

2015

EXECUTIVE SUMMARY



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In 2015, global growth moderated amid heightened international financial market volatility. Throughout the year, the global economic and financial environment was shaped by three major developments. First, global commodity prices fell sharply to post-crisis lows, with significant repercussions for global growth and inflation. Second, international financial markets experienced heightened volatility amid policy shifts in the major economies and concerns over the slowing momentum of global growth, sovereign debt in the euro area, and the fall in commodity prices. The volatility in financial markets was exacerbated by speculative position-taking and the unwinding of those positions, as well as sudden shifts in investors' risk appetite, that led to volatile capital flows. Third, global growth moderated as the modest improvements in growth in the advanced economies were insufficient to offset the lower growth in emerging economies. Growth was also uneven across the advanced economies. While economic activity in the US gained traction, growth in the euro area improved at a modest pace during the year due to unresolved structural constraints. Given the highly challenging external environment, economic growth in Asia moderated during the year as weak export performance weighed on the pace of economic expansion. In particular, growth in PR China remained on a moderating trend, due to the slowing activity in sectors with excess capacity as well as weaknesses in the external sector. Global inflationary pressures also moderated during the year, reflecting mainly lower global commodity prices and the subdued global demand conditions.

In response to the slowing growth momentum in an increasingly uncertain economic and financial environment, the overall global monetary policy stance became more accommodative in most regions. Among advanced economies, there was a divergence in the monetary policy stance of the major central banks. While the US took the first step to normalise interest rates, the euro area and Japan increased monetary stimulus through their respective asset purchase programmes and by introducing negative interest rates. In Asia, several economies reduced key policy rates and introduced fiscal measures to support growth.

Despite the challenging economic environment in 2015, the Malaysian economy registered a growth of 5.0%, supported by continued expansion in domestic demand. The Annual Report provides an analysis of the developments in the Malaysian economy and outlines the challenges ahead. The report also highlights the Bank's efforts to enhance its governance, organisational development and communications.

The Malaysian economy in 2015

The Malaysian economy grew by 5.0% in 2015 (2014: 6.0%), supported by the continued expansion of domestic demand (2015: 5.1%, 2014: 5.9%). Domestic demand was primarily driven by the private sector. Modest improvements in external demand in the second half of the year also provided additional impetus to economic growth.

Private consumption continued to expand, albeit at a more moderate pace as households adjusted their spending to the higher cost of living arising from the implementation of Goods and Services Tax (GST), adjustments in administrative prices, and the depreciation in the ringgit. Nevertheless, households received some support from the higher cash transfers under the Bantuan Rakyat 1Malaysia (BR1M) scheme, the reduction in individual income tax rates for the 2015 assessment year and savings derived from lower domestic fuel prices during the year. Household spending was also supported by continued income growth and stable labour market conditions. Public consumption recorded a sustained growth of 4.3% in 2015 (2014: 4.4%), reflecting the continued efforts by the Government to provide support to growth, while remaining committed to the steady reduction in the fiscal deficit.

Gross fixed capital formation (GFCF) grew by 3.7% in 2015 (2014: 4.8%) mainly due to slower growth in private sector investment. During the year, the expansion in private investment was lower at 6.4% (2014: 11.0%), reflecting the moderation in domestic demand and cautious business sentiments. While investment in new oil and gas explorations moderated, overall private investment continued to be supported

by downstream oil and gas activities, and new and on-going projects in the manufacturing and services sectors. Public investment improved to register a smaller contraction of -1.0% (2014: -4.7%) as the Federal Government and public corporations continued to undertake capital spending, thus providing support to the economy.

On the supply side, all major economic sectors registered more moderate growth, with the exception of the mining sector. The moderation reflected the slower expansion of activity in industries catering to domestic demand. However, export-oriented manufacturing and trade-related services benefited from the modest improvement in external demand.

Labour market conditions remained broadly stable in 2015 as demand for labour was sustained by the continued expansion across all economic sectors. While the labour force participation rate was stable at 67.6% (2014: 67.5%), the unemployment rate edged higher to 3.2% (2014: 2.9%) as more cautious business sentiments led to softer employment prospects towards the second half of the year.

Headline inflation declined to 2.1% in 2015 (2014: 3.2%) as the impact of lower global energy and commodity prices more than offset the effects from a weaker ringgit exchange rate, the implementation of GST and several upward adjustments in administered prices. Despite the lower level of inflation during the year, price increases were more pervasive due to the implementation of GST, the weakening of the ringgit and the higher prices for fresh food. Headline inflation was also relatively more volatile in 2015 reflecting a series of adjustments in domestic fuel prices. Nevertheless, core inflation excluding GST remained stable at 2.3% during the year (2014: 2.3%). The stability of core inflation was a reflection of the more moderate domestic demand conditions, the absence of excessive wage growth and the benign inflation globally.

Malaysia's external position remained resilient in 2015 despite the greater uncertainties in the global economy. While the current account surplus narrowed during the year, it remained supported by a sizeable trade surplus of RM94.6 billion (2014: RM82.5 billion). For the year as a whole, growth in exports and imports moderated to 1.9% and 0.4%, respectively (2014: 6.3% and 5.3%). There were two divergent trends in external trade

during the year. In the first half of the year, the external trade performance was largely weighed down by the decline in commodity prices and the sluggish demand for commodities and commodity-related manufactured products. In the second half of the year, external trade improved due to a rebound in export growth arising from higher demand for manufactured products and commodities, and the positive valuation effects from the ringgit depreciation. For the whole year, the trade surplus was higher, supported by both manufactured and commodity products.

Against the backdrop of continued uncertainties in global financial markets, the external sector experienced significant two-way cross-border capital flows for most of 2015. The financial account recorded a net outflow of RM53.3 billion (2014: net outflow of RM81.6 billion). During the year, considerable volatility was observed in foreign portfolio funds, in part due to the building up and unwinding of speculative positions in the domestic and offshore markets. Net portfolio outflows of non-resident funds amounted to RM19.0 billion (2014: net outflows of RM10.4 billion). Notwithstanding the developments in short-term portfolio flows, it is noteworthy that Malaysia remained a competitive destination for long-term capital, as evidenced by the steady inflow of foreign direct investments (FDI). The bulk of the FDI flows went into the manufacturing sector, primarily in the electronics and electrical (E&E) and petrochemical-related industries.

The international reserves of Bank Negara Malaysia amounted to RM409.1 billion (equivalent to USD95.3 billion) as at 31 December 2015. As at 29 February 2016, the reserves were at RM410.5 billion (equivalent to USD95.6 billion). The international reserves remained ample to facilitate international transactions and were sufficient to finance 8.3 months of retained imports and is 1.2 times of the short-term external debt. The progressive liberalisation of foreign exchange administration rules has resulted in a greater decentralisation of international reserves, which has enabled the economy to reduce its reliance on the Bank's international reserves. This is evident from the increasing acquisition of assets abroad by Malaysian entities. The availability of these external assets enables these entities to meet their external debt obligations without creating a claim on the international reserves. The greater exchange rate flexibility also reduces

reliance on international reserves in managing external pressures.

Malaysia's external debt remained manageable throughout 2015. The external debt stood at RM833.7 billion, equivalent to USD192.2 billion or 72.1% of GDP as at end-2015 (end-2014: RM747.5 billion, equivalent to USD211.8 billion or 67.5% of GDP). The rise in the external debt was mainly due to valuation effects from the depreciation of the ringgit against most currencies during the year. Excluding the foreign exchange revaluation changes, offshore borrowing increased at a more moderate pace of 4.0% in 2015, contributing two percentage points to the overall increase in the external debt. These borrowings were mainly a reflection of the net drawdown of intercompany borrowings by several private corporations in the oil and gas sector, and new issuances of international debt securities. Nevertheless, the profile of Malaysia's external debt remained healthy with more than half being of medium to long-term tenures. Risks from foreign exchange fluctuations were largely contained as about 36% of the external debt is ringgit-denominated, while most of the foreign currency-denominated debt was hedged, either naturally through foreign currency earnings or through the use of financial instruments.

Being a highly open economy, Malaysia is not insulated from the heightened uncertainties and risks from external developments. However, Malaysia has demonstrated its ability to withstand external shocks through economic flexibility and the safeguards provided by the financial buffers and robust policy frameworks that have been built over the course of many years. Malaysia's deep and diversified domestic financial market were able to accommodate the large volume of capital flows, while domestic institutional investors provided sustained demand for domestic financial assets as foreign investors rebalanced their exposures. The Bank's monetary operations and the use of several policy instruments also ensured the availability of sufficient liquidity to support the orderly functioning of the money and exchange rate markets. The flexibility of the exchange rate has also allowed the ringgit to adjust to the changes in external conditions. At the same time, the international reserves has acted as a buffer to prevent excessive volatility in the ringgit exchange rate. As such, despite considerable volatility in capital flows, the impact on domestic

financial markets was not significant, allowing for uninterrupted financial intermediation to support the economy.

Economic and Monetary Management in 2015

The Monetary Policy Committee (MPC) maintained the Overnight Policy Rate (OPR) at 3.25% in 2015, with the focus of ensuring that monetary conditions supported the sustainable growth of the Malaysian economy while maintaining price stability. Against the backdrop of a challenging external environment that affected the outlook for the Malaysian economy, the monetary policy stance remained accommodative and supportive of economic activity. The MPC also maintained its vigilance against risks related to financial imbalances.

The Malaysian economy was projected to grow at a steady pace of between 4.5% and 5.5% in 2015, on the premise that domestic demand would be the anchor to growth amid weak external demand. Headline inflation was forecasted to range between 2.0% to 3.0% as lower global commodity prices and the lower global inflation were expected to offset the increase in domestic cost factors and the effects from a weaker ringgit exchange rate. Underlying inflation was assessed to remain relatively moderate amid slower growth of domestic demand. This outlook, however, was subject to risks arising from a series of developments during the year. These included the impact of the uncertain outlook for commodity prices on the domestic oil and gas sector and the potential negative spillover to investment activity, exports, the overall balance of payments and the Government's fiscal position. Another risk was related to the outcome of the GST introduction in April 2015, especially in terms of the pricing behaviour of firms and possible profiteering. Heightened uncertainties in the global economy and financial markets, and to a certain extent, domestic factors during the second half of the year had also significantly affected domestic financial markets and the ringgit exchange rate.

Notwithstanding these developments, the Malaysian economy proved to be resilient and was sustained by a well-diversified economy. The deep financial markets and well-capitalised financial institutions were able to withstand the large and volatile capital flows and this enabled financial intermediation to continue uninterrupted. Overall domestic liquidity remained sufficient and financial

institutions continued to operate with strong capital and liquidity buffers. Against this backdrop, the MPC assessed that the stance of monetary policy was appropriate and consistent with the achievement of sustainable economic growth and price stability. Monetary policy, together with earlier macro- and micro-prudential measures also continued to play a role in ensuring that the growth of household debt was sustainable and that the risks of financial imbalances emerging was minimised.

Ringgit developments in 2015 were heavily influenced by portfolio investment flows arising primarily from external factors. For the year as a whole, the ringgit depreciated by 18.6% against the US dollar. The broad depreciating trend in the ringgit was an outcome of several key factors. The anticipation and eventual normalisation of US interest rates had resulted in a rebalancing of portfolio investments towards US financial assets and led to a significant appreciation of the US dollar. Furthermore, there were significant portfolio outflows from many emerging market economies, including Malaysia. Concerns over the impact of lower prices of crude oil and commodities on the domestic economy and negative domestic sentiments also led to a larger depreciation in the ringgit against other currencies. For an open economy like Malaysia, the depreciation of the ringgit was a necessary adjustment to the external headwinds facing the economy. A weaker ringgit helped to mitigate potential losses to exporters from lower commodity prices by increasing ringgit earnings from currency conversions. Nevertheless, the massive shifts in cross-border capital flows during the year caused the ringgit to become undervalued and misaligned.

In 2015, the Bank's monetary operations were focused on managing the reduction in liquidity within the banking system caused by the large external outflows. Contractionary pressures on liquidity were offset by the net release of funds placed with the Bank. In addition, the issuance of Bank Negara Monetary Notes (BNMNs) was replaced with other instruments of shorter maturities to enable banks to readily meet any sudden withdrawals of funds caused by the outflows. The Bank also used its monetary operations, including the reverse repo facility, to provide liquidity to the banking system when needed. To further ensure sufficient liquidity in the domestic financial system, the Bank reduced the Statutory Reserve Requirement (SRR) ratio from 4.00% to 3.50%, effective from 1 February 2016. With the continued ample

liquidity conditions and orderly financial market conditions, the financial intermediation process continued to function smoothly, with financing activity remaining at a healthy level.

Net financing to the private sector expanded at an annual rate of 8.2% in 2015 (2014: 8.6%). The more moderate pace of growth during the year was driven by lower growth of loans to the household sector. The lower growth in household debt was partly an outcome of the pre-emptive measures by the Bank and the Government since 2010 to ensure the sustainability of household debt. Financing to businesses, however, remained robust and in line with economic activity, with higher growth in outstanding loans and net issuances of private debt securities (PDS) by businesses. Financing to the small and medium enterprises (SMEs), in particular, continued to record strong growth in 2015 driven mainly by loans to the services sector.

Outlook for the Malaysian Economy in 2016

The international economic and financial landscape is likely to remain challenging in 2016 and will be a key factor that will influence the prospects of the Malaysian economy. Depending on their nature, global developments can pose both upside and downside risks to the Malaysian economic growth. The Malaysian economy is expected to grow by 4.0 - 4.5% in 2016. Domestic demand will continue to be the principal driver of growth, sustained primarily by private sector spending. Private consumption growth is expected to trend below its long-term average, reflecting largely the continued household adjustments to an environment of higher prices and greater uncertainties. These moderating effects, however, will be partially offset by continued growth in income and employment, as well as some support from Government measures targeted at enhancing households' disposable income.

In an environment of prolonged uncertainties and cautious business sentiments, private sector investment growth is projected to be slower compared to its performance in the past five years. Capital expenditure in the upstream mining sector will continue to be affected by the environment of low energy and commodity prices. Support to private sector capital spending will mainly stem from the implementation of on-going and new investment projects, particularly in the manufacturing and services sectors.

Reflecting the Government's commitment to more prudent spending, growth of public sector expenditure is also expected to be more moderate but would continue to be supportive of overall growth. Public investment is, however, projected to turn around to register a positive growth, reflecting higher spending by the Federal Government on fixed assets and the continued implementation of key infrastructure projects by public corporations.

The external sector is expected to remain resilient in 2016. Despite subdued commodity prices, Malaysia's export performance is projected to remain positive, in line with the modest improvement in external demand. The well-diversified nature of Malaysia's exports will continue to support the overall growth in exports. Gross imports are projected to expand further amid an increase in intermediate imports to support the sustained performance of manufactured exports and the higher growth in capital imports due to continued expansion domestic private investment. The overall trade balance in 2016 is expected to continue to record a surplus, albeit one that is smaller. The services account is projected to record a narrower deficit on account of an expected improvement in tourism activity. Overall, the current account surplus is projected to narrow further to 1.0 - 2.0% of gross national income (GNI).

On the supply side, all economic sectors are projected to expand, albeit at a more moderate pace in 2016. The services and manufacturing sectors will remain the key drivers of overall growth. Despite the lower oil and gas prices, growth in the mining sector will be supported by new gas production capacity. Growth momentum in the construction sector is projected to moderate slightly in 2016 amid a modest expansion in both the residential and non-residential sub-sectors.

Headline inflation is projected to be higher at 2.5 - 3.5% in 2016 (2015: 2.1%), due mainly to increases in the prices of several price-administered items and the weak ringgit exchange rate. However, the impact of these cost factors on inflation will be mitigated by the low global energy and commodity prices, generally subdued global inflation and more moderate domestic demand. The trajectory of inflation during the year, however, could be more volatile given the uncertainties relating to global oil and commodity prices as well as the pace of global growth.

Economic and Monetary Management in 2016

Monetary policy in 2016 will focus on ensuring that monetary conditions remain supportive of sustainable domestic growth with price stability, taking into consideration the evolving risks in the external and domestic environments. In particular, global economic and financial developments will need to be closely monitored and assessed in terms of their implications for the domestic growth and inflation outlook. Monetary policy will also continue to take into account the risk of financial imbalances. In addition, given the expectation of continued volatility in external flows, the Bank's monetary operations will be directed towards ensuring that domestic liquidity in the financial system will remain sufficient to support the orderly functioning of the domestic financial markets.

Fiscal policy in 2016 will continue to focus on fiscal consolidation. The 2016 Budget was recalibrated in January 2016 to incorporate the expected decline in global oil prices. Government spending was reprioritised and measures were introduced to broaden revenue sources. Fiscal spending will be prioritised towards high impact infrastructure projects that could have large multiplier effects by increasing the productive capacity of the economy. In addition, emphasis will continue to be accorded towards ensuring inclusive and sustainable growth through welfare enhancements, particularly in the form of socio-economic support to the lower- and middle-income segments to help them cope with the rising cost of living.

Given the expectation of a challenging global financial environment, Malaysia will likely be confronted by volatile movements in capital flows. However, Malaysia's deep and developed financial markets are well-positioned to intermediate these flows, thus ensuring that the functioning of the domestic financial markets will continue to be orderly and supportive of the real economy. Malaysia's ability to withstand external shocks will also be augmented by its ample buffers and robust policy frameworks that have been steadily built over time.

Governance, Organisational Development and Communications

As an institution that serves in the best interest of the nation, the Bank has always placed great emphasis on strengthening its governance standards, accountability and internal capabilities. The Bank's Board of Directors oversees the institution's general policies, administration,

performance in delivering its mandates, management of risks, financial management, and reserves and currency management. In 2015, two Board members completed their terms and four new Board members were appointed. Two new external members were also appointed to the MPC, which marks the first time that the MPC has included members from outside the Bank. The new appointments add to the diversity, collective experience, expertise and knowledge of the Board and the MPC, further strengthening the Board's oversight of the Bank and the MPC.

In 2015, initiatives were implemented to ensure continued strategic focus and a robust risk management culture in all aspects of the Bank's operations. The Bank's Business Plan for 2015 - 2017 provides organisational focus and clarity of the Bank's key outcomes and strategies over the medium-term. During the year, the Bank refined its risk appetite and tolerance statements based on more granular data. This is to ensure that decisions are made with careful consideration of the risks involved and with appropriate mitigating measures. The risk management function is complemented by a risk-based internal audit function for all critical operations of the Bank.

The Bank practices prudent financial management, and vigorously pursues organisational efficiency. Attracting and retaining talent of the right calibre is a key policy. The Bank maintains its heavy investment in building the technical and leadership skills of its staff. To keep abreast with the rapid pace of technological change, the Bank undertook an independent review of its Information and Communications Technology (ICT) architecture in 2015.

Given increased uncertainty in the economic and financial environment, both domestically and internationally, the Bank intensified its communications throughout 2015 to promote better understanding of developments affecting the Malaysian economy and financial system. This was done through more frequent press conferences, interviews and engagement sessions with key stakeholders, which complemented other

communication channels such as the Monetary Policy Statement (MPS).

The Bank also continued to play a role in shaping central banking issues globally through increased engagements and collaborations with the international financial and economic communities. The Bank's thought leadership and advocacy roles have been recognised through the appointment of the Governor as Chair for Responsible Finance Institutes' Council of Advisors, and the Bank's role as observer, one out of three emerging countries appointed, for the Basel Committee on Banking Supervision, and Chair of the BIS Central Bank Governance Group. Global recognition for the Bank's senior leadership has also included the Alliance for Financial Inclusion leadership award and Maya declaration award for global leadership in financial inclusion; "Lifetime Achievement Award for the global development of Islamic finance" awarded by His Highness Sheikh Mohammed bin Rashid Al Maktoum, Ruler of Dubai; the prestigious Wharton Dean's Medal to recognise outstanding leaders of private enterprise, public services and academia; and the "Lifetime Achievement Award" by Central Banking Publications.

A notable outcome in 2015 was the establishment of the Asia School of Business (ASB), a collaboration between the Bank and the Massachusetts Institute of Technology (MIT) Sloan School of Management. The ASB supports the growth of talent by meeting the increasing demand for leadership and management capabilities, especially given Asia's rapid transformation and expanding growth potential.

Bank Negara Malaysia's Audited Financial Statements for 2015

The financial position of Bank Negara Malaysia, as audited and certified by the Auditor General, remained strong in 2015. The total assets of Bank Negara Malaysia amounted to RM440.6 billion, with a net profit of RM7.8 billion for the financial year ending 31 December 2015. Bank Negara Malaysia declared a dividend of RM3.0 billion to the Government for the year 2015.