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The Malaysian economy recorded a growth of 5.3% in the third quarter of 2010

The Malaysian economy registered a growth of 5.3% in the third quarter of 2010, driven by domestic demand amid slowing external demand. The expansion in domestic demand was supported by private sector spending. The slowdown in the global economy has led to the moderation in external demand. On the supply side, all major economic sectors, except mining, continued to expand during the quarter, but at a more moderate pace.

Domestic demand expanded by 5.0% in the third quarter (2Q 10: 9%) led by a sustained expansion in both private consumption and capital spending. Private consumption recorded a growth of 7.1% (2Q 10: 7.9%) supported by favourable labour market conditions and positive consumer confidence. Public consumption declined by 10.2% (2Q 10: 6.9%) as a result of lower government spending on supplies and services. Gross fixed capital formation expanded by 9.8% (2Q 10: 12.9%) driven by capital expenditure from the private sector. Private sector capital spending was supported by the expansion in domestic production amidst high levels of capacity utilisation and positive business sentiments.

On the supply side, major economic sectors, except mining, expanded further but at a more moderate pace. Growth in the manufacturing sector moderated to 7.5% (2Q 10: 16.0%), reflecting mainly the slower growth in external demand. The services sector remained resilient, growing at 5.4% (2Q 10: 7.3%), benefiting from favourable domestic demand conditions. The construction sector expanded by 2.8% (2Q 10: 4.1%), supported by growth in the non-residential and civil engineering sub-sectors. Growth in the agriculture sector increased to 2.7% (2Q 10: 2.4%), following higher production of crude palm oil and rubber. However, the mining sector recorded a contraction of 1.0% (2Q 10: 1.1 %), as the lower production of crude oil offset the higher production of natural gas.

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI), increased to 1.9% on an annual basis in the third quarter (2Q 10: 1.6%). The increase in consumer prices was attributable mainly to the rise of prices of *food and non-alcoholic beverages* (3Q 10: 2.9%, 2Q 10: 2.4%).

In the external sector, the trade surplus narrowed further to RM22.3 billion (2Q 10: RM23.4 billion) in the third quarter. Both gross exports and imports increased at a more moderate pace of 10.4% and 16.5% respectively (2Q 10: 21.7% and 30.3% respectively), in line with the weaker external environment. The slower growth in gross exports was due mainly to the lower exports of manufactured products, reflecting the softening global demand for E&E products, particularly semiconductors. The moderation in gross imports was reflected in the intermediate imports, which increased at a slower pace, in tandem with the moderation in manufactured exports. Capital imports expanded strongly, supported by continued public and business investment spending, while consumption imports expanded at a modest pace. The imports of primary food and beverages as well as motor vehicles, however, remained strong, reflecting positive consumer sentiments.

On a cash basis, gross inflows of foreign direct investment (FDI)* were higher at RM8.9 billion in the third quarter (2Q 10: +RM5.3 billion), reflecting mainly larger inflows of equity capital and the drawdown of inter-company loans. After adjusting for gross outflows due to repayment of inter-company loans, net FDI more than doubled to RM5.0 billion (2Q 10: +RM2.4 billion). Direct investment abroad (DIA)* by Malaysian companies recorded a larger net outflow of RM4.9 billion (2Q 10: -RM3.1 billion) arising from both higher equity capital and net extensions of inter-company loans to subsidiaries abroad. Portfolio investment registered a larger net inflow of RM9.3 billion (2Q 10: +RM6.3 billion), reflecting strong foreign interests in domestic capital markets during the quarter, particularly the equity market. The inflows of portfolio funds continued to be driven by the favourable growth prospects for the Malaysian economy amidst a strengthening of the ringgit.

The international reserves of Bank Negara Malaysia amounted to RM310.8 billion (equivalent to USD100.7 billion) as at 30 September 2010. This level of reserves has taken into account the quarterly adjustment for foreign exchange revaluation loss, following the strengthening of the ringgit against most major currencies during the quarter. As at 15 November 2010, the reserves position amounted to RM326.5 billion (equivalent to USD105.8 billion), sufficient to finance 8.8 months of retained imports and is 4 times the short-term external debt.

Monetary policy supported economic activity

The Overnight Policy Rate (OPR) was raised by 25 basis points in July 2010, bringing the cumulative OPR adjustments for the year-to-date to 75 basis points. The OPR was raised to normalise monetary conditions, in line with the improved economic outlook. In September and November, the OPR was left

*The statistics for FDI and DIA on a cash basis do not include retained earnings

Diterbitkan oleh:
Jabatan Komunikasi Korporat, Tingkat 14, Blok B, Bangunan Bank Negara Malaysia,
Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia.
Telefon: +60(3) 2698 8044 Faksimili: +60(3) 2693 6919
Web: www.bnm.gov.my

unchanged at 2.75%. At the prevailing level of the OPR, monetary policy remains accommodative and the overall level of interest rates is appropriate and consistent with assessments of the growth and inflation prospects.

Following the increase in the OPR on 8 July 2010, the average overnight interbank rate traded higher and interbank rates of other maturities also increased accordingly. In terms of the commercial banks' lending rates, both the average base lending rate and the average lending rate adjusted upwards. The average fixed deposit (FD) rates rose in tandem.

Financing for the economy remained adequate and was accessible across all segments of the economy. The reasonable cost of borrowing and ample liquidity in the financial system supported the demand for financing from both the public and private sectors. Total gross financing raised by the private sector through the banking system and the capital market amounted to RM189.5 billion in the third quarter (2Q 10: RM203.4 billion). On a net basis, banking system loans and PDS outstanding increased by 11% as at end-September (2Q 10: 11.2%). All major loan indicators remained firm in the third quarter.

Net funds raised in the capital market by both the public and private sectors amounted to RM16.9 billion (2Q 10: RM17.6 billion). In the private sector, fund raising activity was mainly in the bond market. In the public sector, funds were raised through issuances of Malaysian Government Securities (MGS) and Government Investment Issues (GII).

Monetary aggregates continued to grow at a sustained pace in the third quarter. M3, or broad money, expanded at an annual growth rate of 8.5% as at end-September 2010 (end-June 2010: 8.8%).

During the quarter, the ringgit appreciated by 5.5% against the US dollar as the diverging economic outlook between Asia and the advanced economies boosted investor sentiments towards the regional economies and financial markets. Domestically, the strong recovery and the further liberalisation of foreign exchange administrative rules also lifted investor sentiments. The ringgit appreciated against the pound sterling (0.4%) but depreciated marginally against Japanese yen (-0.4%). The euro strengthened against most currencies during the third quarter following signs that the sovereign debt concerns may have abated. The ringgit depreciated against the euro (-5.2%). Since the end of the third quarter, however, the euro has pared some of its gains following renewed concerns over the sovereign debt problems. Against regional currencies, the ringgit appreciated during the third quarter against the Chinese renminbi (4%) and Indonesian rupiah (3.7%) but depreciated against the Korean won (-1.9%), Thai baht (-1.1%), Singapore dollar (-0.9%) and Philippine peso (-0.2%).

Financial stability remained intact

Financial system stability was preserved throughout the third quarter. Institutional soundness and orderly functioning of the financial markets continued to support financing activities in the domestic economy.

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The risk-weighted capital ratio and core capital ratio of the banking system remained strong at 14.8% and 13.1% respectively. Excess capital over the minimum 8% RWCR requirement was RM64 billion. Meanwhile, the quality of the loan portfolio remained intact, supported by a high loan loss coverage of 95.4%. Pre-tax profit for the quarter improved on account of higher net interest and financing income and revenue related to financing activities, resulting in returns on assets and equity of 1.6% and 16.6% respectively.

The Capital Adequacy Ratio for the insurance industry stood at 222.7%. Overall profits of insurance and takaful operators strengthened to RM5.6 billion for the quarter, on account of better investment performance and more favourable claims experience in the general business segment as well as continued business expansion.

Domestic economic recovery to proceed amid heightened uncertainty in the global economy

Going forward, there is increased uncertainty over the sustainability of global economic recovery. As the advanced economies continue to be confronted with weak labour markets and fragile financial sectors, there are concerns over the limited policy flexibility given the immediate term need to address the fiscal position. In contrast, most Asian economies remain on a firm recovery path, supported by the strength of domestic activity. New challenges are emerging in the form of large and volatile capital inflows into the regional economies. Going forward, the quantitative easing measures by major central banks will continue to have an influence on the magnitude of capital flows to emerging economies, presenting challenges in the conduct of macroeconomic policy. Several regional and Latin American countries have already adopted macroprudential and administrative measures to maintain financial stability.

Amid the moderation in global recovery, the pace of growth of the Malaysian economy will be influenced by the expected continued slowdown in external demand. Overall growth will continue to be supported by robust domestic economic activity. Private consumption will benefit from the favourable employment situation, firm commodity prices and the accommodative financing environment. Capital spending in domestic-oriented sectors and the economic transformation programmes by the Government will underpin the continued growth of private investment.

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