2010

MONETARY AND FINANCIAL CONDITIONS

INTERNATIONAL MONETARY AND FINANCIAL CONDITIONS

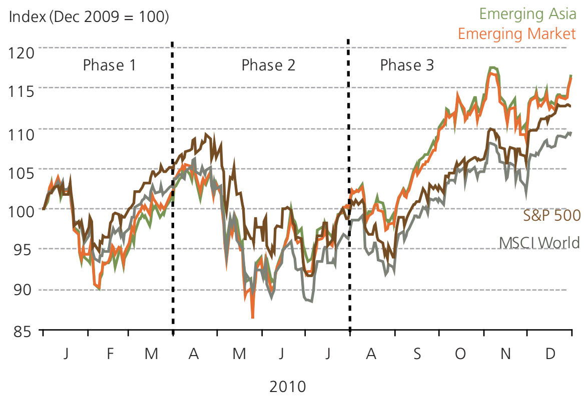
In 2010, developments in international monetary and financial conditions broadly followed three phases. In the first quarter, financial markets in both advanced and emerging economies continued the appreciating trend from 2009, building on the improvement in international economic conditions. In the second quarter, however, global financial markets entered a period of turbulence amid the escalating sovereign debt crisis in Europe and weaker growth prospects for both advanced and emerging economies. By August 2010, financial markets started to improve as policymakers in the advanced economies continued to maintain easy monetary conditions to strengthen the economic recovery. However, the sizeable injection of funds into the international monetary system, arising from this monetary easing, compounded the excess global liquidity situation, leading to a surge of capital flows into emerging economies. As a result, several emerging economies have implemented various measures to manage the risks that the large capital inflows posed for the domestic financial markets and the economy more generally.

Surge in global liquidity amplified the search for yield, leading to a sharp increase in capital flows into emerging economies

The year 2010 started on a positive note, building on the improvement in international economic and financial conditions towards the end of 2009. Global financial markets were on the uptrend, supported by accommodative monetary conditions and positive data on corporate earnings and economic activity. GDP growth in the US and several emerging economies during 4Q 2009 outperformed prior expectations. In February, the US Federal Reserve raised its discount rate by 25 basis points to 0.75%, a move seen by the markets as a first step towards unwinding the extraordinary liquidity measures implemented earlier during the global financial crisis.

Chart 2.1

Selected Equity Market Indices



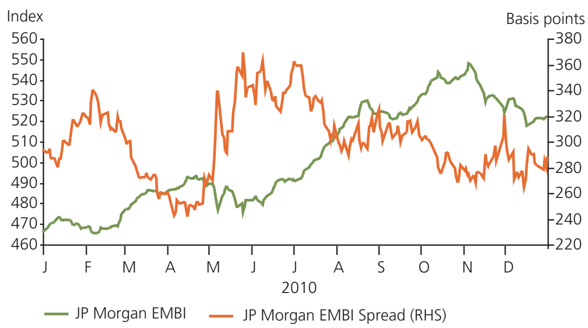
Source: Bloomberg

Despite tentative signs of recovery, it soon became clear that there were still unresolved issues in advanced economies. First, growth was far from entrenched, being driven mainly by temporary factors such as inventory restocking and policy support. Second, concerns over the fiscal positions of several peripheral European countries began to emerge, creating uncertainty in financial markets and dampening investor sentiment on growth prospects in the Eurozone.

In contrast, emerging economies showed firm signs of improvement in both the real and financial sectors. Output growth in several Asian countries outpaced pre-crisis levels. In addition to the strong rebound in equity markets, credit spreads in emerging markets narrowed, with the JP Morgan EMBI spread declining by 33 basis points in 1Q 2010. Some emerging economies started to exhibit incipient signs of overheating in the form of rapid and substantial price increases in certain asset markets, notably the property markets, as in the case of PR China, Hong Kong SAR and Singapore. The favourable outlook and the dissipation of the threat of an economic recession prompted several emerging

Chart 2.2

Emerging Market Bond Index (EMBI) and EMBI Bond Spreads



Source: Bloomberg

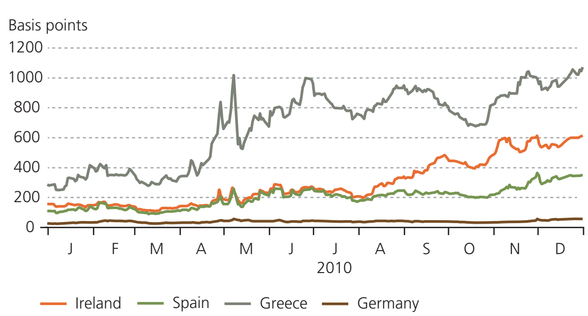
economies including PR China, India, Brazil, Malaysia and Vietnam to begin the process of normalising domestic monetary conditions.

By the second quarter of 2010, however, global financial markets began to encounter a period of turbulence. Financial conditions in the advanced economies deteriorated. The sovereign debt crisis in the euro area, which had surfaced earlier in the year, worsened considerably. Despite earlier measures to calm markets, concerns over the fiscal solvency of a number of peripheral European countries re-emerged, prompting downgrades on the sovereign debt ratings of these economies and further affecting investor confidence. Consequently, the credit default swap spreads of these peripheral countries widened significantly.

To stabilise the financial markets and improve liquidity, European policymakers embarked on a series of measures such as the creation of the €440 billion European Financial Stability Facility (EFSF) and the ECB's purchases of Eurozone government and private debt securities. Following the announcement of the EFSF, financial conditions started to stabilise. Yields on almost all euro sovereign bonds began to decline in April.

Chart 2.3

5-year Credit Default Swaps (CDS)



Source: Bloomberg

In the US, towards the end of the second quarter, there were signs that the recovery was losing traction, adding to the uncertainty and volatility of financial markets. Given the developments in the euro area and the unfavourable unemployment figures and the weaker growth prospects in the US, the threat of a double-dip recession in advanced economies became more pronounced. Additionally, the reregulation of the financial institutions after the crisis prompted a shift in investors' portfolio allocations to less risky assets. Consequently, while equity prices declined, bond yields in major developed markets fell.

Similarly, the recovery of the financial markets in emerging economies was punctuated by heightened investor risk aversion arising from developments in the advanced economies. The effects were compounded by the risk of weaker growth for emerging economies in 2H 2010 as exports were negatively affected by the slower growth prospects of the advanced economies. PR China's growth was also expected to moderate due to its policy tightening. Equity outflows from emerging markets, for example, totalled USD1.6 billion during May and June 2010[1]. The MSCI Emerging Asia and Emerging Market indices fell by 5.9% and 9.1%, respectively, during the period. This shift in funds was followed by a decline in the yield for the 10 year US Treasuries by 85 basis points while gold prices rose by 11.6%.

By August 2010, financial conditions in the advanced economies began to show signs of improvement. This improvement coincided with growing expectations that some central banks would ease monetary policy further to address concerns about the strength and sustainability of economic recovery. This expectation was later realised when the Bank of Japan and the Federal Reserve announced additional quantitative easing (QE) measures through financial asset

[1] Source: Emerging Portfolio Fund Research (EPFR) Global

purchases of USD60 billion and USD600 billion respectively. There were also visible signs that economic conditions were starting to improve as evidenced by the increase in private consumption and better employment prospects. These factors improved investor confidence and revived financial market trading activity globally. With the global markets awash with liquidity, amid low levels of interest rates in the advanced economies, the search for yields led to a steady rise in financial and commodity markets. Between August and December 2010, the S&P 500 index rose by 19.9%. Volatility in the financial and commodity markets, as proxied by the VIX index[2], dropped significantly and returned to levels prior to the sovereign debt crisis fallout earlier in the year. The uptrend in commodity prices also accelerated, with oil prices reaching USD91 per barrel in December 2010.

The surge of global liquidity and the search for yield also led to a sharp increase in foreign portfolio investment flows into emerging economies. As a result, emerging market currencies, in particular the Chilean Peso, South African Rand and New Taiwanese Dollar, appreciated strongly against the USD by 10.6%, 10.0%, and 9.2% respectively between August and December 2010. Better growth prospects and expectations of further currency appreciations added to the interest in emerging markets. The build-up of liquidity in the domestic financial system from the surge in capital inflows, however, raised concerns over the possible formation of asset price

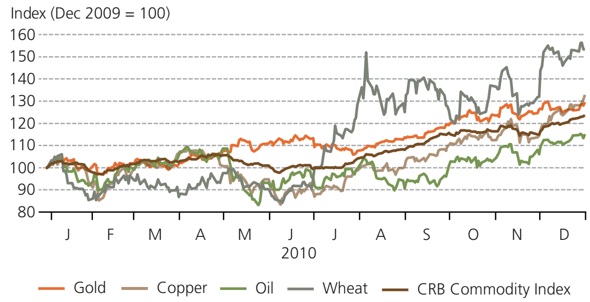
Chart 2.4

Measures of Volatility

Source: Bloomberg

Chart 2.5

Commodity Prices



Source: Bloomberg

bubbles in emerging economies. Some emerging economies, such as Indonesia, Chinese Taipei, South Korea and Brazil introduced policy measures to avoid undue risks related to the large capital flows into their domestic financial and property markets. These measures included taxing inflows, increasing the foreign exchange reserves that banks are required to hold, and liberalising outflows.

Towards year end, stronger signs of inflation began to emerge. The rapid rise in commodity prices and the increase in global food prices led to the intensification of supply driven inflation pressures. Together with the favourable outlook for growth in emerging economies, this prompted some central banks to resume the process of normalisation of monetary conditions. Bank Indonesia, the People's Bank of China, and the Reserve Bank of India began to raise policy interest rates, with several others indicating the intention to do so in the future. The pace, timing and magnitude of policy rate adjustments would, however, differ across countries and regions given the differences in the economic and financial conditions.

It is nevertheless evident that despite the recovery in economic and financial conditions towards the end of 2010, financial conditions were still very much dependent on policy support. In November 2010, Ireland sought a financial rescue package from the EU-IMF, highlighting the continued fragility of economic and financial conditions in the advanced economies. The uneven pace of economic recovery and the divergent monetary stances between the advanced and emerging economies is likely to persist. Rapid and sizeable shifts in capital flows will continue to pose a policy challenge to financial and monetary stability in emerging economies.

[2] VIX is a measure of implied volatility of S&P 500 stock options. It represents the market expectation of stock market volatility over the next 30 day period.

DOMESTIC MONETARY AND FINANCIAL CONDITIONS

Exchange Rate

The ringgit strengthened during the year. As in the previous years, the underlying trend of the ringgit continued to be driven by the positive net trade balance. Ringgit developments, however, were heavily influenced by significant two-way flows of portfolio investments arising from a combination of external and domestic factors. The large gross portfolio inflows during the year were partially offset by the large gross portfolio outflows, resulting in net inflows of RM44.9 billion. For 2010 as a whole, the ringgit appreciated by 11.1% against the US dollar, reaching to a peak of 3.0833 per US dollar on 4 November.

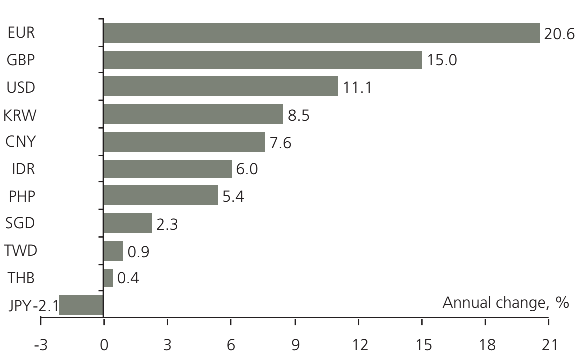
The ringgit appreciated during the year amidst volatile global financial conditions

The surge in portfolio inflows was driven by a combination of "pull" and "push" factors. The dominant "push" factor throughout the year was the expectation of a prolonged low interest rate environment in the advanced economies, which diverted the interest of investors towards higher yielding assets in emerging market economies. This was accentuated by the sizeable liquidity injection from unconventional asset purchases by monetary authorities in the advanced economies. There were also strong "pull" factors from the region due to the stronger recovery prospects and the expectations of further currency appreciation. These two factors were broadly common to all regional countries. For Malaysia, there were also specific factors. First, the Government's announcement of the New Economic Model (NEM), the Economic Transformation Program (ETP) and several other key initiatives to transform the Malaysian economy into a high income nation by 2020 has been received positively by investors. Second, strong GDP growth and the further liberalisation of foreign exchange administration rules during the year also provided the impetus for further strengthening of the ringgit.

The appreciating trend of the ringgit and other regional currencies was punctuated by a number of episodes of reversals arising mainly from global developments such as the sovereign debt and banking system concerns in Europe. Heightened uncertainties from such developments, coupled with the rapid and sizeable shifts in global liquidity from the advanced economies into emerging market economies resulted in volatility remaining elevated for ringgit and other regional currencies during the year. Two of the more significant episodes of reversals were the sovereign debt crisis in Europe in May, and the banking system concerns in Ireland in November. These events

Chart 2.6

Summary of Malaysian Ringgit Performance Against Major and Regional Currencies in 2010

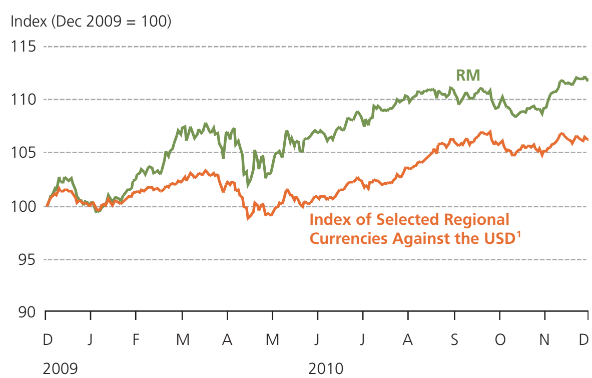


Note: (+) indicates an appreciation of the ringgit against foreign currency

Source: Bank Negara Malaysia

Chart 2.7

Exchange Rate of the Malaysian Ringgit (RM) and Selected Regional Currencies Against the US Dollar



[1] Regional currencies: Chinese renminbi, Indonesian rupiah, Korean won, Philippine peso, Singapore dollar, New Taiwanese dollar and Thai baht. Each currency carries equal weight

Note: An increase in the index represents an appreciation of the ringgit or of selected regional currencies against the US dollar

Source: Bank Negara Malaysia

coincided with net portfolio outflows from Malaysia of RM5.2 billion and RM5 billion in May and November respectively. Within the region, measures introduced by several countries to tighten monetary and credit conditions throughout the year and heightened geopolitical tensions in the Korean peninsula in November also raised concerns about possible disruptions in the regional financial markets and the overall pace of economic recovery.

Relying on the exchange rate as a tool for competitiveness is unsustainable and will harm the economy in the long run

Against other major currencies, the ringgit strengthened against the euro (20.6%) and pound sterling (15%), but weakened against the Japanese yen (-2.1%). The euro's weakness was apparent throughout 2010 amidst sovereign debt and banking system concerns in Europe. Against regional currencies, the ringgit broadly appreciated. Although the ringgit moved in line with other regional currencies, factors specific to each country led to variations in performance between regional currencies. The won was especially affected by the persistent tension in the Korean peninsula as investors withdrew funds amid concerns that a prolonged conflict could disrupt financial markets and derail economic recovery.

Chart 2.8

Exchange Rate of the Malaysian Ringgit (RM) Against Major Currencies

Note: An increase in the index indicates an appreciation of ringgit against the currency

Source: Bank Negara Malaysia

There were some concerns that the strength of the ringgit and the volatility of exchange rates would have adverse implications on the exports sector and the economy. Given the diverse and highly open nature of the Malaysian economy, different economic agents are likely to be affected differently by changes in the ringgit exchange rate against any particular currency (*see white box 'The Impact of Exchange Rate Appreciation on Malaysia Trade'*). As global currency volatility is likely to remain elevated, firms may need to take this into consideration. Those adversely affected may need to re-strategise to become more efficient and competitive or even to venture into other opportunities. Those benefiting from the strengthened currency should seize the opportunity to further improve their competitiveness and build the necessary buffers to cope with times when the situation reverses. Using exchange rate as a tool for competitiveness is very risky and unsustainable and will harm the economy in the long-term as it might create distortions, causes imbalances and lead to trade protectionism. Therefore, orderly foreign exchange market conditions that avoids excessive volatility in the ringgit exchange rate is an important policy objective of the Bank.

Interest rates, bond yields and equity prices

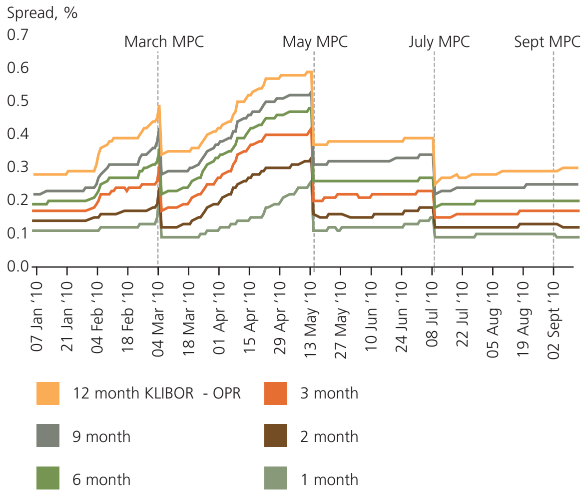
Interest rates rose in 2010 from historic lows due to the Bank's decision to normalise monetary conditions to prevent the risk of financial imbalances that could undermine the recovery process. The Overnight Policy Rate (OPR) was raised on 4 March, 13 May and 8 July, by 25 basis points each time, bringing the cumulative OPR adjustments for the year to 75 basis points. This was half of the 150 basis points cut in the OPR undertaken in 2008/09 to support domestic demand during the global financial crisis. As such, although retail lending rates rose following increases in the OPR, they are still at levels that support domestic demand and economic recovery.

Interest rates were normalised to prevent the risk of financial imbalances, but has remained below pre-crisis levels in 2010

Following the OPR increase, the overnight interbank rate in the money market rose from 2.00% on 1 March 2010 to 2.71% on 9 July 2010.

Chart 2.9

KLIBOR – OPR Spread



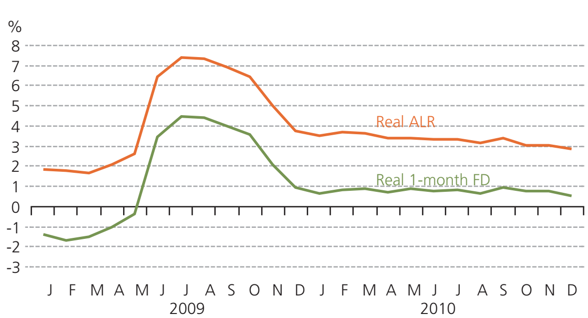
Source: Bloomberg

Interbank rates of other tenures also increased. KLIBOR rates rose in line with market expectations of higher interest rates. Notably, the spread between KLIBOR rates and the OPR increased in anticipation of interest rate increases at the March, May and July Monetary Policy Committee (MPC) meetings, and were relatively stable prior to the September MPC meeting when Bank Negara Malaysia paused raising the policy interest rate. This reflected the clear signal by the MPC that the prevailing level of the OPR was appropriate.

As intended by the MPC, the increase in the OPR resulted in retail deposit rates being revised upwards. Interest rates on fixed deposits increased by between 47-77 basis points. Given the modest inflation in 2010, depositors earned positive real returns on their savings throughout the year.

Chart 2.10

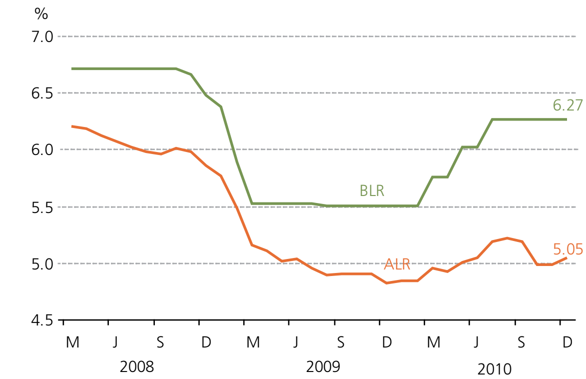
Real Deposit and Lending Rates



Source: Bank Negara Malaysia

Chart 2.11

Commercial Banks' Lending Rates (at end-period)



Source: Bank Negara Malaysia

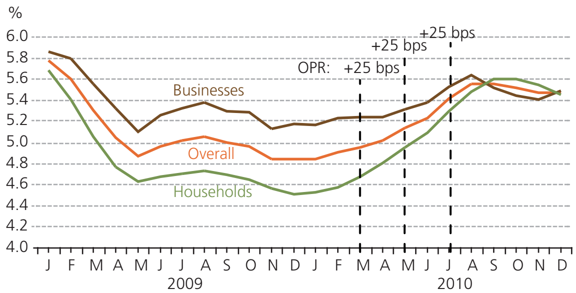
Reflecting the high pass-through of the OPR hikes to money market interest rates, banks responded by increasing retail lending rates to households and businesses. The benchmark lending rate, as measured by the average base lending rate (BLR) of commercial banks, increased by 76 basis points to 6.27%, as at end-July 2010. The adjustment in the BLR was prompt, with all banks increasing their respective BLRs within 6 days of the OPR adjustments.

Accordingly, lending rates on new loans were also revised. This was evidenced by the 78 basis points increase in average lending rates (ALR) on new loans approved, from 4.91% at end-February to 5.69% at end-August. The increase in lending rates on new loans was more pronounced in the household sector, which registered higher lending rates for all purposes, with the exception of credit cards, ranging between 63–95 basis points. Businesses also incurred higher cost of borrowing post normalisation. However, the magnitude of the increase was more modest as some businesses benefited from improved credit worthiness and lower risk premiums as economic conditions continued to improve in 2010.

Nevertheless, the cost of financing to businesses and households remained supportive of economic activity. Despite the increase in interest rates, retail lending rates remained below pre-crisis levels. Specifically, nominal retail lending rates to businesses remained on average 61 basis points below pre-crisis levels, as at end-December 2010. Similarly, lending rates to households were lower than pre-crisis levels by 38 basis points.

Chart 2.12

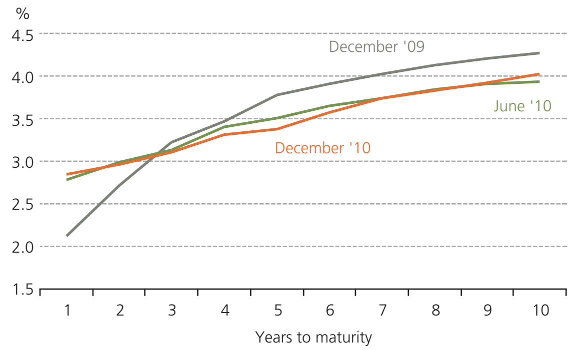
ALR on New Loans Approved (3-month moving average)



Source: Bank Negara Malaysia

Chart 2.14

MGS Benchmark Yield Curve



Source: Bank Negara Malaysia

The benchmark Malaysian Government Securities (MGS) yield curve flattened in 2010, as the short-term and long-term yields showed divergent trends. Yields on bonds of shorter maturities (1-year and below) increased in response to the normalisation of the OPR, similar to the money market and retail lending rates. The pass-through was almost one-for-one, with yields on the 1-year MGS increasing by 74 basis points from January to end-July 2010. By contrast, long-term yields declined in 2010 despite the increase in the OPR on strong demand for MGS, especially from non-residents. In addition to expectations for ringgit appreciation and the search for yield, demand was also supported by benign inflationary expectations.

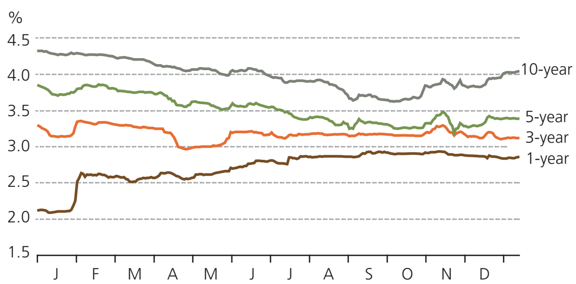
Non-resident holdings of domestic bonds in 2010 rose to RM121 billion from RM69 billion in 2009, accounting for 15.6% of total outstanding bonds at end-December 2010. Overall, yields on the 5-year and 10-year MGS for the year declined by 40 and 25 basis points respectively. This contributed to reducing the overall borrowing costs in the debt market, as corporate bond yields are benchmarked against MGS yields.

The benchmark yield curve flattened in 2010 and helped reduced borrowing costs as corporate bonds were benchmarked against long-term MGS yields

Although yields were lower by the end of the year, there was a clear upward drift in long-term yields on expectations of higher Government borrowings

Chart 2.13

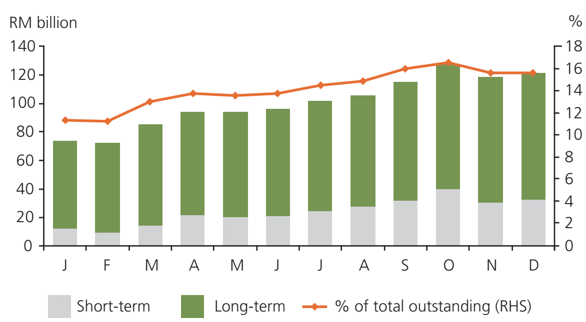
MGS Yields in 2010



Source: Bank Negara Malaysia

Chart 2.15

Outstanding Debt Securities Held by Non-residents in 2010



Source: RENTAS, Bank Negara Malaysia

in 2011 following the announcement of Budget 2011 in October. At the same time, rising global inflationary expectations due to higher commodity prices also contributed to the higher yields. From 15 October to end-December 2010, yields on the 10-year MGS recorded an increase of 37 basis points. On the other hand, short-term yields were largely unaffected by the Budget 2011 announcement, reflecting the lower maturity risk associated with short-term debt securities.

Cost of PDS financing remained low as yields declined following positive sentiment on the prospects for the economy

In the private debt securities (PDS) market, financing costs were kept low, as PDS yields are typically benchmarked against long-term MGS yields. While PDS yields were generally unchanged in the first half of 2010, yields declined in the second half of the year in line with the decrease in benchmark yields. The 5-year AAA and AA rated papers both declined by 17 basis points, while A rated papers declined by 14 basis points.

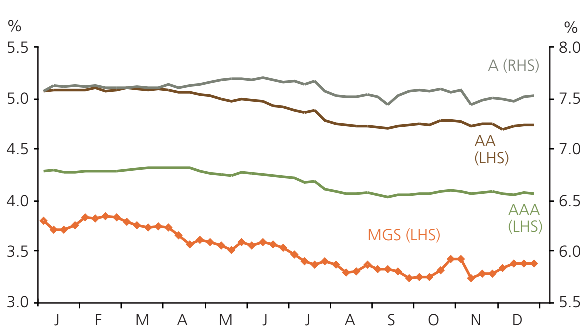
Sentiment in the PDS market continued to improve in line with the strength of the domestic economy, as evidenced by the improved liquidity conditions. Turnover in the PDS market increased to RM89.3 billion in 2010, from RM59.9 billion in 2009. In addition, the number of negative ratings actions declined substantially to 106 in 2010 from 170 in 2009. The improved conditions in the PDS market also helped ensure a conducive environment for debt financing in 2010.

The FBM KLCI recorded significant gains amidst stronger corporate earnings, robust economic growth and portfolio inflows

The domestic equity market rose steadily in early 2010, supported by stronger corporate earnings, robust economic growth and portfolio inflows. Similar to other regional markets, Malaysia experienced greater inflows given its more attractive growth trajectory. By May, however, global market sentiments were affected considerably by the developments in Europe. Subsequently, the benchmark FTSE

Chart 2.16

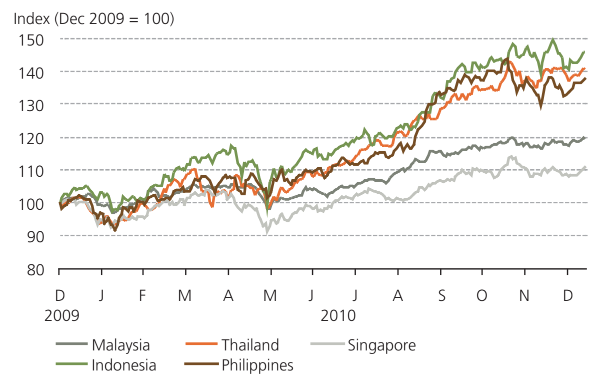
5-year MGS and 5-year PDS Yields in 2010



Source: Bank Negara Malaysia

Chart 2.17

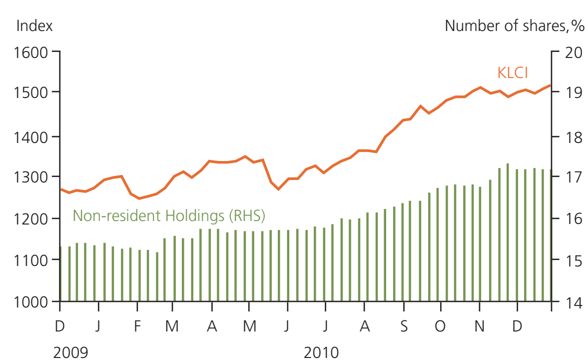
Regional Indices



Source: Bloomberg

Chart 2.18

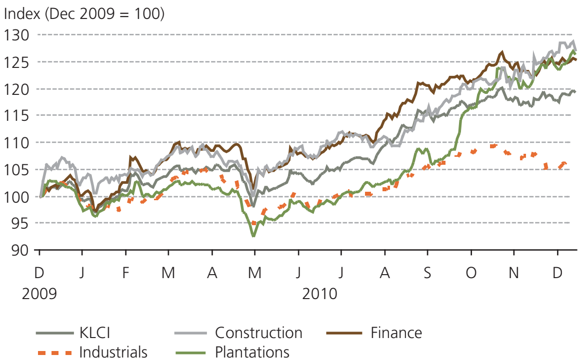
Shares Held by Non-residents in the KLCI



Source: Bursa Malaysia

Chart 2.19

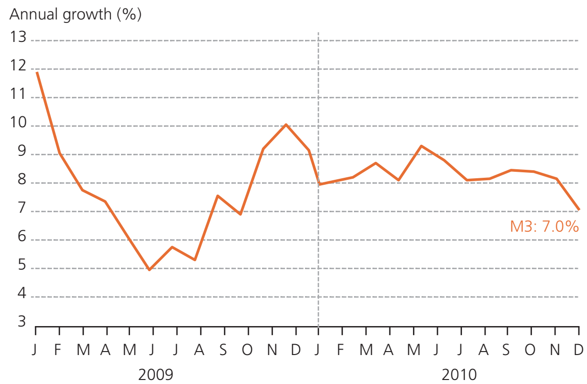
KLCI and Bursa Malaysia Sectoral Indices



Source: Bloomberg

Chart 2.20

Broad Money, M3



Source: Bank Negara Malaysia

Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) underwent a correction, as did other regional markets.

The FBM KLCI resumed its rise in the second half of the year as global market conditions stabilised, supported by increased non-resident purchases. This was driven mainly by expectations of a firmer ringgit, amidst a positive reception to the further liberalisation of the foreign exchange administration rules announced in August. Meanwhile, the search for higher returns in emerging economies, including Malaysia, was amplified by expectations and the eventual implementation of a second round of quantitative easing by the US Federal Reserve. Equity prices were further boosted by strong sectoral performances, with rising earnings of plantation companies due to higher commodity prices, while construction-related stocks benefited from the announcement of several major Economic Transformation Programme (ETP) projects. Several Government initiatives to increase the velocity and liquidity in the local index, such as the divestment of Khazanah Nasional Berhad shareholdings in major companies, also provided additional impetus to the market. In 2010, the FBM KLCI rose by 19.3% (2009: 45.2%).

Liquidity and Monetary Aggregates

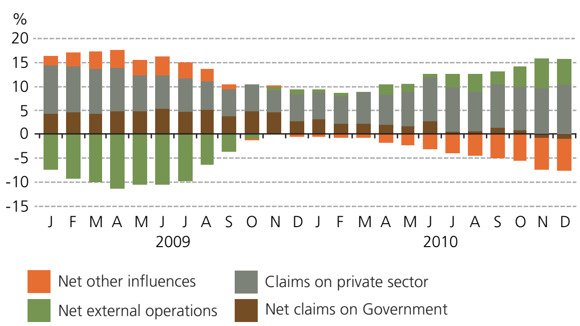
Liquidity conditions in the banking system were ample throughout 2010. The private sector liquidity expanded at a measured pace, in line with real economic recovery and resumption of foreign inflows. Notably, the normalisation of the OPR and consequent upward adjustments in retail lending rates did not dampen private sector liquidity expansion.

Private sector liquidity, as measured by broad money (M3), expanded at a measured pace of between 7.0% and 9.3% throughout the year. The main factor underpinning the expansion in broad money was higher credit extension by the banking system to businesses and households. Private sector liquidity also increased as a result of the higher foreign capital inflows. The expansion in M3, however, was partially mitigated by withdrawals of deposits by the private sector for the purchases of Bank Negara Monetary Notes (BNMNs). This was reflected in the moderation of "net other influences".

In the banking system, ample liquidity conditions prevailed at both the market and institution levels. All banks operated from a position of surplus liquidity with net placements of funds with Bank Negara Malaysia. The large number of banking institutions with surplus liquidity also implied that

Chart 2.21

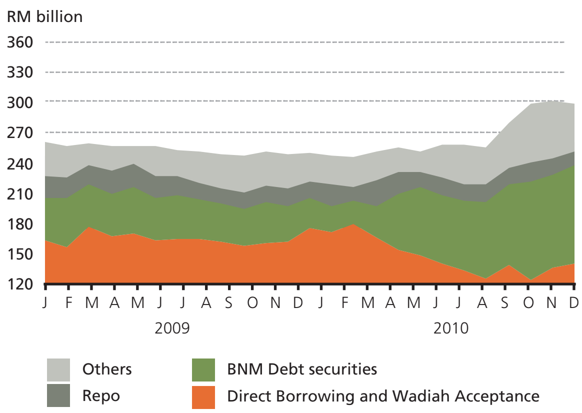
Contribution to M3 Growth



Source: Bank Negara Malaysia

Chart 2.22

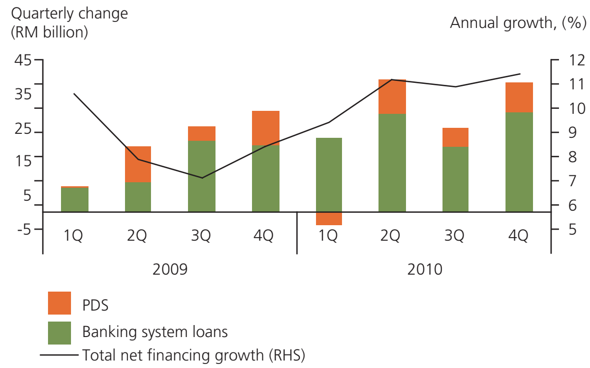
Outstanding Liquidity Placed with BNM (at end-period)



Source: Bank Negara Malaysia

Chart 2.23

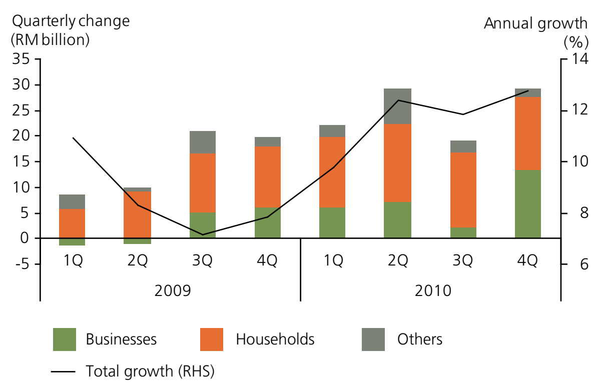
Total Net Financing to the Private Sector through Banking System Loans and PDS



Source: Bank Negara Malaysia

Chart 2.24

Loans Outstanding by Customers



Source: Bank Negara Malaysia

the Malaysian banking system had a low reliance on wholesale funding.

Bank Negara Malaysia conducted operations in the interbank money market to manage the surplus liquidity. Large foreign inflows of liquidity in the second half of the year were sterilised by the Bank to avoid overly expansionary liquidity conditions. This was achieved through the use of a wide range of monetary instruments in the Bank's sterilisation operations, including direct borrowing, repos and the issuance of BNMNs.

FINANCING OF THE ECONOMY

In 2010, financing conditions remained conducive and supportive of economic activity. The easy 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.

Financing expanded by 11.3% in 2010 driven by the economic recovery and supported by accommodative financing conditions

Growth of private sector financing, which has been on an uptrend since the second half of 2009, picked up speed in the first half of 2010. The trend was in tandem with the strong economic recovery recorded during the period. Financing growth subsequently stabilised at 10% as economic activity moderated toward the second half of the year. For the year as a whole, net financing raised by the private sector through the banking system and the capital market expanded by 11.3% (2009: 8.4%). In terms of sectors, the expansion in financing during the year was broad-based with strong demand from both the business and household sectors.

Total financing to the business sector improved, growing by 8.4% in 2010 (2009: 6.3%), with financing extended mainly to the *finance, insurance and business services; manufacturing, real estate; wholesale, retail, restaurants and hotels (WRRH)* and *electricity, gas and water supply* sectors. Banking system loans to businesses expanded by 9.4% in 2010 (2009: 3%). The buoyant demand for financing by businesses was underpinned by improved sales and investment. The increased business activity resulting from higher domestic demand led to more loans being disbursed for the purpose of working capital, increasing at an annual rate of 11% (2009: -1.4%). Loans disbursed for investment purposes also expanded, in particular, for the *purchase of non-residential property* and *transport vehicles*, increasing by 50.5% and 48.8% respectively in 2010 (2009: -10.8% and -4.1%). Corporate expansion activity, especially merger and acquisitions in the *finance, insurance and business services* sector was a further catalyst to financing activity in the second half of 2010. The *manufacturing* sector, however, showed a moderation in its demand for loans, especially for working capital purposes, in the second half of the year. This reflected mainly slower production amidst weaker external demand.

Meanwhile, loans to the household sector increased further by 13.4% in 2010 (2009: 9.8%), with more loans being extended for the *purchase of residential and non-residential properties*; *purchase of securities, passenger cars, personal loans* and *credit cards*. The expansion in household loans reflected the strong growth in consumption expenditure, which in turn was driven by the steady increase in incomes of households, because of stable employment prospects and rising wages. For property loans, in addition to the attractive interest rates, the higher demand was supported by pent-up demand. In November, the Bank announced the implementation of a maximum loan-to-value (LTV) ratio applicable to the third and subsequent house financing facilities taken out by a borrower. The measure aimed at moderating the excessive investment and speculative activity in specific locations of the residential property market.

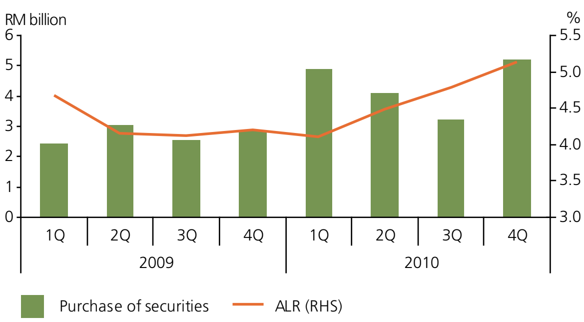
Loan applications for the purchase of passenger cars also continued to increase as households locked-in borrowings at relatively lower rates. This was further supported by the introduction of several new popular car models and other attractive offers for new car buyers.

Notwithstanding the strong financing growth in 2010, there was limited evidence of credit growth being excessive. The overall level of household indebtedness remained at a prudent level. This was supported by the improved capacity of households to absorb adverse shocks, despite the growth in debt levels. Household liquid financial asset to debt ratio increased from 150.9% at end-2009 to 153.9% at end-2010. The ratio of non-performing household loans (NPL) was also low at 2.3% (end-2009: 3.1%). While there was an initial increase in loans extended to individuals for the purchase of securities, mainly to finance the purchase of Amanah Saham Bumiputra (ASB), it moderated subsequently following the normalisation in interest rates. The demand for personal loans also moderated in the second half of the year given the higher lending rates.

In the private debt securities (PDS) market, although the total new issuances were lower in 2010 (2010: RM52.1 billion; 2009: RM58.6 billion), funds raised to finance new investments increased to RM13.5 billion (2009: RM8.7 billion). The PDS issuances were dominated largely by firms in the financial sector. The funds raised in the equity market amounted to RM32.1 billion (2009: RM26 billion). The larger funds raised reflected issuances of several large initial public offerings (IPOs) in line with improved market sentiments.

Chart 2.25

Loan Applications and ALR on New Loans Approved for the Purchase of Securities

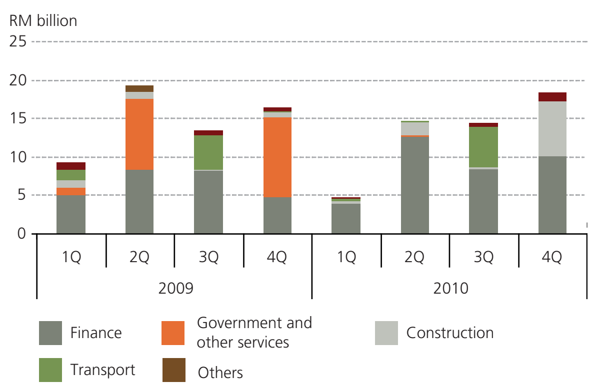


Note: The higher loans in 4Q reflected borrowing for the subscription of two new IPO listed in end-2010

Source: Bank Negara Malaysia

Chart 2.26

Gross PDS Issued by Sector



Note : Data excludes Cagamas bonds and issuances by non-residents

Source: Bank Negara Malaysia

The Impact of Exchange Rate Appreciation on Malaysian Trade

In 2010, the ringgit appreciated by 11.1% against the US dollar. Given that the US dollar is a key currency used globally to conduct trade and investment, this box article discusses how the appreciation would impact the Malaysian economy. The United States is Malaysia's fourth largest trade partner and accounts for 10%[1] of total trade. In this regard, the real effective exchange rate (REER)[2] is a better gauge of Malaysia's overall competitiveness as it takes into account changes in Malaysia's competitiveness vis-à-vis all of Malaysia's major trading partners and not just the United States. By this measure, the REER appreciated by a more moderate rate of 5.9% in 2010. The moderate REER appreciation has allowed the economy to better absorb and adjust to the stronger ringgit exchange rate.

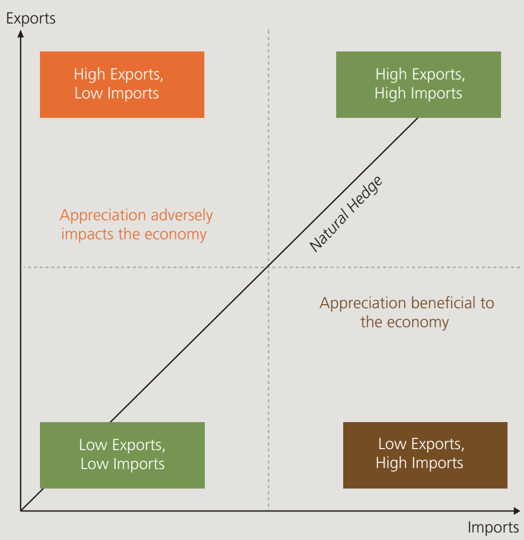
The sectoral impact of ringgit appreciation on trade

The very nature of international trade, which includes both importers and exporters, results in both those who are advantaged and disadvantaged when a currency appreciates or depreciates. Generally, export-dependent sectors in competitive international markets tend to be adversely affected by an exchange rate appreciation. The extent of the impact, however, depends on whether the decline in their exports proceeds can be offset by cheaper imported inputs. When the ringgit appreciates, firms that rely more on export revenue but source their inputs locally (i.e. pay in ringgit) will face a more significant impact on their profit margins. This is especially the case if these firms are price-takers in the international markets. In contrast, firms that source their inputs from abroad but supply the final product domestically will gain from a strong ringgit.

On a relative basis, given the manufacturing sector's large contribution to total output, the sector appears to be most affected as more than 50% of the sector is export-oriented. As Malaysia is part of the global manufacturing network, a majority of Malaysia's manufacturers import raw and processed materials and turn them into intermediate goods before exporting them to another destination for further processing or final consumption. Due to such production linkages, there is a strong co-movement between exports and

Chart 1

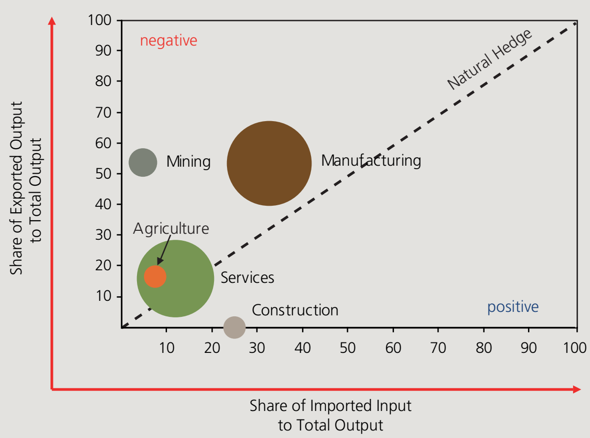
Gainers and losers of exchange rate appreciation



Source : Bank Negara Malaysia

Chart 2

Relative importance of exports and imports by sector



Notes : 1 Derived from the 2005 input-output table
2 Bubble represents sector's output relative to total output of the economy (RM1.6 trillion)

Source : Bank Negara Malaysia

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[1] As at December 2010

[2] Refers to the weighted average of the ringgit against the currencies of Malaysia's major trading partners, adjusted for differences in inflation rates.

imports, which in turn makes trade more responsive to global demand rather than to ringgit performance alone. The close co-movement between exports and imports also broadly serves as a natural hedge for manufacturing firms, thereby limiting the overall impact of exchange rate movements.

The construction sector, on the other hand, stands to gain the most given that it is domestic-oriented. All of its output is priced and consumed domestically, with some of the inputs sourced from abroad. The lower cost of imported inputs, together with stronger demand for properties in domestic markets, has helped construction firms to register stronger operating surplus during the year.

The overall impact on the services sector is broadly balanced. The majority of industries in the services sector will benefit from an exchange rate appreciation given the high import content and limited reliance on exports. The positive impact, however, is partly offset by the adverse effects on the business services industry, as shared services and outsourcing mostly involve exports of services, driven mainly by the Multinational Corporations (MNCs) in Malaysia. These MNCs mostly source inputs domestically in ringgit and export their services internationally in foreign currency.

To assess the overall impact of ringgit appreciation on the economy, Bank Negara Malaysia conducts regular surveys to compile views from various industry players. In a survey conducted in 4Q 2010 that covered 177 companies[3], 38% of the respondents indicated that the appreciation did not have a significant impact on their profit margins. Another 34% of the respondents indicated that the ringgit appreciation would have some adverse impact on their profit margins, while 28% indicated a more favourable impact on their profit margins.

The survey also showed that should the ringgit appreciate further, the impact on industry players are expected to be broadly contained. The majority of respondents suggested that the impact would be either favourable or neutral. Nevertheless, about 35% of respondents indicated an adverse impact on their profit margins arising from further ringgit appreciation.

Implications for businesses
With challenges, come opportunities. While ringgit appreciation could result in some firms facing a decline in profitability, it does open up other growth opportunities. In particular, cheaper costs of imported inputs and capital would facilitate firms' transformation from labour to capital intensive production, which could

Chart 3

Quarterly sectoral survey 4Q 2010: Impact of ringgit appreciation on profit margins

Source: Bank Negara Malaysia

[3] Manufacturing (109), Non-financial services (43), Construction (25)

enhance firm productivity and ultimately profitability. Increased productivity would encourage firms to pay higher wages and promote a more vibrant labour market with a larger pool of highly skilled workers. Higher wages in turn, would empower domestic consumption and open up more opportunities for non-tradable sectors to flourish. This would eventually facilitate the reorientation of the Malaysian economy from being trade-dependent towards one that is driven mainly by domestic demand.

In the medium to long-term, businesses should evaluate whether the strategies being pursued are sustainable and robust to changing circumstances. In the short-term, those adversely affected should undertake steps to hedge their foreign currency exposure. They may also need to re-strategise or even venture into other opportunities. As exchange rate movements are transitory in nature, those benefiting should not be complacent and rely on either a stronger or weaker ringgit, but should instead improve their operations further to cope with the more challenging times when the situation reverses.

Conclusion

The recent ringgit appreciation impacted various sectors differently. While the impact on the broad economic sector was either neutral or positive, there were some sectors that were adversely affected. For a highly open economy like Malaysia, with trade in 2010 accounting for 157.8% of GNI, such an outcome is expected. In this regard, the uncertain external environment makes exchange rate volatility unavoidable. Subject to global conditions, the ringgit would continue to strengthen as the underlying economic fundamentals continue to improve. The Bank will focus on maintaining orderly market conditions and ensuring that the ringgit is aligned with economic fundamentals. Businesses, on their part, must be prepared to adapt to the changing environment, taking into account that such changes in relative prices, if sustained, are a signal for a shift in real resources out of sectors with declining comparative advantage into sectors offering new opportunities with strong comparative advantage.