Monetary and Financial Conditions

For an economy with a high degree of economic and financial openness, developments in the global financial markets that drive capital flows have a profound influence on the domestic monetary and financial conditions. This is particularly the case for Malaysia given that its integration with the global economic and financial system is now greater than it has ever been (see Box on Openness). The cyclical movements and trends in global asset allocation and their impact on financial and real asset prices will have significant implications on domestic liquidity conditions, exchange rates, relative prices and the cost of financing.

OVERVIEW OF INTERNATIONAL MONETARY AND FINANCIAL CONDITIONS

In 2006, developments in the global financial markets were driven by the positive outlook for global economic growth and heightened inflation risks, and their implications on the direction of monetary policy, in an environment of continued excess liquidity. The strong outlook on growth and the possible inflationary implications of higher commodity prices had heavily influenced the monetary policies of the major world economies. Against the backdrop of high global liquidity, there was greater risk taking as investors searched for higher returns, resulting in significant capital flows into the emerging markets. As in other regional countries, monetary and financial conditions in Malaysia were sensitive to the variations in international capital flows.

Global economic developments were generally positive at the beginning of 2006. In Japan, there were early indications that the deflationary forces that were present in the economy for almost a decade had begun to reverse, resulting in the potential for rising interest rates. Economic growth in the US remained favourable despite the consecutive increases in the Fed Funds rate throughout 2005. The Euro area growth also showed improved resilience in the face of potentially higher inflation from the rising commodity prices.

In the emerging market economies, macroeconomic fundamentals also remained strong. The export sector for most emerging economies and thus, GDP growth, performed well, driven by the sustained external demand, stronger commodity prices and strengthened domestic private sector demand. Many emerging economies also exhibited improved fiscal positions as a result of progress in the fiscal consolidation process. These developments, which occurred against the background of increasing financial system deepening in the emerging economies, raised the attractiveness of the emerging markets as an investment destination at a time when the world financial system was awash with liquidity. As the year unfolded, the general optimism of global investors towards the strengthening of the macroeconomic fundamentals in the emerging markets continued to be firm despite occasional bouts of uncertainty and volatility.

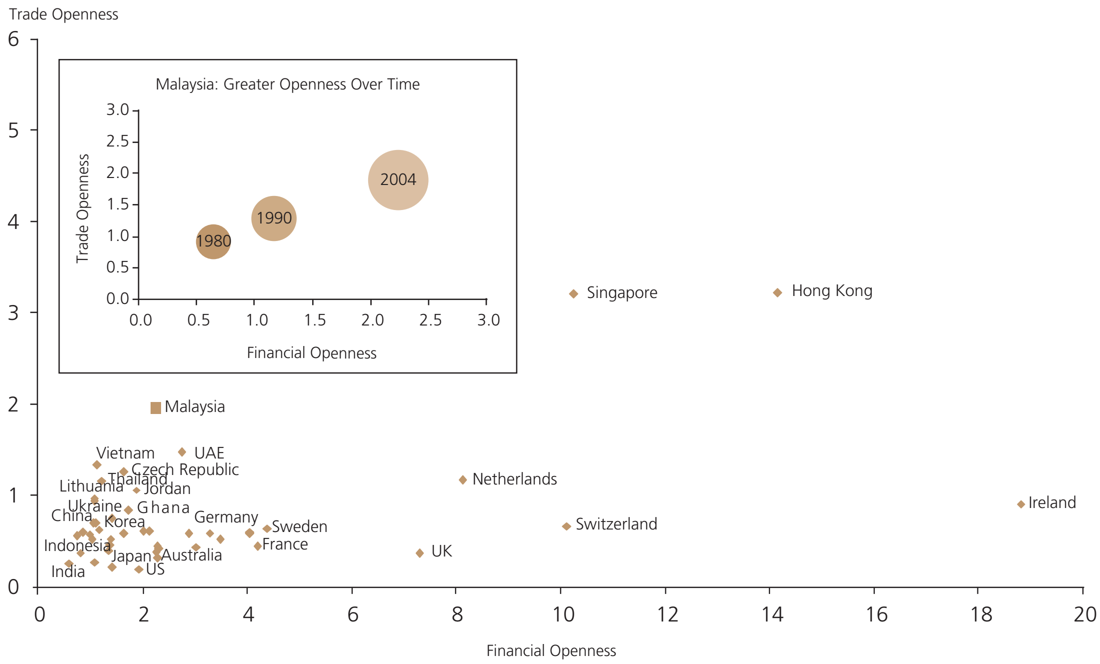
Developments in the global financial markets were driven by the outlook for global economic growth and inflation, as well as the direction of monetary policy, in an environment of continued excess liquidity

With the strong growth performance and high oil prices as the backdrop, the direction of monetary policy in the major industrialised economies throughout 2006 was determined by developments in the inflation outlook. The continued strong growth implied that demand would remain strong, which in turn suggested that oil and commodity prices would likely remain high. Both these developments factored prominently in the inflation outlook and hence monetary policy response during the year. Indeed, inflation expectations were closely influenced by the developments in the commodity prices, especially oil prices, which were generally on an upward trend during the first half of the year.

Consequently, the general view of markets at the turn of the year was that most central banks

Openness of the Malaysian Economy

Chart 2.1
Trade and Financial Openness in 2004



Notes:
1 Trade Openness is the sum of exports and imports relative to GDP
2 Financial Openness is the sum of external assets and liabilities relative to GDP
3 Based on Bank Negara Malaysia calculations; Data from Lane and Milessi-Ferreti (2006); IMF Direction of Trade Statistics (2006, August)
4 Excludes *outlier* Luxembourg

A distinguishing feature of the Malaysian economy is its high degree of openness to trade and cross-border financial flows. As a measure of economic openness, the volume of trade was about twice the size of the economy in 2004. The corresponding measure for financial openness, the stock of external assets and liabilities, was also more than two times the size of the economy.[1]

To obtain a better perspective of the magnitude, Chart 2.1 maps out the openness of the Malaysian economy relative to 58 economies representing the 30 developed economies that make up the Organisation for Economic Co-operation and Development (OECD), as well as 28 emerging economies from Asia, Eastern Europe and Latin America.[2] Malaysia ranks high in terms of trade openness, with only Hong Kong and Singapore having a higher degree of openness.

Malaysia also ranks reasonably high in terms of financial openness, exceeding the median score of 2.03. Of significance is that Malaysia appears to be more open financially relative to more developed economies such as the United States and Japan. Malaysia is also the most financially open country

1 External assets and liabilities refer to claims between a country's residents and non-residents. International holdings are classified into Portfolio Investment (which is subdivided into equity and debt securities), Foreign Direct Investment (which refers to equity participation above 10 percent), Other Investment (which includes debt instruments such as loans, deposits and trade credit), Financial Derivatives and Reserve Assets.

2 The emerging economies included in the sample are Argentina, Brazil, Brunei, Cambodia, Chile, China, Colombia, Croatia, Cyprus, Estonia, Hong Kong, India, Indonesia, Lao PDR, Latvia, Lithuania, Malta, Myanmar, Peru, Philippines, Russia, Singapore, Slovenia, Thailand, Ukraine, Uruguay, Venezuela and Vietnam.

in East Asia after Hong Kong, Singapore and Brunei. Hong Kong and Singapore are highly open by nature of their role as financial centres.

The inset-diagram in Chart 2.1 meanwhile indicates that the degree of openness of the Malaysian economy has increased significantly over time. It is highly likely that this evolution is an outcome of the structural changes occurring in the economy arising from Malaysia's trade orientation, open current account and the liberalisation of the capital account. Thus, the domestic economy and financial system may have, over time, become more sensitive to external developments as Malaysia became more integrated with the global economy.

Chart 2.2
Gross Domestic Product Annual Change (2000 - 2006) (Selected Industrialised Economies)

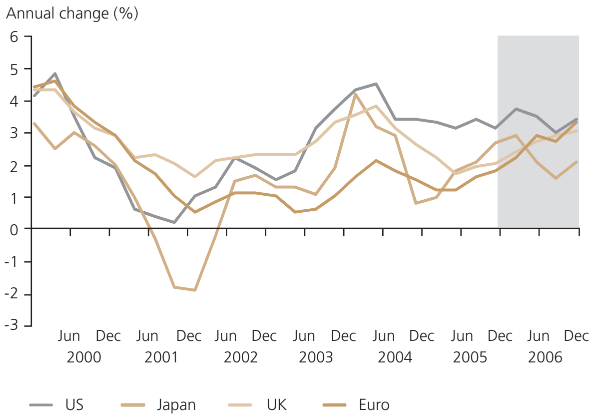


Chart 2.3
Consumer Price Index Annual Change (2000-2006) (Selected Industrialised Economies)

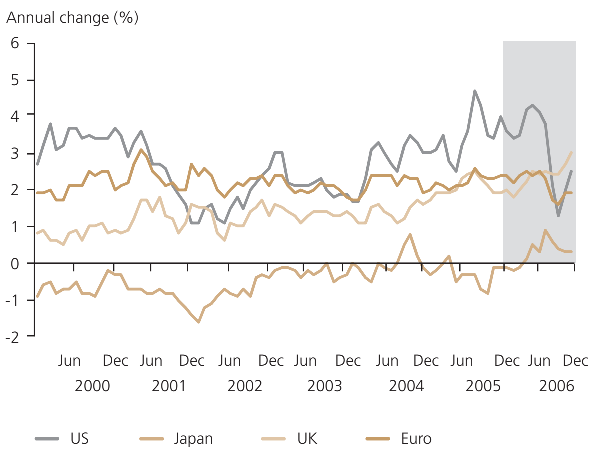
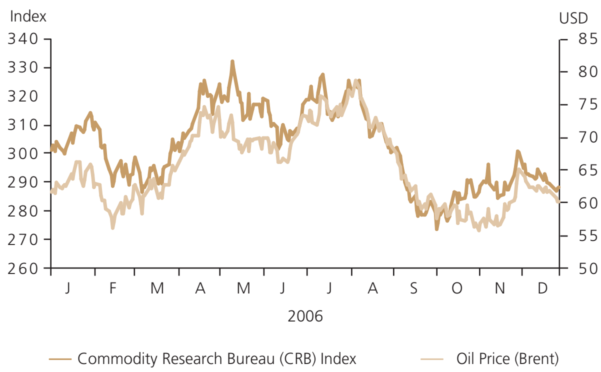


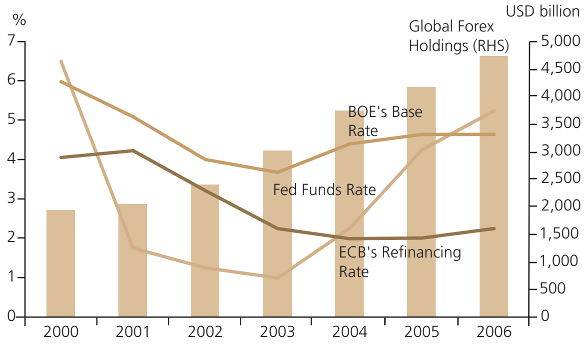
Chart 2.4
Commodities Index and Oil Price (2006)



would adopt a stance that is biased towards tighter monetary policy. Indeed, the major central banks maintained their tightening stance during the year. Since June 2004, the Federal Reserve Board raised rates on seventeen occasions to 5.25% by June 2006 and has now continued to maintain this rate while the Bank of Japan ended its zero interest rate policy in July. The European Central Bank and the Bank of England also raised interest rates to curb incipient inflationary pressures. Similarly, several Asian central banks tightened monetary policy during 2006.

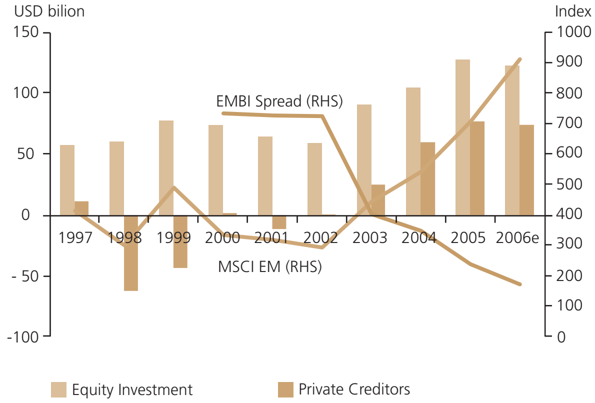
However, despite the tighter monetary conditions and higher global interest rates, easy global liquidity remained the central theme in explaining financial market conditions in 2006. The environment of high global liquidity resulted in the continued search for higher returns across different asset classes and risk profiles. Investors' heightened appetite for risk coupled with the strengthening macroeconomic fundamentals and

Chart 2.5
Global Interest Rates and Foreign Exchange Holdings (2000-2006)



* 2006 data refers to position up to 3Q 2006

Chart 2.6
Capital Inflows into Asia Pacific (1997-2006)



* MSCI EM: Morgan Stanley Capital International Index for Emerging Markets
* JP Morgan EMBI Spread: JP Morgan Emerging Market Bond Index Spread

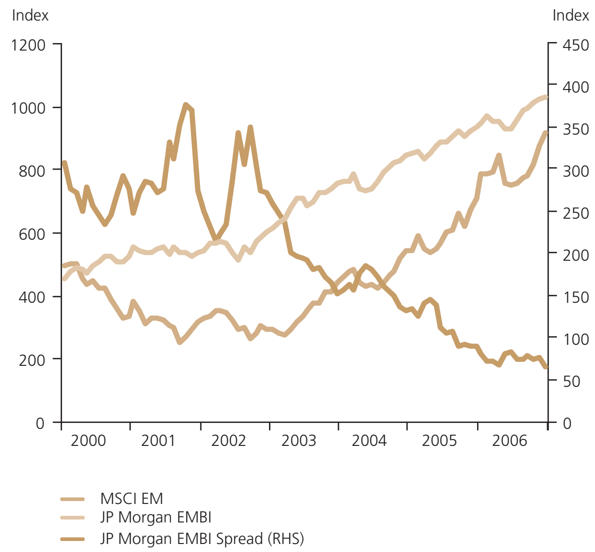
e Estimate
Source: International Institute of Finance (IIF)

the attractiveness of emerging economies as an investment destination saw significant inflows of capital into the emerging markets throughout the year. In 2006, emerging Asia received the bulk of these inflows which went mainly into equity investments. As a result, emerging market equities, as proxied by the Morgan Stanley Capital International (MSCI) Emerging Market index posted strong gains in 2006. The emerging market bond spreads underwent significant compression and risk aversion, as measured by the Chicago Board of Exchange (CBOE) implied volatility index, was at a historical low. As equity and bond prices in these markets were driven significantly higher, there were also some signs of speculative activity in the foreign exchange markets for some of the emerging market economies.

There were thus upward pressures on the currencies of a number of emerging economies as a result of these flows. While these pressures were decidedly the result of strong demand for the emerging market currencies as inflows into the equity and bond markets remained robust, there was evidence that the inflows were also for speculating on the exchange rate. Such short-term speculative flows tend to find their way into short-term instruments.

During the course of the year, there was a convergence of concerns over the strength of monetary tightening, especially in the US and Europe, due to a continued upward bias in the outlook for inflation, that was being driven by record high oil and commodity prices, as well as continued strong global growth. These concerns led to significant changes in the risk outlook,

Chart 2.7
Emerging Markets Bond and Equity Index (2000-2006)



* MSCI EM: Morgan Stanley Capital International Index for Emerging Markets
* JP Morgan EMBI: JP Morgan Emerging Market Bond Index
* JP Morgan EMBI Spread: JP Morgan Emerging Market Bond Index Spread

causing investors to reprice the risk premiums attached to riskier investments. Emerging equity and bond markets underwent a correction in May 2006 as a result of this re-evaluation of risks despite the absence of any significant changes in emerging market fundamentals.

The subsequent recovery however, has been strong, driven by the reversal in risk appetite following the positive reassessment of inflation and growth outlook. In particular, the inflation outlook had turned more benign as commodity prices declined while the Federal Reserve announced a pause in its interest rate hikes.

One feature of the financial market performance during the year has been the strong performances recorded across the different markets and asset classes. In the emerging markets, global capital flows returned as investors found that the risk-reward outlook had

Chart 2.8
Chicago Board of Exchange (CBOE) Implied Volatility Index (2006)

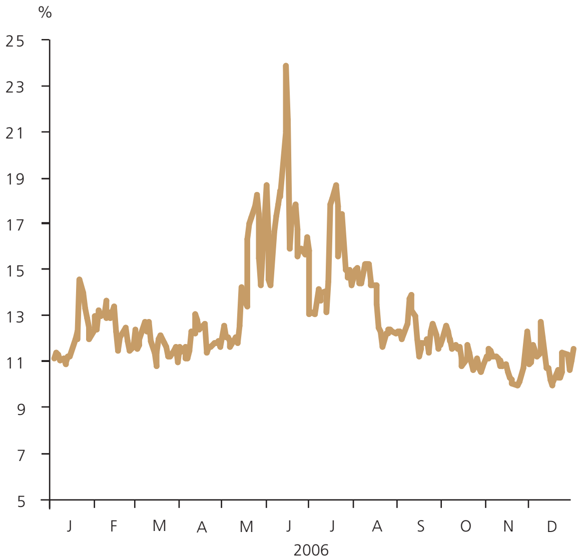
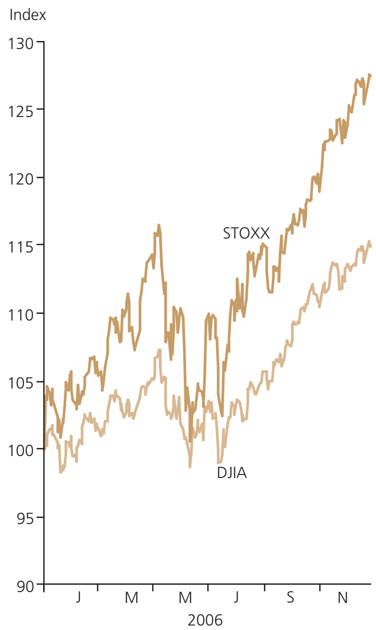
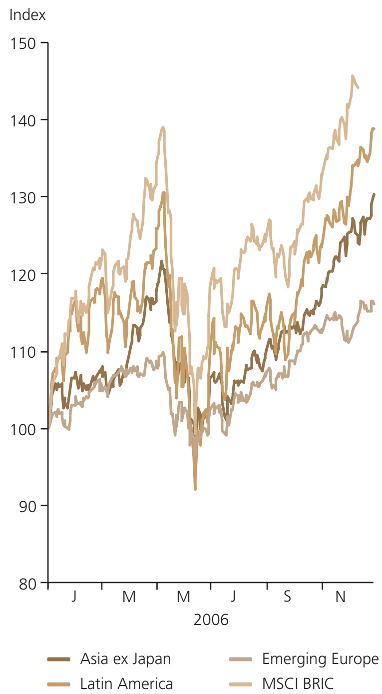


Chart 2.9a
US and European Stock Indices (2006)



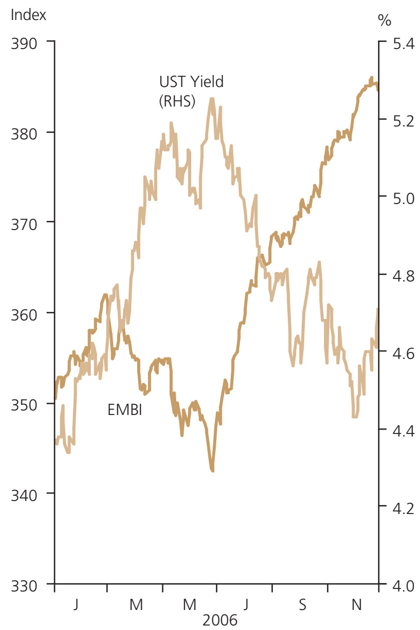
* DJIA: Dow Jones Industrial Average
* Euro Stoxx: Dow Jones Euro Stoxx Index

Chart 2.9b
Emerging Markets Stock Indices (2006)



* MSCI BRIC: Morgan Stanley Capital International Index for Brazil, Russia, India and China

Chart 2.9c
JP Morgan EMBI vs UST 10- year Yield (2006)

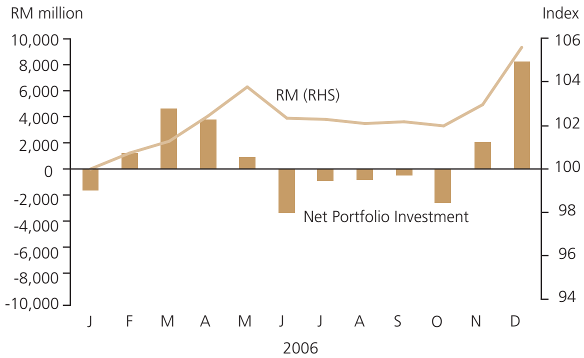


* JP Morgan EMBI: JP Morgan Emerging Market Bond Index
* UST: US Treasury

Source: Bloomberg and Datastream

become favourable. With the emerging markets' macroeconomic fundamentals improving, the inflows of funds lifted the emerging equity markets to much higher levels throughout the rest of the year and resulted in most equity markets surpassing their previous peaks. In the bond market, long-term yields declined significantly as funds flowed into the longer end of the market. As a result, the shape of the domestic yield curve became increasingly influenced by global interest rates. In some emerging economies, the decline in the long-term yields resulted in the yield curve inverting as short-term rates remained unchanged. These developments in the global financial markets had an important impact on monetary and financial market conditions in Malaysia in 2006.

Chart 2.11
Net Portfolio Investment and Exchange Rate of the Malaysian Ringgit (RM) against the US Dollar



Note: An increase in the index represents an appreciation of the ringgit against the US dollar

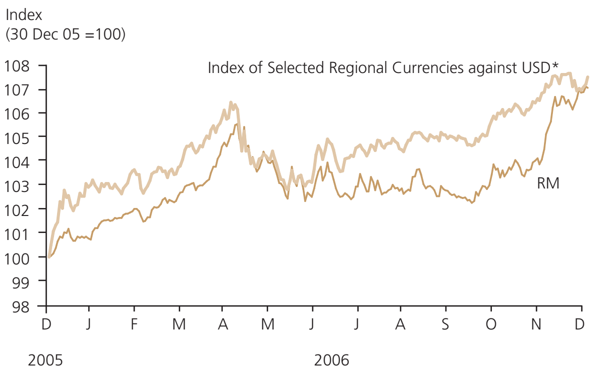
Source: Bank Negara Malaysia's Cash Balance of Payments Reporting System

RINGGIT EXCHANGE RATE DEVELOPMENTS

The ringgit exhibited greater two-way movements in 2006, driven broadly by the larger demand and supply of ringgit in the foreign exchange market. Key factors affecting the ringgit over the course of the year were the trade surplus, investment flows into the country arising from sound economic growth prospects, and market expectations of exchange rate appreciation. These factors were however counterbalanced by strong demand for foreign currencies for outward direct and portfolio investment, repayment and prepayment of external loans and the repatriation of significant amounts of profits and dividends.

The ringgit exhibited greater two-way movements in 2006, driven broadly by the larger demand and supply of ringgit in the foreign exchange market

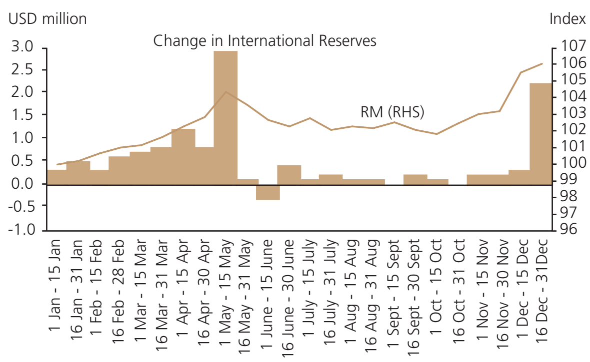
Chart 2.10
Exchange Rate of the Malaysian Ringgit (RM) and Selected Regional Currencies against the US Dollar



* Chinese renminbi, Indonesian rupiah, Korean won, Philippine peso, Singapore dollar, New Taiwanese dollar and Thai baht. Each currency is of equal weight

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

Chart 2.12
Change in International Reserves and Exchange Rate of the Malaysian Ringgit (RM) against the US Dollar



Note: An increase in the index represents an appreciation of the ringgit against the US dollar

Source: Bank Negara Malaysia

The ringgit's performance against the US dollar was broadly in line with the other regional currencies. The ringgit began the year appreciating against the US dollar as the surge of portfolio flows into the region augmented Malaysia's positive net trade receipts in the early part of the year.

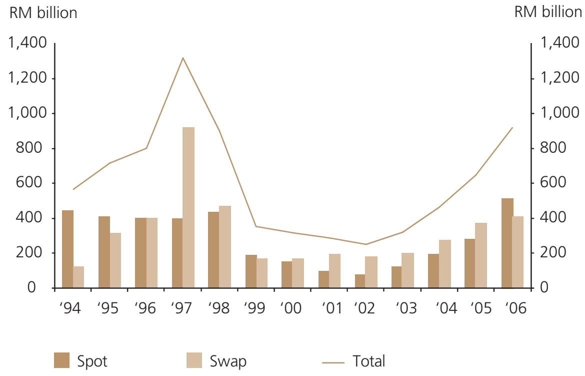
In the latter half of May, the up-trend of the ringgit reversed as a result of the broad withdrawals of investments from emerging market equities and bonds. The retreat from emerging market financial assets was due to the re-assessment of risks by investors amid concerns that the pace of global economic growth would moderate following the tightening of interest rates, in particular, by the major economies, and the rise in commodity prices.

As the effects of the withdrawal from emerging market equities and bonds subsided in July, the ringgit remained relatively stable against the US dollar as net inflows from trade were offset by outflows for overseas direct investment, portfolio investment, repayment and prepayment of external loans and the repatriation of profit and dividends. Reflective of the growing opportunities in the region, there has been a growing trend for Malaysian companies to undertake investments abroad.

In December, the ringgit strengthened further as portfolio flows returned to emerging markets, amidst renewed positive investor sentiments towards regional economic fundamentals. The imposition of capital account measures by the Thai authorities in the latter half of December had only a marginal effect on investor sentiment towards Malaysian financial assets and the ringgit. With renewed inflows, the ringgit strengthened to RM 3.5305 against the US dollar on 28 December. For the year 2006 as a whole, the ringgit appreciated by 7% against the US dollar.

Intervention operations in the foreign exchange market were only to facilitate orderly market conditions, with the underlying trend being determined by the market and the supporting economic fundamentals. There is no predetermined level of the exchange rate. The

Chart 2.13
Volume of Interbank Transactions in the Kuala Lumpur Foreign Exchange Market

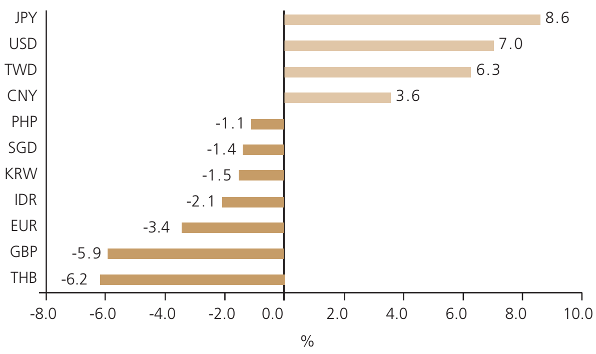


Note : Data from 2002 onwards is based on the new Ringgit Operations Monitoring System (ROMS), whereas observations for previous years are based on transactions of the eight Authorised Dealers

unstable market conditions which occurred in the second half of May, when there was a significant reversal of capital flows, prompted the Bank to stabilise market conditions. When stability ensued in the foreign exchange markets in the aftermath of the sell-down of regional assets in July, the exchange rate continued to be determined by market conditions. The increased exchange rate movements of the ringgit against the US dollar arising from the two-way movements of the ringgit during the year coincided with a 42% expansion in the volume of foreign exchange transactions in the Kuala Lumpur interbank foreign exchange market, the greater part of which was driven by an 83% rise in spot transactions. In view of the greater depth and liquidity of the foreign exchange market, offsetting trade and capital flows can readily be matched, thereby potentially reducing the need for the Central Bank to be present in the market.

Against the other major currencies, the ringgit ended the year stronger against the Japanese yen but weaker against the euro. The Japanese yen weakened due to market expectations that interest rates in Japan would remain low and thus offer large opportunities for carry trades. The euro meanwhile appreciated on market expectations of policy rate increases by the European Central Bank and a positive assessment of economic data favouring the euro relative to the US dollar and

Chart 2.14
Summary of Ringgit Performance against Major and Regional Currencies
(Percent change, 1 Jan-29 Dec 2006)



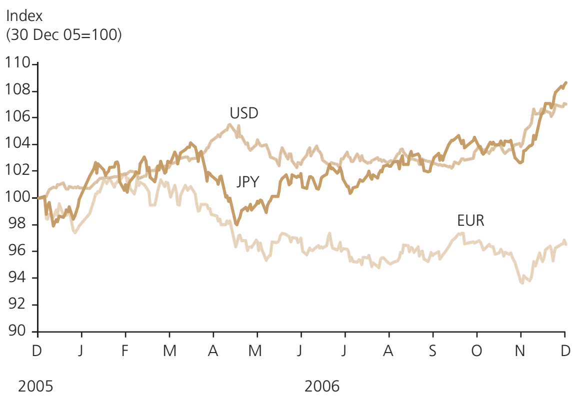
Note: (+) represents an appreciation of the ringgit against the currency
(-) represents a depreciation

Japanese yen. Over the January – February 2007 period, the ringgit appreciated further against the major currencies, amidst continued net trade and investment flows.

The performance of the ringgit compared to that of other regional currencies primarily reflected country-specific developments. In particular, the Thai baht and Indonesian rupiah attracted a sizeable amount of capital inflows due to positive investor sentiment towards these countries' high yielding assets, while the Philippine peso benefitted from inflows of overseas remittances and positive market sentiment arising from the improvements in government finances. Over the January – February 2007 period, the ringgit continued to record a mixed performance against regional currencies. The developments in the global, regional and domestic equity markets at end-February did not have a material impact on the ringgit.

Given the divergent trends of the ringgit against major and regional currencies, the ringgit nominal effective exchange rate (NEER) was stable in 2006, rising by only 0.7%. Between July 2005, when the current regime of a managed float against a basket of currencies was adopted, and the end of February 2007, the ringgit NEER has appreciated by about 4%.

Chart 2.15
Exchange Rate of the Malaysian Ringgit against Major Currencies



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

LIQUIDITY AND MONEY SUPPLY

With high global liquidity and significant inflows during the year, surplus liquidity in the domestic financial system increased in 2006. Apart from the net inflow of direct investment and portfolio funds, the current account surplus and the drawdown of Government deposits with Bank Negara Malaysia also contributed to the increase in liquidity. BNM's sterilisation operations were aimed at offsetting the impact of the flows on domestic liquidity and maintaining relatively stable monetary conditions. Consequently, reserve

Chart 2.16
Determinants of Reserve Money

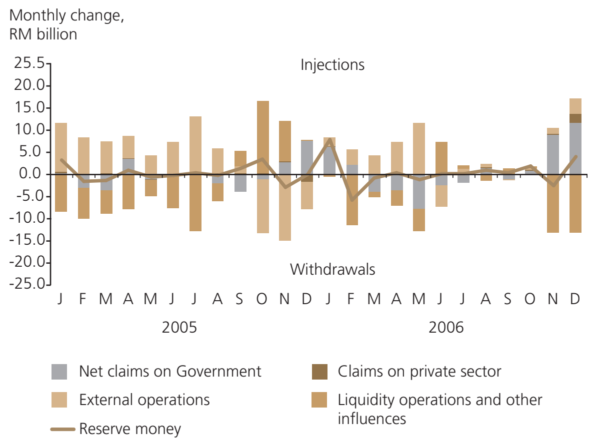
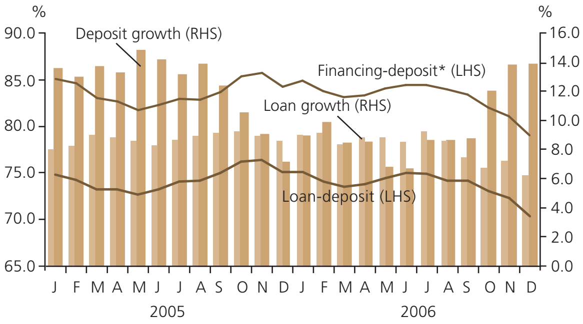


Chart 2.17
Financing-Deposit and Loan-Deposit Ratios



* Financing includes investment in PDS

Table 2.1
Broad Money, M3

	Change (RM billion)	
	2005	2006
M3	**49.7**	**82.4**
Currency in circulation	1.6	3.3
Demand Deposits	8.6	11.8
Broad Quasi-Money	39.4	67.3
Fixed deposits	*4.9*	*32.7*
Savings deposits	*1.9*	*5.2*
NIDs	*12.8*	*14.3*
Repos	*17.3*	*11.8*
FX deposits	*2.5*	*3.2*
Determinants of M3		
Net claims on Government	-5.4	9.2
Claims on the private sector	44.4	34.7
Loans	*44.8*	*36.8*
Securities	*-0.4*	*-2.1*
Net external operations*	18.5	58.6
*Bank Negara Malaysia**	*30.2*	*31.0*
Banking system	*-11.7*	*27.6*
Other influences	-7.9	-20.2

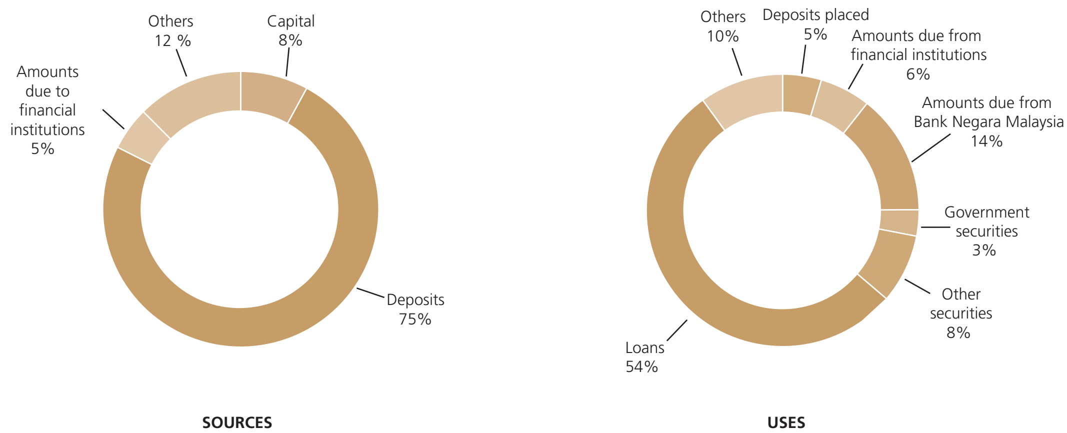
* Pre-revaluation of the international reserves

money increased by RM5.6 billion or 10.6% during the year.

External flows and government operations were the main contributors to higher monetary growth

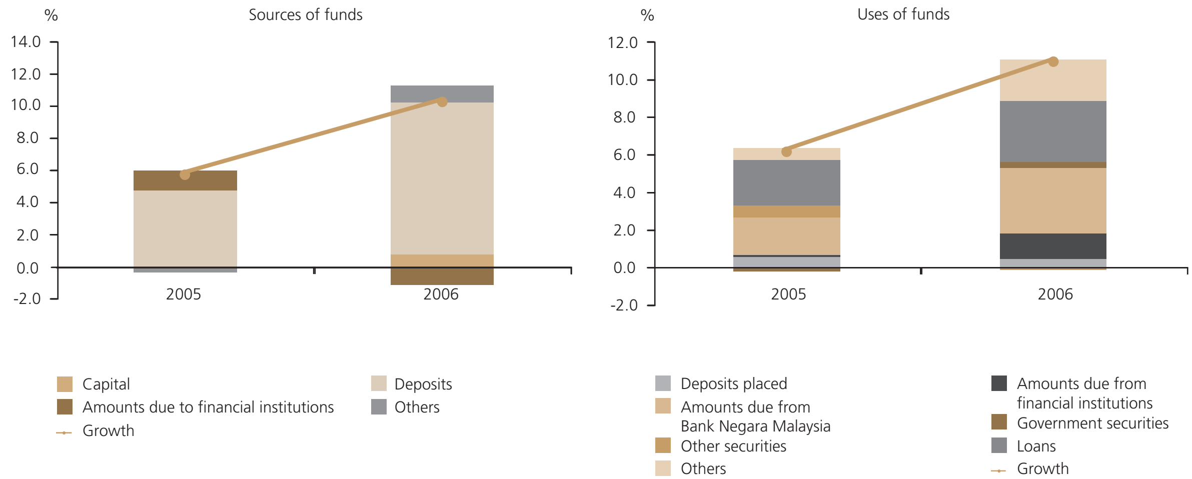
From the perspective of the banking system's balance sheet, deposits placed with the banking system (including discount houses) increased by 13.7%. On the other hand, the banking system's lending to the private sector, as reflected by loans outstanding and private debt securities holdings, expanded at a relatively slower pace compared with deposits. This resulted in the downward trend of the financing-deposit ratio. The additional liquidity was channelled into

Chart 2.18
The Banking System's Sources and Uses of Funds[1] as at end-2006



[1] Adjusted to include discount houses

Chart 2.19
Changes in the Banking System's Sources and Uses of Funds[1]



[1] Adjusted to include discount houses

other assets, most notably in terms of lending to BNM. The banking system's net external assets also increased. To some extent, this reflected the increasing diversification of portfolios of the domestic banking institutions amid a more liberalised environment.

Broad money, M3, which is the currency and deposits of the non-bank private sector, continued to expand during the year. Growth in M3 trended downwards during the first half of the year, but picked up thereafter. At end-2006, M3 was growing at a higher annual growth rate of 12.3% (2005: 8%). The major contributor to the overall expansion and the general trend in M3 growth during the year was net foreign assets, which rose by RM58.6 billion, contributing 71% to the annual increase in M3. In contrast to 2005, Government operations also had an expansionary impact on M3 in 2006, particularly in the second half-year. Higher net claims on the Government were reflective of higher Government expenditures, with a large portion being financed through the drawdown of Government deposits placed with Bank Negara Malaysia. Growth in financing also contributed to M3 expansion, but by a smaller magnitude

Chart 2.20
Monetary Aggregates

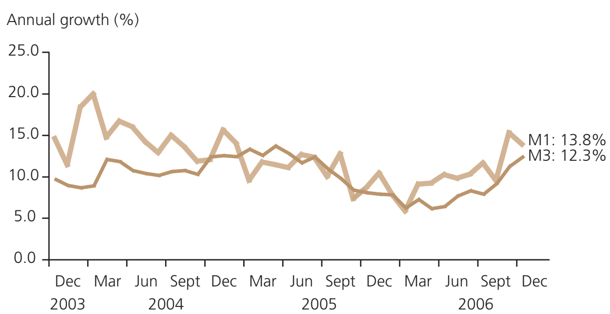
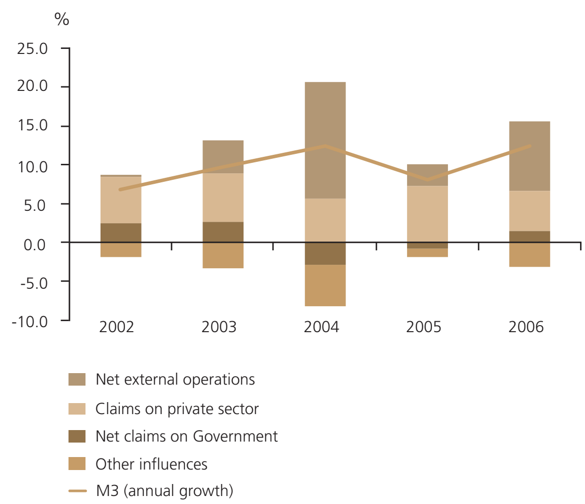


Chart 2.21
Contribution to M3 Growth



compared to 2005, as the growth in loans outstanding moderated towards the end of the year while the banking system's holdings of private debt securities (PDS) were also lower.

M1, a measure of transaction balances, increased by 13.8% in 2006 (2005: 8.5%). The increase mainly reflected higher placements of demand deposits by businesses and to a lesser extent, households. In addition, currency in circulation also increased.

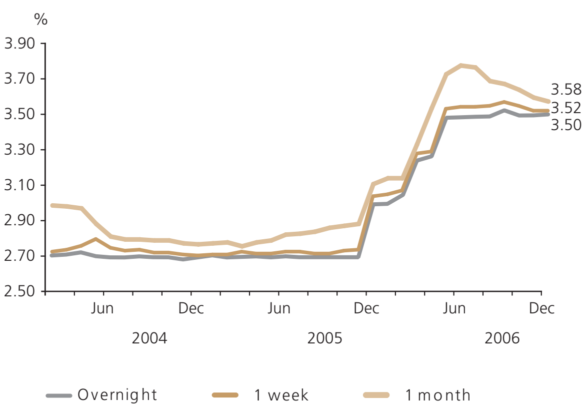
FINANCIAL MARKET CONDITIONS

Amidst the highly active global financial markets in 2006, domestic financial markets were similarly vibrant. Market expectations changed swiftly during the year, not just in response to external financial market developments, but also in response to domestic conditions. The money, bond and equity markets therefore reflected a myriad of inter-related factors, including the central bank's monetary policy decisions in 2006.

Interest Rate Developments

As the economy entered 2006, the strength of domestic economic growth coupled with higher commodity prices had a significant influence on the outlook for domestic inflation. Furthermore, global price developments were also expected to have an influence on domestic inflation. Indeed, with inflation on a rising trend early in the year, there were heightened concerns over the possible implications of a prolonged environment

Chart 2.22
Interbank Rates



of negative real interest rates on the economy. Therefore, with the macroeconomic fundamentals remaining strong, the Bank took the opportunity to align monetary conditions to the prevailing environment of higher inflation. The Overnight Policy Rate (OPR) was increased twice, on 22 February and 26 April, by 25 basis points each time.

Although lending rates rose following the increase in the OPR, interest rates continue to be at historical lows

In the money market, the average overnight interbank rate stayed close to the OPR throughout the year. Prior to the rate increase in February, the daily weighted average overnight interbank rate moved within the range of 2.98% - 3.01%. After the first increase, it continued to move within a narrow band of 3.22% - 3.25%. For the remainder of the year, however, the range was slightly wider, with the overnight rate moving between 3.46% - 3.56%. Specifically, volatility increased temporarily in September when money market participants sourced funds in preparation for the larger-than-expected Malaysian Government Securities (MGS) auction.

The interbank rates for other tenures, namely the one-week and one-month maturities also rose over the course of the year, in line with market expectations of higher interest rates. The one month interbank rate peaked in June and moved downwards thereafter when market participants moderated their expectations of the pace of interest rate increases after inflation began trending downwards and when the OPR was left unchanged following the fourth Monetary Policy Committee (MPC) meeting of the year in May.

At the beginning of the year, market expectations were for more interest rate increases over the course of the year, following the rate increase in November 2005. This was reflected in developments in the interest rate derivatives market. The 3-month KLIBOR futures yield curve shifted upwards over the period January to June.

Chart 2.23
3-month KLIBOR Futures (First-Half 2006)

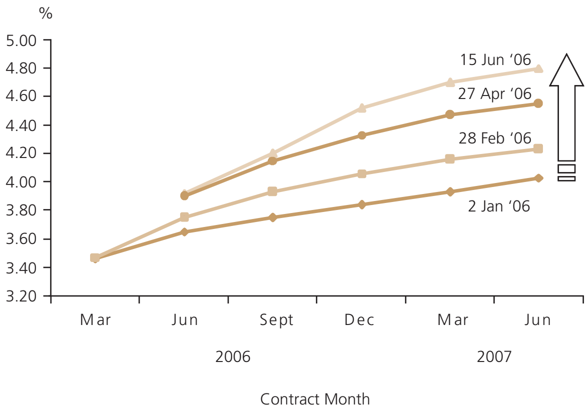
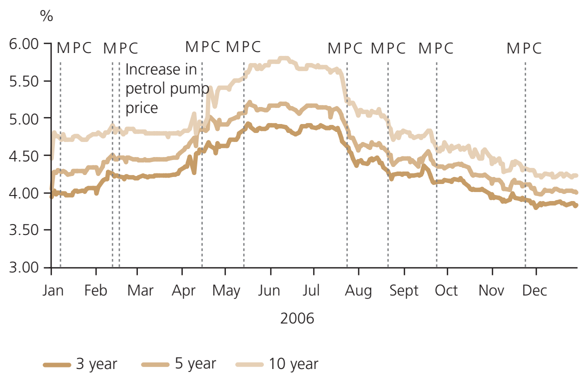


Chart 2.25
Interest Rate Swaps



Similarly, interest rate swaps also trended upwards over the same period reflecting the market's expectation of rate increases in the first half of the year. Anticipation of increases in the OPR was driven by expectations that inflation would be higher amid robust growth prospects for the economy. The expectations were further reinforced by the increase in petrol pump prices by thirty cents on 28 February and inflation reaching the highs of 4.8% in March and 4.6% in April.

Nevertheless, the expectations for further rate increases began to subside in the second half-year. The 3-month KLIBOR futures for the December contract fell by 19 basis points as at 31 July from the highest rate on 15 June 2006. The KLIBOR futures curve continued to shift downwards and flattened by December, indicating expectations were for the OPR to be relatively stable in the near term. Meanwhile, interest rate swaps remained stable after the fourth MPC meeting in May as market participants had already priced in a higher rate. When the OPR remained unchanged in May, interest rate swaps started trending downwards from about mid-July until December when they stabilised. Again, the moderating trend in interest rates during the second half reflected downward revisions in expectations of inflation as well as further increases in the policy rate.

In terms of retail interest rates, the average base lending rate (BLR) of the commercial banks adjusted quickly to changes in the OPR. The average BLR of all commercial banks had risen after the first OPR increase in November 2005 and continued to increase after the OPR changes

Chart 2.24
3-month KLIBOR Futures (Second-Half 2006)

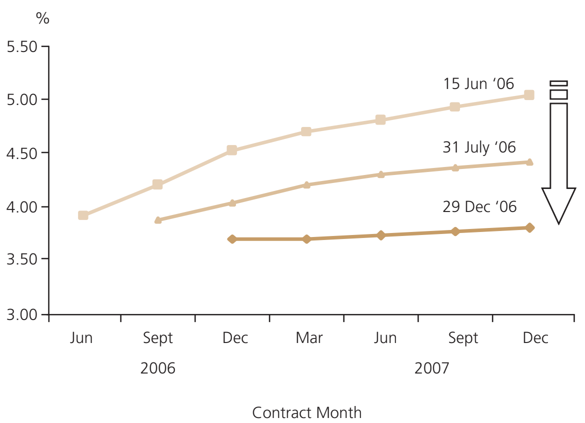


Chart 2.26
Commercial Banks' Lending Rates (at end-period)

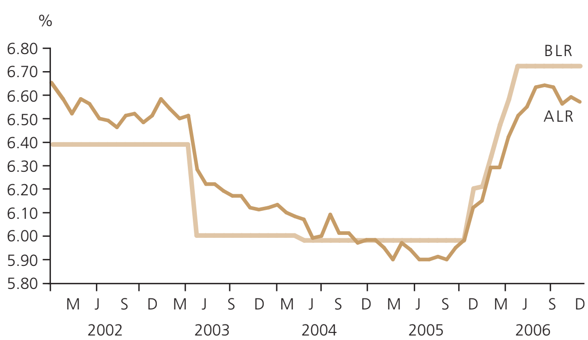
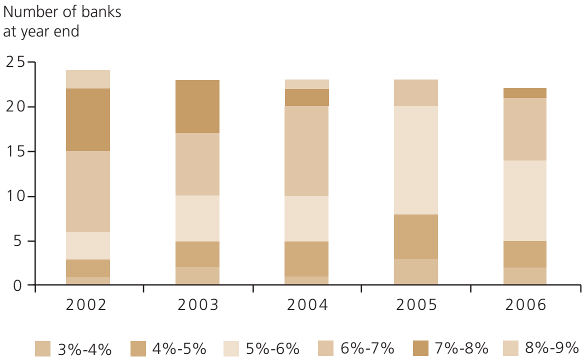


Chart 2.27
Range of Commercial Banks' ALR



in February and April and finally stabilised at 6.72% in mid-May until the end of the year. On the whole, the average BLR increased by 74 basis points, slightly lower than the total increase of 80 basis points in the OPR since November 2005. Most commercial banks had adjusted their BLRs upwards in the range of 50-100 basis points over the period January to May 2006.

The average lending rate (ALR) of the commercial banks increased in 2006 in line with the increase in the BLR. This reflected the re-pricing of existing BLR-pegged loans, the extension of new loans at the higher rates, as well as the maturing of older loans carrying lower interest rates. About 32% of banks had ALRs in the 7-8% range at end-2006, compared with only 13% at end-2005. Overall, the ALR peaked at 6.64% in August and declined slightly to 6.57%

Chart 2.28
1-month Interbank and Fixed Deposit (FD) Rates

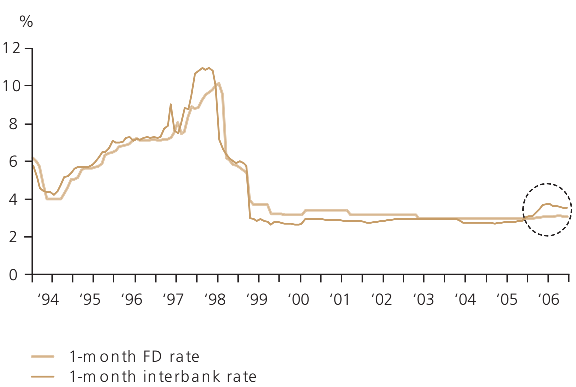
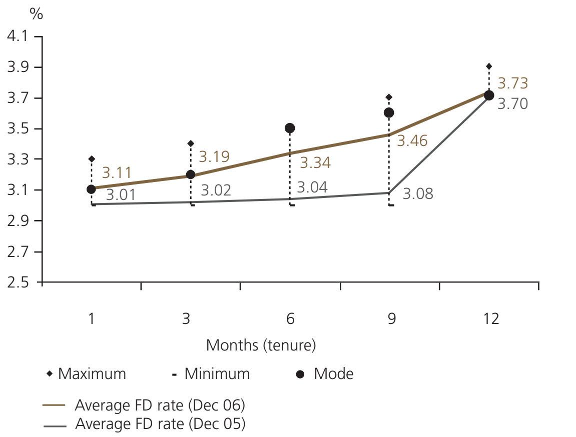


Chart 2.29
Commercial Banks' Fixed Deposit (FD) Rates



in December. Nevertheless, the increase of 59 basis points in the ALR was less than the increase in BLR due to competitive pressures as well as the fact that some loans carry fixed rates and are therefore not re-priced at the higher BLR. These fixed-rate loans, namely hire purchase loans and some housing loans, accounted for 17% and 5% of total loans outstanding respectively at end-2006. Some business loans were also priced on a cost-plus basis (10% of total loans) and have rates that are lower than the BLR.

For new loans approved, the weighted average lending rate was also 59 basis points higher than the average rate for 2005. The smaller increase in the weighted ALR for new loans approved relative to the BLR, reflected to a large extent the increased competition between the banking institutions.

The fixed deposit (FD) rates of the commercial banks were initially slow to adjust to the first increase in the OPR in November 2005. With the policy to ensure positive real rate of return to depositors, coupled with the situation of ample liquidity, FD rates were already higher than the interbank rates. In this environment, the banking institutions were able to source cheaper funds from the interbank market. This reduced their incentive to raise deposit rates. Most banks were also waiting for further increases in the OPR before making substantial changes in their FD rates. Consequently,

Movements of Islamic Rate of Returns and Conventional Interest Rates

An important feature of the Malaysian financial system is its dual banking system where the non-interest rate based Islamic banking system operates alongside the interest rate based conventional banking system. In view of the coexistence of these two systems, it is of interest to explore the extent to which prices differ between the two systems. Also, an understanding of the extent to which Islamic rate of returns change in response to changes in the central bank's policy rate will be crucial towards understanding how fast and effective the monetary transmission is via the Islamic financial system. Generally, the structure of Islamic financing requires the sharing of risks and profits in some pre-agreed ratios. Theoretically, given that the cost of a large proportion of existing Islamic financing is not directly linked to changes in the cost of funds, changes in monetary policy may only have a limited impact on the cost of existing loans.

In the interbank money market, Chart 2.30 shows that the profit rates in the Islamic money market have been generally lower than that in the conventional money market. However, movements in the Islamic profit rates follow closely changes in the conventional money market interest rates. In Chart 2.31, the base financing rate (BFR) of two major Islamic banks, are shown to move fairly closely with the BLRs of conventional banks. Therefore, monetary operations to manage liquidity in both the conventional and Islamic banking system do have a similar impact.

Chart 2.30
Overnight Conventional Rates and Islamic Rate of Returns

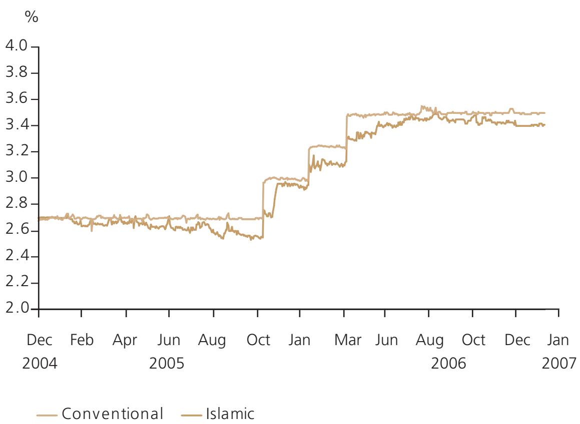
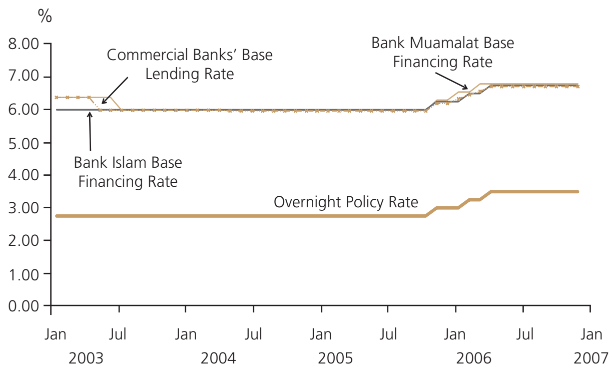


Chart 2.31
Islamic and Commercial Banks' Prime Lending Rates

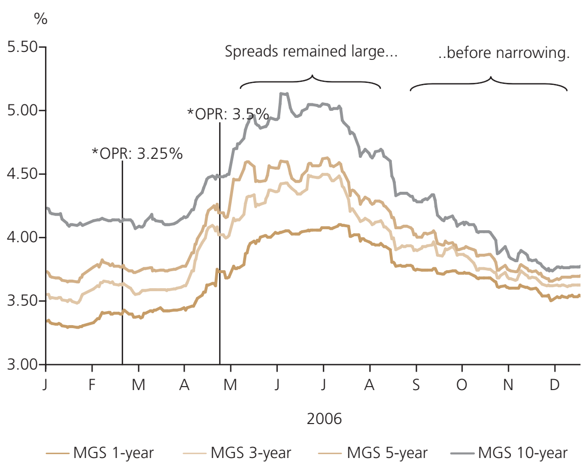


the pace of adjustment in FD rates picked up after the second OPR increase in February. The cost of interbank funds increased in line with the increase in the OPR. For example, the 1-month interbank rate moved convincingly above the corresponding FD rate in December 2005. From March onwards, a total of 13 banks adjusted their 1-month FD rate by 10–30 basis points. By December, the FD rates for tenures of between 1-month and 12-month maturities had increased by 2–46 basis points compared to November 2005. Chart 2.29 shows the change in average FD rates from December 2005 to December 2006, as well as the maximum, minimum and the mode of the FD rates offered by banks at end-December 2006. Real FD rates, which had been negative since May 2005 when inflation first began to rise above 3%, turned positive across all maturities in October 2006.

Bond Markets

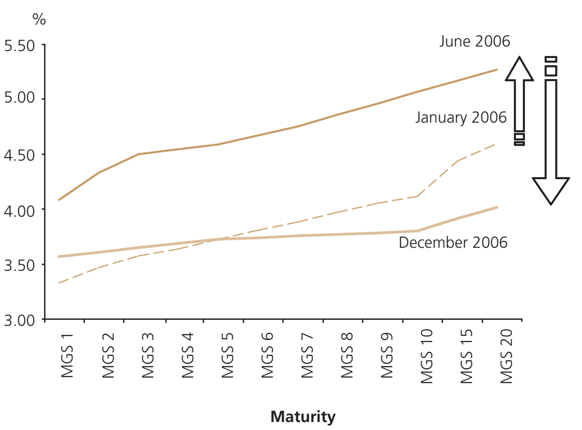
Both global and domestic developments explain the performance of the bond market in 2006. Global market developments amidst high excess liquidity played a major role in influencing the yield direction in 2006, particularly during the second half of the year. High global liquidity and the consequent search for yield channeled large amounts of capital flows into the emerging markets. These global developments, coupled with the strength in the macroeconomic and growth outlook in Malaysia, contributed to a vibrant and active bond market in 2006. On the domestic front, developments relating to the outlook for inflation heavily influenced investors' expectations of the central banks' monetary policy response, which subsequently affected the direction of yields. Expectations regarding the performance of the ringgit exchange rate also played a role in influencing yields during the year.

Chart 2.32
Malaysian Government Securities Yields (2006)



*OPR: Overnight Policy Rate

Chart 2.33
MGS Benchmark Yield Curve 2006



The inflation outlook, domestic interest rates and global liquidity conditions were among the factors determining the movement of yields in the ringgit bond market

The impact of these factors on the ringgit bond market performance in 2006 was manifested in the movements of the yields and the risk premium attached to the Malaysian market. The Malaysian Government Securities (MGS) yields trended upward, and by June, was about 80 basis points higher compared to the beginning of the year, before the market rallied and yields reversed during the second half of 2006. MGS yields reached their highest level in June with the yield on the 10-year MGS breaching the five percent mark, at 5.05%. The maturity spread between the 10-year and 1-year MGS was at its widest when the bond market yields reached its highest levels at mid-year. The correction in global financial markets in May had a modest impact on the bond market as compared to the equity market.

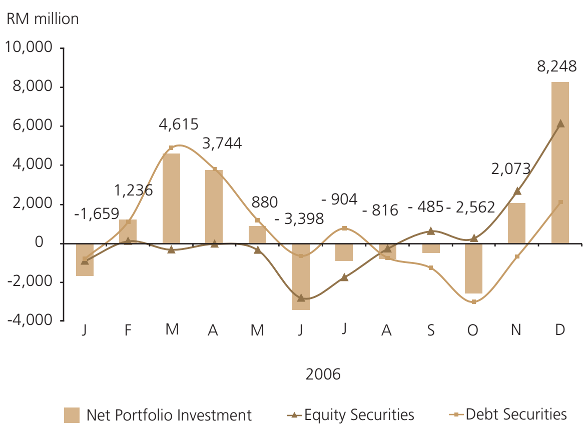
More importantly, there was a significant compression of the maturity spread by the end of 2006. As uncertainty over the global macroeconomic and inflation outlook dissipated, spreads between the 10-year and 1-year maturities, which were at around 80 basis points for much of the first half, narrowed significantly by year end. The MGS benchmark yield curve steepened in the period January to June before reverting to a flatter curve in the second half as more buying interest was concentrated at the longer end towards the end of the year.

In terms of domestic financial developments, expectations regarding the interest rate environment dominated investor interest in the bond market. Investors started the year on a cautious mood following the 25 basis points increase in the OPR in November 2005, as Bank Negara Malaysia began to gradually normalise the level of interest rates. With inflation continuing to show an upward bias in the early part of the year, investors began to price in the likelihood of a rate increase prior to the February and April MPC meetings. Moderating inflationary pressures and lower inflation expectations in the second half of the year influenced investors' perception that interest rates would not increase further. These expectations became more firmly entrenched when inflation began to moderate, increasing investors' confidence that the OPR will be kept unchanged at 3.5%.

Excess global liquidity and the consequent search for yield, especially following the May correction, was also significant in explaining the performance of the Malaysian bond market. The narrowing of the MGS yields after August was mainly the result of long-term rates being influenced by the increasing risk appetite among investors that led to bigger investment flows into the longer end of the yield curve. The Malaysian bond market was also seen as attractive compared to regional markets.

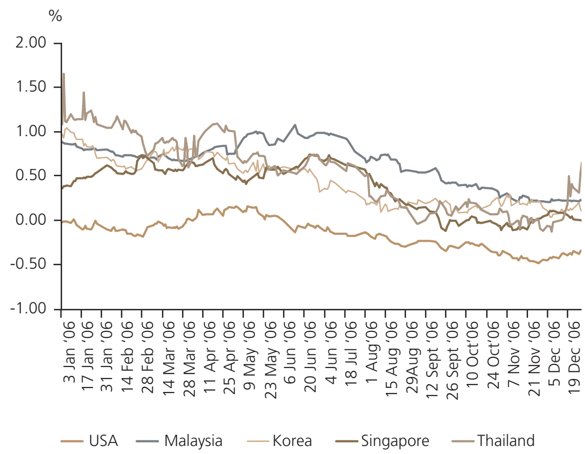
There were also other factors that contributed to cause Malaysian spreads to continue to

Chart 2.34
Net Portfolio Investment Flows into the Country (2006)



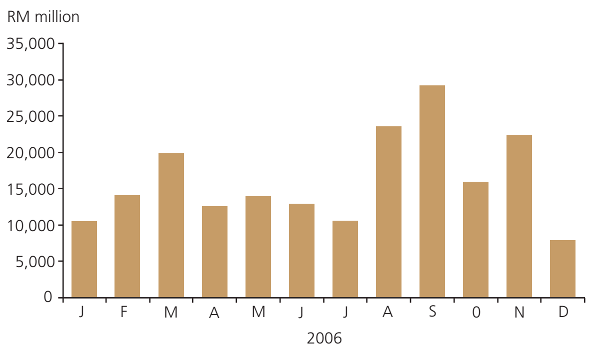
Source: Bank Negara Malaysia's Cash Balance of Payments System

Chart 2.35
Yield Spread (10 year - 1 year) for Selected Countries (2006)



narrow. Towards the year-end, yields were also influenced by the speculation that the ringgit could show further appreciation. This motivated investors to take positions in the ringgit bond market especially in the short-term securities, hence keeping yields on a downward trend. At the same time, the growing size and maturity of the Malaysian bond market led to it being considered for inclusion in the Citigroup World Government Bond index. This inclusion, to be effective in July 2007, resulted in some pre-emptive buying by global fund managers. Moreover, the inaugural issue of the callable MGS on 15 December 2006 also heightened interest in the domestic bond market. As a result, market turnover which had been

Chart 2.36
MGS Turnover 2006

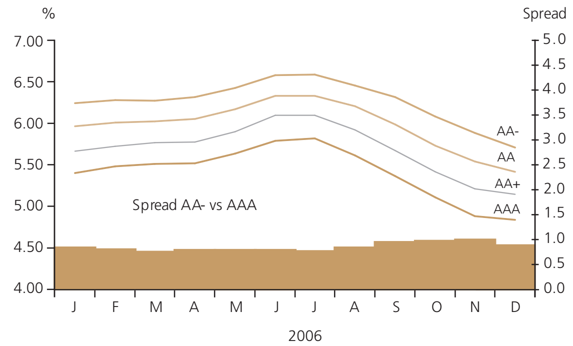


relatively low after the May correction, when foreign investors had pulled back capital from emerging markets, had rose to its highest levels during the second-half of the year.

In the corporate bond market, issuers were more aggressive in entering the market in anticipation of further OPR increases. The rally in the MGS market also sparked buying interests towards the high-grade segment of the corporate bond market.

Despite a higher number of downgrades being recorded in 2006 compared to 2005, the credit spread in the corporate bond market remained stable throughout the year. The higher downgrades were mainly within the investment category and were isolated cases due to more stringent rating criterion being adopted. These

Chart 2.37
Corporate Bonds Indicative Yields (2006)



Increased Cooperation in the Development of the Regional Bond Market

Cooperative efforts to further develop the regional bond markets had advanced in 2006 with several developmental milestones achieved aimed at enhancing the depth and breadth of the regional bond markets.

Asian Bond Market Initiative (ABMI)
Under the auspices of the ABMI, the various working groups established in 2003 to promote the issuance and trading of bonds within the region have achieved several important milestones on a wide range of issues. These include a study on the possible creation of a "Regional Basket Currency Bonds" (RBCB). The study addresses issues on possible structures, impediments as well as effective regulatory framework to facilitate the creation of RBCB. The study on "Credit Guarantee and Investment Mechanism" had also progressed to Phase 2 towards development of a business model on credit guarantee and investment mechanism for the region.

Under the Working Group on Foreign Exchange Transactions and Settlement issues chaired by the Bank, the interim report on the study on "Minimising Foreign Exchange Settlement Risk in ASEAN+3 Region" has been completed and distributed to member countries. The study aimed to provide options to the region in minimising clearing and settlement risk for cross-border bond transactions including the possible establishment of a regional intermediary.

Other areas of collaboration and cooperation focused on identifying measures to promote rating harmonisation and further utilisation of local credit rating agencies in the ASEAN+3 region. Efforts were also undertaken to pool valuable experiences from member countries to identify an appropriate policy framework that could facilitate the funding of infrastructure development through the Asian bond markets. Phase 2 of the technical assistance programmes for 5 participating countries namely Cambodia, Indonesia, Philippines, Thailand and Vietnam has also been completed. To further improve comparability of information on the domestic bond markets in the region, the Asian Bond Online Website, which was developed in 2004, was also enhanced.

Asian Bond Fund

The Asian Bond Fund 2 (ABF2) that was launched in 2005 has experienced encouraging growth of 48% in the number of units and achieved a USD return of 6.9% per annum since its launch. The funds have also gained greater international recognition within the investment community. For the year ending 3 August 2006, Lipper ranked the Pan-Asian Investment Fund (PAIF) first in its survey of open-ended Asia bond funds.

The ABF Malaysia Bond Index fund, one of the funds under the ABF2, was listed in 2005 and has since helped to increase investor interest in the Malaysian bond market. Since listing, it has recorded a return of 3.9% per annum in ringgit terms (8.5% in US dollar[1] terms), placing it among the three best-performing single domestic market funds under the ABF2 umbrella while achieving unit growth of 13%. For 2006, the fund achieved a ringgit return of 4.6% (12.2% in US dollar terms). The number of ABF Malaysia units traded on Bursa Malaysia has been low mainly due to conservative buy-and-hold investors. However, the situation is expected to improve as the domestic market matures and becomes more liquid.

[1] These are total returns which include redistributed regular periodic income, capital gains from any rise in unit price and foreign exchange translation gains, if any, into US dollars.

downgrades thus did not affect the overall market sentiments.

Equity Markets

Despite a cautious start to the year, and notwithstanding some distinct periods of volatility, the Malaysian equity market ended 2006 on a significantly positive note. Among the factors that contributed to the better performance were renewed foreign inflows into the equity markets, strong corporate earnings, corporate mergers and acquisitions and expectation-driven sentiments following the announcement of the Ninth Malaysia Plan (9MP) infrastructure projects.

Driven by positive macroeconomic fundamentals and foreign investor interest, local equity markets performed well in 2006

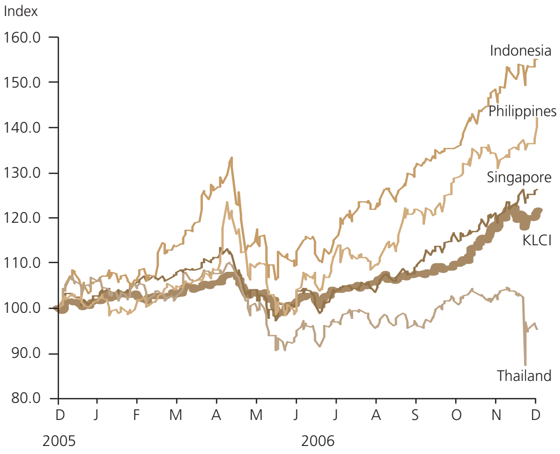
After the relatively weak performance in 2005, the KLCI ended 2006 at 1,096.24 points or 21.8% higher compared to end-2005. Although the benchmark index closed the year at its highest level since 1996, the Malaysian market lagged the other regional markets. The KLCI's performance was weak in the first half of the year but posted stronger gains in second half of the year as foreign investors' interests in the market increased.

There was also significant difference in the performance of the three major domestic indices, with the small-capitalisation MESDAQ recording a better performance relative to the Kuala Lumpur Main Board. On a sectoral basis, the construction and plantation sectors were the strongest performers, each posting gains of 57.5% and 54.2% respectively, for the year.

The KLCI started 2007 on a positive note, supported by inflows of non-resident funds driven by expectations of stronger domestic economic growth, favourable corporate earnings, and stable inflation outlook. The KLCI reached a high of 1,283.47 points on 23 February before the correction at the end of February and early March. As at 7 March 2007, the KLCI stood at 1,156.58 points or 5.50% higher compared to end-2006.

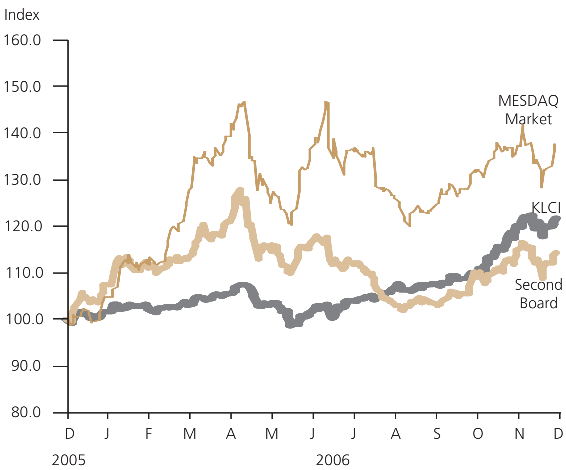
Capital flows into the equity market were important in explaining the KLCI's performance in 2006. The nature of capital flows into the equity market differed significantly between the two halves of the year. Despite the weak inflows

Chart 2.38
Regional Indices



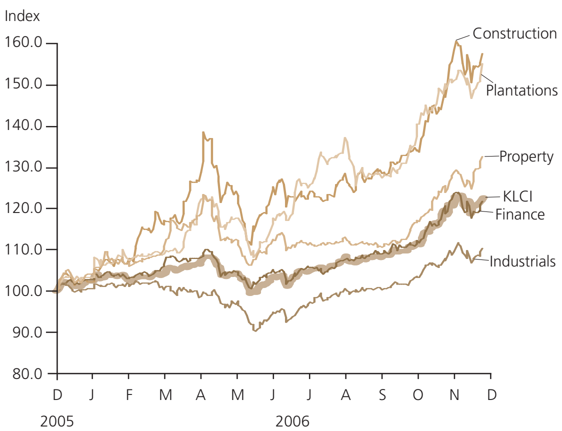
Source: Bursa Malaysia and Bloomberg

Chart 2.39
Bursa Malaysia Indices



Source: Bursa Malaysia and Bloomberg

Chart 2.40
Bursa Malaysia Sectoral Indices



Source: Bursa Malaysia and Bloomberg

Table 2.2
Bursa Malaysia : Selected Indicators

	2005	2006
Price Indices:		
FBM30	5,882.5	7,059.9
Composite	899.8	1,096.2
FBMEMAS	5,737.5	7,169.6
Second Board	80.4	92.0
MESDAQ Market	87.1	119.9
Total Turnover:		
Volume (billion units)	102.3	197.5
Value (RM billion)	177.3	250.6
Average Daily Turnover:		
Volume (million units)	414.3	802.9
Value (RM million)	716.9	1,018.9
Market Capitalisation (RM billion)	695.3	848.7
Market Capitalisation / GDP (%)	140.4	155.3
Total Number of Listed Companies:	1,021	1,027
Main Board	646	649
Second Board	268	250
MESDAQ Market	107	128
Number of Companies Delisted:		
Main Board	9	21
Second Board	5	8
MESDAQ Market	1	1
Market Liquidity:		
Turnover Value / Average Market Capitalisation (%)	25.1	35.9
Turnover Volume / Number of Listed Securities (%)	31.4	59.2
Market Concentration:		
*Market Capitalisation of 10 Most Highly Capitalised Stocks / Total Market Capitalisation (%)	36.1	35.4

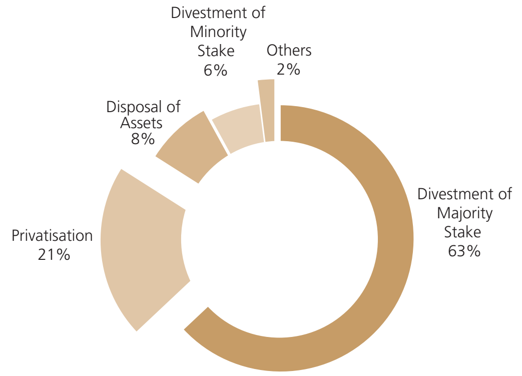
* Based on market transactions only
Source: Bursa Malaysia

of capital into the domestic equity market in the first half of the year, anecdotal evidence pointed towards the presence of offshore hedge funds in selected technology stocks, driven by expectations of stronger export performance in the electronics and electrical sector. Since a large proportion of the companies listed on the Second Board and the MESDAQ Market were technology-related companies, greater interest and trading in these markets resulted in significant market volatility. Following the market correction in May, there were large outflows. However, in the second half of the year, rising inflows into the equity market by foreign funds were focused on the bigger capitalisation stocks in the Main Board, which were more liquid and had greater research coverage.

Expectations of stronger corporate earnings as well as improved macroeconomic outlook also drove the equity market higher in the second half of the year. By the third quarter, commodity prices, especially oil prices, had begun to decline. With inflationary pressures receding, there were clear indications that global and domestic monetary policy tightening was being put on hold. Furthermore, it was evident that despite the three increases in the OPR since November 2005, corporate sector earnings had remained strong. Total revenue rose 7.6% in the third quarter of 2006 compared to the corresponding quarter in 2005. Over the same period, operating income rose by 18.4%. The corporate sector's interest coverage ratio at 5.3 remained high and their ability to continue servicing their debt was relatively unaffected by the higher interest rates.

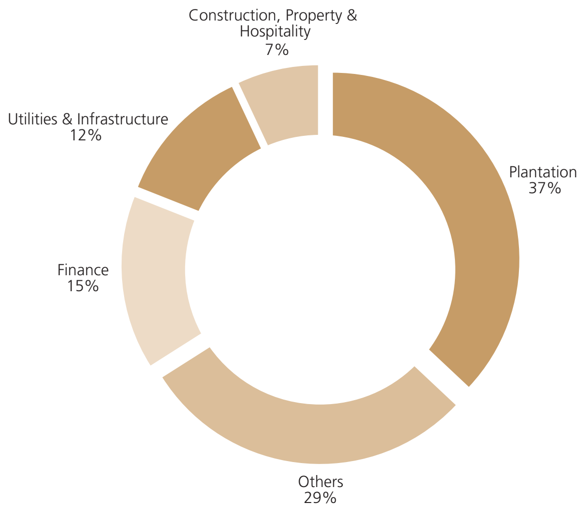
Further positive news on several sectors contributed to the momentum in the equity market. Robust demand for crude palm oil (CPO) throughout the year and continued upward re-ratings by market analysts provided the impetus for the solid performance of the plantation sector relative to other sectors of the KLCI. In addition, the announcement of infrastructure projects under the 9MP during the 2007 Budget release, raised market expectations for stronger earnings in the construction sector which was seen to be one of the main beneficiaries of the plan. The positive news regarding stocks in these two sectors rekindled foreign interest in these sectors and in the equity market in general.

Chart 2.41a
Mergers and Acquisitions (M&A) by Type, 2006



Source: Bursa Malaysia

Chart 2.41b
Mergers and Acquisitions (M&A) by Sector, 2006



Source: Bursa Malaysia

Mergers and acquisitions (M&A) activity also helped to spur the KLCI. A total of 84 successful M&As were recorded in 2006, with a total valuation of RM90 billion. Most of these were either divestment of majority stakes in entities listed in Bursa Malaysia or privatisation exercises. In terms of value, M&A activity was significantly boosted by the merger exercise in the plantation sector that would result in the creation of the world's largest plantation company, valued at RM31.4 billion. The finance sector also saw consolidation activity in the banking sector.

Market turnover for the KLCI in 2006 was the highest since 2000. Despite the higher volatility during the mid-year market correction, volatility

Chart 2.42a
Performance of KLCI in 1H2006

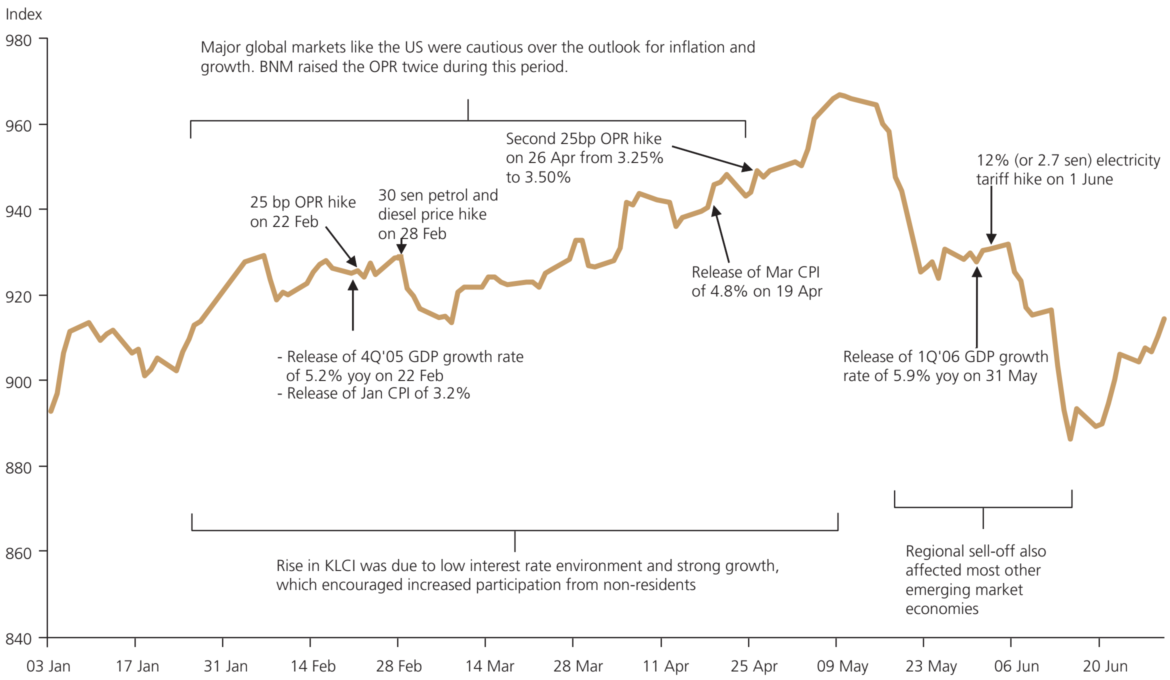


Chart 2.42b
Performance of KLCI in 2H2006

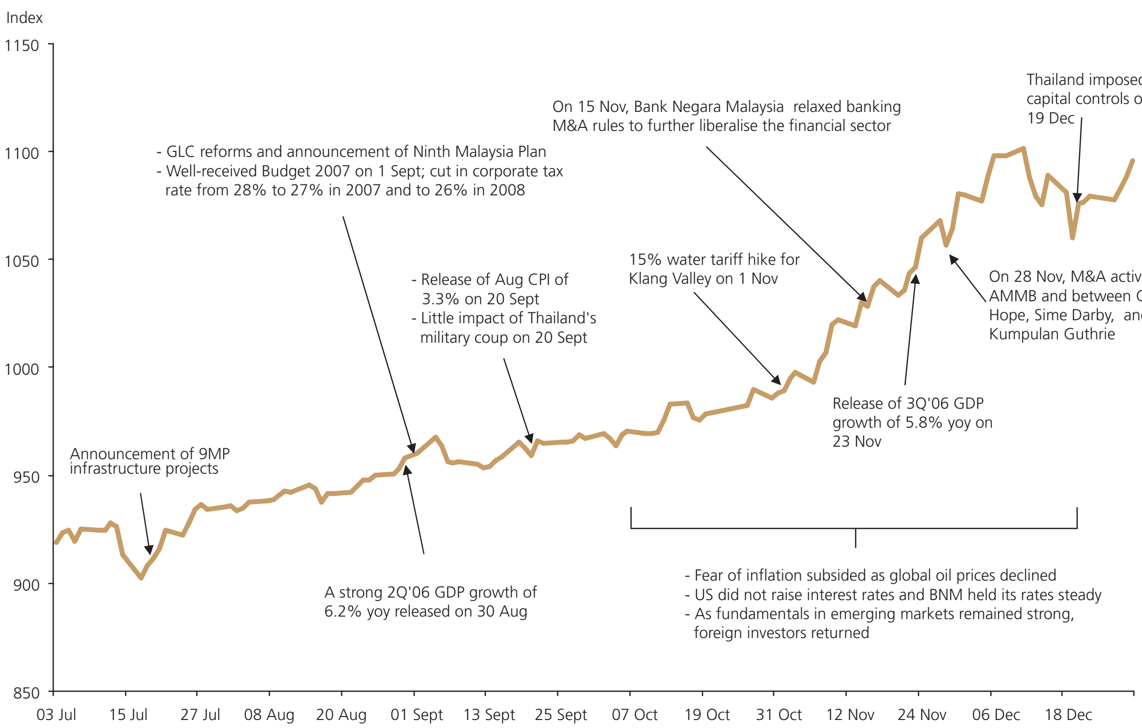
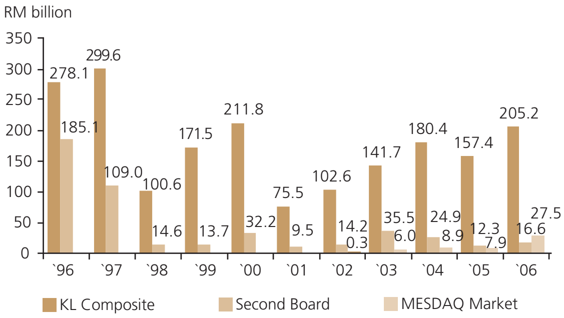
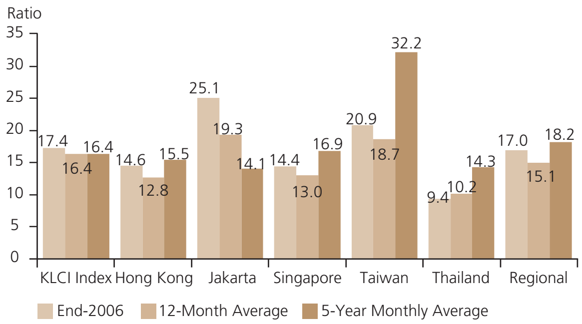


Chart 2.43
Market Turnover of Bursa Malaysia Markets



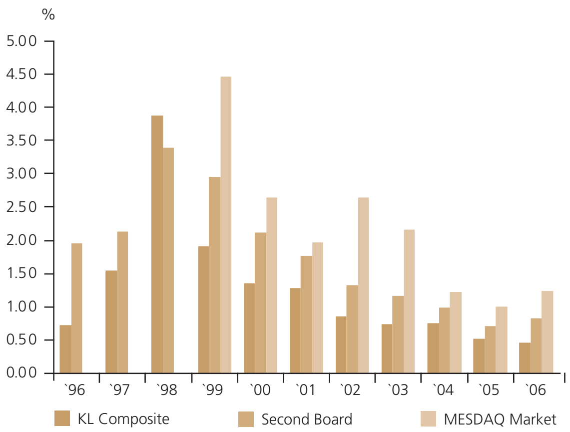
Source: Bursa Malaysia

Chart 2.45
Regional Comparison of Price-Earnings Ratios



Source: Bloomberg, Bank Negara Malaysia estimates

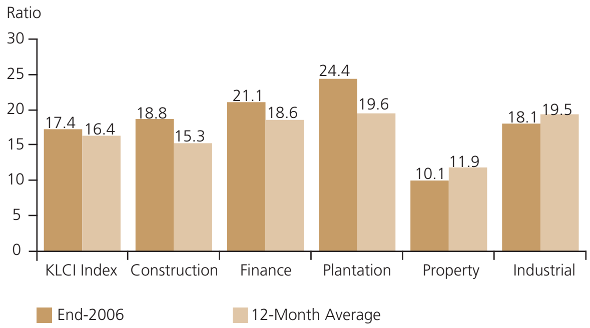
Chart 2.44
Volatility[1] in Bursa Malaysia Markets



[1] Refers to the annual average of the rolling 90-day standard deviation of daily returns

Source: Bank Negara Malaysia's calculations

Chart 2.46
Bursa Malaysia Comparison of Sectoral Price-Earnings Ratios



Source: Bloomberg, Bank Negara Malaysia estimates

levels remained well below historical levels. The Malaysian markets were also not significantly affected by the developments in neighbouring Thailand in the later half of the year, with the domestic indices rebounding very strongly.

Despite the stronger performance in 2006, the KLCI's valuation remained broadly in line with the historical trend. At the end of 2006, the price-earnings (P/E) ratio of the KLCI was slightly higher than its historical average. On a sectoral basis however, the significant gains in the construction and plantation sectors resulted in their P/E ratios being higher than those of the other sectors. All sectors showed higher P/E ratios except for the industrials and property sectors, which remained below their long-term averages.

FINANCING OF THE ECONOMY

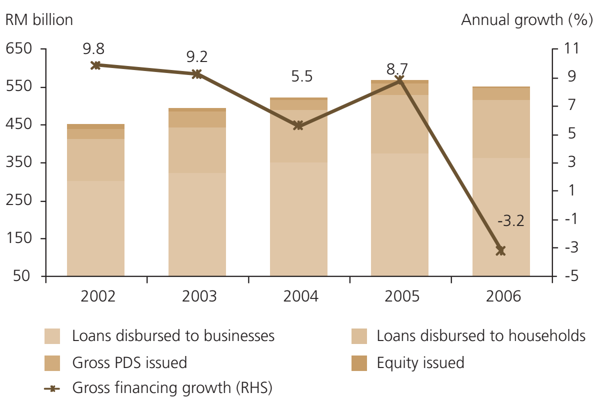
With domestic monetary and financial conditions strongly supportive of economic activity, the private sector was able to be more selective of the avenues and structures that were most suited to their financing needs. Expectations at the beginning of the year were for interest rates to increase. This encouraged borrowers to seek financing via the debt securities market to take advantage of the lower cost of borrowing. In addition, there was a notable shift towards financing avenues that provided borrowers with the necessary flexibility in meeting their longer term funding requirements. As such, while financing via the private debt securities market was sustained at a high level, financing via the banking system and the equity market was slower.

Overview

In 2006, total net financing channelled to the economy, encompassing both public and private financing, increased at a steady rate of 5.9% (7.4% in 2005), broadly in line with the sustained pace of economic growth.

Business operations and investment activity were supported by both internal funds and an increase in net financing of 5.9% (2005: 7%), with foreign sources of financing, namely foreign direct investment (FDI), augmenting domestic-based financing. The reliance on internal funds to some extent, accounted for the disconnect between the slower pace of growth in net financing to businesses vis-à-vis the sustained growth in private investment activity. The PDS market was the main source of domestic long-term financing. Large companies have increasingly sought to raise funds in the PDS market to finance their new activities. While the banking system continued to provide financing to businesses, accounting for the largest share of the disbursement of funds, these mostly comprised short-term revolving facilities with repayments broadly matching disbursements. Nevertheless, among SMEs, credit continued to be mainly sourced from the banking system, and the development financial institutions (DFIs). This includes financing under the Special Funds for SMEs administered by Bank Negara Malaysia and channelled through banking institutions and DFIs.

Chart 2.47
Gross Financing through Banking System and Capital Market



Financing of the households, which was concentrated mainly in the banking system, increased at a more moderate pace of 9.7% (2005: 15%), broadly in line with the growth in consumption expenditure.

Business operations and investment activity continued to be supported by diversified sources of financing and internally generated funds

Financing to the Business Sector

The business sector relied less on borrowed funds for working capital and investment in 2006 as evidenced by the lower amount of bank loan disbursements and steady level of gross PDS issuances. With strong cash surplus positions, many large corporates, particularly those in the manufacturing, services and commodities sectors, continued to rely on internal funds, augmented by FDI. At the same time, companies experiencing higher operating costs and more moderate demand for their goods and services took a more cautious stance in obtaining additional financing. The confluence of these factors led to a steady rather than a strong increase in net financing. Business loans and PDS outstanding expanded at a combined rate of 5% (2005: 6.5%).

Business Financing through the Banking System

The drawdown of bank loans by businesses, as indicated by loan disbursements, was lower by 3.3% in 2006 (6.9% in 2005), mainly reflecting lower working capital financing requirements in the manufacturing, and wholesale and retail trade sectors. In terms of loans outstanding to the manufacturing sector, approximately 26% were accounted for by industries related to the construction sector, namely iron and steel; non-metallic products and fabricated metals. Loan

Table 2.3
Financing of the Economy: Outstanding as at end-December 2006

By customer / By financing type/ institution	Business[1] Total	Business[1] of which: SMEs	Households	Government	Total Financing
	RM million				
Financial Intermediaries	**346,668**	**120,222**	**386,409**	**1,755**	**734,833**
Banking Institutions	258,103	102,501	333,104	1,755	592,962
Development Financial Institutions (DFIs)[2]	23,542	13,221	27,596		51,138
Other Domestic Intermediaries[3]	65,024	4,500	25,709		90,733
Capital Market					
Bond Market[4]	**186,081**			**207,590**	**393,671**
Equity Market[5]	1,916				1,916
Venture Capital[5]	3,310				3,310
External Financing					
Foreign Direct Investment[5]	25,900				25,900
External Debt[6]	77,323			73,156	150,479
Net Change in Financing (2005)					
Financial Intermediaries	**19,852**	**8,540**	**45,902**	**(1,581)**	**64,174**
Banking Institutions	5,790	7,655	39,980	(1,581)	44,189
Development Financial Institutions (DFIs)[2]	4,324	203	5,578		9,902
Other Domestic Intermediaries[3]	9,738	682	344		10,082
Capital Market					
Bond Market[4]	17,969			13,700	31,669
Equity Market[5]	6,315				6,315
Venture Capital[5]	2,589				2,589
External Financing					
Foreign Direct Investment[5]	15,000				15,000
External Debt[6]	3,662			(10,780)	(7,118)
Total	**65,388**	**8,540**	**45,902**	**1,339**	**112,630**
Net Change in Financing (2006)					
Financial Intermediaries	**11,960**	**7,571**	**34,274**	**(1,669)**	**44,566**
Banking Institutions	7,824	6,545	28,741	(1,669)	34,896
Development Financial Institutions (DFIs)[2]	2,544	1,193	5,219		7,763
Other Domestic Intermediaries[3]	1,593	(167)	314		1,907
Capital Market					
Bond Market[4]	10,510			17,120	27,630
Equity Market[5]	1,916				1,916
Venture Capital[5]	3,310				3,310
External Financing					
Foreign Direct Investment[5]	25,900				25,900
External Debt[6]	6,006			(12,963)	(6,956)
Total	**59,602**	**7,571**	**34,274**	**2,488**	**96,365**

[1] Business includes non-bank financial institutions, domestic non-business entities and foreign entities.

[2] Refers to DFIs governed under the Development Financial Institutions Act, 2002.

[3] Other domestic intermediaries include insurance companies, Employees Provident Fund (EPF), housing credit institutions, leasing and factoring companies and Treasury Housing Loan Division.

[4] Bond Market refers to outstanding of private debt securities (PDS) and all Malaysian government securities.
PDS refers to corporate bonds issued including irredeemable convertible unsecured loan stocks (ICULS) and medium term notes (MTN).

[5] Refers to flow during the year.

[6] External financing of Government includes financing to non-financial public enterprises (NFPEs).

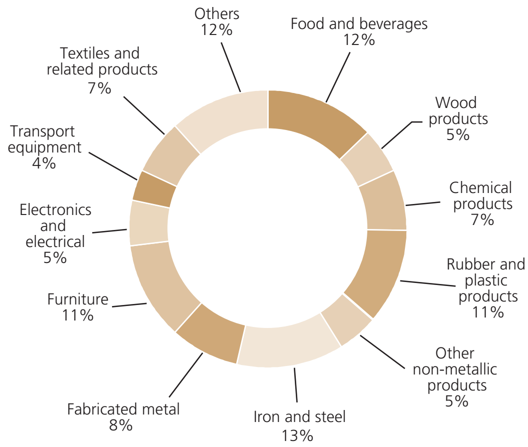
Table 2.4
Special Funds for SMEs administered by Bank Negara Malaysia

Type of Fund	RM million					%	
	Allocations	Approvals	Disbursements	Repayments	Loans Outstanding	Utilisation Rate[1]	Undrawn [2]
	As at end-2006						
Fund For Food	1,300.0	1,768.3	1,682.1	981.7	700.4	136.0	4.9
New Enterpreneurs Fund 2	2,850.0	3,206.7	2,864.1	547.8	2,316.3	112.5	10.7
Fund for Small and Medium Industries 2	6,750.0	7,820.2	7,059.0	2,259.7	4,799.2	115.9	9.7
Bumiputera Enterpreneurs Project Fund	300.0	599.9	516.8	454.0	62.8	200.0	13.9
Rehabilitation Fund for Small Businesses	200.0	18.3	15.7	5.6	10.1	9.1	14.1
Total	**11,400.0**	**13,413.4**	**12,137.7**	**4,248.8**	**7,888.9**	**117.7**	**9.5**
	Change during the year						
Fund For Food	-	144.1	147.6	153.2	-5.6		
New Enterpreneurs Fund 2	500.0	508.4	594.1	162.8	431.3		
Fund for Small and Medium Industries 2	2,000.0	1,471.6	1,655.7	1,233.4	422.2		
Bumiputera Enterpreneurs Project Fund	-	66.6	68.8	59.7	9.1		
Rehabilitation Fund for Small Businesses	-	1.8	7.1	4.9	2.2		
Total	**2,500.0**	**2,192.5**	**2,473.3**	**1,614.0**	**859.3**		

[1] Ratio of approvals over allocations.
[2] Ratio of approvals minus disbursements, over approvals

disbursements declined as growth in the industries related to the construction sector continued to contract in the first half of 2006. Moderate growth performances in the second half of 2006 in selected sub-segments of the rubber and plastic product industries may have also led to lower loan disbursements.

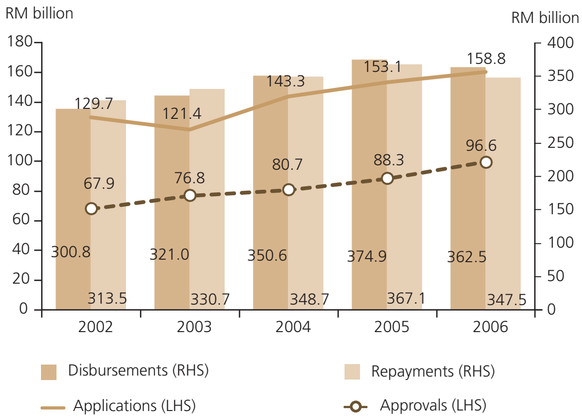
Chart 2.48
Loan Outstanding to the Manufacturing Sub-sectors as at end-2006



The lower loan disbursements in the manufacturing sector, to some extent, mirrored the performance of loan disbursements to the wholesale trade sector, which includes financing to facilitate the distribution of industrial products in addition to household products. Both the wholesale and retail trade sectors were also faced with increased competition amid resilient growth in private consumption.

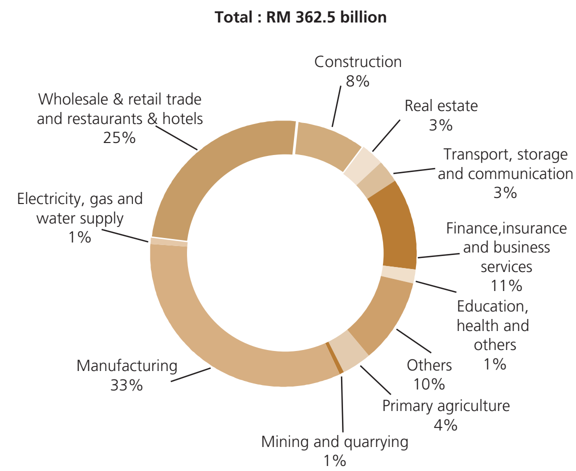
Throughout the year, the ratio of loan approvals to applications remained relatively stable for both large businesses and SMEs indicating that the lower loan disbursements were largely driven by demand rather than supply factors. Competition amidst surplus liquidity spurred banking institutions to provide attractive financing options. In some instances, viable emerging corporates and SMEs obtained financing at cost-plus rates that were lower than the BLR.

Chart 2.49
Business* Sector Loan Indicators



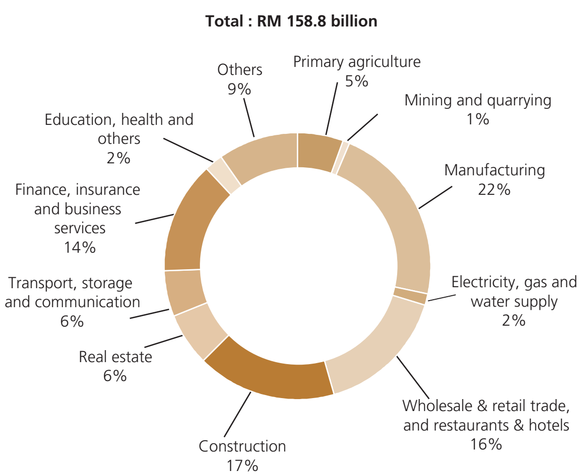
* Business sector includes non-bank financial institutions, domestic non-business entities and foreign entities

Chart 2.51
Business Loan Disbursements by Sector in 2006



While the growth performance of the construction sector and the manufacturing industries related to the construction sector improved in the second half of the year, this did not immediately translate into higher overall loan disbursements. Nevertheless, indicating some pick-up in financing needs, there was a strong recovery in new loan applications and approvals in the fourth quarter. For the year as whole, new loan applications and approvals rose by 4.1% and 12.5% respectively (2005: 6.8% and 9.4% respectively).

Chart 2.50
Business Loan Applications by Sector in 2006



Business Financing through the Bond Market

The bond market remained as one of the important sources of financing for the private sector. In the environment of rising inflation and interest rate during the first half of the year, corporations continued to tap the domestic bond market to meet their funding requirements as well as lock in prevailing interest rates in anticipation of further interest rate increases. Furthermore, as the market activity improved in the second half of the year, corporate interest in issuing debt securities to meet their financing needs remained high.

The bond market was an important source of financing for the private sector with total gross funds raised through the private debt securities market remaining substantial

In 2006, total gross funds raised through the PDS market (excluding Cagamas) remained substantial, amounting to RM31.7 billion (2005: RM35.7 billion). However, the PDS market recorded lower net funds raised of RM11.1 billion due to higher redemptions during the year.

Chart 2.52
Funds Raised through the PDS Market

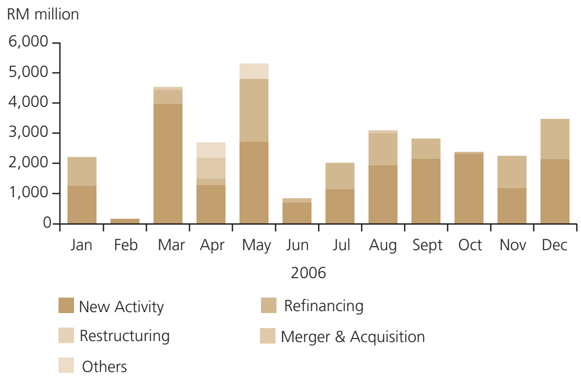


Table 2.5
Funds Raised in the Bond Market

	2005	2006
	RM million	
By Public Sector		
Government Securities (gross)	28,276	26,830
Less Redemptions	15,800	12,850
Equals Net Federal Receipts	12,476	13,980
Government Investment Issues (net)	1,000	9,500
Khazanah Bonds (net)	833	-630
Malaysia Savings Bond (net)	1,516	-1,931
Net Funds Raised	**15,825**	**20,919**
By Private Sector		
Private Debt Securities (gross)	38,196	38,887
Straight Bonds	3,869	8,667
Convertible Bonds	3,745	156
Islamic Bonds	9,537	4,781
Asset Backed Securities	6,210	1,546
Medium Term Notes	12,296	16,588
Cagamas Bonds	2,540	7,150
Less Redemptions	18,617	31,519
Private Debt Securities	13,432	20,617
Cagamas Bonds	5,185	10,902
Net Funds Raised	**19,579**	**7,368**
Net Funds Raised in the Bond Market	**35,404**	**28,287**

The PDS were issued by 95 corporations, mainly in the construction and property, finance and business services as well as utilities (electricity, gas and water) sectors. Major issuers within the construction and property sectors were companies involved in major infrastructure projects including projects under the 9MP. In the finance and business services sector, companies issued debt securities mainly to fund their working capital and financial activities. Meanwhile, independent power producers and companies involved in water related projects continued to resort to the debt securities market to meet long-term financing requirements that requires financing to be raised in small amounts over a long period of time.

Furthermore, the liberalisation of foreign exchange administration rules since April 2004 had encouraged two additional PDS issuances in the Malaysian capital market by foreign entities

Chart 2.53
Private Debt Securities by Sector in 2006: In Terms of Issuer and Amount Issued

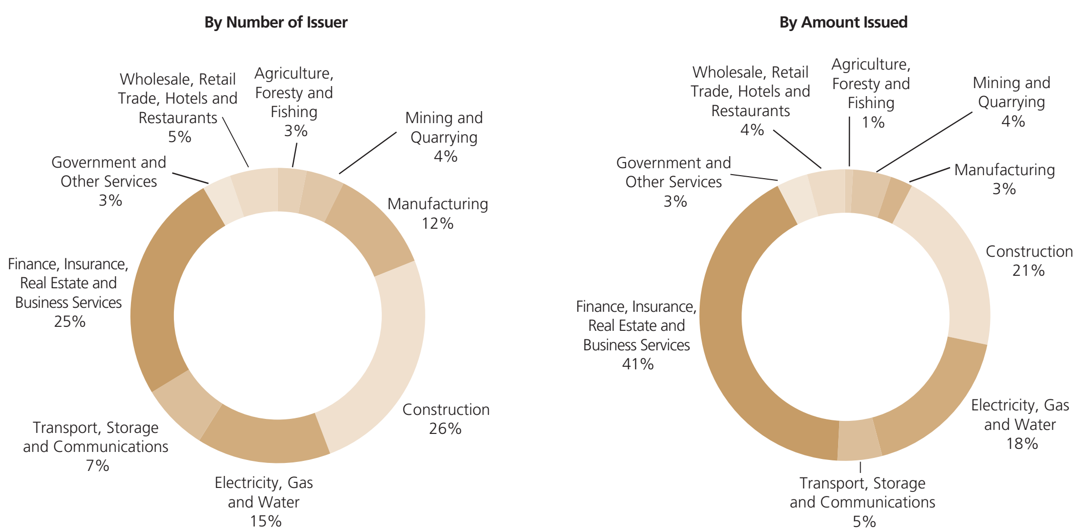


Chart 2.54
PDS Financing by Purpose

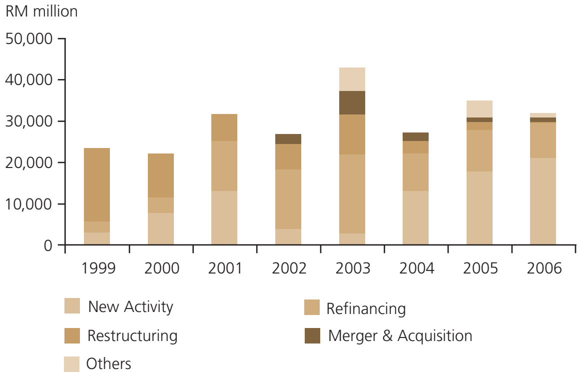
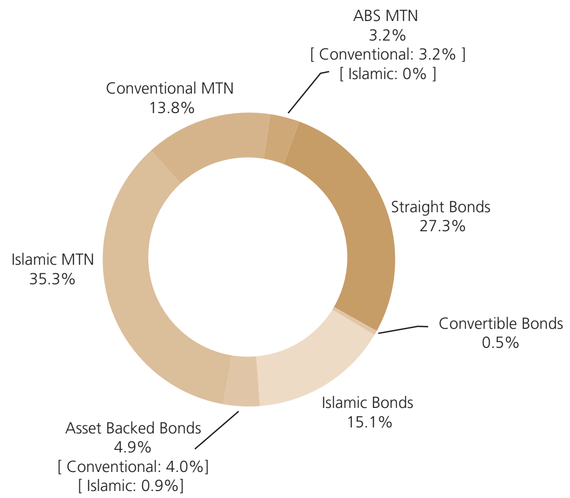


Chart 2.55
PDS Issues by Type of Instrument (Excluding Cagamas)



comprising a multilateral development bank and a multinational corporation. These issues were successful and have resulted in these entities opting to conduct further issuances in the Malaysian market. It is expected that going forward, more such entities will opt to issue their PDS in the Malaysian market.

Most of the PDS issued during the year were channelled for new investment activity (66.1%) and the refinancing of existing debt (28%). The trend in corporate financing through the PDS market has evolved since the Crisis. In the more recent years, most companies have gone to the debt market to finance their new investment activities. The need for financing for restructuring purpose has tapered off since 2004 as the corporate sector has successfully undertaken their restructuring exercise.

The new PDS maturity profile during the year were concentrated on the tenures between one to ten years (74.2% of total new issues of PDS) reflecting the issuers' preference for the short to medium-term financing. Meanwhile, PDS with tenures of

Chart 2.56
PDS Issues by Tenure (Excluding Cagamas)

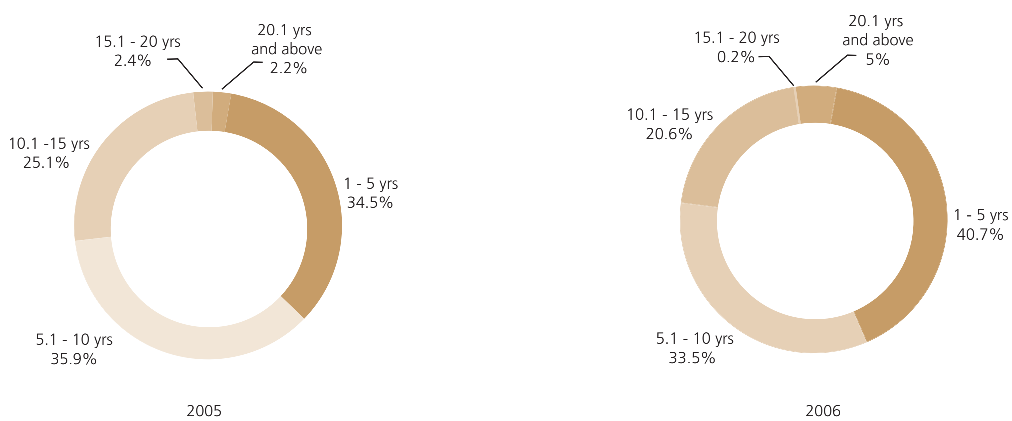
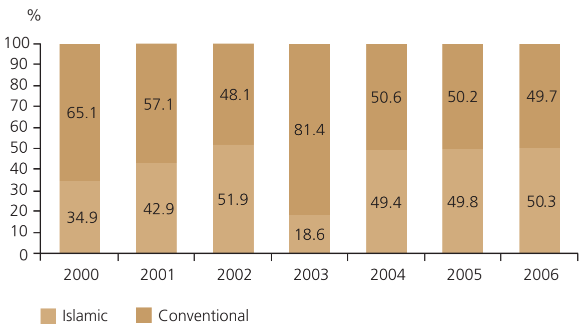


Chart 2.57
Funds Raised via Islamic and Conventional Private Debt Securities



more than 20 years (including the PDS with the longest tenure of 33 years) increased during the year and were mainly issued by companies involved in finance, power production and infrastructure projects that require long-term financing due to their extended gestation periods.

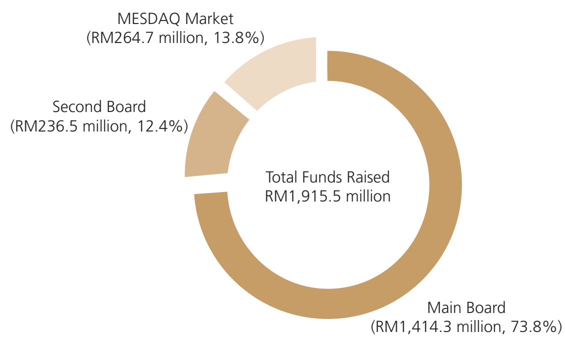
In line with the issuers' preferences for issuing short to medium-term securities, medium-term notes (MTN) programmes remained as the most favoured form of debt securities financing (52% of total new issuances) as the instruments provided issuers with the flexibility to obtain financing whenever they needed it. Also, the measures and initiatives taken to develop a more innovative and sophisticated Islamic capital market have resulted in greater issuance of Islamic products. Islamic securities issuances continued to grow and accounted for 50.3% of total PDS issued during the year.

Business Financing through the Equity Market

Total financing via the equity market in 2006 was RM1.92 billion, significantly below the amount raised in previous years. The reduced attractiveness of equity issues as an avenue to raise funds is attributable to the weak sentiments associated with the Malaysian equity market in the first half of the year. The low interest rate environment that prevailed throughout the year and the tightening of listing criteria on the MESDAQ Market by the Securities Commission were other factors contributing to the lower funds raised through the equity market.

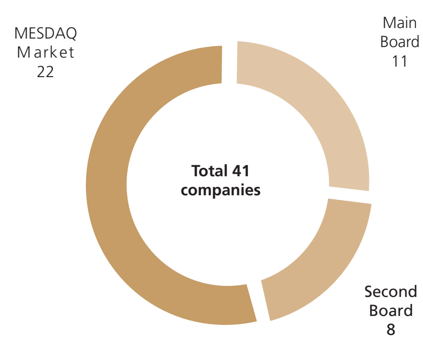
In the first half of 2006, given the uncertainty regarding the outlook on inflation and the possibility of a series of interest rate hikes, issues were delayed in anticipation of a better outcome for their public offerings at a later date. As the year unfolded, the low interest rate environment that prevailed also made other forms of financing more attractive. In particular, more companies sought financing through the PDS market. Listings on the MESDAQ Market were also heavily affected by the Securities Commission's decision to tighten the listing criteria. The policy move, mainly aimed at protecting investors, is however expected to assist in ensuring quality deal-flows into the market over the long-term.

Chart 2.58a
Funds Raised - By Board, (RM million, % share)



Source: Bursa Malaysia

Chart 2.58b
Number of Listings on Bursa Malaysia in 2006



Source: Bursa Malaysia

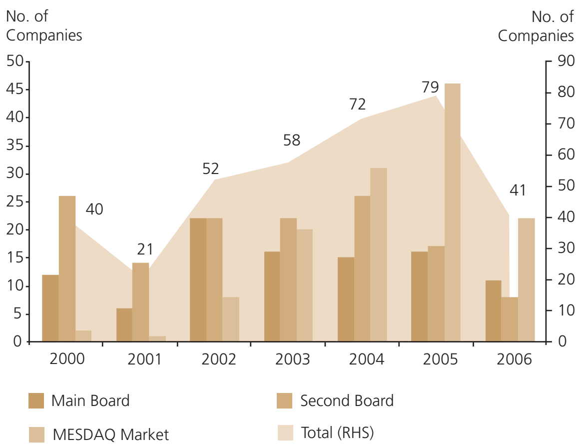
Table 2.6
Financing via the Equity Market (RM million)

	2005		2006	
	Amount (RM)	% Share	Amount (RM)	% Share
Initial Public Offers	5,305.1	84.0	1,518.7	79.3
Public	2,534.7	40.1	619.8	32.4
Offer for sale	2,167.7	34.3	313.4	16.4
Private Placement	602.8	9.5	585.6	30.6
Rights issues	967.7	15.3	367.4	19.2
Warrants	42.3	0.7	29.4	1.5
Total	**6,315.2**	**100.0**	**1,915.5**	**100.0**

Source: Bursa Malaysia

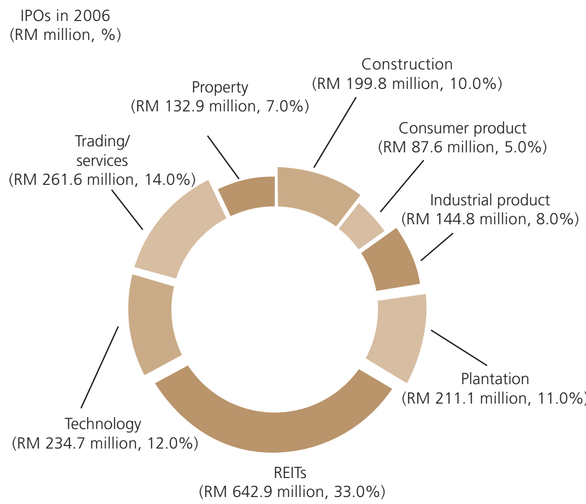
However, equity market sentiments turned more favourable towards the year-end. As a consequence, there were more listings in the Main, Second Board and the MESDAQ Market in the second half of the year. In the first five months of 2006, 18 companies sought listing on the stock market, but from June onwards, 23 companies listed on Bursa Malaysia. In terms of the amount raised, the Main Board remained the most significant avenue for listing on Bursa Malaysia. Significantly more funds were raised through the Main Board (73.8%), as compared to the Second Board (12.4%) and the MESDAQ Market (13.8%). Of significance is that despite the tighter listing requirements, the MESDAQ Market continued to register the highest number of listings among the three boards.

Chart 2.59
Number of Listings on Bursa Malaysia in 2006 - Breakdown by Boards



Source: Bursa Malaysia

Chart 2.60
Initial Public Offerings in 2006 - Breakdown by Sectors



The sectors that received the most financing were the relatively new sector of Real Estate Investment Trusts (REITs), followed by the trading and services and technology sectors. In response to the Government's efforts to promote the development of REITs in the capital market through such incentives as the provision of favourable tax treatments, four new REITs were listed during the year. Funds raised by the REITs sector amounted to RM642.9 million and accounted for 33.6% of funds raised on Bursa Malaysia during the year (2005: 11.3%). The trading and services sector was the next largest issuer with a share of 13.7%, followed by the technology sector with 12.3%.

Financing to the Household Sector

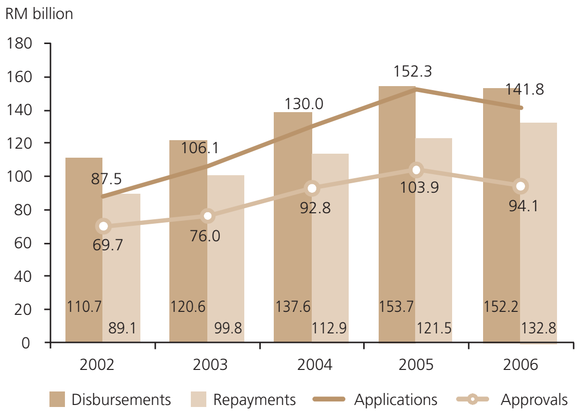
Demand for credit by the household sector mirrored the moderately slower growth in consumption expenditure. Loans outstanding of the household sector with the banking system, the primary source of household financing, increased at a more moderate rate of 9.4% in 2006 (2005: 15.1%). The slower pace of growth was primarily on account of lower financing channelled for the purchase of passenger cars, and to a lesser extent, for residential property. On balance, numerous factors, such as price adjustments and general uncertainty in the car market, influenced decisions regarding the purchasing of the bigger ticket items during the year.

Household financing increased at a more moderate pace mainly on account of lower passenger car loans

Loans outstanding for the purchase of passenger cars increased at a slower rate of 6.6%, broadly in line with the slowdown in demand for new cars. The ratio of loan approvals to applications remained relatively stable throughout the year, indicating that the moderating trends in the passenger car loan indicators were largely driven by demand and not supply factors. In the early part of 2006, car purchases were lower, as households adopted a "wait-and-see" stance with regard to the then yet to be released details of the National Automotive Policy (NAP). Subsequent to the announcement of the particulars of the NAP, demand moderated further, reflecting a confluence of factors. Households to a large degree held back on purchases on account of the lower trade-in values of used cars. This was particularly the case among the buyers replacing their existing cars, who account for a larger fraction of purchases in the car market. Some potential buyers also deferred their purchases on expectations of further price declines.

Loans outstanding for the purchase of residential property increased at a slightly more moderate pace of 8.5% (12.5% in 2005) with loan applications and disbursements lower by 1% and 3.6% respectively. Financing activity for residential property moderated as the pent-up demand for housing appears to have been satisfied over the past few years. In fact, some of the demand had probably been brought forward due to the incentives offered to encourage home ownership as well as the attractive financing packages available from the banks. In addition, households adopted a more cautious attitude during the year, particularly in terms of property

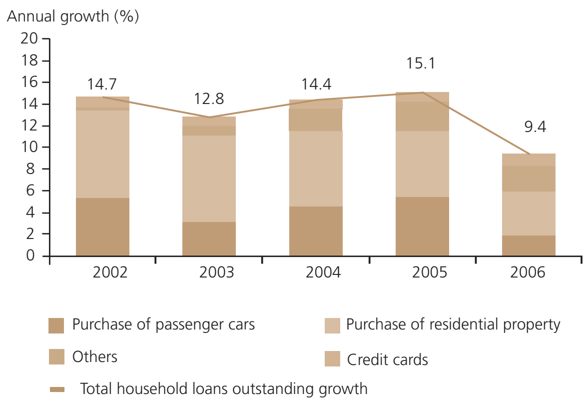
Chart 2.61
Household Sector Loan Indicators



purchases for investment. With overall moderation in demand and a situation of oversupply in some locations, certain households' decisions to defer purchases may have also reflected hopes of lower prices in the future.

Utilisation of credit cards increased during the year. Nevertheless, the repayment ratio[1] which indicates the average amount of debt that is paid in full, remained relatively stable at 60%, reflecting the continued use of credit cards as a means of payment rather than as a mode of obtaining credit. At the same time, the NPL ratio for outstanding credit card debt was lower at 3.7% (end 2005: 4.6%).

Chart 2.62
Banking System Loans Outstanding to Households: Total Growth and Contribution by Purpose



[1] Repayment ratio = [(Total spending + cash advance) - outstanding balance] / (Total spending + cash advance)]