ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE SECOND QUARTER OF 2012

OVERVIEW

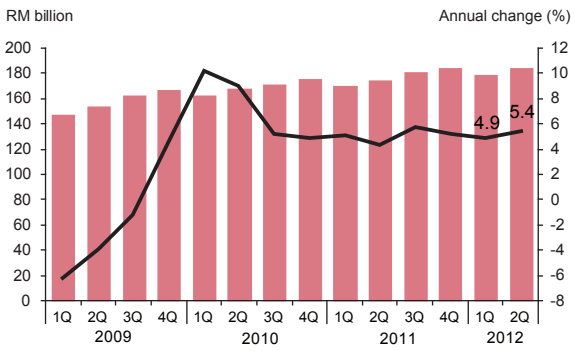
Malaysia recorded higher growth in the second quarter

The global economic environment remained challenging in the second quarter, amidst heightened vulnerabilities in several key economies. Growth in the major advanced economies was weighed down by policy and domestic structural concerns. In Asia, economic activity was affected by weaker external demand. In spite of this challenging environment, the Malaysian economy recorded a higher growth of 5.4% (1Q 12: 4.9%), driven by stronger domestic demand, which rose by 13.8% (1Q 12: 9.7%). This was supported by robust growth in the expenditure of both the private and public sectors, while net exports moderated further due to weaker exports and higher imports. On the supply side, most major economic sectors continued to expand, led by the services, manufacturing and construction sectors.

Gross fixed capital formation recorded a stronger growth of 26.1% (1Q 12: 16.1%), amidst increased capital spending by both the private and public sectors. Private investment strengthened further, supported by investment in the domestic-oriented services sub-sectors, oil and gas and manufacturing industries. Expansion in public investment was driven by non-financial public enterprises' capital spending in the transportation, oil and gas and utilities sectors, as well as the Federal Government's development spending on transportation, trade and industry, public utilities and education.

Growth of private consumption registered a strong growth of 8.8% (1Q 12: 7.4%), supported by firm labour market conditions, robust income growth and improved consumer sentiment. In addition, Government initiatives such as financial assistance to the lower income households and FELDA settlers, as well as increases in the salaries and pensions of civil servants also supported the increase in spending. Public consumption increased by 9.4% (1Q 12: 7.3%), led by higher spending on emoluments and supplies and services.

Higher growth in the second quarter
(at constant year 2005 prices)



Source: Department of Statistics, Malaysia

On the supply side, most economic sectors expanded further. This was supported by domestic-driven activity in the services sector, namely communication, real estate and business services, and the finance and insurance sub-sectors. The manufacturing sector was driven by higher growth in the export-oriented industries and a continued expansion of the domestic-oriented industries. The construction sector recorded a strong double-digit growth for the second consecutive quarter amidst increased activities in the civil engineering sub-sector. The mining sector expansion reflected the higher output of crude oil, while the agriculture sector recorded a contraction due to lower crude palm oil production.

The headline inflation rate, as measured by the annual change in the Consumer Price Index (CPI), moderated to 1.7% in the second quarter (1Q 12: 2.3%). Inflation in the *food and non-alcoholic beverages* category moderated amid a decline in the prices of meat and vegetables.

In the external sector, the current account surplus narrowed in the second quarter to RM9.6 billion, equivalent to 4.4% of GNI. The lower surplus was due mainly to the lower goods surplus, largely as a result of higher expansion of gross imports amid moderating growth in gross exports.

The financial account recorded a turnaround with inflows of RM5.4 billion during the quarter (1Q 12: -RM10.3 billion), as net inflows in other investment and FDI rose, which offset the net outflow of non-resident portfolio funds. FDI was sustained at RM6.1 billion (1Q 12: +RM7.5 billion), supported by inflows of equity capital and higher extensions of inter-company loans to multinational companies operating in Malaysia. Direct investment abroad by Malaysian companies moderated to RM2.5 billion in the second quarter (1Q 12: -RM16.9 billion), reflecting a lower outflow of equity capital and intercompany loans, and net repatriated earnings by Malaysian companies operating abroad. With surpluses in both the current and financial accounts, the overall balance of payments turned around to record a surplus of RM12.7 billion in the second quarter (1Q 12: -RM7.2 billion).

The international reserves of Bank Negara Malaysia increased to RM428.8 billion (equivalent to USD134.2 billion) as at 29 June 2012. This reserve level has taken into account the quarterly adjustment for foreign exchange revaluation gains, following the strengthening of currencies against the ringgit during the period. As at 31 July 2012, the reserves position amounted to RM429.6 billion (equivalent to USD134.5 billion), sufficient to finance 9.5 months of retained imports and is 3.9 times the short-term external debt.

Monetary policy remained supportive of economic activity

The Overnight Policy Rate (OPR) was left unchanged at 3.00% during the second quarter of 2012. At the prevailing level of the OPR, monetary conditions continue to be supportive of economic activity.

Reflecting the unchanged OPR, the average interbank rates of all maturities were relatively stable. In terms of retail interest rates, the average quoted fixed deposit (FD) rates of commercial banks were relatively unchanged during the quarter. The average base lending rate (BLR) of commercial banks remained unchanged at 6.53%, while the weighted average lending rate (ALR) on loans outstanding remained stable, standing at 5.60% as at end-June 2012 (end-March 2012: 5.62%).

In the second quarter, total gross financing raised by the private sector through the banking system and the capital market increased to RM280.6 billion (1Q 12: RM259.9 billion). The higher gross financing was attributable mainly to the increase in loan disbursements to businesses and initial public offerings (IPOs) during the quarter. On a net basis, banking system loans and PDS outstanding expanded at an annual growth rate of 13.0% as at end-June 2012 (1Q 12: 13.3%).

Net funds raised in the capital market amounted to RM27.6 billion during the quarter (1Q 12: RM43.5 billion), mostly by the private sector. Funds raised from the equity market increased significantly to RM12.1 billion (1Q 12: RM1.3 billion), due to a large initial public offering in June. After adjusting for redemptions, net funds raised by the private sector amounted to RM22.6 billion. In the public sector, net funds raised during the quarter amounted to RM5.0 billion (1Q 12: RM13.7 billion).

The monetary aggregates grew at a moderate pace during the second quarter. M1, or narrow money, increased by RM3.5 billion. On an annual basis, M1 expanded by 9.9% as at end-June (end-March 2012: 13.2%). M3, or broad money, grew by 12.8% annually as at end-June 2012 (end-March 2012: 15.0%). The moderate expansion in M3 was attributable to higher Government fundraising activities and net portfolio outflows during the quarter.

The ringgit depreciated by 3.8% against the US dollar in the second quarter, along with most other regional currencies. Renewed uncertainties over the European sovereign debt crisis and its impact on the prospects for regional and global economic growth prompted some investors to reduce holdings of emerging market assets. Against other major currencies, the ringgit depreciated against the pound sterling (-1.6%) and the Japanese yen (-7.0%), while strengthening against the euro (2.0%). Against the other regional currencies, the ringgit depreciated in the range of between 0.7% and 5.4%.

During the period 1 July to 13 August 2012, the ringgit appreciated against the euro (4.7%), US dollar (2.3%), pound sterling (1.9%) and Japanese yen (0.9%).

The ringgit also appreciated against regional currencies, strengthening against the Korean won, Thai baht, Philippine peso, Indonesian rupiah and Chinese renminbi by between 0.6% and 2.3%. The ringgit remained unchanged against the Singapore dollar.

Domestic financial stability is sustained

Financial stability remained intact throughout the second quarter of 2012, underpinned by strong capitalisation of financial institutions and orderly financial market conditions. Financial markets continued to demonstrate strong capacity to withstand external shocks and volatility arising from the escalation of sovereign risk in the Euro area.

The banking sector remained resilient during the quarter, amid sustained profitability and ample liquidity. Capitalisation of the banking sector remained stable with the core capital ratio and risk-weighted capital ratio at 12.9% and 14.7% respectively. Similarly, the insurance sector remained resilient with a strong capital adequacy ratio of 216.7%.

Recovery to continue at a modest pace but downside risks will remain

The global economic recovery continued in the second quarter, albeit at a more modest pace. Going forward, the global economy faces increasing downside risks emanating from the developments in several major economies. Policy uncertainty surrounding the European sovereign debt crisis and fiscal issues in the US are expected to weigh on market sentiments and growth prospects.

For the Malaysian economy, the strong support provided by domestic demand, underpinned by activities in both the private and public sectors have ensured higher growth amidst the challenging global environment. This trend is expected to be sustained going forward, although downside risks emanating from external developments remain.

DEVELOPMENTS IN THE SECOND QUARTER OF 2012

INTERNATIONAL ECONOMIC ENVIRONMENT

Global growth moderated amid heightened volatility in financial market conditions

The global economic environment remained challenging in the second quarter, due mainly to vulnerabilities in several key economies. Growth in the major advanced economies slowed, weighed down by domestic fiscal adjustments, tight credit conditions and sluggish labour markets. Growth momentum in Asia had also moderated, particularly in the more open economies, reflecting the slowing external demand. Domestic demand in the region however was sustained, attributable to favourable macroeconomic fundamentals and policy support.

Conditions in the international financial markets deteriorated as market confidence was affected by the European sovereign debt crisis and the weakening growth prospects in several of the major economies. Earlier in the quarter, policy uncertainty in Greece and rising concern on the Spanish banking system led to a significant rise in risk aversion. This was reflected by a flight of deposits from some European countries, a decline in global equity markets and increased demand for safe haven and liquidity-related flows. As a result, government bond yields of US, Germany and Switzerland declined to record low-levels. In Asia, many economies experienced heightened volatility in capital flows which in turn affected asset prices. Market sentiment improved in June following the pronouncements of several immediate and long-term proposals, agreed during the European Union Summit on 29 June 2012. The proposals aimed to break the negative feedback loop between conditions in the banking system and the sovereign fiscal position and restore confidence in the currency union. These proposed measures include direct recapitalisation of the Spanish banks, the formation of a banking union and a €120 billion growth pact to support growth in the Euro area. However, financial markets remained highly volatile given uncertainties surrounding the implementation details and rising contagion risks. Credit rating agencies further downgraded the credit ratings of sovereigns and banks in several economies, including the US and core European economies. Fifteen US and European banks with large capital market operations were downgraded, reflecting the challenging funding conditions, tighter regulatory requirements and high risk exposures arising from Europe. In addition, Moody's lowered its outlook for triple A-rated Germany, the Netherlands and Luxembourg from stable to negative, citing the increasing risk of a Greek exit from the euro area and rising contingent liabilities as a result of policymakers' policy responses. In late July, financial market concerns on the European sovereign debt crisis reintensified. Spanish 10-year government bond yield rose to a record high of over 7.5% following concerns over regional fiscal problems amid weakening growth prospects. This was compounded by fears of a possible funding shortages in Greece as the release of the bailout funds was delayed, pending review by the IMF, European Commission and European Central Bank.

The **US** economy expanded by a modest growth of 2.2% on an annual basis (1Q 12: 2.5%) in the second quarter. On an annualised basis, the economy grew by 1.5% (1Q 12: 2.0%) due mainly to slower domestic demand activities. Private consumption was sluggish being adversely affected by the decline in net financial wealth and weaker labour market conditions. Employment registered a slower gain of 219,000 jobs in the second quarter (1Q 12: 677,000). In addition, consumer confidence trended downwards, reflecting the cautious outlook of households on the economy. Private fixed investment grew at a slower pace as investment in structure and residential investment offset the increase in equipment and software capital spending. Growth was also constrained by a contraction in government spending. On the inflation front, headline CPI moderated to 1.9% (1Q 12: 2.8%), due to lower fuel prices.

Growth in the **euro area** weakened as domestic demand continued to deteriorate amid high uncertainties surrounding the sovereign debt crisis. Manufacturing activity experienced a deeper contraction in both the

core and peripheral economies as private sector sentiments weakened. In addition, exports growth moderated following weaker global demand. Economic activity in the crisis-affected economies weakened further, weighed down by fiscal austerity measures, higher unemployment and impaired banking sectors which constrained the flow of credit to businesses and households. Inflation moderated slightly to 2.5% (1Q 12: 2.7%) due mainly to lower energy prices.

The **UK** economy remained in a recession as it contracted at a faster pace of 0.7% (1Q 12: -0.3%) on a quarter-on-quarter basis. On an annual basis, real GDP fell by 0.8% (1Q 12: -0.2%). The deterioration in economic activity was partly attributable to the Diamond Jubilee holiday and poor weather conditions. However, underlying economic conditions remained weak amid elevated financial market uncertainties and sluggish private sector sentiments. Domestic demand continued to be negatively affected by fiscal austerity measures, a weak labour market and tight credit conditions. The pace of inflation moderated to 2.7% (1Q 12: 3.5%) due to a decline in the prices of food, energy and clothing.

Advanced Economies: Real GDP Growth

	2011		2012		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
US[1]	2.5[r]	1.3[r]	2.0[r]	1.5[a]	2.4[a]
Japan[1]	-1.9	-4.8	5.5[r]	1.4[p]	3.5[p]
UK	0.5	1.0	-0.2	-0.8[p]	-0.5[p]

[1] Annualised basis
[r] Revised
[a] Advance estimate
[p] Preliminary

Source: National authorities

The **Japanese** economy continued to recover from last year's natural disasters, expanding by 3.5% (1Q 12: 2.9%). On a seasonally adjusted basis, it recorded a growth of 1.4% (1Q 2012: 5.5%). Exports improved (8.8%, 1Q 12: 1%), underpinned by base effect amid higher shipments of automobile. On the domestic front, household spending continued to expand, supported by government subsidies for the purchase of fuel-efficient cars. In addition, disposable income and wage growth remained positive. The change in core consumer prices (excluding fresh food) declined to -0.1% (1Q 12: 0.1%) amid slower increases in energy prices.

Monetary policy remained accommodative in the advanced economies. Further measures were undertaken, given continued weak growth prospects. In the US, the Federal Open Market Committee (FOMC) announced a continuation of its maturity extension programme through the end of 2012 as compared to its previous plan of end-June 2012. The measure was aimed at reducing longer-term interest rates in order to ease financial market conditions and support the economic recovery. The European Central Bank (ECB) widened the range of securities that it would accept as collateral from euro area banks. This would increase the availability of collateral and help to ease credit conditions in the region. In July, the ECB reduced its policy rate by 25 bps to 0.75% and cut the overnight deposit rate to 0% in order to provide further support to bank lending activity. The Bank of England (BoE) expanded its quantitative easing measures by increasing the size of its asset purchase programme in July by £50 billion to £375 billion, while keeping its policy rate at 0.5%. In addition, the BoE and the British government jointly unveiled a £100 billion lending plan for households and businesses. The Bank of Japan (BoJ) increased its asset purchase programme by ¥5 trillion to ¥70 trillion as a measure to address deflation and to support the economic recovery.

Regional Countries: Real GDP Growth

	2011		2012		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
PR China	9.5	9.6	8.1	7.6	7.8
Singapore	1.2	5.0	1.5[r]	2.0[r]	1.8[r]
Korea	3.5	3.8	2.8	2.4[a]	2.6[a]
Chinese Taipei	4.5	5.5	0.4	-0.2[a]	0.1[a]
Indonesia	6.5	6.5	6.3	6.4	6.3
Hong Kong SAR	5.4	6.5	0.7[r]	1.1[p]	0.9[p]

[a] Advance estimate
[r] Revised
[p] Preliminary

Source: National authorities

In **Asia**, economic activity expanded at a moderate pace in the second quarter. Growth performance, however, showed divergent trends, mainly reflecting the degree of openness of the economies. Domestic demand continued to provide support to overall economic activity in the region, partially offsetting the weakness

in external demand. **PR China**'s economy moderated to 7.6% (1Q 2012: 8.1%) due mainly to slower manufacturing activity. Growth in Singapore remained modest at 2.0% (1Q 12:1.5%), as the rebound in the manufacturing sector was offset by a moderation in the construction sector. The **Korean** economy weakened (2.4%; 1Q 12: 2.8%) while growth in **Chinese Taipei** contracted (-0.2%; 1Q 12: 0.4%), as both economies experienced a moderation in private consumption and a decline in investment activity. The **Indonesian** economy grew by 6.4% (1Q 12: 6.3%), supported by sustained private consumption and stronger investment. **Hong Kong**'s economy grew by 1.1% (1Q 12: 0.7%), as stronger consumption and investment offset a weaker external trade performance.

Headline inflation continued to moderate in most regional economies, mainly on account of lower food and energy prices. The slower pace of increase in inflation was also partly attributable to the favourable base effects from last year's high price index levels. Nevertheless, it remained high in a few economies, particularly India, Hong Kong, and Singapore due to elevated costs of food and housing. Amidst continued uncertainties in the global economy and lower inflationary pressures, several monetary authorities in the region eased monetary policies. In April, the Reserve Bank of India lowered its key lending rate by 50 basis points (bps) to 8.00% in an effort to support growth amid slower inflation. The Monetary Authority of Singapore (MAS) maintained its policy of a modest and gradual appreciation of the S$NEER policy band. However, the slope was raised slightly and MAS also restored a narrower policy band, citing the need to manage inflation expectations, ensure medium-term price stability, and keep growth on a sustainable path. The People's Bank of China (PBOC) reduced its benchmark one-year lending rate for the first time since 2008 by a total of 56 bps to 6.00% in June and July. This followed the PBOC's decision to lower the banks' reserve requirement ratio by 50 bps to 20.00% in May to improve liquidity conditions. In July, the Bank of Korea lowered its key policy rate by 25 bps to 3.00%. The Bangko Sentral ng Pilipinas (BSP) cut its key policy rate by 25 bps, reducing overnight borrowing and lending rates to 3.75% and 5.75% respectively, as a benign inflation outlook provided room for it to further lower its interest rates.

Prices of **crude oil**[1] moderated in the second quarter, averaging USD109 per barrel (1Q 12: USD118 per barrel), and generally remained below USD100 in June. This reflected mainly weaker oil demand prospects as uncertainties weighed on the global growth outlook. Easing geopolitical tensions and continued high production by the Organisation of Petroleum Exporting Countries (OPEC) members also contributed to the reversal in oil prices from the peak of USD126 in March. As at 16 July, crude oil prices closed at USD103, recording an 8% decrease since the start of the year. Since the trough in late June, however, oil prices have increased slightly, attributable to renewed geopolitical tensions in the Middle East and the decline in US oil inventory.

In the **foreign exchange markets**, the euro, pound sterling and Asian currencies depreciated against the US dollar, as investors' sentiments continued to be affected by the ongoing European sovereign debt crisis. In the first two months of the quarter, currency movements in these economies were weighed down by growing concerns over the banking crisis and fiscal sustainability in Spain, intensified speculation of a Greek exit and weakening growth prospects in the advanced economies. In June, market concerns were partially alleviated by the result from the Greek election and the positive outcome from the EU summit, leading to a marginal appreciation for those currencies. Other major currencies such as the Japanese yen and Swiss franc appreciated against the US dollar, benefitting from their role as safe haven currencies, amid heightened investor risk aversion in the global financial markets.

Going forward, the global economy faces increasing downside risks, emanating from the developments in several major economies. Policy uncertainty surrounding the European sovereign debt crisis and fiscal issues in the US are expected to weigh on market sentiments and growth prospects. Asia's growth will be affected by the weakening external environment amid modest growth in PR China.

[1] Refers to Brent one-month futures on the Intercontinental Exchange (ICE).

DEVELOPMENTS IN THE MALAYSIAN ECONOMY

Higher growth in the second quarter

The Malaysian economy recorded a higher growth of 5.4% in the second quarter of 2012 (1Q 12: 4.9%), driven by a stronger expansion in domestic demand amid a further moderation in external demand. Both private and public sector spending, particularly on capital investment, recorded robust growth during the quarter. Nevertheless, exports of goods and services moderated further, attributable mainly to weaker demand from the advanced economies. As imports recorded higher growth due to continued expansion in capital and consumption imports in line with the stronger domestic demand, net exports contracted in the second quarter. On the supply side, almost all economic sectors continued to expand. The agriculture sector, however, contracted during the quarter due to lower production of crude palm oil.

Robust growth in domestic demand

Domestic demand recorded a higher growth of 13.8% in the second quarter of 2012 (1Q 12: 9.7%), attributable to the strong performance in investment and consumption activity by both the private and public sectors.

GDP by Expenditure Components
(at constant 2005 prices)

	2011		2012		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Aggregate Domestic Demand (excluding stocks)	5.4	6.8	9.7	13.8	11.8
Consumption	6.5	7.1	7.4	8.9	8.1
Private sector	*6.6*	*6.8*	*7.4*	*8.8*	*8.1*
Public sector	*6.0*	*8.4*	*7.3*	*9.4*	*8.4*
Gross Fixed Capital Formation	2.7	6.0	16.1	26.1	21.3
Private sector	*7.6*	*15.0*	*19.8*	*24.6*	*22.4*
Public sector	*-5.4*	*-6.9*	*10.3*	*28.9*	*19.5*
Net Exports	8.7	-13.3	-20.9	-36.2	-28.4
Exports of Goods and Services	*4.6*	*3.2*	*2.8*	*2.1*	*2.5*
Imports of Goods and Services	*4.0*	*6.5*	*6.8*	*8.1*	*7.5*
GDP	**4.3**	**4.7**	**4.9**	**5.4**	**5.1**

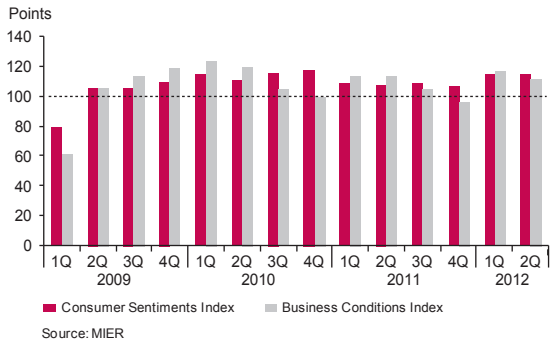
Source: Department of Statistics, Malaysia

Gross fixed capital formation registered a higher growth of 26.1% in the second quarter (1Q 12: 16.1%), supported by both private and public sector capital spending. Private investment strengthened to 24.6% (1Q 12: 19.8%), due to expansion in the domestic-oriented services sub-sectors such as real estate, telecommunication and utilities, continued implementation of upstream oil and gas projects and investment in domestic-oriented manufacturing clusters. Public investment expanded at a robust pace of 28.9% (1Q 12: 10.3%), driven by continued high capital spending by the non-financial public enterprises (NFPEs) in the transportation, oil and gas and utilities sectors and continued growth in Federal Government development expenditure. The bulk of the development expenditure was channeled into transportation, trade and industry, public utilities and education. The strong growth in total investment was also reflected in major investment indicators such as sales of commercial vehicles and imports of capital goods. In addition, business sentiments remained positive in the second quarter, as reflected by the MIER Business Conditions Index which was above the 100-point benchmark level (111.5 points; 1Q 12: 116.5 points).

Private consumption registered a strong growth of 8.8% in the second quarter (1Q 12: 7.4%). Household spending was supported by firm labour market conditions, robust income growth and improved consumer sentiments. Consumption also benefited from recent Government initiatives such as the increase in civil servant salaries, the one-off assistance to lower income households such as *Bantuan Rakyat 1 Malaysia* (BR1M) and the increase in pensions of retired civil servants. In addition, the first (of three) payout of RM5,000 to FELDA settlers in June provided further impetus to consumer spending in the rural areas. The MIER Consumer Sentiments Index rose slightly to 114.9 points (1Q 12: 114.3 points) during the quarter, reflecting improved consumer confidence.

Public consumption increased by 9.4% (1Q 12: 7.3%) due to higher spending on emoluments and supplies and services.

Consumer confidence improved while business sentiments remained optimistic



Source: MIER

Continued growth in most economic sectors

On the supply side, almost all economic sectors continued to expand further, with growth in the second quarter led by strong performance in the services, manufacturing and construction sectors. The services sector registered a better performance reflecting the strong support from domestic demand, while the manufacturing sector benefited from the resilience demonstrated by domestic-oriented industries and improvements in the growth of the primary-related and E&E clusters. The construction sector recorded a strong growth during the second quarter, supported mainly by the civil engineering sub-sector. In the mining sector, growth expanded at a faster pace, reflecting stronger growth in crude oil output, while the agriculture sector contracted due to lower production of crude palm oil.

The **services sector** expanded further by 6.3% in the second quarter of 2012 (1Q 12: 5.3%), supported by firm domestic demand. The **wholesale and retail trade** sub-sector continued to grow, albeit at a moderate pace of 5.9% (1Q 12: 6.4%), weighed down by the slower activity in wholesale of commodities. Nonetheless, growth in the retail segment remained firm, supported by continued household spending. The firm domestic demand also contributed to the robust growth in the **communication** sub-sector (9.5%; 1Q 12: 9.4%), which was supported by high usage of data communication services. In the **finance and insurance** sub-sector, growth increased to 6.6% (1Q 12: 2%), supported by higher fee income and insurance premiums. Growth in the **real estate and business services** sub-sector was higher (7.6%; 1Q 12: 6.9%), as robust investment continued to provide support to the growth of business services segments such as engineering and other professional services. In the **transport and storage** sub-sector, growth was sustained at 5.9% (1Q 12: 5.8%), as the continued growth in the land transportation segment remained supported by strong domestic production activity.

GDP by Economic Activity (at constant 2005 prices)

	2011		2012		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Agriculture	7.7	3.8	2.1	-4.7	-1.5
Mining	-9.3	-6.6	0.3	2.3	1.3
Manufacturing	2.6	4.1	4.4	5.6	5.0
Construction	1.8	3.4	15.5	22.2	18.9
Services	7.1	7.1	5.3	6.3	5.8
Real GDP (Annual Change)	**4.3**	**4.7**	**4.9**	**5.4**	**5.1**
Real GDP (Preceding Change)	**2.5**	**-0.4**	**-3.0**	**3.0**	**-0.7**

Source: Department of Statistics, Malaysia

Performance of the Services Sector (value added at constant 2005 prices)

	Share 2011 (%)	2011		2012		
		2Q	1H	1Q	2Q	1H
		Annual change (%)				
Intermediate Services	**40.6**	**6.1**	**6.2**	**5.1**	**7.2**	**6.2**
Finance & insurance	17.0	5.7	6.7	2.0	6.6	4.3
Real estate & business services	10.0	7.1	6.4	6.9	7.6	7.3
Transport & storage	6.8	5.1	4.6	5.9	5.8	5.9
Communication	6.8	6.5	6.3	9.4	9.5	9.4
Final Services	**59.4**	**7.9**	**7.7**	**5.4**	**5.6**	**5.5**
Wholesale & retail trade	26.6	6.4	6.5	6.4	5.9	6.1
Accommodation & restaurant	4.5	6.4	5.6	6.1	6.8	6.5
Utilities	4.7	2.5	2.1	5.0	4.4	4.7
Government services	14.3	13.6	14.0	4.2	6.0	5.1
Other services	9.4	7.4	6.1	4.3	4.2	4.2
Total Services	**100.0**	**7.1**	**7.1**	**5.3**	**6.3**	**5.8**

Source: Department of Statistics, Malaysia

Selected Quarterly Indicators in the Services Sector

	2011				2012	
	1Q	2Q	3Q	4Q	1Q	2Q
	Index					
MIER Consumer Sentiments Index	108.2	107.9	108.7	106.3	114.3	114.9
MIER Retail Trade Index	99.1	120.8	150.0	92.6	85.3	119.4
MIER Tourism Market Index	113.1	125.4	115.2	126.0	125.2	117.3
	Annual change (%)					
Tourist arrivals	-3.7	-4.8	4.7	5.4	0.4	2.4[1]
Total passenger traffic at all airports	11.8	13.4	10.8	7.0	6.4	1.9
Total consumption credit outstanding	9.5	8.7	8.5	9.5	7.8	7.5
Loans outstanding to the wholesale & retail trade, hotels & restaurants	7.2	6.8	9.6	11.5	11.1	11.1
Imports of consumption goods	5.8	17.5	26.5	25.4	20.3	11.1
Total sales of motor vehicles	7.5	-9.7	0.6	-1.5	-12.6	17.2
Container cargo handled (Port Klang and PTP)	14.4	9.6	9.8	11.5	7.4	2.1[1]

[1] April-May 2012

Source: Various sources

Value added growth in the **manufacturing sector** increased to 5.6% in the second quarter (1Q 12: 4.4%), supported by higher growth in the export-oriented industries and a continued expansion of the domestic-oriented industries. Improvements in the performance of the **export-oriented industries** was driven mainly by higher output growth of the primary-related cluster, as firm regional demand supported the performance of major segments such as chemicals and chemical products, refined petroleum and wood. The E&E cluster also registered further expansions during the quarter, underpinned by the recovery in the global E&E supply chain. This is further supported by the continued strength in the demand for mobile devices, in particular, smartphones and tablets. On the domestic front, the performance of **domestic-oriented industries** was supported mainly by the resilience of the consumer-related cluster with the transport equipment and the food, beverage and tobacco segments registering sustained growth rates, in tandem with the firm growth in private consumption.

Overall, the capacity utilisation rate in the manufacturing sector increased in the second quarter (81%; 1Q 12: 79%). Export-oriented industries operated at 82% of total capacity while the capacity utilisation rate of domestic-oriented industries was 78% (1Q 12: 80% and 75% respectively).

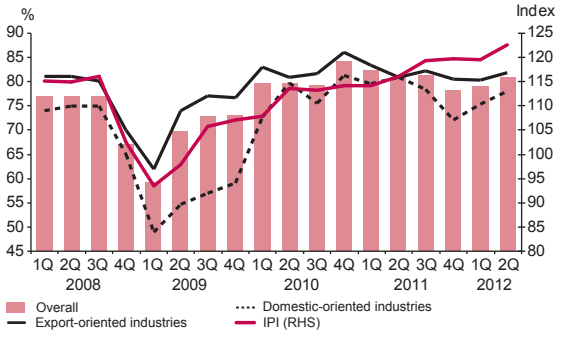
Performance of the Manufacturing Sector

	2011		2012		
	2Q	1H	1Q	2Q	1H
	Annual Change (%)				
Value Added (RM million at constant 2005 prices)	**2.6**	**4.1**	**4.4**	**5.6**	**5.0**
Overall Manufacturing Production[1]	**2.1**	**4.0**	**4.6**	**5.7**	**5.2**
Export-oriented industries	**1.7**	**3.3**	**3.0**	**5.1**	**4.1**
Electronics and electrical products cluster	**-5.5**	**-5.4**	**0.0**	**2.8**	**1.5**
Of which:					
Electronics	-13.4	-15.8	-3.6	3.3	-0.1
Electrical products	6.8	12.0	4.6	2.2	3.4
Primary-related cluster	**6.0**	**8.6**	**4.5**	**6.4**	**5.4**
Of which:					
Chemicals and chemical products	6.2	5.8	9.1	10.4	9.7
Petroleum products	1.4	13.2	3.8	11.6	7.5
Rubber products	18.3	15.4	3.4	4.5	4.0
Off-estate processing	17.6	5.3	2.2	-15.5	-7.8
Domestic-oriented industries	**3.6**	**6.0**	**10.0**	**7.5**	**8.7**
Construction-related cluster	**17.4**	**19.6**	**8.3**	**4.4**	**6.3**
Of which:					
Construction-related products	15.4	15.4	0.9	2.0	1.5
Fabricated metal products	20.1	25.5	17.4	7.4	12.2
Consumer-related cluster	**-6.6**	**-3.7**	**11.4**	**10.4**	**10.9**
Of which:					
Transport equipment	-15.8	-10.4	9.9	12.1	11.0
Food, beverage & tobacco products	2.1	4.3	11.5	10.0	10.7

[1] Industrial Production Index (2005=100)

Source: Department of Statistics, Malaysia

Capacity utilisation rate in the manufacturing sector*



* Beginning 2012, the capacity utilisation rate in the manufacturing sector has been rebased from value-add in year 2006 to value-add in year 2009

Source: Bank Negara Malaysia & Department of Statistics, Malaysia

The **construction sector** recorded a strong growth of 22.2% in the second quarter (1Q 12: 15.5%), driven mainly by the civil engineering sub-sector. The pick-up in the **civil engineering** sub-sector was due to significant progress in infrastructure, utility and oil and gas projects such as the Second Penang Bridge, Seremban-Gemas Double Track, Janamanjung Power Plant, Sabah Oil and Gas Terminal and Melaka Regasification Terminal. The **residential** sub-sector continued to be underpinned by the construction of high-end residential properties while activity in the **non-residential** segment was supported by the construction of industrial buildings in the Samalaju Industrial Park in Sarawak.

Indicators for the Construction Sector

	2011		2012		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Housing approvals	14.1	22.1	75.6	126.9	101.7
New housing sales and advertising permits	11.6	17.7	12.5	13.9	13.2
Production[1] of construction-related materials	17.4	19.6	8.3	4.4	6.3
Basic iron and steel	0.2	6.1	-10.9	1.0	-4.9
Structural non-refractory clay and ceramic products	-11.1	-8.9	3.3	9.1	6.1
Ready-mix concrete	41.0	36.7	18.2	23.7	21.1
Loans for construction activity					
Approval	31.9	30.8	38.2	-9.0	12.3
Disbursement	-3.6	3.7	16.0	17.9	16.9

[1] Industrial Production Index (2005=100)

Source: Ministry of Housing and Local Government, Department of Statistics, Malaysia and Bank Negara Malaysia

Value-added growth of the **agriculture sector** contracted by 4.7% (1Q 12: 2.1%), due mainly to lower production of crude palm oil. The **mining sector** expanded by 2.3% (1Q 12: 0.3%), reflecting stronger growth in crude oil output, following efforts to enhance recovery in production from the existing oil fields and the base effect of weak production in 2Q 11.

Performance of the Agriculture Sector

	2011		2012		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (at constant 2005 prices)	**7.7**	**3.8**	**2.1**	**-4.7**	**-1.5**
Industrial Crops	**10.7**	**1.9**	**1.4**	**-12.3**	**-6.0**
Of which:					
Oil palm	19.4	6.5	3.5	-17.5	-8.6
Rubber	16.3	8.8	-9.4	-2.1	-6.1
Food Crops	**3.7**	**6.3**	**2.8**	**5.8**	**4.3**
Of which:					
Fishing	-3.9	1.5	-4.5	-0.2	-2.3
Livestock	9.4	9.6	11.0	7.7	9.2

Source: Department of Statistics, Malaysia

Performance of the Mining Sector

	2011		2012		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (at constant 2005 prices)	**-9.3**	**-6.6**	**0.3**	**2.3**	**1.3**
Production					
Of which:					
Crude oil and condensates	-18.3	-13.2	0.1	5.7	2.7
Natural gas	2.1	0.7	-0.2	-4.4	-2.2

Source: PETRONAS
Department of Statistics, Malaysia

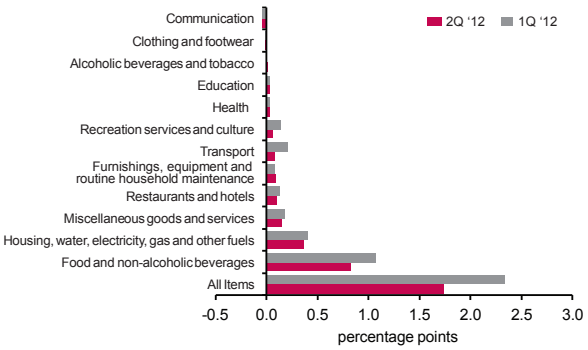
Inflation continued to moderate

The headline inflation rate, as measured by the annual change in the Consumer Price Index (CPI), moderated to 1.7% in the second quarter (1Q 12: 2.3%), reflecting lower inflation in the *food and non-alcoholic beverages* and *transport categories.*

Inflation in the *food and non-alcoholic beverages* category moderated to 2.7% during the quarter (1Q 12: 3.5%). Prices in the *meat* and *vegetables* sub-categories declined by 1.9% and 3.9% respectively (1Q 12: +1.1% and -3.7% respectively) due to the oversupply of these food items. Since May, however, the food supply has begun to normalise. The exceptionally high food prices in the second quarter of 2011 also contributed to the more moderate increase in food inflation.

Inflation in the *transport* category moderated to 0.5% (1Q 12: 1.4%) during the quarter as the impact from the adjustment to the price of RON97 petrol in April and May 2011 dissipated.

Contribution to Consumer Price Inflation



Source: Bank Negara Malaysia

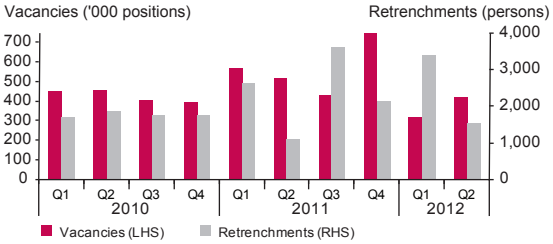
The Producer Price Index (PPI) increased at a slower rate of 0.8% on an annual basis in the second quarter (1Q 12: 3.8%). In terms of composition, prices of the commodity-related components and non-commodity-related components rose at a slower pace of 1.7% and 0.2% respectively (1Q 12: 9.2% and 0.8% respectively). In addition, prices of both local and imported components of the PPI increased at the same rate of 0.8%, which was lower than that recorded in the first quarter of 2012 (4.8% and 1.4% respectively).

Labour market conditions remained favourable during the quarter

Overall labour market conditions remained positive in the second quarter, as the unemployment rate was unchanged at 3.0% for the first two months of the quarter (1Q 12: 3.0%). Total employment in April and May averaged 12.5 million, representing a net job creation of 105,600 persons from the first quarter. Retrenchment declined by more than half to 1,516 persons from 3,388 persons in the preceding quarter.

Labour demand during the quarter remained strong, with a higher number of job vacancies posted in the JobsMalaysia Portal (419,636 positions; 1Q 12: 316,016 positions), reflecting higher job openings across all major sectors. Real wages in the manufacturing sector, however, recorded a lower growth of 5.2% as compared to the preceding quarter (1Q 12: 6.5%).

Labour Market Conditions



Note: : Beginning 2012, vacancies data reflected a technical review
Source: Ministry of Human Resources

External sector remained strong

Overall balance of payments turned around to record a surplus of RM12.7 billion in 2Q 2012 (1Q 2012: -RM7.2 billion), following a net inflow in the financial account amid a lower current account surplus.

The **current account** surplus narrowed in 2Q 2012 to RM9.6 billion, equivalent to 4.4% of GNI. The lower surplus was due to the lower goods surplus of RM29.4 billion (1Q 2012: RM35.8 billion) and higher deficit in the income account. Gross exports moderated to 3.9% (1Q 2012: 4.4%), due mainly to the lower growth in commodity exports. Meanwhile, gross imports expanded by 8.9% (1Q 2012: 6.9%) attributable to the strong growth in capital imports and a turnaround in imports of intermediate goods.

Balance of Payments

	2011		2012		
	2Q	1H	1Q	2Q	1H
	RM billion				
Current Account	**23.0**	**47.3**	**18.1**	**9.6**	**27.7**
(% of GNI)	*10.9*	*11.4*	*8.4*	*4.4*	*6.3*
Goods	36.0	73.5	35.8	29.4	65.3
Services	-1.0	-3.2	-3.8	-3.6	-7.4
Income	-6.7	-12.7	-8.6	-11.7	-20.3
Current transfers	-5.3	-10.4	-5.3	-4.6	-9.9
Financial Account	**51.5**	**45.0**	**-10.3**	**5.4**	**-4.8**
Direct investment abroad	-7.8	-19.0	-16.9	-2.5	-19.5
Foreign direct investment	9.8	21.0	7.5	6.1	13.6
Portfolio investment	48.0	56.5	25.3	-5.0	20.3
Financial derivatives	0.4	0.6	0.0	1.0	1.0
Other investment	1.2	-14.1	-26.1	5.9	-20.2
- Official sector	*-0.2*	*-0.7*	*-0.5*	*-0.3*	*-0.7*
- Private sector	*1.3*	*-13.4*	*-25.6*	*6.1*	*-19.5*
Errors & omissions	-12.7	-14.6	-14.9	-2.2	-17.1
Overall Balance	**61.7**	**77.6**	**-7.2**	**12.7**	**5.5**

Source: Department of Statistics Malaysia

In the second quarter, gross **exports** moderated as the lower growth in exports of commodities offset the improvement in manufactured exports. Exports of commodities grew at a more moderate pace due mainly to the lower prices and demand for agricultural commodities. Exports of minerals were sustained by firm regional demand amidst higher prices of natural gas. The increase in manufactured exports mainly reflected higher exports of non-E&E products, while exports of E&E remained weak. Exports of non-E&E rose mainly on account of higher regional demand for manufactures of metal and machinery, appliances and parts. Exports of E&E continued to register a contraction amidst sluggish demand from the advanced economies.

The expansion in gross **imports** was driven mainly by the strong growth in capital imports and the turnaround in intermediate imports. Imports of capital goods continued to expand following higher imports of aircrafts and machineries, in line with robust domestic demand conditions. Intermediate imports turned around to register a marginal growth of 0.1% (1Q 2012: -1.3%), in tandem with the improvement in manufactured exports. However, growth in imports of consumption goods moderated but remained strong, due mainly to lower imports of processed food and beverage.

Deficit in the **services account** was lower at RM3.6 billion. Higher receipts from the provision of other services, particularly the computer and information services and professional and technical services, more than offset the larger payments for imported services. The deficit in the **income account** widened to RM11.7 billion due mainly to higher investment income accrued to non-resident controlled companies investing in Malaysia and lower investment income accrued to Malaysian companies investing abroad. During the quarter, higher profits were declared and dividends were paid mainly by the non-resident controlled companies investing in the financial, oil and gas and manufacturing sectors.

The **financial account** turned around to record a net inflow RM5.4 billion in 2Q 12 (1Q 12: -RM10.3 billion) due to net inflows in FDI and other investment, which offset a small net outflow of portfolio funds.

Trade Account

	2011		2012		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Gross Exports	**8.8**	**6.8**	**4.4**	**3.9**	**4.2**
Manufactured	1.6	0.5	0.9	2.9	1.9
E&E	*-5.0*	*-6.2*	*-1.7*	*-1.2*	*-1.4*
Non-E&E	*9.4*	*8.5*	*3.4*	*7.2*	*5.4*
Commodities	28.9	24.1	11.7	5.6	8.6
Agriculture	*43.3*	*34.7*	*-8.0*	*-12.3*	*-10.2*
Minerals	*19.3*	*17.0*	*26.0*	*20.0*	*23.0*
Gross Imports	**7.4**	**9.8**	**6.9**	**8.9**	**8.0**
Capital goods	10.2	13.2	21.0	27.3	24.3
Intermediate goods	3.8	7.9	-1.3	0.1	-0.6
Consumption goods	17.5	11.8	20.3	11.1	15.3
Trade balance (RM billion)	**27.4**	**59.1**	**29.8**	**21.3**	**51.1**

Source: MATRADE and Department of Statistics, Malaysia

Malaysia: Direction of Exports

	2011		2012			2011		2012		
	1Q	4Q	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
	Annual change (%)					Share of total exports (%)				
United States	**-7.1**	**-7.5**	**5.5**	**4.4**	**4.9**	**8.5**	**8.4**	**8.3**	**8.6**	**8.5**
European Union (EU)	**3.4**	**4.4**	**-10.4**	**-8.7**	**-9.6**	**10.2**	**10.4**	**9.1**	**9.0**	**9.1**
Selected ASEAN countries[1]	**6.3**	**3.1**	**9.3**	**10.6**	**10.0**	**24.6**	**24.6**	**25.8**	**26.2**	**26.0**
North East Asia	**9.0**	**5.7**	**-2.0**	**2.2**	**0.1**	**24.5**	**24.5**	**22.9**	**24.1**	**23.5**
People's Republic of China	*9.7*	*6.7*	*-3.2*	*10.2*	*3.5*	*12.5*	*12.7*	*11.9*	*13.2*	*12.6*
Hong Kong SAR	*-4.6*	*-2.4*	*-8.1*	*-3.1*	*-5.5*	*4.7*	*4.6*	*4.0*	*4.4*	*4.2*
Chinese Taipei	*14.7*	*15.8*	*-2.0*	*-2.6*	*-2.3*	*3.3*	*3.2*	*3.0*	*3.1*	*3.0*
Korea	*22.1*	*5.3*	*9.4*	*-13.0*	*-2.2*	*4.0*	*3.9*	*4.0*	*3.4*	*3.7*
West Asia	**13.1**	**15.2**	**-4.8**	**-0.9**	**-2.8**	**3.7**	**3.7**	**3.4**	**3.6**	**3.5**
India	**45.6**	**34.4**	**-5.1**	**7.2**	**1.3**	**4.1**	**4.0**	**3.6**	**4.2**	**3.9**
Total exports	**8.8**	**6.8**	**4.4**	**3.9**	**4.2**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

[1]Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam and Vietnam

Source: Department of Statistics, Malaysia

Portfolio investment turned around from a net inflow position to record a small net outflow of RM5 billion during the quarter (1Q 12: +RM25.3 billion). The outflows reflected the continued portfolio investments abroad by residents, and liquidation of debt securities by non-residents, the latter mainly due to heightened risk aversion in the financial markets amidst the escalation of the debt crisis in Europe. These outflows offset the net purchases of equity securities by non-residents. These developments were also experienced in several other countries within the region.

FDI inflows were sustained at RM6.1 billion (1Q 12: +RM7.5 billion), supported by continued inflows of equity capital and higher extensions of inter-company loans to MNCs operating in Malaysia. FDI inflows continued to be broad-based during the quarter, the bulk of which were undertaken by companies in the *oil and gas* and *services* sectors, led by the *finance and insurance* and *professional and technical activities* sub-sectors. The *manufacturing* sector was also a recipient of sizeable investments during the quarter, particularly the *E&E* and *petrochemical* sub-sectors.

Direct investment abroad (DIA) by Malaysian companies moderated to RM2.5 billion in the second quarter (1Q 12: -RM16.9 billion). The smaller net DIA outflow reflected lower outflows of equity capital and intercompany loans, and net repatriated earnings by Malaysian companies operating abroad. DIA were mainly channelled into the *oil and gas* and *services* sectors, particularly the *finance and insurance* and *real estate* sub-sectors. There were also sizeable investments abroad by Malaysian companies in the *construction* sector.

Other investment reversed to register a net inflow of RM5.9 billion in the second quarter (1Q 2012: -RM26.1 billion). This largely reflected sizeable inflows of non-resident deposits and the winding down of assets abroad by the banking sector. These inflows were partially offset by higher net extensions of trade credits.

The official sector registered a small net outflow, due to continued repayment of external loans.

The errors and omissions amounted to -RM2.2 billion in 2Q 2012, partly reflecting the foreign exchange revaluation gains on external reserves during the quarter, following the appreciation of major currencies against the ringgit.

External debt remained manageable

Malaysia's **total external debt** amounted to RM269.5 billion at end-June 2012 (end-March: RM249.5 billion). This is equivalent to 30% of GNI, and remains small as a share to total debt[2] (12.8%).

Medium- and long-term external debt increased to RM159.3 billion (end-March: RM148.3 billion), reflecting net drawdown of external borrowings by the private sector and the strengthening of major and regional currencies against ringgit during the quarter. The latter also resulted in higher public sector external debt despite a net repayment of external borrowings, mainly by the NFPEs. As at end-June 2012, the **short-term external debt** was higher at RM110.2 billion due mainly to higher interbank borrowing.

External Debt Outstanding

	2011	2012	
	end-June	end-Mar	end-June[p]
	RM billion		
Medium- and long-term debt	149.2	148.3	159.3
Public sector	80.0	84.2	87.3
Private sector	69.2	64.1	72.0
Short-term debt[1]	92.3	101.2	110.2
Total external debt	**241.5**	**249.5**	**269.5**
USD billion equivalent	79.1	80.5	83.5
External debt/GNI (%)	28.1	27.8	30.0
Reserves/Short-term external debt (times)	4.4	4.1	3.9[2]

[1] Excludes currency and deposits held by non-residents with resident banking institutions
[2] Based on international reserves as at 31 July 2012
[p] Preliminary

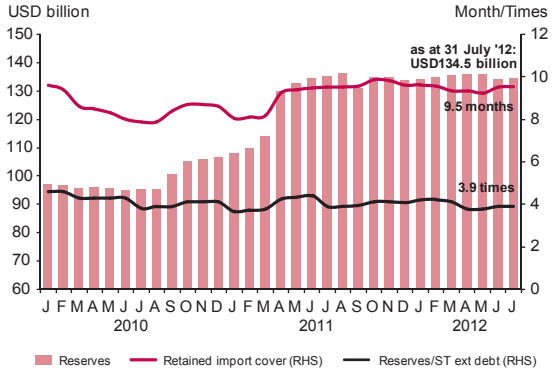
Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

[1] Total debt comprises domestic and external debt. Domestic debt comprises loans by banking system, private debt securities and federal government debt.

Higher international reserves

The international reserves of Bank Negara Malaysia increased to RM428.8 billion (equivalent to USD134.2 billion) as at 29 June 2012. This reserves level has taken into account the quarterly adjustment for foreign exchange revaluation gains, following the strengthening major and regional currencies against ringgit during the quarter. As at 31 July 2012, the reserves position amounted to RM429.6 billion (equivalent to USD134.5 billion), sufficient to finance 9.5 months of retained imports and is 3.9 times the short-term external debt.

Net International Reserves (as at end period)



Source: Bank Negara Malaysia

Higher Government revenue remained supportive of expenditure

Federal Government revenue increased to RM50.7 billion in the second quarter (1Q 12: RM47.9 billion). This was mainly on account of higher income tax collections. The higher revenue supported the increase in operating expenditure, which was channeled mainly to emolument and subsidy payments. Development expenditure increased to RM10.3 billion (1Q 12: RM8.5 billion), which was mainly disbursed to various economic sectors. As a result, the Federal Government recorded a fiscal deficit of 3.4% of GDP during the quarter (1Q 12: -2.6% of GDP). The deficit continued to be financed from domestic borrowings. As at end-June 2012, total outstanding debt of the Federal Government amounted to RM476.7 billion or 51.9% of the estimated 2012 GDP.

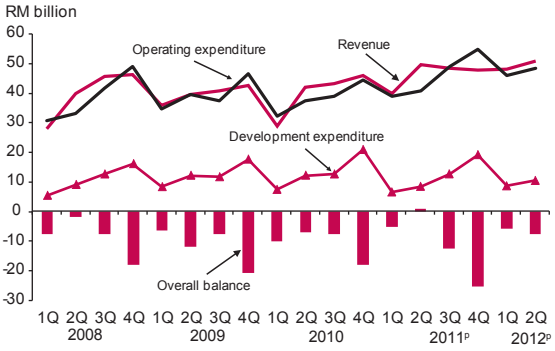
Federal Government Finance[p]

	2011		2012		
	2Q	1H	1Q	2Q	1H
	RM billion				
Revenue	49.6	89.4	47.9	50.7	98.6
% growth	*18.3*	*26.4*	*20.4*	*2.2*	*10.3*
Operating expenditure	40.6	79.2	45.6	48.2	93.8
% growth	*9.5*	*14.9*	*18.0*	*18.8*	*18.4*
Current account	**9.1**	**10.2**	**2.3**	**2.5**	**4.8**
% of GDP	***4.2***	***2.4***	***1.0***	***1.1***	***1.1***
Gross development expenditure	8.3	14.8	8.5	10.3	18.8
% growth	*-31.3*	*-24.0*	*32.3*	*24.0*	*27.6*
Overall balance	**0.8**	**-4.4**	**-5.8**	**-7.8**	**-13.6**
% of GDP	***0.4***	***-1.0***	***-2.6***	***-3.4***	***-3.0***
Memo item:					
Total gross expenditure	48.9	94.0	54.1	58.6	112.7
% growth	*-0.5*	*6.4*	*20.0*	*19.7*	*19.9*
Total Federal Government debt (as at end-period)	437.2	437.2	470.8	476.7	476.7
% of GDP	*49.6*	*49.6*	*51.3*	*51.9*	*51.9*
Domestic debt	421.0	421.0	453.9	458.8	458.8
% of GDP	*47.8*	*47.8*	*49.4*	*50.0*	*50.0*
External debt	16.2	16.2	16.9	17.9	17.9
% of GDP	*1.8*	*1.8*	*1.8*	*1.9*	*1.9*

[p] Preliminary

Source: Ministry of Finance

Federal Government Finance



[p] Preliminary

Source: Ministry of Finance

Potential Output and the Output Gap in Malaysia

1. INTRODUCTION

"The principal objects of the (Central) Bank shall be to promote monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy."

Central Bank of Malaysia Act 2009

The economy can be broadly regarded as operating on a sustainable growth path when it is growing at its full capacity with prices remaining low and stable. This level of output is known as the potential output and it is one of the important factors that central banks consider in formulating monetary policy to achieve their mandates.

There are at least two reasons to be concerned about potential output. First, in the short-run, the output gap - the difference between the actual and potential output - reflects the economy's position in the business cycle and, correspondingly, the possible presence of inflationary pressures arising from the level of utilisation of factors of production and possible capacity constraints. As monetary policy operates with lags, it is necessary to estimate the future path of potential output to access whether the current monetary policy stance is consistent with the desired inflation trajectory. Second, potential output reflects the maximum level of output that an economy is able to sustainably produce over a longer time horizon. Faster growth in potential output would allow for a faster growth in actual output without generating undue price pressures. Knowledge of the determinants of potential output can therefore help in formulating structural policies that are focused on increasing the economy's growth rate in a sustainable manner by improving its growth potential. For instance, selected government initiatives in the New Economic Model (NEM) and Economic Transformation Programme (ETP) strive to achieve this by stimulating private investment in technology-intensive capital and by increasing the talent pool of the labour force.

Despite being a reasonably intuitive and useful concept, potential output is unobservable and needs to be estimated. It cannot be easily embedded into policy functions with certainty as its estimates are known to vary with different estimation approaches. In balancing between the uncertainty surrounding the estimates of the potential output and its inherent usefulness, policymakers in general consider potential output as just one of a wider range of indicators to assess the state of the economy.

The purpose of this note is to outline one of the methodologies that Bank Negara Malaysia uses to estimate the potential output of the Malaysian economy. The production function approach is adopted to estimate potential output and its determinants. In doing so, the linkages between inflation, labour market conditions and the output gap are also established.

The remaining sections of this note are organised as follows. Section II details the methodology for estimating potential output. Section III presents the results. The final section concludes this note.

2. METHODOLOGY

Potential output and the output gap provide crucial information about the state of the economy. When output is above its potential level (positive output gap), the economy is experiencing high resource utilisation. During these periods, labour markets tend to be tighter and wage pressures higher, which can lead to higher inflation. Conversely, the economy is operating with surplus capacity when actual output is below its potential level (negative output gap). This in turn is associated with higher unemployment, lower wage pressures and lower inflation. A reliable estimate of potential output can therefore aid the Central Bank in implementing monetary policy to smooth business cycle fluctuations and manage inflationary pressures.

Broadly speaking, there are two conceptual approaches to estimate potential output, each possessing its own advantages and disadvantages. The first is based on the univariate statistical approach, which involves making a judgement on the components of output that are permanent and transitory. The permanent component is considered to be a measure of potential output, while the transitory component reflects the cyclical and idiosyncratic fluctuations in output. Some examples of such statistical methods are the Hodrick-Prescott (HP) filter, Baxter-King filter and univariate Kalman filter. These methods are appealing because of their low data requirements and ease of application. However, a pitfall is that these methods are atheoretical data-driven techniques and thus provide no guidance to policymakers on the determinants of potential output and its association with inflation.

The second approach relies on multivariate specifications suggested by economic theory such as the Phillips curve, Okun's Law and other more complex representations of the economy. The models are estimated or calibrated using a wide range of techniques, including the production function approach (Hong Kong Monetary Authority, 2001 & 2011 and Congressional Budget Office, 2001), Structural Vector Autoregression (SVAR) models (Arora and Bhundia 2003), multivariate Kalman filters (Benes, Clinton, Garcia-Saltos, Johnson, Laxton, Manchev and Matheson, 2010) and more recently, dynamic stochastic general equilibrium (DSGE) models (Edge, Kiley and Laforte, 2007 and Coenen, Smets and Vetlov, 2009). The appeal of this approach is its economic content. However, the complexities involved in estimating some of these models often result in potential output estimates that are highly sensitive to the underlying assumptions imposed by the researchers[1].

2.1 The Production Function Approach

One of the methods used by Bank Negara Malaysia to estimate potential output and the output gap is the production function, or growth accounting, approach. The biggest advantage of this method is that it relates potential output to the factor inputs of the economy – capital, labour and the level of technological progress. Structural changes that affect any of the three determinants are therefore captured in the computation of potential output. The methodology's robustness to structural change relative to other methods and the ability to provide insight to the determinants of potential output has led to its widespread use by other central banks, government agencies and academics.

[1] A discussion of the various methods and their advantages/disadvantages is beyond the scope of this paper. Refer to Cotis, Elmeskov and Mourougane (2003) for a thorough presentation of the relevant issues and methods and Mishkin (2007) for a non-technical discussion of the issues in estimating potential output.

In keeping with the literature, the production function is assumed to take the following Cobb-Douglas functional form:

$$Y_t = A_t \; L_t^{\alpha} \; K_t^{1-\alpha} \qquad (1)$$

Y_t is seasonally adjusted output, A_t is Total Factor Productivity (TFP), L_t is employment and K_t is capital stock[2]. The production function is assumed to be constant returns to scale, with α and (1-α) being the respective labour and capital shares. We use the income account[3] method to derive the factor shares. This results in α currently being set to 0.4[4], reflecting the current labour income share to GDP. This value is adjusted over time in accordance with the evolution of Malaysia's economic structure.

A is unobserved and is computed as the "Solow residual" by subtracting the contributions of capital and labour from actual output in the following log-linear transformation of the production function:

$$\ln A_t = \ln Y_t - \alpha \ln L_t - (1-\alpha) K_t \qquad (2)$$

Potential output is then computed by:

$$\overline{Y}_t = \overline{A}_t \; \overline{L}_t^{\alpha} \; K_t^{1-\alpha} \qquad (3)$$

With $\overline{Y}_t$ being potential output, $\overline{A}_t$ the trend level of TFP and $\overline{L}_t$ potential employment. The underlying trend of TFP is obtained by the Hodrick-Prescott filter. The output gap, Gap, is computed as:

$$\text{Gap}_t = \frac{Y_t - \overline{Y}_t}{\overline{Y}_t} \qquad (4)$$

2.2 Potential Employment and the Non-Accelerating Inflation Rate of Unemployment (NAIRU)

Potential employment, an input in (3), represents the level of employment that is consistent with a low and stable inflation rate. It is expressed as:

$$\overline{L}_t = L_t^f (1 - \text{NAIRU}_t) \qquad (5)$$

L_t^f is the labour force. The Non-Accelerating Inflation Rate of Unemployment (NAIRU) refers to the level of the unemployment rate where wage, and subsequently, inflationary pressures are absent in either direction. Upward wage pressures tend to be present when unemployment is below NAIRU (i.e. the unemployment gap is negative), and vice versa.

[2] Quarterly capital stock was derived from the annual capital stocks data published by the Department of Statistics Malaysia (DOSM).
[3] Income Account refers to the Distribution and Use of Income Accounts and Capital Account (2006-2008) which is published by the Department of Statistics Malaysia (DOSM).
[4] This value comprises of 2 components in the Income Account. Firstly, it consists of compensation to employees. Secondly, it consists of income earned by the self-employed or people employed in small and medium enterprises, in which the distinction between labour income and company profits is blurred. This aspect of income is accounted for by adding a classification in the Income Account that is known as "mixed income".

NAIRU is estimated in a two step procedure. In the first step, the unemployment rate is decomposed into a trend and a cyclical component[5]. The cyclical component is then used as a reference to estimate the unemployment gap in the subsequent step. In the second step, the Kalman filter is used to estimate the unemployment gap and hence NAIRU. The unemployment gap is modelled as an unobserved component within a Philips curve framework. This approach draws from Turner et al. (2001), Greenslade et al. (2003) and Epstein and Macchiarelli (2010). The details of the steps are as follows:

Step 1: Decomposition of unemployment into trend and cyclical components

The unemployment rate, U_t, is assumed to comprise of a trend, T_t, and a cyclical component, C_t:

$$U_t = T_t + C_t \qquad (6)$$

Step 2: Kalman filter estimation of the Philips curve

The unemployment gap, G_t, is modelled as an unobserved component and is estimated from a Philips curve relationship between inflation and its determinants. The Philips curve model is expressed by the following functional form:

$$\pi_t = \beta\pi_{t-1} + \gamma G_t + \delta Z_t + \epsilon_t \qquad (7)$$

π_t is the year-on-year percentage change in core inflation. This series excludes administered and volatile price items from the consumption basket, and is used to control for supply side influences and to have a series that reflects the underlying demand conditions in the economy. G_t is the unemployment gap, which is unobserved and assumed to follow an AR(1) process. Finally, Z_t is the year-on-year change in import price inflation and is included to control for supply-side and exchange rate influences. For increased precision in estimating equation (7), the coefficients are initialised with values from an OLS regression of a similar functional form, but with the unemployment gap (G_t) that was approximated by the cyclical component from Step 1. G_t is consequently treated as an unobserved component and estimated using the Kalman filter. Finally, NAIRU is computed as the difference between the unemployment rate and the estimated unemployment gap, G_t, and smoothed using the HP filter.

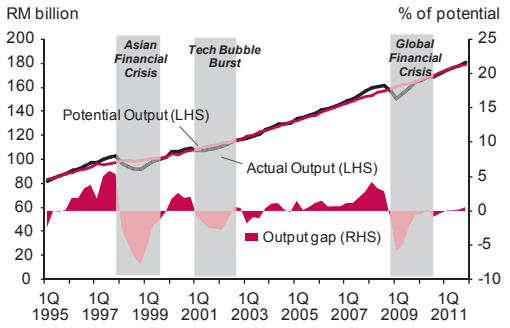
3. RESULTS

3.1 Potential Output and the Output Gap

The estimates of potential output and the output gap are illustrated in Figure 1. The output gap was broadly positive or close to zero for most of the period studied, i.e., 1995-2011. There are three episodes in which large negative output gaps were seen: The Asian Financial Crisis (AFC), the bursting of the technology bubble in the US (Tech Bust) and the recent financial crisis in the advanced economies. In all three cases, the gaps closed within 2 years with improving demand as the economy recovered (Figure 2). Not surprisingly, the output gap was negative for the longest period (8 quarters) and experienced its deepest trough of -8% of GDP in 4Q 1998 during the AFC, given that actual GDP contracted by 7.2% in 1998, the worst decline over the period studied. In contrast, Malaysia's experience during the Tech Bust and the recent crisis was less severe both in depth and duration as actual output recovered back to its potential level within 6 quarters.

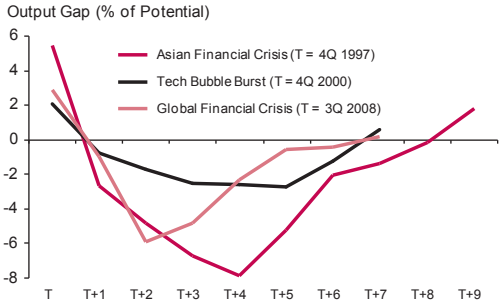
[5] The trend-cycle decomposition was done using the Hodrick-Prescott filter.

Figure 1: Actual and Potential GDP in Malaysia



Source: Authors' calculations and Department of Statistics Malaysia

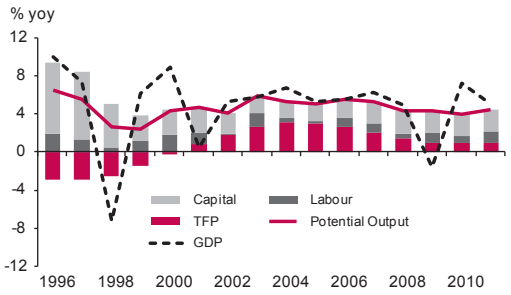
Figure 2: Narrowing of Output Gap during Three Episodes of Economic Slowdown



Source: Authors' calculations
Note: T denotes the quarter before the output gap turned negative

Figure 3 illustrates the growth in GDP, potential output and its respective contributions from capital, labour and total factor productivity (TFP). Growth in potential output normally moderates during economic downturns as investments decline and employment conditions weaken. In Malaysia's case, potential output only declined noticeably during the AFC but did not deviate much from its pre-crisis trend during the Tech Bust and the recent crisis. This is mainly attributable to the slower rate of capital accumulation as total investment declined by 42% in 1998 during the AFC, much larger compared to the investment rates of -1.8% in 2001 during the Tech Bust and -0.5% in 2009 during the recent crisis. Nonetheless, the output gap became negative in all three episodes as the contraction in domestic and external demand caused actual output to fall below the productive capacity of the economy.

Figure 3: Factors Contributing to Potential Output Growth



Source: Authors' calculations and Department of Statistics Malaysia

Table 1: Philips Curve Estimates using the Kalman Filter

Dependent variable is π_t	
Variable	**Kalman filter**
G_t	-0.9169
π_{t-1}	0.7299
Z_t	0.2258
G_{t-1}	0.5692

Note: All estimates are significant at the 1% level

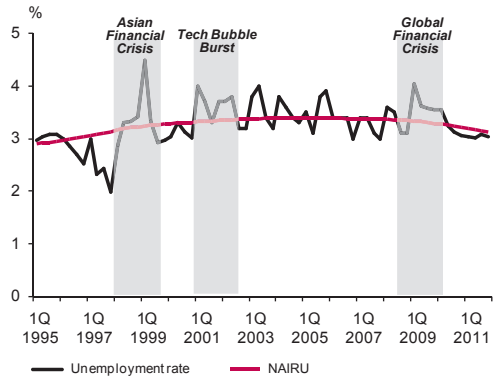
3.2 The Relationship between Inflation, Unemployment and the Output Gap

The estimates of equation 7 are shown in Table 1. The estimated coefficients all possess the expected signs and provide evidence of a statistically significant relationship between inflation and the unemployment gap. Specifically, a higher unemployment gap leads to lower inflation, while higher import prices[6] are passed-through to higher inflation.

[6] This can occur through depreciation in the exchange rate or a higher input cost of imported goods.

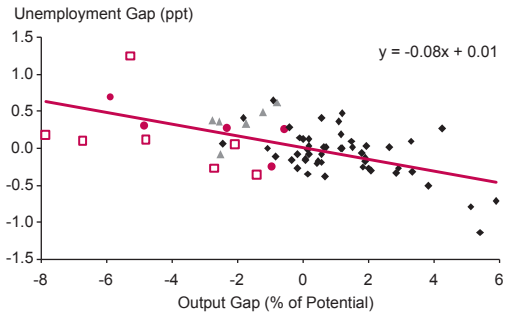
Figure 4 displays the unemployment rate together with NAIRU from 1Q 1995 to 4Q 2011. The figure shows that the unemployment rate was below NAIRU (negative unemployment gap) during the quarters just prior to the AFC, the Tech Bust and the recent crisis, coinciding with periods when the output gap was persistently positive. Figure 5 corroborates this observation, by illustrating evidence of a negative relationship between the unemployment gap and the output gap. A stronger labour market, reflected by a lower unemployment gap, corresponds to a higher output gap. Conversely, the unemployment gap was noticeably higher during the three aforementioned episodes when economic conditions were weak and output gap was negative.

Figure 4: Actual Unemployment and NAIRU



Source: Authors' calculations and Department of Statistics Malaysia

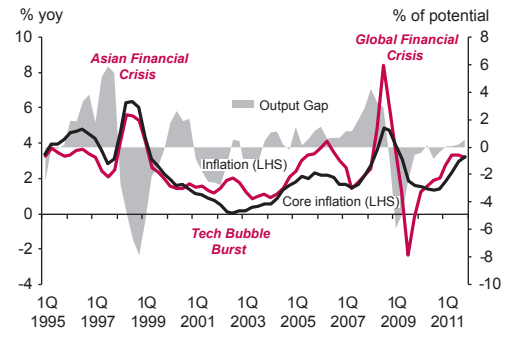
Figure 5: Output Gap and Unemployment Gap



Source: Authors' calculations and Department of Statistics Malaysia
Note: Observations from 1Q 1995 to 4Q 2011

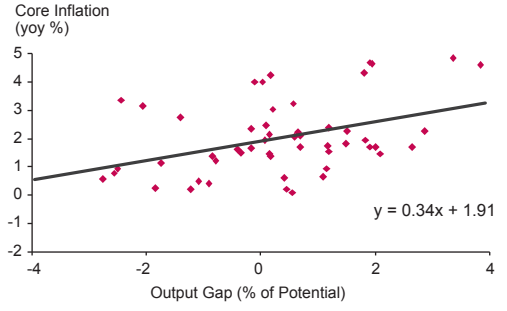
Although lower inflation is normally seen alongside negative output gaps, this was only witnessed during one of the three highlighted episodes – the Tech Bust. In fact, even with large negative output gaps, the economy experienced higher inflation during the AFC and the recent crisis (Figure 6). One explanation is the large depreciation in the exchange rate[7] during the AFC and the sharp increase in global commodity prices during the recent crisis. Figure 7 lends support to this hypothesis. It illustrates a positive relationship between core inflation and the output gap, implying that once we strip out the supply-side and exchange rate related shocks from the inflation time series, the relationship between the output gap and inflation is indeed positive.

Figure 6: Output Gap and Inflation



Source: Authors' calculations and Department of Statistics Malaysia

Figure 7: Output Gap and Core Inflation



Source: Authors' calculations and Department of Statistics Malaysia
Note: Observations from 1Q 1995 to 4Q 2011, excluding periods with supply shocks

[7] A depreciation in the exchange rate typically leads to higher import prices which can result in increased inflationary pressures.

4. CONCLUSION

This note outlines one of the methodologies that is used by the Central Bank to estimate potential output and the output gap for Malaysia. Using the production function approach, the estimations establish linkages between inflation, unemployment and the output gap that are in accordance with expectations – a higher output gap corresponds with higher inflation (excluding supply shocks) and lower unemployment, and vice versa.

The results show that the output gap was broadly positive or close to zero for most of the period studied (1995-2011) except for three episodes during which large negative output gaps are observed: The Asian Financial Crisis (AFC), the bursting of the technology bubble in the US (Tech Bust) and the recent financial crisis in the advanced economies. The negative output gap was the largest and longest during the AFC, followed by the recent crisis and the Tech Bust. This is not surprising as the economic downturn during the AFC was caused by a regional financial crisis. This disrupted financial intermediation and the supply of credit to firms and households during this period, causing a large decline in private sector spending. In contrast, the latter two episodes were temporary external demand shocks. While the country was adversely affected through lower exports during these episodes, financial stability was preserved and domestic demand remained comparatively resilient. Overall, the robustness and intuitiveness of the results support the inclusion of the output gap as one of the important indicators that the Central Bank monitors to assess the state of the economy.

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MONETARY AND FINANCIAL DEVELOPMENTS

Interest rates remained stable

The Overnight Policy Rate (OPR) was left unchanged at 3.00% during the second quarter of 2012. At the prevailing level of the OPR, monetary conditions continue to be supportive of economic activity.

Reflecting the unchanged OPR, the average overnight interbank rate was stable during the quarter, moving within a range of 2.90% to 3.00% between 2 April and 29 June 2012. Interbank rates of other short-term maturities were also relatively steady.

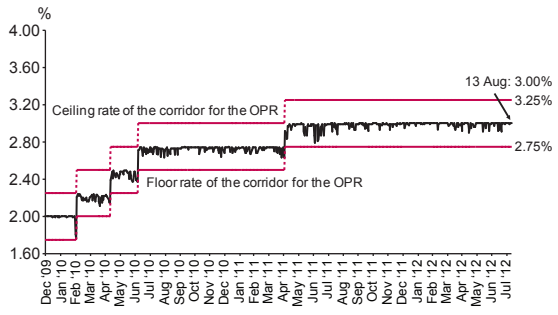
Rates on interest rate swaps and the 3-month Kuala Lumpur Interbank Offer Rate (KLIBOR) futures, however, moderated and remained relatively low, reflecting market expectations for the OPR to remain unchanged.

Retail deposit rates were stable during the quarter. The average quoted fixed deposit (FD) rates of commercial banks were relatively unchanged. As at end-June 2012, the average quoted FD rates of commercial banks for the 1 to 12 months tenures ranged between 2.90% and 3.19% respectively.

Borrowing costs to the economy were also relatively stable during the period. The average base lending rate (BLR) of commercial banks remained at 6.53%, while the weighted average lending rate (ALR) on loans outstanding was also stable at 5.60% as at end-June 2012 (end-March 2012: 5.62%).

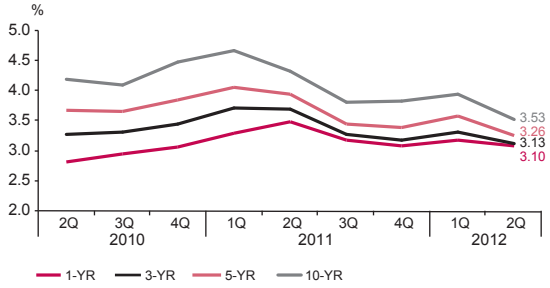
As such, interest rates remained supportive of economic activity.

Daily Weighted Average Overnight Interbank Rate



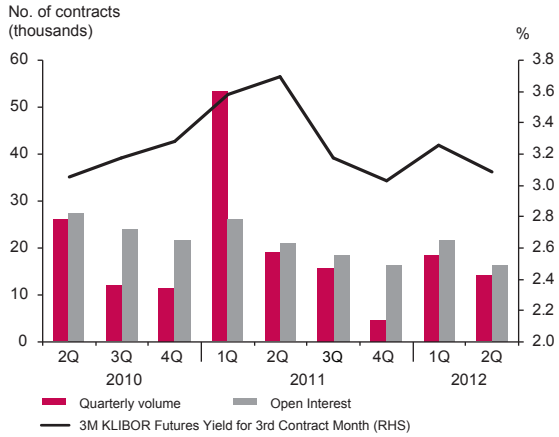
Source: Bank Negara Malaysia

Interest Rate Swap: Rates



Source: Bloomberg

3 Month KLIBOR Futures



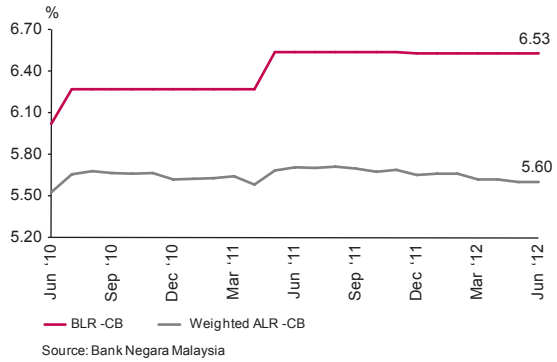
Source: Bursa Malaysia

Interest Rates

	2011	2012	
	2Q	1Q	2Q
	At end-period (%)		
Overnight Policy Rate (OPR)	3.00	3.00	3.00
Interbank rates			
Overnight	2.97	3.00	2.99
1-month	3.08	3.06	3.06
Base lending rate (BLR)			
Commercial banks	6.54	6.53	6.53
Weighted average lending rate (ALR)			
Commercial banks	5.71	5.62	5.60
Fixed deposit rates			
Commercial banks			
1-month	2.95	2.93	2.90
12-months	3.23	3.21	3.19

Source: Bank Negara Malaysia

Lending Rates of Commercial Banks (At end-period)



Source: Bank Negara Malaysia

Determinants of Broad Money, M3

	Change during the period				
	2011		2012		
	2Q	1H	1Q	2Q	1H
	RM billion				
M3	**44.9**	**72.9**	**38.8**	**26.6**	**65.4**
Net claims on Govt	-11.4	-15.1	-4.9	-10.1	-14.9
Claims on private sector	37.8	60.5	23.1	53.3	76.4
Loans	*29.3*	*55.8*	*18.4*	*48.9*	*67.3*
Securities	*8.5*	*4.8*	*4.7*	*4.4*	*9.1*
Net foreign assets[1]	69.3	94.5	17.2	-9.4	7.8
BNM	*58.0*	*73.8*	*0.4*	*4.9*	*5.2*
Banking System	*11.2*	*20.7*	*16.8*	*-14.3*	*2.6*
Other influences	-50.7	-67.0	3.3	-7.2	-3.9

[1] Pre-revaluation

Source: Bank Negara Malaysia

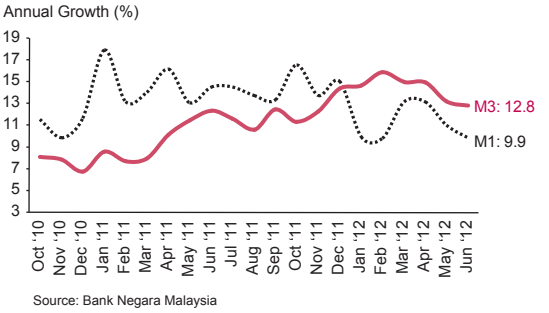
M3 continued to expand

The monetary aggregates grew at a more moderate pace during the second quarter. M1, or narrow money, increased by RM3.5 billion. On an annual basis, M1 expanded by 9.9% as at end-June (end-March 2012: 13.2%). M3, or broad money, grew by 12.8% annually as at end-June 2012 (end-March 2012: 15.0%), and increased by RM26.6 billion on a quarter-on-quarter basis.

The increase in M3 reflected the continued extension of credit to the private sector, particularly to businesses, in line with the sustained pace of economic activity. Nevertheless, the expansion in M3 was partially offset by Government fundraising, as the drawdown of deposits by the private sector was used to finance the purchase of Malaysian Government Securities (MGS) and Government Investments Issues (GII). Meanwhile, net portfolio outflows were also recorded during the quarter, driven mainly by concerns surrounding the European sovereign debt crisis, thereby further moderating M3 expansion.

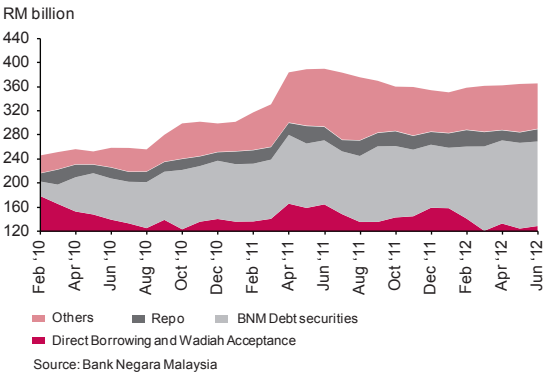
In the banking system, ample liquidity conditions prevailed at both the institutional and system-wide levels. The level of surplus liquidity placed with BNM was relatively stable during the quarter.

Monetary Aggregates



Source: Bank Negara Malaysia

Outstanding Liquidity Placed with Bank Negara Malaysia (At end-period, RM billion)



Source: Bank Negara Malaysia

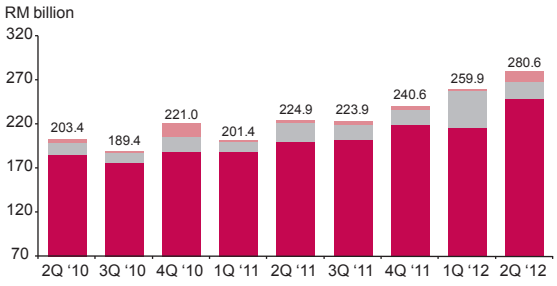
Private sector financing activity strengthened further in the second quarter

In the second quarter, financing conditions remained supportive of economic activity. Total gross financing raised by the private sector through the banking system and the capital market increased to RM280.6 billion (1Q 12: RM259.9 billion). The higher financing reflected increased loan disbursements mainly to businesses and initial public offerings (IPOs) during the quarter. On a net basis, banking system loans and PDS outstanding expanded at an annual growth rate of 13.0% as at end-June 2012 (1Q 12: 13.3%).

All major loan indicators remained broadly in line with economic activity in the second quarter. In the business sector, higher loan disbursements reflected mainly the drawdown of funds to finance working capital in the *manufacturing; real estate; finance, insurance and business services* and *wholesale and retail, restaurants and hotels* sectors. Demand for new financing by businesses also increased with higher loan applications mainly from the *finance, insurance and business services; wholesale and retail, restaurants and hotels* and *construction* sectors. On an annual basis, business loans outstanding expanded at a growth rate of 14.3% as at end-June (1Q 12: 10.8%).

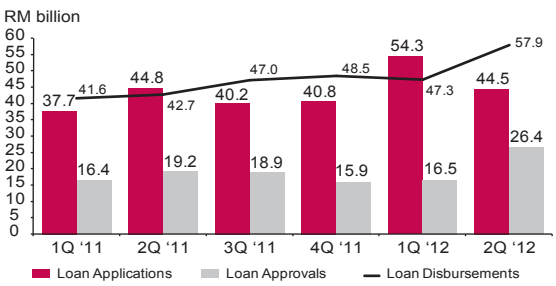
Financing to the household sector continued to expand at a steady pace during the quarter to increase at an annual growth rate of 11.8% as at end-June (1Q 12: 11.9%). Demand for loans was higher across most purposes during the quarter, with increased loan applications especially for the *purchase of residential property*, *passenger cars* and for *personal use*.

Gross Private Sector Financing through Banking System and Capital Market



Source: Bank Negara Malaysia

Bank Lending to SMEs



Source: Bank Negara Malaysia

Financing of the Private Sector through Banking System and Capital Market

	During the period (RM billion)					Annual growth (%)				
	2011		2012			2011		2012		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
Gross total financing	**224.9**	**426.3**	**259.9**	**280.6**	**540.6**	**10.6**	**8.4**	**29.1**	**24.8**	**26.8**
Loans disbursed*	200.8	389.5	216.7	248.9	465.6	8.4	8.3	14.9	24.0	19.6
Gross PDS (excl. Cagamas)	20.3	31.9	41.9	19.6	61.5	45.9	73.9	260.6	-3.2	93.0
Equity	3.8	4.9	1.3	12.1	13.4	-9.7	-67.6	20.7	215.0	171.2
Net total financing (A)+(B)	**51.2**	**83.9**	**45.8**	**54.3**	**100.1**	**12.8**	**12.8**	**13.3**	**13.0**	**13.0**
Banking system	38.9	64.9	25.0	48.8	73.9	13.1	13.1	12.5	13.0	13.0
Loans outstanding (A)	*35.6*	*64.4*	*19.7*	*44.1*	*63.8*	*13.5*	*13.5*	*12.2*	*12.6*	*12.6*
Holding of PDS	*3.3*	*0.5*	*5.3*	*4.8*	*10.1*	*7.7*	*7.7*	*17.3*	*18.6*	*18.6*
PDS outstanding (B)	15.6	19.6	26.1	10.2	36.3	10.6	10.6	16.5	14.0	14.0
Memorandum item										
Gross PDS (incl. Cagamas)	20.9	33.1	44.8	20.6	65.4	42.0	70.8	266.5	-1.4	97.4

*Banking systems loans include loans sold to Cagamas

Source: Bank Negara Malaysia

Loan Indicators

	During the period (RM billion)					Annual growth (%)				
	2011		2012			2011		2012		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
Total										
Loan applications	199.7	368.2	195.4	220.1	415.6	25.8	26.3	16.0	10.2	12.9
Loan approvals	110.0	197.7	89.8	111.3	201.0	21.7	23.2	2.4	1.1	1.7
Loan disbursements	200.8	389.5	216.7	248.9	465.6	8.4	8.3	14.9	24.0	19.6
Loan repayments	173.8	341.9	205.4	212.0	417.4	7.4	8.1	22.2	22.0	22.1
Change in loans outstanding*	35.6	64.4	19.7	44.1	63.8	13.5	13.5	12.2	12.6	12.6
Of which:										
Business enterprises**										
Loan applications	96.6	176.2	105.3	115.2	220.4	34.9	33.9	32.3	19.2	25.1
Loan approvals	55.5	94.3	45.3	57.9	103.2	29.3	30.7	16.5	4.3	9.3
Loan disbursements	134.8	256.8	152.5	184.2	336.6	7.8	6.1	24.9	36.7	31.1
Loan repayments	116.9	226.7	145.8	154.3	300.1	5.0	4.7	32.8	32.0	32.4
Change in loans outstanding*	11.6	22.9	3.5	25.4	29.0	12.1	12.1	10.8	14.3	14.3
SMEs**										
Loan applications	44.8	82.5	54.3	44.5	98.8	30.7	32.6	44.0	-0.7	19.8
Loan approvals	19.2	35.6	16.5	26.4	42.9	21.1	23.9	0.4	37.8	20.6
Loan disbursements	42.7	84.4	47.3	57.9	105.2	16.6	17.0	13.7	35.5	24.7
Loan repayments	36.6	73.9	46.0	46.8	92.8	13.1	12.2	23.4	27.9	25.6
Change in loans outstanding*	7.5	10.9	4.8	11.8	16.6	14.1	14.1	19.9	22.0	22.0
Large corporations										
Loan applications	51.9	93.7	51.0	70.7	121.7	38.9	35.0	21.7	36.3	29.8
Loan approvals	36.3	58.7	28.8	31.4	60.2	34.1	35.3	28.3	-13.4	2.5
Loan disbursements	92.0	172.5	105.1	126.3	231.4	4.2	1.4	30.7	37.2	34.2
Loan repayments	80.2	152.8	99.9	107.4	207.3	1.7	1.4	37.6	33.9	35.7
Change in loans outstanding*	4.1	12.0	-1.2	13.6	12.4	10.8	10.8	5.1	9.4	9.4
Households										
Loan applications	103.0	191.9	90.2	104.9	195.1	18.4	20.0	1.4	1.9	1.6
Loan approvals	54.6	103.3	44.5	53.4	97.9	14.9	17.0	-8.8	-2.1	-5.3
Loan disbursements	66.1	132.7	64.2	64.8	129.0	9.6	12.9	-3.5	-2.0	-2.7
Loan repayments	57.0	115.3	59.5	57.7	117.3	12.8	15.6	2.1	1.4	1.7
Change in loans outstanding*	15.4	30.1	11.9	16.7	28.6	12.8	12.8	11.9	11.8	11.8

* The annual growth is for end-period.
** Include loans to individual businesses.

Source: Bank Negara Malaysia

Fund raising activity in the capital market remained healthy

Net funds raised in the capital market amounted to RM27.6 billion during the quarter (1Q 12: RM43.5 billion). As in the previous quarter, the bulk of funds were raised by the private sector. Funds raised from the equity market increased significantly to RM12.1 billion (1Q 12: RM1.3 billion), due to a large initial public offering in June. New PDS issuances also remained healthy at RM20.6 billion (1Q 12: RM44.8 billion). Funds were raised mainly to finance new activity and for working capital and general business activities. After adjusting for redemptions, net funds raised by the private sector in the capital market amounted to RM22.6 billion (1Q 12: RM29.8 billion).

In the public sector, net funds raised amounted to RM5.0 billion (1Q 12: RM13.7 billion). Funds were raised through the new issuance of a 3.5-year, 5.5-year and 20-year Malaysian Government Securities (MGS), a 10.5-year and 15-year Government Investment Issue (GII) as well as the re-opening of a 3-year MGS, 7-year MGS and a 7-year GII.

Net Funds Raised in the Capital Market

	2011		2012		
	2Q	1H	1Q	2Q	1H
	RM billion				
By Public Sector	**3.5**	**28.1**	**13.7**	**5.0**	**18.7**
Government securities, *net*	5.0	29.6	15.6	9.6	25.2
Malaysian Government Securities	*16.7*	*31.8*	*12.8*	*16.1*	*28.9*
Government Investment Issues	*10.0*	*19.5*	*12.0*	*11.1*	*23.1*
Less: Redemptions	*21.8*	*21.8*	9.2	17.6	26.8
Khazanah Bonds, *net*	-	-	-	-	-
Savings Bonds, *net*	(1.4)	(1.5)	(1.9)	(4.6)	(6.5)
By Private Sector	**17.3**	**22.5**	**29.8**	**22.6**	**52.4**
Shares	3.8	4.9	1.3	12.1	13.4
Debt securities, *net*	13.5	17.5	28.5	10.5	39.0
Private Debt Securities	*20.9*	*33.1*	*44.8*	*20.6*	*65.4*
Less: Redemptions	*7.4*	*15.6*	*16.3*	*10.1*	*26.4*
Total	**20.8**	**50.6**	**43.5**	**27.6**	**71.1**

Note: Numbers may not add up to total due to rounding

Source: Bank Negara Malaysia and Bursa Malaysia

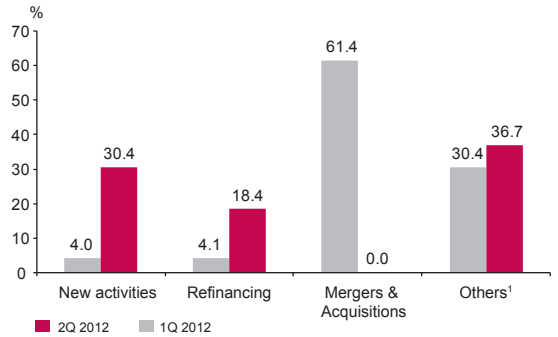
Loans by Sector

	Loans disbursed						Loans out-standing
	During the period					Share of total	Share of total
	2Q 11	1H 11	1Q 12	2Q 12	1H 12		
	(RM billion)					(%)	
Business enterprises	**134.8**	**256.8**	**152.5**	**184.2**	**336.6**	**72.3**	**45.5**
Large corporations	*92.0*	*172.5*	*105.1*	*126.3*	*231.4*	*49.7*	*29.6*
*SMEs**	*42.7*	*84.4*	*47.3*	*57.9*	*105.2*	*22.6*	*15.9*
Selected sectors							
Agriculture, hunting, forestry and fishing	5.9	11.5	5.7	8.1	13.8	3.0	2.3
Mining and quarrying	1.1	2.2	1.4	2.8	4.2	0.9	0.6
Manufacturing	42.0	83.3	46.3	55.4	101.7	21.8	9.1
Construction	10.1	20.3	11.9	11.9	23.8	5.1	3.9
Real estate	8.5	14.9	8.0	15.5	23.5	5.0	5.4
Electricity, gas and water supply	1.2	2.7	1.7	2.1	3.8	0.8	0.8
Wholesale, retail, restaurants and hotels	33.8	64.5	44.1	45.6	89.6	19.3	7.2
Transport, storage and communication	4.3	8.7	4.6	4.9	9.6	2.1	2.7
Finance, insurance and business services	18.7	33.6	21.5	30.0	51.5	11.1	8.0
Households	**66.1**	**132.7**	**64.2**	**64.8**	**129.0**	**27.7**	**54.5**
Purchase of residential properties	15.7	30.7	16.4	15.0	31.5	6.8	25.4
Consumption credit	40.9	81.0	37.1	40.0	77.1	16.6	19.1
Of which:							
Credit cards	*24.2*	*47.4*	*21.4*	*21.5*	*42.9*	9.2	3.0
Purchase of passenger cars	*8.6*	*17.5*	*8.6*	*10.2*	*18.8*	*4.0*	*11.2*
Others	9.5	21.0	10.7	9.7	20.4	*4.4*	*9.9*
Total	**200.8**	**389.5**	**216.7**	**248.9**	**465.6**	**100.0**	**100.0**

*Include loans to individual businesses.

Source: Bank Negara Malaysia

Private Debt Securities Issued by Purpose (% of total)



[1] Includes issuance by non-residents & Cagamas and for the purpose of working capital and general business activities

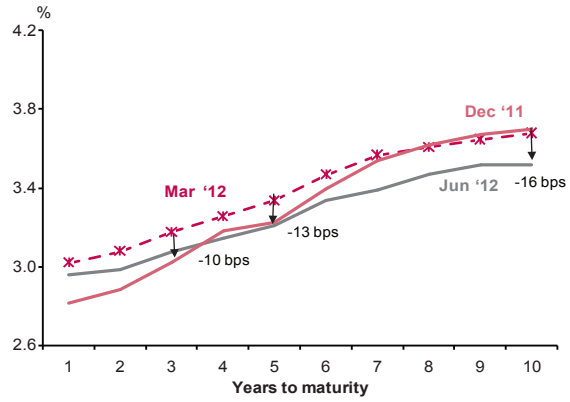
Source: Bank Negara Malaysia

Bond yields declined

MGS yields were on a declining trend in the second quarter. This mainly reflected expectations that domestic monetary conditions would remain accommodative, given moderate domestic growth and lower inflationary pressures amidst increasing signs of slowing global growth particularly in the advanced economies and PR China. The decline in yields was across the board, with the 3-year, 5-year and 10-year MGS recording a decline of 10, 13 and 16 basis points respectively.

In the PDS market, yields on the 5-year AAA and AA corporate bonds also recorded a marginal decline of 1 basis point, in line with the decline in MGS yields. Yields on the 5-year A-rated paper, however, increased marginally by 9 basis points.

Trend in MGS Yields

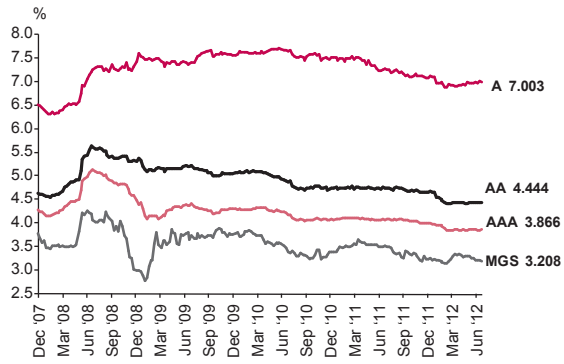


Source: Bank Negara Malaysia

Decline in secondary trading in the bond market

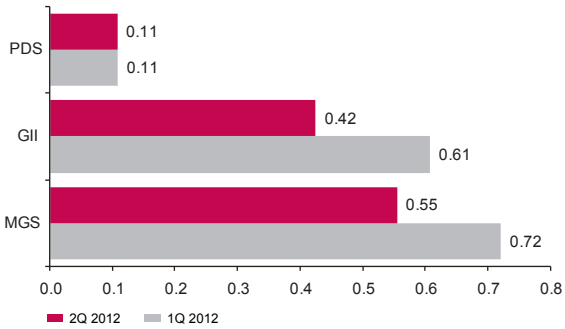
Total trading in the secondary market declined to RM252 billion during the quarter (1Q 12: RM312 billion). Both the MGS and GII segments registered lower liquidity ratios of 0.55 and 0.42 respectively, while the liquidity ratio in the PDS segment was unchanged at 0.11.

5-year MGS and 5-year Corporate Bond Yield



Source: Bank Negara Malaysia

Liquidity Ratio: Turnover / Outstanding



Source: Bank Negara Malaysia

Positive performance of KLCI

The FBM (FTSE Bursa Malaysia) KLCI rose by 2.8 points, ending the second quarter at 1599.2 (end-March 2012: 1596.3). The index decreased in the first half of the quarter reflecting renewed uncertainties over the European sovereign debt crisis and concerns over the prospect for regional and global growth, which prompted investors to reduce holdings of equity assets. In the second half of the quarter, the market returned to its end-1Q 2012 level on expectations of further stimulus by major economies to mitigate the prospects of a slowdown in economic growth.

The positive performance of the local bourse was also supported by domestic institutional buying in June. Market capitalisation increased to RM1.37 trillion at end-June 2012 (end-March 2012: RM1.36 trillion), while the daily average turnover decreased to 1.21 billion units (1Q 12: 2.02 billion units) during the quarter. Open interest in the FBM KLCI futures increased to 32,173 contracts as at end-2Q 2012 (1Q 12: 29,962).

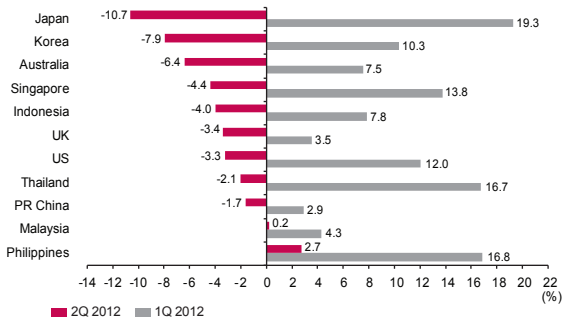
On 13 August 2012, the KLCI ended higher at 1,646.3 points (since end-June 2012: 3.0%), with market capitalisation of RM1.44 trillion (since end-June 2012: 5.0%).

Ringgit depreciated against regional and most major currencies

Global foreign exchange markets experienced significant volatility during the second quarter in light of several high profile events affecting the world economy. Renewed uncertainties over the European sovereign debt crisis and the prospects for regional and global economic growth prompted some investors to reduce holdings of emerging market assets. As a result, the ringgit depreciated by 3.8% against the US dollar in the second quarter, along with most other regional currencies. Against other major currencies, the ringgit depreciated against the pound sterling (-1.6%) and the Japanese yen (-7.0%), while strengthening against the euro (2.0%). Against the other regional currencies, the ringgit depreciated in the range of between 0.7% and 5.4%.

During the period 1 July to 13 August 2012, the ringgit appreciated against the euro (4.7%), US dollar (2.3%), pound sterling (1.9%) and Japanese

Performance of Selected Global and Regional Markets in 2012 (% growth QoQ)



Source: Bloomberg and Bank Negara Malaysia calculations

Bursa Malaysia: Selected Market Indicators

	2011	2012	
	As at end		
	June	Mar	June
Price Indices			
Composite	1,579.1	1,596.3	1,599.2
FBMEMAS[1]	10,842.3	10,939.6	10,917.6
ACE Market[2]	4,198.2	4,583.8	4,354.7
Market capitalisation (RM billion)	1,342.2	1,355.4	1,367.9
No. of companies listed	953	939	927
	During the quarter		
	2Q	1Q	2Q
Average daily turnover			
Volume (million units)	1,038.8	2,019.9	1,205.8
Value (RM million)	1,638.7	1,977.8	1,517.1

[1] FBMEMAS stands for FTSE Bursa Malaysia EMAS Index
[2] From 3 August 2009, Mesdaq market was replaced with ACE Market

Source: Bursa Malaysia

Bursa Malaysia: Market Turnover

	2011				2012					
	2Q		1H		1Q		2Q		1H	
	Billion units	RM billion	Billion units	RM billion	Billion units	RM billion	Billion units	RM billion	Billion units	RM billion
Turnover	65.4	103.2	167.5	235.0	119.2	116.4	76.0	95.6	195.1	212.0
Of which:										
Main Board	49.5	100.0	133.6	228.4	75.6	109.5	48.7	91.1	124.3	200.5
Of which										
Consumer Products	4.0	5.0	8.1	10.4	9.4	7.8	4.2	6.4	13.6	14.2
Industrial Products	10.5	15.7	29.4	36.9	13.3	16.7	10.7	10.1	24.1	26.8
Construction	2.8	5.9	7.4	14.9	2.8	4.9	1.5	2.8	4.4	7.7
Trading/Services	17.2	36.5	50.6	82.6	29.4	39.9	19.5	37.6	48.9	77.5
Finance	4.7	20.9	9.1	45.5	4.0	19.8	3.2	17.4	7.3	37.3
Properties	6.3	7.2	19.0	16.9	7.8	6.5	4.0	3.6	11.7	10.1
Plantations	1.2	5.2	3.5	13.4	1.7	5.8	1.5	7.1	3.1	12.9
Infrastructure	0.7	2.1	1.8	4.5	2.0	3.4	1.5	3.3	3.4	6.7
ACE Market[1]	10.9	2.1	19.2	3.4	27.7	4.3	19.8	3.2	47.5	7.5

[1] From 3 August 2009, Mesdaq market was replaced with ACE Market

Source: Bursa Malaysia

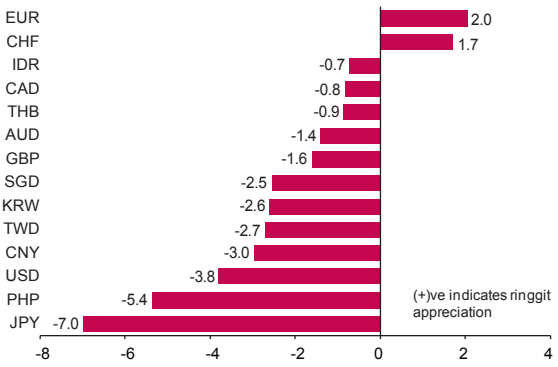
yen (0.9%). The ringgit also appreciated against regional currencies, strengthening against the Korean won, Thai baht, Philippine peso, Indonesian rupiah and Chinese renminbi by between 0.6% and 2.3%. The ringgit remained unchanged against the Singapore dollar.

Market activity for foreign exchange derivatives rose with the increased volatility in the financial markets

The volume of foreign exchange swaps and forwards grew by 10.8% in the second quarter (1Q 12: +1.9%). The rise was driven by hedging activities by local exporters, who were proactively managing their foreign currency exposure through forward selling of the US dollar, taking advantage on the US dollar appreciation against most other currencies.

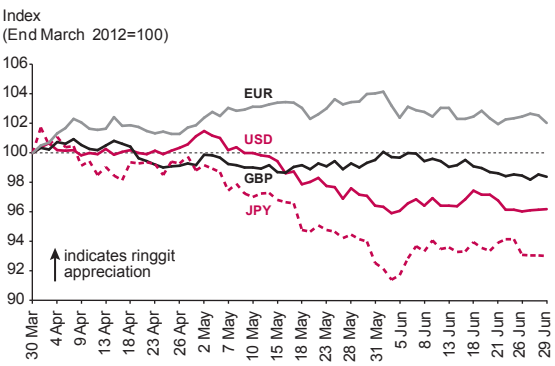
The costs of raising US dollars in the foreign exchange market increased during the quarter due to volatility in global foreign exchange markets, with the 5-year USD/RM cross-currency swaps widening from 133bps in March to 145bps in June. The cross-currency swaps subsequently increased further to 173bps on 12 July 2012, as domestic institutional investors investing abroad resulted in additional demand for dollars. Nevertheless, easing concerns over the European sovereign debt crisis have seen the cross-currency swaps moderate to 149bps on 20 July 2012.

Summary of Ringgit Performance Against Selected Currencies Percent Change (1 April - 30 June 2012)



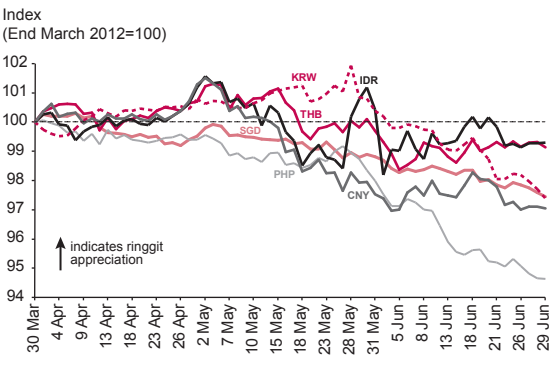
Source: Bank Negara Malaysia

Ringgit Performance Against Major Currencies



Source: Bank Negara Malaysia

Ringgit Performance Against Regional Currencies



Source: Bank Negara Malaysia

Performance of Ringgit Against Selected Currencies

RM per foreign currency	As at end				% change since*		
	21 Jul 05	2Q 11	1Q 12	2Q 12	21 Jul 05	2Q 11	1Q 12
US dollar	3.8000	3.0205	3.0680	3.1895	19.1	-5.3	-3.8
Euro	4.6212	4.3820	4.0955	4.0133	15.1	9.2	2.0
Pound sterling	6.6270	4.8648	4.9008	4.9804	33.1	-2.3	-1.6
100 Japanese yen	3.3745	3.7538	3.7396	4.0198	-16.1	-6.6	-7.0
Singapore dollar	2.2570	2.4577	2.4405	2.5043	-9.9	-1.9	-2.5
100 Thai baht	9.0681	9.8308	9.9433	10.030	-9.6	-2.0	-0.9
100 Philippine peso	6.8131	6.9649	7.1407	7.5447	-9.7	-7.7	-5.4
100 Indonesian rupiah	0.0386	0.0352	0.0334	0.0336	14.8	4.5	-0.7
100 Korean won	0.3665	0.2826	0.2702	0.2775	32.1	1.9	-2.6
Chinese renminbi	0.4591	0.4673	0.4870	0.5018	-8.5	-6.9	-3.0

*(+) indicates appreciation of ringgit against respective currency and (-) indicates depreciation.

Source: Bank Negara Malaysia

MANAGING RISKS TO FINANCIAL STABILITY

Domestic financial stability is sustained

Financial stability remained intact throughout the second quarter of 2012 underpinned by strong capitalisation of financial institutions and orderly financial market conditions. Financial markets continued to demonstrate strong capacity to withstand external shocks and volatility arising from the escalation of sovereign risk in the Euro area. Confidence in the financial system was also preserved during the quarter.

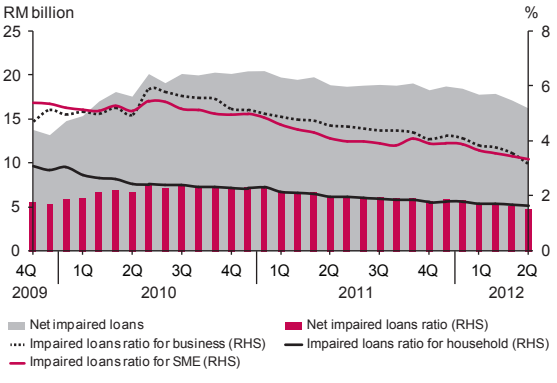
Sound economic fundamentals supported the stable credit risk outlook of the banking system. Impaired loans and loans that are in arrears between one to less than three months improved slightly in terms of value and ratio. As at end-June 2012, impaired loans and loans-in-arrears ratios were at 1.5% of net loans (1Q 12: 1.8%) and 3.4% of gross loans (1Q 12: 3.5%) respectively. Insurers' credit exposures accounted for only 3.3% of insurers' total capital (1Q 12: 3.4% of total capital).

Household debt-to-GDP stabilised at 75.6% as at end-June 2012. Accumulation of debts by the household sector continued to be supported by a commensurate expansion in financial assets. On a quarterly basis, household debt grew by 2.9% (1Q 12: +2.2%) while household assets grew by 2.5% (1Q 12: +4.7%). Although outstanding credit card balances increased by 1.3%, the amount of overdue balances recorded a decline of 8.7%. Additionally, financing for the purchase of residential properties grew at a slower pace of 2.8% (1Q 12: 3.4%). Impaired loans ratio for the household sector improved to 1.6% (1Q 12: 1.7%) demonstrating households' continued ability to meet debt obligations.

The growth in credit to businesses accelerated to 6.7% for the quarter (1Q 12: 0.9%) driven primarily by lending for real estate and other business activities. Impaired loans ratio for the business sector continued to decline to 3.2% of business loans (1Q 12: 3.8%) amid a favourable operating environment. Credit risk for this portfolio remained manageable, with default risk, as measured by the expected default frequency, rising only slightly to 0.6% (1Q 12: 0.5%).

Despite renewed pressures in the European economies, domestic equity market volatility improved during the quarter to 7.9% (1Q 12: 12.3%), underpinned by sustained positive domestic market sentiment. Trading liquidity in the debt and equity market remained intact with relatively stable turnover ratios and bid-ask spread observed. Banking system exposures to interest rate risk and equity risk remained stable at 4.7% and 0.8% of capital base respectively. Interest rate and equity risks were well-contained in the insurance sector, accounting for 3.3% and 6.7% of total capital available respectively.

Banking System: Loan quality

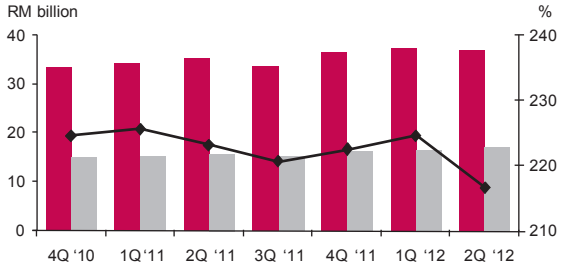


Source: Bank Negara Malaysia

The financial sector remained resilient

Strong capitalisation continued to support the resilience of the domestic financial sector to withstand potential shocks. Capitalisation of the banking sector remained stable with the core capital ratio and risk-weighted capital ratio at 12.9% (1Q 12: 13.2%) and 14.7% (1Q 12: 14.8%) respectively. Total capital in excess of the minimum regulatory level of 8% remained strong, at above RM70 billion. The quality of banks' capital remained high, with about 88% in Tier 1 capital, comprising mainly paid-up capital and reserves. Similarly, the insurance sector recorded a strong capital adequacy ratio of 216.7% (1Q 12: 224.6%) and a high capital buffer above RM20 billion.

Insurance Sector: Capitalisation

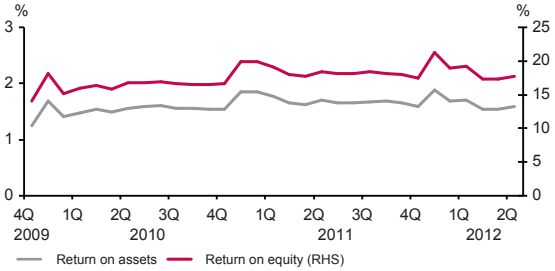


Source: Bank Negara Malaysia

Banking system profitability was sustained with returns on assets and equity of 1.6% (1Q 12: 1.7%) and 17.7% (1Q 12: 19.1%) respectively. Pre-tax profit for the quarter amounted to RM6.8 billion (1Q 12: RM7.6 billion) attributable to revenue from continued growth in financing activities. Nevertheless, net trading and investment income declined by 37% amid more volatile market conditions.

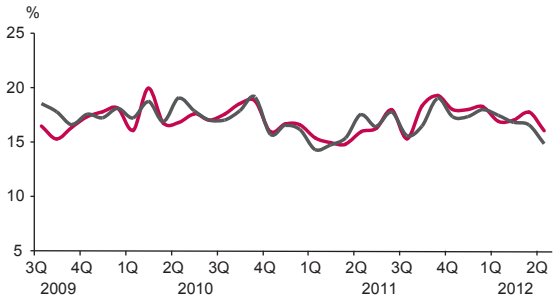
The life insurance and family takaful businesses recorded lower excess of income over outgo totalling RM3.7 billion (1Q 12: RM3.9 billion) due to a lower net investment gain of RM0.2 billion (1Q 12: RM0.7 billion). Nevertheless, business premiums continued to grow by 12.5% during the quarter. Profitability of the general insurance and takaful sector remained stable with underwriting and operating profits of RM402.5 million and RM684.3 million respectively. This was driven mainly by the higher premium income from motor business and slight moderation in

Banking System: Profitability



Source: Bank Negara Malaysia

Banking System: Liquidity Buffer to Total Deposit Ratio



Source: Bank Negara Malaysia

claims. The claims ratio for the Motor 'Act' cover (mandatory insurance cover required under the Road Transport Act 1987) remains an area of concern, as it continued to rise to 240.7% (1Q 12: 206.7%).

Liquidity in the banking system remained ample to meet the demands for deposit withdrawals and other liquidity obligations. The liquidity buffer accounted for 14.9% of total deposits for liquidity needs maturing within 1 month. Banks' foreign currency liquidity mismatch remained manageable with the slight easing of on-shore USD liquidity. The negative mismatch position in the less than one month maturity bucket improved to RM7.9 billion.

Insurance and Takaful Sectors: Indicators

	2011		2012			2011		2012		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
	RM million					Annual Change (%)				
Life Insurance & Family Takaful										
Excess of Income Over Outgo	3,780.0	7,012.1	3,912.9	3,661.9	7,574.8	27.1	19.2	21.1	-3.1	8.0
General Insurance & General Takaful										
Operating profit	557.2	1,111.1	652.6	684.3	1,336.9	-3.1	1.0	17.8	28.1	23.0
Claims ratio (%)	61.4	61.4	60.6	59.0	59.0	-1.1	-1.1	-1.5	-4.0	-4.0

Source: Bank Negara Malaysia

Governor's Keynote Address at the Management Association of the Philippines (MAP) Luncheon Seminar: "Why Asia? Asia's Prospects and How Emerging Markets Shall Shape the Region's Future" Manila, 2 May 2012

Keynote Address by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

It is my great pleasure to be here in Manila to give this luncheon address. Let me thank the Management Association of the Philippines for the invitation to speak here today on Asia's future prospects; why Asia and how will emerging Asia shape the region.

Opportunities in Asia are now boundless. Key in generating these opportunities are the economic flexibility of the region, the diverse nature of the region that has generated the potential to leverage on regional complementarities, and the demographic advantages of the region. These opportunities are also being enhanced by the significant payoffs gained from a decade of reforms, and the intensification of regional economic and financial integration that is now taking place and resulting in a more connected and cohesive region. Despite being at different stages of development and operating in different economic systems, the benefits are also increasingly being more widely shared. Finally, the region has also benefited immensely from the resilience built, and more recently, from having the policy flexibility to minimise to the effects of the recent global financial crisis.

Let me elaborate on these prevailing trends that are shaping emerging Asia's future. Asia's growth prospect is very much underpinned by the transformative momentum that has, for a number of decades, brought emerging Asia to its current growth trajectory. The economic flexibility of emerging Asia has enabled most of the economies in the region to adjust to the changing conditions and to shift resources to new areas of comparative advantage. Emerging Asia has demonstrated that it has not been weighed down by structural rigidities and impediments. Capital and labour mobility has been strengthened by the economic and financial reforms that have resulted in the shift towards greater market orientation and liberalisation. Changing economic structures and transformation within specific sectors, including the participation in cross border production chains, have been gaining significance. Emerging Asia has also been able to leverage on technology to push beyond prevailing frontiers. Firms in emerging Asia are also increasingly innovating and allocating resources to research and development, and becoming leading players in their various respective industries.

An equally important economic shift that is taking place in Asia is the rebalancing of the economies from being export-dependent to domestic demand becoming an important source of growth. Rising incomes, stable labour market conditions and resilient financial systems have supported private consumption and investment activity. Asia is, therefore, transitioning from being just global producers to being global consumers. Asia also has the policy space to support and strengthen domestic demand. Asia is becoming a huge cumulative market in the global economy.

Reinforcing the economic flexibility of Asia is the diversity of the region. Asia is one of the most diverse regions in the world in terms of size, stage of development, resources, economic structure, degree of openness and market orientation. In harnessing each other's comparative advantage and leveraging on the regional complementarities, for Asia as a region, the whole has become significantly greater than the sum of its individual economies. Over the recent decade, this has generated a significant expansion in intra-regional trade, investment and financial flows. This trend is expected to intensify significantly

going forward. The diversity of emerging Asia also presents immense opportunities in terms of the growing markets across the entire spectrum of products and services.

The third key trend that is shaping the future of the region is its demographic advantages. Asia is by far the most populous region of the world, accounting for 60 per cent of the world's population. A vast, growing and young middle class population, with increasing affluence, will be a key defining characteristic, and an underlying growth driver of Asia. By 2030, it is projected that the current 500 million Asian middle class will grow by more than six-fold, to be more than 3 billion. This will have significant implications on global consumption and trade patterns, and on urbanisation and infrastructure development. The scale is immense. The Asian Development Bank has also projected that over this decade, Asia will require an investment of over 8 trillion US dollars in infrastructure development. It has been projected that every year, 44 million Asians are expected be added to the urban population.

The opportunities generated by these trends are being further enhanced by greater regional economic and financial integration. The intensification in regional integration will not only contribute towards accelerating Asia's growth momentum, but also further strengthen the resilience and stability of the region. The increased intra-regional trade and investment linkages within Asia over this recent decade have strengthened Asia's economic resilience to external shocks. Indeed, the changing patterns of trade have allowed Asia to better withstand and emerge with an earlier recovery from this recent global financial crisis. It has also enabled Asia to be less susceptible to the ongoing deleveraging in the advanced economies. The more recent efforts have focused on strengthening regional financial integration - not only to sustain regional financial stability, but also to promote more efficient intermediation of funds in Asia to support the region's growth prospects. It will allow for the effective rechannelling of Asia's sizeable surplus funds towards productive investments in the region. Going forward, the intensification of regional integration will mutually reinforce the strengthening of domestic demand in Asia, thereby enhancing the region's economic growth prospects.

While regional economic and financial integration will intensify going forward, driven by the opportunities it presents and the conscious policies for a more cohesive region, Asia will continue to be integrated with the global economy and the international financial system. The external environment for Asia has, however, changed significantly. The protracted weakness in global demand can be expected to persist over the medium term, given the structural nature of the problems confronting several of the major economies. Any setback in the recovery process, or any severe economic contraction in any of these economies, would affect Asia through the trade channel.

In addition, the Asian region is also affected by the significant and continuous global policy spillovers. This includes the effects of the implementation by several of the major economies, the fiscal austerity measures, the unprecedented quantitative easing, the unintended consequences of the regulatory reform, the effects from deleveraging arising from the efforts by both the public and financial sectors to reduce their levels of indebtedness, and the effects of resolution of stressed financial institutions. These global policy spillovers are affecting international trade and financial flows.

How has Asia managed these fundamentals forces affecting our region? It is the wide ranging actions that have been taken by Asia during the decades before that has well positioned Asia to absorb and manage the effects of these global developments. The strengthening of domestic demand, building resilient financial systems, and facilitating regional financial and economic integration that has been reinforced by growth supporting policies, have contributed to particularly mitigate the effects of slower trade on the regional economies.

Similarly, the development of the domestic financial system particularly the domestic financial markets, the strengthening of the surveillance system and the legal, regulatory and supervisory frameworks, have increased

the capacity and capability to manage consequences on access to cross border financing, and from quantitative easing, deleveraging activities, and financial sector resolution in the major economies. In addition, this has been reinforced by the building of buffers during the good times. Financial intermediaries remain well capitalised with strong buffers, while the international reserves remain sufficient to deal with surges and reversals in capital flows.

A more recent development in this decade is greater regional collaboration and cooperation. Asia is well ahead in the areas of surveillance arrangements, financial safety nets, and crisis management. These frameworks and arrangements have been built up during the good times. Information sharing and the establishment of regional arrangements and platforms, including the building of regional financial infrastructures and markets, are not only to facilitate the efficient intermediation of financial resources, but also to safeguard financial stability in the region. This trend paves the way for coordinated policy actions to manage and mitigate the risks and vulnerabilities to the region.

Conclusion

The global economic and financial environment remains highly dynamic and uncertain. While emerging Asia is unmistakably contributing to reshaping the configuration of the global economy and the international financial system, the fundamental underlying factors driving this global transformation needs to be continually reinforced. It will require our own continuous economic and financial transformation. Most important will be to ensure the continued economic flexibility of the region to adjust to the rapidly changing global and regional conditions, the strengthening of the connectivity among the emerging economies in general and within the Asian region, and to boost further the resilience of the region to withstand any destabilising developments.

The ASEAN economies have a distinct advantage. In terms of their economic flexibility, their size and stage of development provides the prospects of having greater agility to adjust to the rapidly changing conditions. In terms of the connectivity, the ASEAN region is a highly cohesive region. Historically, it goes a long way back to the 1950s. Cooperation and collaboration are evident in most areas of economic activity and in the financial sector, in both the public and private sectors. Policy-makers participate in several regional agreements and arrangements. The large economies have the opportunity to leverage on the potential synergies from a greater interface with the ASEAN grouping.

To realise the Asian potential, continuing the transformative momentum and enhancing the cohesiveness of the region would not be complete without ensuring that the benefits of development is widely shared. Experience has shown, even in the advanced economies, that when inequality is high and significant, instability follows. Greater inclusiveness within economies and across the region is important to ensure the sustainability of our growth and development. An important part of this transformative momentum and greater inclusion will be the transformation involving education, health care and the social security system. Addressing these challenges will ensure Asia has a high potential to remain on its growth and development trajectory.

Governor's Keynote Address at the IBBM-APABI Conference: "Global Challenges and Local Opportunities" Kuala Lumpur, 8 May 2012

Keynote Address by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

It is my honour to officiate this Asian-Pacific Association of Banking Institutes (APABI) Conference hosted here in Kuala Lumpur by the Institute of Bankers Malaysia (IBBM). This Association has an important role in bringing together financial industry training institutes that share a common goal to equip financial institutions with the capacity to deal with the transformational developments that are shaping the financial sector - by supporting the continued renewal of its most valuable asset, human capital.

The global financial industry is experiencing a period of profound change. In the advanced economies, decades of exceptional growth are giving way to contracting financial and economic conditions, greater regulation and significant government intervention, while in the emerging world however, financial and economic growth have continued. In addition, the intensification of policies and reforms to address structural issues in several of the major advanced economies will also have a significant bearing on the future growth prospects for many financial institutions and businesses. This is reinforced by the implementation of new prudential standards, both at the national and global levels, which are also set to substantially redefine the expected norms and the boundaries of modern finance.

As emerging Asia aspires towards achieving higher levels of income and living standards, a different path from that which led the way for many advanced economies will need to be considered. The global financial crisis and the Asian financial crisis have provided us with many important lessons that should form the underpinnings for the development of a sound economic and financial policy framework. Such a framework must effectively combine strong regulation and market discipline to reinforce financial stability. The recent crisis has shown that markets cannot be exclusively relied on to rein in excesses. A broader perspective of regulation that looks beyond individual institutions is also essential to identify the build-up of system-wide risks. Equally, financial institutions need to consider how to meaningfully include such system-wide perspectives in their approach to managing risks in their respective institutions.

Public policy also has a crucial role in promoting economic development that benefits society at large, and that addresses the disproportionate social welfare effects of a financial crisis on the most vulnerable groups of society, including low-income households, retail consumers and small businesses. Specifically, policies that protect the core savings of these groups, promote financial inclusion and contain excessive leverage should also form an integral component of the resolution and reform agenda. Given the high costs of financial crises there is now a better appreciation of the need for such policies to co-exist with free markets, working to efficiently allocate economic capital to achieve more sustainable outcomes.

While significant challenges continue to confront several of the advanced economies as they seek to address the structural problems that remain unresolved, Asia must chart its own path in formulating strategies to develop our economies and financial systems. Following the Asian financial crisis, most emerging economies in Asia have strengthened their economic and financial fundamentals, improved their fiscal and external debt positions, and reformed their banking sectors. This has supported our economies through the recent global financial turmoil. With a significantly stronger foundation, Asia has now every potential to meet its growth and development goals in a manner that avoids the pitfalls that will undermine our future prospects. This morning, I would like to focus my

remarks on five factors that I believe will serve to anchor sustainable growth and stability in Asia going forward.

Supporting sustainable growth and stability in Asia

First is that the growth of the financial sector in Asia remains largely anchored in productive, real economic activity. In contrast to developments in recent years, financial innovation in Asia has mostly served to support the legitimate financing, investment and risk management needs of businesses and households. The growth of the financial sector has not significantly outstripped economic growth and new innovations in financial products and services have not taken on the degree of complexity and high leverage observed in the economies that were affected by the crisis. Financial institutions in Asia also had limited exposure to highly leveraged activities, such as complex derivatives and structured credit instruments. Consistent with the more traditional banking models in Asia, there are now calls for a return to basic banking and its clear separation from higher risk-taking activities. The growth of Islamic finance, with its emphasis on the close link between financial transactions and real economic activity and which embraces universal values such as transparency and fairness, further supports this trend.

The emphasis on productive financial innovation has also been reinforced by a long standing focus in Asia on promoting effective consumer protection arrangements. In the recent period, this has received renewed attention by authorities given the experience of the recent crisis which has underscored how market conduct failures that led to widespread mis-selling and predatory lending, was not only detrimental to consumers, but also a source of systemic risk. An emphasis on product transparency and disclosure, responsible sales and marketing practices as well as investment in financial education have served to better align the interests of financial institutions and consumers, thus reducing the potential for harmful practices. Asian economies have also taken steps to strengthen the financial safety net including deposit insurance, while putting in place institutional arrangements for debt counselling and restructuring. These measures can contribute towards pre-empting widespread defaults particularly during periods of stress.

Second is the continued commitment and sustained progress in the development of strong regulatory and supervisory systems for the financial sector. Significant progress has been achieved in Asia in this recent decade to strengthen the institutional arrangements and the capacity to safeguard financial stability. This includes putting in place more comprehensive regulatory frameworks, improving supervisory approaches and having clear mandates for central banks and supervisory authorities to deal with system-wide risks. While these measures have yielded tremendous pay offs, efforts have continued to be made to strengthen further the resilience of the financial system. New initiatives are being pursued to enhance surveillance and crisis management tools to enable swift responses to emerging risks and vulnerabilities in the financial system, including those within the traditionally unregulated segments of the financial system. Authorities in Asia are also continuing to refine and sharpen the efficacy of “macroprudential” instruments to manage excesses and imbalances in the financial system. Asia already has considerable experience with these instruments during periods of escalating asset prices and excessive financial market volatility. They therefore already represent an important part of the broader toolkit for managing risks to financial stability.

The effort to implement global regulatory reforms is also now underway in Asia, with many jurisdictions making significant progress in detailing out rules to implement the Basel III standards. The international reform package aims to significantly raise the resilience of the global banking system and to promote sound risk-taking. The standards will see banks holding larger amounts of capital, including buffers which can be drawn down as losses occur, thus ensuring their continued ability to support lending to the economy even during times of crisis. At the same time, the standards will also require banks to significantly strengthen their liquidity and funding positions in order to support orderly credit intermediation processes. Concerns have however been raised about the unintended consequences that may arise from the implementation of these standards

- including potential ramifications on the real economy - and therefore the need for the reforms to be implemented cautiously. This underscores the importance of conducting impact and behavioural studies during the transition period, and the need to consider how the national implementation of the global standards should reflect domestic experiences and circumstances.

Third is the high priority placed on the pursuit of a balanced and equitable growth through the financial inclusion agenda as a key component of Asia's overall strategy for sustaining medium and long-term economic progress. At its core, the financial inclusion agenda seeks to empower all individuals, irrespective of income level, economic activity or geography, to have the means and opportunity to undertake financial transactions, generate income, accumulate assets and to financially protect themselves against unexpected adverse events.

Countries in this region have been active in pioneering sustainable financial inclusion tools and models. Due in large part to a strong public policy focus on promoting an inclusive financial sector, the financial industry in Asia is also more attuned to financial inclusion objectives in their business outlook. This can be seen from recent evidence of financial institutions in the region that have successfully adopted "double bottom line" strategies that combine enhanced financial access goals with profitability, thus enabling the financial inclusion agenda to be achieved in a responsible and sustainable manner. Institutions in several parts of Asia have been effective in utilising innovative means of outreach to overcome geographical and cost barriers in delivering essential financial services such as microcredit, affordable insurance, avenues for savings, and accessible payments and remittance services. Governments in the region continue with measures to bridge the gap with the necessary financial infrastructure, developing rules for orderly and responsible business conduct, and catalysing the volume of financial transactions by channelling social transfers, wages or pensions through the formal financial system.

Such advancements by the region in financial inclusion contribute towards eradicating poverty and uplifting living standards. As growth in the region continues, it will become even more important to ensure that such growth does not further widen the social divide and disenfranchise those who remain excluded from its benefits. An inclusive growth process in the region, which draws marginalised segments into the formal financial system and that empowers small businesses and consumers already within the financial system to better utilise financial services, will enhance the contribution of this segment of the population to the economic growth process.

Fourth, is the greater regional economic and financial integration in Asia which has been supported by strengthened institutional frameworks for safeguarding regional financial stability and a deepening of regional cooperation. With greater cross-regional participation in the respective domestic financial systems, efforts have intensified to build a strong foundation that will promote regional stability alongside the measures implemented to strengthen domestic frameworks. These include wide ranging measures to develop regional financial markets, to improve liquidity management across borders, to strengthen cooperation networks for the supervision of regionally-active financial institutions and to establish regional infrastructure to enhance the efficiency and lower the risks associated with cross-border payments and settlements.

Regional arrangements between central banks and supervisory authorities have also been significantly strengthened to actively share information on emerging risks to regional stability and where necessary to coordinate regional responses. An important part of this includes the ongoing work to enhance the frameworks for crisis management including the orderly resolution of financial institutions with significant cross-border operations. Within the ASEAN region, measures are currently being pursued to promote greater consistency in the adoption of regulatory and supervisory standards in anticipation of a larger role for ASEAN banks in driving regional integration as part of the broader agenda to realise an ASEAN Economic Community by 2015. Collectively, these arrangements aim to ensure that the expansion of cross-border financial linkages takes place

within a framework and process that adequately mitigates systemic risk across borders.
Fifth, central banks and regulatory authorities in most emerging economies in Asia have the broader mandate that includes a focus on the development of the financial sector as a means not only to enhance the growth and development potential, but also to reinforce a strong foundation for financial stability.
In Malaysia, the development and reform of the financial sector in the decade that followed the Asian financial crisis has not only developed the financial sector to better serve the Malaysian economy, but it has also better positioned financial institutions to withstand the destabilising episodes emanating from external shocks. This has included strengthening financial intermediaries, not only in terms of scale but also in their financial positions, risk management and governance practices. This has contributed to more efficient financial intermediation while improving access to financing, particularly for small and medium scale businesses. Efforts to develop a vibrant capital market have meanwhile opened up alternative channels for financing, while mitigating concentration risk in the financial system and enhancing its ability to absorb large and volatile cross-border capital flows.

These factors will place Asia on a firm foundation to achieve its growth and development goals. While public policy clearly has an important role, it is as important for the financial industry to align itself with the desired outcomes of sustainable growth within a longer term horizon. This will involve a number of important considerations for financial institutions, including the rethinking of business models in the light of a re-assessment of risk and return expectations, a reflection on fundamental value systems that ultimately shape individual actions, with greater premium placed on responsible and ethical behaviour, and the regulatory changes taking place.

New imperatives for talent development in the financial sector

Having the required talent will be a key pillar in managing the challenges confronting the Asian financial sector moving forward. The increased demand and competition for highly-skilled financial professionals in the financial sector continues to be fierce. In Malaysia, demand is expected to be particularly pronounced for specialised skills in risk management and high growth and niche areas.

At the same time, the new financial landscape also raises critical leadership and organisational challenges, particularly as banks in Asia become larger and more complex with increasingly diverse geographical and product markets. This underscores the need for financial institutions to be helmed by world-class leaders, with critical strategic and leadership capabilities to build institutions that are dynamic, resilient and agile in the face of a more challenging operating environment. In line with the increasing regional character of the financial sector, there will also be a greater emphasis on talent that better appreciates national and cultural differences. Meanwhile, boards of directors are also be expected to have a more effective role in providing independent oversight and strategic guidance that promotes the long-term resilience and continued viability of financial institutions.
These imperatives translate into significant demands on human capital development. New talent development strategies are needed, as well as a critical re-assessment of the existing content and approach to training for the financial industry workforce to ensure their continued relevance, within a broader regional context. This represents a significant challenge and an important priority for Asia. In order to bring talent development to the next level, there is scope to pursue meaningful strategic partnerships in financial sector education and training. With growing cross-border linkages of the region's financial systems, there are significant benefits to be gained from improving the quality and consistency of standards in financial sector training in the region.

On collaboration in financial industry training

This conference represents a unique collaborative opportunity to discuss current issues and trends in human capital development in the banking sector across different financial systems within the Asia Pacific region. The efforts of APABI in providing

this platform should therefore be well leveraged by its member institutes. Given the varying levels of financial sector development across the region, there will be tremendous benefit in the sharing of ideas and methodology on human capital development especially in newly introduced areas in banking and finance.

In Malaysia, our approach to human capital talent development is also founded on the collaborative approach. With the establishment of the Asian Institute of Finance (AIF) in 2009, talent development in the financial sector is given a strategic priority and is coordinated in a holistic manner, across the spectrum of the financial services industry. This is important as many of the initiatives supporting these human capital development strategies are multi-disciplinary and multi-layered. Under this arrangement individual training institutes comprising banking, insurance, Islamic finance and the capital markets sector have now converged onto a single platform to formulate a unified approach in strategic direction. The ultimate goal for this is to develop financial sector talent with world class capabilities to drive a sustainable growth and development of the financial sector.

Conclusion

Notwithstanding a more challenging period ahead, the financial industry in Asia is well-positioned to benefit from continued favourable growth prospects, supported by strengthened fundamentals that underpin the financial sector. The financial industry has an important role in reinforcing these fundamentals through the business strategies that are pursued, alignment of incentives and developmental priorities, including the development of human capital. Conferences such as this can contribute towards developing a broader understanding of the important issues to the industry, and to direct the focus of cooperative opportunities to build a stronger foundation for sustainable growth. On that note, I wish you a productive and engaging Conference.

Governor's Keynote Address at the Wharton Global Alumni Forum: "Asia in the World: Sustaining the Region's Transformative Momentum" Jakarta, 22 June 2012

Keynote Adress by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

The global economy is experiencing a period of profound change. Asia is very much at the centre of this global change. Asia's changing role in the global economy has not only been in terms of its growing size, but also in terms of its influence in global economic and financial developments. The issue before us is whether Asia will continue its transformative momentum over the medium to longer term, to become an increasingly important source of global growth and stability.

It is my very great honour and pleasure to be here in Jakarta to speak at this Wharton Global Alumni Forum. Exactly a decade ago, I was actually invited to speak on the same subject on the state and future of Asia at the Wharton School in Philadelphia. Then, having just emerged from the Asian financial crisis, the region was again being challenged by a series of economic and financial shocks, in particular, the bursting of the dot com bubble in the United States in the year 2000. Observers had questioned the sustainability of the region's medium and longer term growth prospects. Now, five years into the global financial crisis, Asia is faced with an even more challenging and uncertain global environment, as significant spillovers originating from Europe and the United States are being felt by the region. Again, questions on the sustainability of the region's economic growth prospects are being raised. My remarks today will focus on the new challenges that are confronting Asia, and whether its resilience built in this decade will now enable Asia to rise to these greater and more complex challenges.

Challenges Arising from Global Spillovers

Given the degree of openness of most of the Asian economies, Asia is highly integrated with the global economy. While Asia benefited from this openness, it also resulted in the region being more vulnerable to global financial and economic developments. Many previous episodes of economic recession and crisis were triggered by external shocks, which at times exacerbated and amplified domestic vulnerabilities. These include the commodity price shocks in the 1970s and '80s, the large swings of destabilising capital flows in the 1990s, the bursting of the tech bubbles and the SARs epidemic in the early 2000s, and finally the global recession which saw an unprecedented decline in global trade.

The ongoing global financial and economic crisis is resulting in turbulence in the international financial markets. In part, this is emanating from the global policy spillovers arising from the unprecedented monetary easing, which has resulted in surges of capital inflows in search of higher returns in a low interest rate environment. This is followed by reversals arising from the deleveraging efforts to reduce public and private indebtedness. These volatile capital flows in the international financial markets have increased the volatility in exchange rates and asset markets. The low international interest rate environment has also been a factor that has increased the prospect for the financialisation of commodity markets.

Finally, there is the impact of the potential unintended consequences of the global financial regulatory reforms. The effort to implement the new global regulatory reforms is already underway in Asia, with many jurisdictions making significant progress. These reforms are aimed to significantly enhance financial institutional soundness and safeguard financial stability. Concerns have, however, been raised on the unintended consequences that may arise in the emerging economies, including its potential ramifications on the real economy. This underscores the importance to implement

these reforms cautiously, including the need to conduct impact and behavioural studies, and to consider how the national implementation of these global standards should reflect the respective domestic experiences and circumstances.

Factors Underlying the Transformation of Asia

Asia's rapid growth trajectory over several decades has been underpinned by a number of fundamental characteristics. These same characteristics are still present and will continue to support the ongoing transformation that is currently taking place. More recently, distinct strategies have been implemented to strengthen further the macroeconomic fundamentals and financial system soundness in the region. These stronger foundations, of steady growth, low unemployment, relatively low inflation, and strong and more developed financial systems, have strengthened Asia's resilience and its ability to manage external vulnerabilities. They have placed Asia today in a stronger position to secure and sustain its future growth and stability, compared to a decade ago

Three prominent characteristics that are common to most countries in the region have contributed to Asia's economic success. First and most important is the economic flexibility of Asia – the ability to adjust to changing conditions without being weighed down by structural impediments and policy rigidities. The significant investment in productivity enhancements and technology is complemented by the high degree of capital and labour mobility. Financial reforms for deregulation and greater market orientation and liberalisation have also facilitated the region to continually shift resources to new areas of comparative advantage. These have not only enhanced Asia's competitiveness, but also yielded a more diversified economic structure. More recently, the policy strategy has been to strengthen domestic demand as an important driver of growth. This will serve to anchor Asia's growth prospects. As domestic demand strengthens, Asia is transitioning from being global producers to becoming global consumers. This trend will also contribute towards more balanced global growth.

Asia is one of the most diverse regions in the world – in terms of market size, stage of development, resource endowment, economic structure, financial sector development, and market systems. Asia has leveraged on the complementarities arising from this diversity. This is reflected in the increased cross-border production networks in Asia, where substantial gains have been experienced from the region being involved in the entire supply chain for a wide range of products and services. Increased intra-regional trade and investment over the recent decade has also resulted in a more diversified export structure – in terms of markets and products. Going forward, this diversity will continue to present significant opportunities in the form of large and growing markets across a wide spectrum of goods and services

Accounting for 60 percent of the world's population, Asia is by far the most populous region of the world. This demographic advantage is a key economic asset for the region. In this current decade, a young middle class population has emerged, and it is growing both in number and in affluence. Asia's current middle class of 500 million people is projected to increase by more than six-fold, to exceed 3 billion people, by 2030. This tremendous increase in scale will significantly raise Asia's potential to be important consumers in the global economy. In parallel, urbanisation and infrastructure development will reinforce this trend. This increase in consumption and the greater need for investment will anchor the growing importance of domestic demand in Asia.

These fundamentals have been reinforced by the implementation of distinct strategies that have been undertaken in this recent decade following the Asian financial crisis, to strengthen the region's ability to manage external shocks. The effectiveness of these reforms was put to test during the recent global crisis. While affected by the crisis, the effects on the domestic economies and financial systems have been relatively contained. Importantly, financial intermediation has not been disrupted, and the financial systems have continued the supply of credit to support the real economy.

Following the Asian financial crisis, wide-ranging financial reforms were undertaken to strengthen the financial systems of the region. The building of sufficient capital and liquidity buffers during good times provided the ability to support the continued credit intermediation process. Improved regulatory and supervisory approaches, underpinned by enhanced governance and risk management practices, have enhanced financial stability in the region. Enhanced surveillance arrangements and a wider range of policy tools have placed policymakers in better state of readiness to deal with problems in the financial system pre-emptively. Macroprudential policies have also been extensively relied upon to mitigate the risks from excesses and imbalances in the financial system. Continued efforts were also made to further advance financial sector development in the region. In particular, the development of the domestic bond market has served to reinforce the foundations for financial stability in Asia. Financial activities have also remained generally anchored by productive real economic activities. In addition to the region's strong external position, high international reserves and more flexible exchange rates have also enabled Asia to absorb and adjust to changing external conditions.

The increasing cohesiveness of Asia is also a core strength and source of stability for the region. Steps have been intensified during this recent decade for greater financial integration. The motivation for greater financial integration is not only to unlock the growth potential of the region, but to achieve more effective and efficient intermediation of funds in the region, particularly by channelling the large surplus funds in the region to productive investments in the region. This would also support regional economic integration. While Asia's trade with economies outside the region has doubled since 2000, intra-Asia trade has tripled. Now, more than fifty five percent of Asia's total export is within the region. Intra-regional investment activity has also increased significantly during this decade.

It is important to recognise that the approach to a more integrated Asia is different from that adopted by Europe. In the early 2000s, a study undertaken by the ASEAN ten economies concluded that the region did not have the preconditions for a single currency. A different route would therefore be taken to achieve greater integration. For the ASEAN region, it would involve a sequenced liberalisation of the financial sector and capital account, and the development of regional financial markets and financial infrastructure including the regional payments and settlement system. This arrangement also allows for a gradual pace of integration to ensure domestic readiness and the flexibility to take into account the prevailing conditions and stage of development of the participating financial system. Regional collaborative efforts also have been significantly enhanced in the area of crisis management. The region is now well ahead in the areas of regional surveillance and supervisory arrangement, and in crisis prevention, management and resolution. Regional support mechanisms have also been established. There are also regional institutional arrangements in place for the active sharing of information on the emerging risks to regional stability and on building domestic capacities and to coordinate regional responses in the event of eminent risks to the region. These efforts will be further strengthened into the future.

Islamic Finance as a Growth Area in Asia

The rapid integration of Islamic finance into the international financial system is a growing feature in the financial landscape of Asia. Developments in several emerging economies in Asia have seen the rapid expansion of Islamic finance. Global Islamic financial assets are now estimated to be more than 1 trillion US dollars. While more than 60 percent of the world's Muslim population is in Asia, the interest in Islamic finance transcends to beyond this community. The inherent principle of Islamic finance, which requires financial transactions to be accompanied by underlying economic activity, ensures the close link between the expansion in financial assets with the real economy. It also increases its potential in fostering sustainable growth. This has positioned Islamic finance to be well-anchored to serve the real economy, and enhances its potential as a sustainable and stable form of financial intermediation.

With the intensification of the internationalisation of Islamic finance, it has an increasing role in bridging economies through the mobilisation and channelling of funds to productive investment activities across borders. More than 600 Islamic financial institutions operate in more than 75 countries. The sukuk market is fast becoming an important platform for international fund raising and investment activities that are generating increased cross-border flows. From an outstanding amount of 33 billion US dollars in 2006, the sukuk market has expanded to 180 billion US dollars by the end of 2011, of which 66 percent originated from Asia. There has also been a growing trend for multi-currency sukuk issuances in Asia, attracting global investors to participate in this market.

In reinforcing the internationalisation of Islamic finance, global initiatives have been taken to strengthen its institutional and international infrastructure, with emphasis in ensuring financial stability. International prudential standards and best practices have been issued by the Islamic Financial Services Board, which was established in 2002. The industry is also guided by international accounting standards that have been issued by the Accounting and Auditing Organisation for Islamic Financial Institutions, which was established in 1990. The International Islamic Liquidity Management Corporation (IILM), established in 2010, is a further global collaborative effort to enhance liquidity management in the Islamic financial system.

Conclusion

To fully realise the Asian potential, continuing the transformative momentum of the region will not be complete without ensuring that the benefits of development are widely shared. Experience has shown, even in the advanced economies, that when inequality is high and a significant proportion of the population is excluded from the opportunity to participate meaningfully in income and wealth generation, instability follows. To ensure that rapid economic growth and transformation does not further widen the social divide and disenfranchise those who remain excluded from its benefits, access to high-quality, healthcare, social security and financial inclusion is now an important focus of the region.

The contour of the global economy is fundamentally changing amidst mounting challenges and continued uncertainties. In this environment, Asia has become an important source of stability. While the region is affected by the ongoing economic and financial crisis originating from Europe and the United States, the Asian region continues to remain on a growth trajectory, although at a more modest level. Greater regional cohesiveness and cooperation, however, has enhanced Asia's potential to address these new challenges that are confronting the region. The success of the region is not only in the interest of the Asian economies, but the world.

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2 May 2012

In her keynote address at the Management Association of the Philippines Luncheon Seminar in Manila entitled "Why Asia? Asia's Prospects and How Emerging Markets Shall Shape the Region's Future", Governor Dr. Zeti highlighted that opportunities in Asia are now boundless and key in generating these opportunities are the region's economic flexibility, high diversity and demographic advantages. She noted that while the global economic and financial environment remains highly dynamic and uncertain, emerging Asia would continue to contribute in reshaping the configuration of the global economy and international financial system. She further noted that the fundamental underlying factors driving this change would require Asian countries' continuous economic and financial transformation to ensure economic flexibility to adjust to the rapidly changing global and regional conditions.

3 May 2012

The Bank was named the winner of the Bank Regulator of the Year Award in the Asia Pacific Region and Best Conduct of Business Regulator Award for 2012 by the Asian Banker. In announcing the results, the Asian Banker mentioned that the Bank has demonstrated exemplary supervision and rigorous conduct, successfully steering Malaysia's financial system to emerge mostly unscathed through the global financial crisis. The Bank has also strategically positioned Malaysia as the leading Islamic financial hub in Asia, at the forefront of the international market in Islamic finance. The awards programme was held in conjunction with the Asian Banker Summit 2012, Asia's most important annual risk event, featuring leading practitioners from a cross-section of banks and global regulators.

8 May 2012

In her keynote address at the Asian-Pacific Association of Banking Institutes Conference, hosted by Institute of Bankers Malaysia in Kuala Lumpur, entitled "Global Challenges and Local Opportunities", Governor highlighted that the financial industry in Asia is well-positioned to benefit from continued favourable growth prospects, supported by strengthened fundamentals that underpin the region's financial sector. She added that Asian economies have also taken steps to strengthen the financial safety net including deposit insurance, while putting in place institutional arrangements for debt counselling and restructuring which can contribute towards pre-empting widespread defaults, particularly, during periods of stress. She further noted that the regional arrangements between central banks and supervisory authorities have also been significantly strengthened to actively share information on emerging risks to regional stability and where necessary to coordinate regional responses.

11 May 2012

At its third meeting for 2012, the Bank's Monetary Policy Committee (MPC) decided to maintain the Overnight Policy Rate (OPR) at 3.00%. The MPC stated that while the global economy continues to recover, recent developments namely rising concerns over the sovereign debt crisis and policy uncertainties in Europe and uncertainty in the pace of economic recovery in North America have increased the risks to global growth. Growth momentum in Asia was also affected by the slowdown in international trade activity. While the Malaysian economy is affected by the global developments, domestic demand has continued to support growth, driven by firm consumption and investment activity. In the MPC's assessment, there remain continued uncertainties emanating from the global economic and financial environment. The MPC will continue to carefully assess these evolving conditions and their implications on the overall outlook for inflation and growth of the Malaysian economy.

14 May 2012

The Bank hosted the second meeting of the Financial Stability Board (FSB) Regional Consultative Group for Asia in Kuala Lumpur. The meeting discussed issues relating to vulnerabilities and regional financial stability, particularly the implications on the macroeconomy, markets and funding liquidity arising from the deleveraging of European financial institutions. In this context, members of the group discussed about policy options to address the impact and negative consequences of external and domestic developments. In addition, they also discussed the consequences of the global financial reforms on emerging markets and developing economies. The group also reviewed the FSB's activities and initiatives since it last met and discussed implementation challenges facing the region.

17 May 2012

The Bank and the Central Bank of the Republic of Turkey signed a Memorandum of Understanding (MoU) in Istanbul, Turkey. The MoU aims to foster strategic cooperation towards promoting bilateral investment and liquidity arrangements, to support the development of the financial services sector and to enhance economic and financial linkages between the two countries through bilateral trade and investment. This will also include building the required financial infrastructure, payments and settlements arrangements to facilitate bilateral trade in the respective local currencies of the two countries. The implementation of this MoU would pave the way for greater collaboration in enhancing inter-linkages between both nations.

23 May 2012

The Bank announced that Malaysia has sustained its economic growth momentum in the first quarter of 2012 by registering a growth of 4.7%, despite the challenging external environment. Domestic demand remained firm, supported by both private and public sector economic activity. On the supply side, growth of the construction sector strengthened further and the mining sector turned around to record a marginal growth while other sectors, namely, services, manufacturing and agriculture moderated. The headline inflation rate moderated to 2.3% in the first quarter, attributed mainly to moderation in food prices and transportation costs.

29 May 2012

The Bank issued two types of commemorative coin in conjunction with The 100th Anniversary of World Association of Girl Guides and Girl Scouts. The commemorative coins were launched by Her Majesty The Raja Permaisuri Agong Tuanku Hajah Haminah in Ipoh, Perak. The coins were issued as Silver Proof and Nordic Gold Brilliant Uncirculated with a face value of RM10 and RM1 respectively.

30 May 2012

The Bank announced the introduction of a new Islamic monetary instrument, the Collateralised Murabahah. The Collateralised Murabahah is a new low credit-risk financial instrument that enables collateralised interbank transactions in the Islamic Money Market in Malaysia. It adds diversity to the existing liquidity management tools and further promotes greater liquidity in the Islamic financial market. This monetary instrument can be used by Islamic financial institutions to obtain liquidity from the Bank under the standing facility and it will also be expanded to facilitate daily Islamic money market operations in the interbank market.

21 June 2012

The Bank announced that it will host the third Global Islamic Finance Forum (GIFF) 2012 in Sasana Kijang, Kuala Lumpur from 18 - 20 September 2012, themed "Internationalisation of Islamic Finance: Bridging Economies" in recognition of the tremendous international prospects of the thriving Islamic Finance industry. Considered as one of the key international events in the calendar of Islamic finance, the GIFF 2012 is a high-level multi-track forum that brings together regulators, scholars and financial industry players who are key drivers in shaping Islamic finance globally.

22 June 2012

In her keynote address at the Wharton Global Alumni Forum in Jakarta, Indonesia entitled "Asia in the World: Sustaining the Region's Transformative Momentum", Governor highlighted that Asia is in a better state of readiness to deal with global financial shocks as a result of the wide-ranging financial reforms undertaken in the aftermath of the Asian financial crisis. She noted that the effectiveness of these reforms was put to test during the recent global crisis. While affected by the crisis, the effects on the Asian domestic economies and financial systems have been relatively contained whereby financial intermediation has not been disrupted, and the financial systems have continued the supply of credit to support the real economy. She further noted that improved regulatory and supervisory approaches, underpinned by enhanced governance and risk management practices, have also enhanced financial stability in the region.

On the same day, the Bank issued three types of commemorative coin in conjunction with the Installation of His Majesty Seri Paduka Baginda Yang di-Pertuan Agong XIV Almu'tasimu Billahi Muhibbuddin Tuanku Alhaj Abdul Halim Mu'adzam Shah ibni AlMarhum Sultan Badlishah. The commemorative coins were presented to His Majesty at Istana Negara, Kuala Lumpur. The coins were issued as Gold Proof, Silver Proof and Nordic Gold Brilliant Uncirculated with a face value of RM100, RM10 and RM1 respectively.

26 June 2012

The Bank updated on the status of Islamic Mega Bank licence applications, informing that entities applying for such licences are required to meet all the existing rules and regulations set forth by the Bank with the applications being market driven and private sector led. A full licence will only be awarded once all legal and regulatory requirements are met. The issuance of such licences in Malaysia will increase the internationalisation of Islamic Finance in the Malaysian financial system thus enhancing the country's global financial and economic inter-linkages.