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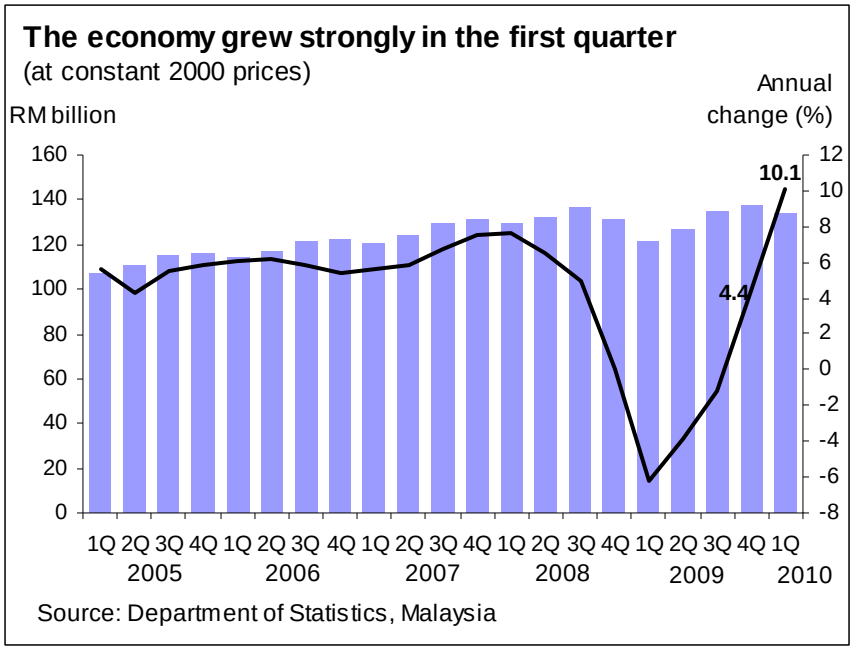
ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE FIRST QUARTER OF 2010

OVERVIEW

The Malaysian economy grew strongly in the first quarter

The Malaysian economy registered a strong growth of 10.1% in the first quarter of 2010, led by continued expansion in domestic demand and stronger external demand. The expansion in domestic demand was supported by higher private consumption and sustained public sector spending. The robust external demand provided further impetus to domestic growth through its spill-over effects on production, employment and overall sentiments. On the supply side, all economic sectors recorded positive growth during the quarter, led by strong growth in the manufacturing and services sectors.



During the quarter, domestic demand expanded by 5.4% (4Q 09: 2.8%), due mainly to higher private consumption and sustained public sector spending. Private consumption spending grew by 5.1% (4Q 09: 1.6%), supported by continued improvement in labour market conditions amidst an environment of low inflation and improved consumer sentiment. The public sector continued to provide additional impetus to growth, with public consumption registering an expansion of 6.3% during the quarter, due mainly to higher expenditure on emoluments as well as supplies and services. Gross fixed capital formation continued its positive growth momentum, growing by 5.4% (4Q 09: 8.2%), supported by sustained public sector capital spending and a modest recovery in private sector business spending activity. Private investment activity benefited from the significant increase in production and external demand, which led to improvements in both capacity utilisation and business sentiments. Public sector capital spending continued to provide support to the domestic economy with the bulk of the development expenditure channelled into education, transportation, and agriculture and rural development.

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On the supply side, all economic sectors registered positive growth during the first quarter, with strong performance in the manufacturing and services sectors. The recovery momentum in the manufacturing sector strengthened further, with the sector registering a strong growth of 16.9% (4Q 09: 5.0%). Similarly, the services sector recorded a higher growth of 8.5% (4Q 09: 5.2%), with strong performance across all sub-sectors. The agriculture sector expanded further, supported mainly by strong rubber production amid higher prices. The construction sector continued to expand at a strong pace of 8.7% during the quarter (4Q 09: 9.3%), supported by the implementation of construction-related projects under the second fiscal stimulus package and the Ninth Malaysia Plan. The mining sector turned around to register a positive growth of 2.1% (4Q 09: -2.8%), largely reflecting the strong pick up in natural gas production.

The headline inflation rate, as measured by the change in the Consumer Price Index (CPI), increased to 1.3% on an annual basis in the first quarter (4Q 09: -0.2%). The increase in consumer prices was attributed mainly to the price increase in *food and non-alcoholic beverages* (1Q 10: 1.4%; 4Q 09: 0.9%).

In the external sector, the trade surplus increased to RM39 billion in the first quarter (4Q 09: RM32.4 billion). Both gross exports and imports grew strongly by 30.8% and 35.1% respectively (4Q 09: 5.1% and 6.7% respectively), as global conditions improved and domestic demand strengthened. The higher growth in exports reflected mainly increased demand for E&E products, especially from the regional countries, and a strong turnaround in the export of commodities. Meanwhile, the substantial increase in gross imports was led by a sharp increase in intermediate imports (37.9%; 4Q 09: 0.1%), in tandem with the recovery in manufacturing activity. In addition, capital and consumption imports also registered positive growth, reflecting the strengthening of domestic demand.

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On a cash basis, FDI inflows remained broad-based while portfolio investments recorded a net inflow in the first quarter. Gross inflows of foreign direct investment (FDI)[1] amounted to RM4.6 billion in the first quarter (4Q 09: RM10.1 billion), channelled mainly into the manufacturing, services, and oil and gas sectors. Meanwhile, net direct investment abroad by Malaysian companies was lower at RM2.3 billion (4Q 09: -RM5.2 billion), arising from lower net extension of inter-company loans to subsidiaries abroad and lower outflows of equity capital. The bulk of these investments was undertaken by companies in the services sector, particularly those in the finance and insurance, business services and telecommunication sub-sectors. Portfolio investments turned around to record a net inflow of RM3.9 billion (4Q 09: -RM2.6 billion), mainly into the domestic debt market. The inflows reflected improved investor sentiments on the stronger growth prospects of the Malaysian economy.

The international reserves of Bank Negara Malaysia amounted to RM311.7 billion (equivalent to USD95.3 billion) as at 31 March 2010, and RM313.9 billion (equivalent to USD96 billion) as at 30 April 2010. The reserves position is sufficient to finance 8.5 months of retained imports and is 4.4 times the short-term external debt.

Monetary policy continues to support economic activity

The Overnight Policy Rate (OPR) was raised by 25 basis points on 4 March 2010. The adjustment reflected the change in the economic outlook as well as the need to normalise monetary conditions to prevent the build-up of financial imbalances that would be detrimental to the long-term sustainable growth of the Malaysian economy. The overall stance of monetary policy, however, remains supportive of growth.

[1] The statistics for FDI on a cash basis does not include retained earnings and investment in the form of imported machinery and equipment

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Following the increase in the OPR, the average overnight interbank rate traded higher and interbank rates of other maturities also rose accordingly. In terms of lending rates, both the average base lending rate and the average lending rate were adjusted upwards. Despite the increase in interest rates, retail lending rates remain near historic lows. The average fixed deposit rates also rose in tandem.

Financing conditions remain supportive of economic activity, underpinned by the sound banking system and well-functioning capital market, as well as the availability of ample liquidity. Gross financing raised by the private sector through the banking system and the capital market was sustained at RM190.2 billion in the first quarter. The high level of gross financing was on account of steady loan disbursements. Financing to both the business and household sectors expanded at a higher rate during the first quarter.

Net funds raised in the capital market by both the public and private sectors amounted to RM22.6 billion in the first quarter (4Q 09: RM29.6 billion). The bulk of funds were raised by the public sector. In the private sector, fund-raising activity was mainly from the equity market.

Monetary aggregates continued to grow at a sustained pace in the first quarter. M3, or broad money, expanded at an annual growth rate of 8.7% at end-March 2010 (end-December 2009: 9.2%).

During the quarter, the ringgit appreciated by 4.6% against the US dollar, broadly in tandem with regional currencies. This was due mainly to investor optimism on the growth prospects of the regional economies. The ringgit also appreciated against the euro (12.2%), pound sterling (11.5%) and Japanese yen (5.9%). Against regional currencies, the ringgit appreciated within the range of 1.4% to 4.6%. Between 1 April and 12 May 2010, the ringgit appreciated against the US dollar (1.6%), euro (7.7%), pound sterling (2.8%) and Japanese yen (0.8%). Against regional currencies, the ringgit appreciated between 0.4% and 2.1%.

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The financial sector exhibited continued resilience

The banking sector remained resilient with strong capital buffers, stable asset quality and strong liquidity position. The financial institutions continued to record profits in the first quarter of 2010 backed by stronger demand for financing and insurance protection as well as favourable conditions in the financial markets.

As at end-March 2010, the risk-weighted capital ratio and core capital ratio of the banking system remained strong at 14.9% and 13.2% respectively, with more than RM60 billion worth of capital buffer. The net non-performing loans ratio (inclusive of impaired loans) was stable at 1.8%. Loan loss provisions were also high at more than 90%. Beginning from the financial year 2010, the financing portfolio of banks is reported in accordance to "FRS 139 Financial Instruments: Recognition and Measurement". The implementation of FRS 139 has had manageable impact with years of progressive preparation by banks for its implementation. Pre-tax profit for the quarter was sustained, supported by higher net interest income from financing portfolio, resulting in return on equity of 15.2% and return on assets of 1.4% by banks.

The insurance industry maintained strong level of capital with Capital Adequacy Ratio of 241.9% (4Q 09: 230%). Strong demand from individuals and businesses for insurance protection in an environment of improving business conditions saw insurance and takaful operators recording profit totalling RM3.4 billion.

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Growth of the domestic economy to be sustained going forward

The recovery of the global economy continued to gather pace in the first quarter, with stronger growth performance across most regions, particularly the Asian economies. Economic activity was sustained in the advanced economies amid continued policy support, stabilisation of financial systems and improved business and consumer confidence. Meanwhile, the regional economies continued their robust expansion in the first quarter, supported by sustained domestic demand and strong export growth. Going forward, considerable uncertainties remain due to the ongoing sovereign debt problems in Europe and the diminishing support from policy stimulus. Despite these developments and the potential destabilising effects on financial markets, the assessment is that it would generally have limited effects on emerging market economies.

The strong and broad-based expansion of the domestic economy in the first quarter affirms that the recovery of the Malaysian economy is firmly established. Going forward, growth is expected to be sustained, supported by the continued expansion in domestic and external demand. Expansion in domestic demand is expected to be supported by the favourable employment conditions, improving consumer and business confidence and an accommodative policy environment, while external demand will be supported by stronger regional trade and the global upturn in the E&E cycle.

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