

2012

MONETARY AND FINANCIAL CONDITIONS

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INTERNATIONAL MONETARY AND FINANCIAL CONDITIONS

Global financial markets continued to be influenced by ongoing uncertainties arising from the challenging global environment. International investor sentiments in 2012 were driven by concerns over the protracted sovereign debt crisis and fiscal issues in several of the advanced economies amid a weak global recovery, easy monetary conditions and low interest rates environment. Emerging economies remained resilient, supported by sustained domestic demand, despite being affected by surges and reversals of capital flows given their greater financial openness and integration with global financial markets. Significant monetary easing in the advanced economies further amplified conditions in the financial markets of the emerging economies.

Protracted sovereign debt crisis and fiscal situations in several of the advanced economies continued to influence global financial conditions

During the course of 2012, developments in international monetary and financial conditions broadly followed three distinct phases. The first quarter of the year saw continuing recovery from the market turbulence experienced in the second half of 2011. However, optimism in the global financial markets diminished in the second quarter of the year amid renewed concerns on the economic, banking and political situation in the euro area, together with the prospect of a faltering global recovery. Market conditions recovered in the second half of the year as the troubled European countries received the required funding, while policy-makers in the advanced economies pledged further monetary easing.

At the beginning of 2012, the global financial markets continued to recover from the market turbulence experienced in the second half of the

Chart 2.1

Selected Equity Market Indices



Source: Bloomberg

previous year. The positive sentiment in the global financial markets were supported by three key factors. Firstly, in January, the US Federal Reserve extended its pledge to keep interest rates low until late 2014, indicating the expectation for persistent unemployment and that inflation will be below its long-term objective until at least 2014¹. Secondly, debt concerns in the euro area were temporarily alleviated following the success of the Greek government in securing a second financial package amounting to €130 billion and a €107 billion private sector debt write-off in February. Thirdly, the European Central Bank (ECB) provided an additional €529.5 billion of liquidity through its second 36-month Long-Term Refinancing Operation (LTRO2), which was participated by 800 euro area banks². As a result, the global financial markets improved in the first quarter with the MSCI World index increasing by 10.9%, while measures of volatility such as the Chicago Board Options Exchange Volatility Index (VIX) and Merrill Lynch Option Volatility Estimate (MOVE), also trended downwards.

As global sentiment improved, investors also resumed their interest in the emerging economies given the favourable interest rate differentials and relatively stronger macroeconomic fundamentals

¹ Federal Open Market Committee's statement press release, January 25, 2012.

² ECB press conference, 8 March 2012.

Chart 2.2

JP Morgan Emerging Markets Bond Index (EMBI) Spread



Source: Bloomberg

compared to the advanced economies. The additional global liquidity from the balance sheet expansion of the crisis-affected advanced economies, had led to strong net inflows of about USD42.3 billion³ to the emerging economies in the first quarter. Reflecting these developments, the MSCI Emerging Markets index increased by 13.6% as regional equity markets increased by 4% to 17%. The JP Morgan Emerging Markets Bond Index (EMBI) spread between the emerging market bonds and US Treasuries also narrowed by 84.8 basis points, driven by the strong demand for emerging market bonds.

Despite the optimism in the global financial markets, structural weaknesses in the advanced economies continued to weigh down on the pace of global recovery. The International Monetary Fund (IMF), in its January 2012 World Economic Outlook (WEO) Update, lowered its global growth estimate for 2012 from 4% to 3.3%. Inflation in both the advanced and emerging economies was expected to be benign on account of slowing global growth, as well as the moderating commodity prices. Although oil prices were expected to remain relatively stable in 2012, non-oil commodity prices were projected to decline by 14% due to weaker global demand and improving supply conditions.

In the second quarter of 2012, concerns over the European sovereign debt crisis resurfaced following uncertainties over the political situation in Greece and the further deterioration in the health of the Spanish banking system. In Greece,

³ Source: Emerging Portfolio Fund Research (EPFR) Global.

Chart 2.3

10-year Yields of Selected European Sovereign Debt



Source: Bloomberg

the hung parliament in May triggered concerns on whether the country would be able to fulfil the conditions stipulated in its previous two financial packages. Speculation was rife that Greece may consider exiting the euro, thereby undermining the integrity of the monetary union. Simultaneously, the health of the Spanish banking system continued to deteriorate, raising doubts over the authorities' capacity to support the domestic banking system and the economy. In May, several Spanish banks were downgraded by Standard & Poor's, and the country's largest mortgage lender, Bankia, was nationalised. Sentiments began to worsen as it became increasingly clear that monetary policy alone would not be adequate to resolve the underlying issues in the euro area economies⁴. Market concerns were reflected in the sharp increase in sovereign yields for Greece, Portugal, Spain and Italy. Greece, in particular, saw its yields on 10-year sovereign debt increase by an unprecedented 1,025.7 basis points, while Portugal, Spain and Italy experienced a spike in yields by 92.7 basis points, 82.7 basis points and 46.1 basis points respectively by the end of May.

Speculation over the extent to which international rating agencies would downgrade the credit ratings of selected European countries and banks in the advanced economies was also a source of uncertainty. Moody's announced a ratings review for several US and European banks in February. Investors, however, remained uncertain of the magnitude of the potential downgrades.

⁴ Source: BIS Quarterly Review, June 2012.

Chart 2.4

Global Financial Market Volatility



Note: ¹Refers to VIX Index
²Refers to MOVE Index

Source: Bloomberg

The confluence of these developments led to marked declines across financial markets globally. From end-March to the beginning of June, the MSCI World index declined by 12.3% and volatility reached its peak for 2012, though remaining lower than the volatility experienced in the second half of 2011.

The escalation of the European debt crisis amid incipient signs of a weaker recovery in the US and moderating growth in PR China had cast further doubt over the pace of global economic recovery. Rising concerns over the fragile global recovery prompted investors to slow their pace of accumulation of emerging market financial assets or to partly unwind their positions. As a result, equity markets of emerging economies experienced a total net capital outflow of about USD11.7 billion⁵. The bond markets in the emerging economies, however, continued to experience sustained inflows underpinned by the stronger fundamentals of the emerging economies. Hence, bond markets in the emerging economies were still receiving net capital inflows of USD10.2 billion, albeit lower than the USD19 billion received in the first quarter⁶. On balance, the heightened risk aversion saw a net capital outflow from the emerging markets during the second quarter.

By the second half of the year, sentiments started to recover as events in Europe began to point towards some resolution. In Greece, the political

⁵ From end-March to end-June.

⁶ Flows numbers in the paragraph are sourced from EPFR Global which are estimates.

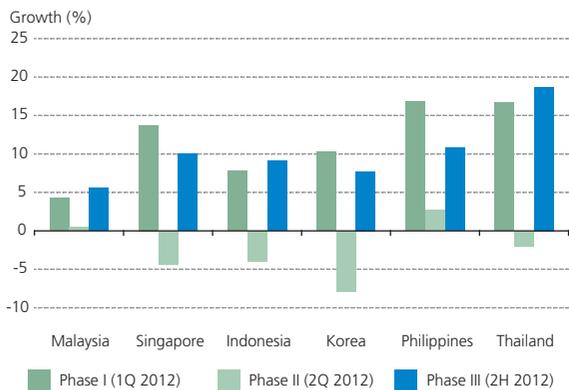
parties that were supportive of austerity measures were able to form a coalition government with a simple majority after the country's second election. Additionally, an EU summit held at end-June relaxed the strict requirements for access to financial assistance. Countries requesting aid were no longer subjected to the joint oversight of the European Commission, the IMF, and the ECB, and the aid could be directly provided to banks rather than through governments. This meant that future financial assistance could be negotiated and disbursed more quickly and flexibly. Additionally, the international rating agencies announced the extent to which certain countries and banks were to be downgraded. Moody's downgraded Spain's sovereign rating from A3 to Baa3, the lowest investment grade, in June. In the week after, the credit rating agency also downgraded 15 major US and European banks and placed Germany, the Netherlands and Luxembourg on negative outlook due to possible contagion from the European sovereign debt crisis. These announcements alleviated the uncertainties that had prevailed over the degree of potential rating downgrades.

During the second half of the year, further easing of monetary policy globally and improving sentiments provided the impetus for stronger performance in the financial markets

Furthermore, pledges and ensuing actions by central banks in both the advanced and emerging economies to ease monetary policy saw a stronger performance in the global financial markets. The US Federal Reserve and the ECB first announced in July that further monetary easing measures were forthcoming. In September, the US Federal Reserve launched a USD40 billion a month, open-ended, bond purchasing programme for mortgage-backed securities while extending its pledge to maintain low interest rates until mid-2015. Concurrently, the ECB announced its Outright Monetary Transactions programme whereby the central bank would engage in the unlimited purchase of sovereign bonds from distressed member states that requested for assistance. Rising downside

Chart 2.5

Performance of Selected Regional Equity Indices



Source: Bloomberg

risks to growth also prompted several regional central banks to reduce their policy rates.

The various easing measures by central banks worldwide renewed market optimism and provided support for the global financial markets to maintain their upward trend until the end of the year. Optimism on the prospects of the emerging economies, given the resilience of domestic demand in most of these economies, attracted net inflows of USD76.1 billion⁷ during the second half of the year. As a result, regional equity markets increased by 5% to 18%, while the JP Morgan EMBI spread declined by 108.4 basis points.

Although monetary easing and the other policy initiatives in the advanced economies improved sentiments in the global financial markets, investor sentiments remained erratic against new developments. While measures by the European policy-makers brought some relief to the international financial markets, the next phase of implementing the announced measures remains critical in sustaining investor confidence. Although emerging economies have been broadly resilient in managing the volatility of the global financial markets, challenges remained. As uncertainties and prolonged periods of monetary easing remained a feature of the global economic and financial landscape, the resilience of the financial markets in emerging economies will continue to be tested by developments in the advanced economies and the shifting investor sentiments.

⁷ Source: Emerging Portfolio Fund Research (EPFR) Global.

DOMESTIC MONETARY AND FINANCIAL CONDITIONS

Exchange Rate

The exchange rate of the ringgit during the course of 2012 was driven by two-way flows of trade, direct investment and portfolio funds, which reflected a combination of external and domestic factors. In tandem with developments in the international financial markets, ringgit movements during the year followed three distinct phases. From January to early March, the ringgit strengthened due to portfolio inflows, driven mainly by optimism over the growth prospects for Asia amid the low interest rate environment in the advanced economies. Between March and June, however, increased uncertainty led to the unwinding of the holdings of financial assets in the region, thereby resulting in a depreciation of regional currencies, including the ringgit. From July to December, renewed optimism over the prospects for the global economy resulted in the resumption of portfolio inflows and ringgit appreciation. The ringgit ended the year at RM3.0583 against the US dollar, an appreciation of 3.9%.

Ringgit movements were driven by two-way flows of trade, direct investment and portfolio funds throughout the year

The ringgit appreciated by 6.0% from January to early March. The Malaysian economy showed continued underlying strength amid generally positive prospects for the region. This, coupled with expectations of a prolonged low interest rate environment in the advanced economies, attracted international investors towards regional financial assets. This resulted in net portfolio inflows of RM25.3 billion into Malaysia in the first quarter of the year. Against this backdrop, the ringgit reached RM2.9900 on 1 March 2012, the strongest intraday level since September 2011.

The appreciating trend of the ringgit and other regional currencies was interrupted over the March to June period. This was in reaction to renewed uncertainties over the sovereign debt crisis in Europe and concerns over the weakening US recovery and the moderation of PR China's

Commodity Price Boom: Is Financialisation a Factor?

Introduction

Following decades of relative stability, global commodity prices rose sharply during the recent decade and have experienced considerable volatility since then (Chart 1). This noticeable shift has generated considerable debate and polarised opinion on the drivers of commodity prices. Historically, the primary drivers of commodity prices have been fundamental changes in global demand and supply factors. Short-term shocks such as sudden disruptions in supply that create shortages globally have at times also affected commodity prices. These factors continue to be important. However, the acceleration and swings in commodity prices in recent years combined with the rapid proliferation of financial instruments indexed to commodity prices have raised questions on the role that financial market participants have in determining commodity prices. This article looks at both sides of the argument and leverages on available literature and studies to provide some insights on the extent that greater financialisation of commodities, through the creation of financial products based on commodities, drive the recent trends in commodity prices.

The role of demand and supply conditions in driving commodity prices

There is a general consensus that historically, fundamental factors such as changes in global demand and supply conditions have been important drivers of commodity prices. The recent acceleration in global commodity prices, specifically between 2004 and 2008, was no different.

Following a sustained period of strong world economic growth, global oil consumption increased more rapidly between 2001 and 2007 than in the previous decades¹. Most of this increase can be attributed to the rising demand from emerging economies (especially PR China and India), as a combination of steady income and population growth propelled the growth of economic activity. Emerging economies' energy and food consumption have been increasing steadily since 1996, growing at an annual rate of 3.0% and 1.7% respectively². PR China's energy and food consumption alone grew at 7.1% and 1.8% over the same period. Conversely, in the advanced economies, energy consumption declined by 0.1% while food consumption grew at a modest rate of 0.8% during this period³ (Charts 2 and 3).

The demand for agricultural inputs for the production of biofuels was another significant factor. The introduction of subsidies for biofuel production, especially in Australia, Canada, PR China, European Union and the US during the 2006-2009 period caused a diversion of some food commodities to the production of biofuels. As a result, biofuel production accounted for a significant share of global use of several food commodities – 20% for sugar cane, 9% for vegetable oil and coarse grains and 4% for sugar beet⁴. In fact, under the US law, 40% of the corn harvest must be used to make biofuel⁵.

Chart 1

Global Commodity Prices



Source: S&P GSCI Spot Index, Bloomberg

¹ Based on European Central Bank (2010), the annual average growth of global oil consumption was about 27% between 2001 and 2007, compared to 19% and 2% in 1991-2000 and 1980-1990 respectively.

² British Petroleum Statistical Review, FAO, OECD, and Bank Negara Malaysia calculations (Emerging economies include Brazil, PR China, India, Russian Federation, Bangladesh, Indonesia, Iran, Iraq, Kazakhstan, the Republic of Korea, Myanmar, Pakistan, the Philippines, Saudi Arabia, Thailand, Turkey, Vietnam, Egypt, South Africa, Ethiopia, Nigeria, Mexico, Argentina, Chile, Colombia, Peru, Venezuela, Serbia and Ukraine).

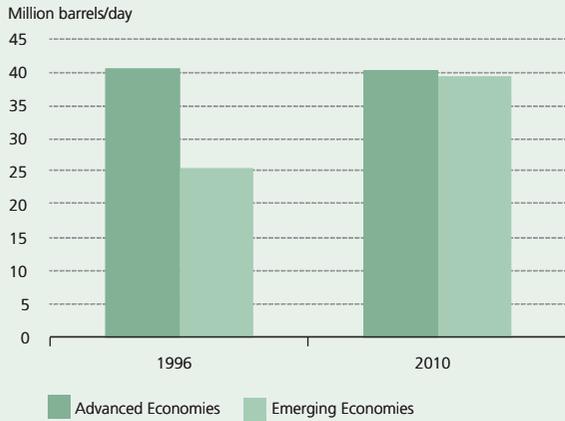
³ British Petroleum Statistical Review, FAO, OECD, and Bank Negara Malaysia calculations (Advanced economies include Australia, Canada, European Union, Japan and the US).

⁴ Policy report on Price Volatility in Food and Agricultural Markets contributed by FAO, IFAD, IMF, OECD, UNCTAD, WFD, World Bank, WTO, IFPRI and the UN HLTF.

⁵ Energy Independence and Security Act of 2007.

Chart 2

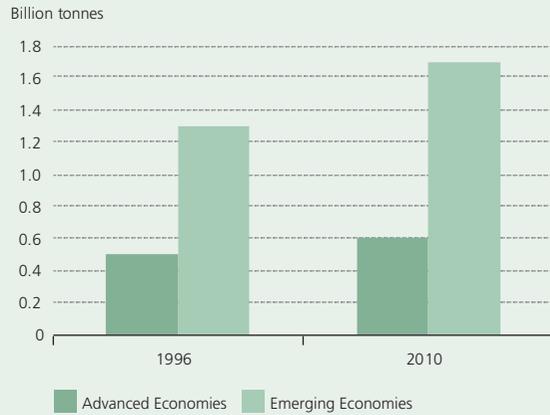
Global Energy (Crude Oil) Consumption



Source: British Petroleum Statistical Review

Chart 3

Global Food (Cereal) Consumption



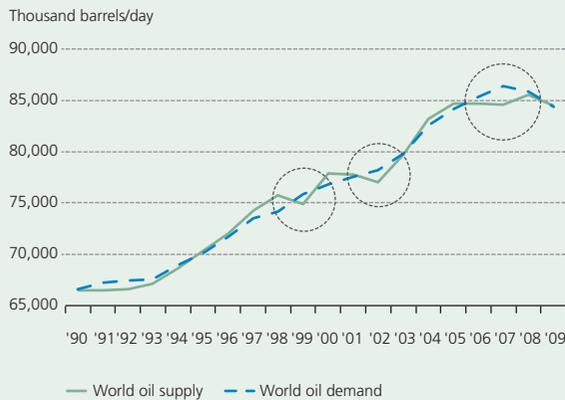
Source: Food and Agriculture Organisation of the United Nations (FAO), Organisation of Economic Co-operation and Development (OECD)

The rise in biofuel production also created pressure on prices of agricultural products which are not used in the production of biofuels, as more agricultural land was converted to produce crops needed for biofuel production.

The impact of rising demand for commodities on prices was more pronounced because supply could not keep up. For example, the sharp rise in global commodity prices occurred at a time when there was increasing tightness in global oil supply. World oil production began to stagnate between 2004 and 2009, mainly due to geological constraints in some of the large non-OPEC oil-producing countries. It has been viewed that the sudden slowdown in world crude oil production during this period contributed to the sharp rise in oil prices⁶ (Chart 4).

Chart 4

World Oil Demand and Supply



Source: US Energy Information Administration (EIA)

Unexpected short-term supply disruptions from socio-political and weather-related events also caused surges in prices over this recent decade. Climatic factors, for example, were major contributors to the rise in prices of agricultural commodities between 2007 and 2010. In 2008, a drought in Australia, which is an important global supplier of wheat, led to a shortage of wheat supply in an already tight market, causing a sharp rise in prices⁷. More recently, in 2010, severe drought and wildfires in the Russian Federation destroyed one fifth of Russia's crop, which caused their annual wheat production to fall by 25 million tonnes. As a result, wheat prices rose sharply, from USD5 per bushel in August 2010 to a peak of USD9 per bushel in February 2011. The fall in supply and subsequent rise in prices were exacerbated by Russia's decision in August 2010 to ban grain exports for the remainder of that year.

⁶ Kaufmann (2011), European Central Bank (2010).

⁷ Wheat supply was already tight following consecutive droughts in Australia in 2006 and 2007 and a frost that damaged crops in the US in mid-2007.

Growing influence of non-commercial traders on the commodities market

While there is no doubt that the long-term trend of commodity prices can, for the most part, be attributed to fundamental shifts in global demand and supply of commodities, there are signs to suggest that financial market participants are increasingly becoming more influential in the commodity markets, relative to the traditional, commercial traders.

First, funds allocated to commodity derivatives have risen substantially since 2004.

The increasing interest in the commodities market by non-commercial traders⁸ has led to a more than six-fold increase in the outstanding futures and options contracts on commodity exchanges, from roughly 10 million contracts in 1999 to over 60 million contracts in 2011⁹. The low interest rate environment, which triggered investors to search for higher returns in non-traditional asset classes, and financial innovation allowing a wider base of investors to have exposure to the commodities market, are cited as reasons behind the rise and the attractiveness of commodities as investment alternatives.

Second, there has been unprecedented growth in index investment¹⁰. A major element behind the recent inflow of financial investments into commodities markets is the emergence of commodity index investors. The rise in index investment is substantial, with the estimated assets allocated to commodity index trading strategies rising from USD15 billion in 2003 to USD210 billion in 2012¹¹. Collectively, index investors make up a significant portion of non-commercial participants in commodity markets. Their unique motivation and specific investment strategy¹², which could at times be detached from the fundamentals of the underlying commodities, coupled with the sheer volume of their investments have led many market observers to conclude that the participation of index investors could exert considerable influence on commodity price movements.

Third, non-commercial trades (speculators and index investors) outnumber commercial commodity trades. Financial market transactions currently overwhelm actual trading of physical commodities. A recent report¹³ suggests that non-commercial trades now account for at least 64% of all recorded oil trading positions. In the past, non-commercial positions in oil trading usually accounted for 30% of total trades¹⁴.

Fourth, there is a strong co-movement between speculative net buying and selling activities in the commodity futures market and commodity prices. To some extent, the net speculative positions of commodity futures contracts, which nets off the non-commercial traders' 'buy' and 'sell' orders, can be a reflection of investor sentiments and their views on the future¹⁵.

⁸ Agents in the commodities market are typically categorised into commercial and non-commercial traders. The United States Commodity Futures Trading Commissions (CFTC) defines commercial traders as those that either produce or consume physical commodities while non-commercial traders are purchasers of commodity futures that do not operate in the physical market and do not have exposure to the prices of the physical commodities. The non-commercial traders include not only the speculators, who can buy and sell commodity futures contracts based on their views, but also the index investors, who passively hold commodity futures position as a component of a diversified portfolio.

⁹ Bank for International Settlements (2011).

¹⁰ Index investment is no different from a mutual fund, whereby the funds invested in the commodity index are used to purchase the basket of commodities specified by the index, which explains the reason why index investors have only buy (long) positions in the commodities market.

¹¹ US CFTC's Index Investing Data

¹² Given their motivations to hold commodities as part of a diversification strategy, index investors may continue to maintain their commodity holdings regardless of market conditions or price movements. This provides artificial demand in the market. On the other hand, if investors decide to withdraw their investments due to reasons unrelated to the fundamentals of the underlying commodities, index managers in such indices will have no choice but to liquidate their positions, regardless of their outlook for the commodities. In addition, the rigidity of the weights attached to each commodity in an index may require the buying and selling of certain commodities to maintain the original allocation. Again, these transactions may not necessarily reflect the fundamental factors driving the commodities underlying the index.

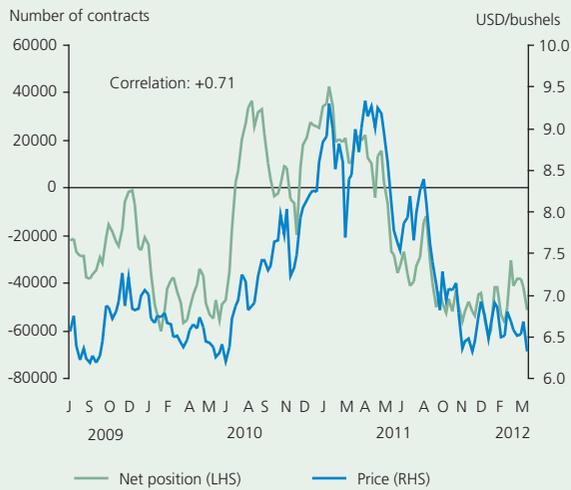
¹³ US CFTC Commitment of Traders Report 2012

¹⁴ Hall (2012)

¹⁵ Typically, in the commodities market, there are buyers and sellers of the futures contracts of the same commodity. The buyers' and sellers' orders, when 'netted out', becomes the net speculative position. When there are more buy orders relative to sell orders, there is a net speculative long position and when there are more sell orders compared to buy orders, there is a net speculative short position.

Chart 5

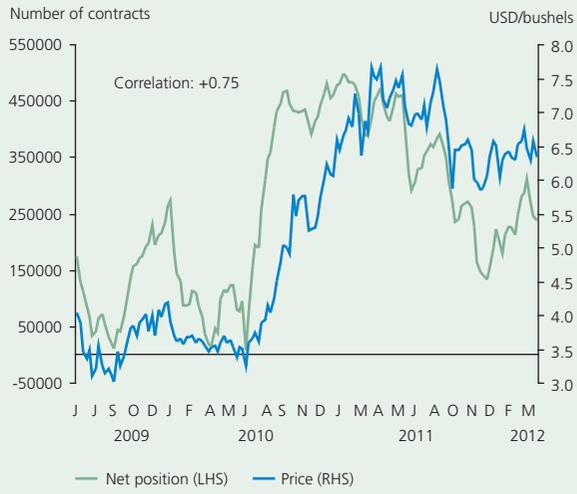
Net Speculative Positions on Wheat Futures Contracts and Impact on Price



Source: US Commodity Futures Trading Commission (CFTC)

Chart 6

Net Speculative Positions on Corn Futures Contracts and Impact on Price



Source: US Commodity Futures Trading Commission (CFTC)

The high degree of co-movement between net speculative positions and spot commodity prices provides some indication of the influence speculators have on commodity price movements (Charts 5 and 6).

Fifth, there is rising co-movement between global commodity indices and equity indices. Prior to 2004, movements in the commodity and equity markets appeared uncorrelated. Commodity prices were mostly influenced by the fundamentals behind each commodity while the equity market was more susceptible to swings in the risk appetite of investors. Since 2004, however, the increased participation of financial investors meant that global commodity markets became more sensitive to portfolio rebalancing by financial investors. This caused movements in commodity prices to be more correlated with prices in other asset markets, including the equity markets. Between the period 2006 and 2012, the correlation between commodity¹⁶ and equity¹⁷ indices rose substantially, from almost zero in 2004 to 0.6 in 2012¹⁸.

The extent of influence of financialisation

Given the growing consensus that both fundamental and financial factors do, to varying degrees, have a role in influencing commodity price movements, research and studies have naturally turned to assessing their relative importance. The common conclusion from existing literature is that while global demand continues to account for the long-run trend of commodity prices, speculative investment flows into commodity markets amplify the movements in commodity prices¹⁹. Notwithstanding the different categorisation of financial participants in the commodities market and the varying methodologies applied, empirical evidence suggests that, on balance, fundamental factors appear to matter more in explaining commodity price trends. Financialisation of commodities, however, can and did exacerbate the boom-bust cycle in commodity prices in the short-run. More specifically, a range of studies found that speculative activities amplified commodity price movements by between 15-28% (Table 1).

¹⁶ S&P GSCI Spot Index

¹⁷ S&P 500

¹⁸ Bank Negara Malaysia calculations.

¹⁹ While some studies attribute speculative activities to all non-commercial investors and quantify their impact as a whole, others disaggregate the non-commercials to distinguish the impact of only the index investors given the nature of their investment strategies and the significant amount of their investments.

Table 1**Summary of Studies That Have Tried to Quantify the Impact of Speculative Activities in the Commodities Market**

Studies	Impact (%)
Gilbert (2009)	~15
Van der Molen (2009)	26.8
Khan (2009)	19-28*
United Nations Conference on Trade and Development (2011)	20-25
Pollin and Heintz (2011)	26.5*
Davies (2011)	25*
Lombardi and Robays (2011)	15
Lenzner (2012)	22*
Juvenal and Petrella (2012)	~15

* Includes Bank Negara Malaysia calculations

Conclusion

The rapid increase and sharp swings in commodity prices in recent years have led to a reassessment on the drivers of commodity prices. While there is increased acceptance on the role that the financialisation of commodities has in driving commodity prices, its importance relative to fundamental factors remains an open question. Certainly, the impact that non-commercial traders have on global commodity price movements and the dynamics behind them needs to be better understood. An area of research interest which is largely absent in the existing literature is the relationship between monetary policy and commodity prices. Among key questions of interest are the extent to which highly accommodative monetary policy globally in recent years has contributed to the financialisation of commodities and hence commodity price swings, the impact on global food prices and the supply for human consumption, and the efficacy of monetary policy in addressing supply-related inflation, especially in highly-open emerging economies.

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Chart 2.6

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



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

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

Source: Bank Negara Malaysia

economy, factors which had raised concerns over the prospects of global and regional economic growth. International investors consequently unwound holdings of emerging market assets. The increased global uncertainty also prompted higher hedging activity by local exporters, as reflected by the larger concentration of forward sales by local exporters in the 3-6 month tenure.

Portfolio inflows resumed in the second half of the year. Expectations for further monetary easing in the US and the eventual implementation of the policy, together with expectations for progress in resolving the European sovereign debt crisis, led to renewed investor optimism towards global and hence regional growth prospects. This in turn led to increased demand for regional financial assets. The release of positive economic data for Malaysia during the period provided additional impetus for the further strengthening of the ringgit. Consequently, the ringgit appreciated by 4.3% against the US dollar during this period.

Against other major currencies, the ringgit appreciated against the Japanese yen (15.2%) and the euro (1.7%), but depreciated against the pound sterling (-0.9%). The ringgit's performance against regional currencies was mixed. The ringgit appreciated against the Thai baht (0.2%), Chinese renminbi (2.5%) and Indonesian rupiah (9.2%), but depreciated against other regional currencies by between 2.4% and 4.2%. For the

year as a whole, the ringgit's Nominal Effective Exchange Rate (NEER), a measure of the ringgit's performance against the currencies of Malaysia's major trading partners, appreciated by 3.0%.

The improved sentiments towards the ringgit in the second half of the year led to a decline in the demand for hedging. Foreign exchange forward activity fell by 21% during this period compared to the first half of the year. In addition, the improved sentiments also led to increased US dollar liquidity in the domestic market. An indication of this improved liquidity was that the 5-year USD/RM cross-currency swap points, which indicated the cost of raising US dollars in the domestic foreign exchange market, declined from 145 basis points in June to 125 basis points in December.

Chart 2.7

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

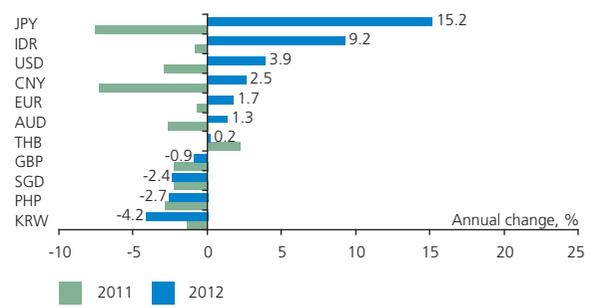


Note: An increase in the index indicates an appreciation of the ringgit against the currency

Source: Bank Negara Malaysia

Chart 2.8

Summary of Malaysian Ringgit (RM) Performance Against Major and Regional Currencies



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

Source: Bank Negara Malaysia

The more balanced two-way trade and investment flows contributed to the orderly functioning of the Malaysian foreign exchange market, despite the sharp increases in volatility in the international currency markets. The 34% increase in gross inflows during the year coincided with a 39% increase in gross outflows. As a consequence, the Bank's international reserves position remained relatively stable over the course of the year, and the exchange rate was largely determined by market conditions.

Interest rates, bond yields and equity prices

After raising interest rates in 2010 and 2011, the Monetary Policy Committee (MPC) maintained the Overnight Policy Rate (OPR) at 3.00% throughout 2012. Consequently, domestic monetary conditions remained supportive of economic activity, while minimising the risks of financial imbalances.

Interest rates remained stable in 2012, reflecting the stance of monetary policy to promote balanced and sustainable growth of the economy

Reflecting the unchanged OPR, money market rates remained relatively stable throughout the year. The average overnight interbank rate (AOIR) traded close to the OPR, within a range of 2.89-3.00%, while interbank rates of other short-term tenures were also relatively

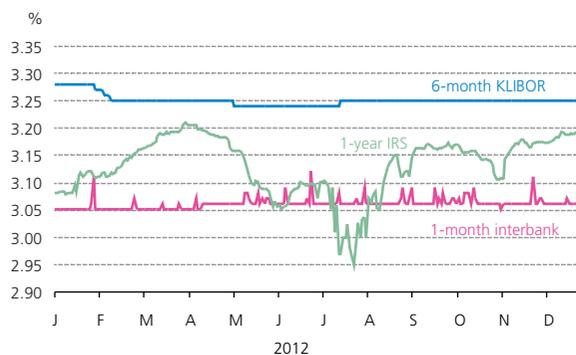
unchanged. Medium-term money market rates however, were influenced by market expectations for OPR changes. In the first half of the year, KLIBOR and interest rate swaps (IRS) rates moderated slightly as markets anticipated a monetary policy response amid greater downside risks to the domestic economy given slower global growth. Market interest rates, however, normalised in the second half of the year as market participants revised their interest rate expectations in light of the resilience of the domestic economy.

Retail lending rates were also relatively stable during the year. The benchmark lending rate, as measured by the average base lending rate (BLR) of commercial banks, remained at 6.53%. At the same time, the weighted average lending rate (ALR) of total loans outstanding experienced a gradual moderation of 14 basis points, to end the year at 5.52%. This reflected the gradual maturing of older loans, which were contracted prior to the 2008 financial crisis when the OPR and hence borrowing costs were higher, and the addition of new loans at relatively lower rates.

Both businesses and households continued to benefit from low interest rates throughout 2012. The low retail lending rates reflected three factors. First, the cost of funds remained low as a result of the stable monetary policy stance. Second, with sustained domestic demand and income growth, the credit profile of borrowers in general remained healthy as evidenced by the low proportion of loan defaults. This prevented credit risk premiums from widening. Third, the increased competitive environment kept the margins charged on loans at low levels.

Chart 2.9

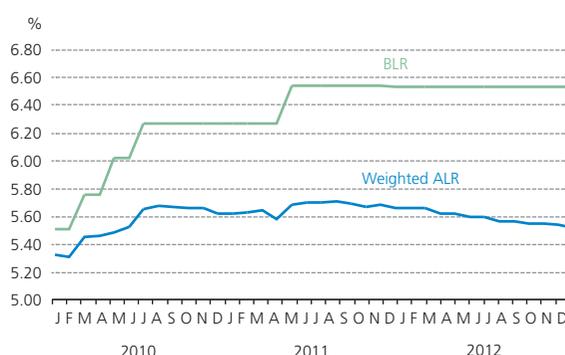
Money and Financial Market Rates



Source: Bank Negara Malaysia and Bloomberg

Chart 2.10

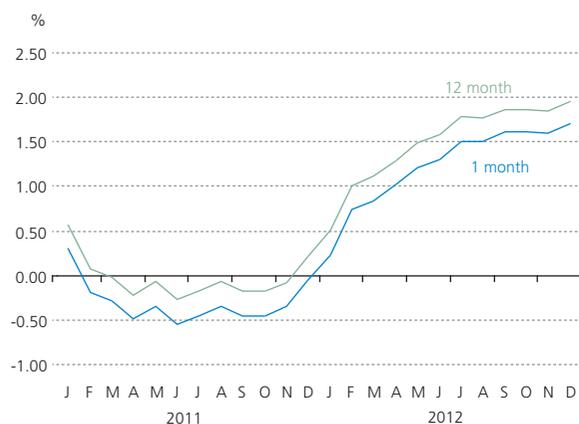
Commercial Banks' Lending Rates (at end-period)



Source: Bank Negara Malaysia

Chart 2.11

Real Fixed Deposit Rates



Source: Bank Negara Malaysia

Deposit rates of commercial banks were stable throughout the year. As at end-December 2012, the average quoted fixed deposit rates of commercial banks for the tenures of 1 to 12 months ranged between 2.90% and 3.15% respectively. Depositors continued to be compensated with increasing positive real rates of return, due in part to the downward trend in inflation during the course of the year.

MGS yields were largely shaped by a combination of external and domestic factors

Movements in yields on Malaysian Government Securities (MGS) during the year were largely influenced by a combination of external and domestic factors. Market expectations for a lower OPR following concerns over the slowing global growth and the implications on the domestic economy, coupled with the increased non-resident demand for MGS kept yields low. However, a reversal of earlier market expectations for a decrease in policy rates combined with the larger government bond auctions did result in some upward pressure on yields during the year.

MGS yields started the year on a downward trend given market expectations of a policy rate cut. Yields on the 1-year MGS fell to a yearly low of 2.76% in February, well below the OPR rate of

Chart 2.12

MGS Yields



Source: Bank Negara Malaysia

3.00%. In March, however, yields increased, with the 1-year MGS yield rising by 19 basis points following the reversal of market expectations on the OPR. In the subsequent period, despite renewed concerns over the European sovereign debt crisis and the prospect of a faltering global recovery, non-resident holdings of MGS increased by RM10.9 billion from April to July, driven by the relatively strong fundamentals of the domestic economy. This contributed to a downward trend in MGS yields across all maturities. This trend was interrupted in August and September, as the large size of government bond auctions during the period resulted in some upward movement in the yields. Yields were broadly stable towards year-end, with the exception of a temporary decline in October following the announcement of further quantitative easing measures by the US Federal Reserve. Overall, the benchmark MGS yield curve flattened in 2012, reflecting a combination of a rise in short-term yields by 3 to 19 basis points and a decline in the 10-year MGS yields by 20 basis points.

Reflecting Malaysia's strong macroeconomic fundamentals, Malaysian government bonds remained attractive amongst international investors. Sustained non-resident inflows into the MGS market resulted in the share of non-resident holdings of MGS increasing sharply to a high of 44.4% of total outstanding MGS by end-December 2012. While such inflows contributed towards increasing the depth, breadth and vibrancy of the bond market and enhancing the efficiency of price discovery, it also suggested possible vulnerability of the bond market to a sharp and sudden

Chart 2.13

Outstanding Debt Securities Held by Non-Residents

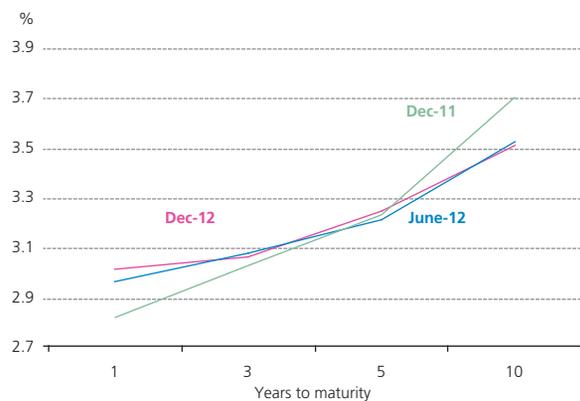


Source: RENTAS, Bank Negara Malaysia

withdrawal of non-resident funds, with destabilising consequences on the financial system. This, however, was not a concern based on three factors. First, Malaysia has a deep and liquid bond market that is able to effectively intermediate the inflows, being the fourth largest in Asia after Japan, PR China and Korea⁸. Including sukuk, private debt securities and central bank securities, non-resident holdings make up only 22.3% of the total domestic bond market. Second, the strong demand for MGS by local institutional investors would provide a backstop in the event of a reversal in flows. The bulk of the domestic investor base consists of pension funds and

Chart 2.14

MGS Benchmark Yield Curve



Source: Bank Negara Malaysia

⁸ In percentage of GDP, Malaysia's bond market is the third largest in Asia after Japan and Korea, while in terms of volume, it is the fourth largest after Japan, PR China and Korea.

financial institutions, which also includes a more developed insurance industry, continue to demand investible assets given the growth in their liabilities. Third, despite the ongoing uncertainties in global financial markets, the underlying fundamentals such as growth and interest differentials will continue to provide support for the local bond market.

PDS yields remained favourable for fund-raising amid high demand for financing from infrastructure and ETP-related projects

The domestic private debt securities market (PDS) registered strong growth in 2012 amid favourable market conditions. Fund-raising activity in the PDS market increased significantly, with new PDS issuances amounting to a record high of RM121.1 billion, reflecting the higher demand for financing from infrastructure-related projects and the Economic Transformation Programme (ETP). Despite the significant increase in the supply of PDS, the cost of bond market financing remained favourable. PDS yields declined across the board, with yields on the 5-year AAA, AA and A-rated papers registering a decrease of 18.5 basis points, 35.1 basis points and 12.6 basis points respectively for the year. Both liquidity and credit conditions also improved in 2012. Total turnover in the PDS market increased to RM161.4 billion in 2012 from RM112.3 billion

Chart 2.15

5-year MGS and 5-year PDS Yields



Source: Bank Negara Malaysia

Chart 2.16

Regional Equity Indices



Source: Bloomberg

in 2011, while the number of negative rating actions during the year declined to 25 from 51 in 2011.

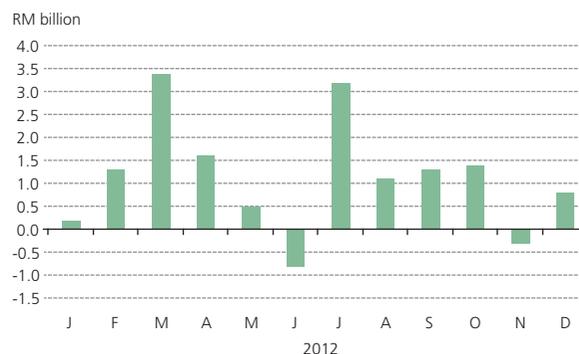
Domestic equity market remained resilient despite uncertainties surrounding the global economic outlook

Despite uncertainties surrounding the global economic outlook, the domestic equity market remained resilient. In 2012, the FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) increased by 10.3% (2011: 0.8%) to close at 1,689 points. A broadly similar trend was also observed in other regional markets. The positive performance was driven by the favourable outlook for the domestic economy and demand from non-residents, despite there being several episodes of temporary withdrawals by non-residents following heightened global risk aversion.

The FBM KLCI, in tandem with other regional markets, increased in the first quarter of the year following improved market sentiments arising from positive developments in the European sovereign debt crisis and further easing by central banks in the advanced economies. Moreover, significant progress of the ETP projects, especially with the commencement of construction work for the Mass Rapid Transit (MRT) project, contributed to the improvement in investors' confidence,

Chart 2.17

Net Buying of Equities by Non-Residents



Note: (-) indicates more selling activities by non-residents

Source: Bursa Malaysia

giving rise to more buying interest in the domestic equity market. The upward trend in the index, however, was interrupted in the subsequent quarter amid renewed uncertainty over the faltering global growth, leading to reduced holdings of local equities by non-residents and higher volatility of the FBM KLCI returns.

In the second half of 2012, domestic equity prices recovered strongly and reached historical highs as global uncertainties subsided and positive domestic fundamentals supported the equity market performance. Expectations for further stimulus measures in the advanced economies, reinforced by better-than-expected performance of the domestic economy in the second quarter

Chart 2.18

Volatility of Returns on the KLCI¹



¹Refers to 30-day rolling standard deviation of daily returns

Source: Bank Negara Malaysia calculations

Responsiveness of the Malaysian Government Securities Yield Curve to Movements of Sovereign Bond Yields Abroad

Introduction

The greater financial integration over the past decade has led to more synchronised movements of financial markets across the globe. As the domestic bond market, particularly the Malaysian Government Securities (MGS) market, deepens, the movements of the domestic yield curve are increasingly influenced by movements in foreign bond yields as both domestic and foreign investors respond to global developments and sentiments. Such inter-linkages may have resulted in stronger correlations between MGS yields and sovereign yields in other economies. In effect, at any given point in time, the shape of the MGS yield curve could be influenced by a change in foreign yields that are responding to shocks that may not have any influence on macroeconomic factors in Malaysia. As the yield curve provides important information on expectations of the economic conditions, it is therefore important to understand the extent of the co-movement between the domestic and foreign yield curves. Given this motivation, this study attempts to assess the importance of foreign yields in influencing the domestic yield curve. The study also evaluates whether there are any important differences in the response of the MGS yield curve to shocks originating from the advanced economies compared to those emanating from the regional bond markets.

Information content of the yield curve

The study of the yield curve is developed based on the term structure of interest rates, which is built upon the expectations hypothesis (EH)¹. EH essentially equalises the long-term interest rates with short-term interest rates and market expectations of future interest rates² and a risk premium, reflecting the opportunity costs of holding bonds. The yield curve is a plot of yields on securities of different maturities at a particular point in time. These maturities range from the shortest period of one month, up to ten, or even thirty years for the more advanced markets. Accordingly, the shapes of the yield curve provide an indication of market expectations of the future path of short-term interest rates. A normal yield curve is upward sloping as longer-maturity bonds would carry higher yields due to an increase in risk associated with time. A steepening yield curve reflects market expectations of higher short-term rates in the future underpinned by anticipation of a higher policy rate following expectations of rising inflation. The reverse is true in the case of a flattening of the yield curve. The yield curve could also shift in a parallel manner, in which both short-term and long-term yields move in the same direction following a change in risk premia across all maturities. The risk premia for government bonds refers to the added compensation needed for investors to hold domestic bonds given the overall risk profile of a country, including its default risk, credit risk and liquidity risk. A country with weak fiscal discipline and rising credit risk, for instance, would have to offer a higher yield to draw investors into holding its bonds.

Estimating the response of the MGS yield curve to shocks from foreign government bond markets

One of the approaches in modeling the yield curve is the Nelson-Siegel (NS) exponential framework³. The model estimates three measures of the yield curve, which represent the level, slope and curvature components of the yield curve. These components refer to how the shape of the yield curve would change following a shock. The level component refers to the effect of the shock on long-term yields and such an effect is normally reflected in parallel shifts in yields of all maturities. A shift in the level component reflects structural influences such as a change in the market perceptions on a country's long-term inflation outlook, or a change in the assessment of credit worthiness of a country. The slope component reflects the effect of the shocks to short-term yields that will result in a change in the degree of steepness of the yield curve. The key factor that often alters the slope of the yield curve is a change in market expectations about domestic monetary policy decisions. As central banks

¹ Apart from EH, there are other theories used to explain the term structure of interest rates, and these include liquidity premium theory, market segmentation theory, pure expectations theory and preferred habitat theory.

² $(1 + i_{lt})^n = \rho + (1 + i_{st})^1(1 + i_{st})^2 \dots (1 + i_{st})^n$ where the subscripts *lt*, *st* are abbreviations for long-term and short-term respectively. ρ is the risk premium and the superscripts 1, 2, ..., *n* indicate the time periods.

³ The model is developed by Nelson and Siegel (1987) and extended by Diebold and Li (2006).

generally target a very short-term interest rate, a shift in the market's expectations towards a lower future policy rate for example, will cause the yield curve to flatten, reflecting lower short-term interest rates in the future. The curvature component refers to the effect of the shock on medium-term yields compared to other maturities, which would cause the yield curve to become more 'hump-shaped'. All these components are unobservable but the NS framework would allow the estimation for these underlying components. Through the estimation of these components, a time varying yield curve could be established and its dynamics could be tested against the relevant factors that drive the movements of short-term and long-term bond yields. In this study, the NS methodology is employed to distinguish the responses of the MGS yield curve to shocks that originate from either the advanced or regional markets. Using monthly data from four advanced economies and seven regional economies⁴, the slope and level components of the yield curves are extracted for each of the eleven countries.

After obtaining the different components of the yield curves, the study adopts a two-step approach to test for co-movements. In the first step, a variance decomposition study is undertaken to assess the extent of co-movement of MGS yields vis-à-vis movements of the foreign sovereign bond yields. Next, the respective bond yield components from the regional and advanced markets are analysed along with the MGS yield components using the VAR model, in which the re-aggregated generalised impulse response function is generated to synthesise the dynamic responses of the MGS yield curve to shocks coming from the regional and advanced economies. This exercise would be useful in determining whether there are important differences in the responses of MGS yields to shocks from the regional and advanced economies.

Strong co-movement between MGS and foreign government bond yields

The results from the variance decomposition approach show the significant co-movements between foreign government bond yields and the MGS yields. In terms of the long-term yields, it appears that both regional and advanced markets collectively contribute by about 80% of the total variations in the long-term MGS yields with the advanced markets alone accounting for about 45% of the total variations. For the short-term MGS yields, the regional and advanced markets together contribute over two-third to the total variations in MGS yields. These results generally conform to empirical findings for financially open capital markets in which variations in yield curves globally could account for the majority of the variations in the slope and level factors⁵. In particular, the strong co-movement of yields reflects the importance of the advanced markets in influencing global asset prices (including sovereign yields). This is supported by the IMF Spillover Report for the US, which highlights that the US market represents close to two-thirds of the total equity and government bond market turnover of the five large and systemically-important economies⁶. Such a global dominance of the US financial markets has often contributed to large spillover effects of asset prices in the US on other markets⁷.

MGS yield curve respond differently to shocks from advanced markets compared to shocks from regional markets

The results of the second part of the study are broadly summarised in Chart 1, which shows the impulse responses of the MGS level and slope components following shocks to the corresponding yield components of the advanced and regional markets. The impulse response is calculated over the 1-month, 3-month, 6-month and 12-month horizons. A notable pattern is observed in which the MGS yield curve responds differently to shocks from advanced markets vis-à-vis shocks from regional markets.

⁴ The advanced economies comprise of the euro area, the UK, the US, and Japan while regional markets include PR China, Hong Kong SAR, Indonesia, the Philippines, Singapore and Thailand. Data length varies for each country, from the earliest 1992 up to 2011.

⁵ Diebold, Li and Yue (2008) shows that global level factors account for 60% to 80% of total variations in the US, Japan, Germany and the UK, while global slope factor accounts for almost entire variations for economies with common business cycle.

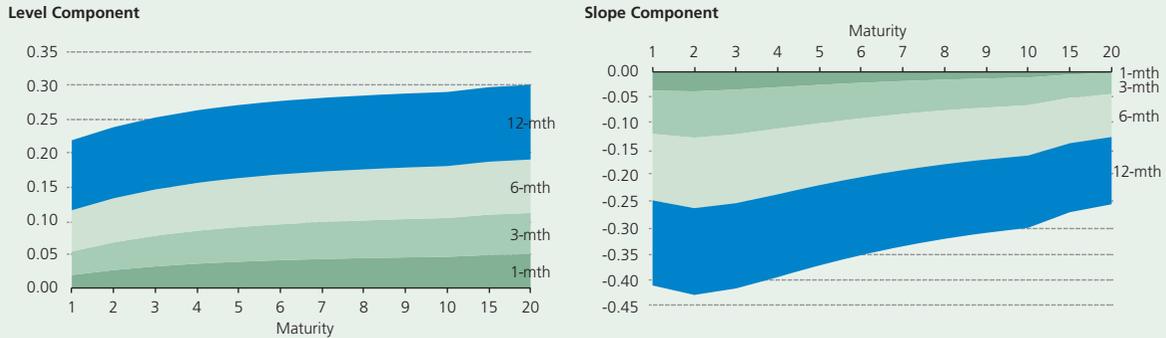
⁶ The five 'systemic' economies are PR China, the euro area, Japan, the UK and the US. Sourced from The United States Spillover report by IMF, July 2011.

⁷ The report indicated that the US interest rates and global risk measures explain over half of the variation in Emerging Market Economies (EME) spreads.

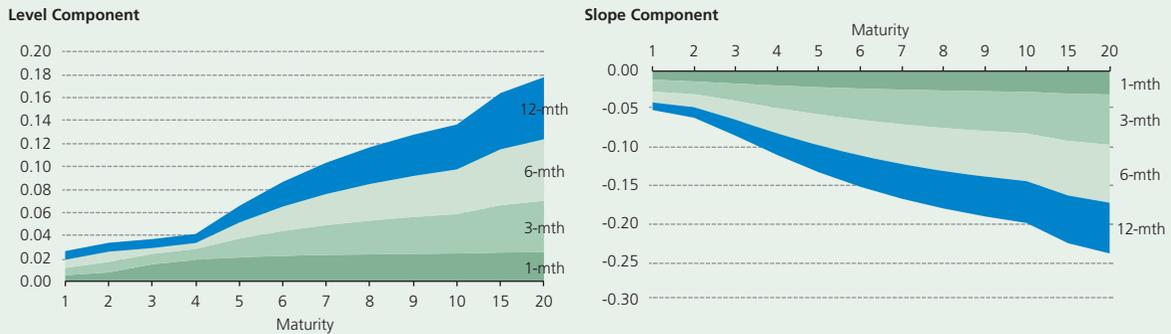
Chart 1

Re-aggregated Generalised Impulse Response Functions

Panel A: Dynamic Responses of the MGS Yield Curve to Shocks to Yields in the Advanced Markets



Panel B: Dynamic Responses of the MGS Yield Curve to Shocks to Yields in the Regional Markets



Note: The R-GIRFs show the effect of yields compared to its baseline; a negative response of the R-GIRF means the yields fall below the baseline rather than implying a negative yield.

Source: Bank Negara Malaysia, Bloomberg

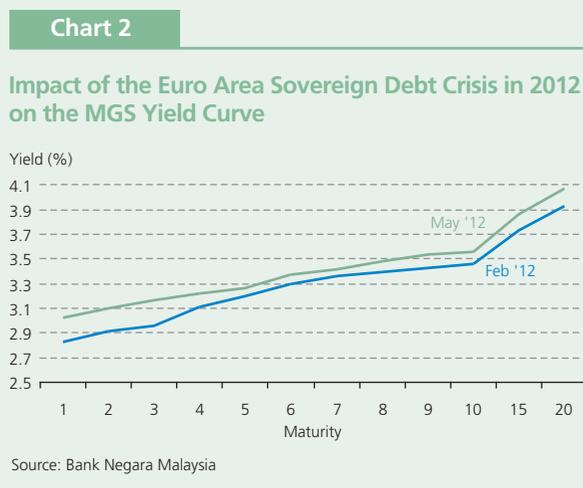
Shocks from advanced markets influenced the MGS yield curve through risk premium adjustments

A shock⁸ in the slope and level components of the yield curves in the advanced economies leads to a parallel shift in the MGS yield curve (Panel A). The parallel shift in the yield curve suggests that the shock from the government bond markets in the advanced economies is transmitted to MGS yields through risk premium adjustments. For example, a negative shock to investors' balance sheets or increased uncertainty in the advanced markets would cause domestic and foreign investors to liquidate their assets in emerging markets in favour of more liquid assets in other markets⁹. This means that, for a given level of expected future growth and inflation in the domestic economy, investors would require a higher compensation for holding domestic bonds. The investor behavior in disengaging from the emerging markets could result in a tightening of liquidity conditions in the domestic market, which will be reflected as an increase in the risk premium, resulting in an upward shift in the yield curve. Such adjustments could take place even without substantial changes in the fundamentals of the domestic economy, hence causing a temporary disconnection between information retrieved from the yield curve and economic fundamentals.

⁸ This study is not meant to assess how different type of shocks could affect bond yields in advanced or regional markets. Nevertheless, for illustration purposes, a factor that could result in a parallel shift of the yield curve in advanced economies could be driven by heightened sovereign risks, which would result in a sharp rise in the bond yields across all maturities.

⁹ See Krishnamurthy (2009) and Frankel and Schmukler (1998).

Chart 2 exemplifies the movement of the MGS yield curve following a heightening of risk aversion in the euro area in the second quarter of 2012. The MGS yield curve shifted up in parallel during this period despite an unchanged domestic monetary policy and macroeconomic conditions.



Shocks from regional markets influenced the MGS yield curve through growth and inflation expectations

A shock to the slope and level components of regional bond yields result in a tilting (flattening or steepening) of the MGS yield curve (Panel B) rather than a shift in yields of all maturities as observed in the case of the advanced markets. While economic fundamentals in the region varies, the tilting movement of the MGS yield curve broadly reflects the similarity in growth and inflation expectations in the regional markets, given the strong synchronisation of business cycles within the region, which is primarily driven by greater trade and financial integration¹⁰. Also, given the extensive production network within the region and its central role in the global supply chain, the region is likely to be exposed to common global shocks. For example, an adverse shock on global demand would be manifested into slower growth and more subdued inflation for regional economies and this will be translated into expectations of a policy rate cut. Such expectations in regional economies would be reflected in a flattening of the yield curve in the region. Investors, therefore, tend to assess the regional economies as a group and hence may fail to distinguish key differences between these economies. This leaves the regional markets exposed to more synchronised surges and reversals of capital flows.

Conclusion

The study indicates that there are important differences in the response of the MGS yield curve to shocks from the government bond markets in the advanced and regional economies. Shocks from the advanced markets would induce risk premia adjustments while shocks from the regional markets are reflected in changes in growth and inflation expectations. Such findings point towards the increasing influence of global sentiments in affecting the domestic government bond market. While the growing financial integration helps to deepen the domestic bond markets, it also brings many challenges. In particular, this article highlights that changes in global sentiments and regional economic outlook could alter the shape of the MGS yield curve, even in the absence of changes in the domestic economic conditions.

¹⁰ Studies by Sato and Zhang (2006) and Rana (2007) provide support to the synchronisation of business cycles in the East Asian region.

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of 2012, improved market sentiments and kept the FBM KLCI on an upward trend. The performance of the domestic market also attracted buying interest from non-residents, with non-resident net purchases of equities averaging around RM1.3 billion per month in the second half of 2012. The index reached a new high of 1,675.7 points on 1 November 2012 before retracting in response to profit-taking and growing worries over the US fiscal cliff. In December, the upward momentum of the index resumed, with the index ending the year at another new high of 1,689 points. This renewed surge reflected optimism surrounding the resolution for the US fiscal cliff issue and higher demand for blue-chips stocks.

In terms of the domestic market fundamentals, equity prices during the year were driven mainly by the finance-related stocks due to the sustained favourable performance of firms within this sector. In addition, robust activity in the initial public offering (IPO) market provided further support to the domestic equity market following successful issuances of large IPOs such as Felda Global Ventures Holdings Bhd (fourth largest in the world⁹), IHH Healthcare Bhd and Astro Malaysia Holdings. Overall, market capitalisation increased to RM1.47 trillion as at end-2012 (2011: RM1.28 trillion), while daily average turnover increased to 1.36 billion units (2011: 1.34 billion units).

Liquidity and Monetary Aggregates

Liquidity in the banking system was ample throughout 2012. Bank Negara Malaysia's

operations were focused on managing the surplus liquidity and maintaining stable monetary conditions. Private sector liquidity continued to expand mainly on account of favourable credit conditions and continued inflows of foreign funds into Malaysia.

In the banking system, ample liquidity conditions prevailed at both the system-wide and institutional levels. This was evidenced by the large number of financial institutions with net placements of funds in the interbank market. At the system level, compared to 2011, liquidity conditions in the interbank money market in 2012 were more stable, reflecting more balanced two-way flows from trade and investment. Overall, surplus liquidity placed with Bank Negara Malaysia grew by a modest 1.1% in 2012 (2011: 22.5%).

Bank Negara Malaysia conducted operations in the domestic money market to manage the surplus liquidity. A build-up of excess liquidity could give rise to financial distortions including an over-extension of credit to the private sector, mis-pricing of risk, and excessive risk-taking; all of which could result in excessive growth of leverage and misalignment in asset prices. Accordingly, excess liquidity in the banking system was absorbed through a wide range of market-oriented instruments including direct borrowing, and the Statutory Reserve Requirement (SRR). During the year, the ratio was maintained at 4.00%. Greater emphasis was accorded to the use of securities-based instruments such as repurchase agreements (repos) and Bank Negara Malaysia

Chart 2.19

KLCI and Bursa Malaysia Sectoral Indices

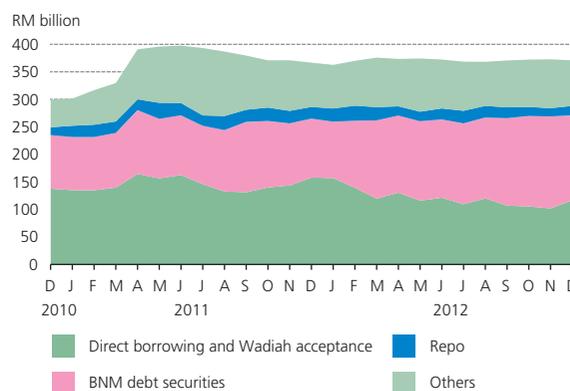


Source: Bloomberg

⁹ Source: Annual Report 2012, Bursa Malaysia.

Chart 2.20

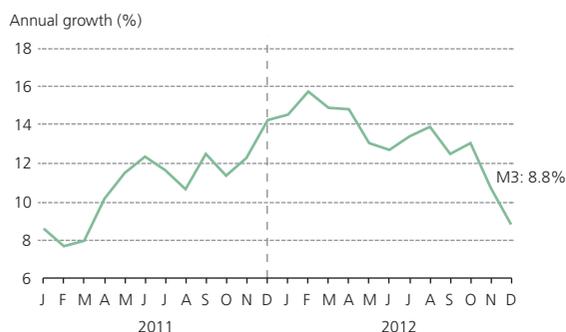
Outstanding Liquidity Placed with BNM (at end period)



Source: Bank Negara Malaysia

Chart 2.21

Broad Money, M3



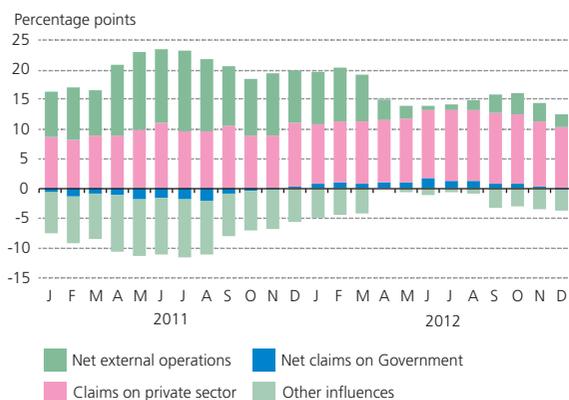
Source: Bank Negara Malaysia

Notes (BNMNs) for draining surplus liquidity from the system, as well as facilitating greater flexibility in liquidity management by financial institutions.

Private sector liquidity, as measured by broad money or M3, grew by 8.8% during the year. The increase was underpinned by both domestic and external factors. On the domestic side, private sector liquidity rose substantially on account of higher credit extension by banks to businesses and households, in line with the sustained domestic demand. On the external side, broad money expanded due to net foreign inflows, reflecting Malaysia's trade surplus and portfolio inflows. The expansion in M3, however, was contained in part by sterilisation operations by the Bank. This was reflected in the contraction of 'other influences'.

Chart 2.22

Contribution to M3 Growth



Source: Bank Negara Malaysia

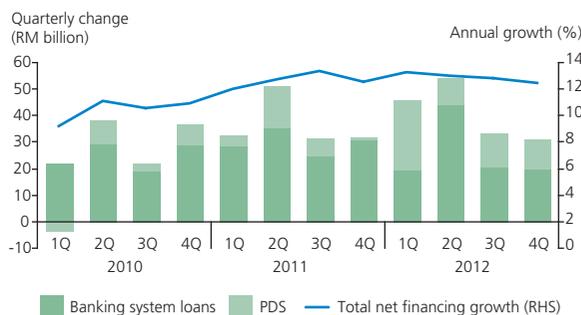
FINANCING OF THE ECONOMY

Financing to businesses and households remained supportive of domestic economic activity in 2012. The reasonable cost of borrowing and ample liquidity conditions in the financial system sustained financing to all segments of the economy.

Strong financing growth mainly reflected increased financing to domestic-oriented businesses

Chart 2.23

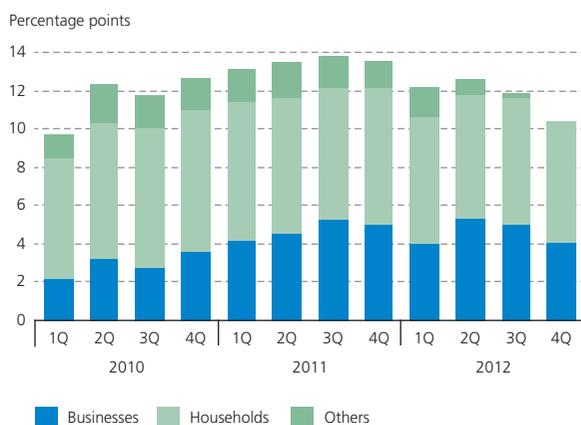
Total Net Financing to the Private Sector through Banking System Loans and PDS Issuances



Source: Bank Negara Malaysia

Chart 2.24

Contribution to Annual Growth in Total Loans Outstanding



Source: Bank Negara Malaysia

Private sector financing expanded in line with the continued expansion in domestic demand. For the year as a whole, net financing to the private sector through the banking system and the capital market expanded at an annual rate of 12.4% (2011: 12.5%). The strength in financing growth during the year was attributable mainly to business financing, which was driven by the strong performance of the domestic-oriented businesses and those involved in ETP-related projects. Demand for financing from households showed a gradual downward trend during the year.

In the business sector, total financing extended through financial institutions and the capital market increased by 14.5% (2011: 11.5%). The expansion in banking system loans to businesses (2012: 10.9%; 2011: 13.5%) reflected the increase in loans disbursed mainly to finance the investment and working capital needs of domestic-oriented businesses, especially those involved in the ETP-related projects and commodity-related sectors. The bulk of the loans were extended to the *real estate; wholesale and retail, restaurants and hotels; finance, insurance and business services; agriculture and construction* sectors. Hence, notwithstanding a moderation in loan applications from the *manufacturing* sector due to weaker external demand conditions, the overall demand for loans by businesses remained strong, underpinned by the sustained growth in business and investment activity.

Business demand for funding from the capital market increased significantly, with issuances of PDS amounting to RM121.1 billion in 2012 (2011: RM69.6 billion). The bulk of the issuances were from the *finance, insurance, real estate and business services and transport, storage and communications* sectors to fund infrastructure and ETP-related projects as well as for working capital requirements. Financing via the equity market also increased significantly to RM27.4 billion (2011: RM12.6 billion), following several large IPOs from the *plantation and services* sectors.

Demand for loans by households, while still remaining relatively strong, showed signs of moderation. Outstanding loans increased by 11.6% in 2012 (2011: 12.9%), driven mainly by

Chart 2.25

Loans Outstanding by Borrowers



Source: Bank Negara Malaysia

loans for the *purchase of residential properties, passenger cars and securities*. Favourable employment prospects and sustained income growth supported the demand for financing from households during the year. Loan growth for the *purchase of passenger cars* increased to 7.7% in 2012 (2011: 5.9%). Loan growth from consumption credit moderated to 6.2% in 2012 (2011: 15.4%), partly reflecting the pre-emptive measures instituted by the Bank to ensure prudent debt levels and to prevent potential risks arising from excessive credit expansion. The slowing trend in household loans was, however, gradual as loans for the *purchase of residential and non-residential properties*, which accounts for the bulk of household loans (56% of total household loans outstanding), continued to grow, albeit at a more moderate pace.

Chart 2.26

Gross PDS Issued by Sector



Source: Bank Negara Malaysia

