2012

EXECUTIVE SUMMARY

In 2012, global economic growth moderated amid a more challenging environment compared to 2011. In the advanced economies, growth was uneven, with the US experiencing a fragile recovery and the euro area remaining in recession. The weakened economic conditions in the advanced economies affected international trade, which in turn affected domestic economic activity in the emerging economies. Weaker global growth prospects, coupled with the ongoing fiscal uncertainties in the advanced economies also contributed to sustained volatility in the international financial markets. Nonetheless, market sentiments improved towards the latter part of the year following stronger commitments and important steps taken by authorities in resolving the European sovereign debt crisis.

Despite the weak external environment, the Malaysian economy performed better than expected, delivering faster and higher quality growth. The Annual Report provides an analysis of the developments in the Malaysian economy and the policies pursued by the Bank during the year. It also provides an assessment of the prospects of the Malaysian economy amidst the ongoing developments in the global economic and financial landscape and the key challenges going forward. In addition, the report also highlights the organisational changes in the Bank to further strengthen its governance and capacity through enhancements in strategic management, risk management and talent development.

The Malaysian Economy in 2012

The Malaysian economy performed better than expected in 2012, recording a strong growth of 5.6%. The overall growth performance was driven by higher growth in domestic demand, which outweighed the negative impact from the weak external environment. Domestic demand recorded the highest rate of expansion over the recent decade, underpinned by higher consumption and investment spending. Despite the uncertainties in the external environment, domestic consumer confidence picked up amidst positive income growth, continued strength in the labour market, the low inflation environment and supportive financing conditions.

Investment activity was a key driver of the domestic economy during the year, with increased capital spending by both the private and public sectors. Private investment was particularly robust, recording a double-digit growth of 22%. The share of private investment rose to 15.5% of GDP in 2012, the highest since 1998. This was led by strong capital spending in the consumer-related services sectors, domestic-oriented manufacturing sectors and the implementation of major infrastructure projects. Public investment also registered a strong growth of 17.1%, driven by higher capital spending by public enterprises. In addition, the strong investment performance was also attributed to the commencement and progress of several infrastructure projects, including those under the Economic Transformation Programme (ETP), and the steady improvement in the investment climate.

Private consumption registered a firm growth of 7.7% in 2012. The strong performance was attributed to favourable income growth, Government transfers to low- and middle-income households, and supportive financing conditions. In the public sector, public consumption recorded a moderate growth of 5% amidst continued fiscal consolidation efforts during the year.

On the supply side, all economic sectors continued to expand in 2012. The construction sector benefited from the strong expansion in investment activity, registering its highest pace of growth since 1995. While the growth of export-oriented activities was dampened by the slowdown in external demand, the growth of domestic-related activities, particularly in the services and manufacturing sectors, was supported by the strong performance of domestic demand.

Labour market conditions remained stable in 2012 with continued gains in employment, observed mostly in the services and agriculture sectors. However, total retrenchments increased due mainly to higher layoffs in the manufacturing sector. During the year, the unemployment rate declined marginally to 3%.

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), averaged 1.6% in 2012 (2011: 3.2%).

Inflation was lower than expected, on account of the slower rate of price increases in the *food and non-alcoholic beverages* and *transport* categories. Food items, which have been the main drivers of inflation in recent years, registered more moderate price increases following modest external price pressures and significant improvements in domestic food supplies. The magnitude of the adjustments to administered prices was also lower than in the previous year. Core inflation, an indicator of demand-driven price pressures, moderated to 2.4% in 2012 (2011: 2.7%).

Malaysia's external position remained resilient in 2012 despite the challenging external environment. The overall balance of payments remained strong as the current account surplus was more than adequate to meet the net outflows in the financial account. Reflecting the cyclical and structural adjustments taking place in both the global and domestic economy, the current account surplus was lower at RM60 billion in 2012 (2011: RM97.1 billion) due mainly to a smaller goods surplus and larger deficits in the services and income accounts. The moderation in the goods surplus was a result of robust import growth, following the improvement in domestic demand, amid lower export growth caused by the weak external demand and lower commodity prices. The services account registered a larger deficit due to higher payments for imported transportation services and lower net travel receipts, while the larger net income payment reflected the higher income accrued to foreign companies operating in Malaysia.

On the financial account, Malaysia continued to experience two-way capital flows, with foreign inflows attracted by the resilient growth prospects. Despite significant global uncertainties, foreign direct investment (FDI) inflows were sustained and remained broad-based, with significant inflows into high-growth areas, such as the oil and gas sector and the communication services sub-sector. Some of the funds were also channelled into projects under the ETP. Direct investment abroad (DIA), were largely undertaken by companies in the services and oil and gas sectors, and continued to be channelled into the regional economies, reflecting the deepening economic integration in Asia.

Malaysia's external debt declined to RM252.8 billion (USD81.7 billion) as at end-2012 (2011: RM257.4 billion), equivalent to 28% of GNI (2011: 30% of GNI). During the year, the medium- and long-term external debt of the private sector increased. This, however, was largely offset by the net repayment of public sector medium- and long-term external debt and the net repayment of short-term interbank borrowings. The appreciation of the ringgit against some of the major currencies during the year also contributed to the lower value of external debt in ringgit terms. Overall, Malaysia's external debt profile continued to be skewed towards a longer maturity structure, with medium- and long-term debt accounting for 63.2% of total external debt. The external debt continues to be well supported by the country's strong economic fundamentals.

Net international reserves increased by RM3.9 billion to RM427.2 billion (equivalent to USD139.7 billion), as at 31 December 2012. As at 28 February 2013, the reserves level amounted to RM429 billion (equivalent to USD140.3 billion), which is adequate to finance 9.5 months of retained imports and is 4.6 times the short-term external debt. The international reserves held by the Bank remain usable and unencumbered.

Economic and Monetary Management in 2012

Monetary policy in 2012 was focused on managing the downside risks to growth amid moderating inflation. Although the Malaysian economy remained on a steady growth path and inflation was on a downward trend, the high degree of global economic and financial uncertainty remained a risk to the Malaysian economy's growth prospects. In balancing the risks to inflation and growth of the economy, the Monetary Policy Committee (MPC) considered the prevailing Overnight Policy Rate (OPR) level to be appropriate, and kept the policy rate unchanged at 3.00% throughout 2012.

Strong loan demand throughout the year, while warranting close monitoring, was not a concern as total loan growth was supported mainly by lending to businesses, with lending primarily supporting expansion of the domestic-oriented industries and the ETP-related projects. While there were concerns over the potential risk of excessive indebtedness of the household sector, the risk was assessed to be confined to specific household segments. As such, the MPC was of the view that a change in monetary policy stance was not appropriate. These trends were also being addressed by macroprudential measures and the guidelines issued on responsible financing practices that was introduced at the beginning of the year to promote prudent and responsible lending and borrowing behaviour. Nevertheless, the MPC continued to assess developments in household credit to ensure the risk of household indebtedness becoming excessive remained contained.

Monetary policy was also confronted with the challenge of sustained large and volatile portfolio flows throughout the year. There continued to be large global surplus liquidity in search of higher yields, which were attracted to the emerging economies, including Malaysia, given the relatively stronger fundamentals. The developments in the advanced economies and the rapid changes in sentiments in the global financial markets further contributed to the volatility of portfolio flows. For the most part, the financial system was able to effectively intermediate these flows without generating substantial distortions in domestic financial markets and monetary conditions. This reflected the cumulative policy efforts by the Bank to deepen and increase the resilience of the Malaysian financial system over the recent decade.

The performance of the ringgit during the year was influenced by the global and regional developments amid periods of heightened volatility in the global financial markets. From January to early March of 2012, the ringgit strengthened due to portfolio inflows, supported by the continued underlying strength of the Malaysian economy amid the positive growth prospects of Asia and the prolonged low interest rate environment in the advanced economies. The appreciating trend of the ringgit reversed temporarily between March and June, as renewed uncertainties over the situation in key economic regions led to concerns over the prospects for global and regional economic growth and prompted the unwinding of the holdings of financial assets in the region by investors. The depreciation trend, however, was brief as portfolio inflows resumed towards the second half of the year, attracted by the strong performance of the domestic economy. The ringgit ended the year at RM3.0583 against the US dollar, thus recording a year-on-year appreciation of 3.9%.

During the year, the yields of Malaysian Government Securities (MGS) were largely influenced by a combination of external and domestic factors. Despite renewed concerns over the European sovereign debt crisis, firm demand from non-residents kept yields low. However, strong domestic fundamentals and increased supply of government bonds exerted some upward pressure on yields. The domestic private debt securities market (PDS) registered high growth amid ample liquidity and strong demand for financing to support infrastructure-related projects, including those under the ETP. The FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) advanced by 10.3% to close at 1,689 points in 2012 (2011: 0.8%). The positive performance was driven mainly by the favourable outlook for the domestic economy.

Liquidity conditions in the banking system remained ample throughout 2012. Private sector liquidity continued to expand, mainly on account of favourable credit conditions and continued inflows of foreign funds. Liquidity conditions in the interbank money market were more stable compared to 2011, reflecting more balanced two-way flows from trade and investment activity. Sterilisation operations by Bank Negara Malaysia were conducted to prevent the build-up of liquidity that could give rise to financial imbalances.

Financing conditions remained supportive of economic activity. The strength in financing growth during the year was attributable mainly to business financing. Demand for loans by households, while still remaining relatively strong, moderated. Net financing through the banking system and the capital market expanded at an annual rate of 12.4% (2011: 12.5%).

Outlook for the Malaysian Economy in 2013

The Malaysian economy is expected to remain on a steady growth path, with an expansion of 5-6% in 2013. Economic activity will be anchored by the continued resilience of domestic demand, and supported by a gradual improvement in the external sector. Private investment is expected to remain robust, driven by capacity expansion by the domestic-oriented firms and the continued implementation of projects with long gestation periods. Investments by the external-oriented businesses is also expected to be higher amid the gradual improvement in external demand, while private consumption is projected to grow at a more moderate rate in the second half of the year, although it will continue to be well supported by sustained income growth and positive labour market conditions. Government spending is expected to record a lower growth given the ongoing consolidation of the

Government's fiscal position and as the role of the private sector gains greater significance. In line with the more favourable external sector, gross exports are projected to record a higher growth in 2013 supported by the export of manufactured products. Gross imports are expected to moderate, in tandem with the projected trend in domestic demand. Overall, this is expected to result in a lower negative contribution to real GDP from net exports. As import growth continues to outpace export growth amid the continued deficit in the income account and in current transfers, the current account surplus, while still remaining significant is expected to narrow further in 2013.

On the supply side, all major economic sectors are expected to record continued expansion in 2013. The services and manufacturing sectors are expected to be the key contributors to overall growth, driven by the continued resilience of domestic demand and supported by higher international trade activity. Growth in the construction sector is projected to remain strong, supported by the implementation of major infrastructure projects. In the commodities sector, the growth of agriculture is expected to improve due to the higher output of crude palm oil and food commodities while the mining sector is expected to strengthen following the higher production of natural gas, crude oil and condensates.

Headline inflation is expected to average 2-3% in 2013. This inflation projection takes into account the expected higher global prices of selected food commodities and the adjustments to domestic administered prices. Demand-driven price pressures are expected to be moderate. The wider forecast range reflects the greater uncertainty in the external and domestic environment.

Overall, the growth prospects of the Malaysian economy will continue to be underpinned by the strength of its fundamentals. Of importance, labour market conditions will remain favourable, with the unemployment rate projected to remain low at 3.1% of the labour force in 2013. In addition, the financial system continues to demonstrate resilience against the challenging external environment, with financial intermediation expected to continue to provide strong support to domestic economic activity. The introduction of macroprudential and other policy measures have helped to manage the risks from the increase in household indebtedness. Malaysia's favourable external position is to remain intact, with international reserves at healthy levels and a low external debt that is within prudent limits.

Given the challenging external environment, there, however, remain risks to the economic outlook. The potential re-emergence of instability in the euro area and slower growth in Malaysia's major trading partners would affect the Malaysian economy. While pressures from global commodity prices have receded, upside risks from non-fundamental factors, such as adverse weather conditions and geopolitical developments, could push commodity prices higher and adversely affect the growth prospects of economies that are major trading partners of Malaysia. Potential upside to the domestic economy could emerge if the recovery in the advanced economies turns out to be better than expected.

Economic and Monetary Management in 2013

Under this challenging global economic environment, the focus of policies by the Government and the Bank will be on supporting the Malaysian economy to grow at a sustainable level while mitigating the risks arising from the global environment, including possible shocks to inflation.

Monetary policy in 2013 will focus on addressing potential risks to inflation and growth. The MPC considered the prevailing level of the OPR and the current monetary policy stance to be appropriate for the inflation and growth outlook. In addition to domestic conditions, the MPC will continue to carefully assess the global economic and financial developments and their implications on the overall outlook for inflation and growth of the Malaysian economy.

Fiscal policy in 2013 will continue to focus on sustaining the growth momentum of the domestic economy and facilitating the long-term transformation of the economy, while ensuring the sustainability of public finances. The 2013 Budget placed emphasis on ensuring the efficient use of fiscal resources, achieving inclusive growth and strengthening fiscal management, all within the path of a sustained and gradual fiscal consolidation plan.

Organisational Development and Governance

In 2012, the Bank further reinforced its efforts in organisational development and achieving more effective governance. During the year, the Board of Directors met each month to deliberate on various aspects of the Bank's operations, including the performance of the Bank in effecting monetary and financial stability, and matters pertaining to the Bank's financial position, reserves management, currency management and the management of its staff. The Board was supported by three Board Committees that were chaired by non-executive directors, namely the Board Governance, Audit and Risk Committees, which collectively have the role of ensuring the effectiveness of the internal audit function, as well as pre-emptively managing risks that may hinder the achievement of the Bank's objectives.

During the year, initiatives were implemented to ensure continued strategic focus and a robust risk management culture in all aspects of the Bank's operations. 2012 marked the first year of the Bank's second cycle of its three-year Business Plan, which sets the medium-term strategic direction and aligns the Bank's resources towards achieving the Bank's objectives. A major milestone in 2012 was the passing of the new legislation, the Financial Services Act 2013 and the Islamic Financial Services Act 2013, which have been designed to provide a modern and cohesive regulatory framework for the financial sector. Another initiative was to improve the organisational efficiency and productivity in the area of support services. All departments offering such support services were restructured into a new division, with the aim of professionalising the services. In sustaining a high performing workforce, the Bank continued to modernise its human capital policies and practices with the introduction of a new Job Family framework. The principles of the new framework aim to attract, assess, develop, reward and retain talent in the Bank.

The Bank also continued an active two-way communication on the Bank's policies and developments in the financial system. Efforts were intensified through various channels to promote awareness and provide greater clarity on the Bank's key initiatives, including on the financial inclusion agenda, the internationalisation of Islamic finance, the circulation of the new currency series, and the wider usage of renminbi for trade settlement and investment. A major initiative in the communication drive and financial education awareness campaigns was on financial scams to highlight to investors and the public on the dangers of investing in such schemes.

As part of the continued effort to enhance regional and international cooperation among central banks and regulatory authorities, the Bank continued to provide a broad range of technical cooperation programmes, to share Malaysia's experience in central banking and to facilitate knowledge sharing with counterparts from central banks across the globe. The Bank's facilities at Lanai Kijang and Sasana Kijang were fully utilised for this endeavour.

Bank Negara Malaysia's Audited Financial Statement for 2012

The financial position of Bank Negara Malaysia, as audited and certified by the Auditor General, remained strong in 2012. The total assets of Bank Negara Malaysia amounted to RM476.3 billion, with a net profit of RM5.6 billion for the financial year ended 31 December 2012. Bank Negara Malaysia declared a dividend of RM1.5 billion to the Government for the year 2012.