2010

EXECUTIVE SUMMARY

The year 2010 saw a continuation in global economic recovery, which had begun in the second half of 2009. Nevertheless, the international environment remained highly uncertain, weighed down by continued structural weaknesses in the advanced economies and large swings in global financial markets. The emerging economies, however, experienced a rapid resumption of economic growth, but faced increasing challenges from volatile capital flows and rising inflationary pressures. Amidst this environment, the Malaysian economy resumed its growth path, underpinned by a strong expansion in domestic activity and greater integration with the region. 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 landscapes and the key challenges going forward. The report also highlights the organizational changes in the Bank to strengthen its governance and capacity through enhancements in strategic management, risk management and talent development.

The Malaysian Economy in 2010

After the downturn in 2009, the Malaysian economy experienced a strong resumption of growth in 2010 with an expansion of 7.2%. Growth was driven mainly by robust domestic demand, with strong expansion in private sector activity. Meanwhile, the public sector continued to support the domestic economy through the implementation of programmes to further enhance the country's infrastructure and the public sector delivery system. External demand rebounded strongly in the first half of the year, underpinned by strong regional demand and to some extent, the low base effect. However, it subsequently moderated in the second half-year in tandem with the slowdown in global trade and the diminishing base effect.

Domestic demand conditions were robust. For the year as a whole, the overall aggregate domestic demand expanded strongly by 6.3% (2009: -0.5%). Private consumption expanded at a faster rate of 6.6% (2009: 0.7%), supported by better labour market conditions and the steady increase in incomes. Higher prices of crude palm oil and rubber supported increased spending by households in the rural areas. Continued access to credit amid an accommodative monetary environment also supported consumer spending. Robust consumer spending was reflected in the strong performance of major consumption indicators such as passenger car sales, retail sales and imports of consumption goods.

Private investment rebounded strongly to register a double-digit growth of 13.8% in 2010 (2009: -17.2%). Capital spending expanded across all sectors following favourable domestic economic conditions and improvements in external demand. The strong performance of investment activity was reflected in the improvement of major investment indicators. Import of capital goods increased by 16.2%, while sales of construction-related materials rose by 11% in 2010.

The public sector continued to provide support to growth during the year. Public investment increased by 5.5% (2009: 8%), partly reflecting the continuation of the second stimulus package amounting to RM5 billion in the first half of the year. Development expenditure was channelled mainly towards improving rural infrastructure and urban public transportion as well as enhancing the provision of public education and healthcare services. Meanwhile, growth in public consumption moderated to 0.1% (2009: 3.1%), attributable mainly to lower spending on supplies and services as the Government reprioritised spending programmes and reduced non-essential expenditure. Nevertheless, expenditure on emoluments was higher, in part because of the improved salary scheme for selected segments of the civil service.

On the supply side, all economic sectors registered a strong performance in 2010. The services sector expanded by 6.8% (2009: 2.6%) and was the largest contributor to growth, contributing 3.9 percentage points to the overall GDP growth. The sector expanded by 7.9% in the first half-year driven by higher growth in all sub-sectors. With the slowdown in external demand which affected the trade- and manufacturing-related services sub-sectors, growth moderated to 5.8% in the second half. The sustained expansion in domestic consumption activity, nevertheless, continued to benefit the services sub-sectors that are dependent on domestic demand, particularly the wholesale and retail trade; and communication sub-sectors.

The manufacturing sector rebounded strongly to register a growth of 11.4% (2009: -9.4%), driven largely by the strong growth in the first half-year, with expansion in both the export- and domestic-oriented industries. In the export-oriented industries, growth of the electronics and electrical products (E&E) cluster was underpinned by the revival of global corporate IT investments and higher consumer spending on electronics while growth of the primary-related cluster was in line with the recovery of the external environment. Robust growth in the domestic-oriented industries was supported mainly by strong domestic consumption activity. The pace of growth of the sector, however, moderated towards year-end due to slower external demand and the diminishing base effect.

The construction sector grew by 5.2% in 2010 (2009: 5.8%). Growth was supported mainly by the non-residential sub-sector, reflecting the construction of commercial properties and the upgrading and repair of public buildings. The civil engineering sub-sector continued to expand reflecting further progress in the implementation of infrastructure projects. Construction activity in the residential sub-sector declined, as fewer units of new residential properties were launched by developers, especially in the early part of 2010. Meanwhile, house prices increased by 6% on an annual basis during the first three quarters of 2010, almost twice the size of the average increase of 3.4% during 2000-09.

The agriculture sector (including forestry and fishing) expanded by 1.7% (2009: 0.4%). The production of food crops was sustained, while the production of industrial crops declined at a slower pace as rubber production picked up because of higher prices. Global agricultural commodity prices increased significantly during the year following stronger demand amid constrained supply due to adverse weather conditions. Prices of crude palm oil increased considerably during the year while rubber prices closed at record high on 30 December 2010.

The mining sector increased by 0.2% (2009: -3.8%) supported by higher production of natural gas to meet higher demand from major importers such as Japan and Taiwan, as well as the first full-year of exports to PR China. Crude oil output, however, continued to decline due mainly to lower production from the maturing oil fields and the shutdown of several oil fields for maintenance.

Conditions in the labour market improved in 2010 as reflected in lower retrenchments, higher number of vacancies and gains in employment. The unemployment rate declined to 3.2% of the labour force (2009: 3.7%), following stronger growth in employment (1.8%; 2009: 0.4%), compared to the growth in the labour force (1.3%; 2009: 0.8%).

Inflation increased during the year driven by supply factors arising from higher food and commodity prices and adjustments to administered prices. However, overall inflation remained low. Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), averaged 1.7% in 2010 (2009: 0.6%). Meanwhile, core inflation, an indicator of the demand-driven pressures on prices, moderated to 1.5% in 2010 (2009: 2.7%).

Malaysia's external position remained resilient in 2010, underpinned by a sizeable current account surplus and lower net outflows in the financial account. The acceleration of domestic demand provided impetus for the strong growth of gross imports which outpaced the growth of gross exports, leading to a slightly smaller trade surplus. The services account recorded a small surplus, supported by higher receipts from tourism as well as computer and IT services. Meanwhile, the lower net outflows in the financial account largely reflected the higher inflows of portfolio investment and foreign direct investment (FDI) given the improvement in both global and domestic economic conditions.

Gross exports expanded by 15.6% in 2010 (2009: -16.5%), with relatively stronger growth in the first half-year, supported by strong regional demand and to a certain extent, the low base effect of the previous year. The growth momentum, however, moderated in the second half, weighed down by the slower growth in manufactured exports, namely exports of electronics and electrical products (E&E). Commodity exports, on the other hand, remained resilient throughout the year and expanded by 26.9% (2009: -28.2%), supported by robust regional demand and high commodity prices. Gross imports grew by 21.7% (2009: -16.3%), with expansion across all major import categories, reflecting the pick-up in manufacturing activity and robust domestic demand.

The financial account recorded a smaller net outflow of RM21.9 billion (2009: -RM80.2 billion). Net portfolio inflows increased in line with regional trend given the prospects for strong growth as well as expectations for stronger regional currencies and higher interest rates. The improving global economic conditions and corporate profitability, as well as more favourable investment climate led to higher inflows of FDI. Direct investment abroad also rose as Malaysian companies continued to tap profitable opportunities overseas. However, other investment outflows, which largely reflected trade credits and placement of deposit abroad by residents, moderated during the year. As at 28 February 2011, the reserves level amounted to RM338.6 billion (equivalent to USD109.8 billion), which is adequate to finance 8.1 months of retained imports and is 4.3 times the short-term external debt. The international reserves held by the Bank remain usable and unencumbered.

Malaysia's external debt declined to RM226.3 billion or equivalent to 30.2% of GNI at the end of 2010. This reflected the decline in the medium- and long-term debt due to the net repayment of external loans by the private sector. Within the public sector, the NFPEs also registered a net repayment of external loans, including the maturity of several bonds. In contrast, the Federal Government recorded a net drawdown of external loans, primarily because of the issuance of the USD1.25 billion 5-year global sukuk in May 2010. The sukuk issuance was aimed at promoting Malaysia as a global Islamic financial hub as well as to establish a new US dollar benchmark for Malaysian corporates. During the year, the short-term external debt outstanding increased to RM79.4 billion, attributed primarily to higher non-bank private sector borrowings. The short-term external debt remained relatively small, accounting for only 10.6% of GNI, 24.2% of international reserves and 10.7% of goods and services exports.

Domestic Monetary and Financial Conditions in 2010

With the recovery becoming more entrenched, the focus of monetary policy during the early part of 2010 was on the need to normalise the extraordinary monetary stimulus undertaken in 2009. It was recognised that leaving the Overnight Policy Rate (OPR) at a low level for a sustained period could give rise to financial imbalances and create distorted incentives for economic agents, leading to the mispricing of risks, financial disintermediation and excessive credit growth. The OPR was, thus, gradually raised by 25 basis points each time in March, May and July 2010.

Monetary policy remained accommodative and supportive of growth. As the borrowing costs were still below the already low pre-crisis levels, financing conditions remained supportive of economic activity with growth in private sector financing remaining robust throughout 2010. Meanwhile, inflation remained low at 1.7% for the year as a whole. On the risk of a build-up of financial imbalances, assessments carried out throughout the year showed that growth in overall asset prices and credit were generally not excessive and continued to be in line with the improvements in the economy.

The larger and more volatile international financial flows to emerging economies also posed policy challenges in 2010. For Malaysia, these inflows have been manageable with no discernible signs of the inflows creating imbalances in the domestic economy and financial system. The ringgit exchange rate movements remained orderly, while sterilisation operations ensured that the impact of the excess liquidity on domestic monetary conditions was contained. The depth and resilience of the financial system allowed these funds to be better intermediated, while the healthy level of international reserves served to mitigate the risks arising from reversal of these flows.

The ringgit appreciated during the year, driven by the current account surplus and net portfolio inflows. Apart from common factors that attracted portfolio inflows to the region, there were also factors specific to Malaysia that provided impetus for such inflows and the further strengthening of the ringgit. The announcement of several key initiatives to transform the Malaysian economy and the further liberalization measures were among these factors. While the appreciation of the ringgit was generally orderly, it was punctuated by episodes of portfolio flow reversals, especially following the sovereign debt crisis in Europe in May and the developments in Ireland in November which induced heightened uncertainties. For the year as a whole, ringgit appreciated against the US dollar, euro and pound sterling, but depreciated against the Japanese yen.

The domestic equity market rose steadily in early 2010 but underwent a correction in May following developments in Europe. The market, however, rebounded in the second half of the year along with improved global market conditions, strong corporate performance and positive government measures. For the year as a whole, the FBM KLCI rose by 19.3% (2009 :45.2%).

Liquidity conditions in the banking system were ample throughout 2010. Private sector liquidity expanded at a measured pace, in line with real economic recovery and the resumption of foreign inflows. The sterilisation operations of the Central Bank were instrumental in ensuring that there was sufficient liquidity to support the economy, while not being excessive to result in misallocation of financial resources.

Financing conditions remained supportive of economic activity. The ready access to financing, relatively low cost of borrowing and ample liquidity in the financial system supported the demand for financing from both the private and public sectors. Net financing raised by the private sector through the banking system and the capital market expanded by 11.3% (2009: 8.4%) with strong demand from both the business and household sectors.

Outlook for the Malaysian Economy in 2011

The Malaysian economy is projected to grow by 5–6% in 2011. Growth is likely to improve during the course of the year with better growth performance in the second half of the year. The growth momentum will be underpinned by strong domestic demand, emanating primarily from private sector activity. Private consumption will be supported by favourable labour market conditions, higher disposable incomes, sustained consumer confidence and ready access to financing. Private investment is expected to remain strong, supported by capital spending by the domestic-oriented industries given the high levels of capacity utilisation and positive business confidence, as well as the implementation of key initiatives announced by the Government under the Economic Transformation Programme (ETP). Meanwhile, the public sector will remain supportive of growth, with higher capital spending projected in the second half of 2011. This is mainly resulting from the implementation of new projects and the acceleration of on-going projects to promote private sector activity.

On the supply side, all economic sectors are expected to expand in 2011, supported mainly by the continued growth of domestic demand. The services and manufacturing sectors are expected to grow at a more moderate pace given the high statistical base of 2010 with the expansion being driven by domestic demand dependent sub-sectors. Trade-related services and export-oriented manufacturing industries, however, will record slower growth, in line with the expected moderation in external demand. Meanwhile, growth in the agriculture and mining sectors is projected to strengthen, benefiting respectively from the expected turnaround in the production of industrial crops amid high commodity prices and the higher output of natural gas following the opening of two new gas fields. Further progress of on-going infrastructure projects and new projects due for implementation under the ETP will provide the impetus for the construction sector.

On the external front, the current account surplus is projected to amount to RM100.7 billion or 12.5% of GNI in 2011, reflecting a higher trade surplus and sustained services account surplus. The trade surplus is expected to emanate primarily from robust commodity exports supported by higher prices and sustained demand, particularly from the region. Meanwhile, the surplus in the services account will be driven by higher receipts from the travel account with the expected increase in tourist arrivals, especially from the region, amid active promotional campaigns and increased access to the country through the low-cost airline carriers. On the financial account, foreign direct investment inflows are expected to increase given the favourable economic outlook, better corporate earnings, rising business confidence, further improvements in global FDI flows and the Government's wide-ranging economic transformation projects. Direct investment abroad is expected to remain large as companies continue to seek new markets and business opportunities abroad.

The projected growth of the Malaysian economy is based on the expectation of moderate growth in advanced economies and a return to more normal growth rates by the Asian economies. Nevertheless, there remain risks to the growth projection which include sharper than expected deterioration in external conditions, significant volatility in capital flows given the continued uncertainty in international markets and higher than anticipated inflation emanating from supply-driven factors.

Labour market conditions are expected to remain positive in 2011, with the continued expansion in employment stemming primarily from growth in the domestic-oriented sectors. Job creation will be led by the services sector, particularly in the distributive trade, finance and insurance, and communication sub-sectors. In the manufacturing sector, despite a more moderate growth in the export-oriented industries, gains in employment will remain firm, supported by the expansion in the consumer-related and construction-related clusters. The unemployment rate is projected to remain at 3.2% of the labour force in 2011.

Headline inflation is expected to increase further in 2011 to average at 2.5 – 3.5%, driven primarily by the significant increases in global commodity and energy prices. There are also some incipient signs that domestic demand factors could result in possible upward pressure on prices in the latter part of the year in line with the sustained expansion in economic activity.

Economic and Monetary Management in 2011

Under this challenging global economic environment, the focus of policy is to support the sustainable growth of the economy while managing the risks to inflation. Fiscal policy will be geared towards preparing the nation towards becoming a developed and high-income economy. This will be achieved through measures to strengthen private investment and enhance infrastructure and the public sector delivery system. Among the measures announced in the 2011 Budget to facilitate private sector activity include the public-private partnership initiatives in the implementation of Government development projects, identification of high-impact projects for private sector investment and enhancing sources of private sector financing.

Monetary policy will continue to facilitate economic growth while managing the risks of inflation and the build-up of financial imbalances arising from high global liquidity, volatile capital flows and elevated commodity prices. Additional targeted instruments such as macro-prudential lending measures may be deployed if excessive risk-taking behaviour and asset price escalation were to occur within specific segments of the market. As a pre-emptive measure to manage the risk of an excess build-up of liquidity, the Statutory Reserve Requirement (SRR) ratio was raised from 1.00% to 2.00%, effective 1 April 2011.

Organisational Development and Governance

During 2010, the Bank continued with its effort in organisational development and promoting more effective governance. An important development was the operationalisation of Central Bank of Malaysia Act 2009 (CBA) which allows for development of a more robust governance framework. Under the CBA, two new Board committees, namely the Board Governance Committee and the Board Risk Committee were formed to undertake the oversight function of ensuring an effective governance and a more robust risk management process in the Bank. During the year, several initiatives were being implemented, aimed at promoting a strong risk management culture and pre-emptively managing risks that may affect the achievement of Bank's objectives. Efforts were also undertaken to strengthen Business Continuity Management (BCM). The Bank also undertook a strategic review of its 2009-2011 Business Plan to assess progress towards objectives and to realign resources where necessary to ensure more effective utilisation of resources.

The Bank continues to promote communication outreach and engagement with its stakeholders through various channels and initiatives. These include strategic engagements to enhance better understanding of developments in the economy and financial system and the Bank's monetary policy decisions, access to financing, financial literacy and financial inclusion. In an increasing challenging environment along with the high shareholders expectations, the Bank will continue to provide greater clarity on the Bank's role in the drive to achieve the economic transformation into a high income economy.

As part of the continuous effort to enhance regional and international cooperation, the Bank continues to be involved in technical collaboration with external agencies to other central banks from developing economies in the areas of institutional capacity building, Islamic finance and financial inclusion

Bank Negara Malaysia's Audited Financial Statements for 2010

The financial position of Bank Negara Malaysia, as audited and certified by the Auditor General, remained strong in 2010. Total assets of Bank Negara Malaysia amounted to RM390.2 billion with a net profit of RM6.2 billion for the financial year ended 31 December 2010. Bank Negara Malaysia declared a dividend of RM2 billion to the Government for the year 2010.