ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE SECOND QUARTER OF 2016

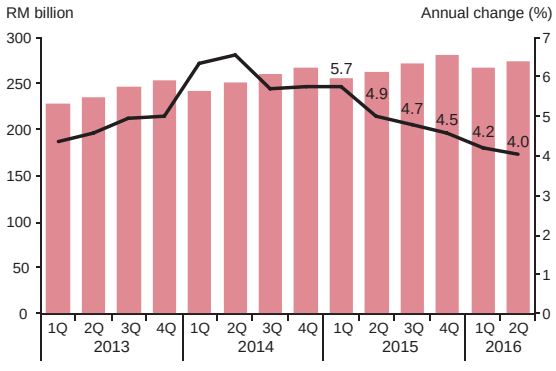
OVERVIEW

In the second quarter of 2016, the global economy expanded at a more moderate pace, with uneven growth momentum across economies. Growth remained modest in the advanced economies amid continued cyclical and structural weaknesses. In Asia, economic expansion was supported by domestic demand, but was weighed down by persistent weakness in export performance. While the initial impact from the result of the UK's EU referendum created uncertainty and heightened risk aversion, financial market volatility has since subsided. Amid continued growth concerns and low inflation, several major and regional central banks conducted further easing to support economic activity.

The Malaysian economy expanded by 4.0% in the second quarter of 2016

The Malaysian economy registered a growth of 4.0% in the second quarter of 2016 (1Q 2016: 4.2%). Despite the stronger expansion in domestic demand, growth was weighed down by the continued decline in net exports and a significant drawdown in stocks. On the supply side, growth continued to be driven by the major economic sectors. On a quarter-on-quarter seasonally-adjusted basis, the economy recorded a growth of 0.7% (1Q 2016: 1.0%).

The economy expanded by 4.0% in the second quarter (at constant 2010 prices)



Source: Department of Statistics, Malaysia

Private sector activity remained the key driver of growth, expanding at a faster pace of 6.1% in the second quarter (1Q 2016: 4.5%). Private consumption grew by 6.3% (1Q 2016: 5.3%), supported by continued wage and employment growth as well as the additional disposable income from Government measures. Private investment grew at a faster pace of 5.6% (1Q 2016: 2.2%), driven mainly by continued capital spending in the services and manufacturing sectors. Public investment growth turned around to register a positive growth of 7.5% (1Q 2016: -4.5%), on account of higher spending on fixed assets by both the Federal Government and public corporations. Growth of public consumption also improved in the second quarter to 6.5% (1Q 2016: 3.8%), due mainly to higher spending on supplies and services.

On the supply side, all economic sectors continued to expand, with the exception of the agriculture sector. The higher growth in the services sector was underpinned primarily by stronger household spending while the manufacturing sector was supported by the electronics and electrical cluster. Growth in the construction sector was stronger, dominated by the civil engineering sub-sector. The performance of the mining sector improved, due mainly to higher crude oil and natural gas production during the quarter. Growth in the agriculture sector declined, due to the lagged impact of El Niño on crude palm oil production.

Inflation, as measured by the annual change in the Consumer Price Index (CPI), declined to 1.9% in the second quarter of 2016 (1Q 2016: 3.4%), due mainly to the lapse of the impact of the Goods and Services Tax (GST), which was implemented in April 2015. The decline in inflation was observed in all twelve CPI categories.

The trade surplus amounted to RM17.9 billion in the second quarter of 2016 (1Q 2016: RM23.9 billion). Gross export

recorded a higher growth of 1.4%, (1Q 2016: 1.0%), driven mainly by a smaller contraction in the growth of commodity exports which offset the slower manufactured export growth. Gross imports registered a positive growth of 3.1% (1Q 2016: -0.4%), reflecting mainly higher imports of capital goods and continued growth in imports of consumption goods.

In the second quarter of 2016, the current account surplus narrowed to RM1.9 billion, equivalent to 0.6% of GNI (1Q 2016: RM5.0 billion or 1.8% of GNI). The smaller current account surplus was due mainly to lower trade surplus, higher investment income received by foreign investors in Malaysia and continued outward remittances by foreign workers in Malaysia.

The international reserves of BNM rose to RM390.4 billion (equivalent to USD97.2 billion) as at 30 June 2016 (end-March: RM381.5 billion; USD97.0 billion). This reserves level has taken into account the quarterly adjustment for foreign exchange revaluation changes. As at 29 July 2016, the reserves position amounted to RM391.1 billion (equivalent to USD97.3 billion). The international reserves remain ample to facilitate international transactions. They are sufficient to finance 8.1 months of retained imports, significantly higher than the 3-month international threshold. The reserves level is also adequate to meet external obligations given the reserves to short-term external debt coverage of 1.2 times. It is important to note that not all short-term external debt creates claim on reserves given the external assets and export earnings of borrowers.

Interest rates remained stable

The Monetary Policy Committee (MPC) maintained the Overnight Policy Rate (OPR) at 3.25% during the second quarter of 2016. The average overnight interbank rate traded within the range of the corridor for the OPR while other short-term interbank market rates up to the 1 month tenure remained stable. The Kuala Lumpur Interbank Offered Rates (KLIBOR) continued to moderate following the easing in the long-term funding needs of interbank players, while the weighted average base rate (BR) of commercial banks was relatively stable at 3.83% (1Q 2016: 3.79%).

On 13 July 2016, the MPC decided to reduce the OPR by 25 basis points to 3.00%. The adjustment to the OPR was intended for the degree of monetary accommodativeness to remain consistent with the policy stance to ensure that the domestic economy continues on a steady growth path amid stable inflation, supported by continued healthy financial intermediation in the economy. This is against an environment of increased downside risks to global growth. Following the OPR reduction, the 3-month KLIBOR declined 25 basis points from 3.65% to 3.40%. As at end-July, the weighted average BR of commercial banks had decreased by 21 basis points to 3.62% (end-June: 3.83%), with downward revisions of BR by most banks ranging from 20 to 25 basis points. Correspondingly, fixed deposit (FD) rates declined by an average of 18 basis points for tenures 1-year and below.

M3, or broad money, increased by RM7.0 billion on a quarter-on-quarter basis to record an annual growth rate of 1.9% as at end-June (end-March: 0.9%). The increase in M3 during the quarter was driven mainly by the continued expansion in credit extended to the private sector by the banking system. The level of surplus liquidity placed with BNM remained ample and was relatively stable during the quarter.

Total gross financing raised by the private sector through the banking system, development financial institutions (DFIs), and the capital market amounted to RM292.1 billion (1Q 2016: RM290.8 billion). On a net basis, the growth of loans extended by the banking system, DFIs, and outstanding issuances of corporate bonds expanded by 6.9% as at end-June (end- March 2016: 7.5%). On an annual basis, outstanding business loans grew at a slower pace of 3.8% as at end-June (end-March 2016: 4.9%) due to the stronger growth in loan repayments relative to disbursements. The growth of outstanding household loans moderated to 6.2% on an annual basis as at end-June (end-March 2016: 6.5%), reflecting mainly the moderation in outstanding loans for the *purchase of non-residential property, purchase of passenger cars,* and *purchase of residential property*. Net

funds raised in the capital market were higher at RM33.4 billion in the second quarter of 2016 (1Q 2016: RM25.4 billion) with bulk of the funds raised by the public sector.

The ringgit and most regional currencies depreciated against the US dollar during the quarter due to uncertainties surrounding US monetary policy. The ringgit, however, faced stronger depreciation pressure due to continued volatility in global crude oil prices and lower weightage of certain Malaysian stocks during the rebalancing of the MSCI Emerging Markets Index. The depreciation was, however, partially offset in June as expectations of a delay in a US interest rate increase resurfaced amid the release of weaker-than-expected US labour market data.

Overall, the ringgit depreciated by 2.5% against the US dollar during the quarter. The ringgit also depreciated against the euro (-0.6%) and the Japanese yen (-10.9%), but appreciated against the pound sterling (4.3%) and the Australian dollar (0.4%). The ringgit also depreciated against most regional currencies, by between 0.4% and 3.2%.

Domestic financial system remains resilient

Domestic financial stability was sustained despite the global uncertainties stemming mainly from the developments in PR China and the outcome of the UK's EU referendum. Domestically, the direct impact from UK's EU referendum on financial institutions has been minimal given the limited exposure to the UK. Volatility in the domestic financial markets rose on 24 June 2016, but resumed its easing trend to end the quarter at levels below that recorded in the first quarter. As a whole, liquidity conditions remained supportive of the financing needs of businesses and households. While businesses and households continue to adjust to the more challenging environment and higher cost of living, this is expected to have modest impact on financial institutions' earnings and asset quality. Supported by strong capital buffers, financial institutions have the capacity to weather adverse economic and market developments without disruptions to domestic financial intermediation.

Financial institutions maintained strong levels of capitalisation. The common equity tier-1 capital ratio stood at 12.9%, whilst tier-1 capital and total capital ratios were at 13.9% and 16.4%, respectively. More than 90% of banking system capital comprises retained earnings, paid-up capital and reserves which have strong loss-absorbing qualities. Similarly, the capital adequacy ratio for the insurance and takaful sectors remained high at 228.1% (1Q 2016: 242.6%). At the end of the quarter, the combined capital buffers of financial institutions amounted to RM153.8 billion.

Domestic demand will remain the key driver of growth

Going forward, global economic activity is expected to remain subdued despite unprecedented easing of monetary conditions in major and regional economies. The pace of expansion in the advanced economies is expected to remain modest, while in Asia, domestic demand will continue to underpin growth. Further bouts of financial market volatility resulting from rising concerns on the US presidential elections and increased risks of political contagion following the UK's EU referendum could materially affect the markets through international capital flows. Overall global economic conditions have become increasingly challenging, with higher downside risks.

Growth of the Malaysian economy is expected to be 4 - 4.5%. Domestic demand will continue to be the main driver of growth, supported primarily by private sector spending. Private consumption is projected to expand further, underpinned by continued growth in wages and employment, as well as additional disposable income from Government measures. While the growth in private investment has moderated due to lower capital expenditures in the oil and gas sector, overall investment will remain supported by the implementation of infrastructure development projects and capital spending in the manufacturing and services sectors. Exports are projected to remain weak given the subdued global demand. Overall, while domestic conditions remain resilient, uncertainties in the external environment may pose downside risks to Malaysia's growth prospects.

DEVELOPMENTS IN THE SECOND QUARTER OF 2016

INTERNATIONAL ECONOMIC ENVIRONMENT

Moderate global growth

In the second quarter of 2016, the global economy expanded at a more moderate pace, with uneven growth momentum across economies. Growth remained modest in the advanced economies amid continued cyclical and structural weaknesses. In Asia, economic expansion was supported by domestic demand, but was weighed down by persistent weakness in export performance. While the initial impact from the result of the UK's EU referendum created uncertainty and heightened risk aversion, financial market volatility has since subsided. Amid continued growth concerns and low inflation, several major and regional central banks conducted further easing to support economic activity.

International financial market conditions became more volatile, particularly in June. During the first half of the quarter, equity markets declined due to the release of weaker Chinese economic data and the continued decline in oil prices. However, both major and regional equities rose from May onwards, following tentative signs of stabilisation in oil prices and the Federal Reserve (Fed)'s decision to keep its federal funds rate unchanged during the June FOMC meeting. Nevertheless, the unexpected outcome of the UK's EU referendum in June resulted in an initial financial market shock, with the British pound declining to a 31-year-low against the US dollar. In this environment of heightened risk aversion, the Japanese yen appreciated due to safe haven flows, while most regional currencies ended the quarter lower against the US dollar. Financial market volatility subsided in the week following the referendum, as concerns abated.

Brent crude oil price rose to an average of USD47 per barrel (1Q 2016: USD35 per barrel), the highest since 3Q 2015. The increase was broadly underpinned by improvements in market sentiments on expectations of a narrower gap between global oil supply and demand. Of significance, concerns over the global oversupply condition eased during the quarter as a result of a series of supply disruptions in oil producing countries such as Nigeria, Canada, Iraq and Libya, as well as a downtrend in US crude oil inventories. The global oil demand remained supported by oil consumption in the emerging economies, particularly in PR China and India. Towards the end of the quarter, however, price movements were highly volatile, reflecting mainly shifts in demand in the oil futures market. A weaker US dollar in early-June initially lifted Brent crude oil price to its highest level since mid-October 2015, at USD52 per barrel on 8 June. Subsequently, uncertainties surrounding the UK's EU referendum and its unexpected result led to a decline in Brent crude oil price. Nonetheless, as immediate concerns over the potential impact of the result waned, oil price increased, ending the quarter at USD50 per barrel.

The US economy grew at a more moderate pace in the second quarter (1.2%; 1Q 2016: 1.6%). However, on a seasonally adjusted annualised basis, growth momentum rose to 1.2% (1Q 2016: 0.8%). Economic activity was underpinned by private consumption amid sustained personal disposable income growth and steady labour market conditions. Headwinds remained for the corporate sector, particularly from weaker corporate profits. Additionally, inventories and net exports were a larger drag on growth. During the quarter, headline inflation remained steady at 1.1%, due mainly to increases in prices of shelter and transportation services.

According to preliminary estimates, growth in the euro area was relatively sustained (1.6%; 1Q 2016: 1.7%) during the second quarter, driven mainly by private consumption and investment activity. On a seasonally-adjusted quarter-on-quarter basis, growth moderated to 0.3%, from 0.6% in the previous quarter. Although external demand improved marginally (April - May 2016 average: 0.5%, 1Q 2016: -1.1%), it remained weak compared to last year's performance (2015: 5.4%). In spite of a highly accommodative monetary policy stance, deflationary pressures persisted, with headline inflation recording a decline of 0.1% (1Q 2016: +0.1%) and core inflation remaining subdued at 0.8%.

The UK economy grew at a faster pace in the second quarter (2.2%; 1Q 2016: 2.0%), as the weakness in the construction and agriculture sectors was offset by improvements in the services and manufacturing sectors. Nevertheless, household and business sentiments continued to be weighed down by uncertainty following the results of the UK's EU referendum. Growth in headline inflation was modest, at 0.3% (1Q 2016: 0.4%).

In Japan, overall economic activity remained subdued. Industrial production continued to decline (-1.9%, 1Q 2016: -3.2%), reflecting mainly contractions in the manufacturing, electricity and mining subcomponents. Exports contracted further (-9.5%, 1Q 2016: -7.9%), on account of slower demand from key trading partners. In addition, consumer spending remained in contraction amid a slower wage growth of 1.2% (1Q 2016: 1.4%). Headline inflation (excluding fresh food) declined further to -0.4% (1Q 2016: -0.1%) while core inflation (excluding food and energy) remained modest at 0.6% (1Q 2016: 0.7%).

Advanced Economies: Real GDP Growth

	2015		2016		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
US	3.0[r]	3.1[r]	1.6[r]	1.2[a]	1.4[a]
Euro area	1.6	1.5	1.7	1.6[p]	1.6[p]
UK	2.4	2.6	2.0	2.2[p]	2.1[p]

[a] Advance estimate
[p] Preliminary estimate
[r] Revised

Source: National authorities

Overall monetary policy stance in the advanced economies remained highly accommodative, with most central banks conducting further easing. Following the outcome of the UK's EU referendum, the Bank of England (BOE) reduced the bank rate by 25bps to a record low of 0.25% in August 2016. In order to further support growth and inflation, the BOE launched a new stimulus package, which includes a new Term Funding Scheme to reinforce the pass-through of the cut in bank rate, the purchase of up to GBP10 billion of UK corporate bonds and an expansion of the asset purchase scheme for UK government bonds of GBP60 billion, thereby taking the total stock of these asset purchases to GBP435 billion. The Reserve Bank of Australia (RBA) also lowered the cash rate by 25bps to 1.75% in May 2016 and then again to 1.50% in August 2016, following weaker-than-expected inflation. The RBA also noted that the price pressures in the housing market have abated, hence the potential risks of lower interest rates are less than they were a year ago. The Bank of Japan (BOJ) kept interest rates steady but decided to double the annual pace of the purchases of exchange-traded funds (ETF) to about 6 trillion yen. Against the backdrop of increased uncertainties surrounding the global economy, the BOJ increased the size of its lending program, which provides US dollars to Japanese companies in a bid to support their overseas activities. The European Central Bank (ECB) decided to keep its key policy rates and monthly asset purchase of EUR80 billion unchanged. Likewise, the Bank of Canada (BOC) maintained its target for the overnight rate at 0.5%. However, both the ECB and BOC have noted that headwinds to growth have increased following the result of the UK's EU referendum. Conversely, the Federal Reserve (Fed) kept the Federal Funds Rate unchanged in July, highlighting that the labour market has strengthened and near-term risks to the US economic outlook have diminished.

Growth in PR China was sustained at 6.7% in the second quarter (1Q 2016: 6.7%). By sector, the improvement in the industrial sector (6.3%, 1Q 2016: 5.8%) was offset by a more moderate expansion in the services sector (7.5%, 1Q 2016: 7.6%). During the quarter, the introduction of policy measures provided some support to investment activity. These include increased financing for infrastructure investment and the easing of house purchase restrictions. Nevertheless, the overall economy continued to face headwinds from weaker business sentiments, ongoing adjustments across sectors with excess capacity and a more modest external demand. Inflation was sustained at 2.1% (1Q 2016: 2.1%) as the increase in house prices was offset by more moderate growth in food and clothing categories.

In Asia, several economies registered moderate improvements. Economic activity in Korea expanded at a faster pace (3.2%; 1Q 2016: 2.8%), underpinned by stronger private consumption and a recovery in exports. Growth in Indonesia picked up to 5.2% (1Q 2016: 4.9%), supported mainly

by higher government spending and a smaller decline in export growth. Economic activity in Chinese Taipei registered a positive growth of 0.7% (1Q 2016: -0.7%), following a rebound in exports. Growth in Singapore was sustained at 2.1% (1Q 2016: 2.1%), as the improvement in the manufacturing sector, driven mainly by the biomedical manufacturing and electronic clusters, partially offset the weakness in the services sector during the quarter.

Regional Countries: Real GDP Growth

	2015		2016		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
PR China	7.0	7.0	6.7	6.7	6.7
Indonesia	4.7	4.7	4.9	5.2	5.1
Korea	2.2	2.3	2.8	3.2[a]	3.0
Singapore	1.8	2.2	2.1[r]	2.1	2.1
Chinese Taipei	0.6	2.3	-0.7	0.7[a]	0.0

[a] Advance estimate
[r] Revised

Source: National authorities

Inflation remained subdued in a number of Asian economies. Lower fuel prices contributed to a decline in transportation and utility costs, offsetting the higher rate of inflation for food items in a few economies. Following a period of deflation since 1Q 2015, Thailand recorded its first quarterly increase in inflation during the quarter, as the drought during the quarter caused food prices to increase at a faster pace than the decline in fuel pump prices.

Monetary policy remained accommodative in the region with a few central banks lowering their policy rates during the quarter. The Reserve Bank of India (RBI) and the Bank of Korea (BOK) lowered their key policy rates by 25 basis points to 6.50% and 1.25%, respectively, to support domestic economic activity. Additionally, the RBI also eased liquidity conditions by lowering the cash reserve ratio and increasing its reverse repo rate to support credit growth. The Central Bank of China (Taiwan) also lowered its key policy rate by 12.5 basis points to 1.375% in view of higher downside risks to economic growth. The Monetary Authority of Singapore (MAS) reduced the slope of the Singapore dollar nominal effective exchange rate (S$NEER) from a gradual appreciation path to zero percent, noting that economic activity is expected to expand at a more modest pace than previously projected.

Going forward, global economic activity is expected to remain subdued despite unprecedented easing of monetary conditions in major and regional economies. The pace of expansion in the advanced economies is expected to remain modest, while in Asia, domestic demand will continue to underpin growth. Further bouts of financial market volatility resulting from rising concerns on the US presidential elections and increased risks of political contagion following the UK's EU referendum could materially affect the markets through international capital flows. Overall global economic conditions have become increasingly challenging, with higher downside risks.

DEVELOPMENTS IN THE MALAYSIAN ECONOMY

The Malaysian economy grew by 4.0% in the second quarter

The Malaysian economy expanded by 4.0% in the second quarter of 2016 (1Q 2016: 4.2%). Private sector expenditure remained the key driver of growth (6.1%; 1Q 2016: 4.5%), and contributed towards the continued expansion in domestic demand. However, growth was affected by the continued decline in net exports and a significant drawdown in stocks. While real exports registered a better performance (1.0%; 1Q 2016: -0.5%) due to higher demand for manufactured products, real imports increased at a faster rate of 2.0% (1Q 2016: 1.3%) on account of improvement in growth of capital and intermediate goods. As a result, net exports continued to register a negative growth during the quarter, albeit at a slower pace of -7.0% (1Q 2016: -12.4%). The drawdown in stocks was attributed to lower production in agriculture and manufactured products. On a quarter-on-quarter seasonally-adjusted basis, the economy recorded a growth of 0.7% (1Q 2016: 1.0%).

Continued expansion in domestic demand

Domestic demand grew by 6.3% in the second quarter of the year (1Q 2016: 3.6%), with private sector expenditure expanding at a stronger pace of 6.1% (1Q 2016: 4.5%). **Private consumption** growth expanded by 6.3% (1Q 2016: 5.3%), supported by continued wage and employment growth, as well as the additional disposable income from Government measures. **Private investment** registered a higher growth of 5.6% in the second quarter (1Q 2016: 2.2%), underpinned mainly by continued capital spending in the services and manufacturing sectors, amid some improvements in business confidence.

Public consumption recorded a stronger growth of 6.5% (1Q 2016: 3.8%), as a result of higher spending on supplies and services. **Public investment** turned around to register a positive growth of 7.5% (1Q 2016: -4.5%), driven by higher spending on fixed assets by both the Federal Government and public corporations.

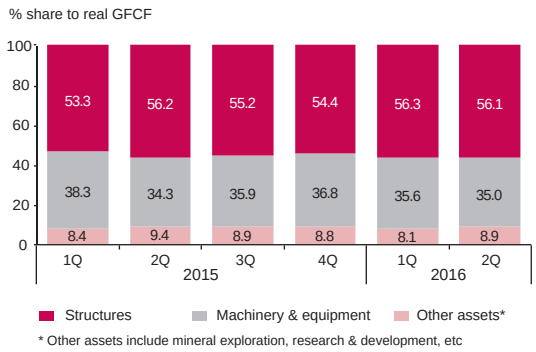
GDP by Expenditure Components
(at constant 2010 prices)

	Share 2015 (%)	2015		2016		
		2Q	1H	1Q	2Q	1H
		Annual change (%)				
Aggregate Domestic Demand (excluding stocks)	91.6	4.6	6.3	3.6	6.3	5.0
Private Sector	69.2	5.7	7.6	4.5	6.1	5.4
Consumption	*52.4*	*6.4*	*7.7*	*5.3*	*6.3*	*5.8*
Investment	*16.9*	*3.9*	*7.4*	*2.2*	*5.6*	*4.0*
Public Sector	22.4	0.9	1.8	0.4	6.9	3.6
Consumption	*13.5*	*6.9*	*5.6*	*3.8*	*6.5*	*5.2*
Investment	*8.9*	*-8.1*	*-3.7*	*-4.5*	*7.5*	*1.1*
Net Exports	8.6	-11.1	-10.5	-12.4	-7.0	-9.8
Exports of Goods and Services	*72.9*	*-4.0*	*-2.4*	*-0.5*	*1.0*	*0.2*
Imports of Goods and Services	*64.3*	*-3.1*	*-1.1*	*1.3*	*2.0*	*1.6*
GDP[1]	**100.0[1]**	**4.9**	**5.3**	**4.2**	**4.0**	**4.1**
GDP (q-o-q growth, seasonally adjusted)	**-**	**0.9**	**-**	**1.0**	**0.7**	**-**

[1] Numbers do not add up due to rounding and exclusion of stocks
Source: Department of Statistics, Malaysia

In terms of total investment, **gross fixed capital formation (GFCF)** registered a faster expansion of 6.1% (1Q 2016: 0.1%), supported by both public and private investment. By type of assets, the higher capital spending was due to the turnaround in machinery and equipment investment (8.1%; 1Q 2016: -7.1%) and the continued growth in structures investment (5.9%; 1Q 2016: 5.7%).

GFCF by Type of Assets



* Other assets include mineral exploration, research & development, etc
Source: Department of Statistics, Malaysia

Major economic sectors continued to expand

On the supply side, all sectors continued to expand, with the exception of the agriculture sector. The higher growth in the services sector was underpinned primarily by stronger household spending while growth in the manufacturing sector was supported by the electronics and electrical cluster. Growth in the construction sector was stronger, dominated by the civil engineering sub-sector. The performance of the mining sector improved, due mainly to higher crude oil and natural gas production during the quarter. Growth in the agriculture sector declined, due to the lagged impact of El Niño on crude palm oil production.

The **services sector** grew at a higher rate of 5.7% in the second quarter (1Q 2016: 5.1%), underpinned primarily by stronger household spending. The wholesale and retail trade sub-sector recorded a higher growth of 6.7% (1Q 2016: 5.2%), in line with the improvement in private consumption. In the information and communication sub-sector, growth remained robust (8.8%; 1Q 2016: 8.5%), driven by continued strong demand for data communication services. Growth in the finance and insurance sub-sector sector improved to 1.6% (1Q 2016: 0.1%), on account of higher premiums in the insurance segment. The expansion in the real estate and business services sub-sector was due mainly to professional services in the business services segment, while growth of the transportation and storage sub-sector was supported by passenger traffic and trade activity.

GDP by Economic Activity (at constant 2010 prices)

	Share 2015 (%)	2015		2016		
		2Q	1H	1Q	2Q	1H
		Annual change (%)				
Services	53.5	5.0	5.7	5.1	5.7	5.4
Manufacturing	23.0	4.2	4.9	4.5	4.1	4.3
Mining	9.0	6.0	7.8	0.3	2.6	1.4
Agriculture	8.9	4.6	0.3	-3.8	-7.9	-6.0
Construction	4.4	5.6	7.6	7.9	8.8	8.4
Real GDP	**100.0[1]**	**4.9**	**5.3**	**4.2**	**4.0**	**4.1**
Real GDP (q-o-q seasonally adjusted)	**-**	**0.9**	**-**	**1.0**	**0.7**	**-**

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

Source: Department of Statistics, Malaysia

Performance of the Services Sector (value added at constant 2010 prices)

	Share 2015 (%)	2015		2016		
		2Q	1H	1Q	2Q	1H
		Annual change (%)				
Intermediate Services	**38.1**	**4.8**	**5.2**	**4.7**	**5.5**	**5.1**
Finance & insurance	12.9	0.2	1.0	0.1	1.6	0.8
Real estate & business services	8.0	6.2	6.8	6.4	6.8	6.6
Transport & storage	6.6	5.4	5.5	5.8	5.9	5.8
Information & communication	10.6	9.3	9.4	8.5	8.8	8.7
Final Services	**61.9**	**5.1**	**5.9**	**5.4**	**5.8**	**5.6**
Wholesale & retail trade	27.4	5.8	7.8	5.2	6.6	5.9
Food & beverages and accommodation	5.2	6.6	6.9	6.2	6.9	6.6
Utilities	4.8	3.9	3.8	6.7	5.4	6.1
Government services	16.3	4.0	3.9	5.3	4.9	5.1
Other services	8.2	4.7	4.7	4.6	4.4	4.5
Total Services	**100.0[1]**	**5.0**	**5.7**	**5.1**	**5.7**	**5.4**

[1] Numbers do not add up due to rounding

Source: Department of Statistics, Malaysia

Selected Quarterly Indicators in the Services Sector

	2015		2016		
	2Q	1H	1Q	2Q	1H
	Index				
MIER Consumer Sentiments Index	71.7	72.2	72.9	78.5	75.7
MIER Retail Trade Index	76.8	81.1	65.9	105.0	85.5
MIER Tourism Market Index	84.7	92.7	93.0	99.5	96.3
	Annual change (%)				
Total passenger traffic at all airports	1.6	0.4	3.8	2.8[1]	3.4[2]
Total consumption credit outstanding	2.7	2.7	1.9	1.8	1.8
Total loans outstanding	9.1	9.1	6.4	5.6	5.6
Loans outstanding to the wholesale & retail trade, hotels & restaurants	8.2	8.2	7.0	5.2	5.2
Imports of consumption goods	25.4	15.2	24.6	9.9	16.4
Total sales of motor vehicles	-11.2	-3.3	-22.0	-6.3	-14.5
Container cargo handled (Port Klang and PTP)	6.0	9.3	6.3	5.1	5.7

[1] Apr-May 2016
[2] Jan-May 2016

Source: Various sources

The **manufacturing sector** expanded by 4.1% in the second quarter (1Q 2016: 4.5%). Growth in the export-oriented industries benefited mainly from the higher production of semiconductors and petrochemical-related products. The domestic-oriented industries were supported by sustained production of food and beverages and construction-related materials. Motor vehicle output, on the other hand, remained weak.

Performance of the Manufacturing Sector

	Share in 2015 (%)	2015		2016		
		2Q	1H	1Q	2Q	1H
		Annual Change (%)				
Overall Value Added (at constant 2010 prices)	**100.0**	**4.2**	**4.9**	**4.5**	**4.1**	**4.3**
Export-oriented industries	63.6	4.1	5.5	4.5	7.0	5.8
Domestic-oriented industries	36.4	4.5	3.8	4.6	-0.4	1.8
Overall Manufacturing Production[1]	**100.0**	**4.1**	**4.8**	**4.3**	**3.9**	**4.1**
Export-oriented industries	**77.6**	**4.3**	**4.7**	**4.2**	**4.2**	**4.2**
Electronics and electrical products cluster	**25.0**	**4.8**	**7.6**	**5.9**	**8.5**	**7.3**
Of which:						
Electronics	15.3	-6.1	-3.3	6.0	9.8	7.9
Electrical products	7.6	37.7	39.0	6.4	7.8	7.1
Primary-related cluster	**52.6**	**4.0**	**3.1**	**3.2**	**1.8**	**2.5**
Of which:						
Chemicals and chemical products	14.3	5.5	7.6	3.3	4.9	4.1
Petroleum products	21.0	0.9	1.5	1.2	5.0	3.0
Rubber products	2.5	7.6	3.1	6.9	4.7	5.7
Off-estate processing	6.4	7.3	-5.9	2.7	-21.5	-11.6
Domestic-oriented industries	**22.4**	**3.5**	**5.4**	**4.6**	**2.8**	**3.7**
Construction-related cluster	**11.3**	**2.8**	**4.8**	**4.9**	**5.0**	**5.0**
Of which:						
Construction-related products	8.2	2.9	5.4	4.7	4.5	4.6
Fabricated metal products	3.1	2.8	3.7	5.4	5.9	5.6
Consumer-related cluster	**11.1**	**4.1**	**6.1**	**4.2**	**0.9**	**2.5**
Of which:						
Transport equipment	5.5	6.0	7.4	2.0	-7.4	-3.1
Food, beverage & tobacco products	5.4	1.7	4.5	7.3	13.0	10.1

[1] Industrial Production Index (2010=100)

Source: Department of Statistics, Malaysia

The **construction sector** grew by 8.8% in the second quarter (1Q 2016: 7.9%), driven by the civil engineering sub-sector. Growth in the civil engineering sub-sector was stronger, underpinned by petrochemical, transport and utility-related projects. In the special trade sub-sector, growth was sustained, supported by early-work activity such as site clearance and piling activity. The residential sub-sector expanded at a faster pace during the quarter, reflecting higher construction activity of both high-end and affordable housing projects. In the non-residential sub-sector, growth weakened further following slower construction activity in the commercial property, especially in the office space segment.

Growth in the **agriculture sector** contracted by 7.9% (1Q 2016: -3.8%), due mainly to a double-digit decline in the production of palm oil amid the lagged impact of El Niño on yields. The performance of the **mining sector** improved (2.6%, 1Q 2016: 0.3%), on account of higher crude oil and natural gas production, particularly in Sabah.

Performance of the Agriculture Sector

	Share in 2015 (%)	2015		2016		
		2Q	1H	1Q	2Q	1H
		Annual change (%)				
Value Added (at constant 2010 prices)	**100**	**4.6**	**0.3**	**-3.8**	**-7.9**	**-6.0**
Industrial Crops	**61.0**	**6.0**	**-1.6**	**-9.2**	**-16.3**	**-13.1**
Of which:						
Oil palm	46.9	10.5	-0.4	-10.0	-19.3	-15.2
Rubber	7.2	-4.7	1.0	-13.0	-4.5	-9.7
Food Crops	**39.0**	**2.5**	**3.2**	**3.5**	**5.3**	**4.4**
Of which:						
Fishing	10.7	-0.2	2.2	-2.1	6.6	2.0
Livestock	10.7	3.1	3.7	5.0	4.9	4.9

Source: Department of Statistics, Malaysia

Performance of the Mining Sector

	2015		2016		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
Value Added (at constant 2010 prices)	**6.0**	**7.8**	**0.3**	**2.6**	**1.4**
Production					
Of which:					
Crude oil and condensates	13.7	17.0	-0.3	0.6	0.2
Natural gas	-2.3	-1.8	0.0	3.9	1.9
Other mining and support services	10.7	12.5	6.5	8.6	7.6

Source: Department of Statistics, Malaysia

Indicators for the Construction Sector

	Share 2015 (%)	2015		2016		
		2Q	1H	1Q	2Q	1H
		Annual change (%)				
Value of construction work done	100.0	8.2	11.6	11.1	11.7	11.4
Non-residential	34.0	15.5	19.8	3.8	2.1	3.0
Residential	29.4	7.8	13.5	8.4	12.5	10.4
Civil engineering	31.8	1.5	2.9	21.3	21.6	21.4
Special Trade[1]	4.7	7.4	5.7	17.3	13.5	15.4
Housing approvals		-16.0	-19.5	-22.1	-36.6	-30.8
Production[2] of construction-related materials		2.8	4.8	4.9	5.0	5.0
Hydraulic cement		12.8	16.3	-7.9	-8.1	-8.0
Other porcelain and ceramic products		21.6	26.1	0.7	7.1	4.0
Other articles of concrete, cement and plaster n.e.c		4.9	12.6	-8.9	9.1	-0.2
Prefabricated structural components for building or civil engineering of cement, concrete or artificial stone		-6.4	-9.9	21.7	21.1	21.4
Capital imports (excluding lumpy items)		-2.8	3.9	-8.1	2.9	-2.7
Loans for the construction sector						
Approval		46.0	35.4	0.4	-14.1	-8.5
Disbursement		5.7	4.4	-2.8	5.4	1.1

[1] Works such as site preparation, electrical installation and painting
[2] Industrial Production Index (2010=100)

Source: Department of Statistics, Malaysia, Ministry of Urban Wellbeing, Housing and Local Government and Bank Negara Malaysia

Headline inflation declined in the second quarter 2016

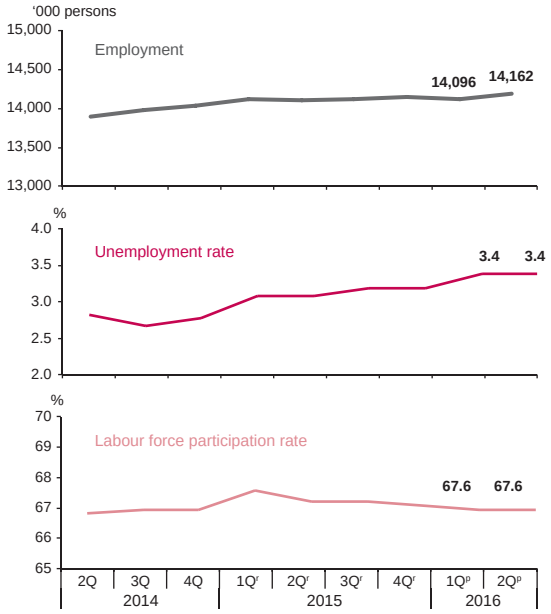
Inflation, as measured by the annual change in the Consumer Price Index (CPI), declined to 1.9% in the second quarter of 2016 (1Q 2016: 3.4%) due mainly to the lapse of the impact of the Goods and Services Tax (GST), which was implemented in April 2015. The decline in inflation was observed in all twelve CPI categories. The *transport* category recorded the largest decline in inflation to -6.6% in the second quarter (1Q 2016: -1.6%) due mainly to the base effect from higher domestic fuel prices in the corresponding period last year. The price of RON95 petrol averaged RM1.70 per litre in 2Q 2016, which was lower than the average price of RM1.98 per litre recorded in 2Q 2015.

The Producer Price Index (PPI) declined in the second quarter of 2016 by 2.1% (1Q 2016: -4.4%). The decline was driven mainly by lower prices of intermediate materials, particularly in the *processed fuel and lubricants* category, reflecting the continued environment of low global energy and commodity prices during the quarter.

Stable labour market

Labour market conditions remained stable in the second quarter. Employment increased during the quarter, registering a moderate net gain of 66,000 jobs[1]. This was almost equal to the expansion of the labour force during the period. As a result, the unemployment rate was unchanged at 3.4% of the total labour force (1Q 2016: 3.4%). Labour force participation was sustained, at 67.6% of the total labour force (1Q 2016: 67.6%). New positions posted on JobStreet.com at 66,088 positions suggest sustained demand for new hires (1Q 2016: 61,378).

Labour Market Indicators*



* The Labour Force Survey (LFS) figures for 1Q 2015 onwards reflect new current population estimates by DOSM

[p] Preliminary
[r] Revision

Source: Department of Statistics, Malaysia

Consumer Price Index

Category	Weights (%) (2010=100)	1Q 2016	2Q 2016
		Annual change, %	
Total	**100**	**3.4**	**1.9**
Food and non-alcoholic beverages	30.2	4.6	4.2
Housing, water, electricity, gas and other fuels	23.8	3.0	2.5
Transport	13.7	-1.6	-6.6
Others	32.3	4.8	2.8

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

[1] Preliminary estimates

Wage indicators suggest continued wage growth in key economic sectors. In the distributive trade services sub-sector[2], wage growth was stronger at 5.3% (1Q 2016: 4.6%), while employment growth was slightly higher at 3% (1Q 2016: 2.5%). Aggregate wages in the manufacturing sector also continued to grow favourably by 5% (1Q 2016: 6.9%), supported by high wage growth in the export-oriented sectors, particularly in the E&E, petrochemicals and textiles clusters. Employment growth in the sector, however, declined marginally (-0.1%; 1Q 2016: -0.5%), as manufacturers remained cautious on the outlook for demand.

External position remains sound in the second quarter, despite narrowing current account surplus

In the second quarter of 2016, the **current account** surplus narrowed to RM1.9 billion, equivalent to 0.6% of GNI (1Q 2016: RM5.0 billion or 1.8% of GNI). The smaller current account surplus was due mainly to lower trade surplus, higher investment income received by foreign investors in Malaysia and continued outward remittances by foreign workers in Malaysia.

Balance of Payments[1]

	2015		2016		
	2Q	1H	1Q	2Q	1H
	RM billion				
Current Account	**8.1**	**19.5**	**5.0**	**1.9**	**6.9**
(% of GNI)	*2.9*	*3.5*	*1.8*	*0.6*	*1.2*
Goods	23.6	51.3	23.5	19.8	43.3
Services	-5.0	-8.5	-6.8	-4.6	-11.5
Primary income	-4.6	-12.3	-6.7	-8.2	-14.9
Secondary income	-5.9	-11.0	-4.9	-5.1	-10.0
Financial Account	**5.7**	**-24.1**	**5.8**	**9.5**	**15.3**
Direct investment	0.7	-0.8	3.7	5.3	9.0
Assets	*-17.6*	*-27.5*	*-11.2*	*-3.8*	*-15.0*
Liabilities	*18.2*	*26.8*	*14.9*	*9.1*	*24.1*
Portfolio investment	-11.8	-19.7	13.1	0.1	13.2
Assets	*-8.1*	*-15.4*	*-5.9*	*-4.7*	*-10.6*
Liabilities	*-3.7*	*-4.3*	*19.0*	*4.8*	*23.8*
Financial derivatives	-0.4	-0.4	0.5	0.0	0.5
Other investment	17.3	-3.2	-11.5	4.1	-7.4
Errors & omissions[2]	-4.3	-1.5	-38.4	-2.7	-41.1
Overall Balance	**8.5**	**-7.2**	**-27.6**	**8.8**	**-18.8**

Assets: (-) denotes outflows due to the acquisition of assets abroad by residents
Liabilities: (+) denotes inflows due to the incurrence of foreign liabilities
[1] In accordance with the Sixth Edition of The Balance of Payments and International Investment Position Manual (BPM6) by the International Monetary Fund (IMF)
[2] Includes unrealised foreign exchange revaluation gains/losses on international reserves

Source: Department of Statistics, Malaysia

Trade Account

	Share 2015 (%)	2015		2016		
		2Q	1H	1Q	2Q	1H
		Annual change (%)				
Gross Exports	**100.0**	**-3.7**	**-3.1**	**1.0**	**1.4**	**1.2**
Manufactured	80.2	2.3	1.2	6.4	4.8	5.6
E&E	*35.6*	*3.1*	*4.9*	*3.6*	*3.5*	*3.5*
Non-E&E	*44.6*	*1.6*	*-1.5*	*8.7*	*5.7*	*7.2*
Resource based	*22.3*	*-5.5*	*-8.9*	*1.6*	*6.4*	*4.1*
Non-resource based	*22.3*	*9.8*	*7.3*	*16.2*	*5.1*	*10.3*
Commodities	19.2	-23.0	-16.8	-18.3	-13.7	-16.2
Minerals	*10.6*	*-36.0*	*-21.6*	*-32.5*	*-24.4*	*-29.2*
Agriculture	*8.6*	*-2.7*	*-9.3*	*6.5*	*-2.9*	*1.5*
Gross Imports	**100.0**	**-5.2**	**-2.6**	**-0.4**	**3.1**	**1.4**
Intermediate goods	58.2	-4.6	-1.0	-3.1	-0.3	-1.7
Capital goods	14.0	-12.5	-2.5	-12.9	10.2	-1.9
Consumption goods	9.1	25.4	15.2	24.6	9.9	16.4
Others (including re-exports and dual-use goods	18.7	-12.9	-13.9	8.7	5.3	7.0
Trade balance (RM billion)	**–**	**20.4**	**41.7**	**23.9**	**17.9**	**41.8**

Source: MATRADE and Department of Statistics, Malaysia

In the second quarter of 2016, gross export recorded a higher growth of 1.4%, (1Q 2016: 1.0%), driven mainly by a smaller contraction in the growth of commodity exports which offset the slower manufactured export growth. Gross imports registered a positive growth of 3.1% (1Q 2016: -0.4%), reflecting mainly higher imports of capital goods, smaller decline in intermediate imports amid more modest expansion in consumption imports. As a result, the trade surplus was lower at RM17.9 billion (1Q 2016: RM23.9 billion).

During the quarter, contraction in commodity exports was smaller, attributable mainly to higher demand for LNG and rubber and an improvement in the prices of these commodities. The slower growth in manufactured exports was due mainly to a more moderate expansion in exports of non-resource-based manufactured products amid a sustained growth in E&E exports. After several quarters of strong growth, growth of non-resource-based manufactured exports such as machinery, appliances and parts, as well as metal products slowed down in the second quarter of 2016. Nonetheless, exports of semiconductors improved in tandem with higher productions, underpinning E&E export growth.

[2] The distributive trade services sub-sector consist of wholesale and retail trade, and motor vehicles sub-sectors.

In terms of destination, exports to key trading partners, particularly PR China and the EU, recorded a contraction during the quarter. Exports to PR China slowed down following lower demand for metal and petroleum products. Exports to the EU also declined due mainly to slower exports of E&E products, as well as machinery, appliances and parts. These weaknesses, however, were offset by the stronger export performance to the US amid continued demand for E&E products, particularly semiconductors. Higher LNG demand also provided some support to the improvement in exports to Japan.

Gross imports registered a positive growth of 3.1% during the quarter (1Q 2016: -0.4%), supported mainly by higher imports of capital and transport equipment in line with the improvement in investment activity. The strong growth in consumption imports also contributed to gross import growth following continued demand for imported semi-durable and non-durable consumer goods. Intermediate imports registered a smaller contraction, in line with the more moderate manufacturing export performance.

Malaysia: Direction of Exports

	Share 2015 (%)	2015		2016		
		2Q	1H	1Q	2Q	1H
		Annual change (%)				
European Union (EU)	**10.1**	**4.4**	**3.1**	**7.9**	**-0.1**	**3.8**
Japan	**9.5**	**-26.6**	**-14.1**	**-20.6**	**-8.4**	**-15.7**
United States	**9.4**	**4.0**	**9.1**	**13.1**	**17.4**	**15.3**
ASEAN[1]	**28.1**	**-0.8**	**-1.6**	**6.5**	**5.4**	**6.0**
North East Asia	**24.0**	**2.1**	**-2.5**	**-4.3**	**-9.6**	**-7.1**
People's Republic of China	*13.0*	*17.1*	*1.9*	*1.3*	*-16.6*	*-8.7*
Hong Kong SAR	*4.7*	*-8.0*	*-1.0*	*-3.2*	*2.8*	*-0.2*
Korea	*3.2*	*-14.9*	*-11.8*	*-13.7*	*0.4*	*-7.9*
Chinese Taipei	*3.0*	*-16.2*	*-10.6*	*-15.1*	*-7.1*	*-10.9*
West Asia[2]	**2.8**	**-10.1**	**-9.0**	**5.2**	**5.6**	**5.4**
India	**4.1**	**-2.9**	**3.9**	**3.0**	**-1.1**	**0.9**
Total exports	**100.0**	**-3.7**	**-3.1**	**1.0**	**1.4**	**1.2**

[1] Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam, Vietnam, Cambodia, Myanmar and Laos
[2] United Arab Emirates, Saudi Arabia, Oman, Iraq, Qatar, Kuwait, Jordan, Lebanon, Bahrain, Syria, Palestine, Yemen and Iran

Source: Department of Statistics, Malaysia

The deficit in the services account was smaller at RM4.6 billion (1Q 2016: deficit of RM6.8 billion), attributable largely to lower net payment for *construction services* following the completion of an oil and gas facility, *telecommunication, computer and information services,* as well as *personal, cultural and recreational services* for acquiring less foreign media and entertainment content. Higher net travel surplus was recorded in 2Q 2016 due mainly to lower payments for outbound tourism amid improvement in receipts from inbound tourism.

The deficit in the primary income account widened to RM8.2 billion (1Q 2016: a deficit of RM6.7 billion), due mainly to higher investment income accrued to foreign investors in Malaysia as larger profits were registered during the quarter (RM18.1 billion; 1Q 2016: RM14.1 billion). This more than offset the increase in income generated by Malaysian firms investing abroad (RM11.3 billion; 1Q 2016: RM9.0 billion). During the quarter, FDI firms in manufacturing, services and mining sectors have declared large profits following higher demand and better commodity prices compared to the first quarter of 2016. Of importance, the FDI companies continued to retain a portion of the investment incomes for reinvestment in Malaysia

The net payment for secondary income account was broadly sustained at RM5.1 billion in 2Q 2016 (1Q 2016: a net payment of RM4.9 billion), primarily on account of larger remittances by foreign workers for Hari Raya festivity.

In the second quarter of 2016, the **financial account** recorded a net inflow of RM9.5 billion (1Q 2016: net inflow of RM5.8 billion), due mainly to net inflows in the direct investment and in the other investment account.

Direct investment account registered a net inflow of RM5.3 billion (1Q 2016: net inflow of RM3.7 billion), as the incurrence of direct investment liabilities continued to outpace the accumulation of direct investment assets.

On the assets side, outward direct investment amounted to RM3.8 billion (1Q 2016: net outflow of RM11.2 billion). Of these, Direct Investment Abroad (DIA) by Malaysian companies declined to RM3.5 billion (1Q 2016: net outflow of RM11.3 billion), due mainly to lower injection of equity capital and extension of loans to subsidiaries abroad. The bulk of DIA was undertaken by companies in the services sector, namely the finance and insurance, recreation and utilities sub-sectors. This is followed by investments in the mining sector.

On the liabilities side, inward direct investment amounted to RM9.1 billion (1Q 2016: net inflow of RM14.9 billion). Of these, Foreign Direct Investment (FDI) moderated to RM8.8 billion (1Q 2016: net inflow of RM15.0 billion), mainly on account of lower injection of equity capital by multinational companies into their Malaysian operations. FDI inflows were largely channelled into the manufacturing sector, particularly the electrical and electronics industry, and to a lesser extent the petrochemicals industry. There was also FDI into the services sector, mainly the real estate and information and telecommunication sub-sectors.

Portfolio investment by non-residents recorded a lower net inflow of RM4.8 billion (1Q 2016: net inflow of RM19.0 billion). During the quarter, there was a net liquidation of equities as investor sentiments were affected by the uncertainty over the stance of US monetary policy, volatility in global crude oil prices and the reduction of Malaysia's weightage in the MSCI Emerging Markets Index. Nevertheless, the liquidation in equities were more than offset by higher purchases of debt securities, as the continued search for yield by non-resident fixed income investors led to strong demand for Malaysian Government Securities (MGS) and Government Investment Issues (GII) as well as for the issuance of the foreign currency denominated Wakala Global Sukuk by the Federal Government. Portfolio investment by residents registered a net outflow of RM4.7 billion (1Q 2016: net outflow of RM5.9 billion), due mainly to the continued acquisition of foreign financial assets by domestic banks and institutional investors. Collectively, resident and non-resident portfolio investment recorded a marginal net inflow of RM77 million (1Q 2016: net inflow of RM13.1 billion).

Other investment account turned around to record a net inflow of RM4.1 billion (1Q 2016: net outflow of RM11.5 billion). The inflows were mainly attributed to the repatriation of interbank placements abroad by Malaysian banks following their maturity as well as a net placement of interbank deposits by non-resident financial institutions in the domestic banking system. The public sector recorded a net outflow, due mainly to a net repayment of external loans by the public corporations.

Following these developments, the overall balance of payments registered a surplus of RM8.8 billion in the first quarter (1Q 2016: deficit of RM27.6 billion). Errors and omissions amounted to –RM2.7 billion or -0.8% of total trade, mostly reflecting the foreign exchange revaluation changes in international reserves arising from the strengthening of most currencies against the ringgit during the quarter.

Manageable external debt

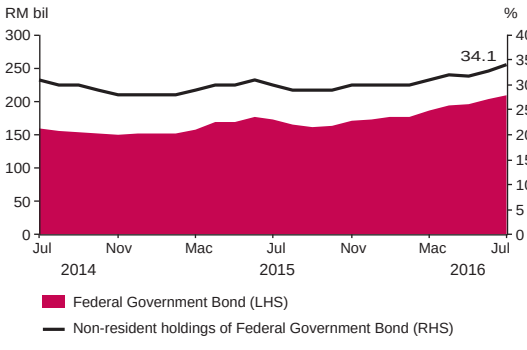
Malaysia's external debt stood at RM848.2 billion, equivalent to USD209.0 billion or 69.0% of GDP as at end-June 2016 (end-March 2016: RM809.1 billion or USD 203.7 billion, equivalent to 65.8% of GDP). The higher external debt was attributed to the drawdown of external borrowing and higher non-resident holdings of domestic debt securities during the quarter. There were also valuation effects following the strengthening of most currencies against the ringgit.

The weakening of the ringgit mainly affected the outstanding amount of offshore borrowing, which increased by 6.3% to RM466.7 billion as at end-June 2016 (end-March 2016: RM439.0 billion). The impact of exchange rate valuation changes on offshore borrowing was, nevertheless, manageable as borrowings by corporations, namely public and non-bank private corporations are largely hedged, either naturally through foreign currency earnings, or through the use of financial instruments. As at end-June, the offshore borrowing remained low at 38.0% of GDP compared to 60% of GDP during the Asian Financial Crisis (AFC) in 1997-98.

Excluding the foreign exchange valuation changes, offshore borrowing increased by 4.1% during the quarter. This partly reflects a Federal Government issuance of USD1.5 billion Wakala Global Sukuk, with the proceeds to be used to redeem an earlier USD1.2 billion Wakala Global Sukuk maturing in July 2016 and to finance development expenditure. There was a net drawdown of interbank borrowing, mainly for financing, liquidity management and investment purposes. In addition, there were net issuances of foreign-currency bond and drawdown of long-term offshore loans by banks partly to diversify the maturity structure of their funding. Non-bank private corporations also recorded a net drawdown of intercompany loans during the quarter.

The non-resident holdings of ringgit-denominated domestic debt securities increased by RM8.4 billion to RM232.3 billion (end-March 2016: RM223.9 billion). Most acquisitions were in Federal Government domestic debt securities, namely MGS and Government Investment Issues. More specifically, non-resident holdings of Federal Government bond increased to 34.1% of the outstanding value or RM209.7 billion as at end-July 2016 (end-March 2016: RM186.7 billion). The majority of these investors are long-term investors, mainly asset managers, central banks and pension funds, which reflects the improving sentiments on Malaysia's economy. On the other hand, the non-resident holdings of Bank Negara Monetary notes further declined to RM12.9 billion as at end-June 2016 (end-March 2016: RM21.1 billion).

Non-Resident Holdings of Federal Government Bond



Source: Bank Negara Malaysia

Overall, Malaysia's external debt remains manageable, with medium- to long-term external debt accounting for more than half of the outstanding position (60.7%). The short-term external debt was slightly lower during the quarter and accounted for only 39.3% of the total external debt (end-March 2016: 40.6%). The international reserves were adequate to cover the short-term external debt by 1.2 times. About two-thirds of the short-term external debt is held by the banking sector, which not all pose a claim on international reserves since the debt is partly covered by the banks' corresponding external assets. The bulk of the remaining short-term external debt was accounted for by trade credits and intercompany loans. Trade credits are largely backed by export earnings, while intercompany loans are generally on flexible and concessionary terms, such as no fixed repayment schedule and zero or low interest rate.

Outstanding External Debt

	2015	2016	
	end-June	end-Mar	end-June
	RM billion		
Offshore borrowing[1]	429.0	439.0	466.7
USD billion equivalent	*112.5*	*110.5*	*115.0*
Medium- and long-term	*251.7*	*271.8*	*288.4*
Public sector	119.4	117.0	121.7
Private sector	132.3	154.8	166.7
Short-term	*177.3*	*167.1*	*178.4*
NR holdings of dom. debt securities	209.2	223.9	232.3
Medium- and long-term	*186.4*	*197.8*	*215.8*
Short-term	*22.8*	*26.1*	*16.5*
NR deposits	84.2	78.8	77.3
Others[2]	69.6	67.5	71.9
Medium- and long-term	*58.6*	*11.4*	*11.0*
Short-term	*11.0*	*56.1*	*60.9*
Total external debt	**791.9**	**809.1**	**848.2**
USD billion equivalent	*207.7*	*203.7*	*209.0*
External debt (Redefined)			
Total debt/GDP (%)	68.4	65.8	69.0
Short-term debt[3]/Total debt (%)	43.3	40.6	39.3
Reserves/Short-term debt[3] (times)	1.2	1.2	1.2[5]
External debt (Previous definition)			
Total debt/GDP (%)	37.1	35.7	38.0
Short-term debt[4]/Total debt (%)	41.3	38.1	38.2
Reserves/Short-term debt[4] (times)	2.2	2.3	2.2[5]

[1] Equivalent to the external debt as previously defined, comprised mainly foreign currency loans raised, and bonds and notes issued offshore.
[2] Comprise trade credits, IMF allocation of SDRs and miscellaneous.
[3] Short-term offshore borrowing, NR holdings of short-term domestic debt securities, NR deposits, short-term trade credits and miscellaneous.
[4] Equivalent to short-term offshore borrowing.
[5] Based on international reserves as at 29 July 2016.

Note: NR refers to non-resident

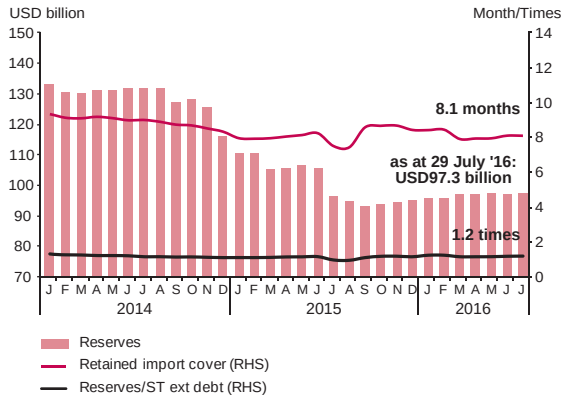
Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

International reserves remain ample to facilitate international transactions

The international reserves of BNM amounted to RM390.4 billion (equivalent to USD97.2 billion) as at 30 June 2016 (end-March: RM381.5 billion; USD97.0 billion). This reserves level has taken into account the quarterly adjustment for foreign exchange revaluation changes.

As at 29 July 2016, the reserves position amounted to RM391.1 billion (equivalent to USD97.3 billion). The international reserves remain ample to facilitate international transactions. They are sufficient to finance 8.1 months of retained imports, significantly higher than the 3-month international threshold. The reserves level is also adequate to meet external obligations given the reserves to short-term external debt coverage of 1.2 times. It is important to note that not all short-term external debt creates claim on reserves given the external assets and export earnings of borrowers.

Net International Reserves (as at end period)

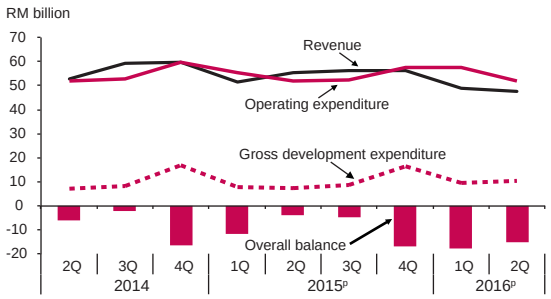


Source: Bank Negara Malaysia

Government spending increased

During the second quarter of 2016, Federal Government expenditure increased by 5.8%, due primarily to higher development expenditure. Development expenditure increased by 43.9% on an annual basis (1Q 2016: 16.1%) and was mainly channelled towards the *transportation* and *trade and industry* sectors. Operating expenditure registered a slower annual growth rate of 0.5% (1Q 2016: 3.5%), reflecting the Government's expenditure rationalisation measures, as reflected by a marked decline in *subsidies* and *grants and transfers.* Revenue declined by 14.0% (1Q 2016: -5.3%), due mainly to lower individual income tax collection. Overall, the Federal Government recorded a lower deficit of 5.0% of GDP (1Q 2016: -6.1% of GDP) during the quarter. As at end-June 2016, total outstanding debt of the Federal Government amounted to RM655.7 billion or 53.4% of the estimated 2016 GDP.

Federal Government Finance



p Preliminary
Source: Ministry of Finance, Malaysia

Federal Government Finance[p]

	2015		2016		
	2Q	1H	1Q	2Q	1H
	RM billion				
Revenue	55.3	106.8	48.8	47.5	96.3
% annual growth	*4.9*	*4.9*	*-5.3*	*-14.0*	*-9.8*
Operating expenditure	51.8	107.3	57.4	52.1	109.5
% annual growth	*0.2*	*0.3*	*3.5*	*0.5*	*2.1*
Current account	**3.4**	**-0.5**	**-8.6**	**-4.6**	**-13.2**
% of GDP	***1.2***	***-0.1***	***-2.9***	***-1.5***	***-2.2***
Net development expenditure	7.3	15.1	9.2	10.4	19.6
% annual growth	*3.5*	*8.3*	*16.1*	*43.9*	*29.4*
Overall balance	**-3.8**	**-15.6**	**-17.7**	**-15.0**	**-32.8**
% of GDP	***-1.4***	***-2.8***	***-6.1***	***-5.0***	***-5.6***
Memo item:					
Total net expenditure	59.1	122.4	66.5	62.5	129.0
% annual growth	*0.6*	*1.2*	*5.1*	*5.8*	*5.4*
Total Federal Government debt[1]					
(as at end-period)	627.5	627.5	626.9	655.7	655.7
% of GDP	*54.2*	*54.2*	*51.0*	*53.4*	*53.4*
Domestic debt	429.2	429.2	416.7	424.9	424.9
% of GDP	*37.1*	*37.1*	*33.9*	*34.6*	*34.6*
External debt	198.3	198.3	201.2	230.8	230.8
% of GDP	*17.1*	*17.1*	*17.1*	*18.8*	*18.8*
Non-resident holdings of RM-denominated Federal Government debt	*179.5*	*179.5*	*190.2*	*206.2*	*206.2*
% of GDP	*15.5*	*15.5*	*15.5*	*16.8*	*16.8*
Offshore borrowing	*18.8*	*18.8*	*19.9*	*24.7*	*24.7*
% of GDP	*1.6*	*1.6*	*1.6*	*2.0*	*2.0*

[p] Preliminary
[1] A portion of the Housing Loan Fund debt amounting to RM21.9 billion (1.8% of estimated 2016 GDP) has been transferred to the new statutory body for civil servant housing loans (Public Sector Home Financing Board, LPPSA) beginning 2016

Note: Beginning first quarter of 2015, GDP has been rebased from base year 2005 to base year 2010

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

MONETARY AND FINANCIAL DEVELOPMENTS

Interest rates remained stable

The Monetary Policy Committee (MPC) maintained the Overnight Policy Rate (OPR) at 3.25% during the second quarter of 2016. During the quarter, the average overnight interbank rate traded within the range of 3.05% and 3.24% while other short-term interbank market rates up to the 1-month tenure remained stable. The Kuala Lumpur Interbank Offered Rates (KLIBOR), as did the KLIBOR futures, continued to moderate following the easing in the long-term funding needs of interbank players. Interest rate swaps continued to trend lower during this quarter, reflecting the lower Malaysian Government Securities (MGS) yields. Both the weighted average base rate (BR) of commercial banks and weighted average lending rate (ALR) remained relatively stable during the quarter at 3.83% and 5.42%, respectively (1Q 2016: 3.79% and 5.41%, respectively).

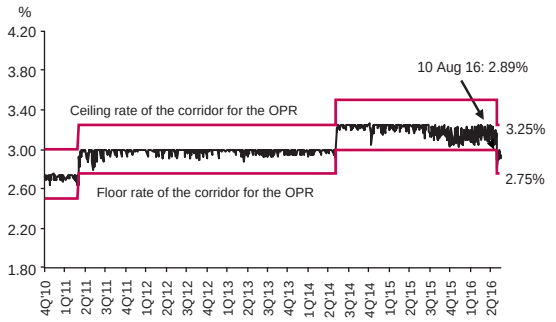
On 13 July 2016, the MPC decided to reduce the OPR by 25 basis points to 3.00%. The adjustment to the OPR was intended for the degree of monetary accommodativeness to remain consistent with the policy stance to ensure that the domestic economy continues on a steady growth path amid stable inflation, supported by continued healthy financial intermediation in the economy. This is against an environment of increased downside risks to global growth. Following the OPR reduction, the 3-month KLIBOR declined 25 basis points from 3.65% to 3.40%. As at end-July, the weighted average BR of commercial banks decreased by 21 basis points to 3.62% (end-June: 3.83%), with downward revisions of BR by most banks ranging from 20 to 25 basis points. Correspondingly, fixed deposit rates declined by an average of 18 basis points for tenures 1-year and below.

Interest Rates

	2015	2016	
	2Q	1Q	2Q
	At end-period (%)		
Overnight Policy Rate (OPR)	3.25	3.25	3.25
Interbank rates			
Overnight	3.24	3.04	3.13
1-month	3.48	3.25	3.44
Base lending rate (BLR)			
Commercial banks	6.79	6.80	6.82
Weighted average base rate (BR)			
Commercial banks	3.79	3.79	3.83
Weighted average lending rate (ALR)			
Commercial banks	5.44	5.41	5.42
Fixed deposit rates			
Commercial banks			
1-month	3.08	3.08	3.08
12-month	3.31	3.31	3.29

Source: Bank Negara Malaysia

Daily Weighted Average Overnight Interbank Rate



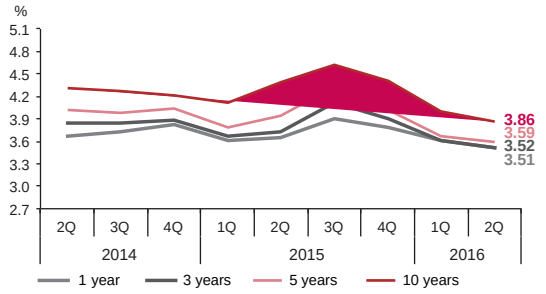
Source: Bank Negara Malaysia

Lending Rates of Commercial Banks (At end-period)



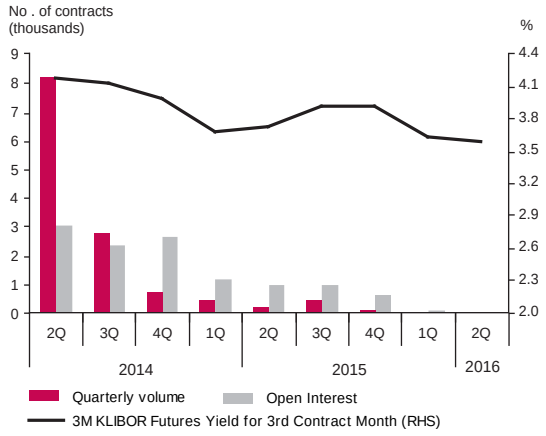
Source: Bank Negara Malaysia

Interest Rate Swap: Rates



Source: Bloomberg

3 Month KLIBOR Futures



Source: Bursa Malaysia

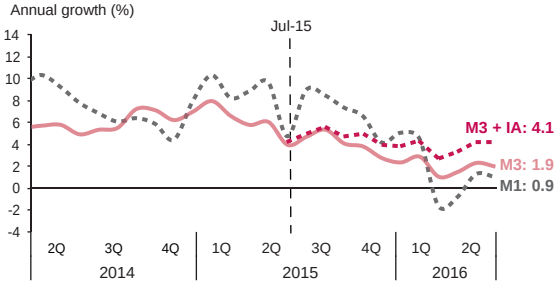
M3 expanded during the quarter

M1, or narrow money, increased by RM9.7 billion during the quarter. On an annual basis, M1 recorded a growth rate of 0.9% as at end-June (end-March: -1.7%). M3, or broad money, increased by RM7.0 billion on a quarter-on-quarter basis to record an annual growth rate of 1.9% as at end-June (end-March: 0.9%).

In terms of the broad money determinants, the increase in M3 during the quarter was driven mainly by the continued expansion of credit extended to the private sector by the banking system. The expansion, however, was partially offset by the continued issuance of equity by banks and the reclassification of Islamic Investment Accounts that took place in July 2015, both reflected in the *other influences* component.

In the banking system, liquidity remained ample at both the institutional and system-wide levels. The level of surplus liquidity placed with BNM remained relatively stable during the quarter.

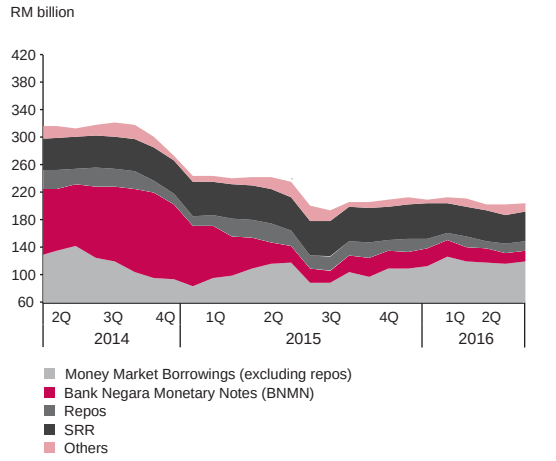
Monetary Aggregates



Note: From July 2015 onwards, the compilation of M3 is adjusted to exclude Islamic Investment Accounts (IA) due to a data reclassification exercise. This is reflected as a negative contribution through *'other influences'*. The dotted line represents M3 growth had this reclassification not taken place

Source: Bank Negara Malaysia

Outstanding Liquidity Placed with Bank Negara Malaysia (At end-period, RM billion)



Source: Bank Negara Malaysia

Determinants of Broad Money, M3

	Change during the period				
	2015		2016		
	2Q	1H	1Q	2Q	1H
	RM billion				
M3	**-7.5**	**27.9**	**9.4**	**7.0**	**16.5**
Net claims on Government	-20.4	-25.1	-0.9	-1.9	-2.8
Claims on private sector	23.2	51.6	11.2	22.3	33.5
Loans	*22.3*	*47.5*	*10.6*	*16.9*	*27.5*
Securities	*0.9*	*4.1*	*0.6*	*5.5*	*6.0*
Net foreign assets[1]	-3.5	2.6	-19.7	7.8	-11.9
BNM	*8.2*	*-9.0*	*-26.9*	*8.6*	*-18.3*
Banking System	*-11.7*	*11.7*	*7.2*	*-0.8*	*6.4*
Other influences	-6.7	-1.3	18.8	-21.2	-2.4

[1] Post-revaluation
Note: Numbers may not add up due to rounding

Source: Bank Negara Malaysia

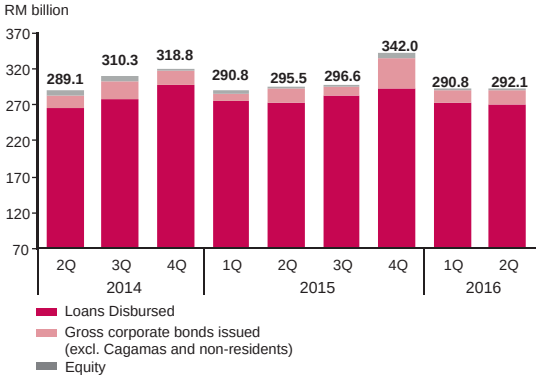
Private sector financing was sustained in the second quarter

In the second quarter, total gross financing raised by the private sector through the banking system, development financial institutions (DFIs), and the capital market amounted to RM292.1 billion (1Q 2016: RM290.8 billion). On a net basis, the growth of loans extended by the banking system, DFIs, and outstanding issuances of corporate bonds expanded by 6.9% as at end-June (end- March 2016: 7.5%).

Net lending to businesses by the banking system and DFIs increased by RM3.1 billion during the quarter (1Q 2016: -RM4.8 billion). On an annual basis, outstanding business loans grew at a slower pace of 3.8% as at end-June (end-March 2016: 4.9%) due to the stronger growth in loan repayments relative to disbursements. Although the growth in the level of loans disbursed by the banking system and DFIs to businesses slowed down to 0.1% on an annual basis, the level of loans disbursed to SMEs increased to RM66.4 billion during the quarter (2Q 2015: RM65.4 billion) with loans extended mainly to the *construction, real estate,* and *agriculture* sectors.

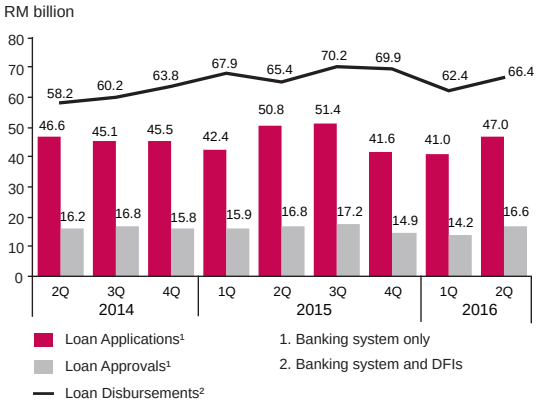
Net financing to the household sector expanded by RM12.4 billion during the quarter (1Q 2016: RM8.5 billion). On an annual basis, the growth of outstanding household loans moderated to 6.2% as at end-June (end-March 2016: 6.5%), reflecting mainly the moderation in outstanding loans for the *purchase of non-residential property, purchase of passenger cars,* and *purchase of residential property*.

Gross Private Sector Financing through the Banking System, Development Financial Institution (DFIs) and Capital Market



Source: Bank Negara Malaysia

Lending to SMEs



Source: Bank Negara Malaysia

Financing of the Private Sector through the Banking System, DFIs and Capital Market

	2015		2016			2015		2016		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
	During the period (RM billion)					Annual growth (%)				
Gross total financing	**295.5**	**586.2**	**290.8**	**292.1**	**582.9**	**2.2**	**1.2**	**0.0**	**-1.1**	**-0.6**
Loans disbursed	272.1	547.2	271.8	269.9	541.7	2.2	2.8	-1.2	-0.8	-1.0
Gross Corporate bond (CB)[1]	20.1	31.1	17.9	20.1	38.0	13.5	-17.7	63.0	0.1	22.3
Equity	3.3	8.0	1.1	2.1	3.1	-36.4	-15.0	-76.8	-37.4	-60.5
Net total financing	**34.3**	**61.5**	**11.5**	**24.9**	**36.5**	**8.1**	**8.1**	**7.5**	**6.9**	**6.9**
Outstanding loans (Banking system* and Development Financial Institution (DFIs)	27.8	51.2	4.6	17.2	21.8	8.7	8.7	6.3	5.5	5.5
Outstanding CB	6.4	10.2	7.0	7.7	14.7	6.1	6.1	11.4	11.5	11.5
Memorandum item										
Gross CB[2]	20.5	31.9	18.4	20.1	38.5	10.8	-18.2	60.5	-1.9	20.4

* Include loans sold to Cagamas
[1] Excluding Cagamas and foreign issuances
[2] Including Cagamas and foreign issuances
Note: Numbers may not add up due to rounding

Source: Bank Negara Malaysia

Loan Indicators

	During the period (RM billion)					Annual growth (%)				
	2015		2016			2015		2016		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
Total										
Loan applications[1]	208.2	386.8	187.7	212.6	400.3	0.5	-1.6	5.1	2.1	3.5
Loan approvals[1]	102.5	196.5	76.7	89.5	166.2	4.5	3.8	-18.4	-12.7	-15.4
Loan disbursements[2]	272.1	547.2	271.8	269.9	541.7	2.2	2.8	-1.2	-0.8	-1.0
Loan repayments[2]	252.0	518.7	275.8	264.7	540.5	2.1	3.6	3.4	5.0	4.2
Change in outstanding loans*[,2]	27.8	51.2	4.6	17.2	21.8	8.7	8.7	6.3	5.5	5.5
Of which:										
Business enterprises[3]										
Loan applications	97.8	176.3	87.8	102.7	190.5	7.2	-0.7	12.0	5.0	8.1
Loan approvals	47.0	86.9	35.7	43.6	79.3	33.8	24.2	-10.4	-7.2	-8.7
Loan disbursements	194.2	387.3	195.9	194.4	390.3	5.0	3.8	1.4	0.1	0.8
Loan repayments	182.2	377.0	201.0	192.5	393.5	1.8	3.9	3.2	5.6	4.4
Change in outstanding loans*	9.1	18.9	-4.8	3.1	-1.6	8.0	8.0	4.9	3.8	3.8
SMEs										
Loan applications	50.8	93.2	41.0	47.0	87.9	9.0	3.5	-3.3	-7.5	-5.6
Loan approvals	16.8	32.7	14.2	16.6	30.7	3.7	4.6	-10.9	-1.5	-6.1
Loan disbursements	65.4	133.2	62.4	66.4	128.8	12.4	16.0	-8.1	1.6	-3.3
Loan repayments	62.4	123.7	61.8	67.5	129.3	13.8	13.9	0.9	8.1	4.5
Change in outstanding loans*	7.0	22.0	2.9	8.1	11.0	16.7	16.7	9.0	9.2	9.2
Large corporations[3]										
Loan applications	47.0	83.1	46.8	55.7	102.6	5.4	-5.0	29.9	18.5	23.4
Loan approvals	30.2	54.2	21.6	27.1	48.6	59.7	40.1	-10.0	-10.4	-10.2
Loan disbursements	128.9	254.1	133.5	128.0	261.5	1.6	-1.7	6.6	-0.7	2.9
Loan repayments	119.8	253.3	139.2	125.0	264.2	-3.5	-0.5	4.3	4.3	4.3
Change in outstanding loans*	2.1	-3.1	-7.7	-5.0	-12.7	1.5	1.5	1.5	-0.9	-0.9
Households										
Loan applications	110.4	210.5	99.9	109.9	209.7	-4.8	-2.3	-0.2	-0.5	-0.4
Loan approvals	55.0	108.6	40.6	45.9	86.0	-11.9	-8.1	-24.3	-17.3	-20.8
Loan disbursements	77.9	159.8	75.9	75.6	151.5	-4.2	0.4	-7.4	-3.0	-5.2
Loan repayments	69.8	141.8	74.8	72.2	147.0	2.8	2.9	3.9	3.5	3.7
Change in outstanding loans*	14.1	31.6	8.5	12.4	21.0	8.6	8.6	6.5	6.2	6.2

* The annual growth is for end-period
[1] Loan applications and approvals for all segments include only banking system loans
[2] Loan disbursements, repayments and change in outstanding loan for all segments includes banking system and develpoment financial institutions (DFIs)
[3] Includes domestic financial institutions, government, domestic other entities and foreign entities, except for loan outstanding which refers to businesses only
Note: Numbers do not add up due to rounding

Source: Bank Negara Malaysia

Loans by Sector (Banking System and DFIs)

	Loans disbursed						Outstanding Loans
	During the period (RM billion)					Share of total	Share of total
						(%)	
	2Q 2015	1H 2015	1Q 2016	2Q 2016	1H 2016		
Business enterprises[1,*]	**194.2**	**387.3**	**195.9**	**194.4**	**390.3**	**72.0**	**42.5**
Large corporations[1]	*128.9*	*254.1*	*133.5*	*128.0*	*261.5*	*48.3*	*24.6*
*SMEs**	*65.4*	*133.2*	*62.4*	*66.4*	*128.8*	*23.8*	*17.8*
Selected sectors[1]							
Agriculture, hunting, forestry and fishing	11.5	21.1	12.0	12.4	24.4	4.5	2.8
Mining and quarrying	4.3	11.4	1.8	2.1	3.9	0.7	0.7
Manufacturing	52.3	103.2	49.9	49.5	99.3	18.3	6.4
Construction	15.7	33.5	17.2	16.6	33.8	6.2	4.6
Real estate	12.1	25.3	12.6	14.7	27.4	5.0	6.4
Electricity, gas and water supply	2.6	5.0	2.4	2.7	5.1	0.9	0.8
Wholesale, retail, restaurants and hotels	50.0	97.7	49.1	51.1	100.2	18.5	6.9
Transport, storage and communication	6.8	13.5	5.6	8.3	13.9	2.6	2.5
Finance, insurance and business services	23.4	48.5	28.7	26.5	55.1	10.2	3.2
Households	**77.9**	**159.8**	**75.9**	**75.6**	**151.5**	**28.0**	**57.5**
Purchase of residential properties	21.8	43.1	20.3	19.7	40.0	7.4	27.5
Consumption credit	45.1	92.8	45.9	46.8	92.7	17.1	19.8
Of which:							
Credit cards	*24.3*	*50.9*	*26.3*	*26.2*	*52.5*	*9.7*	*2.2*
Purchase of passenger cars	*9.5*	*20.4*	*8.7*	*8.6*	*17.3*	*3.2*	*9.2*
Others	11.0	24.0	9.7	9.1	18.8	3.5	10.2
Total	**272.1**	**547.2**	**271.8**	**269.9**	**541.7**	**100.0**	**100.0**

* Include loans to individual businesses.
[1] Include domestic financial institutions, government, domestic other entities and foreign entities.
Note: Numbers do not add up due to rounding

Source: Bank Negara Malaysia

Higher net financing from the capital market

Net funds raised in the capital market were higher at RM33.4 billion in the second quarter of 2016 (1Q 2016: RM25.4 billion). The bulk of the funds were raised by the public sector (RM23.6 billion) through new issuances of 5-year and 10-year Malaysian Government Securities (MGS), as well as the re-opening of 7-year, 20-year, and 30-year MGS and 7-year, 10-year and 15-year Government Investment Issues (GII). Government debt redemptions were lower at RM2.2 billion (1Q 2016: RM7.0 billion) during the period, contributing to the increase in net funds raised by the public sector.

In the private sector, net funds raised were also higher at RM9.8 billion (1Q 2016: RM6.7 billion) due mainly to higher net issuances of corporate bonds. Funds raised in the private bond market were primarily from the *Finance, Insurance, Real Estate and Business Services* and *Agriculture, Forest and Fishing* sectors, and were mainly used for the purpose of financing infrastructure projects, working capital and general business activities.

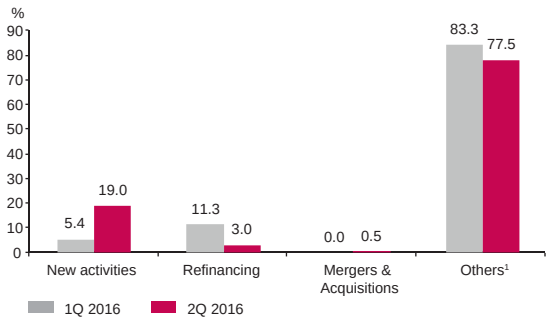
Net Funds Raised in the Capital Market

	2015		2016		
	2Q	1H	1Q	2Q	1H
	RM billion				
By Public Sector	**30.1**	**43.3**	**18.7**	**23.6**	**42.3**
Government Securities, Gross	30.1	57.1	25.7	25.8	51.5
Malaysian Government Securities	12.5	26.0	12.1	16.2	28.3
Government Investment Issues	14.1	23.6	13.6	9.6	23.2
Sukuk Pinjaman Perumahan Kerajaan	3.5	7.5	-	-	-
Less: Redemptions	-	13.8	7.0	2.2	9.2
Malaysian Government Securities	-	11.8	-	2.2	2.2
Government Investment Issues	-	2.0	7.0	-	7.0
Sukuk Pinjaman Perumahan Kerajaan	-	-	-	-	-
By Private Sector	**9.1**	**17.4**	6.7	**9.8**	**16.5**
Shares	3.3	8.0	1.1	2.1	3.1
Corporate bonds, Net	5.8	9.4	5.6	7.7	13.3
Corporate bonds, Gross	*20.5*	*31.9*	*18.4*	*20.1*	*38.5*
Less: Redemptions	*14.7*	*22.5*	*12.7*	*12.4*	*25.1*
Total	**39.3**	**60.7**	**25.4**	**33.4**	**58.8**

Note: Numbers may not add up to total due to rounding

Source: Bank Negara Malaysia and Bursa Malaysia

Corporate Bond Issued by Purpose (% of total)



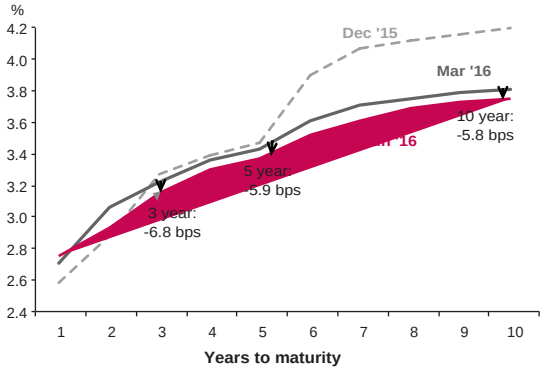
[1] Includes issuance for the purpose of working capital and general business activities as well as issuance by non-residents and Cagamas

Source: Bank Negara Malaysia

Bond yields declined further in the second quarter

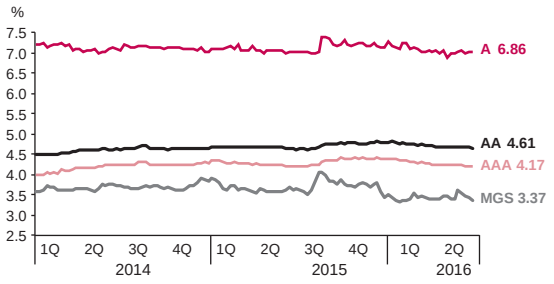
MGS yields remained on a downward trend for most of the quarter, especially for the medium- to longer-tenured papers, due to non-resident purchases. This mainly reflected the search for higher yields among non-resident investors in emerging sovereign bond markets, including Malaysia, following increased market expectations for a delay in US policy rate increases. Non-resident investors increased MGS holdings by RM10.5 billion during the quarter. As at end-June 2016, the share of non-resident holdings of MGS reached a historical high of 49.8% of total MGS outstanding (May 2013: 49.5%). As a result, the 3-year, 5-year and 10-year MGS yields declined by 6.8, 5.9 and 5.8 basis points, respectively. In the private bond market, yields remained stable on account of sustained demand by domestic investors.

Trend in MGS Yields



Source: Bank Negara Malaysia

5 year MGS and 5 year Corporate Bond Yields

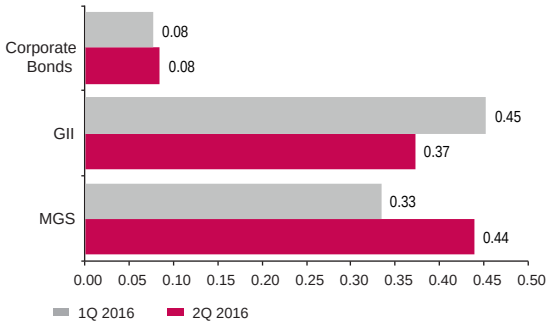


Source: Bank Negara Malaysia

Higher trading in the bond market

Trading in the secondary market was higher at RM286.9 billion during the quarter (1Q 2016: RM254.1 billion) reflecting increased trading by non-residents and financial institutions. The increase in turnover was mainly concentrated in the trading of MGS which registered a higher liquidity ratio of 0.44. The corporate bond segment remained relatively unchanged at 0.08 while GII registered a lower liquidity ratio of 0.37.

Liquidity Ratio: Value of Bonds Traded / Outstanding



Source: Bank Negara Malaysia

FBM KLCI declined during the quarter

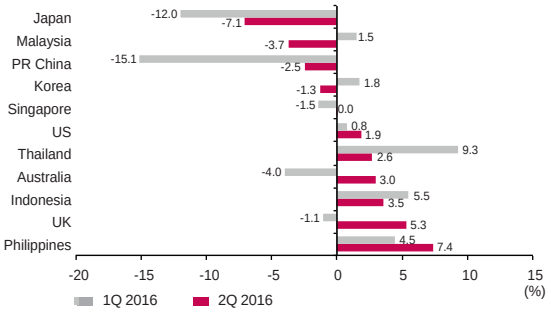
During the second quarter of 2016, the FBM (FTSE Bursa Malaysia) KLCI declined by 3.7% to close at 1,654.1 points at end-June (end-March 2016: 1,717.6 points).

The downward trend in the FBM KLCI was particularly evident between end-April and May 2016. The decline during this period was in line with most regional equity markets as global market sentiments continued to be weighed down by uncertainties surrounding US monetary policy and volatility in global crude oil prices. The decline also reflected liquidation by non-resident investors due to the lowering of Malaysia's weightage in the MSCI Emerging Markets Index, a global benchmark for emerging market equities. Domestic developments that led to weaker investor sentiments also added to the downward pressure on the index. In June, the FBM KLCI recovered slightly as market expected a delay in US policy rate increases, while global oil prices improved.

Overall, market capitalisation declined to RM1.66 trillion as at end-June 2016 (end-March 2016: RM1.71 trillion) while the daily average turnover moderated to 1.77 billion units (1Q 2016: 1.88 billion units) during the quarter.

On 10 August 2016, the KLCI ended higher at 1673.0 points (since end-June 2016: 1.1%), with a market capitalisation of RM1.69 trillion (since end-June 2016: 2.0%).

Performance of Selected Global and Regional Equity Markets in 2016 (% growth QoQ)



Source: Bloomberg and Bank Negara Malaysia calculations

Bursa Malaysia: Selected Market Indicators

	2015	2016	
	As at end		
	June	Mar	June
Price Indices			
Composite	1,706.6	1,717.6	1,654.1
FBMEMAS[1]	11,771.9	11,920.8	11,530.2
ACE Market[2]	6,220.3	5,637.0	5,145.1
Market capitalisation (RM billion)	1,659.0	1,707.4	1,660.3
No. of companies listed	905	904	905
	During the period		
	2Q	1Q	2Q
Average daily turnover			
Volume (million units)	1,918.0	1,875.8	1,770.6
Value (RM million)	2,002.1	2,052.2	1,996.4

[1] FBMEMAS stands for FTSE Bursa Malaysia EMAS Index
[2] From 3 August 2009, MESDAQ market was replaced with ACE Market

Source: Bursa Malaysia

Bursa Malaysia: Market Turnover

	2015				2016					
	2Q		1H		1Q		2Q		1H	
	Billion units	RM billion	Billion units	RM billion	Billion units	RM billion	Billion units	RM billion	Billion units	RM billion
Turnover	120.8	126.1	245.2	254.6	112.5	124.1	111.5	125.8	224.1	249.9
Of which:										
Main Board	72.7	114.1	148.5	231.8	76.3	117.0	75.3	118.9	151.5	235.9
Of which										
Consumer Products	6.2	6.2	13.7	12.6	8.8	7.3	8.1	6.9	16.9	14.2
Industrial Products	14.3	12.4	27.0	23.4	14.6	19.3	14.2	15.7	28.8	35.0
Construction	4.6	7.0	8.3	12.9	4.1	5.3	3.9	5.2	8.0	10.6
Trading/Services	31.2	52.1	63.9	107.6	30.7	48.0	30.9	51.5	61.6	99.5
Finance	3.0	18.3	6.4	39.6	3.1	20.1	3.6	23.6	6.7	43.7
Properties	5.3	4.9	10.7	9.7	6.4	3.4	5.6	3.3	11.9	6.7
Plantations	1.0	3.4	2.0	6.9	1.6	5.9	1.5	5.6	3.1	11.5
Infrastructure	1.1	5.3	2.1	9.7	0.8	3.2	0.7	2.8	1.5	6.0
ACE Market[1]	40.3	9.9	81.5	18.7	20.5	4.1	23.2	4.5	43.8	8.6

[1]From 3 August 2009, MESDAQ market was replaced with ACE Market

Source: Bursa Malaysia

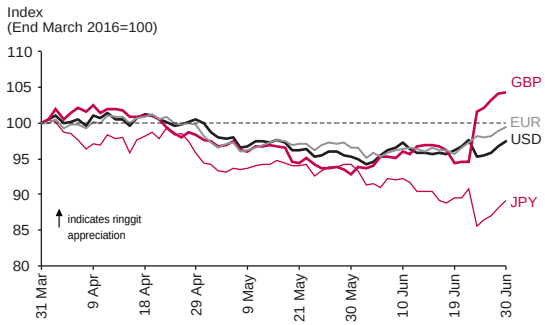
Ringgit weakness driven primarily by external factors

The ringgit and most regional currencies depreciated against the US dollar during the quarter due to uncertainties surrounding US monetary policy. The ringgit, however, faced stronger depreciation pressure due to continued volatility in global crude oil prices and the lower weightage of certain Malaysian stocks during the rebalancing of the MSCI Emerging Markets Index. The depreciation was, however, partially offset in June as expectations of a delay in a US interest rate increase resurfaced amid the release of weaker-than-expected US labour market data.

Overall, the ringgit depreciated by 2.5% against the US dollar during the quarter. The ringgit also depreciated against the euro (-0.6%) and the Japanese yen (-10.9%), but appreciated against the pound sterling (4.3%) and the Australian dollar (0.4%). The ringgit also depreciated against most regional currencies, by between 0.4% and 3.2%.

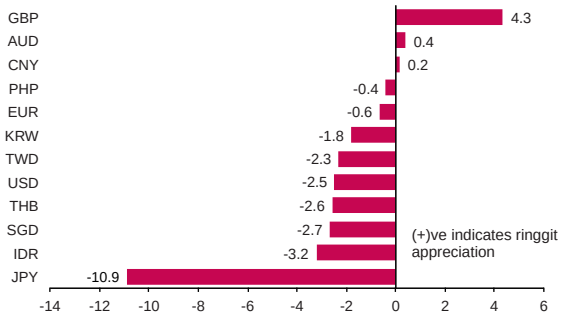
Between 1 July and 10 August 2016, the ringgit appreciated against the US dollar (0.7%). The ringgit also appreciated against the pound sterling (3.2%), and the euro (0.2%), but depreciated against the Japanese yen (-0.7%) and the Australian dollar (-2.7%). The ringgit exhibited a mixed performance against regional currencies.

Ringgit Performance against Major Currencies



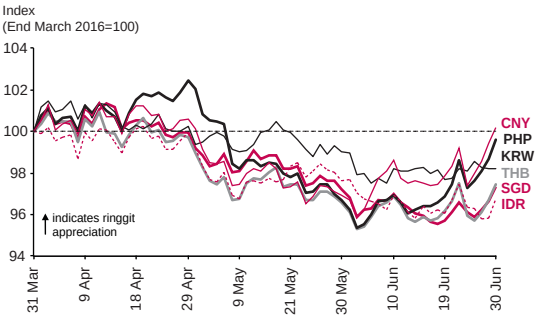
Source: Bank Negara Malaysia

Summary of Ringgit Performance against Selected Currencies Percent Change (1 April - 30 June 2016)



Source: Bank Negara Malaysia

Ringgit Performance against Regional Currencies



Source: Bank Negara Malaysia

Performance of Ringgit against Selected Currencies

RM per foreign currency	As at end			% change since*	
	2Q 2015	1Q 2016	2Q 2016	2Q 2015	1Q 2016
US dollar	3.7855	3.9220	4.0225	-5.9	-2.5
Euro	4.2364	4.4377	4.4664	-5.2	-0.6
Pound sterling	5.9527	5.6234	5.3910	10.4	4.3
Australian dollar	2.9059	3.0009	2.9899	-2.8	0.4
100 Japanese yen	3.0946	3.4892	3.9145	-20.9	-10.9
Singapore dollar	2.8096	2.9023	2.9816	-5.8	-2.7
100 Thai baht	11.205	11.134	11.428	-2.0	-2.6
100 Philippine peso	8.3899	8.5233	8.5599	-2.0	-0.4
100 Indonesian rupiah	0.0284	0.0295	0.0305	-6.9	-3.2
100 Korean won	0.3384	0.3427	0.3489	-3.0	-1.8
100 New Taiwan dollar	12.257	12.180	12.472	-1.7	-2.3
Chinese renminbi	0.6099	0.6064	0.6054	0.7	0.2

* (+) indicates appreciation of ringgit against respective currency and (-) indicates depreciation.

Source: Bank Negara Malaysia

Greater volatility in the financial markets saw greater demand for foreign exchange derivatives

Foreign exchange derivatives volume grew by 20.2% on a quarter-on-quarter basis in the second quarter of 2016 (1Q 2016: -8.9%). The rise was mainly attributed to the higher volume of cross currency swaps and foreign exchange swaps, by 42.7% and 9.6% from the previous quarter, respectively. Hedging demand increased during the period as the market saw greater global volatility emerging from the UK's EU referendum, the uncertainties on the timing of the Federal Reserve's interest rates hike, and global growth concerns amid weak economic data across major economies.

During the quarter, the 5-year USD/RM cross-currency swap widened to 88 bps from the previous quarter closing of 73 bps. The highest spread was recorded in June, in the immediate aftermath of the UK's EU referendum following heightened risk aversion. Residents recorded higher selling as exporters took advantage to hedge their foreign currency exposure.

MANAGING RISKS TO FINANCIAL STABILITY

Domestic financial system remains resilient

Financial stability was sustained despite global uncertainties associated with developments in PR China and the outcome of the UK's EU referendum. Domestically, the direct impact from the UK's EU referendum on financial institutions has been minimal given the limited exposure to the UK. Volatility in the domestic financial markets rose on 24 June 2016, but resumed its easing trend to end the quarter at levels below that recorded in the first quarter. Overall liquidity conditions remained supportive of financing needs of businesses and households. While businesses and households continue to adjust to the more challenging business conditions and higher cost of living, this is expected to have modest impact on financial institutions' earnings and asset quality. Supported by strong capital and liquidity buffers, financial institutions have the capacity to weather adverse economic and market developments without disruptions to domestic financial intermediation.

Sustained debt servicing capacity of households and businesses

The debt servicing capacity of borrowers remained intact. Loan delinquencies (measured by loans-in-arrears of between one and three months) were unchanged at 2.0% of total bank loans. Loan impairments rose marginally in value terms but remained low at 1.3% of net loans (1Q 2016: 1.2%). Banks' provisions against loan losses stood at 90%. Including regulatory reserves for loans and financing, banks' buffers for potential credit losses remained at satisfactory levels. In the insurance and takaful industry, credit exposures were broadly stable at 4.2% of total capital available (1Q 2016: 4.3%). These are mainly in the form of holdings of the Malaysian Government Securities and highly-rated corporate bonds.

Household debt sustained its slower growth momentum, increasing by 6.2% at the end of the quarter (1Q 2016: +6.5%; 2Q 2015: +8.3%). House financing continued to be the main driver of the increase in household debt. Underpinned by sustained demand for affordable housing, house financing grew by 10.2% (1Q 2016: +10.7%; 2Q 2015: +12%). Overall employment and income conditions are expected to remain favourable amid on-going process and man-power reviews by businesses given the current environment. Along with strengthened affordability assessments by lenders, these further support the debt servicing capacity of households.

Most household borrowers have some flexibility to respond to income shocks and rising living expenses. Highly leveraged borrowers in the lower income group are, however, beginning to show weaker repayment capacity. Bank exposures to these borrowers have declined over the years to now account for 19.5% of total bank lending to households (2013: 25.1%). Improvements in non-bank lending standards have further reduced the overall proportion of vulnerable household borrowers to 22.6% (2013: 28.4%) of total household debt from banks and non-banks.

Household delinquencies remained unchanged at 1.4%, while impairment improved to 1.6% of total household debt (1Q 2016:1.7%), respectively. This suggests that households are actively managing their finances, thus limiting potential wide-scale losses to banks. The Bank's stress tests continue to show that excess capital buffers of banks, currently at RM120.8 billion, are more than sufficient to absorb extreme losses under adverse scenarios.

Banks' credit risks from exposures to the business sector are manageable. In recent years, a number of Malaysian corporates have ventured overseas for business opportunities and to diversify revenue base. For those with significant operations in the UK, the direct impact from the result of the UK's EU referendum has been limited. These corporations are mainly involved in property development, where projects have already been locked in with strong take up rates. This contains any potential spillovers to the domestic financial system.

The expected default frequency for businesses improved slightly to 0.61% (1Q 2016: 0.69%), largely reflecting expectation of better domestic

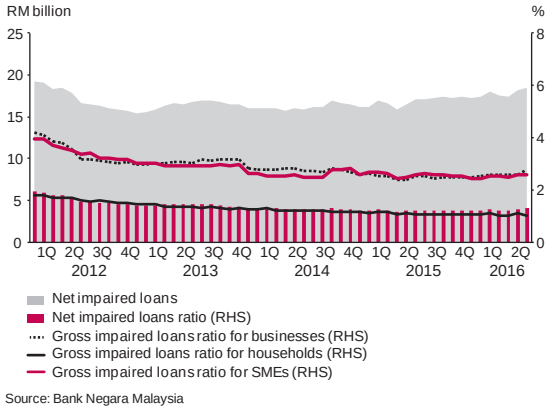
demand and low input cost. Aggregate leverage of Malaysian businesses[3], as measured by the median debt-to-equity ratio, improved further to 41.9% in 1Q 2016 (4Q 2015: 44.5%).

Credit conditions remained conducive for businesses, including SMEs. There is limited evidence of broad-based tightening in the supply of credit observed thus far. As at the end of the quarter, total debt of businesses expanded by 6.7% (1Q 2016: 7.5%). This was largely led by higher fund raising from the capital market. Outstanding bank financing to businesses grew at a slower pace (2Q 2016: 4.2%; 1Q 2016: 5.2%). The growth was driven mainly by financing to small and medium enterprises (SMEs) (9.9%). External borrowings by businesses declined (1Q 2016: RM273.3 billion; 4Q 2015: RM289.9 billion), largely on account of smaller effects from currency translations. Growth in new external borrowings was almost flat. Rollover and funding risks from external borrowings continued to be limited, with more than 40% of external borrowings in the form of inter-company obligations by multinational corporations with operations in Malaysia. In addition, more than 70% of the external borrowings have maturity beyond one year.

Businesses' financials remained healthy. The median interest coverage ratio (ICR) stood at 4.2 times in the first quarter of 2016 (4Q 2015: 4.4 times). Aggregate liquidity to meet short-term debt obligations also remained intact. The median current assets-to-current liabilities ratio (current ratio) and cash-to-short-term debt ratio (CASTD) were largely unchanged at 1.7 times and 1.1 times, respectively (4Q 2015: 1.7 times and 1.2 times, respectively). Across the industries and sectors, the performance was however mixed. Businesses in the export-oriented sectors continued to exhibit sustained financial health backed by stronger financial buffers and modest leverage levels. This was despite weak commodity prices and subdued global demand. Banks' exposures to the crude palm oil and oil and gas sectors, which remained challenged by low commodity prices, accounted for 3.9% and 2.1% of total credit exposures to businesses, respectively. Businesses in the domestic-oriented sectors, however, were more affected by continued weakness in consumer demand and stiff competition in the retail sector. This resulted in higher delinquencies and impairment, mainly in domestic-oriented sectors, namely real estate, oil and gas, construction and wholesale and retail trade sectors. However, banks' overall business portfolio remained of high quality. The ratios of impaired and delinquent loans were unchanged at 2.8% and 0.4% of bank lending to businesses, respectively at end-2Q 2016. Banks' exposures to large business borrowers with weak financials (ICR below two times and CASTD below one time) remained limited at 6.5% of total banking system credit exposures to corporations.

The housing market remained soft amid more cautious consumer sentiment. Total housing transactions, in terms of volume and value, declined by 16.6% to 49,612 units (4Q 2015: -3.1% to 58,859 units) and 9.5% to RM16.2 billion (4Q 2015: -4.1% to RM19.3 billion), respectively, during the first quarter of 2016. This trend was observed across all house price segments, particularly in major states such as Selangor, Johor and Penang. Moving forward, the demand for affordable housing will continue to lend support to housing market, while encouraging continued shift in supply towards low-to-medium priced segments. Consistent with these trends, speculative activity in the housing market has remained subdued. The number of borrowers with at least three outstanding housing loans expanded at a slower annual rate of 1.9% in 2Q 2016 (1Q 2016: 2.4%). The number of housing loans being settled in under three years (as a proxy for borrowers who engage in speculative buying and selling) remained stable at 10.8% of total housing loans settled during the quarter (1Q 2016: 12.0%).

Banking System: Loan Quality



Source: Bank Negara Malaysia

[3] Based on 160 companies listed on Bursa Malaysia with market capitalisation of 80% (excluding financial institutions) covering 10 key economic sectors.

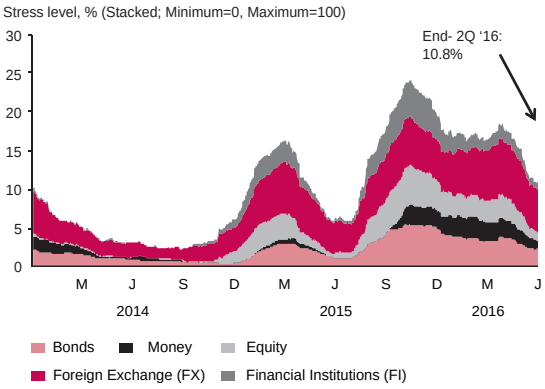
Domestic financial market conditions remained orderly

Conditions in the domestic financial markets remained orderly throughout the quarter. The effects of the UK's EU referendum on domestic financial markets were limited and short-lived. The government bonds, corporate bonds and money markets remained stable. Volatility in the ringgit foreign exchange market was higher than usual around the time leading to the outcome of the EU referendum and just following the release of the outcome. However, market volatility eased at the end of the day as liquidity remained supported by financial market participants. For the quarter as a whole, average volatility for the 10-year MGS yield and FBM KLCI trended lower (2Q 2016: 9.5% and 9.9%, respectively; 1Q 2016: 13.5% and 11.3%, respectively). This continues the trend that was observed since October 2015. Portfolio investments recorded a marginal net inflow of RM77 million (1Q 2016: net inflows of RM13.1 billion) as higher non-resident inflows into the government bond markets was offset by non-resident outflows from the equity market and investments abroad by the domestic institutional investors.

Non-residents continue to show interest in the Malaysian financial markets. At the end of the second quarter, non-residents held about half of total outstanding MGS (49.8%; 1Q 2016: 48.7%). A total of 59.1% of the holdings comprised MGS with maturities of up to 5 years. Correspondingly, yields on the 3, 5 and 10-year MGS eased to 3.15%, 3.37% and 3.74%, respectively (1Q 2016: 3.21%, 3.43% and 3.80%, respectively). The FBM KLCI ended the quarter lower at 1,654.1 points (1Q 2016: 1,717.6 points). This was largely driven by weaker performance of some corporates and continued uncertainty in US monetary policy. The price-to-earnings (PE) ratio of FBM KLCI eased to 18.2 times during the second quarter (1Q 2016: 19.2 times) but remained above the 10-year average PE ratio of 16.2 times. Equity holdings by non-residents accounted for 22.8% of total market capitalisation (1Q 2016: 23.0%).

Trading volume was higher. The bid-ask spreads were unchanged, at 0.1% of the mid-price for MGS and 0.4% of mid-price for FBM KLCI. The monthly turnover ratio averaged at 14.9% for MGS and 2.1% for FBM KLCI (1Q 2016: 11.9% and 2.0%, respectively). In the currency market, ringgit depreciated by 2.5% against the US dollar to end the quarter at RM4.0225 per US dollar (1Q 2016: RM3.9220). The 5-year sovereign credit default swap spread rose marginally to 156.1 basis points (1Q 2016: 153.9 basis points, 3Q 2015: 238.9 basis points), while the 5-year cross-currency basis swap spread increased to 83 basis points (1Q 2016: 73 basis points). This was, however, still lower than the level observed in 3Q 2015 (115 basis points) when ringgit was at its weakest level against the USD in recent years.

Financial Market: Financial Market Stress Index (FMSI)



Note: The FMSI is a risk monitoring tool for the financial market that is developed based on the European Central Bank's (ECB's) Composite Indicators of Stress Index (CISS). It is constructed from indicators of volatility in five components of the domestic financial markets - the foreign exchange (FX), equity, bond, money markets and financial institutions (FIs). The stress level at a specific date is expressed as a value between 0 and 100, which signifies the lowest to highest stress level.

Source: Bloomberg and internal computation

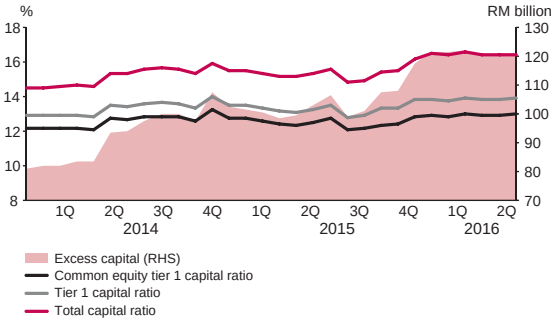
Sustained strength and resilience of financial institutions

Financial institutions maintained strong levels of capitalisation. The common equity tier-1 capital ratio of the banking system stood at 12.9%, whilst tier-1 capital and total capital ratios were at 13.9% and 16.4%, respectively. More than 90% of banking system capital comprises retained earnings, paid-up capital and reserves which have strong loss-absorbing qualities. Similarly, the capital adequacy ratio for the insurance and takaful sectors remained high at 228.1% (1Q 2016: 242.6%). At the end of the quarter, the combined capital buffers of financial institutions amounted to RM153.8 billion.

Earnings were resilient amid more moderate financing performance. The banking system interest/financing margin net of operating costs and loss provisions remained stable at 0.56 percentage points (ppts) (1Q 2016: 0.55 ppts) while returns on assets and equity edged higher to 1.4% and 13.2% respectively (1Q 2016: 1.3% and 12.4%, respectively). Pre-tax profit for the banking system increased to RM9 billion (1Q 2016: RM7.7 billion) on account of sustained net interest income from financing activities and higher dividend income from subsidiaries. Income from treasury and fee-based activities edged lower during the quarter.

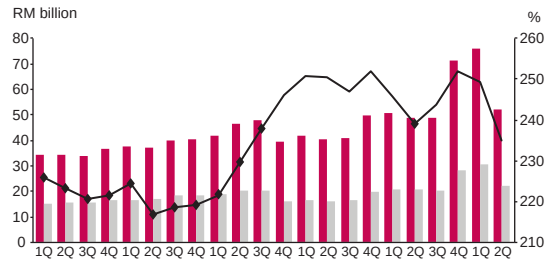
In the insurance and takaful sector, general insurers and takaful operators recorded slightly lower operating profit of RM809.6 million (1Q 2016: RM821.0 million), on account of higher claims ratio, particularly in fire and motor businesses. On the other hand, the weaker equity market continued to weigh on the performance of life insurers and family takaful operators. This resulted in a lower excess income over outgo of RM2.7 billion (1Q 2016: RM4.7 billion).

Banking System: Basel III Capitalisation



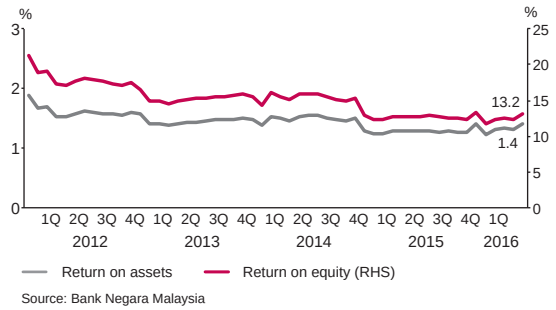
Source: Bank Negara Malaysia

Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

Banking System: Profitability



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2015		2016		
	2Q	1H	1Q	2Q	1H
	RM million				
Life insurance & family takaful					
Excess of income over outgo	1,844	7,180	4,703	2,668	7,371
General insurance & general takaful					
Operating profit	682	1,463	821	810	1,631
Claims ratio (%)	64.9	57.4	54.0	56.5	55.3
	Annual Change (%)				
Life insurance & family takaful					
Excess of income over outgo	-59.8	-8.0	-11.9	44.7	2.7
General insurance & general takaful					
Operating profit	-15.2	-10.1	5.1	18.8	11.5
Claims ratio (percentage points)	6.0	0.4	3.7	-8.3	-2.2

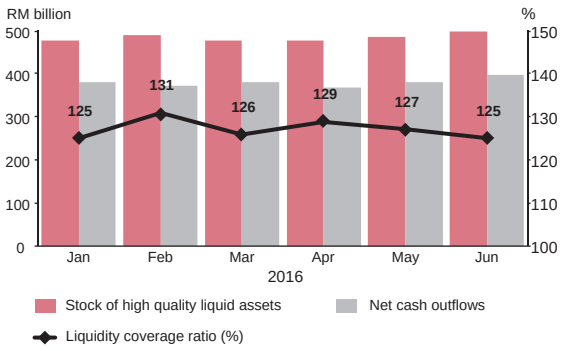
Source: Bank Negara Malaysia

Market risk exposures of financial institutions were at manageable levels, supported by active risk management and hedging strategies. Bank exposures to interest rate risk in the trading book and equity risk accounted for 1.2% and 0.9% of total capital, respectively (1Q 2016: 1.1% and 0.8%, respectively). The foreign exchange (FX) net open position of banks stood at 7.2% of total capital (1Q 2016: 6.5%), with banks continuing to actively manage FX exposures amid ringgit volatility. For the insurance and takaful industry, market risk exposures edged higher to 13.7% (1Q 2016: 13.1%) of total capital available, driven largely by increase in interest rate risk. Equity risk, which forms the bulk of insurers' market risk exposures, remained broadly stable at 7.4% (1Q 2016: 7.3%) of total capital available.

Liquidity in the banking system remained ample to support intermediation activities. Total banking system placements, reverse repos with Bank Negara Malaysia and statutory reserve requirements amounted to RM178.5 billion. This represents the amount that can be unwound to meet banks' liquidity needs. The banking system Basel III Liquidity Coverage Ratio (LCR)[4] stood at 125% (1Q 2016: 126%), well above the current minimum regulatory requirement of 70%. A total of 44 banks recorded LCR levels above 100%.

Domestic funding conditions continued to improve during the quarter. Competition for corporate deposits eased following the reduction in the statutory reserves requirement in February. The quoted 1-month and 3-month fixed deposit rates for large corporate depositors fell between 5 and 40 basis points during the quarter. Overall, the average cost of deposits was unchanged at 2.55% while the 3-month KLIBOR eased to 3.65% (1Q 2016: 3.71%). On aggregate, banking system deposits were marginally lower (2Q 2016: -0.5%; 1Q 2016: -0.9%). This partly reflected a decline in corporate and non-bank financial institutions' deposits (2Q 2016: -0.8% and -1.7%, respectively; 1Q 2016: -4.2% and 1.8%, respectively) due to continued investments in other asset classes. Including Islamic investment accounts[5], total bank funding recorded a growth of 3.4% during the quarter (1Q 2016: +2.3%).

Banking System: Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

[4] The Basel III LCR has been phased in since June 2015, with initial compliance set at 60% and progressive increments of 10% each year until 100% with effect from 2019. The current minimum requirement is set at 70%.

[5] Under the Islamic Financial Services Act 2013, Islamic banking institutions are required to reclassify Islamic deposits under the repealed Islamic Banking Act 1983 into Islamic deposits and investment accounts. A two-year transition period was accorded to banking institutions to ensure a seamless and effective process of reclassification. This transition period ended on 30 June 2015.

While banks' funding structure remains predominantly deposit-based (69.8% of total funding) and in local currency (92.1% of total deposits), banks have been diversifying their funding structure in recent periods. This is, in part, a reflection of financial deepening and banks' efforts to narrow maturity mismatches in the funding structure. The amount of outstanding medium- and long-term ringgit and foreign currency denominated instruments issued by banks expanded by 5% (1Q 2016: +12%) annually to RM100 billion. At present, such medium term instruments account for 4.2% of total banking system funding. Taking into account the broader funding base, the loan-to-funds ratio remained stable at 82.6% (1Q 2016: 82.6%).

Net external liabilities of banks were smaller at RM128 billion at end-1Q 2016 (4Q 2015: RM139 billion), driven mainly by moderating interbank borrowings. Malaysian banks have small exposures to counterparties in the UK, at approximately 1% of total banking system assets and liabilities respectively. This limits the domestic contagion risk from developments in the UK. Exposures via the currency channel were also contained as external claims denominated in pound sterling accounted for only 7% of total banking system capital.

Governor's Keynote Address at the Global Islamic Finance Forum 5.0 "Future of Islamic Finance: Delivering Actions Today for a Sustainable Tomorrow" Kuala Lumpur, 11 May 2016

Keynote Address by

Datuk Muhammad bin Ibrahim
Governor, Bank Negara Malaysia

It is my pleasure to be here today to speak at the Global Islamic Finance Forum 2016. The forum which was conceived in 2007 has now become a hallmark event for the Islamic finance industry - where the best minds and leaders of the industry come together to address the issues, opportunities and imperatives that are shaping the current and future path of Islamic finance. The fact that this event has attracted more than a thousand participants from all over the world is a testament to the growing global significance of Islamic finance.

Today, Islamic finance is one of the fastest growing segments of the financial industry in many parts of the world. It registered double-digit growth rates in the past decade despite challenging circumstances globally. Its reach and influence has expanded beyond the traditional Islamic markets, with increasingly strong footholds in banking, takaful and the capital market. Global sukuk issuances, for instance, increased by 13% in the first quarter this year despite less favourable market conditions. This positive growth continues to be supported by the progressive development of market infrastructures, strengthened regulatory and supervisory frameworks and active industry participants. In at least 10 jurisdictions, Islamic banking now represents more than 20% of total banking assets - a feat that has been achieved in under a decade.

And in many more countries, Islamic financial services are now available alongside conventional financial services. These developments underscore a clear and sustained trend in which Shariah-compliant financial products and services have continued to gain traction among businesses and individuals from all walks of life.

In fact, the value propositions of Islamic finance has extended beyond faith and origins that appeal to the global community. It is the intrinsic qualities of Islamic finance that are multifaceted that have pulled interest from diverse backgrounds. At the core of Islamic finance lies virtues that encompass both moral and commercial aspect in deriving potential solutions for economic and financial stability. The values and principles that Islamic finance carry have opened new pathways towards achieving economic prosperity while safeguarding the interest of the public. What used to be a novel idea has become mainstream. Indeed, Islamic finance is for all.

In Malaysia, efforts led by the Central Bank to develop Islamic finance spans over three decades. The invaluable contributions by earlier Governors of the Central Bank laid the foundations for the development of an international Islamic financial centre in Malaysia, serving both global and domestic demand. Their visionary leadership in this journey not only ensured that our fundamentals were strong, they had significantly raised the global profile of Islamic finance with Malaysia setting an example that would encourage development in other countries. In the early 1980s, Governor Abdul Aziz Taha has laid down the foundations for the establishment of the first Islamic bank and the issuance of the first government sukuk. The dual financial system that we see in Malaysia today is the realisation of the vision framed by Governor Jaffar Hussein way back in 1990. From there on, we continued to advance on many fronts, including the establishment of the Shariah Advisory Council under the leadership of Governor Ahmad Don. Significant milestones were achieved with Governor Zeti at the helm of the Central Bank. During this

period, Islamic finance morphed from a niche segment into the financial mainstream, and from a largely domestic-centric focus to one of global relevance. In particular, her immense contributions have enabled us to achieve much more to expand the frontiers of Islamic finance as a global community.

I wanted to take the opportunity today to acknowledge their tremendous contributions. Moving forward, the Bank will continue to build upon these foundations in making advancement that will further strengthen Islamic finance's growth trajectory.

In the same way that past efforts have delivered solid growth in the industry and significantly enhanced Islamic finance potential for future growth, our present actions will largely determine the future prospects of Islamic finance. As was the case in the past, we will continue to require innovative solutions and collaborative strategies to take Islamic finance to the next level of development. Positive transformations taking place around us will continue to pave the way for new growth opportunities for the industry. Collectively, we need to understand these developments and leverage on them to advance economic and social goals, and manage the attendant risks.

Today, I would like to touch on three key issues, the rise of fintech and its impact on Islamic finance, the growing importance of responsible, inclusive and sustainable finance and the preconditions necessary to sustain a value-based financial system.

One of the most significant transformational developments of our era is the technological revolution. More specifically, the fintech revolution was made possible by maturing social, mobile and cloud technologies. The digital revolution and widespread penetration of technology-driven applications in nearly every segment of the financial sector is already upon us. Fintech innovations are fundamentally altering the way we experience and deliver financial products and services. According to a recent McKinsey report, the number of fintech start-ups globally has now exceeded 2,000, more than twice the number less than a year ago. Such growth is expected to continue as innovators tap into the preferences of millions of technology savvy millennials who are more receptive to new ways of consuming financial services.

Fintech is challenging the status quo of the financial industry. New business models will emerge. Delivery channels will challenge existing norms. Transaction costs will be reduced. Rather than looking at the fintech revolution as unwelcoming, financial institutions ought to embrace it as an opportunity.

In the area of payment services for example, e-payment has revolutionised payment mechanisms through convenient and accessible channels. In Islamic finance, a recent initiative in Malaysia has been the Investment Account Platform (IAP) that was launched in February this year. It is an important example of a collaborative strategy by the industry to bring game-changing innovations to the market. The IAP is the first Islamic banking-intermediated internet-based platform that combines the expertise of Islamic banks and efficiency of technology to channel funds from investors to viable economic ventures. It promotes risk-sharing financial transactions by providing the platform for Musharakah and Mudharabah-based equity financing. The platform has strong prospects to support cross-border investments and increase global connectivity through the participation of banks worldwide.

The potential impact of such technological disruptions is significant. An estimated 10% to 40% of overall banking revenues could be at risk by 2025 due to fintech innovations outside banking institutions that are able to achieve a significant pricing advantage. In Islamic finance, like the Investment Account Platform in Malaysia, fintech has immense potential to be the next game changer. It offers opportunities for industry players to radically transform operational models by adopting digitisation strategies that will be able to deliver much greater scale or alternatively, a high degree of specialisation. It also opens up new possibilities for improving efficiencies, reducing wastage and enhancing the customer experience. All of this adds up to stronger market positioning and financial performance.

To further explore and leverage or these opportunities, plans are currently underway to organise an inaugural Islamic Finance Symposium on Innovation that will provide a platform for the academia and industry to come together to develop and test breakthrough ideas and innovative solutions in Islamic finance.

On its part, Bank Negara Malaysia has been actively engaging with fintech firms to better understand their activities and provide guidance on the regulations that may apply to them. The adoption of fintech is clearly not without risks, particularly in the wake of rising cybersecurity threats that could compromise safeguards that protect financial assets and customer data. The Bank has commenced a review of the changes and additional guidance needed to ensure that the regulatory framework remains appropriate to manage the risks, while encouraging productive innovation that will drive costs down and improve the quality of service to consumers.

We are looking at this from several perspectives: first, the impact of fintech strategies on the management of risks by financial institutions; second, the potential for fintech start-ups to introduce new risks to the broader financial system as a result of regulatory arbitrage; and third, the impact to consumers. We will be providing more information to the market on our approach to the regulation of fintech developments as our review progresses. In the meantime, our engagements with individual firms will continue, supported by dedicated resources within the Bank to lead the review.

Another important development in this recent decade has been the growing emphasis on responsible, inclusive and sustainable finance. The global financial crisis provided a dramatic reminder of the basic purpose of financial intermediation - as a means to create sustainable value in the real economy. Without this anchor, finance will always be inherently unstable. The central role of finance in any economy also places a critical responsibility on financial actors to promote and embrace responsible behavior, consistent with the long term preservation and development of the economy, society and environment.

In a number of developed markets, Sustainable, Responsible and Impact Investing (SRI) and Environment, Social and Governance (ESG) considerations are gaining significant momentum.

Similar trends are also starting to gain traction in emerging markets. Islamic finance is uniquely positioned to champion this cause, guided by the overarching Shariah principle which emphasises the protection and preservation of the benefits and interests of society at large. More than 750 verses in the Quran relate to the importance of achieving balance and moderation in one's life, whilst being responsible and accountable in the use of natural resources. The Islamic finance agenda must therefore embrace this cause as its core mission - a mission that has become more urgent in light of growing economic and social inequalities and environmental concerns.

The first Socially Responsible Investment Sukuk that was issued last year is an example of impact investing that generates positive social outcomes. It pioneered an innovative sukuk structure where the returns are dependent on the performance of the selected schools which are supported by proceeds from the sukuk investments. The issuance of more SRI sukuk in the future would further reinforce the value proposition of Islamic finance that combines financial returns and social welfare enhancement. Another key innovation with far reaching potential is the creation of a new financial asset class that is backed by carbon credit-based solutions structured using Islamic finance principles. This idea has enormous potential to incentivise concrete actions by businesses to reduce carbon emissions. The industry should endeavour to capitalise on the commitment of the government, as announced by the Prime Minister of Malaysia on 12 April 2016, to consider providing incentives to buyers of Malaysian rainforest carbon credits to spur the development of this new asset class.

Over the longer term, the first precondition to sustain a value-based financial ecosystem is to direct serious efforts at aligning performance measures to take into account both economic and social outcomes.

In Malaysia, Islamic financial activities are governed by a comprehensive contract based regulatory framework designed to achieve end-to-end Shariah compliance. Consistent with this framework, Islamic financial institutions are expected to evaluate and manage the impact of their activities, beyond that which is solely concerned with financial gains.

To further entrench this shift, a proposal is being developed for Islamic financial institutions to disclose their Corporate Value-Intent (CVI) as a measure of their performance and commitment towards value creation. This proposal is an important step to encourage a strong corporate and market focus on how Islamic financial institutions are generating value, not just for shareholders, but for the communities which they are a part of. On-going collaboration and active engagement with the industry are currently being undertaken under this initiative to ensure proactive behaviours and sustained momentum towards the creation of a sustainable development.

Another precondition for long term sustainable value creations is the availability of top-notch talent to drive and execute innovative business strategies that will realise the full potential of Islamic finance. Based on market assessments, a greater pool of quality professionals are required to sustain the growth of global Islamic finance that is estimated to surpass $3 trillion total assets size by 2020. The challenge in meeting this demand however goes beyond the numbers. The next phase of growth and development of Islamic finance calls for a deep talent pool that not only has a strong foundation in the application of Islamic finance principles, but also the much broader set of competencies required to use those applications effectively to provide and implement solutions to real world problems. And such talent must be developed not only within Islamic financial institutions, but also the professional ancillary service providers that are part of the Islamic finance ecosystem.

In Malaysia, there are close to 40 professional ancillary services entities under the MIFC Community which play an important role in the development of Islamic finance. These entities provide a range of key services that include Shariah advisory, accounting, tax, rating, research, accreditation and legal services, many of them serving global demand and setting benchmarks for international best practices. To increase the impact and influence of Islamic finance, whether in a domestic or global context, all its key components must move forward together to provide complete and comprehensive solutions. This is also critically important to reduce risks inherent in any innovative venture where progress on one front without the other is more likely to invite problems.

Conclusion

There has never been a better time where a confluence of developments have called for us to propagate the value of Islamic finance in addressing the challenges confronting us today; issues relating to inequality, financial excesses and environmental damage and degradation. To elevate the Islamic finance industry to the next level, the formulation of game-changing strategies must bring in elements that leverage on technology, accelerate innovation and develop well-rounded talent to meet future needs of Islamic finance. These strategies offer an important opportunity to reinforce the foundations of a strong and resilient Islamic financial system, and advance its development and contribute towards a more inclusive and stable global financial system. It is incumbent upon us all to make the most of it to support sustainable economic growth and help to improve the lives of many. And it is on us to continuously reinvent and re-anchor our industry so that we can forge stronger links with our stakeholders. Our future will be secured if we remain relevant.

ASLI 20th Malaysian Banking Summit "Future Banking: Reimagining Banks - Driving Transformation and Innovation" Kuala Lumpur, 26 May 2016

Keynote Address by

Datuk Muhammad bin Ibrahim
Governor, Bank Negara Malaysia

It is my pleasure to be here at ASLI's 20th Malaysian Banking Summit. The theme "Future Banking: Reimagining Banks - Driving Transformation and Innovation" is especially relevant in light of the significant changes taking place in the banking industry and wider economy.

The new world ahead

The financial crisis may have struck almost a decade ago, but has left in its wake a profoundly transformed landscape. With global economic growth remaining slow and uneven, it is increasingly clear that this is no mere downturn in the business cycle, but a realignment of the world economic order. Structural reforms continue to take place in many advanced and emerging economies albeit at varying pace across countries. Such reforms are critical as this will contribute towards enhancing future growth prospects. In an environment of weak growth, authorities face considerable challenges in managing the immediate effects of some of the reforms. The limits of monetary policy under unorthodox and unprecedented policies continue to be tested in a number of economies, with outcomes that still remain debatable.

Broader forces of change are also underway. Of significance is the accelerated pace of technological change, driven by increased processing power and connectivity. Across various sectors, disruptive technologies are rapidly expanding the horizon of economic opportunities while challenging existing business models. In the case of banking for instance, we have already seen greater competition from new entrants amid the emergence of fintech. Rapid urbanisation, which is more pronounced in emerging markets, and demographic changes such as an ageing population are other key trends which have major implications on economic and socio-political conditions. At the same time, there is a growing appreciation for the far-reaching impact of climate change, giving rise to calls for more sustainable growth models and innovation.

All these developments that are taking place in the banking industry today have created an environment much different from the one prior to the crisis. And together with the implementation of the post-crisis global regulatory reforms, which remains a key priority, their implications require careful and deep thinking as banks plan for the future.

Domestic policy continuity and priorities

Our banking industry is facing the current rapidly changing and challenging economic environment from a position of strength, following the successful reform measures that were implemented. Given the high degree of openness of the Malaysian economy and the increased integration with the international financial system, external developments have continuously affected our domestic economy. But the economy has been able to weather these challenges and have remained on a steady growth path of 4 to 6% over the past five years.

In recent quarters, economic growth, however, has moderated. This was attributable to a number of external and domestic shocks affecting the economy since late 2014. The major policy reforms such as the implementation of the GST also saw households and businesses adjusting their

spending. As we move forward, these shocks will gradually dissipate and growth of the Malaysian economy will improve. Further support is also forthcoming in the form of Government measures to increase disposable income; thus, facilitating households and firms' on-going adjustments. The assessment is therefore for the economy to grow by 4 to 4.5% for 2016. Importantly, our financial system remains resilient and supportive of the economy. It is important to recognise the underlying reasons for the resilience of the Malaysia economy. This resiliency has been as a result of the continued strength of our fundamentals and the successful reforms and structural adjustments we have undertaken over the last decade.

Three changes to the economy have been particularly instrumental. Firstly, the structure of the economy has become more diversified and over-reliance on any particular industry has been mitigated. Secondly, growth has also become more balanced, driven by continued private sector activities with imbalances and excesses kept in check through keys measures implemented by the Government and Bank over several years. This has been complemented by crucial fiscal reforms that, while having short-term costs and being very unpopular, ultimately put the economy on a more sustainable growth path. Third, is the continued strength of our external position. This can be seen from our high level of international reserves, the manageable level of external indebtedness and the continued surplus in the current account balance.

Together with the greater flexibility of our exchange rate, this has strengthened the capacity of our economy to cope with external shocks and ensure that financing to the private sector is not interrupted.

Going forward, continuity in Bank Negara Malaysia's financial sector policies will be preserved. We will continue to strengthen our prudential regulatory framework in line with global standards, while introducing new developmental initiatives and maintaining a strong focus on the fair treatment of financial consumers. Following transformational measures taken in the past few decades to significantly strengthen the financial system, the banking industry in Malaysia is managing this transition from a position of strength. The capitalisation of the banking system is at its highest level of 16.5%. The combined excess capital of banks above the regulatory minimum level stands at over RM120 billion. The banking system Liquidity Coverage Ratio is also comfortably above 120% against the current regulatory minimum of 70%. This strong position has been an important element to facilitate orderly adjustments in transitioning towards global standards without disruptions to financial intermediation, thus ensuring the smooth flow of financing to the economy.

To enhance Malaysia's growth potential, several initiatives had been identified that will help boost productivity, improve the income-earning potential of Malaysians and expand opportunities in new markets. Building from Malaysia's leading position as an international Islamic finance centre, efforts to promote the sustainable growth of Islamic finance supported by a dynamic ecosystem will create opportunities for high income employment. At the same time, ASEAN integration remains high on Bank Negara Malaysia's agenda.

Meeting the e-payment targets that Bank Negara has set is also vital to enhance our economic efficiency, competitiveness and productivity. And we will continue to direct efforts at ensuring that all Malaysians can participate effectively in the financial system.

Bank Negara will also continue to work with the Government on a range of economic priorities to sustain the Malaysian economy on a steady growth path. This includes the continued support and development of SMEs, and improvement in access to affordable housing. An area that demands greater attention and coordination going forward is the 'sharing economy'. We have already seen how the likes of Uber and AirBnB have changed the business model of the transport and hotel sectors, and enhanced the earning potential for asset owners, lower costs for users, and drive innovation and service quality improvements among incumbent providers. They can also bring important benefits for the environment through the reduction of wastage

and control of over-consumption. Similar innovative trends are also emerging within the banking and finance sector. To reap the benefits of technological advancements, the Bank will work closely with relevant agencies and innovators in this space on new ways of delivering new products and services.

I would like to take the opportunity this morning to talk about some of the measures that Bank Negara Malaysia is taking to support growth in the financial services sector, encourage innovation and strengthen resilience. My remarks will touch on the areas of regional financial integration, fintech development, systemic focus on regulation, governance and the role of banks in ensuring an inclusive financial system.

Advancing regional financial integration

The ASEAN Banking Integration Framework (or ABIF) that was finalised last year was a significant milestone towards greater ASEAN integration. An agreement forged between 10 key economies at different stages of economic and financial systems development is in itself a remarkable achievement. This is in sharp contrast with recent global trends. In the decades leading up to the 2007 financial crisis, global financial integration took unprecedented strides forward as capital markets and banking systems expanded and diversified, increasing the mobility of capital. But of late, there has been a reversal of this trend. A recent study by McKinsey found that following the crisis, banks globally have shed $722 billion in assets and operations, of which almost half were foreign-based. Cross-border flows have also declined significantly, remaining at 60% of pre-crisis levels. To some extent, this is expected as markets undergo corrections and new regulations were introduced to address weaknesses in existing models for integration. The crisis has led to forces of change that are creating two diverging paths ahead: greater fragmentation of finance as operating structures adopt a narrower and more domestic focus, or a move towards alternative, more sustainable approaches to integration.

ASEAN integration however, has adopted sustainable approaches to integration and continued to gain momentum. Importantly, this has been pursued in tandem with the need for greater private sector integration, thereby supporting a natural path of evolution for the region's financial sectors and overall economy.

As a whole, this has resulted in a measured approach to integration, mindful of different needs of member countries and supported by regional frameworks and bilateral arrangements. In doing so, risks are also better managed by preserving a strong focus on strengthening prudential frameworks and capacity developments and giving economies more time to adjust to new circumstances. With more than 600 million people, with a combined GDP of USD2.5 trillion and a burgeoning middle class, ASEAN holds enormous potential for economic growth for member countries. We expect that intra-regional trade will flourish and consequently sources of growth and trade will become much more diversified.

Since the finalisation of the ABIF, Bank Negara Malaysia has signed three Heads of Agreement (HOAs) with Indonesia, Thailand and the Philippines, paving the way for banks in the four economies to expand their presence and contribute towards regional growth. Bank Negara has also actively pursued initiatives to develop a viable regional cross currency market to support trade and investment by expanding the availability of multiple choices of currencies that businesses can use for trade and settlement. Malaysia and Thailand recently established the first cross-currency settlement and clearing arrangement between two ASEAN countries, following similar arrangements with China and South Korea. Moving forward, Malaysia remains committed to regional efforts to advance financial integration. This will be guided by the ASEAN Economic Community Blueprint 2025, which focuses on the three key pillars of financial integration, financial inclusion and financial stability in the region.

Facilitating fintech developments

I am pleased today to announce that Bank Negara will introduce a framework for fintech firms to test innovations in the financial services operational environment. Earlier this month at the Global Islamic Finance Forum, I spoke briefly about the work that Bank Negara Malaysia has undertaken with respect to fintech. Indeed, Bank Negara has long recognised the power of technology in driving the financial sector forward. Over the years, banks have harnessed the power of technology to reap significant benefits. Bank Negara has supported this development on many fronts including in the areas of payments, internet banking, agent banking, Islamic finance and money exchange and remittances. Fintech will be a new addition to the list.

Fintech developments such as blockchain, artificial intelligence and biometric applications are now expanding the frontiers of banking. Because of the profound implication of new technology, we require a re-think of the regulatory framework in addressing consumer protection and market conduct issues as well as the technological impact on the orderly functioning of financial markets. We expect that the framework would enable fintech firms to provide regulated financial services directly to the public, or in partnership with financial institutions, and to operate under more flexible regulatory arrangements. We take cognisance that some innovations cannot be achieved within existing regulatory parameters. Nonetheless, to protect the interests of consumers, this will be subject to certain safeguards. The innovation must provide a clear benefit to the general public or financial industry. A firm that operates within the framework must also commit to observe reasonable standards of service, transparency to customers, appropriate funding and reporting requirements. These are not meant to stifle the creative process at play, but rather facilitating an orderly process while protecting consumers interests and maintaining market confidence.

The Bank also expects the framework to deliver a number of key benefits. It will provide regulatory clarity for fintech start-ups, and for banks and consumers that use their services. It will also lower barriers to entry and accelerate the time-to-market for productive innovations. Our aim is therefore to support fintech firms that go on to upscale their activities, and aid fintech firms to better anticipate and adjust to appropriate regulatory expectations.

Strengthening the systemic focus of regulation

Bank Negara Malaysia's regulatory and supervisory framework will continue to reflect the increasing focus on systemic risks. This addresses a key lesson from global financial crisis – that greater attention needs to be directed at identifying and managing systemic risks that arise from interactions between financial institutions and markets, and their collective impact on the broader financial system.

As interlinkages within and beyond the Malaysian financial system deepen, the sources of potential vulnerabilities and shocks can be amplified, with larger and more complex institutions posing greater risks to system-wide stability. Bank Negara Malaysia's prudential standards and the intensity of our supervision will be more differentiated going forward to reflect these risks. In recent months, we have issued two standards on operational risk and compliance.

These standards reflect the differentiation by setting higher expectations for larger and systemically important financial institutions. Bank Negara is also assessing options to ensure that systemically important institutions have adequate capital buffers; that their capital is proportionate to the risks posed to the broader financial system and the possible costs of failure. In addition, we are progressing work in coordination with PIDM to develop an effective resolution and recovery framework. Banks are expected to continuously assess and identify critical functions from a systemic perspective within their operations, and prepare contingency and recovery plans to preserve those functions under a stress scenario. Bank Negara will engage the banking industry to share more information on this initiative, including our implementation approach. A concept paper on this will also be issued for comments.

Raising the bar on governance

Finally, we will continue to raise the bar on governance. The role played by governance failures in the recent crisis is well documented, particularly in respect of incentive systems, accountability structures and controls. More broadly, there is also a strengthened emphasis on the softer aspects of governance such as behavioural norms, corporate culture and ethics. We should not forget these lessons or else history will repeat itself.

Malaysian financial institutions should be the gold standard for good governance practices. Because of their important role within the economic system, banks have the added responsibility of maintaining public trust and confidence.

In addition, we also expect the banking industry to take the lead in promoting good governance practices more broadly across corporate Malaysia, through financing and investment activities, or professional advice to clients. An important regulatory priority for Bank Negara in this regard is to align incentives with a sound risk culture and ethical conduct, underpinned by effective independent oversight by the board. On this, Bank Negara recently published several proposals to enhance the corporate governance framework for financial institutions in Malaysia to address these issues. While proposals on board composition appear to have generated more attention in the media, the most significant enhancements actually relate to expectations for the board and senior management to set the right "tone from the top", and the explicit responsibilities placed on them to play a more critical role in shaping the core values and culture of the institution. This includes expanded requirements on compensation practices and disclosures to strengthen market discipline. Banks must also put in place a transparent whistleblowing policy that enables the escalation of concerns without the risk of reprisal.

Good governance is ultimately driven by a workforce that is committed to the highest standards of knowledge, competence and conduct. Competition for talent in the financial industry has intensified greatly, in an environment where public opinion of banks globally is also at an all-time low following the last crisis. Recent trends among graduates of leading business schools worldwide indicate a shift towards other well-paying alternatives to careers in banking, notably to technology and consulting firms. According to the Financial Times, the popularity of banking as a career has dropped 41% since 2008. Globally, banks' reputations have also been dented to varying degrees by poor quality of service, staggering control failures and misconduct.

The professionalisation of the banking industry is therefore critical to strengthen the talent pipeline, while restoring and maintaining public trust in the banking industry. An important step in this direction is the transformation of Institute Bank-Bank Malaysia (IBBM) into the Asian Institute of Chartered Bankers (AICB) as the professional body for bankers and the Asian Banking School as the education service provider. The AICB plays a key role in spearheading the vision of professionalising bankers through the development of professional qualifications, a specialised certification track to support continuing professional development and a membership framework that subjects members to a strict code of conduct, professionalism and ethics. The prestigious Chartered Banker qualification, for example, aims to provide comprehensive education on banking to support sound judgment and decision-making. The industry should therefore take full advantage of these opportunities to build a solid team of professional bankers that are able to perform effectively in a rapidly evolving landscape.

Fundamental role of banks to support inclusive financial participation for all

It is important to bear in mind that growth in financial services must also serve to enhance economic opportunity for all. Since the establishment of the Financial Inclusion Framework in 2011, major inroads have been made in widening the accessibility to financial services in Malaysia.

Agent banking has been a key strategy to improve access, particularly in the rural areas. 92% of our population has some form of access to financing. Moving forward, expanding public access to financial services will remain important for the remaining 8% of the unbanked population in Malaysia. There will also be greater emphasis on the quality of services provided.

The social impact of greater financial inclusion is significant as it helps improve people's lives. In this respect, banks have a critical role to play to make it easier for people to save, make payments and obtain affordable loans to improve standards of living and build more resilient communities. It would be a remiss to talk about the future of banking without embracing this very fundamental role of banks.

As our economy becomes even more financialised, it is important that banks strike a balance between legitimate profit-seeking goals, and their responsibility to provide the public with full and fair access to financial services. Some banks today are still falling short of expectations to offer basic banking services to the people who only need such services. We have observed poor communications by the front-line staff of such banks on the basic banking products which must be offered by all banks. In some cases, prohibitive conditions are attached to the opening of basic banking accounts in clear violation of Bank Negara Malaysia's requirements. This must change. In offering basic banking services, banks should also leverage on technological advancement that can support inclusive finance initiatives. These include adopting more innovative delivery channels, leveraging on big data to reach a wider community and to offer suitable products that are priced affordably.

Concluding remarks

The world as we know it is set to change dramatically just as it had over the last few decades, except that future changes will happen at a much more rapid pace, and in sectors where we least expect it. The ability of banks to adapt will be critical to its relevance. More likely than not, banks that are agile and have absolute clarity on their value proposition for their customer, society and wider economy, will be the ones that will endure. Banking as we know today will no doubt change in form as the future takes shape. What is more important that the core purpose of banking remains intact – that is to provide reliable passage for resources to move to productive use, including under the most challenging conditions.

I thought I would close these remarks by quoting Machiavelli 'There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things'.

CALENDAR OF EVENTS
April – June 2016

14 April

The Bank issued commemorative coins in conjunction with the 70th Anniversary of Radio Televisyen Malaysia (RTM). RTM is the first broadcaster in Malaysia and launched its inaugural radio broadcast on 1 April 1946 and initial television broadcast on 28 December 1963.

27 April

The Yang di-Pertuan Agong, advised by the Prime Minister, appointed Datuk Muhammad Ibrahim as the Governor of Bank Negara Malaysia for a term of five years, starting on 1 May 2016. In a statement on his appointment, Governor Muhammad said, "It is important for the central bank to maintain monetary and financial stability, remain focused on its strategic agenda and work towards contributing to a better future for all Malaysians."

9 May

The Bank issued commemorative coins in conjunction with the 50th Anniversary of Yayasan Sabah. Yayasan Sabah (the Sabah Foundation) was founded by the late Tun Datu Haji Mustapha bin Datu Harun on 10 May 1966. Its main objective is to enhance the socioeconomic standing of all Malaysians in Sabah, especially those in rural areas, through various education and economic developmet programmes.

11 May

In his keynote address at the Global Islamic Finance Forum 5.0 – themed "Future of Islamic Finance: Delivering actions today for a sustainable tomorrow" – Governor Muhammad highlighted that Islamic finance is growing at a rapid pace globally. He paid special tribute to previous Governors of Bank Negara Malaysia for their visionary leadership in raising the global profile of Islamic finance.

In his speech, Governor Muhammad highlighted three key issues, the rise of fintech and its impact on Islamic finance, the growing importance of responsible, inclusive and sustainable finance and the preconditions necessary to sustain a value-based financial system. Governor Muhammad concluded that the strategies to elevate the Islamic finance industry should incorporate elements that leverage on technology, accelerate innovation and develop well-rounded talent to meet future needs of Islamic finance.

13 May

The Bank announced that the Malaysian economy expanded by 4.2% in the first quarter of 2016 (4Q 2015: 4.5%). The slight moderation in growth mainly reflected external shocks to the economy and cautious spending by the private sector. On the supply side, growth continued to be driven by the major economic sectors. On a quarter-on-quarter seasonally-adjusted basis, the economy recorded a growth of 1.0% (4Q 2015: 1.2%).

On the same day, the Bank announced the establishment of the Financial Markets Committee (The Committee). The Committee is established with the objective to broaden industry engagement with a focus on reviewing and formulating comprehensive strategies for the wholesale financial markets to meet the diverse and complex demands of a more developed and internationally integrated economy.

The Committee comprises participants / representatives from Bank Negara Malaysia, financial institutions, corporations, financial service providers and other institutions or stakeholders which have prominent roles or participation in the financial markets.

19 May

The Bank maintained its Overnight Policy Rate at 3.25% at the May Monetary Policy Committee (MPC) meeting. The MPC said that at this level of the OPR, the stance of monetary policy is accommodative and supportive of economic activity. MPC recognised there are downside risks in the global economic and financial environment and is closely monitoring and assessing their implications on domestic price stability and growth.

26 May

In his keynote address at the ASLI 20th Malaysian Banking Summit – themed "Future Banking: Reimagining Banks – Driving Transformation and Innovation", Governor Muhammad highlighted several measures taken by Bank Negara Malaysia to support growth in the financial services sector, encourage innovation and strengthen resilience. These measures include advancing regional financial integration, facilitating fintech developments, strengthening the regulatory and supervisory framework on systemic risks, enhancing the corporate governance framework, and enhancing the role of banks in ensuring an inclusive financial system. He concluded that the pace of change will be more rapid and the ability of banks to adapt will be critical to its relevance.

28 May

The Bank issued commemorative coins in conjunction with the 100th Anniversary of Persatuan Pandu Puteri Malaysia (PPPM). PPPM is committed to producing women of calibre, through encouraging the application of knowledge, skills and values of the Girl Guides in line with its vision of "taking the lead in developing the potential of girls and women for change."

1 June

The Bank co-organised with Dewan Bahasa dan Pustaka the Pertandingan Pidato antara Institusi Kewangan Piala Gabenor Bank Negara Malaysia (Pertandingan Pidato Piala Gabenor). The event has been held for the past eight years and the finals featured 12 finalists from approximately 80 who contested. The objective of the Pertandingan Pidato Piala Gabenor is to foster a sense of pride in and passion for the national language as well as to encourage its usage in the financial sector.

2 June

The Bank announced the establishment of a Financial Technology Enabler Group (FTEG), which will be responsible for formulating and enhancing regulatory policies to facilitate the adoption of technological innovations in the Malaysian financial services industry. The FTEG is part of the Bank's commitment to support innovations that will improve the quality, efficiency and accessibility of financial services in Malaysia.

15 June

The Bank and Financial Markets Association of Malaysia (FMA or PPKM) jointly announced the migration to Kuala Lumpur USD/MYR Reference Rate as part of the effort to adopt global best practices for the domestic financial market. The migration which will be effective 18 July 2016 refers mainly to (i) the adoption of new methodology in the USD / MYR Spot Fixing (PPKM-MYR) based on market transaction data; (ii) extension of the official closing hour for onshore ringgit market from 5.00 p.m. to 6.00 p.m.

Under the new methodology, the reference rate will be known as the Kuala Lumpur USD/MYR Reference Rate. It will be published daily at 3:30 p.m. and is computed based on the weighted average volume of the interbank USD / MYR FX spot rate transacted by the domestic financial institutions between 8:00 a.m. to 3:00 p.m. The market transaction data is sourced from online reporting by domestic financial institutions to Bank Negara Malaysia. The new methodology is more transparent and better reflects underlying trade during the day.

Acronyms and Abbreviations

ABIF	ASEAN Banking Integration Framework
ADB	Asian Development Bank
AFC	Asian Financial Crisis
AFI	Alliance for Financial Inclusion
AIF	Asian Institute of Finance
ALR	average lending rate
APN	Asian Payment Network
BI	Bank Indonesia
BIS	Bank for International Settlements
BLR	base lending rate
BNM	Bank Negara Malaysia
BNMN	Bank Negara Monetary Notes
BoC	Bank of Canada
BoE	Bank of England
BoJ	Bank of Japan
BR	Base Rate
CASTD	cash-to-short-term debt
CBC	Central Bank of the Republic of China
CET1	common equity tier 1
CMP	Commodity Murabahah Programme
CoFC	consumption of fixed capital
CPI	Consumer Price Index
DFIs	development financial institutions
DIA	direct investment abroad
DOSM	Department of Statistics, Malaysia
DSR	debt service ratio
E&E	electronics and electrical
E&O	Errors and Omissions
ECB	European Central Bank
EOR	enhanced oil recovery
ETP	Economic Transformation Programme
EU	European Union
FBM KLCI	FTSE Bursa Malaysia Kuala Lumpur Composite Index
FD	fixed deposit
FDI	foreign direct investment
Fed	Federal Reserve
FFR	federal funds rate
FOMC	Federal Open Market Committee
FSB	Financial Stability Board
FSTEP	Financial Sector Talent Enrichment Programme

FX	foreign exchange
GDP	Gross Domestic Product
GFCF	gross fixed capital formation
GFP	goods for processing
GIFF	Global Islamic Financial Forum
GII	Government Investment Issues
GNI	Gross National Income
GST	Goods and Services Tax
HoA	Heads of Agreement
HQLA	high-quality liquid asset
HSDPA	High-Speed Downlink Packet Access
ICR	interest coverage ratio
IDB	Islamic Development Bank
IFSA	Islamic Financial Services Act 2013
IILM	International Islamic Liquidity Management
IMF	International Monetary Fund
IRS	interest rate swaps
IT	information technology
JCC	Japanese Crude Cocktail
KLCI	Kuala Lumpur Composite Index
KLIBOR	Kuala Lumpur Interbank Offered Rate
LCR	Liquidity Coverage Ratio
LIA	loans-in-arrears
LNG	liquefied natural gas
LTF	loan-to-funds
MGII	Malaysian Government Investment Issue
MGS	Malaysian Government Securities
MHPI	Malaysia House Price Index
MIDA	Malaysian Investment Development Authority
MIER	Malaysian Institute of Economic Research
MoU	Memorandum of Understanding
MPC	Monetary Policy Committee
MSIC	Malaysia Standard Industrial Classifications
NBFI	non-bank financial institutions
OPEC	Organisation of the Petroleum Exporting Countries
OPR	Overnight Policy Rate
PBOC	People's Bank of China
PDS	private debt securities
PE	price-to-earnings
PMI	Purchasing Managers' Index
PPI	Producer Price Index
PTP	Port of Tanjung Pelepas

QAB	Qualified ASEAN Banks
QE	quantitative easing
RBI	Reserve Bank of India
RM	Ringgit Malaysia
SDA	Special Deposit Account
S$NEER	Singapore dollar nominal effective exchange rate
SME	small and medium enterprise
SNA	System of National Accounts
SNB	Swiss National Bank
SRR	Statutory Reserve Requirement
SST	Sales and Services Tax