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

OVERVIEW

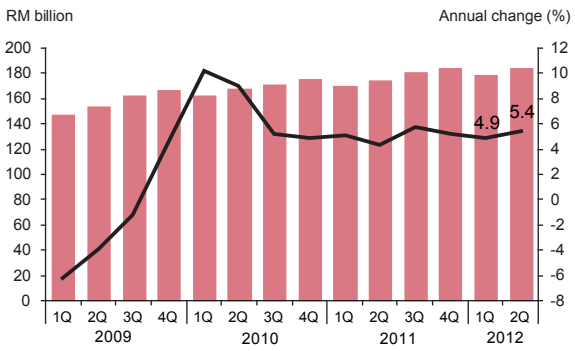
Malaysia recorded higher growth in the second quarter

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.