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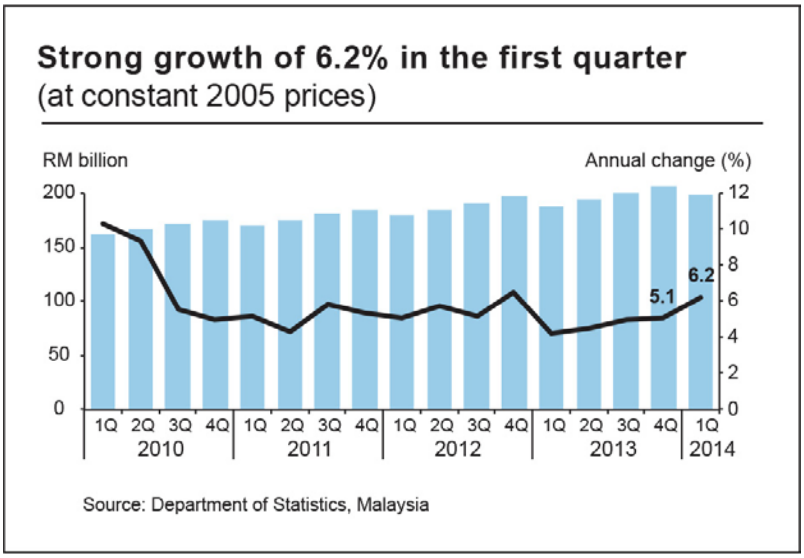
ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE FIRST QUARTER OF 2014

The Malaysian economy expanded by 6.2% in the first quarter of 2014

Global economic activity expanded at a moderate pace in the first quarter. The US economy experienced a slower growth, mainly due to unusually adverse weather conditions. In the euro area, the recovery was supported by modest improvements in exports, while domestic demand remained sluggish due to structural constraints. Growth in several Asian economies expanded at a slower pace as domestic demand was affected by country-specific developments.

The Malaysian economy registered a strong growth of 6.2% in the first quarter of 2014 (4Q 2013: 5.1%), driven by a stronger expansion in domestic demand and a turnaround in net exports. On the supply side, the major economic sectors grew further, supported by both domestic and trade activities. On a quarter-on-quarter seasonally-adjusted basis, the economy grew by 0.8% (4Q 2013: 1.9%).



Private consumption growth remained strong at 7.1% (4Q 2013: 7.4%) in the first quarter, supported by stable employment conditions and continued wage growth. Growth in public consumption increased to 11.2% (4Q 2013: 5.2%), reflecting higher Government spending on supplies and services. Gross fixed capital formation grew by 6.3% (4Q 2013: 6.5%), driven by robust private sector capital spending amidst a contraction in public investment growth. Growth in private investment remained strong at 14.1% (4Q 2013: 16.6%), underpinned by capital spending in the manufacturing and services sectors. Public investment declined by 6.4% (4Q 2013: -1.4%), reflecting the contraction in capital spending by both the Federal Government and the public enterprises.

On the supply side, growth was supported by the major economic sectors. The services sector expanded further, driven by the improvement in finance and insurance and sustained growth in consumption- and production-related services. Growth in the manufacturing sector was underpinned by the strong performance in the export-oriented industries. The construction sector recorded stronger growth, driven mainly by the residential sub-sector. Meanwhile, the agriculture sector registered higher growth, underpinned by the production of food crops while the mining sector registered a lower decline due to a smaller contraction in the output of crude oil.

The headline inflation rate, as measured by the annual change in the Consumer Price Index (CPI) averaged 3.4% in the first quarter of 2014 (4Q 2013: 3.0%). The increase was on account of higher inflation in the *housing, water, electricity, gas* and *other fuels and transport* categories.

The trade surplus amounted to RM26.4 billion in the first quarter of 2014 (4Q 2013: RM27.5 billion). Gross exports grew at a stronger pace of 10.9% (4Q 2013: 10.2%), reflecting the continued expansion of global economic activity while gross imports expanded at a more moderate pace of 5.5% (4Q 2013: 11.6%).

The international reserves of Bank Negara Malaysia (BNM) amounted to RM424.6 billion (equivalent to USD130.2 billion) as at 31 March 2014. This reserve level has taken into account the quarterly adjustment for foreign exchange revaluation changes. As at 30 April 2014, the reserves position amounted to RM427.8 billion (equivalent to USD131.2 billion), sufficient to finance 9.4 months of retained imports and is 1.3 times the redefined short-term external debt.

With effect from the first quarter of 2014, Malaysia has redefined its external debt. This is in recognition of the significant development in the depth and breadth of Malaysia's financial markets and the consequent increase in the participation of non-resident investors in ringgit-denominated domestic debt securities in recent years. Following this redefinition, non-resident holdings of ringgit-denominated debt securities, non-resident deposits, trade credits provided by foreign trade counterparts and other debt liabilities will now be included as part of Malaysia's external debt. As at end-March 2014, Malaysia's redefined external debt stood at RM700.1 billion, equivalent to USD212.5 billion or 65.2% of GDP (end-December 2013: RM694.6 billion or USD209.2 billion, equivalent to 70.4% of GDP). The increase in the external debt is due mainly to higher offshore borrowing by the private sector and non-resident holdings of ringgit-denominated debt liabilities. More than half of the total external debt has a long-term maturity profile. The short-term debt remained manageable with reserves coverage of 1.3 times as at end-March 2014. Malaysia's external position remains resilient, underpinned by sound domestic economic fundamentals. In addition, well-developed capital markets, strong financial intermediaries, and the presence of large domestic institutional investors have provided the financial system with greater resilience to effectively manage any external shocks (see Box Article on 'The Redefinition of External Debt').

Interest rates remained stable

The Overnight Policy Rate (OPR) was maintained at 3.00% during the first quarter of 2014. At the prevailing level of the OPR, monetary conditions remain supportive of economic activity.

The 3-month interbank rate was higher during the quarter following the absence of trades with BNM at the 3-month tenure as a result of the reduction in the maximum tenure of BNM's Range Maturity Auction (RMA) from 3 months to 2 months. The average interbank rate for other maturities remained relatively stable. Retail deposit rates were stable during the period. The average quoted fixed deposit (FD) rates of commercial banks were relatively unchanged. Borrowing costs were also stable. The average base lending rate (BLR) of commercial banks remained unchanged at 6.53% while the weighted average lending rate (ALR) on loans outstanding was generally stable during the period (end-March 2014: 5.39%; end-December 2013: 5.36%).

The monetary aggregates expanded at a slower pace in the first quarter of 2014. M1, or narrow money, decreased slightly by RM0.6 billion during the quarter. On an annual basis, M1 expanded by 11.4% as at end-March (end-December 2013: 13.0%). M3, or broad money, increased by RM19.5 billion on a quarter-on-quarter basis to record an annual growth rate of 5.9% as at end-March (end-December 2013: 8.1%). The expansion of M3 during the quarter was mainly on account of credit extended to the private sector by the banking system and higher net claims on the Government.

Total gross financing raised by the private sector through the banking system and the capital market amounted to RM282.2 billion in the first quarter (4Q 2013: RM302.8 billion). On a net basis, outstanding banking system loans and PDS expanded at an annual growth rate of 9.6% as at end-March (end-December 2013: 9.8%). Net funds raised in the capital market were higher at RM39.4 billion in the first quarter (4Q 2013: RM33.7 billion). The steady growth in net financing has continued to provide support to economic growth.

The ringgit and most other regional currencies continued to be affected by global developments in the first quarter of the year. The commencement of the scale-back of US Federal Reserve's (Fed) asset purchase programme, concerns over the growth outlook for several emerging market economies and geopolitical developments in Eastern Europe led to higher risk aversion and an outflow of funds from regional financial markets. Nevertheless, expectations of stimulus measures in PR China and the continued accommodative monetary policy in the US provided support for the ringgit during the quarter. Overall, the ringgit appreciated by 0.4% against the US dollar. The ringgit also appreciated against the euro (0.7%), but depreciated against the pound sterling (-0.5%) and Japanese yen (-1.5%). Performance of the ringgit against regional currencies was mixed.

Between 1 April and 14 May 2014, the ringgit appreciated against the US dollar by 1.4%. The ringgit also appreciated against the euro (1.6%), Japanese yen (0.7%), pound sterling (0.1%) and most regional currencies.

Financial stability continued to be preserved

The Malaysian financial system continued to demonstrate resilience throughout the first quarter despite volatility in the global and domestic financial markets. Financial intermediation continued to be supported by sound financial institutions, orderly financial market conditions and sustained confidence in the financial system.

The banking system remained well-capitalised with the common equity tier 1 (CET1) capital ratio, tier 1 capital ratio and total capital ratio well above the minimum regulatory levels, at 12%, 12.8% and 14.4%, respectively. The total capital buffer of the banking system stood at more than RM80 billion. Similarly, the capital adequacy ratio of the insurance sector remained strong at 249.7% (4Q 2013: 246.1%), with an excess capital buffer of RM25 billion.

Global recovery and the continued strength of domestic demand will underpin growth

Going forward, recovery in the global economy is expected to continue. International trade will be supported by the continued recovery in the advanced economies. In Asia, while domestic demand is expected to moderate, it will continue to underpin the overall performance of these economies, with additional support coming from the improving external conditions. Continued uncertainty over the monetary policy in key advanced economies, economic developments in both the advanced and emerging market economies, as well as geopolitical developments, are likely to generate continued volatility in the global financial markets.

For the Malaysian economy, growth will remain anchored by domestic demand, with additional support from the improvement in the external environment. Exports will continue to benefit from the recovery in the advanced economies while private domestic demand is expected to remain the key driver of the overall growth. Going forward, the Malaysian economy is therefore expected to remain on a steady growth path.

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GDP by Economic Activity
(at constant 2005 prices)

	Share 2013 (%)	2013 1Q	2013 4Q	2013 Year	2014 1Q
		Annual change (%)			
Agriculture	7.1	6.2	0.2	2.1	2.3
Mining	8.1	-1.5	-1.2	0.7	-0.8
Manufacturing	24.5	0.4	5.2	3.5	6.8
Construction	3.8	14.2	9.8	10.9	18.9
Services	55.2	6.1	6.4	5.9	6.6
Real GDP	**100.0[1]**	**4.2**	**5.1**	**4.7**	**6.2**
Real GDP (q-o-q seasonally adjusted)	**-**	**-0.3**	**1.9**	**-**	**0.8**

[1] Numbers do not add up due to rounding and exclusion of import duties component

Source: Department of Statistics, Malaysia

GDP by Expenditure Components
(at constant 2005 prices)

	2013 1Q	2013 4Q	2013 Year	2014 1Q
	Annual change (%)			
Aggregate Domestic Demand (excluding stocks)	7.5	6.7	7.4	7.4
Consumption	5.3	6.8	7.0	7.8
Private sector	*6.4*	*7.4*	*7.2*	*7.1*
Public sector	*0.6*	*5.2*	*6.3*	*11.2*
Gross Fixed Capital Formation	13.0	6.5	8.5	6.3
Private sector	*10.0*	*16.6*	*13.1*	*14.1*
Public sector	*18.4*	*-1.4*	*2.2*	*-6.4*
Net Exports	-12.9	-6.8	-12.6	14.9
Exports of Goods and Services	*-3.4*	*5.7*	*0.6*	*7.9*
Imports of Goods and Services	*-2.2*	*7.1*	*2.0*	*7.1*
GDP	**4.2**	**5.1**	**4.7**	**6.2**
GDP (q-o-q growth, seasonally adjusted)	**-0.3**	**1.9**	**n.a.**	**0.8**

Source: Department of Statistics, Malaysia

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The Redefinition of External Debt

There are several accepted conventions in the classification of the external debt of a country. One is to emphasise on the foreign currency obligations owed by residents to non-residents. This was the standard practice when most cross-border debt flows were accounted for by residents raising financing in foreign currencies in more developed financial markets. This was in fact the practice adopted by Malaysia, where external debt consisted only of foreign currency-denominated debt, namely loans raised, and bonds and notes issued offshore.

The International Monetary Fund (IMF), et al. (2013)[1] have proposed a wider coverage for external debt, which takes into account the non-resident holdings of local-currency denominated debt papers and other debt-related non-resident financial flows, such as trade credits, currency and deposits, and other loans and liabilities (see Table 1). Under this definition, external debt would include all liabilities that require payment of principal and/or interest at some point in the future, and are owed to non-residents by residents of an economy irrespective of the currency denomination of the debt.

Table 1: Components of Malaysia's previous and redefined external debt

External debt by maturity & instruments	Previous	Redefined
Short-term		
Inter-bank borrowing (FX+)	✓	✓
Inter-company borrowing (FX+)	✓	✓
Other loans* (FX+)	✓	✓
Trade credits		✓
NR++ holdings of domestic money market instruments		✓
Currency and deposits		✓
Other liabilities**		✓
Long-term		
Bonds issued abroad (FX+)	✓	✓
Inter-company borrowing (FX+)	✓	✓
Other loans* (FX+)	✓	✓
Trade credits		✓
NR++ holding of domestic bonds		✓
Other liabilities**		✓

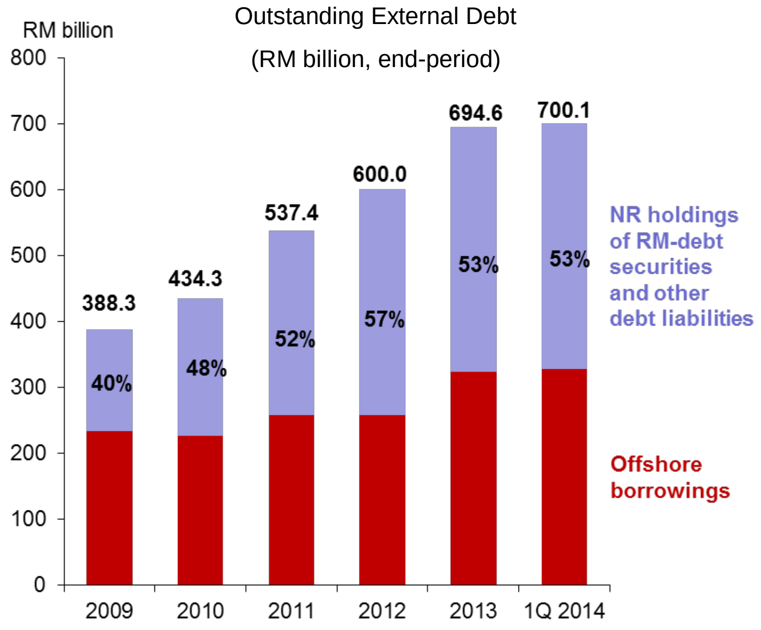
*+ FX: Foreign currency   ++ NR: non-residents   * Includes non-related company borrowing*
*** Other liabilities refer to IMF allocation of SDRs, and liabilities of pension funds and life insurance companies to NR*

[1] IMF, Bank for International Settlements (BIS), the Commonwealth Secretariat (Comsec), Eurostat, the Organization for Economic Co-operation and Development (OECD), the Paris Club Secretariat, the United Nations Conference on Trade and Development (UNCTAD) and the World Bank, 2013, External Debt Statistics: Guide for Compilers and Users, Washington D.C.

Over the last decade, Malaysia's financial markets have developed significantly amid progressive liberalisation of the financial system. Consequently, Malaysia's bond market is now the largest in Southeast Asia and the second largest in Asia ex-Japan, while non-resident participation in domestic financial markets has increased significantly.

With this redefinition, Malaysia's external debt stood at RM700.1 billion (USD212.5 billion or 65.2% of GDP) as at end-March 2014, compared to RM327.9 billion or 30.5% of GDP under the previous definition. The higher redefined external debt reflects the high level of non-resident holdings of ringgit-denominated debt securities, accounting for about two-thirds of the increase in the external debt following the redefinition. This is the outcome of the greater depth, openness and attractiveness of Malaysia's financial markets.

Chart 1: Malaysia's redefined external debt



Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Since these debt securities are ringgit-denominated obligations, the potential for currency mismatches in the country's external indebtedness is reduced. It is also crucial to note that the Federal Government debt remains unchanged. The redefinition of external debt is a prudential measure which allows the Government to better assess its exposure to non-residents. Importantly, although the redefined external debt level is higher, Malaysia's external indebtedness indicators remain within the international benchmark for prudence and external soundness.

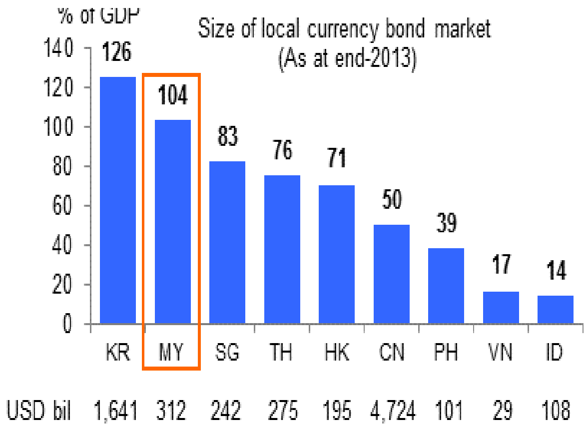
Table 2: Malaysia's external indebtedness indicators

	Standard international threshold	Malaysia's external debt, end-March 2014	
		Previous definition	Redefined
Reserves / ST external debt (times)	1.0	3.3	1.3
Total external debt / GDP (%)	60-90	30.5	65.2
ST external debt / Total external debt (%)	n.a	39.2	47.7
ST external debt/ Exports of goods & services (%)	Smaller is better	15.1	39.3

Source: Reinhart. Carmen and Kenneth *Rogoff, "Growth in a Time of Debt", American* Economic Review, May 2010; Guidotti-Greenspan rule and Bank Negara Malaysia

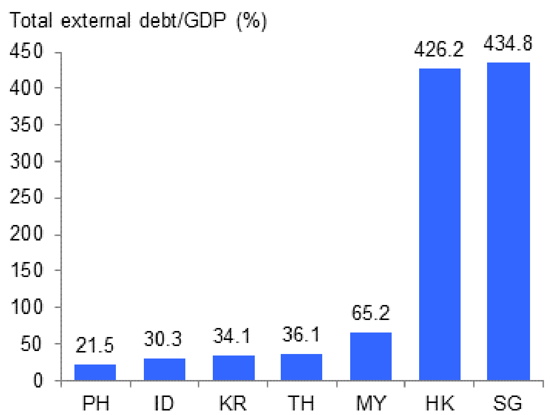
The redefinition of external debt, in essence, consolidates debt statistics that are already publicly available. Moreover, given the rapid deepening and diversification of the Malaysian financial market (Chart 2), the published data would be disaggregated to indicate the nature of Malaysia's external debt position, particularly the growing participation of non-residents in the markets. It is noteworthy that the prevalence of higher external debt amid the growing depth and sophistication of domestic capital markets is a general observation for countries moving to more developed financial markets, as is the case with Hong Kong SAR and Singapore (Chart 3).

Chart 2: Malaysia's local bond market among the largest in Asia excluding Japan



Source: ADB Asian Bonds Online, March 2014

Chart 3: Malaysia's external debt position relative to other regional countries



Note: end-2013 data, except for Malaysia (end-March 2014)

Source: World Bank Quarterly External Debt Statistics, International Monetary Fund

External Robustness

Malaysia's external position remains robust, underpinned by the country's strong economic fundamentals:

- **Growing participation of domestic institutional players in Malaysia's capital market:** In the event of a sell-off by non-residents, domestic players, particularly the well diversified institutional investors, have the capacity to absorb the ringgit-denominated papers. This would mitigate the risk of disruptive price movements in the financial markets. Malaysia now has several large institutional investors, a more developed insurance industry and a larger fund and wealth management industry that would absorb these ringgit-denominated papers.

- **Greater ability to withstand market and financial shocks:** Given the more developed financial system and stronger financial intermediaries, Malaysia would be less susceptible to any financial stress stemming from volatile capital flows. In addition, an adequate level of reserves to finance such short-term external debt (reserves-to-short-term external debt ratio of 1.3 times, higher than the 1:1 minimum international ratio), the continued current account surplus, coupled with sizeable liquid foreign assets in the banking sector, would also provide additional buffers against any external shocks to the economy.

The robustness of Malaysia's external position was evident following the Fed's announcement of its intentions to scale back its quantitative easing measures in May 2013. Amid high global financial market volatility and uncertainty in response to the announcement, emerging market economies, including Malaysia, experienced large capital reversals. Nevertheless, Malaysia's financial system remained resilient and financial stability remained intact with no disruption to financial intermediation.

The redefinition of Malaysia's external debt is, therefore, assessed to be timely, so as to better consolidate Malaysia's external financial obligations in a transparent manner, and to reflect the extent of the advancement in Malaysia's financial markets over this recent decade.

Bank Negara Malaysia
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