2011

EXECUTIVE SUMMARY

The global economy grew at a more moderate pace in 2011 after the strong rebound in 2010. The growth momentum was weighed down by continued structural weaknesses and fiscal issues in the advanced economies, geopolitical developments in the Middle East and North Africa region and the disruptive impact of natural disasters on global manufacturing production. These developments reverberated onto international financial markets and contributed to heightened market volatility throughout the year. Despite the less favourable external environment, emerging economies continued to record firm domestic-driven economic growth. At the same time, emerging economies faced increasing challenges from volatile capital flows and rising inflationary pressures. Amidst this environment, the Malaysian economy continued to grow steadily underpinned by the expansion in domestic activity and firm regional demand. The Annual Report provides detailed analyses of the developments in the Malaysian economy and policies pursued by the Bank during the year, as well as an assessment of the prospects for the economy against the backdrop of on-going developments in the global economic and financial landscape and key challenges going forward. 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 2011

The Malaysian economy recorded a steady pace of growth of 5.1% in 2011 (2010: 7.2%), despite the challenging international economic environment. Growth was lower in the first half of the year, particularly in the second quarter, as the economy was affected by the overall weakness in the advanced economies and the disruptions in the global manufacturing supply chain arising from the natural disaster in Japan. Although the global economic environment became increasingly more challenging and uncertain in the second half-year, Malaysia's economic growth improved due to stronger domestic demand.

Domestic demand registered a strong growth of 8.2% in 2011 (2010: 6.3%), driven by both household and business spending, and higher public sector consumption. Private consumption strengthened in 2011, growing by 6.9% (2010: 6.5%), supported by a broad-based growth in income following the overall improvement in labour market conditions and higher commodity prices.

Private investment expanded by 14.4% in 2011 (2010: 17.7%). Higher capital expenditure was evident across all sectors, especially in the first half of the year, driven mainly by strong domestic demand. However, the strong investment momentum began to moderate slightly towards the second half of the year, especially in the manufacturing sector, following increased uncertainties on the global economic environment.

The public sector continued to provide support to growth during the year. Public consumption expanded substantially by 16.8% in 2011 (2010: 0.5%), the outcome of higher public expenditure on emoluments, supplies and services, and the one month bonus payment during the year. Public investment, however, contracted by 2.4% in 2011 (2010: 2.8%) following the lapse of the second stimulus package in 2010. Nevertheless, capital spending by the non-financial public enterprises (NFPEs) remained strong, providing support to overall public investment.

From the supply side, the overall growth in 2011 was sustained by firm activity in the domestic-oriented sectors. The services sector remained the key contributor to growth amid robust domestic demand throughout the year. The sector recorded sustained growth of 6.8% in 2011 (2010: 6.8%) to contribute 3.9 percentage points to overall GDP growth. The wholesale and retail trade sub-sector continued to register steady performance, underpinned by robust private consumption. Meanwhile, the finance and insurance sub-sector expanded firmly following strong performance in bank lending and increased collection of insurance premiums.

The manufacturing sector continued to expand, albeit at a more modest pace (2011: 4.5%; 2010: 11.4%) as growth in the domestic-oriented industries outweighed weakness in the export-oriented industries. Subdued external demand, particularly from the advanced economies, had weighed down on the performance of the export-oriented industries. Supply disruptions also contributed to the under-performance of the sector. Nevertheless, the domestic-oriented industries remained resilient, supported by favourable domestic demand conditions.

The construction sector expanded at a moderate rate of 3.5% in 2011 (2010: 5.1%) due to slower activity in the civil engineering and non-residential sub-sectors. The civil engineering and special trade sub-sector registered slower growth following the completion of major highway projects and maintenance and upgrading work under the second stimulus package. Growth in the non-residential sub-sector also moderated after strong double-digit growth in the previous year. Growth was weighed down by concerns of an oversupply of office space, particularly in the Klang Valley area. The residential sub-sector registered a much improved performance with a turnaround in growth. The average national house price rose at a faster pace of 8.6% in the first three quarters of the year (2010: 6.7%), significantly above the average growth rate of 3.7% between 2000 and 2010.

The agriculture, forestry and fishing sector expanded at a stronger pace of 5.6% in 2011, supported by a recovery in the production of crude palm oil (CPO). The production of CPO increased by 11.3% to 18.9 million tonnes as good weather conditions and firm prices supported strong production. Output of other key crops such as rubber and food crops was sustained by strong regional and domestic demand.

Value-added in the mining sector contracted by 5.7% in 2011, reflecting the decline in the production of crude oil and condensates. This decline was caused by the shutdown of several production facilities for maintenance purposes, declining production from mature fields, and lower-than-expected production from new fields. Despite higher demand from Japan following the natural disasters in March, output of natural gas rose only marginally, as production was affected by shutdowns of gas processing facilities in Peninsular Malaysia.

Overall labour market conditions improved in 2011, as reflected by the gains in employment and higher number of vacancies. The unemployment rate declined to 3.1% of the labour force in 2011 from 3.3% in the previous year, the lowest annual rate recorded since the year 2000.

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), averaged 3.2% in 2011 (2010:1.7%). The increase in inflation in the first half of the year was due mainly to supply factors arising from higher food prices and the upward adjustments of administered prices. Inflation peaked in June at 3.5% and subsequently stabilised in the second half of 2011, as the impact from the upward adjustments in the prices of petroleum products and sugar in 2010 gradually diminished. Core inflation, an indicator of the demand-driven pressures on price pressures, rose to 2.7% in 2011 (2010:1.5%).

Malaysia's external position strengthened further in 2011 despite the difficult external environment. The overall balance of payments turned around to record a strong surplus position with the current account achieving another large surplus while the financial account reversed to register a net inflow position. The positive current account performance was supported by a larger trade surplus, emanating mainly from strong commodity exports that reflected the higher commodity prices, and lower net income outflows. The turnaround in the financial account was largely attributed to the continued foreign direct investments (FDI) and inflows of portfolio funds given the positive growth prospects of the Malaysian economy.

The current account surplus widened to RM97.9 billion or 11.8% of GNI (gross national income), from RM88.1 billion or 11.9% of GNI in 2010, reflecting the higher trade surplus arising from the sustained expansion in exports of commodities and non-electronics and electrical (E&E) manufactured products. Nevertheless, in line with the moderate growth in the advanced economies and heightened uncertainties in the global financial markets, gross exports grew at a more modest pace of 8.7% (2010: 15.6%) in 2011. The moderation in gross exports was due mainly to the contraction in exports of E&E products. The lower growth in manufactured exports mainly reflected the weaker external demand. Nonetheless, robust regional demand and favourable commodity prices provided crucial support for exports of commodities and resource-based non-E&E products.

In 2011, the financial account reversed from a net outflow position to record a net inflow of RM15.5 billion (2010: -RM19.9 billion), largely due to the continued FDI and inflow of portfolio funds. Despite heightened uncertainty in the global financial markets, portfolio inflows continued to be buoyed by prospects for strong growth in the region, and expectations for stronger regional currencies. Of significance, FDI inflows were also higher in response to the robust domestic economic conditions and higher corporate profitability. Similarly, direct investment abroad (DIA) by Malaysian companies was higher mainly as an outcome of the expansion of existing business operations abroad. Other investment outflows, which largely reflected private sector flows, moderated sharply during the year.

As at 31 December 2011, the net international reserves amounted to RM423.3 billion (equivalent to USD133.6 billion), which is adequate to finance 9.6 months of retained imports and is 4.1 times the short-term external debt. As at 29 February 2012, the reserves level amounted to RM426.7 billion (equivalent to USD134.7 billion), which is adequate to finance 9.4 months of retained imports and is 4.1 times the short-term external debt. The international reserves held by the Bank remain usable and unencumbered.

Malaysia's total external debt rose to RM257.2 billion (or USD80.4 billion), equivalent to 31% of GNI at the end of 2011 (2010: RM227.1 billion). This reflected the increase in the medium- and long-term as well as short-term debt. The increase in the medium- and long-term external debt partly reflected the net drawdown of external borrowings by the Federal Government and the private sector. In July 2011, the Federal Government successfully issued a dual tranche (5-year and 10-year) Wakala Global Sukuk of USD2 billion. The issuance was Malaysia's third US dollar-denominated sovereign Sukuk issuance, with the preceding Global Sukuk Issuance in 2010. During the year, outstanding short-term external debt rose to RM103.9 billion (2010: RM79.4 billion), attributed primarily to increased interbank borrowings. Nevertheless, the short-term external debt exposure remained relatively small, accounting for only 12.5% of GNI, 24.5% of international reserves and 12.9% of exports of goods and services. The appreciation of some of the major currencies against the ringgit during the year also contributed to the rise in the overall external debt level. As at end-year, Malaysia's external debt profile continued to be skewed towards a longer maturity structure with medium- and long-term debt accounting for 59.6% of total external debt.

Domestic Monetary and Financial Conditions in 2011

Monetary policy in 2011 focused on sustaining economic growth, while containing the risks to inflation and preventing the build-up of financial imbalances. Maintaining the momentum from 2010, the Malaysian economy experienced sustained growth in the first half of the year. Inflation was expected to be higher compared to the previous year, driven mainly by supply factors and to a lesser extent, domestic demand pressures. Monetary policy in the first half of the year was therefore focused on the need to further normalise interest rates. The Monetary Policy Committee (MPC) raised the Overnight Policy Rate (OPR) by 25 basis points on 5 May 2011 to 3.00%. In the second half of the year, however, the downside risks to economic growth increased significantly due to deteriorating global economic and financial conditions, whereas the upside risks to inflation had begun to moderate. Given the balance of risks, the MPC considered the prevailing OPR level to be appropriate and kept the policy rate unchanged for the remainder of the year.

A key challenge to the conduct of monetary policy during the year was the significant and volatile portfolio inflows. The capital inflows and the consequent build-up of liquidity in the domestic financial system, if not managed, could lead to financial imbalances and create risks for macroeconomic and financial stability. As such, to pre-emptively respond to these risks, the Statutory Reserve Requirement was raised by 1 percentage point each time in March, May and July to 4.00% to reduce the size of the excess liquidity in the banking system.

The performance of the ringgit during the year was influenced by volatility in international financial markets arising primarily from external developments. Between early January and July 2011, the ringgit strengthened due to significant portfolio inflows. Strengthening fundamentals and positive investor sentiments continued to attract capital flows towards regional markets. The appreciating trend of the ringgit and other regional currencies was, however, reversed in August and September as investor risk aversion rose sharply following heightened uncertainty surrounding the global growth outlook and mounting concerns over the sovereign debt crisis in Europe. The relief following the positive outcomes of the EU summit in October was brief, as capital outflows and ringgit volatility increased towards the end of 2011 amidst renewed market concerns over the crisis in Europe. Ringgit ended the year at RM3.1770 against the US dollar, a depreciation of 2.9%.

The Malaysian Government Securities (MGS) market was significantly influenced by external factors. While MGS yields increased in the first four months of the year, they subsequently reversed to chart a downward trend following strong non-resident inflows. Conditions in the domestic private debt securities (PDS) market also evolved favourably, as market liquidity and credit conditions improved.

The FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) increased by 0.8% to close at 1,530.7 in 2011 (2010: 19.3%). Domestic equity prices rose in the first half of 2011 on strong domestic fundamentals, but underwent a correction in the second half-year. The FBM KLCI stabilised in late-September and gradually recovered as investors reacted positively to the improvement in global growth prospects following measures undertaken in the advanced economies to stabilise international financial markets.

Liquidity conditions in the banking system remained ample throughout 2011. Private sector liquidity expanded strongly on account of the sizeable capital inflows in the first half of 2011. Despite the episodes of large capital outflows in the second half of 2011, a net expansion in liquidity was recorded for the year as a whole. The sterilisation operations of the Bank were instrumental in offsetting the impact of the flows on domestic liquidity and maintaining relatively stable domestic monetary conditions.

Financing conditions remained supportive of economic activity. The reasonable cost of borrowing and ample liquidity in the financial system sustained financing to all segments of the economy. Net financing raised by the private sector through the banking system and the capital market expanded by 12.5% (2010: 10.9%) with strong demand for financing from both businesses and households.

Outlook for the Malaysian Economy in 2012

Amid the more challenging external environment, Malaysia's economy is projected to experience a steady pace of growth of 4 - 5% in 2012. Domestic demand is expected to remain resilient and will continue to be the anchor for growth. Several measures that were announced in the 2012 Budget are expected to provide support to private consumption. These include the upward revision of public sector wages and the one-off financial assistance to low and middle-income groups. Private investment will be supported by domestic-oriented industries and the ongoing implementation of projects under the Economic Transformation Programme (ETP). The public sector will remain supportive of growth in 2012, with higher capital expenditure by both the Federal Government and the non-financial public enterprises. The implementation of the Special Stimulus Package through Private Financing Initiative that was announced in the 2012 Budget would provide further impetus to real activity during the year.

On the supply side, most sectors will continue to expand in 2012. Nevertheless, the slower growth in global demand may adversely affect the export-oriented industries in the manufacturing sector as well as the trade-related industries in the services sector. The performance of domestic-oriented industries, on the other hand, is expected to remain firm, benefiting from resilient domestic demand conditions. In particular, the construction sector is projected to record stronger growth, supported by the implementation of major infrastructure projects and the Special Stimulus Package. Growth in the mining sector is also expected to recover. However, the agriculture sector is likely to register a more moderate growth on account of lower growth of both palm oil and natural rubber following the strong performance seen in 2011 and the expected moderation in commodity prices.

On the external front, the current account surplus is projected to remain large at RM109.5 billion or 12.2% of GNI. Although gross exports are expected to record a slower growth in 2012, the trade account surplus will remain large. This trade surplus will be primarily supported by exports of commodities and non-E&E manufactured products. It also reflects the anticipated slower growth in gross imports in tandem with the weaker demand for manufactured exports and the more moderate growth in private domestic demand. Deficits in the services and income accounts are also projected to narrow further in 2012. On the financial account, long-term capital flows are likely to moderate but short-term capital flows could be higher and more volatile, amid heightened global uncertainty.

The GDP growth projection of between 4 – 5% in 2012 is premised upon the expectation of a moderation in global growth and the timely and full implementation of measures announced in the 2012 Budget. Several risks, however, remain. These risks include an escalation in the eurozone sovereign debt crisis and much slower growth in our major trade partners. Should growth in the advanced economies turn out to be stronger than expected, there is some upside potential to domestic growth in 2012. It should also be noted that the authorities have sufficient policy flexibility to support the domestic economy and respond to global developments.

Labour market conditions are expected to soften in 2012 amid the slower economic activity. The unemployment rate is projected to increase to 3.2% of the labour force in 2012 (2011: 3.1%). Job creation is projected to be concentrated in the domestic-oriented sectors, particularly in the services and construction sectors, as domestic demand is expected to remain firm. Employment in the export-oriented sectors may be affected by the weakening external demand.

Headline inflation is expected to moderate in 2012, averaging between 2.5-3.0%. The lower inflation projection reflects the moderation in global commodity prices and a more modest growth in domestic demand. However, upside risks to inflation remain, and could emanate from higher-than-expected global commodity prices, domestic supply disruptions and possible adjustments to administered prices.

Economic and Monetary Management in 2012

Against the challenging global economic environment, the focus of policies by the Government and the Bank is on supporting the Malaysian economy to grow at sustainable levels while managing the risks to inflation. Fiscal policy will be geared towards stimulating domestic economic activity and providing support to the economic transformation program. A key challenge for the Government in 2012 is to continue providing support to domestic demand amid the weakening external sector, while ensuring that the fiscal position remains sustainable. In this regard, greater emphasis has been placed in the 2012 Budget on generating growth through private sector investment and consumption. This includes measures for accelerating investment, further developing human capital and enhancing rural development, and the implementation of programmes to improve the socio-economic well-being of Malaysians.

Monetary policy will continue to facilitate economic growth while managing the risks to inflation and the build-up of financial imbalances. Prevailing monetary conditions remain supportive of economic activity. Should the global economy enter a new phase of even weaker growth during the course of 2012 and adversely affect the outlook for the Malaysian economy, the MPC at Bank Negara Malaysia has the flexibility to respond to adjust the degree of monetary accommodation. Strong fundamentals, greater policy flexibility and closer cooperation with central banks within the region also places Malaysia in a strong position to face the challenges posed by large and volatile movements of capital flows.

Organisational Development and Governance

In 2011, the Bank had further reinforced its efforts in organisational development and the promotion of more effective governance. During the year, the Board of Directors met to deliberate on various aspects of the Bank's operations including the performance of the Bank in effecting monetary and financial stability, the formulation of the Financial Sector Blueprint and the review of regulatory laws governing financial institutions. At the same time, several initiatives were implemented internally under the oversight of the Board Governance, Audit and Risk Committees with the aim of better aligning the Bank's initiatives with its mandate, ensuring the effectiveness of the internal audit function in providing independent assessments and oversight, as well as, promoting a strong risk management culture and pre-emptively managing risks that may hinder the achievement of the Bank's objectives. 2011 also marked the conclusion of the Bank's Business Plan 2009-2011, which had contributed significantly to the Bank's transformation towards becoming a strategy-focused and high performance organisation. During the year, the Bank launched Sasana Kijang, a modern centre of excellence for central banking and financial services, which is expected to play a significant role in promoting regional and international collaboration.

The Bank's communications function remained important in fostering stakeholder confidence, especially amid the uncertain global economic and financial environment of 2011. More frequent engagements were undertaken on the Bank's assessment of the impact of external developments on the Malaysian economy and financial sector, as well as, to highlight the underlying strength of domestic economic fundamentals in sustaining the growth momentum of the Malaysian economy. Public outreach programmes aimed to enhance financial literacy, capability, inclusion and access to financing continued to be an important part of the Bank's developmental agenda. With the launch of the new Malaysian currency series in December 2011, the Bank has also engaged closely with financial institutions, businesses and cash-handling vendors to ensure a smooth transition to the new coins and notes coming into circulation in 2012.

As part of the continuous effort to enhance regional and international cooperation, the Bank continues to be involved in technical collaboration with external agencies and central banks from other emerging economies, particularly in the areas of Islamic finance, organisational development, financial inclusion, consumer protection and financial education.

Bank Negara Malaysia's Audited Financial Statement for 2011

The financial position of Bank Negara Malaysia, as audited and certified by the Auditor General, remained strong in 2011. The total assets of Bank Negara Malaysia amounted to RM473 billion with a net profit of RM4.7 billion for the financial year ended 31 December 2011. Bank Negara Malaysia declared a dividend of RM2 billion to the Government for the year 2011.