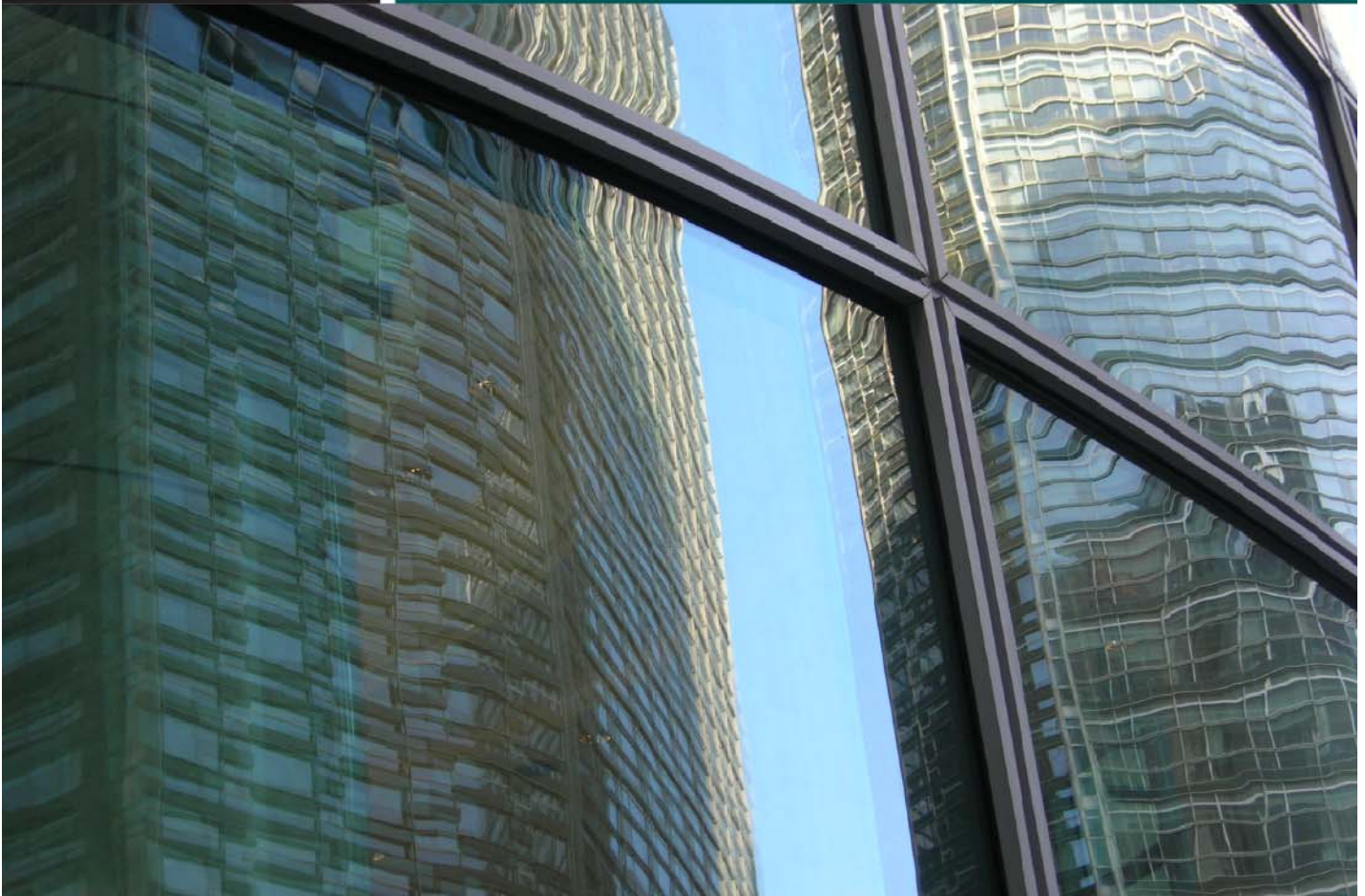


RAM

ECONOMIC OUTLOOK Review & Update

August 2010



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RAM

Malaysia's Economic Outlook Review and Update 2010

August 2010

DISCLOSURE AND UPDATE: The forecasts and outlook contained in this report are based on the prevailing assumptions and circumstances at the time of the report. Although the forecasts are intended to hold for the duration of a year, subsequent events may cause these assumptions to change and necessitate adjustments to the viewpoints and expectations in light of the altered circumstances. Any such change will be issued by RAM Holdings Berhad in the form of a commentary or an update.

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I. EXECUTIVE HIGHLIGHTS

Moderate growth momentum in 2H 2010 amid fading low-base effects and prevailing uncertainties in crisis-hit economies

Malaysia's GDP growth is expected to grow at a slower pace of 5.6% in 2H 2010, on account of moderating external demand, fading low-base effects and easing restocking activities. The projected growth for the second half of this year is broadly in line with the country's potential output supporting expectations for full year economic performance to register 7.4% overall.

Resilient domestic demand

Resilient domestic demand, which had driven a 6.5% consumption growth and a 9.4% rebound in investment activities in 1H 2010, contributed significantly to the rapid recovery, along with an upturn in external demand conditions. Stable unemployment trends and increased consumption of durable goods indicate improving consumer sentiment, leading to a rising propensity to consume. As a result, private consumption (in particular) is expected to maintain its upbeat momentum with a 7.7% growth for the year, slightly higher than the public-sector component, where growth is anticipated to reach 6.4%.

The environment of accommodative interest rates, increasing liquidity in the banking system and easy credit conditions creates a facilitative backdrop for investment activities. Given the robust showing in the first half of the year, investor confidence is seen to have strengthened while lingering uncertainty over the direction of economic performance seems to have dissipated somewhat. This will sustain vigorous investment activity in the second half, with an overall 9.9% expansion for 2010.

Rebound in external demand partially supported by changing trade patterns

Export growth is attributable to sustained (and increasing) demand from Newly Industrialised Economies and China. This trend is expected to continue as Asian economies still power much of the current global growth momentum; the crisis-hit economies are expected to continue experiencing lethargic recovery. For the full year, exports are projected to expand 12.9%, with imports clocking up 18.3%, backed by a pick-up in industrial and investment activities.

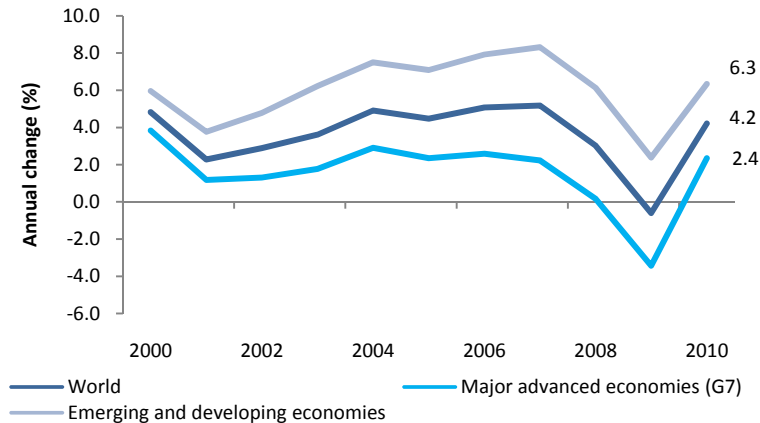
Moderate upward price pressures in line with better economic performance

Malaysia's inflation rate reflects increasing consumer confidence and recovering global demand following the worldwide financial turbulence. The year-on-year increase in the domestic inflation rate to 1.9% in July (coinciding with the commencement of the Malaysian Government's subsidy-rationalisation programme) is mainly attributable to the food and transport components. All things considered, we have maintained our estimated inflation rate of 2.5% for 2010.

II. GLOBAL ECONOMIC PROSPECTS

After a tumultuous year, external demand is recovering, albeit at a lacklustre pace. Demand conditions worldwide have yet to revert to pre-crisis levels due to the all-encompassing effects of the global financial crisis. Despite this, there has been a distinctive difference in the speed of recovery throughout this year; growth in developing economies has vastly outpaced that of the developed countries.

Figure 1: Global growth of the major economic blocs, and projections for 2010



Source: International Monetary Fund & RAM Economics

Domestic demand in the advanced economies has been constrained by severely weakened labour markets, as cumulative job losses from the crisis remain significantly high; as at June 2010, the number of unemployed people in the G3¹ came up to around 33.8 million, from 21.4 million at the beginning of the crisis in 2008. Furthermore, the fiscal austerity measures implemented by these countries – in an attempt to calm volatile financial markets – are expected to exert further downside risk on demand. Despite this, it is important to note that recovery in the advanced economies will continue, albeit slower than initially anticipated, as recovery momentum still depends on the build-up of both investor and consumer confidence.

The significant pace of recovery in the emerging markets, however, brings about the threat of inflation and its overall impact on long-term growth. In particular, China's rising price levels have already triggered several labour strikes in its industrial zones in recent months. While several policy tools had been successfully implemented to control the escalation of domestic prices in the first half of 2010, this also highlights the possible implications of an expected "cooling off" in the output of the world's second-largest economy.

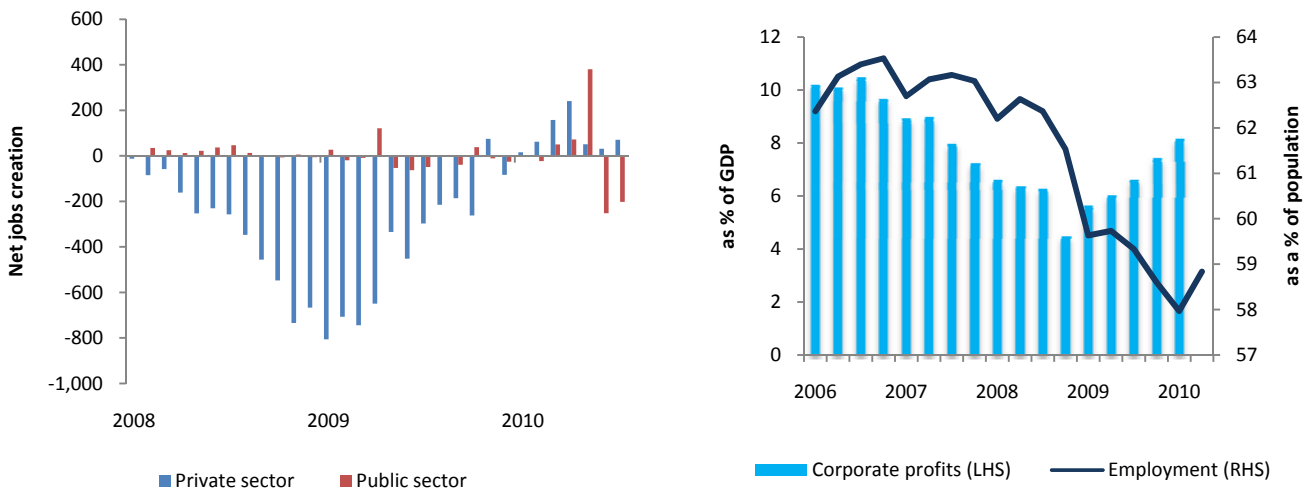
Malaysia's relatively open economy will undoubtedly be affected by these events. On the other hand, the aggressive measures taken by these economically prominent nations have the overall impact of ensuring the sustainability of longer-term global growth.

¹ The G3 economic bloc encompasses the large advanced economies of the United States, the Euro region (i.e. the 16 most developed economies in Europe) and Japan.

Advanced economies' demand conditions – weak with pockets of strength

The United States ("US"), which had lost as many as 8.5 million jobs in the private sector during the slump, has only recovered 0.7 million jobs in recent months. To make matters worse, there are expectations of more job losses from the public sector in the coming months, as a weakened economy and high debt levels constrain government expenditure. Furthermore, the ongoing housing slump has continued exerting a tremendous toll on American consumers' wealth as credit conditions - with regard to this specific sector - remain tight. While US corporate profits have indeed been recovering, employment in general continues to decline. This phenomenon is the result of the previous year's crisis, which has prompted companies to hoard cash as banks tighten credit in order to rejuvenate their (the banks') balance sheets.

Figure 2: US employment situation and corporates' profit performance



Source: US Bureau of Labour Statistics and Bureau of Economic Analysis

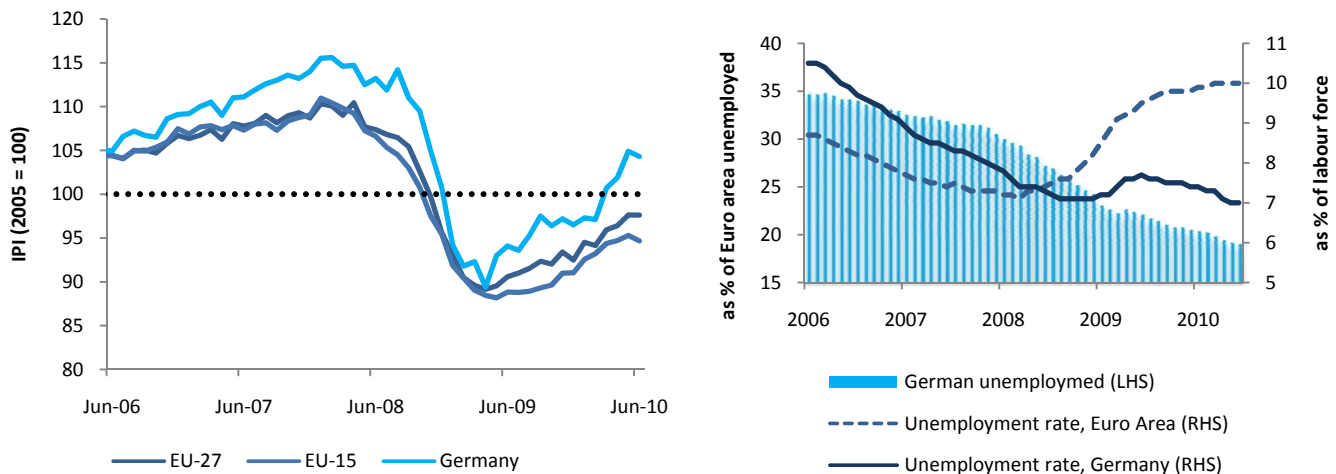
Nonetheless, a prolonged sluggishness in the American labour market is not inevitable as corporations are likely to start hiring again once banks ease up on credit conditions as debt fears in Europe begin to subside, which is expected after announcements on the European Financial Stability Mechanism and the release of favourable region-wide stress test results for banks. The US Federal Reserve's recent action of increasing domestic liquidity through further quantitative easing and maintaining low interest rates are expected to encourage firms to generate employment. Moreover, the recently signed laws in the US – the emergency USD26 billion jobs bill and the Manufacturing Enhancement Act – will likewise act to prop up employment in the short term.

As a result of the expected slow - but recovering - private-sector job creation and stop-gap interventionist policies in employment, any improvement in American consumer demand will remain a long-drawn-out process. It is therefore very unlikely that the world's largest economy will be able to revisit its pre-crisis employment conditions in the short term.

Despite the declining importance of Europe as a major export destination for Malaysia (10.7% of total exports in 1H 2010 vs 12.4% in 2H 2004), it still remains a substantial source of global demand for finished goods. Europe’s unemployment rate of 10% (marginally higher than that of the US) and its ongoing fiscal-restructuring programme is expected to soften this demand, hence affecting the production of trade-surplus countries in Asia.

However, it must be noted that export-oriented Germany has been enjoying a speedier recovery than its immediate neighbours. Germany’s higher labour productivity and larger exposure to the international markets – in terms of merchandise trade – has inevitably resulted in a faster pace of recovery for its industrial sector. Additionally, the *Kurzarbeit* programme – a scheme subsidising companies that retain workers – had allowed Germany to maintain a relatively healthy labour market and domestic consumer demand throughout the recent global financial crisis.

Figure 3: Comparison of industrial production index (or IPI) and labour-market conditions in Germany vs EU



Source: Eurostat and CEIC

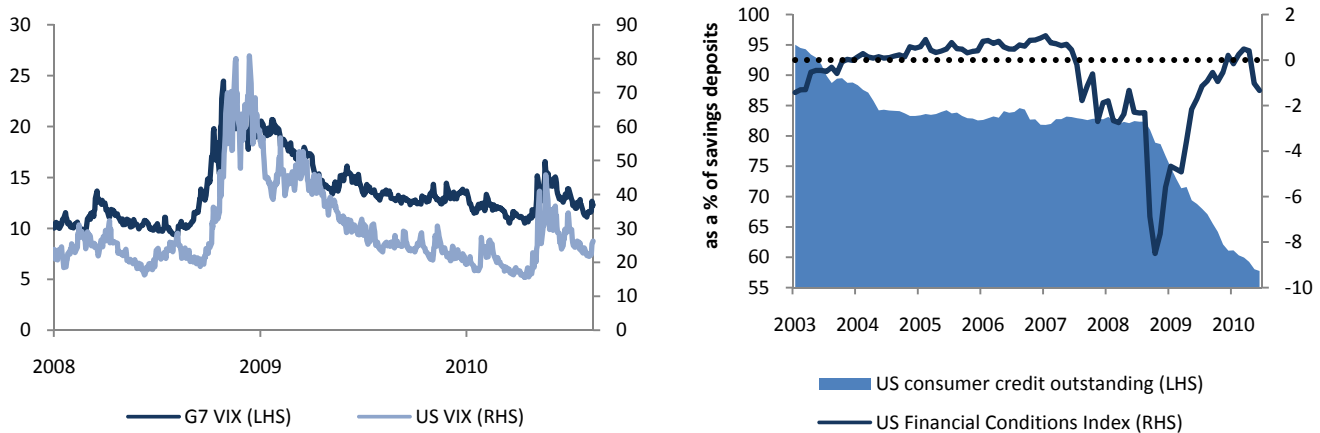
While Europe’s economic recovery is expected to remain weak in the short term as it grapples with its internal finances, Germany – Malaysia’s largest export destination in that region – whose growth has accelerated since the start of this year (2Q 2010: 2.2% quarter-on-quarter, seasonally adjusted), is expected to expand substantially in 2010. Consequently, Germany’s domestic demand is anticipated to play an important role in mitigating any fall in Europe’s demand for Malaysian exports.

In total, demand from the advanced economies – particularly the US and Europe – is expected to stay weak for the remainder of this year, especially if there are further shocks to global demand or financial flows. However, this is unlikely to persist in the long run as structural issues in these economies are addressed and private-sector confidence begins to build up.

Global financial conditions – stabilisation and recovery

Global financial conditions – particularly in the US – remain somewhat volatile, as measured by the Volatility Index² (“VIX”) for composite US and G7 equities shown below. The increased volatility in recent months can be attributed to fears of yet another contraction in global output as advanced economies have pledged several fiscal austerity measures to combat their excessive debts, and as China fights to contain its accelerating inflation.

Figure 4: US and G7 financial conditions indicators



Source: Bloomberg and CEIC

Indeed, financial conditions³ in the US have worsened as this increased pessimism has translated into higher interest payments and tighter lending standards as the credit risk premium increases (refer to Figure 4, right panel). This has led to a further contraction in bank lending while lower consumer wealth levels have reduced credit creation within the economy. While this has considerably subdued demand, it indicates that American households have rebalanced their consumption behaviour and, as such, contribute to the sustainability of the US banking sector’s recovery.

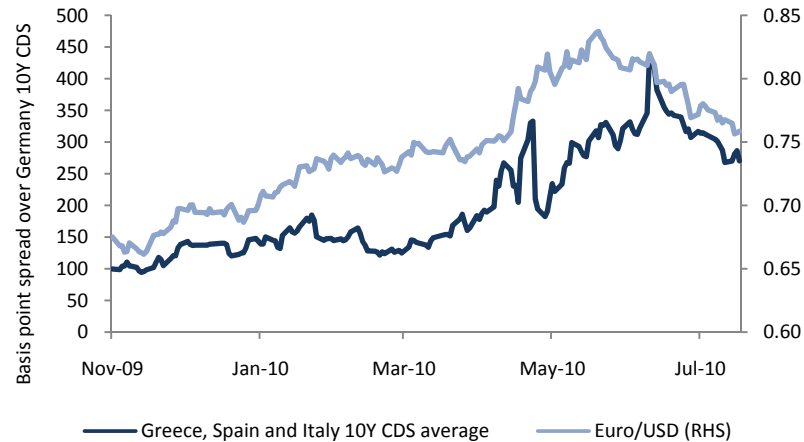
In Europe, banks’ substantial exposure to fiscally unstable government debt (the sovereign debts in some of these countries are estimated to reach 150% of their GDP by the end of this year) has caused significant financial turmoil within the region since end-2009. This ongoing saga is best represented by the highly indebted countries’ credit-default swap⁴ spreads against Germany and the performance of the region’s currency (the euro) through the year.

² VIX shows the expected change in prices in the following month (regardless of upside and downside changes)

³ Financial conditions are measured by Bloomberg’s Financial Conditions Index which is a composite of different US markets (equities, bonds and money); the index represents the number of deviations the current market conditions move above or below the market average

⁴ Credit-default swaps are used as a proxy to measure investors’ perspective of a security’s default.

Figure 5: Selected European credit-default swap spreads (average) and the performance of the euro



Source: Bloomberg and CEIC

Measures that have been implemented of late have prevented the total collapse of financial confidence in the European Union (“EU”). This includes the announcement of the joint EU-International Monetary Fund €750 billion European Financial Stability Mechanism, designed to provide short-term liquidity for the region’s sovereign debt and the release of favourable region-wide bank stress-test results, where only 7 out of the 91 tested banks had failed amid a scenario of adverse sovereign shocks. Furthermore, many of the high-deficit nations such as Greece, Italy and Spain have pledged to stabilise their public finances over the short term, to calm their highly volatile financial markets.

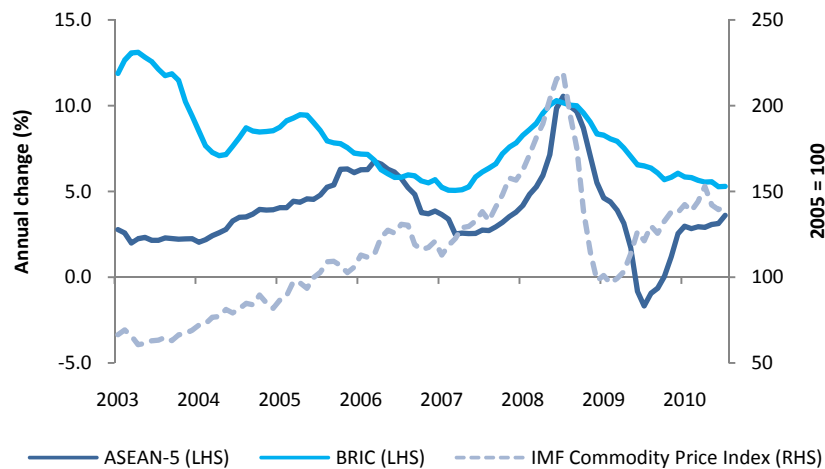
Despite several months of demand growth, international financial conditions are still fairly volatile. However, it is unlikely that this will persist over the longer term as confidence returns and global demand becomes more entrenched amid the sizeable bail-out fund, coupled with the implementation of the fiscal austerity measures throughout the developed world.

Sustainability of large emerging markets’ growth

Another serious concern for global growth is the sustainability of the recovery of the developing economies. The rapid pace of growth of large emerging markets – i.e. Brazil, Russia, India and China (colloquially known as the BRIC countries) – is expected to moderate as each of these countries contends with domestic inflation. The figure below shows that inflation in other emerging markets (such as the ASEAN-5⁵) is generally dictated by global commodity prices, unlike their more prominent cousins.

⁵ The ASEAN-5 economic bloc comprises large, developing South-east Asian economies - Malaysia, Indonesia, the Philippines, Thailand and Vietnam

Figure 6: Inflation rates in selected emerging economic blocs⁶ and global commodity prices



Source: CEIC, International Monetary Fund, Russia Ministry of Finance

This divergence in inflation rates implies that inefficient cost-push or demand-pull price mechanisms still exist in these large economies. For example, in India and Russia, underdeveloped infrastructure and adverse weather conditions have caused considerable price adjustments – especially with regard to domestic consumer goods – while China’s large capital inflow and the pent-up pressure of depressed wages over the previous years have likewise accelerated inflation.

While significant inflationary pressure has continued building up in the BRIC countries since the end of 2009, especially since commodity prices have staged a comeback, only China has taken significant steps to cool its economy. The policies implemented in recent months include restrictions on bank lending, forced closures of inefficient factories, and allowing a more flexible exchange rate. Despite all these efforts, labour strikes erupted in China in June, underlining the need to further quell its escalating domestic prices.

That said, the strong growth of these economies should be able to contain inflation, such that it will not spiral out of control and adversely affect real domestic consumption. However, more measures need to be taken – such as allowing a greater degree of exchange-rate flexibility – to ensure that growth will indeed be sustainable in the long run.

⁶ Inflation by economic blocs is weighted by the average income per capita of every country in each bloc in 2000-2008

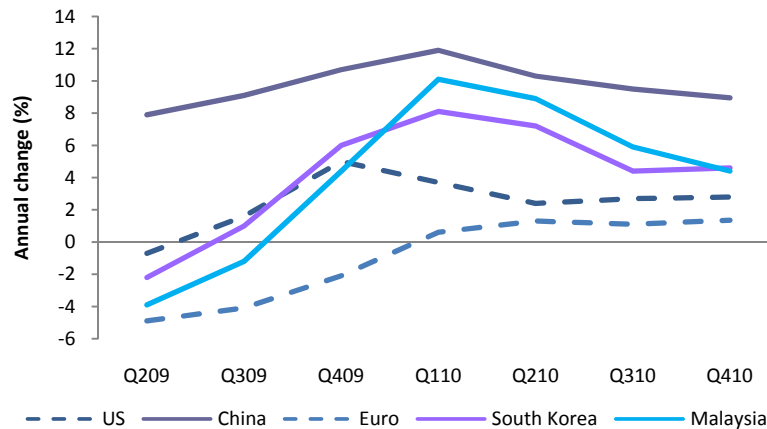
III. MALAYSIA'S FIRST HALF ECONOMIC PERFORMANCE AND SECOND HALF OUTLOOK

Global growth supported by V-shaped economic rebound in Asian economies

As global growth momentum began to pick up by the end of 2009 after the worldwide economic slump triggered by the American sub-prime credit crisis, there was a noticeable trend of a "dual-speed" recovery that defined the different regions. Although rapid V-shaped recoveries were observed in Asian economies, crisis-hit economies exhibited both weak and slow upturns.

The US and EU pulled out of the recession through strong stimulus spending and accommodative monetary policies. With the effects of stimulus spending coming to an end and the prevalence of serious structural imbalances within their economies, however, prospects for sustained recovery momentum remain clouded by uncertainties. Bloomberg consensus estimates foresee the growth of developed economies remaining sluggish; for the robust Asian region, growth is expected to moderate in the second half of this year, when low-base effects taper off.

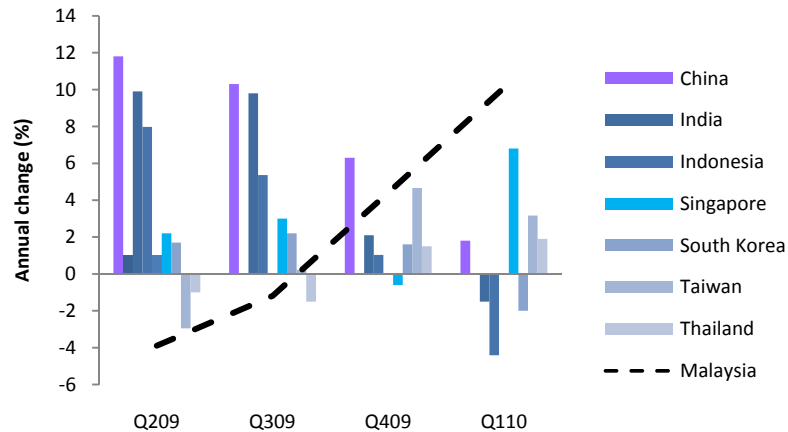
Figure 7: Dual-speed recovery in global economy



Source: Bloomberg and RAM Economics

The diagram below illustrates the growth path of the Malaysian economy through the recession, when growth sank to its lowest point of 6.2% in 1Q 2009 before staging the impressive turnaround in 1Q 2010 with a 10.1% expansion. During this period, growth in Asia had been uneven relative to the extent to which the countries had been affected by the global crisis and also the patterns of their respective recoveries. During recent Malaysia's economic contraction, many of the economies in the region had been expanding, exceeding Malaysia's performance by a wide margin (i.e. China, India and Singapore). As Malaysia's recovery kicked off, however, it broadly outperformed its ASEAN neighbours, though still lagging behind a number of the more developed newly industrialised economies ("NIEs") such as Singapore and China (which has consistently maintained high rates of growth during this period). Moving forward, the NIEs are expected to remain resilient and maintain commendable rates of growth, which will be an important factor in sustaining external demand conditions.

Figure 8: Growth within Asia



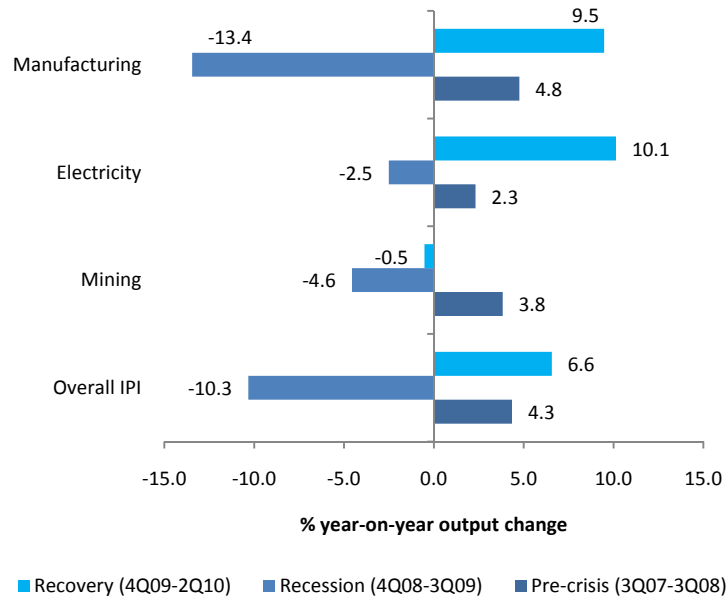
Source: Bloomberg and RAM Economics

Note: The dotted line represents Malaysia's growth rate; bars indicate the percentage-point differences between the growth rates of Malaysia and other Asian economies.

Robust industrial activity

Industrial activity resumed positive growth towards the end of 2009 (as represented by the robust performance of the Industrial Production Index or "IPI"), and contributed significantly to the turnaround in GDP. The strong uptrend in industrial activity has been underlined by the low-base effects from the previous year, when economic activity bottomed out in the first half of 2009; this can be attributed to both the resilience of domestic demand and a rebound in external demand. Meanwhile, healthier business sentiments and the increased confidence of industrial companies vis-a-vis boosting output had contributed to the surge in imports of intermediate and capital goods.

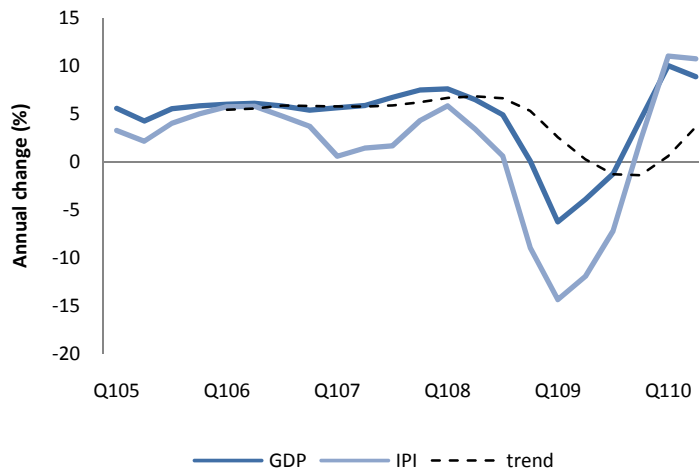
Figure 9: Comparison of pre- and post-crisis industrial activity



Source: Bank Negara Malaysia and RAM Economics

A comparison of pre- and post-crisis industrial activity shows that the significant contraction during the recession has been offset by the momentum of recovery and the reversion to pre-crisis industrial capacity.

Figure 10: IPI and overall growth trends



Source: Bank Negara Malaysia

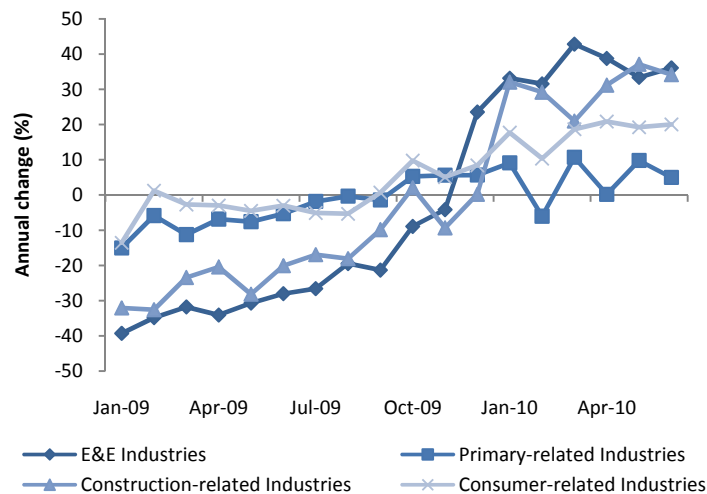
Overall economic growth in 1H 2010 came up to an impressive and robust 9.5%, which is in line with our expectation of 9.4%. The upturn in economic performance is attributable to the strong recovery in manufacturing activities, which accelerated 16.4% in the first half – in contrast to the deep contraction of 16.7% experienced in

1H 2009. Despite evidence of the low-base effect being a significant factor in the double-digit growth achieved, the vigorous industrial activities and exports had also contributed to resilience and a rapid recovery. Moreover, the robust showing of the construction and services sectors, which expanded by a respective 6.3% and 7.9% in the first half, is also consistent with our expectations. The healthy showing of these sectors signal increasing confidence among the business community, as growth in construction indicates a higher level of capacity undertaken by both the public and private sectors.

Meanwhile, the faster pace of industrial activity was broad-based, with both export- and domestic-oriented industries contributing to its overall expansion of 10.9% in 1H 2010. Nonetheless, there was a divergence in the magnitude of growth experienced by the sub-sectors within the broader classifications, with electrical and electronic (“E&E”) production leading the sluggish growth in primary-related industries.

A similar trend can be observed in domestic-oriented activities, where construction-related industries had driven growth, largely outperforming the consumer-related segment. These activities are estimated to have contributed a respective 30.8% and 17.8% to IPI expansion - patterns that are consistent with the recovery in external demand (driving the pick-up in E&E-related activities) and the resilience of the construction sector. Going forward, construction activity is expected to remain steady; growth in primary-sector activities such as agriculture and mining is expected to contribute to expansion at a stable albeit marginal rate, consistent with the trends experienced in the first half of this year.

Figure 11: Industrial activity in the export- and domestic-oriented industries



Source: Bank Negara Malaysia and RAM Economics

The Malaysian economy is expected to moderate in 2H 2010, expanding 5.6% and bringing the overall growth for the year to 7.4% - albeit a vast improvement over the 1.7% contraction experienced in 2009. This is in line with the trends observed in industrial output and also the tapering off of the low-base effects that had been prevalent in the first half. The manufacturing and services sectors are expected to be

the major growth engines in terms of sectoral performance; they are anticipated to post respective 8.1% and 6.2% rates of growth in 2H 2010.

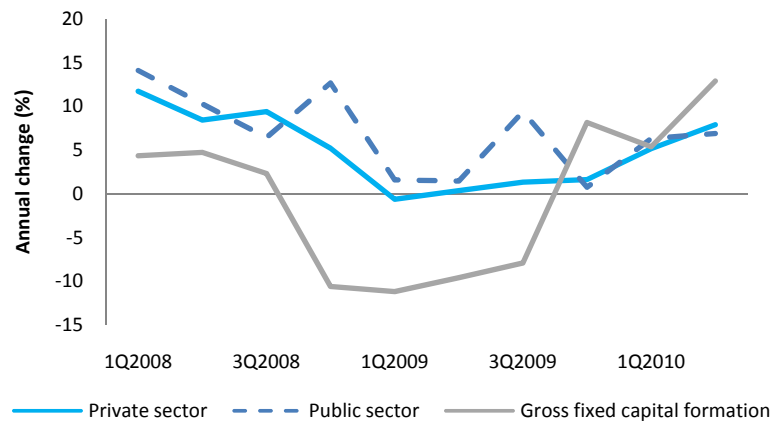
Resilient domestic demand

Consumption and investment activities exhibited a strong upturn in the first half. Public- and private-sector consumption was comparable, with both clocking in at 6.5% in 1H 2010. Investment activity had also staged a notable recovery in 1H 2010, with a 9.4% expansion following a decline throughout the recession. However, any apparent uncertainty over economic recovery seems to have dissipated going into this year, as evident from by the strong trends in investment activity.

The upturn in economic activity is attributable to the solid recovery in export performance, which recorded a 16.5% expansion in 1h 2010 in contrast to the deep contraction in 1H 2009. Despite the clear low-base effect that features significantly in the double-digit growth, changing trade patterns had also supported the resilience and rapid recovery (discussed later in this report).

Both private and public consumption had held steady (albeit with public spending appearing more lumpy) throughout the recession, picking up pace in the first half of this year.

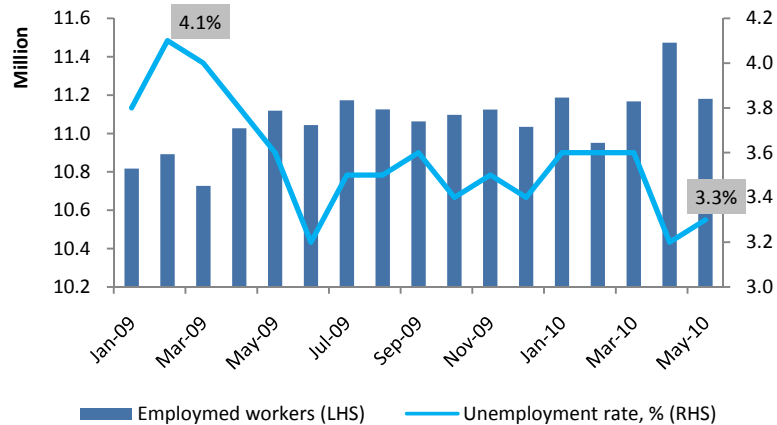
Figure 12: Trends in domestic demand



Source: Bank Negara Malaysia and RAM Economics

The resilience of domestic spending had been backed by stable unemployment during the downturn, which had peaked at 4.1% in 1Q 2009 before retreating rapidly a few months after, to hover around the domestic economy’s natural rate of unemployment. Unemployment levels have since remained stable, currently standing at 3.3%; it is expected to remain so in the medium term.

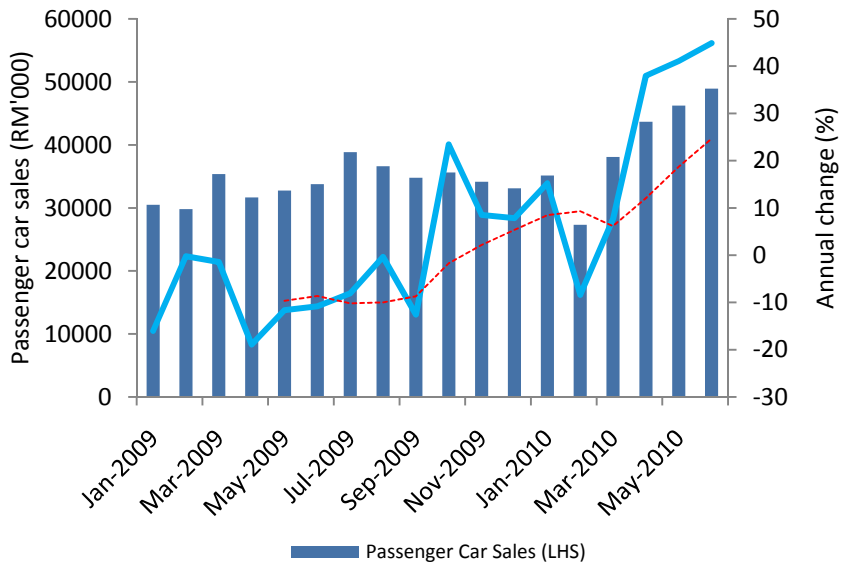
Figure 13: Broad labour trends



Source: Department of Statistics, Malaysia

Another supporting factor in the build-up of consumption activity and also an indication of strengthening consumer confidence is the strong uptrend in purchases of consumer durables. Domestic consumption activity is expected to maintain its buoyant momentum, coming in at 8.2% in 2H 2010 on the back of stable employment (and the implied increased propensity to consume with the overall rise in income), along with more upbeat consumer sentiments.

Figure 14: Trends in purchases of consumer durables

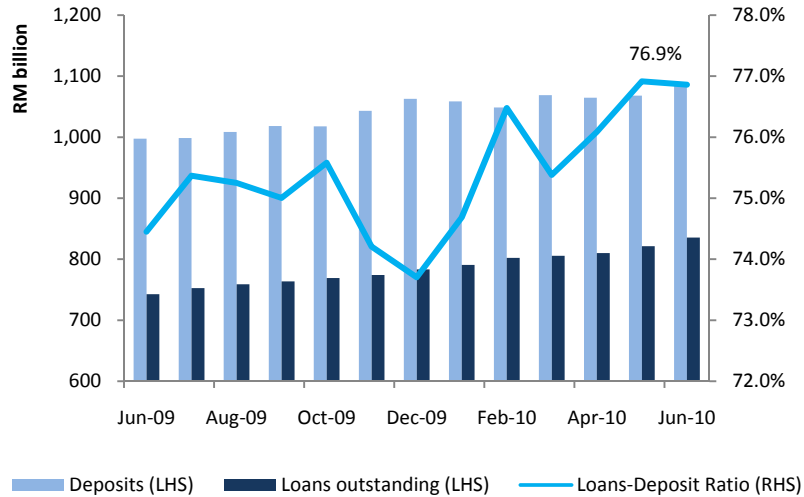


Source: Bank Negara Malaysia and RAM Economics

The financing environment is also indicative of facilitative investment conditions, supported by accommodative interest rates and the high liquidity levels of banking institutions. Deposits in banking institutions exceeded RM 1 trillion in 1H 2010 while the loans-to-deposits ratio stands at just below 77%. These are indicative of banks'

relative capacity to extend loans to feasible projects. Amid this scenario, investment activities are expected to increase 10.4% in 2H 2010.

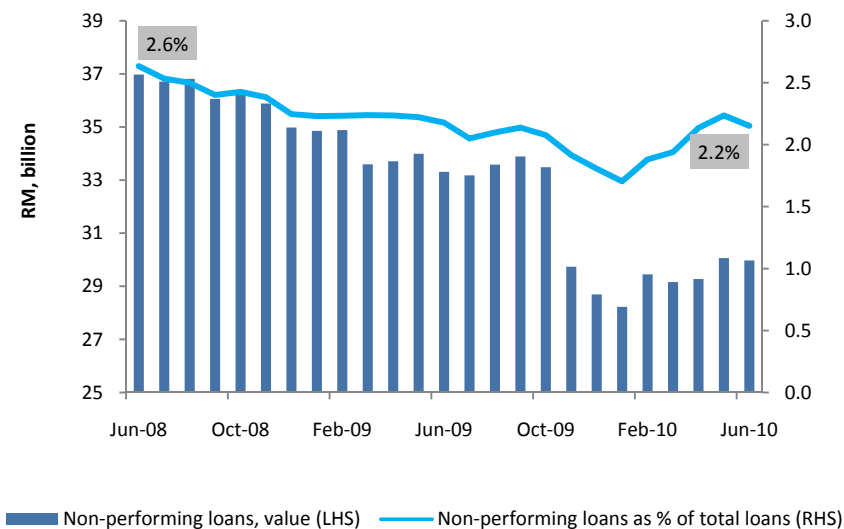
Figure 15: Liquidity and stability of banking institutions



Source: Bank Negara Malaysia and RAM Economics

On the other hand, the higher value of outstanding loans cannot be taken in isolation as a sign of credit over-extension, in light of the easy credit conditions. The credit quality of loans disbursed has remained stable - and had even fallen during the global crisis, with non-performing loans coming up to 2.2% of total loans in the system. These factors point to the sustained investment activities expected in the second half of this year.

Figure 16: Credit quality of banking institutions' loans



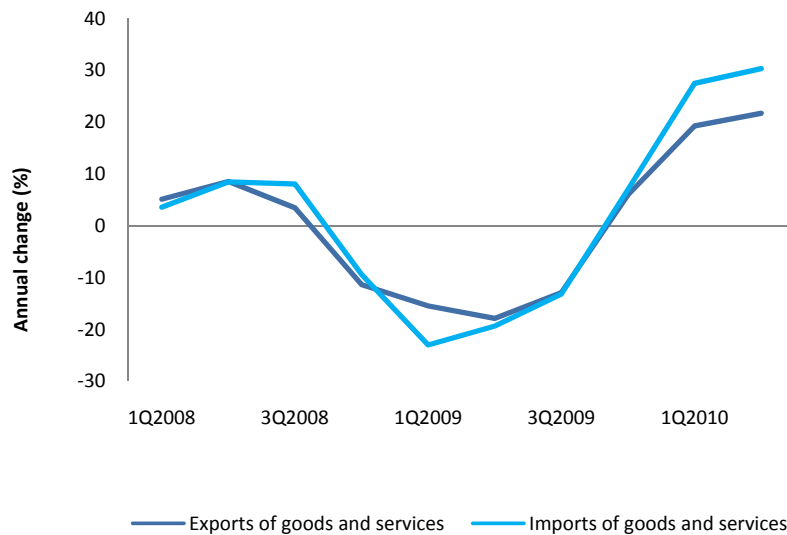
Source: Bank Negara Malaysia and RAM Economics

Rebound in external demand partially supported by changing trade patterns

Not only has the resilience in domestic demand been a major contributor to the sterling growth performance in the first half, the rebound in external demand has also significantly supported the growth momentum.

Both exports and imports recovered in the first half, with respective increases of 16.5% and 24.5%. This had been triggered by the broad-based recovery of global economies, especially within Asia, and also increased domestic industrial activity that had driven demand for more imported capital and intermediate goods. Towards the end of the second quarter, a levelling off of growth momentum in trade can be observed, although the changing trade patterns will help partially offset any adverse implication brought about by the continued sluggish growth of the developed economies.

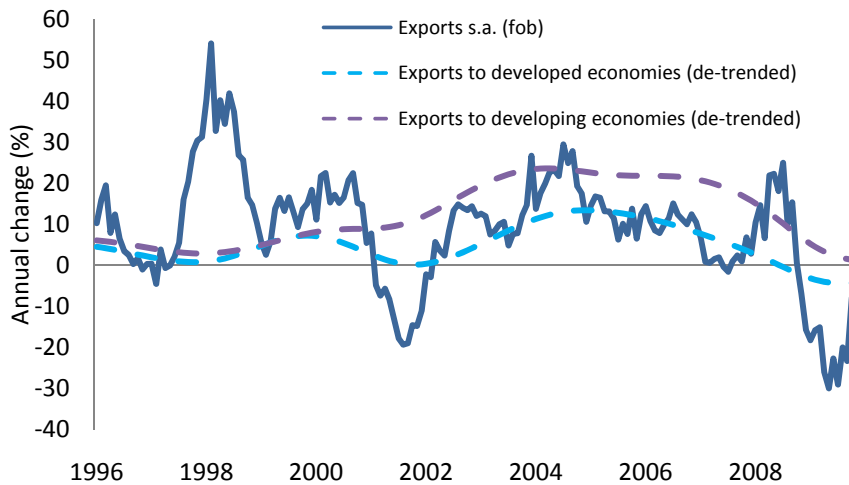
Figure 17: Trade trends and growth momentum



Source: Department of Statistics, Malaysia

There is evidence that among the 3 major upheavals since the mid 1990s – the Asian financial crisis of 1997/98, the dot.com bust in 2000/01 and the sub-prime credit crisis of 2008/09 - the most significant decline in Malaysian exports had been felt during the most recent slump. Although exports to developing economies had generally decelerated, those to trading partners in developed economies had contracted significantly. In this regard, it is clear that developing economies are becoming increasingly more important as providers of relative stability to export demand amid adverse demand shocks.

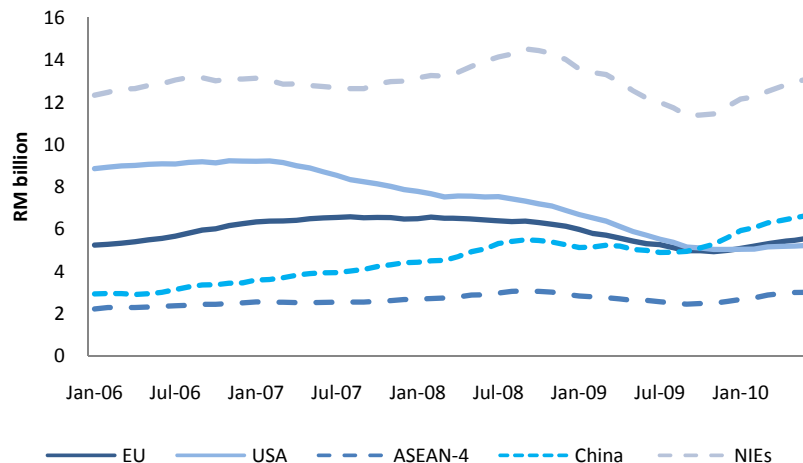
Figure 18: Impact of external shocks on export activities



Source: International Monetary Fund and RAM Economics

As mentioned earlier, the NIEs and China have become major export destinations and key drivers of continued momentum in external demand, even as uncertainty still shadows the crisis-hit economies, which are still grappling with their own structural problems. Notably, however, growth in exports to neighbouring ASEAN nations has not been as strong as expected, despite the relatively shorter distance and the trade alliances formed. In this regard, there is more scope for the enforcement of stronger economic ties, to enhance the volume of trade to these destinations.

Figure 19: Export volumes to major trading partners



Source: Department of Statistics, Malaysia and RAM Economics

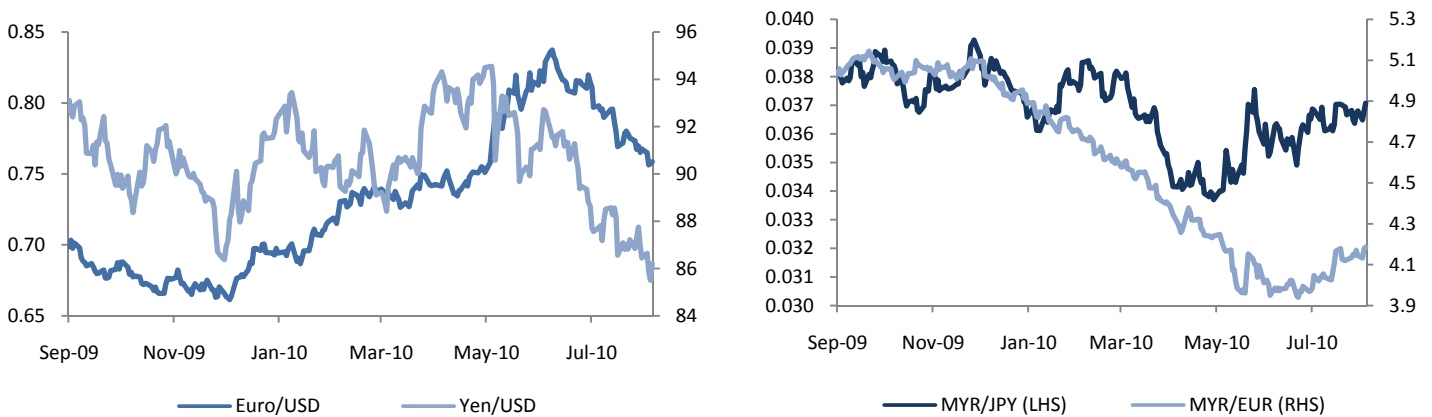
Looking ahead, Malaysia's export performance is expected to moderate in 2H 2010, with a 9.7% growth rate; so too will imports, which are expected to record a 13.4% increase.

IV. FINANCIAL INDICATORS AND PRICE EXPECTATIONS

Continued strengthening of the ringgit against major currencies

There have been significant fluctuations in the currency markets this year, particularly with regard to the reserve currencies. These volatile movements largely reflect global investor confidence in the respective (individual) advanced economies – whose growth and pace of recovery remain fairly uncertain – and the policies implemented to instil such confidence (such as the EU-wide stress tests on banks, conducted in July). The figure below shows the loss of confidence in the EU’s currency, as its sovereign debt woes have undermined the region’s financial health and economic recovery; at the height of the uncertainties, the euro had lost more than a quarter of its value from last year.

Figure 20: Movements of major reserve currencies against the US dollar and the Malaysian ringgit

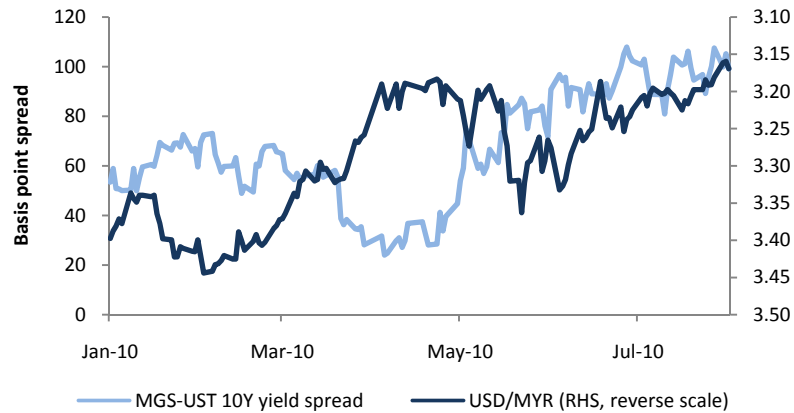


Source: x-rates.com

Meanwhile, the Malaysian ringgit has strengthened significantly against the US dollar this year (gaining roughly 7% to date). An important contributing factor is Malaysia’s improving growth prospects relative to the US, which may have heightened investor confidence.

Additionally, the US Federal Reserve has stated that it will leave its benchmark interest rate at a low 0%-0.25% for an extended period. This has widened the interest-rate differential between the US and Malaysia - favourable for further inflows of foreign capital into the latter. The figure below shows the yield differential between key government bonds and the exchange rate.

Figure 21: US-Malaysia sovereign yield spreads and exchange rate

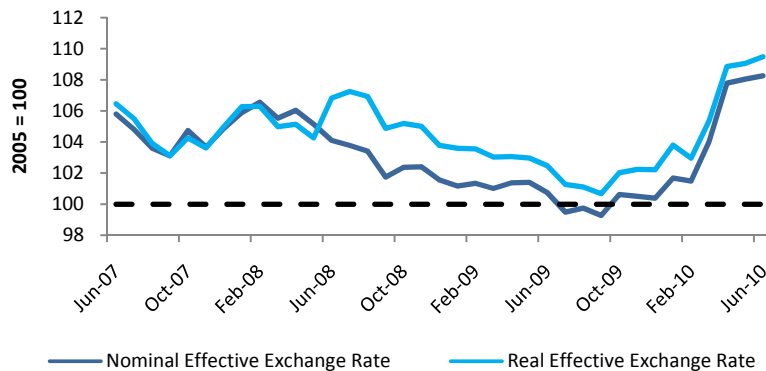


Source: *x-rates.com, Bloomberg and Bond Pricing Agency Malaysia*

As a result of the substantial US-Malaysia interest-rate differential, a sizeable trade surplus and divergent recovery prospects, the ringgit is expected to strengthen to RM3.00 per US dollar by year-end. The overall strengthening of the ringgit will be supported by Bank Negara Malaysia’s recent relaxation of foreign-exchange rules with regard to international trade; this is expected to further attract investors’ interest through the remainder of this year.

With a significantly divergent growth path relative to the advanced economies, the ringgit’s nominal and real effective exchange rates have appreciated since the trough in mid-2009.

Figure 22: The ringgit’s nominal and real effective exchange rates



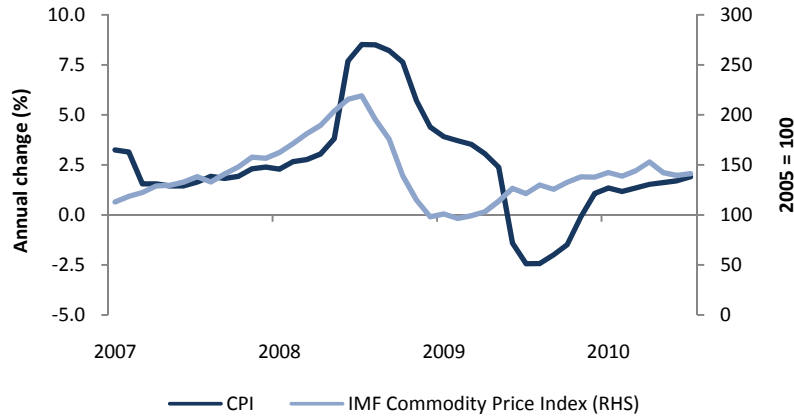
Source: *Bank for International Settlements*

Nevertheless, the gradual improvement in external demand and the change in the direction of Malaysia’s exports have offset any loss of competitiveness arising from the currency’s appreciation. The ringgit’s effective exchange rate is expected continue appreciating as Malaysia’s growth prospects are seen to significantly diverge from those of its major trading partners.

Moderate upward price pressures in line with improved economic performance

In 1H 2010, Malaysia’s inflation rate reflects increasing consumer confidence and recovering global demand following the financial turbulence. The increase in the domestic inflation rate to 1.9% in July (coinciding with the commencement of the Malaysian Government’s subsidy-rationalisation programme) is mainly attributable to the food and transport components.

Figure 23: Malaysia’s inflation rate and global commodity prices



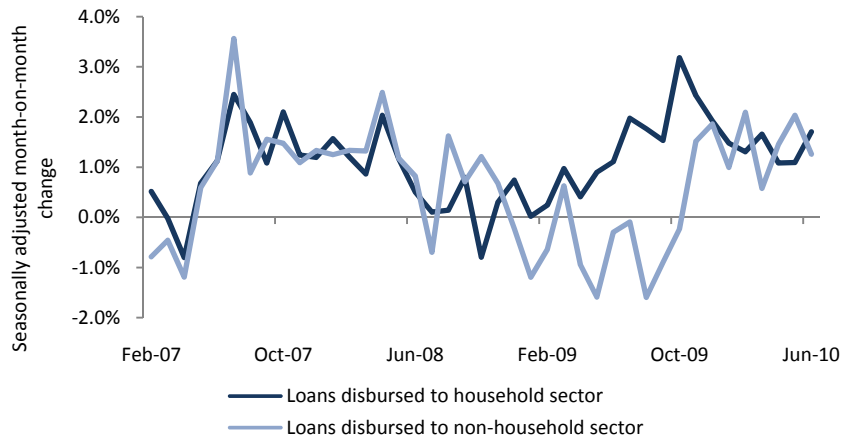
Source: x-rates.com, Bloomberg and Bond Pricing Agency Malaysia

In the short to medium term, inflation will be largely driven by the Government’s subsidy-rationalisation programme and the consequent price hikes. If the rationalisation programme is implemented more frequently or is carried out too rapidly, heightened domestic price expectations may result in a cyclical wage-price spiral. However, this scenario is unlikely to occur as the Government has taken great pains to inform the general public of the ongoing rationalisation programme, and has implied that it will be a gradual, long-term process. Although the estimated inflation rate of 2.5% for 2010 has been maintained, consumer prices are still expected to rise further to 2.7% in 2011, as global demand continues to recover (fuelling commodity prices), further subsidy cuts are implemented and general domestic consumer demand strengthens.

Continued normalisation of interest rates

Bank Negara Malaysia’s lifting of the Overnight Policy Rate (“OPR”) a total of 3 times this year has brought it to 2.75% to date. These increases had come on the back of improving domestic demand, which had pushed up prices and spurred rapid credit creation.

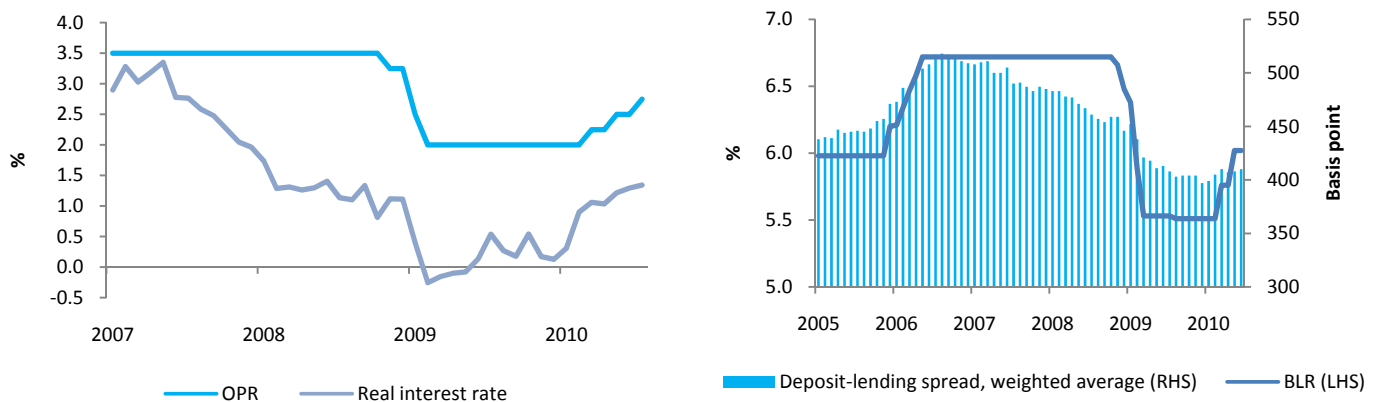
Figure 24: Indicators of credit creation in Malaysia



Source: Bank Negara Malaysia and RAM Economics

The sustained, robust growth in retail loans to the household sector throughout the recession, coupled with strengthening investor confidence in 4Q 2009, had caused credit to swell as all sectors of the economy had taken advantage of the accommodative interest rates and the economy's faster-than-anticipated recovery from the global slump. Against this backdrop, the domestic real interest rate⁷ recently recovered to pre-crisis levels, following the normalisation of the OPR this year. Notably, the OPR remains significantly lower than in 2008, and as such remains fairly accommodative to domestic growth. While domestic commercial banks are gaining less from the deposit-lending spread, it is still considerable at around 400 basis points; this is likely to increase further as banks will be more cautious to avoid over-exposure to credit amid accelerating domestic growth, by further diversifying their loan portfolios to encompass a greater proportion of loans to corporates.

Figure 25: Interest-rate indicators in Malaysia



Source: Bank Negara Malaysia and RAM Economics

With 2 more Monetary Policy meetings left for the year, we have maintained our estimate for year-end OPR at a relatively accommodative 2.75%-3.00%. A further 25-basis-point upward adjustment may be warranted at the final meeting of the

⁷ Calculated as the OPR after adjusting for the core inflation rate, i.e. the inflation rate excluding fuel and food prices.

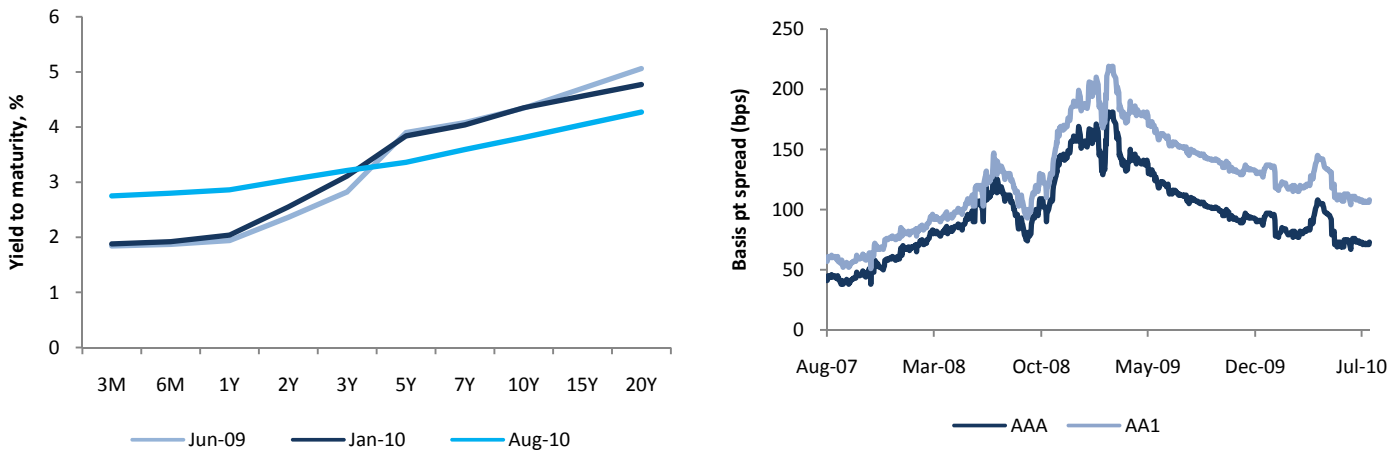
year, should excessive credit creation or speculative activity manifest into asset bubbles.

Expected pick-up in bond issuance in 2H 2010

The domestic bond market had been significantly affected by the 75-basis-point increase in the OPR this year, along with the brighter outlook for the domestic economy, as inflation expectations remained relatively mild. The increases in the key policy rate had shifted the short-end of the yield curve upwards while better economic prospects had increased investors’ appetite for longer-tenured bonds.

The more positive domestic economic landscape has narrowed corporate bond spreads, compared to the height in early 2009. However, there is still some volatility stemming from the uncertainties over the pace of a full-force recovery in the global economy.

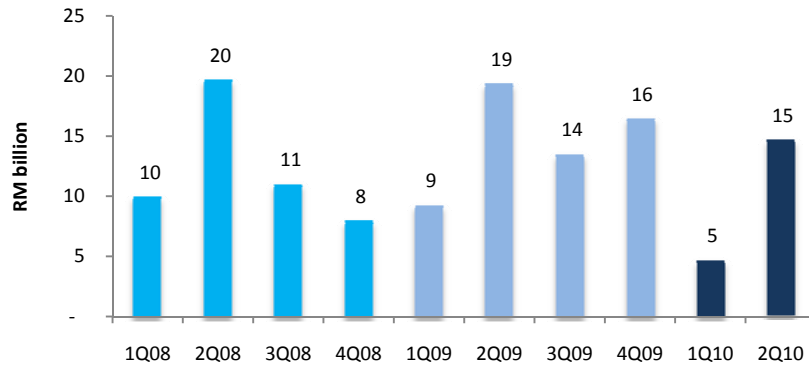
Figure 26: Domestic bond-yield indicators – Malaysian Government Security (or MGS) yields and corporate bond spreads



Source: Bond Pricing Agency Malaysia

The issuance of private debt securities (“PDS”) had begun this year at a relatively lethargic pace. This reflected investors’ lingering doubts over the longer-term recovery of the domestic economy as global conditions remained significantly volatile, especially in the first quarter. Nonetheless, debt issues had been dominated by financial institutions, whose capital bases had been strengthened by increased financing.

Figure 27: Issuance of domestic PDS



Source: Bank Negara Malaysia

Looking ahead, the pace of issuance is expected to accelerate in the second half of the year, amid sufficiently robust domestic economic growth and as the local financial guarantor, Danajamin, continues to expand its operations. Under these circumstances and trends in issuance observed in the first half, gross PDS issuance is expected to reach RM45-50 billion for the entire year.

V. STATISTICAL SUMMARY SHEETS

Table 1: Annual GDP growth by expenditure aggregate

	2008	2009	2010f
Final consumption expenditure	9.0	1.2	7.4
<i>Private sector</i>	8.5	0.7	7.7
<i>Public sector</i>	10.7	3.1	6.4
Gross fixed capital formation	0.7	-5.6	9.9
<i>Private sector</i>	1.0	-17.2	11.5
<i>Public sector</i>	0.5	8.0	8.4
Exports of goods and services	1.6	-10.4	12.9
Imports of goods and services	2.2	-12.3	18.3
GDP	4.7	-1.7	7.4

Table 2: Annual GDP growth by industry

	2008	2009	2010f
Agriculture	3.2	0.4	2.9
Mining and Quarrying	-2.0	-3.8	1.3
Manufacturing	0.6	-9.4	12.0
Construction	7.1	5.8	4.7
Services	8.0	2.6	7.0
GDP	4.7	-1.7	7.4

Table 3: Half-yearly GDP growth by expenditure aggregate

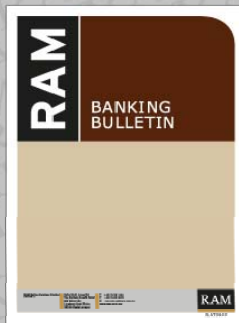
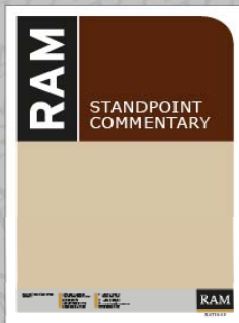
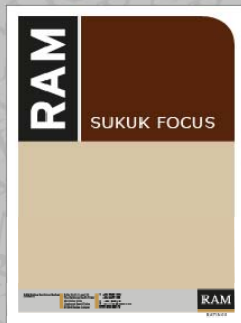
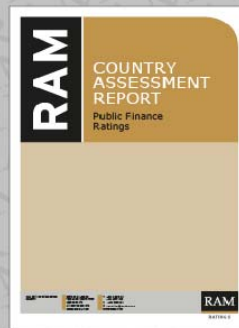
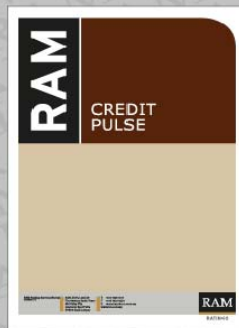
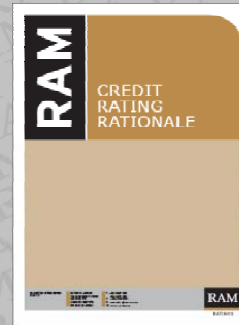
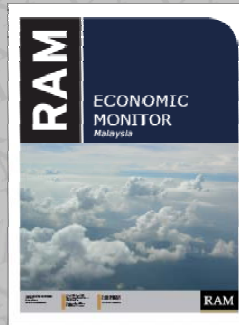
	1H 2009	2H 2009	1H 2010	2H 2010f
Final consumption expenditure	0.2	2.1	6.5	8.2
<i>Private sector</i>	-0.2	1.5	6.5	8.8
<i>Public sector</i>	1.5	4.3	6.5	6.4
Gross fixed capital formation	-10.4	-0.6	9.4	10.4
Exports of goods and services	-16.7	-4.1	16.5	9.7
Imports of goods and services	-21.1	-3.7	24.5	13.4
GDP	-5.1	1.6	9.5	5.6

Table 4: Half-yearly GDP growth by industry

	1H 2009	2H 2009	1H 2010	2H 2010f
Agriculture	-2.0	2.6	4.5	1.5
Mining and Quarrying	-4.4	-3.2	2.0	0.6
Manufacturing	-16.2	-2.2	16.4	8.1
Construction	2.9	8.6	6.3	3.3
Services	0.8	4.3	7.9	6.2
GDP	-5.1	1.6	9.5	5.6

**** f = forecast by RAM Economics**

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