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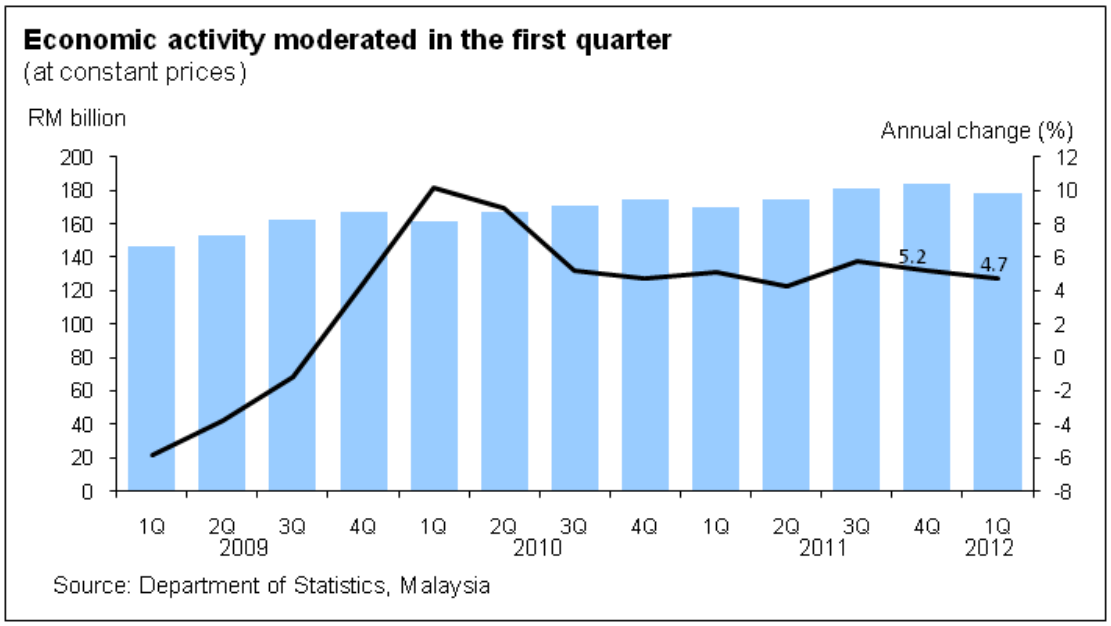
ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE FIRST QUARTER OF 2012

OVERVIEW

Growth of the Malaysian economy moderated in the first quarter

Global economic growth expanded at a slower pace in the first quarter of 2012. While growth in the US improved, several European economies slipped into recession. In Asia, economic activity continued to expand, albeit at a moderate pace, due to the slower export growth during the quarter. Domestic demand continued to provide support to economic activity. Notwithstanding the challenging external environment, growth of the Malaysian economy was sustained at 4.7% (4Q 11: 5.2%). Domestic demand remained firm, supported by both private and public sector economic activity, while exports moderated amid weaker external demand. On the supply side, growth in most major economic sectors moderated in the first quarter, as the more modest growth in export-oriented activity more than offset the sustained growth in domestic-oriented activity.

Domestic demand remained resilient, increasing by 9.6% (4Q 11: 10.4%). Growth of private consumption remained strong at 7.4% (4Q 11: 7.3%), supported mainly by continued income expansion and stable labour market conditions and reinforced by high commodity prices, improved consumer sentiments, and the disbursement of the income support programmes. Public consumption grew by 5.9% (4Q 11: 22.9%) amid continued expansion in spending on emoluments and supplies and services. Gross Fixed Capital Formation increased at a faster pace of 16.1% (4Q 11: 8.4%), supported by capital spending by both the private and public sectors. Private investment expanded strongly, supported by the implementation of investment projects, particularly in the oil and gas sector. For public investment, the Federal Government's development expenditure was mainly channeled into the trade and industry, and public utilities sectors, while capital spending by the non-financial public enterprises (NFPEs) was channeled mainly into the transportation and mining sectors.



On the supply side, both the services and manufacturing sectors moderated further in the first quarter, reflecting the more modest growth in trade-related activity and continued expansion in domestic-related activity. Growth in the construction sector strengthened further, supported by the implementation of civil engineering projects and development of residential projects. The agriculture sector moderated on account of slower production of crude palm oil and rubber, while the mining output turned around to record a marginal growth.

The headline inflation rate, as measured by the annual change in the Consumer Price Index (CPI), moderated to 2.3% in the first quarter of 2012 (4Q 11: 3.2%). Inflation in the *food and non-alcoholic beverages* category was lower due mainly to a smaller increase in meat prices and a decline in the price of vegetables. Inflation in the *transport* category moderated as the impact from the adjustment to the price of RON97 petrol in January and February 2011 tapered off.

In the external sector, the current account surplus narrowed in the first quarter, but remained sizeable at RM18.1 billion, equivalent to 8.4% of GNI. The lower surplus reflected the smaller goods surplus and larger income outflows. The goods surplus narrowed to RM32 billion as import growth outpaced the expansion in exports.

The financial account recorded a larger net outflow of RM10.3 billion during the quarter (4Q 11: -RM0.2 billion), due mainly to net outflows in other investments which more than offset the large inflows of foreign portfolio funds. FDI increased further to RM7.5 billion (4Q 11: +RM6.5 billion) during the quarter, supported by larger inflows of equity capital and higher earnings retained by the existing multinational companies (MNCs) operating in Malaysia. Direct investment abroad by Malaysian companies increased further to RM16.9 billion in the first quarter (4Q 11: -RM14.7 billion), reflecting substantially higher extensions of inter-company loans to subsidiaries abroad

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and higher outflows of equity capital. The overall balance of payments turned around to record a deficit of RM7.2 billion in the first quarter (4Q 11: +RM6.2 billion), following a lower current account surplus and a higher net outflow from the financial account.

The international reserves of Bank Negara Malaysia amounted to RM416.1 billion (equivalent to USD135.7 billion) as at 30 March 2012. The reserves level has taken into account the quarterly adjustment for foreign exchange revaluation loss, following the strengthening of ringgit against major and regional currencies during the quarter. As at 15 May 2012, the reserves position amounted to RM417.5 billion (equivalent to USD136.1 billion), sufficient to finance 9.3 months of retained imports and is 4.1 times the short-term external debt.

Monetary policy remained supportive of economic activity

The Overnight Policy Rate (OPR) was left unchanged at 3.00% in the first quarter. At the prevailing level of the OPR, monetary conditions remain 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 stable during the quarter. The average base lending rate (BLR) of commercial banks was unchanged at 6.53% throughout the period. The weighted average lending rate (ALR) on loans outstanding remained stable, standing at 5.63% as at end-March 2012 (end-December 2011: 5.66%). The cost of borrowing for businesses and households remained below pre-crisis levels.

In the first quarter, total gross financing raised by the private sector through the banking system and the capital market increased to RM259.9 billion (4Q 11: RM240.6 billion). The higher financing was attributable mainly to the increase in net private debt securities (PDS) issuances. On a net basis, banking system loans and PDS outstanding expanded at an annual growth rate of 13.3% as at end-March (4Q 11: 12.5%).

Net funds raised in the capital market increased to RM43.5 billion during the quarter (4Q 11: RM19.4 billion). The bulk of funds were raised by the private sector, particularly through the issuance of private debt securities. After adjusting for redemptions, net funds raised by the private sector amounted to RM29.8 billion (4Q 11: 3.5 billion). In the public sector, net funds raised amounted to RM13.6 billion (4Q 2011: RM15.9 billion).

The monetary aggregates continued to grow in the first quarter. M3, or broad money, recorded an annual growth rate of 15% as at end-March (end-December 2011: 14.4%), reflecting the continued extension of credit to the private sector.

The ringgit appreciated by 3.6% against the US dollar in the first quarter, in line with the trend of other regional currencies. Better-than-expected

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economic data, particularly from the US, resulted in increased investors' optimism and renewed interest for financial assets in the region. Against other major currencies, the ringgit appreciated against the Japanese yen (9.6%) and the euro (0.4%), but depreciated against the pound sterling (-0.1%). The ringgit also strengthened against other regional currencies in the range of 0.1% to 3.8%. During the period of 1 April to 21 May 2012, the ringgit appreciated against the euro (2.3%), but depreciated against the Japanese yen (-5.4%), the US dollar (-2.0%) and the pound sterling (-1.1%). Against regional currencies, the ringgit appreciated against the Korean won (0.7%), but depreciated against the Thai baht, Singapore dollar, Indonesian rupiah, Philippine peso and Chinese renminbi by between -0.6% and -1.6%.

Financial stability continued to be preserved

Financial stability was maintained throughout the first quarter of the year, underpinned by sound financial institutions and orderly financial market conditions. The continued effective functioning of financial intermediation has provided a supportive environment for economic activity.

The banking sector remained resilient during the quarter, continuing to maintain healthy prudential buffers, profitability and liquidity positions. The core capital ratio and risk-weighted capital ratio of the banking system remained firm at 13.0% and 14.7% respectively. Similarly, the insurance sector remained resilient with a strong capital adequacy ratio of 224.8%.

Recovery to continue at a modest pace but downside risks remain

Going forward, the European sovereign debt crisis remains a risk to the global economy. The continued high oil prices, driven mainly by geopolitical tensions, further adds to uncertainty in the global environment. Nevertheless, the ongoing gradual recovery in the US is expected to provide an upside potential to global growth prospects. For Asia, while economic activity may be affected by external developments, growth will continue to be underpinned by sound domestic macroeconomic fundamentals and policy flexibility.

For the Malaysian economy, while the challenging external environment will remain a risk to Malaysia's growth prospects, domestic demand is expected to remain resilient. The continued expansion in spending by the private sector, further supported by public sector expenditure, are expected to underpin the overall growth performance.

Bank Negara Malaysia
23 May 2012

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