chart 2.20
Commercial Banks' Lending Rates (at end-period)

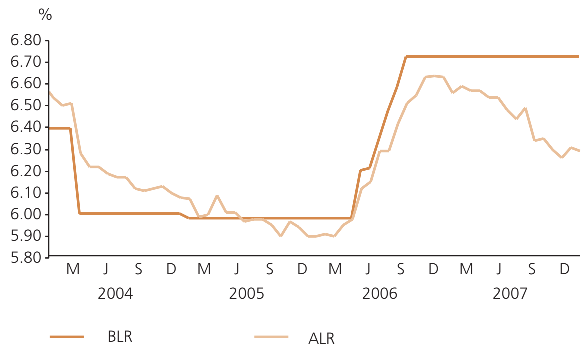


Chart 2.21
Range of Commercial Banks' ALR

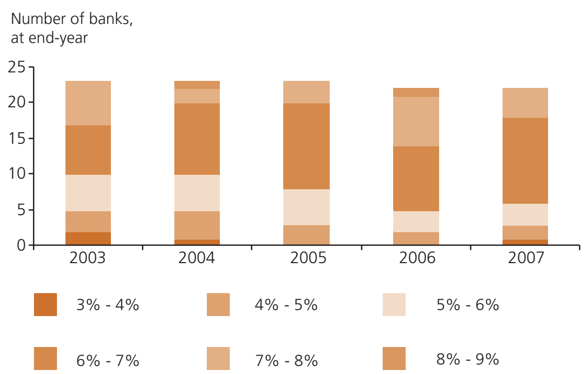
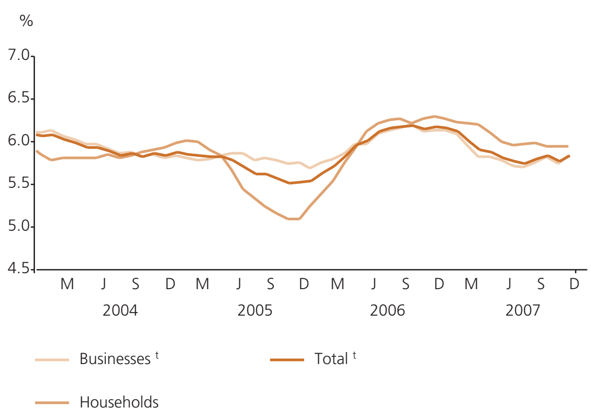


Chart 2.22:
Commercial Banks' ALR on New Loans Approved (6 months moving average)



t Trend in the ALR on new loans was adjusted to remove the one-off effect of a large loan approved in the transport, storage and communication sector

Chart 2.23
Commercial Banks' Fixed Deposit Rates

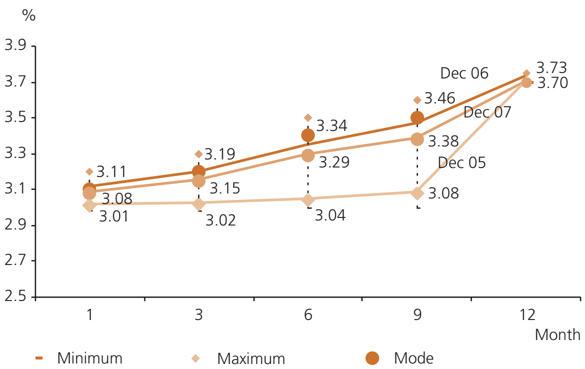
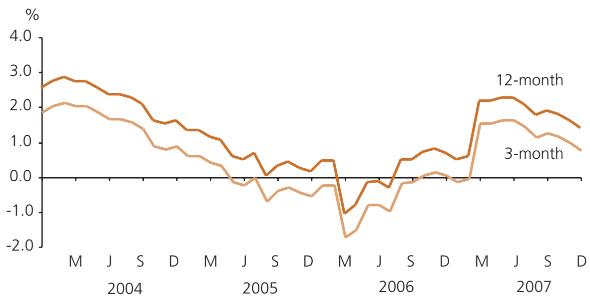


Chart 2.24
Real Fixed Deposit Rates



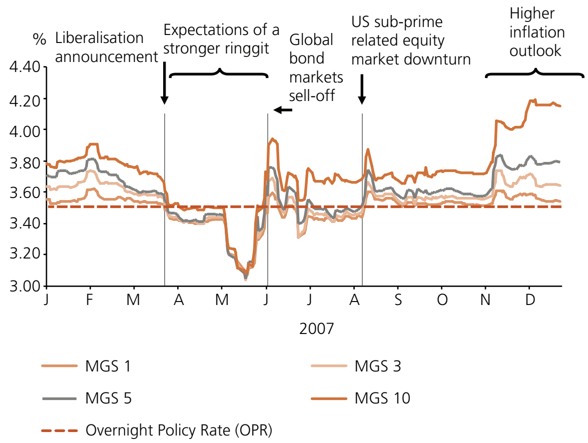
loanable funds, leading to more aggressive competition amongst the banks.

Fixed Deposit (FD) rates softened slightly in 2007. The adjustments in FD rates, however, were modest in comparison to the downtrend in lending rates. The FD rates of the 1 and 12 month tenures are supported by the floor rates imposed by Bank Negara Malaysia on retail fixed deposits. As at end-December, FD rates between the 1 and 12 months tenures were between 3.08% and 3.70% respectively.

Bond Markets

The performance of the bond market in 2007 was driven by both global and domestic factors. Expectations regarding the movement of the ringgit exchange rate and the anticipation of changes in monetary policy stance, together with global financial market developments influenced the movements in yields. Consequently, the year saw large two-way capital flows in the bond

Chart 2.25
Malaysian Government Securities Yields



Source: Bank Negara Malaysia

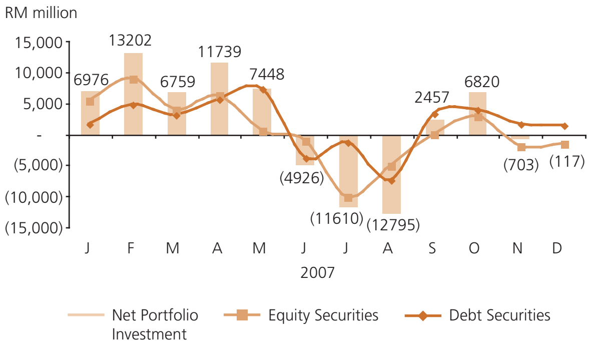
market, leading to greater volatility in bond yields, especially in the MGS market.

Yields in the ringgit bond market were relatively more volatile, affected by the disorderly conditions in the global financial markets including in the foreign exchange markets, and changes in inflationary expectations

The expectation of a stronger ringgit resulted in larger foreign accumulation of ringgit-denominated assets, including bonds. Large inflows into the bond market pushed yields downwards and caused the MGS yields up to the 10-year maturity to dip below the OPR level in April. The large inflows also resulted in the narrowing of the spreads between the 10-year MGS and the shorter term securities. Similarly in regional economies, the yield curve in Korea, Singapore and Thailand also flattened.

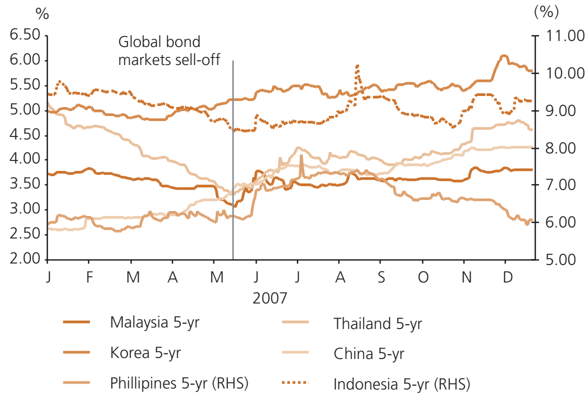
While the MGS bond market enjoyed a positive rally in the first half of 2007 and correspondingly a significant decline in yields,

Chart 2.26
Net Portfolio Investment Flows into the Country



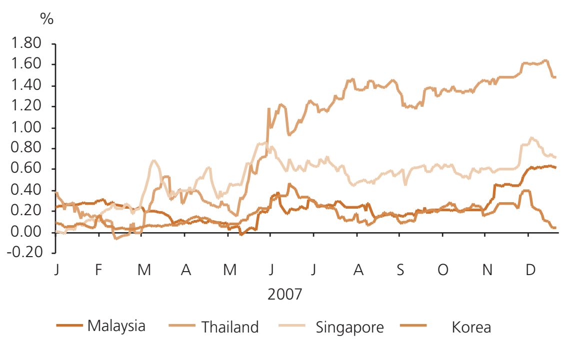
Source: Bank Negara Malaysia's Cash of Balance of Payments System

Chart 2.28
Regional 5-year Government Securities Yield



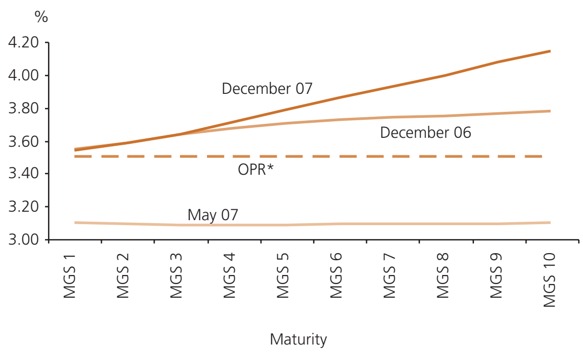
Source: Bloomberg

Chart 2.27
Yield Spread (10-yr against 1-yr) for Selected Countries



Source: Bloomberg

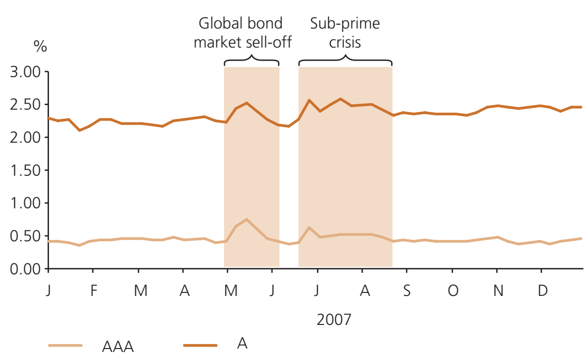
Chart 2.29
MGS Benchmark Yield Curve 2007



*OPR: Overnight Policy Rate
Source: Bank Negara Malaysia

the dramatic change in global financial markets led to reversals in the direction of the yields in the second half of 2007. The sub-prime and credit crisis caused a sell-off in the Malaysian and regional bond markets, pushing yields sharply upwards. However, market sentiments improved in August 2007 following the aggressive response from the US Federal Reserve. Expectations of higher inflation pushed the bond yields to rise towards year-end as investors priced in the possibility of a monetary policy response. The spreads between the 10-year MGS and the shorter and medium-term MGS widened and eventually led to the steepening of the MGS benchmark yield curve in December. Nevertheless, as inflows continued to enter the bond market, the rise in yields moderated.

Chart 2.30
Corporate Yield Spread Against MGS (3-year)



Source: Bank Negara Malaysia

In the corporate bond market, yields generally moved in tandem with the movement of Government bond yields, especially for the higher rated credits. However, during periods of uncertainty, the lower-rated issues were subjected to a slight widening in the spreads.

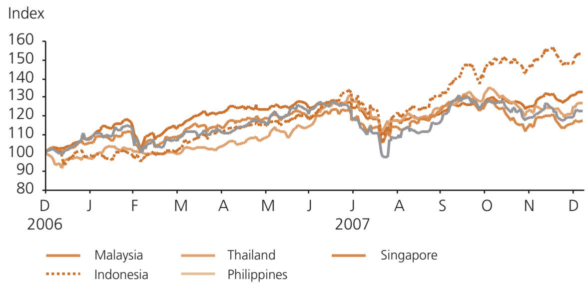
Equity Markets

The benchmark Kuala Lumpur Composite Index (KLCI) started the year on a bullish note and crossed the 1,300 level in April for the first time in 13 years. The KLCI continued its upward momentum and achieved several new highs to reach 1,445.03 at year-end, recording a gain of 31.8% in 2007. Nonetheless, the rise in the equity market was punctuated by a number of market corrections and temporary withdrawals by foreigners due to the repricing of risks arising from global and regional developments such as the Shanghai market correction in February, the global bond markets sell-off in June and the heightened global market uncertainty in August following the US sub-prime loans fallout. The KLCI, however, rebounded quickly, buoyed by the strong fundamentals of the domestic economy, robust corporate earnings and rising commodity prices. Positive sentiments arising from the Government's pro-growth policies and an increase in mergers and acquisitions activity also provided added impetus to the local equity market.

Despite bouts of volatility due to global financial developments, the KLCI was resilient in 2007, gaining support from strong macroeconomic fundamentals and favourable corporate earnings

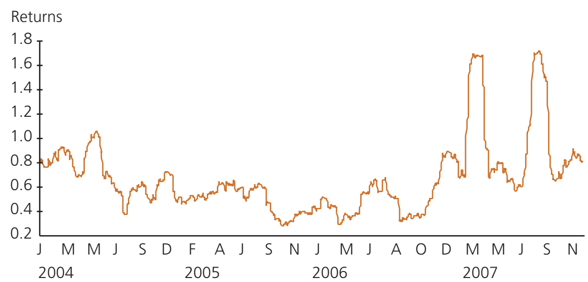
During the year, the Second Board and the MESDAQ Market underperformed the Main Board which is more liquid with higher quality stocks. A confluence of positive factors pushed the plantation sector to emerge as the best performing sector in the market, followed by the property and construction sectors. The plantation sector gained 87.4%, while the construction and property sectors recorded increases of 56.5% and 49.3% respectively in 2007. Market turnover rose significantly during the year with the average daily volume of shares traded rising by 93% to 1,548 million units, while the value of turnover more than doubled to RM2,346 million.

Chart 2.31
Regional Indices



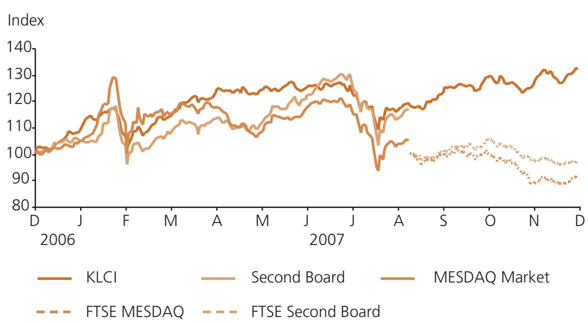
Source: Bloomberg

Chart 2.32
Volatility of Returns on the KLCI[1]



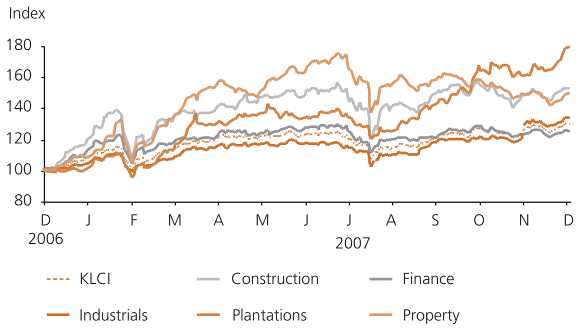
1 Refers to the 30-day rolling standard deviation of daily returns
Source: Bank Negara Malaysia estimates

Chart 2.33
Bursa Malaysia Indices**



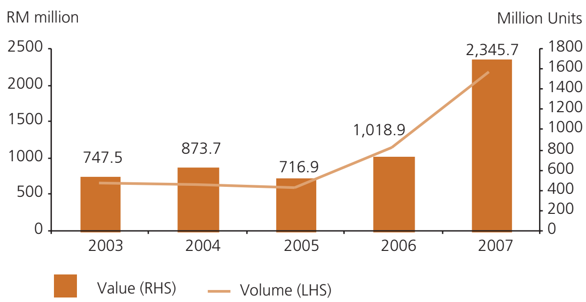
** From September 10, 2007, the Second Board and MESDAQ was replaced with Second Board and FTSE MESDAQ
Source: Bloomberg

Chart 2.34
Bursa Malaysia Sectoral Indices



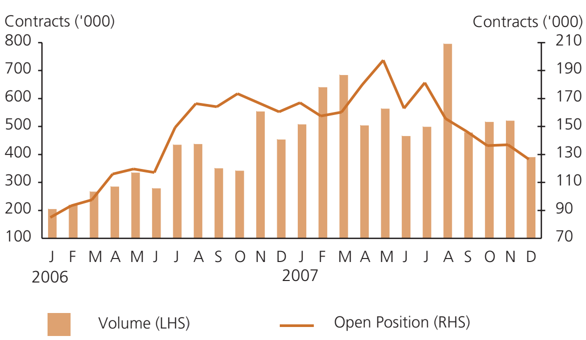
Source: Bloomberg

Chart 2.35
Average Daily Turnover of Bursa Malaysia



Source: Bursa Malaysia

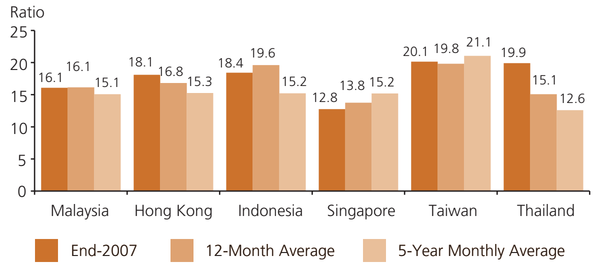
Chart 2.36
Bursa Malaysia Derivatives: Total Monthly Volume and Month-end Open Interest



Source: Bursa Malaysia

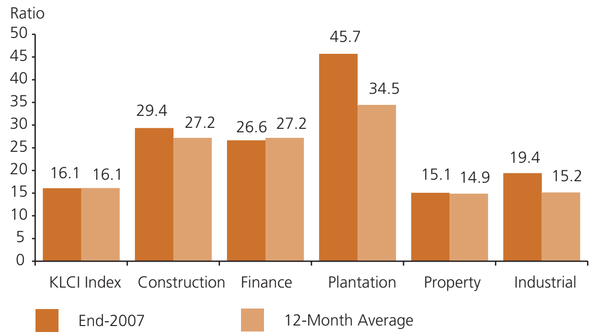
Active trading in the KLCI and the crude palm oil (CPO) futures led to the stronger performance of the derivatives market in 2007.

Chart 2.37
Regional Comparison of Price-Earnings Ratios



Source: Bloomberg, Bank Negara Malaysia estimates

Chart 2.38
Bursa Malaysia Comparison of Sectoral Price-Earnings Ratios



Source: Bloomberg, Bank Negara Malaysia estimates

Strong gains in the underlying stocks and the high CPO prices were key factors in driving the interest in the derivatives market. Total annual trading volume for derivatives (comprising KLCI futures, crude palm oil futures, 3-month KLIBOR futures and MGS futures) in 2007 was 6.6 million contracts or an increase of 57.8% (2006: 4.2 million contracts).

The KLCI's valuation at current price-earnings (P/E) multiple of 16.1 times as at end-2007 was slightly higher than the historical 5-year monthly average multiple P/E of 15.1 times. Meanwhile, the plantation and construction sectors outperformed the overall market on improved earnings outlook and reratings by investors.

The KLCI began on a positive note in 2008, with stronger interest in the plantation stocks helping the market to reach an all-time high of 1,516.2 on 11 January 2008. However,

Table 2.2
Bursa Malaysia: Selected Indicators

	2006	2007
Price Indices (Index):		
FBM30	7,059.9	9,343.7
Composite	1,096.2	1,445.0
FBMEMAS	7,169.6	-
Second Board	92.0	-
MESDAQ Market	119.9	-
FTSE Second Board	-	6,732.4
FTSE MESDAQ	-	6,109.2
Total Turnover:		
Volume (billion units)	197.5	360.4
Value (RM billion)	250.6	540.2
Average Daily Turnover:		
Volume (million units)	802.9	1,584.4
Value (RM million)	1,018.9	2,345.7
Market Capitalisation (RM billion)	848.7	1,106.2
Market Capitalisation / GDP (%)	148.2	172.4
Total Number of Listed Companies:	1,027	987
Main Board	649	636
Second Board	250	227
MESDAQ Market	128	124
Number of Companies Delisted:		
Main Board	21	48
Second Board	8	13
MESDAQ Market	1	2
Market Liquidity:		
Turnover Value / Average Market Capitalisation (%)	33.3	52.2
Turnover Volume / Number of Listed Securities (%)	59.2	98.9
Market Concentration:		
*Market Capitalisation of 10 most Highly Capitalised Stocks / Total Market Capitalisation (%)	35.4	38.3

* Based on market transactions only

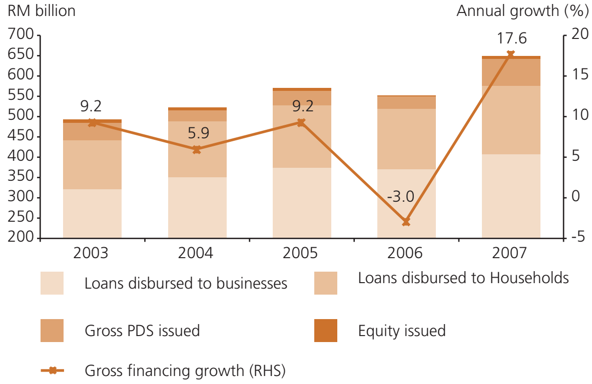
Source: Bursa Malaysia

following the corrections in global equity markets arising from concerns about the severity of the US economic slowdown, the KLCI closed lower at 1,357.4 at end-February 2008. The losses were, however, cushioned by the continuing rise in plantation stocks as crude palm oil prices hit new peaks.

FINANCING OF THE ECONOMY

Financing activity expanded in 2007 providing strong support to the domestic economy. Amid ample liquidity and low borrowing costs, total net financing channeled to the economy, encompassing both the public and private sectors, increased at a higher rate of 9.3% (2006: 6.1%). In terms of financing to the private sector, there was higher demand for financing

Chart 2.39
Gross Financing through Banking System and Capital Market

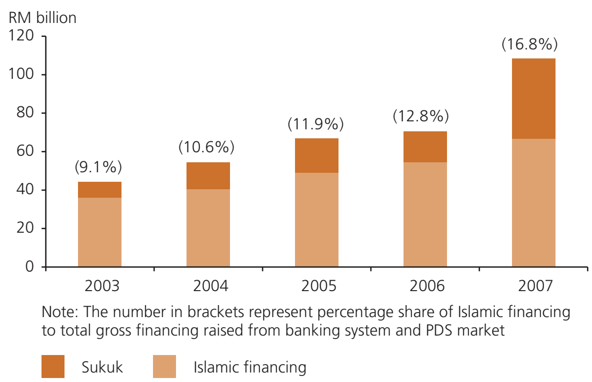


from both the business and household sectors, to support investment and consumption activities. Increased corporate expansion activity, including mergers and acquisitions and privatisations, and progress on projects under the Ninth Malaysian Plan provided additional impetus to the growth of financing during the year.

The robust growth of the economy was well supported by ample financing from the financial system

Of importance, the turmoil in the global financial markets in the second half of 2007 had a limited impact on domestic financing activity. Bank financing activity continued to record a

Chart 2.40
Financing raised via Islamic Instruments



Note: The number in brackets represent percentage share of Islamic financing to total gross financing raised from banking system and PDS market

Table 2.3
Financing of the Economy

By financing type/institutions \ By customer	Business[1] Total	Business[1] of which: SMEs	Households	Government	Total Financing
	RM million				
Net Change in Financing (2006)					
Financial Intermediaries					
Banking Institutions	10,011	8,705	26,605	(1,669)	34,948
Development Financial Institutions (DFIs)[2]	2,404	942	5,172	-	7,576
Other Domestic Intermediaries[3]	2,302	(167)	314	-	2,616
Capital Market					
Bond Market[4]	13,485	-	-	15,120	28,605
Equity Market	1,916	-	-	-	1,916
Venture Capital	721	-	-	-	721
External Financing					
Foreign Direct Investment	22,183	-	-	-	22,183
External Loan[5]	8,387	-	-	(10,850)	(2,463)
Total	**61,409**	**9,481**	**32,091**	**2,601**	**96,100**
Net Change in Financing (2007)					
Financial Intermediaries					
Banking Institutions	24,376	9,491	27,169	(328)	51,217
Development Financial Institutions (DFIs)[2]	3,326	877	6,126	-	9,452
Other Domestic Intermediaries[3]	13,421	(218)	1,112	-	14,534
Capital Market					
Bond Market[4]	32,849	-	-	24,780	57,629
Equity Market	7,126	-	-	-	7,126
Venture Capital	-	-	-	-	-
External Financing					
Foreign Direct Investment	27,939	-	-	-	27,939
External Loan[5]	2,178	-	-	(13,926)	(11,749)
Total	**111,215**	**10,150**	**34,407**	**10,526**	**156,148**

[1] Business includes non-bank financial institutions, domestic non-business entities and foreign entities.
[2] Refers to DFIs governed under the Development Financial Institutions Act, 2002.
[3] Other domestic intermediaries include insurance companies, Employees Provident Fund (EPF), housing credit institutions, leasing and factoring companies and the Treasury Housing Loan Division.
[4] Bond Market refers to outstanding private debt securities (PDS) and all Malaysian government securities.
PDS includes irredeemable convertible unsecured loan stocks (ICULS) and medium term notes (MTN) issued by the corporate sector.
[5] External financing of Government includes financing to non-financial public enterprises (NFPEs).

strong growth of 8.6% (2006: 6.3%) during the year. While there was greater risk aversion for securities below the AA-rating, the bond market remained vibrant, with several large issuances contributing to the highest annual amount of funds raised to date, amounting to RM66.5 billion (2006: RM30.7 billion).

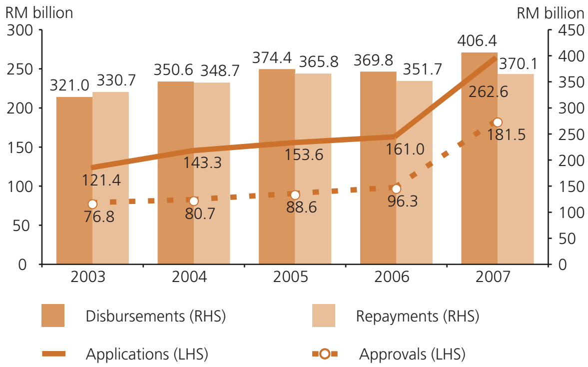
The concerted efforts undertaken by Bank Negara Malaysia in positioning Malaysia as the leading Islamic financial hub have yielded positive results. In 2007, issuances of Islamic securities rose by 161.2% to account for 62.7% of total PDS issued. Two of the largest issuances in the corporate bond market, amounting to RM22.4 billion, were sukuk. Meanwhile, the disbursements of Islamic financing increased at a rapid pace of 22% in 2007 (+11% in 2006) to account for 11.6% of total loans disbursed by the banking system.

Financing to the Business Sector

In 2007, the demand for financing by businesses was underpinned by the sustained growth in business and investment activity. Businesses supported their activities by acquiring a larger amount of financing from bank loans and the capital market, as well as from internal funds. Although bank loans continued to account for a significant share in the total financing to businesses (25.9%), the types and mechanisms of financing have gradually changed over the years, amid the evolving nature of the economy and the financial system (see Box Article). In essence, businesses are relying more on the banks for short-term financing to fund their working capital, whilst using the bond market to secure longer term financing for capital investments.

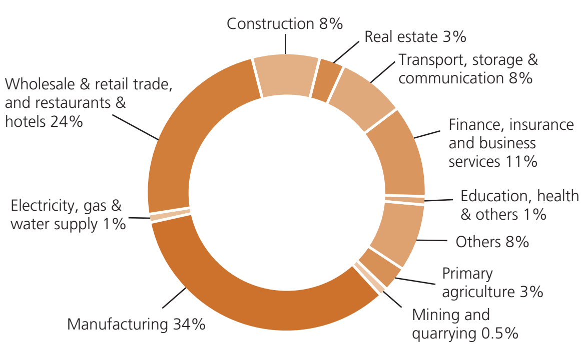
New loan applications and approvals to the businesses registered strong growth rates of 63.1% and 88.4% respectively (2006: 4.8% and 8.7% respectively). Compared to 2006, loan disbursements turned around to register a stronger growth of 9.9% (2006: -1.2%). The bulk of the loans disbursed to businesses were for the purpose of working capital (75.6% of total loans disbursed), with larger amount of funds channeled to the manufacturing (mainly domestic-oriented industries), wholesale trade, and construction sectors – economic sectors that experienced stronger activity during the year. Mergers and acquisitions activity in the finance, insurance and business services sector spurred higher loans to this sector, which was also reflected in loans extended for the purchase of securities. A significant development during the year was the disbursement of a large syndicated bridging loan by several banks to finance the privatisation activity of a company. The loan, however was refinanced in December 2007 via the private debt securities market.

Chart 2.41
Business* Sector Loan Indicators



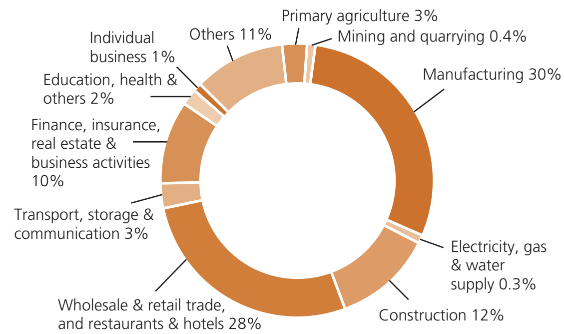
* Businesses includes non-bank financial institutions, domestic non-business entities and foreign entities

Chart 2.42
Business Loan Disbursements by Sector in 2007



Total : RM 406.4 billion

Chart 2.43
Loan Disbursements to SMEs by Sector in 2007



Total : RM 141.5 billion

The SMEs, meanwhile, continued to enjoy greater access to financing from the banking system and the development financial institutions (DFIs), including financing under the Special Funds administered by Bank Negara Malaysia. Outstanding SME loans of the banking system rose at a higher growth rate of 9.1% in 2007 (2006: 5.1%) to account for 17.7% of total outstanding banking system loans. While the distribution of funds remained broad-based, the manufacturing, wholesale and retail trade, and construction sectors accounted for the biggest shares of 30%, 28% and 12% of total loans disbursed to SMEs respectively. The year 2007 also marked the introduction of a new avenue of financing for the SMEs. In May, Cagamas SME Berhad issued an inaugural synthetic collateralised loan obligation amounting to RM600 million, which was backed by a SME loan portfolio residing at a banking institution.

Financing via the bond market (excluding Cagamas and issuance by non-residents) was buoyant in 2007, with gross funds raised rising

Table 2.4
Special Funds for SMEs administered by Bank Negara Malaysia

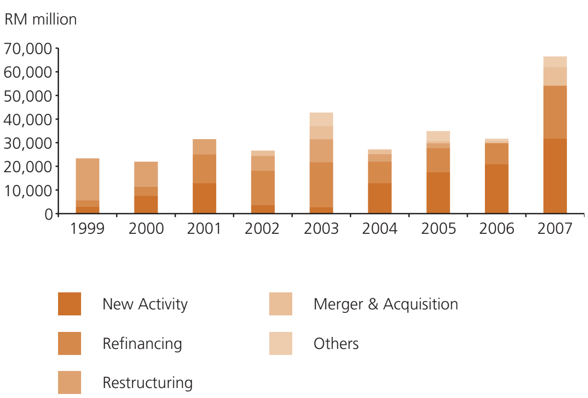
Type of fund	RM million					%	
	Allocations	Approvals	Disbursements	Repayments	Loans Outstanding	Utilisation Rate[1]	Undrawn[2]
	As at end-2007						
Fund For Food	1,300.0	1,730.4	1,706.5	1,366.3	340.2	133.1	1.4
New Enterpreneurs Fund 2	2,850.0	3,436.6	3,203.1	807.1	2,396.0	120.6	6.8
Fund for Small and Medium Industries 2	6,750.0	10,117.9	8,776.3	3,981.5	4,794.8	149.9	13.3
Bumiputera Enterpreneurs Project Fund	300.0	760.3	656.2	584.9	71.3	253.4	13.7
Rehabilitation Fund for Small Businesses	200.0	17.7	19.9	10.5	9.4	8.9	12.4
Special Relief Guarantee Facility	500.0	471.9	-	-	-	94.4	100.0
Total	**11,900.0**	**16,534.9**	**14,362.0**	**6,750.3**	**7,611.7**	**138.9**	**13.1**
	Change during the year						
Fund For Food	-	37.9	24.3	384.5	360.2		
New Enterpreneurs Fund 2	-	229.9	338.9	259.3	79.6		
Fund for Small and Medium Industries 2	-	2,297.7	1,717.3	1,721.7	4.4		
Bumiputera Enterpreneurs Project Fund	-	160.4	139.5	130.9	8.5		
Rehabilitation Fund for Small Businesses	-	0.5	4.2	4.9	0.7		
Special Relief Guarantee Facility	500.0	471.9	-	-	-		
Total	**500.0**	**3,121.5**	**2,224.3**	**2,501.4**	**277.2**		

[1] Ratio of approvals over allocations.
[2] Ratio of approvals minus disbursements, over approvals.

significantly to RM66.5 billion (RM30.7 billion in 2006). Despite large redemptions during the year, the net issuance of debt securities (excluding Cagamas and issuance by non-residents) was still higher at RM19 billion (2006: RM10.1 billion). The bulk of the PDS issued during the year were used for new investment activity (48%), the refinancing of existing debt (34%) and for mergers and acquisitions activity (12%).

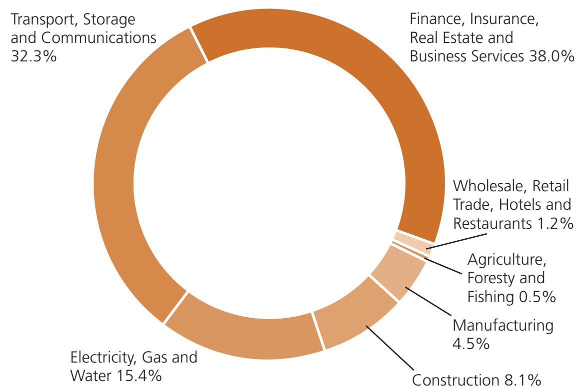
During the year, there were several large PDS issuances with the longer maturity profiles being used to fund the privatisation of a major telecommunications firm as well as the acquisition of an energy provider. The share of PDS with tenures of more than 10 years rose to 30% of total PDS issued (2006: 27%). In addition, the year also witnessed considerable progress in asset securitisation, as reflected by the higher issuance of asset-backed securities (ABS). A total of RM7.4 billion was raised in

Chart 2.44
PDS Financing by Purpose
(Excluding Cagamas and Issuance by Non-Resident)



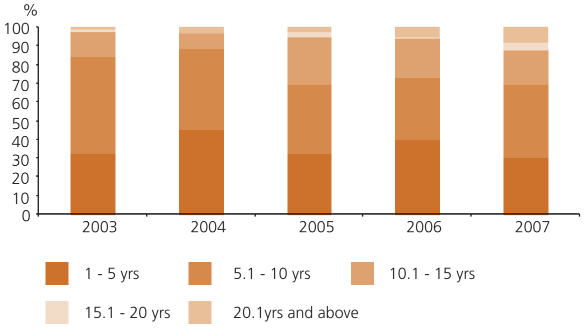
Source: Bank Negara Malaysia

Chart 2.45
PDS by Sector in 2007:
In Terms of Amount Issued
(Excluding Cagamas and Issuance by Non-Resident)



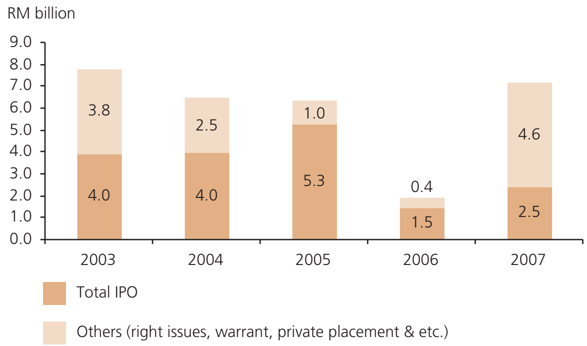
Source: Bank Negara Malaysia

Chart 2.46
PDS Issues by Tenure (Excluding Cagamas and Issuance by Non-Resident)



Source: Bank Negara Malaysia

Chart 2.48
Total Financing Raised via the Equity Market

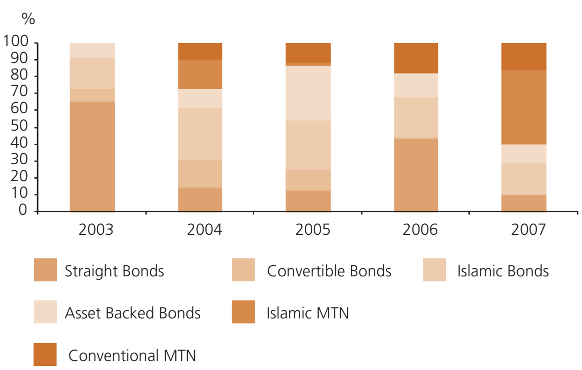


Source: Bursa Malaysia, Bank Negara Malaysia estimates

the capital market through the issuance of ABS (including residential mortgage-backed securities or RMBS). This accounted for 11.1% of funds raised in the capital market.

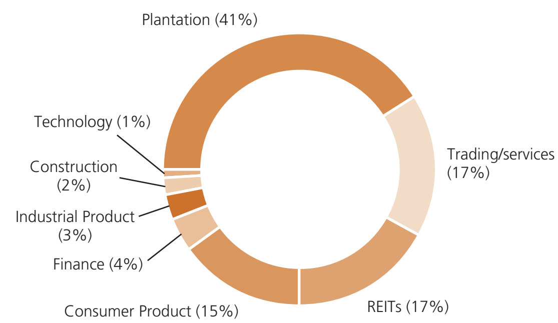
Financing via the equity market, was also significantly higher in 2007. Total funds raised from the market increased to RM7.1 billion from RM1.9 billion in 2006. New funds were mostly raised through rights issues (61%), followed by initial public offerings or IPOs (35%). The plantation, trading and services and Real Estate Investment Trusts (REITs) sectors raised the most funds through IPOs.

Chart 2.47
PDS Issues by Type of Instruments (Excluding Cagamas and issuance by Non-Resident)



Source: Bank Negara Malaysia

Chart 2.49
Initial Public Offerings by Sectors in 2007



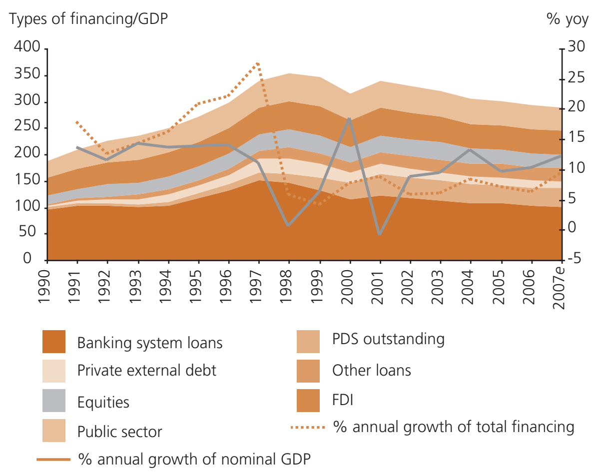
Source: Bursa Malaysia and Bank Negara Malaysia estimates

The Evolution of Financing Sources for the Malaysian Economy

Since the early 1990s, amidst relatively strong and sustained growth, the Malaysian economy has undergone significant structural change and has become more diversified. The financial system, which plays a pivotal role in facilitating and supporting economic growth, has also undergone significant transformation. Financial deepening, coupled with the changing sources of growth of the economy, has contributed to the changing structure of the sources, types and level of financing.

The financing ratio (total financing[1] as a percentage to GDP) has steadily moderated since 2001, with financing growing at a slower pace compared with nominal GDP (see chart 2.50). This is a clear divergence from the trend for most of the 1990s, when financing growth exceeded the growth of GDP. The moderating trend in the ratio can be largely attributed to structural changes in the economy, with private consumption gaining prominence over private investment as the key growth driver. Such a marked shift in growth patterns was evident when comparing the periods before and after the Asian crisis. During the pre-crisis period (1990-1997), the economy was driven mainly by investment, with a higher volume of financing for capital-intensive industries and large infrastructure projects. Loans extended to the business sector experienced a strong average annual growth of 30% over the period. With the sources of growth of the economy shifting from investment to consumption, especially since 2001, the financing needs of the economy became less intense. In the post-crisis period (2001-2007), the corporate sector focused on de-leveraging and following the period of over investment, private investment began to decelerate. Consequently, the financing profile of businesses also changed, with businesses mainly borrowing short term to meet working capital needs, reducing their long–term loans for investment and relying more on the bond market, thus causing loans outstanding of the business sector to advance at a slower pace. At the same time, the shift in bank financing to the household sector resulted in a significant reduction in the average size of loans disbursed, mainly because financing to households for the purchase of fixed assets and consumption durables were smaller compared to the amount required for investment outlays by businesses. The combination of these factors led to a decline in the financing intensity by the banking institutions.

Chart 2.50
Financing Ratio of the Malaysian Economy, 1990-2007



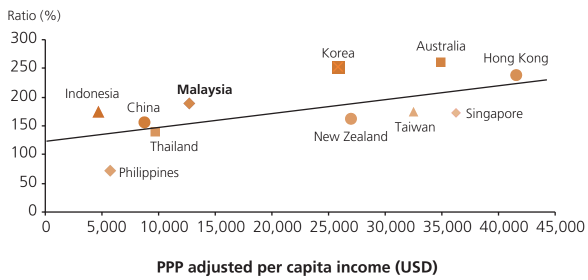
e Estimate
Source: Bank Negara Malaysia calculations

[1] Total financing comprises of two main components: (1) Domestic sources which consist of loans from the banking institutions, PDS, equities and loans from other domestic non-bank financial institutions (development financial institutions, Employee Provident Fund, insurance companies, leasing and factoring companies, the Treasury Housing Loan Division and Malaysia Building Society Berhad). (2) External sources which consist of foreign direct investments as well as short and long-term borrowings from abroad.

The different sectors of the economy also exhibited varying degrees of financing intensity, which is defined as the ratio of financing to sectoral output. The construction sector, which was one of the primary drivers of economic growth during the pre-crisis period, was characterised by a high financing intensity, as more capital was needed for construction and large infrastructure projects. The manufacturing and services sector, which became the biggest contributors to economic growth after the crisis, have lower financing requirements. The lower financing intensity in the manufacturing sector could be attributable to the large presence of MNCs, which rely more on internally generated funds for their operations. The services sector requires less financing for their investments given that the nature of their operations are less capital intensive. The shift in the sectors that drive economic growth thus is also a key factor accounting for the moderation in the financing to GDP ratio.

Although the financing to GDP ratio has moderated over the past several years, it has remained at a relatively high level. A cross-country comparison indicated that at 189%, the ratio of outstanding banking system loans and private debt securities to GDP for Malaysia was relatively high given its level of development, compared to some other regional countries (see chart 2.51). This was due to several factors. With regards to bank financing, Malaysia has a successful policy of promoting financial inclusion across regions and sectors. Households, for example, faced minimal constraints in accessing bank financing. Even as early as the first half of the 1990s, lending for the purchase of properties and cars had already accounted 20.4% of the total outstanding loans of the banking system (2007: 41.8% of total outstanding loans). An added impetus to the growth in household loans was that in the aftermath of the Asian crisis, the banking institutions shifted their focus from the business sector to the financing of the household sector as part of their business diversification strategies. Combined with the Government's policy of raising home ownership, which was manifested through various measures, household borrowing experienced marked growth in 2001-2005.

Chart 2.51
Financing[1] to GDP Ratio and PPP Adjusted per Capita Income: Country Comparison in 2007



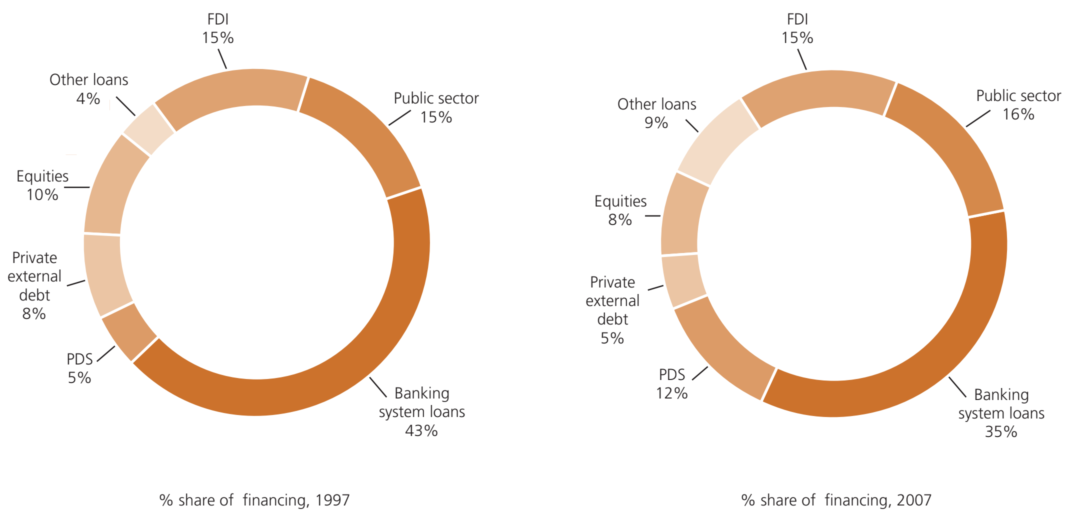
[1] Financing comprises of only banking system loans as well as private and public bonds outstanding

Source: Based on Bank Negara Malaysia calculations; data from Asian Bonds Online, CEIC and World Economic Outlook databases.

There were also significant changes in the sources of financing for the economy. In the last decade, the financial system in Malaysia has strengthened significantly and undergone significant transformation thus creating a more diversified and deeper financial system. Of significance has been the growing importance of the capital market in providing medium to long-term funding for corporates. Bank Negara Malaysia, together with other agencies undertook various measures to develop a strong market infrastructure and a comprehensive legal and regulatory framework to support the growth of the bond market. The Asian Development Bank, in June 2006, ranked the Malaysian debt securities market as the second largest in Asia after Japan. The share of financing through the issuance of PDS grew substantially from 5% of total financing in 1997 to 12% in

2007 (see chart 2.52). Although the share of loans extended by the banking system relative to overall financing declined from 43% to 35%, the banking system, nevertheless, remains an important source of financing for the working capital of businesses as well as for funding household investment and consumption. Over the same period, the share of household loans to total banking system loans increased from 33% to 56%. The role of other domestic intermediaries, namely the development financial institutions (DFIs), insurance companies and housing credit institutions as alternative providers of financing has also become more important. These institutions complemented the banking institutions by providing financing to selected sectors of the economy. More specialised institutions such as the DFIs have been increasing their financing, especially to the SMEs. As a result, financing from DFIs has expanded strongly at an average annual growth rate of 33% over the last seven years, to account for a larger share of 5.1% of total financing as at end-2007 (1.0% as at end-1997).

Chart 2.52
Sources of Financing



A distinctive development in the financing of the economy has been the growing importance of Islamic financing. Bank Negara Malaysia has implemented a range of measures to develop the Islamic finance industry, which have yielded significant results. Over the period of 2001-2007, financing via Islamic instruments expanded significantly at an average annual growth of 23% to support funding for new growth areas and to serve as an alternative source of financing for the economy.

In recent years, new measures have been introduced to deepen and enhance the efficiency of the financial system. Among others, key measures include the liberalisation of foreign exchange administration rules to allow multilateral financial institutions and multinational corporations to issue both ringgit and non-ringgit denominated instruments in the capital market; the launch of Malaysia International Islamic Financial Centre (MIFC) initiative; allowing locally incorporated foreign banks to establish Islamic subsidiaries; and the introduction of web-based Fully Automated System for Issuing/ Tendering (FAST). With these measures, the financial system will continue to evolve and become more effective in intermediating financial resources and risks, and supporting the continued transformation of the Malaysian economy.

Financing to the Household Sector

Financing of the household sector has been a major focus of growth by the banking institutions. Of the total increase in banking system loans outstanding in 2007, 55.6% was to the household sector. During the year, bank loans disbursed to the household sector advanced by 12.6% (2006: -1%). The strong performance was largely attributed to strong income growth of households, underpinned by stable employment prospects and rising wages. Wealth effects from the robust performance of the stock market, coupled by Government incentives as well as attractive and competitively priced loan products offered by banks were among the contributing factors to household loans reaching their highest level since 2005.

Loan disbursements for the purchase of residential property rebounded strongly to grow by 12.5% in 2007 (2006: -5.6%). Positive outlook for income and employment prospects underscored the strong increase in the demand for residential property. This was further augmented by various measures and initiatives introduced by the Government and other regulatory agencies to boost the residential property sector. Following the announcement of the exemption of real property gains tax in March 2007, financing for the purchase of residential property rose steadily to register firmer growth in the second half of 2007. The trend is expected to continue with the introduction of additional measures such as the 50% exemption of stamp duty on purchases of houses below RM250,000 as well as the monthly withdrawal from EPF Account II for the repayment of housing loans effective January 2008. This contributed to the strong growth in housing loan applications and approvals at 43.8% and 27.3%, respectively, in 2007 (2006: -7.2% and -11.5% respectively).

Chart 2.53
Household Sector Loan Indicators

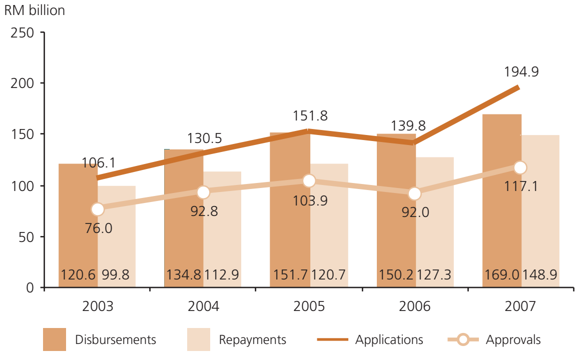
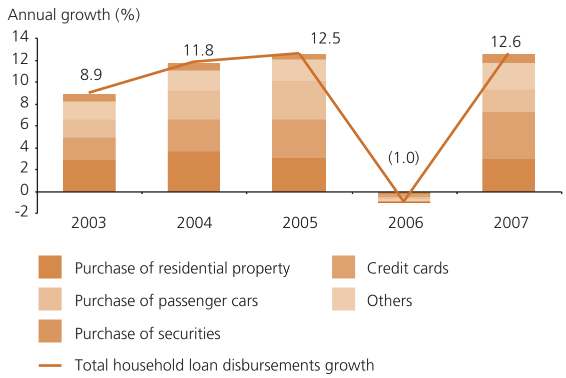


Chart 2.54
Banking System Loan Disbursements to Households: Total Growth and Contribution by Purpose



During the year, consumption credit expanded amid higher utilisation of credit cards and the drawdown of personal loans. Nonetheless, the repayment ratio[2] for credit cards remained high at 58.4% (2006: 58.2%) reflecting the continued use of credit cards as a means of payment rather than as a mode of financing.

Financing for the purchase of passenger cars turned around to register positive growth in second half of the year. For the year as a whole, car loans declined at a slower pace of -0.2% (2006: -27.2%). The rebound in growth was consistent with the revival of the car market following the launches of new mass-market and fuel-efficient models. More importantly, the used car market has also begun to see more stable prices, which facilitated consumer decisions to sell and replace their cars.

Despite the robust growth in financing, the overall level of household indebtedness remained at prudent levels. This was evident from the substantial improvement in the non-performing loans (NPL) ratio of households from 7.1% in 2006 to 5.3% in 2007. In addition, the NPL ratios for outstanding loans for residential property, passenger cars and credit cards were lower at 7.2%, 2.6% and 2.5% respectively (2006: 8.8%, 4.2% and 3.7% respectively).

[2] Repayment ratio = [(Total spending + cash advance) – outstanding balance] / (Total spending + cash advance).