

BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

The BNM Quarterly Bulletin presents a quarterly review of Malaysia's economic, monetary and financial developments. It includes the Bank's latest assessments on the direction of the economy going forward. The Bulletin also provides insights on current economic and financial issues, including highlights of policy initiatives undertaken by Bank Negara Malaysia in pursuit of its mandates.

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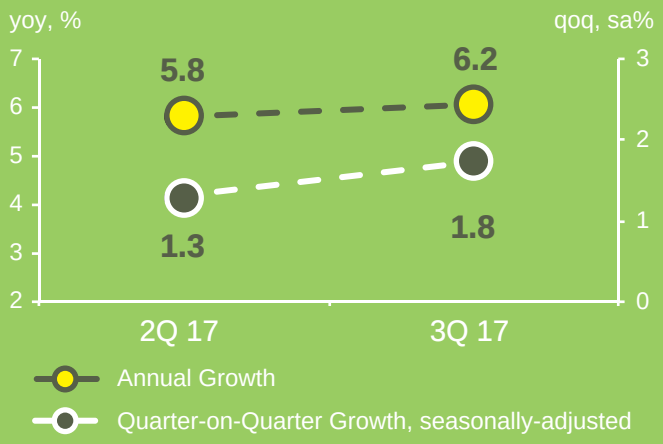
Key Highlights on

Economic and Financial Developments in 3Q 2017

Higher GDP growth of 6.2%

Continued growth in domestic demand and across all economic sectors

Real GDP Growth



Domestic demand grew by 6.6% (2Q17: 5.7%), driven by the private sector

On the supply side, the manufacturing and services sectors remained the key drivers of growth

Inflation moderated due mainly to lower domestic fuel prices

Inflation in the transport category was lower

Higher Crude Oil Prices
3Q17: USD52/barrel
2Q17: USD50/barrel

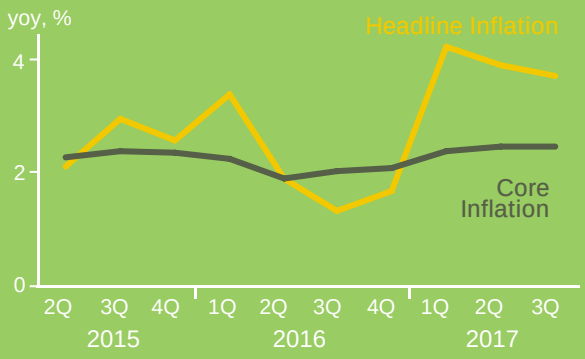
Stronger Ringgit
3Q17: RM4.26/USD
2Q17: RM4.33/USD

Lower RON95 Petrol Price
3Q17: RM2.09/litre
2Q17: RM2.10/litre

* Arrow denotes the impact on inflation

Core inflation remained stable

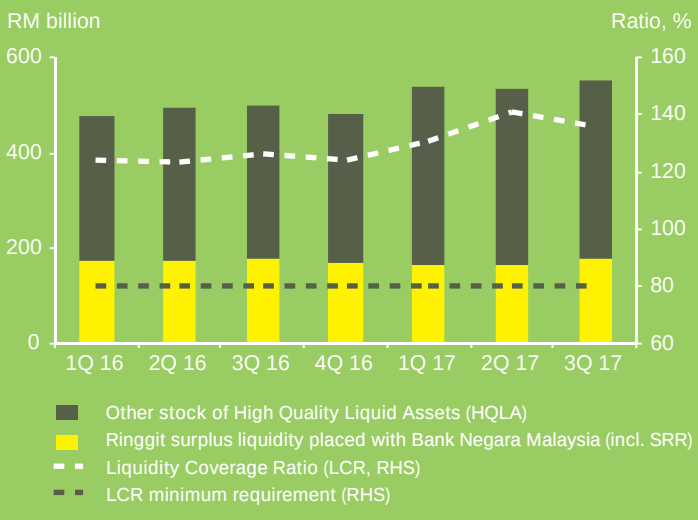
Headline and Core Inflation



Financing conditions remained supportive of the economy

Sufficient liquidity in the banking system to support intermediation

Liquidity Coverage Ratio and Liquid Assets



SMEs, including start-ups, continued to have access to financing

SME Financing Applications and Approvals



Source: Department of Statistics, Malaysia and Bank Negara Malaysia unless stated otherwise
For more information, visit www.bnm.gov.my

Key Highlights on
Box Articles

Rethinking Investment Incentives

A review of the investment incentives framework is timely for a future-ready Malaysia

FDI was a game changer

- In the past, FDI had driven exports, employment and productivity
- However, benefits have stagnated amid high use of foreign inputs

Foreign Inputs

- Foreign services
- Imported inputs
- Foreign workers

81% of firms would have invested **without incentives**

Incentives result in high fiscal costs and may be redundant

- Corporate tax foregone ~6.0 - 8.9% of Government tax revenue
- Evidence that firms would have invested even without incentives

Source: World Bank Facility for Investment Climate Advisory Services

Fast-paced global environment requires nimble incentives

- Principles-based approach to identifying quality FDI
- Incentives tied to performance- and outcome-based indicators

Climate change **Innovation**
Tech disruption Skilled jobs
Rapid urbanisation Economic complexity
Changing investor preferences

Imbalances in the Property Market

Supply-demand imbalances in residential and commercial property markets could pose risks to the wider economy

Rise in Unsold Residential Properties

- Decade-high level of unsold units (130,690 units as of 1Q 2017)
- 83% of unsold units are above RM250,000
- 61% of unsold units are high-rise apartments

Oversupply of Office and Shopping Complexes

1-in-3 Offices to be vacant by 2021

140 New malls to enter market by 2021

Source: Jones Lang Wootton, National Property Information Centre

A Vulnerable Property Market Poses Risks to the Economy

1. Slower economic growth and higher unemployment
   - Property-related sectors accounted for 10% of GDP and employed 1.4 million Malaysians in 2016
2. Multiple sectors suffer prolonged weakness
3. Harm the banking and financial institutions
4. Negatively impact the Current Account of the Balance of Payments
5. Impairs Government's fiscal position if bailouts are required

Source: Department of Statistics, Malaysia and Bank Negara Malaysia unless stated otherwise
For more information, visit www.bnm.gov.my

Key Highlights on

Financial Markets Committee (FMC)

Financial Markets Committee (FMC) continues to enhance resiliency and develop the domestic financial market

1st series (Dec. 2016)

Rebalance onshore foreign exchange demand and supply

- 25% retention of export proceeds in foreign currency
- Trade settlement among residents in ringgit
- Streamline prudential limit on onshore and offshore foreign currency investment

Promote foreign exchange risk management onshore

- Active and dynamic hedging framework for residents and institutional investors
- Expansion of Appointed Overseas Office framework

2nd series (Apr. 2017)

Additional foreign exchange risk management flexibilities

- Further flexibilities for dynamic hedging for institutional investors
- Active hedging for corporations

Improve bond market liquidity

- Liberalise regulated short-selling

Promote fair and effective market conduct

- New Code of Conduct for Wholesale Financial Markets
- Principles for Fair and Effective Financial Market

Source: Bank Negara Malaysia

International Economic Environment

HIGHLIGHTS

- **Continued expansion in global growth, as consumption and investment grew further.**
- **Asian economies recorded sustained double-digit export performance, following continued strength in global demand.**
- **Equity market performance improved amid lower financial market volatility.**

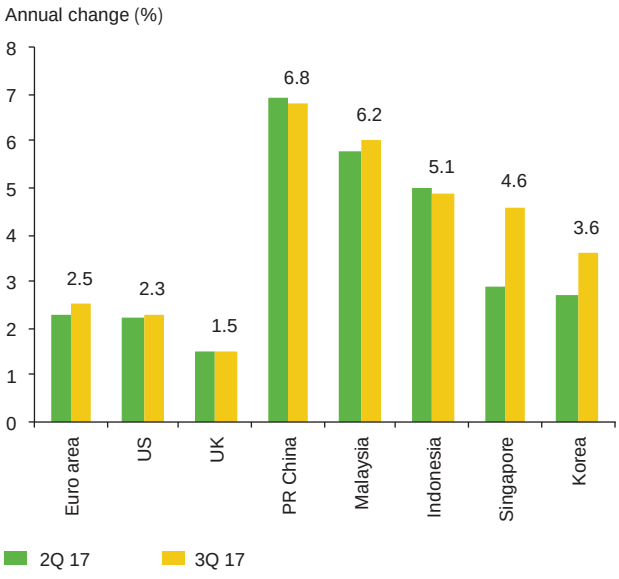
Global growth expanded further

Global economic activity continued to expand in the third quarter of 2017. High-frequency indicators such as the global purchasing manager indices (PMI) and industrial production in the advanced economies and most major countries in Asia registered further improvements. This reaffirms that economic growth is becoming increasingly more entrenched across countries.

Third quarter GDP releases showed sustained growth in the advanced economies, supported by private consumption and investment. This continued to provide support to global demand, as imports from the advanced economies expanded further. Domestic demand in PR China remained supportive of growth and global trade, albeit at a marginally more moderate pace. As a result, Asia continued to benefit from these favourable external developments, augmenting the strength in domestic demand.

Continued global economic expansion in 3Q 2017

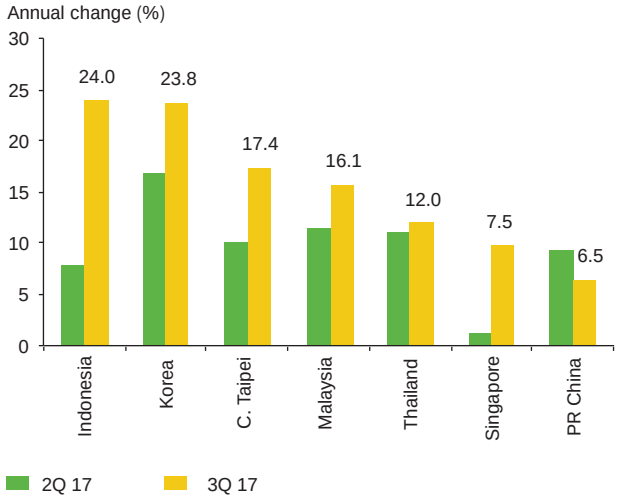
Chart 1: GDP Growth



Source: National authorities

Improvements in trade in 3Q 2017

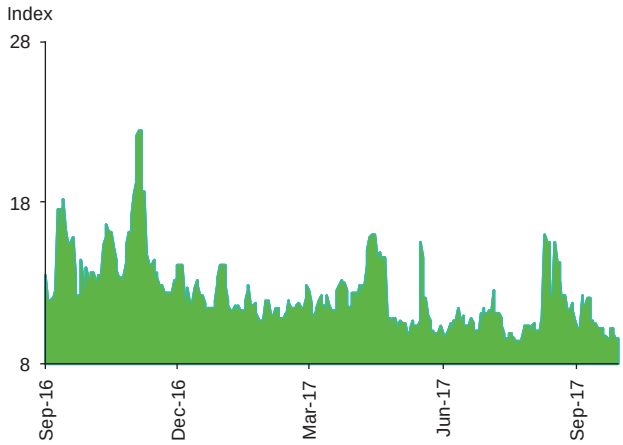
Chart 2: Export Growth of Selected Economies (in USD terms)



Source: National authorities

Low volatility in financial markets

Chart 3: Chicago Board Options Exchange (CBOE) Volatility (VIX)



Source: Bloomberg

Broad pickup in trade in Asia

Global trade continued to show a firmer growth momentum, recording broad-based expansion across product categories and destinations. Continuous improvements in investment in the advanced economies and sustained infrastructure and property construction in PR China provided the impetus to global trade.

During the quarter, exports of Asian economies registered strong double-digit growth, especially in the electrical and electronics (E&E) sector. Korea and Chinese Taipei benefitted from higher shipments of semiconductors for use in electronics products. Of significance, Korea's exports recorded the fastest pace of expansion since 1Q 2011 (3Q 2017: 23.8%; 1Q 2011: 29.6%). Indonesia's exports turned around to register a robust growth of 24.0%, reflecting improvements in both oil and non-oil exports and the low base effect from the previous year (3Q 2016: -4.9%).

Lower volatility in the financial markets

During the quarter, global financial market volatility declined. Of significance, the release of better-than-expected economic data in the major economies lifted investors' sentiments, particularly in the first half of the quarter.

However, volatility returned in the second half of the quarter, following the intensification of geopolitical tension in North Korea and adverse weather conditions in the US, which weighed on global stock performance. Towards the end of the quarter, investors' concerns over the impact of the hurricane season dissipated as production resumed and jobless claims normalised. Investors' confidence also improved, in response to US officials' comments on a more diplomatic approach in resolving the tension between the US and North Korea.

Developments in the Malaysian Economy

HIGHLIGHTS

- **The Malaysian economy grew by 6.2% in the third quarter.**
- **Headline inflation declined to 3.8% due mainly to lower average domestic fuel prices. Core inflation remained stable at 2.5%.**
- **Current account balance widened to 3.7% of GNI due to a larger goods surplus, which offset the higher deficits in the income accounts.**

The Malaysian economy expanded by 6.2% in the third quarter of 2017

The Malaysian economy recorded a stronger growth of 6.2% in the third quarter of 2017 (2Q 2017: 5.8%). Private sector spending continued to be the main driver of growth. The external sector also contributed positively to growth, as real exports expanded at a faster pace (11.8%; 2Q 2017: 9.6%), supported by stronger demand from major trading partners. On a quarter-on-quarter seasonally-adjusted basis, the economy grew by 1.8% (2Q 2017: 1.3%).

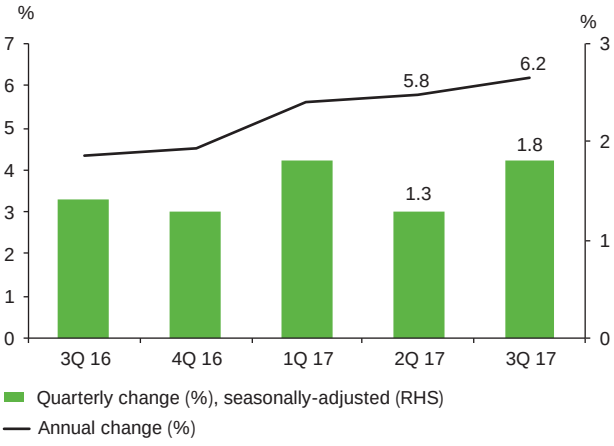
Domestic demand driven by the private sector

Domestic demand grew by 6.6% in the third quarter of the year (2Q 2017: 5.7%), supported by continued expansion in both private sector expenditure (7.3%; 2Q 2017: 7.2%) and public sector spending (4.1%; 2Q 2017: 0.2%).

Private consumption expanded by 7.2% (2Q 2017: 7.1%), underpinned by better labour market conditions. In particular, private sector wages were sustained amid stronger employment growth.

Stronger growth in 3Q 2017

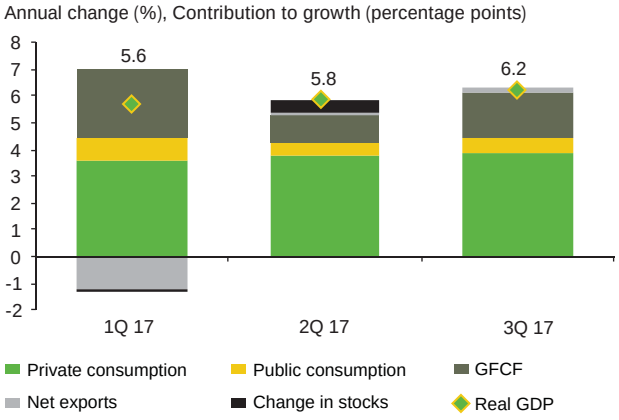
Chart 4: GDP Growth



Source: Department of Statistics, Malaysia

Private sector demand remained the key driver of growth

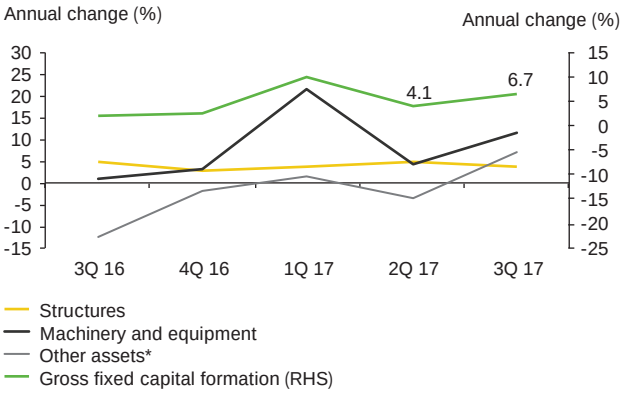
Chart 5: Contribution of Expenditure Components to GDP Growth



Source: Department of Statistics, Malaysia

Gross fixed capital formation expanded at a faster pace

Chart 6: GFCF Growth by Type of Assets



*Other assets include mineral exploration, research & development and capitalised planting

Source: Department of Statistics, Malaysia

Private investment registered a stronger growth of 7.9% (2Q 2017: 7.4%), mainly in the services and manufacturing sectors. Within the manufacturing sector, both export- and domestic-oriented sub-sectors undertook higher capital spending during the quarter. Business sentiments also remained above the optimism threshold, in line with favourable external and domestic demand conditions.

Public consumption expanded by 4.2% (2Q 2017: 3.3%) following faster growth in emoluments amid continued prudence in spending on supplies and services.

Public investment turned around to register positive growth of 4.1% during the quarter (2Q 2017: -5.0%). This was due to higher fixed assets spending by both the Federal Government and public corporations.

Gross fixed capital formation (GFCF) growth was higher at 6.7% (2Q 2017: 4.1%) driven by higher growth in private investment and the positive turnaround in public investment. By type of assets, capital spending on machinery and equipment improved to 11.5% (2Q 2017: 4.4%) while investment in structures moderated to 3.6% (2Q 2017: 5.1%). Investment in other types of assets was higher at 7.2% (2Q 2017: -3.7%).

Continued expansion across all economic sectors

On the supply side, growth was supported by continued expansion across all sectors.

The services sector registered a higher growth in the third quarter of 2017. Growth of the wholesale & retail trade sub-sector was supported by continued growth in household spending. The information and communication sub-sector remained strong, driven by higher demand for data communication services, while the transportation and storage sub-sector benefited from the robust trade activities.

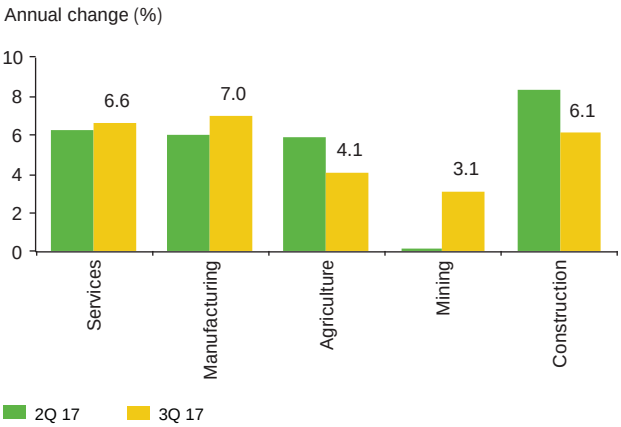
The manufacturing sector grew at a faster pace during the quarter, supported by broad-based improvements in both export- and domestic-oriented industries. Export-oriented industries benefitted from robust global demand for semiconductors and higher petroleum-related refinery activity. Domestic-oriented industries were supported by continued demand for food-related products and construction-related materials, in addition to stronger growth in transport equipment driven by auto parts and ship building activities.

Growth in the mining sector recorded stronger growth during the quarter, supported by higher natural gas production, particularly in Sabah and Sarawak. However, growth in the agriculture sector moderated, reflecting mainly lower rubber and CPO production due to adverse weather conditions.

Growth in the construction sector moderated during the quarter particularly due to lower non-residential activity in the commercial sub-segment.

Higher growth across most economic sectors

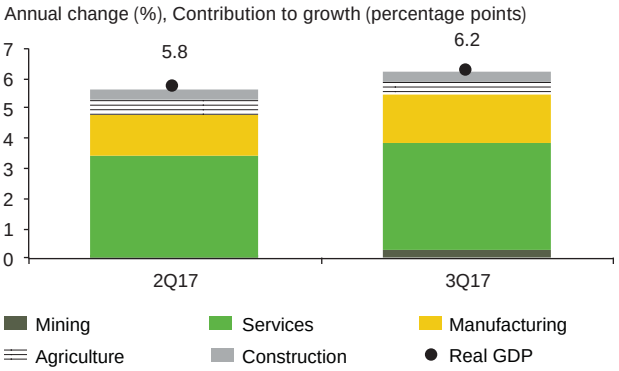
Chart 7: Growth by Sector



Source: Department of Statistics, Malaysia

Services and manufacturing sectors remained the key drivers of growth

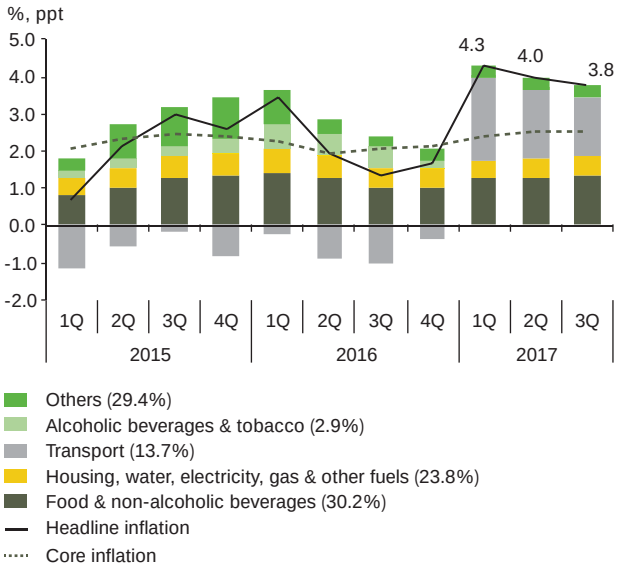
Chart 8: Real GDP by Economic Sector



Source: Department of Statistics, Malaysia

Lower inflation mainly reflected the decline in transport inflation

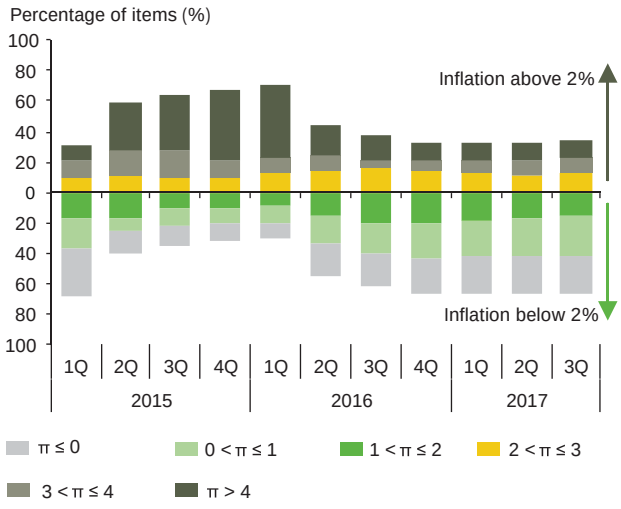
Chart 9: Headline Inflation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Inflation pervasiveness remained broadly stable

Chart 10: Inflation Pervasiveness



Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Headline inflation moderated due to lower *transport* inflation

Headline inflation[1] moderated to 3.8% in the third quarter of 2017 (2Q 2017: 4.0%) due mainly to lower ***transport*** inflation at 11.7% (2Q 2017: 13.4%). Although domestic fuel prices trended upward during the quarter due to rising global oil prices, domestic fuel prices averaged slightly lower compared to the previous quarter (RON95 petrol in 3Q 2017: RM2.09 per litre; 2Q 2017: RM2.10 per litre). The lapse in the impact from the upward adjustment of satellite TV charges also contributed to the lower inflation during the quarter. However, ***rental*** and ***non-durable household goods*** recorded higher inflation during the quarter. ***Rental*** inflation increased to 2.9% (2Q 2017: 2.7%), although the increase was limited to selected geographical areas and property types. Inflation for ***non-durable household goods*** also rose to 3.8% (2Q 2017: 1.8%) following the spillover of higher input costs.

Core inflation was stable at 2.5% during the quarter. The percentage of the CPI basket that registered inflation of more than 2% remained broadly unchanged (3Q 2017: 34%; 2Q 2017: 33%).

[1] As measured by the annual change in the Consumer Price Index (CPI).

Improving labour market conditions

Labour market conditions in the third quarter of 2017 were supportive of growth. Private sector wage growth was sustained at 7.3% (2Q 2017: 7.3%) while employment growth registered some improvements (2.0%; 2Q 2017: 1.8%). During the quarter, labour force expansion was relatively matched by net employment gains resulting in a stable unemployment rate of 3.4% (2Q 2017: 3.4%). Labour demand also improved as the number of vacancies posted on a major job search website increased to 68,794 positions in the third quarter (2Q 2017: 65,478 positions).

The sustained growth in private sector wages was driven by wage growth in the services and manufacturing sectors. Services sector wage growth rose to 5.9% (2Q 2017: 5.6%), supported by the strength in the ICT and transportation and storage sub-sector. Manufacturing wages remained in double-digit territory for the second consecutive quarter, growing by 10.6% (2Q 2017: 11.2%).

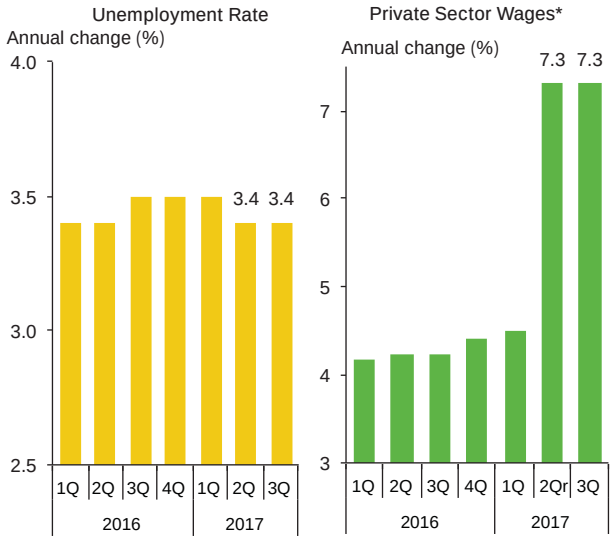
Robust external sector performance

In the third quarter of 2017, gross exports expanded at a faster pace of 22.1% (2Q 2017: 20.5%). The robust performance reflected mainly the strength of manufactured exports which continued to register double-digit growth. As export growth outpaced import growth, the trade surplus widened to RM26.7 billion (2Q 2017: RM24.1 billion).

The strong manufactured export growth was supported by higher demand from most of Malaysia's key trading partners, particularly regional economies, the EU and US. Of significance, the sustained strong global demand for semiconductors continued to benefit E&E exports.

Stable unemployment rate and sustained wage growth

Chart 11: Labour Market Indicators

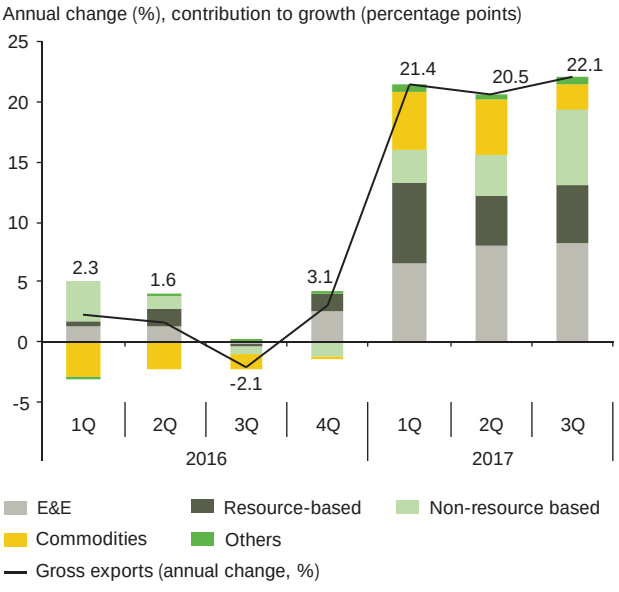


*Private sector wages is derived from the salaries and wages data published in the Monthly Manufacturing Statistics and Quarterly Services Statistics by the Department of Statistics, Malaysia. It covers 62% of total employment.
r Revised

Source: Department of Statistics, Malaysia

Export growth driven mainly by manufactured exports

Chart 12: Gross Exports by Products

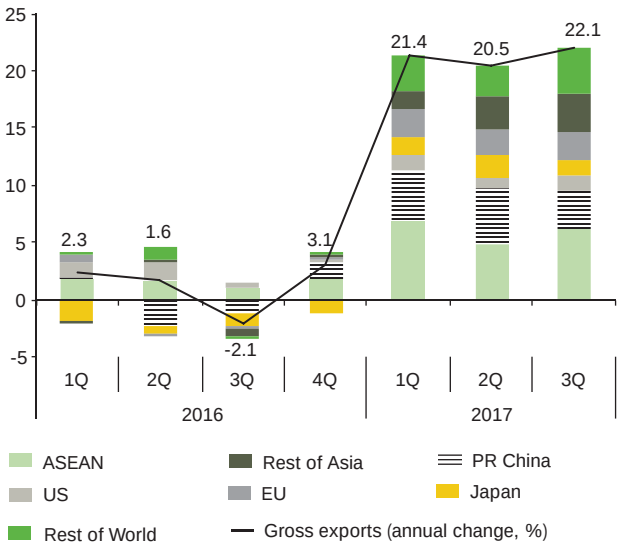


Source: Department of Statistics, Malaysia

Export growth was also broad-based across markets

Chart 13: Gross Exports by Markets

Annual change (%), Contribution to growth (percentage points)

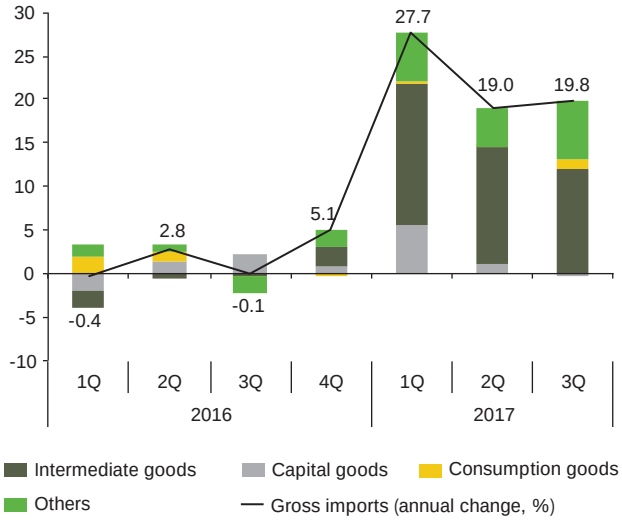


Source: Department of Statistics, Malaysia

Strong imports, particularly in intermediate and imports for re-exports

Chart 14: Gross Imports by Products

Annual change (%), Contributionto growth (percentage points)



Source: Department of Statistics, Malaysia

Resource-based manufactured exports also expanded faster, driven mainly by stronger exports of petroleum products to the region. Growth of non-resource based manufactured exports accelerated, largely on account of higher exports of metals and machinery and equipment. Commodity exports moderated due mainly to slower growth in CPO output and a contraction in crude petroleum production.

Gross import growth remained strong (3Q 2017: 19.8%; 2Q 2017: 19.0%), on account of continued strength in intermediate imports and higher growth in imports of consumption and goods for re-exports. This was in line with strong manufacturing export performance and continued strength in domestic demand. Growth in capital imports was flat reflecting mainly a high base effect arising from the delivery of a large liquefied natural gas vessel in July 2016. Excluding this delivery, capital imports expanded at a faster pace, in tandem with higher investment activity in the manufacturing and services sectors.

Current account surplus widened

The current account surplus widened to RM12.5 billion in the third quarter of 2017 (2Q 2017: RM9.6 billion) accounting for 3.7% of GNI (2Q 2017: 3.0% of GNI). This was due primarily to a larger goods surplus which offset the higher deficits in the income accounts and sustained deficit in the services account.

The goods surplus widened to RM31.7 billion[2] in 3Q 2017 (2Q 2017: RM27.0 billion), as exports grew at a faster pace, while intermediate and capital imports moderated from the second quarter of 2017. The deficit in the services account was broadly sustained at RM4.9 billion (2Q 2017: -RM5.0 billion). The travel account registered a bigger surplus of RM9.2 billion, supported by higher tourist arrivals and spending amid major sporting events held during the quarter. This improvement was partly offset by a larger deficit in construction services (3Q 2017: -RM3.3 billion; 2Q 2017: -RM2.4 billion), reflecting mainly lower receipts due to the near completion of construction projects in Qatar and India.

The higher deficit in the primary income account in 3Q 2017 (-RM8.6 billion; 2Q 2017: -RM8.2 billion) was largely attributable to lower income generated by Malaysian firms investing abroad (RM11.4 billion; 2Q 2017: RM12.4 billion). Income earned by foreign investors in Malaysia remained sizeable (-RM18.9 billion; 2Q 2017: -RM19.4 billion).

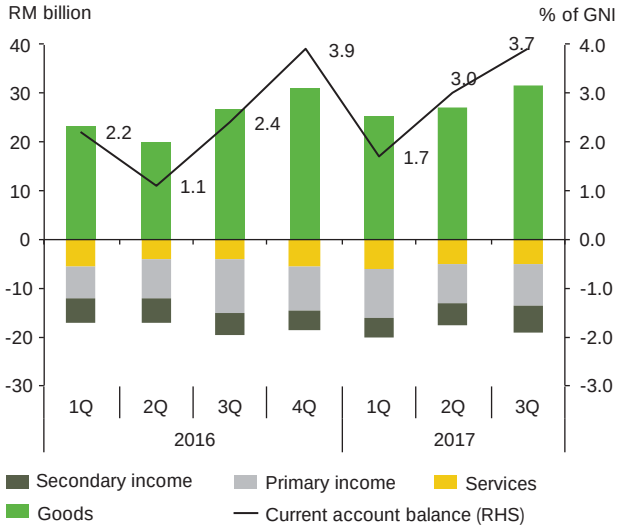
The deficit in the secondary income account was larger at RM5.7 billion (2Q 2017: -RM4.2 billion). Outward remittances amounted to RM9.5 billion (2Q 2017: -RM8.7 billion) driven by foreign worker remittances while inward remittances were lower (RM3.8 billion; 2Q 2017: RM4.4 billion).

Financial account recorded net outflows

In the third quarter of 2017, the financial account registered a net outflow of RM1.2 billion (2Q 2017: net inflow of RM7.3 billion), as higher inflows of long-term foreign direct investments (FDI) and sustained foreign inflows into domestic portfolio assets were offset by portfolio investments abroad by residents and outflows arising from banks' liquidity and treasury management operations.

Higher current account surplus

Chart 15: Current account balance

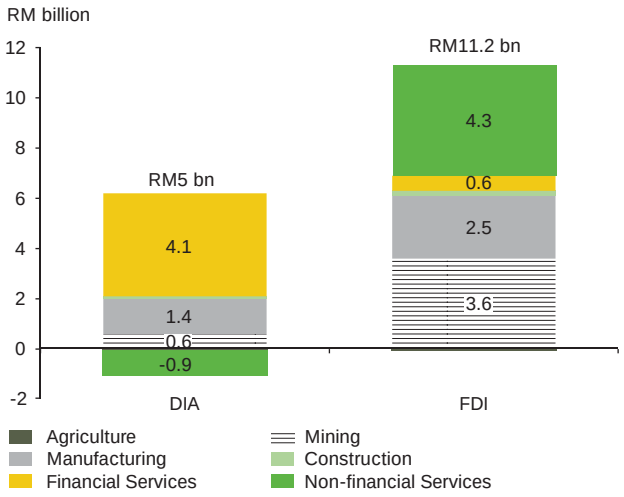


Source: Department of Statistics, Malaysia

[2] The difference between the goods surplus and trade surplus may arise from the exclusion of goods for processing, storage and distribution in the goods accounts as per the 6th Edition of the Balance of Payments and International Investment Position Manual (BPM6) by the IMF.

DIA channeled mainly into financial services sub-sector while FDI was broad-based across sectors

Chart 16: Net Direct Investment Flows by Sector

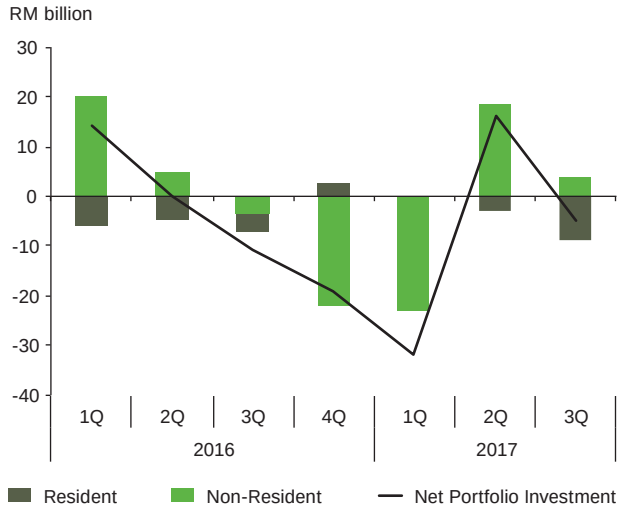


Note: For DIA, positive values refer to net outflows while negative values refer to net inflows

Source: Department of Statistics, Malaysia

Net outfows in portfolio investment account contributed by residents

Chart 17: Portfolio Investments by Residency



Source: Department of Statistics, Malaysia

The direct investment account turned around to register a net inflow of RM6.2 billion (2Q 2017: net outflow of RM7.1 billion), as FDI inflows more than offset outflows of direct investments abroad (DIA) during the quarter. FDI increased to RM11.2 billion (2Q 2017: net inflow of RM8.3 billion), due mainly to higher injections of equity capital and reinvestment of earnings from parent companies. FDI inflows were channeled mainly into the *real estate activities* sub-sector, followed by the *mining* and *manufacturing* sectors. DIA by Malaysian companies declined to RM5 billion (2Q 2017: net outflow of RM15.4 billion), on account of lower capital injections and earnings retained by subsidiaries abroad for reinvestment. DIA outflows were channeled mainly into the *financial services* sub-sector and the *manufacturing* sector.

The portfolio investment account registered a net outflow of RM5.1 billion (2Q 2017: net inflow of RM16 billion). Portfolio investments by non-residents recorded a net inflow of RM3.7 billion (2Q 2017: net inflow of RM18.8 billion). Sustained strong export growth and better-than-expected economic performance continued to attract foreign investors into the domestic financial markets. However, these inflows were partially offset by maturities of Malaysian Government Securities (MGS) and Government Investment Issues (GII) during the quarter. Resident portfolio investments registered a higher net outflow of RM8.8 billion (2Q 2017: net outflow of RM2.8 billion), due to the continued investments in both equity and debt securities abroad by domestic fund managers and financial institutions.

The other investment account recorded larger net outflows of RM3.3 billion (2Q 2017: net outflow of RM1.3 billion), due mainly to the maturity of currency and deposits placed by foreign financial institutions in the domestic banking system.

Following these developments, the overall balance of payments registered a surplus of RM2.9 billion in the third quarter (2Q 2017: a surplus of RM2.7 billion). Errors and omissions, which includes the revaluation changes on reserves, amounted to -RM8.5 billion or -1.9% of total trade.

Manageable external debt

Malaysia's external debt edged lower to RM873.8 billion, equivalent to USD204.7 billion or 65.0% of GDP as at end-September 2017 (end-June 2017: RM877.5 billion or USD202.3 billion). The lower external debt largely reflects the repayment of maturing interbank borrowing and valuation effects following the strengthening of the ringgit against selected major and regional currencies during the third quarter. These more than offset the increase, in particular, in non-resident (NR) holdings of domestic debt securities and deposits, as well as other debt liabilities.

Malaysia's external debt remains manageable given its currency and maturity profiles, as well as the availability of large external assets. More than one-third of total external debt is denominated in ringgit (34.0%), mainly in the form of NR holdings of domestic debt securities and in ringgit deposits in domestic banking institutions. As such, these liabilities are not subjected to valuation changes from the fluctuations in the ringgit exchange rate.

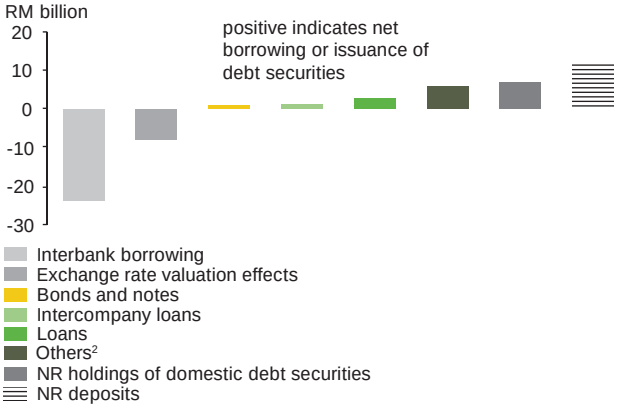
The remaining external debt of RM577.0 billion (66.0%) is denominated in foreign currency (FC) and accounted mostly by banking institutions and corporates (97.1% of total FC borrowings). These are subject to prudential liquidity management practices and hedging requirements. The bulk of these obligations are offshore borrowings, raised mainly to expand productive capacity and to better manage financial resources within corporate groups. As at end-September 2017, the offshore borrowing remained low at 36.8% of GDP compared to 60.0% of GDP during the Asian Financial Crisis.

Of the total FC-denominated external debt (inclusive of valuation effects), more than one-third (or amounting to RM204.7 billion) is accounted by interbank borrowing and FC deposits in the domestic banking system. This largely reflects the banks' intragroup liquidity management and placements of deposits from foreign parent entities, which are subjected to prudent liquidity management practices. Among these are internal limits on funding and maturity mismatches. This is then followed by long-term bonds and notes issued offshore which amounted to RM161.6 billion as at end-September 2017, primarily to finance asset acquisitions abroad that will generate future income. The intercompany loans are typically on flexible and concessionary terms, such as no fixed repayment schedule or low interest rate.

From a maturity perspective, more than half of the total external debt is skewed towards medium- to long-term tenure (56% of total external debt), suggesting limited rollover risks. It is important to note that the progressive liberalisation of foreign exchange administration rules has also resulted in greater decentralisation of the country's international reserves. This is reflected in the increasing acquisition of assets abroad by resident banks and corporates. In particular, banks and corporates hold around three-quarters of Malaysia's external assets (as at end-3Q 2017: RM1.3 trillion), which can also be drawn upon to meet their external debt obligations (as at end-3Q 2017: RM664.5 billion), without creating a claim on international reserves. As at 31 October 2017, international reserves is 1.1 times the short-term external debt and is sufficient to finance 7.6 months of retained imports.

Lower external debt in 3Q 2017

Chart 18: Changes in External Debt
Net Change[1]: -RM3.7 billion

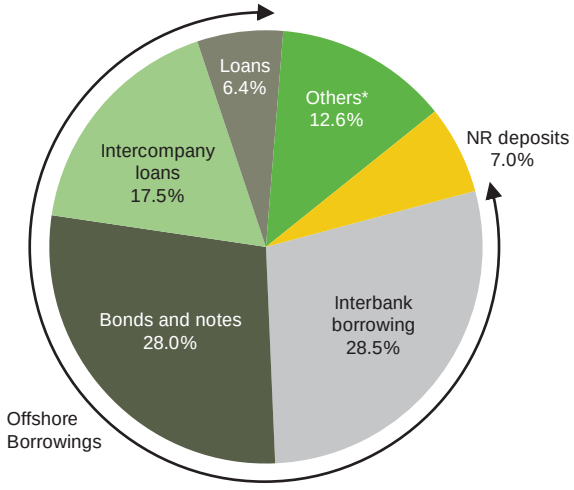


[1]Changes in individual debt instruments exclude exchange rate valuation effects
[2]Comprises trade credits, IMF allocation of SDRs and other debt liabilities
Note: NR refers to non-residents

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

About half of FC-denominated debt subjected to prudent liquidity management practices and flexible terms

Chart 19: Breakdown of Foreign Currency-Denominated External Debt (% of Share)



*Includes trade credits and miscellaneous, such as insurance claims yet to be disbursed and interest payables on bonds and notes

Source: Bank Negara Malaysia

Box Article 1

Rethinking Investment Incentives

Authors: Mohd Shazwan Shuhaimen, Nurul Hana Ahmad Ghazali, Kevin Wong Tho Foo, Loke Po Ling and Sarah Syamimi Mohd Suhaimi

HIGHLIGHTS

- **While FDI was a game-changer in transforming the Malaysian economy in the past, there is mounting evidence that the net benefits have been narrowing in recent periods.**
- **The total cost of incentives used to attract FDI has been significant, and there are indications its effectiveness is waning.**
- **There is room to improve the existing investment incentives framework and landscape such that Malaysia continues to attract quality investments with greater economic spillovers going forward.**

Introduction

Malaysia's longstanding appeal as a preferred destination for foreign direct investment (FDI) has been supported by a conducive investment climate, modern infrastructure and attractive incentives. While these investments have benefited the economy in the past, there is growing evidence to suggest that the net benefits have plateaued in recent years amid substantial costs to attract them in an increasingly competitive environment. The diminishing net benefits, together with a changing global environment necessitates a rethink of the investments that would safeguard Malaysia's future-readiness, and the incentives designed to attract these investments. This article assesses the benefits and costs of FDI and the effectiveness of the current investment incentives framework in attracting investments. The article also discusses potential areas for reforms that would enhance positive economic spillovers from FDI.

Overview of FDI in Malaysia

Investment is a key driver in expanding productive capacity for the sustainable future growth of the economy. In Malaysia, investment activity has grown by almost tenfold over the last 35 years, with foreign affiliates[1] (hereby known as FDI) playing a large role in this achievement. Between 2010 and 2015, FDI accounted for almost 40% of nominal gross fixed capital formation.

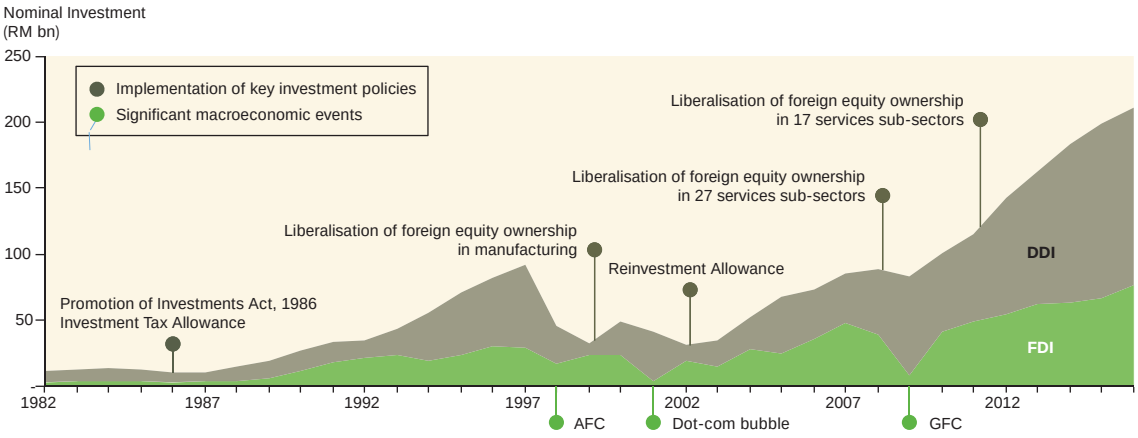
While Malaysia has received FDI since the turn of the 20th century, the rapid industrialisation in the 1970-80s witnessed the influx of multinational corporations (MNCs) particularly in the manufacturing and mining sectors (Chart 1). Shaped by both external developments and domestic policies, such as the liberalisation of foreign equity ownership requirements in the services sector post-2008, FDI has become increasingly broad-based. There is now greater global presence in the services sector, mainly in the finance and insurance, wholesale and retail as well as transportation and communication sub-sectors (Chart 2). The presence of MNCs in the investment landscape reflects Malaysia's appeal as an attractive business destination, underpinned by pro-business policies, an educated workforce, well-developed infrastructure and an array of competitive investment incentives. In fact, Malaysia is one of the main profit centres for FDI in the region, with average returns[2] of 12.9% between 2010 and 2016 (Chart 3).

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[1] A 'foreign affiliate' is defined as an enterprise operating in Malaysia with more than 50% of its equity owned by a foreign company. This concept differs from the Fifth Edition of the Balance of Payments Manual by the International Monetary Fund, which suggests a foreign equity ownership of at least 10% to be defined as FDI.

[2] Returns are measured by FDI investment income (comprising dividends, retained earnings and interest income) over the stock of outstanding FDI. For a detailed discussion on the divergence in the rate of returns between FDI and direct investment abroad by Malaysian corporations (DIA), please refer to the BNM Annual Report 2016 Box Article 'Payoffs from Going Global: Assessing the Returns from Malaysia's Direct Investment Abroad'.

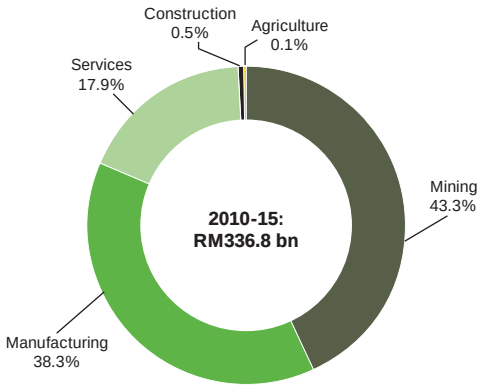
Chart 1: The landscape of investment in Malaysia and policy implementation



Note: DDI refers to investment by domestic private corporations

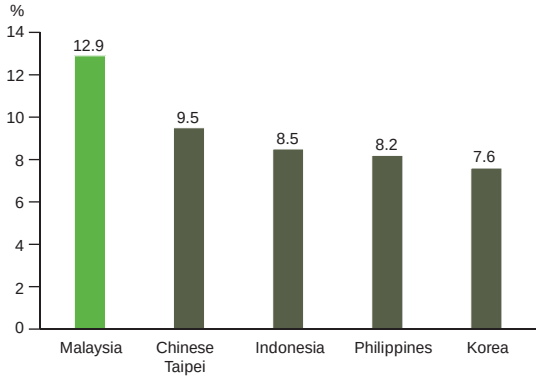
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Chart 2: Gross Fixed Capital Formation of Foreign Affiliates (FDI) by Sector



Source: Department of Statistics, Malaysia

Chart 3: FDI Returns (Average: 2010-2016)



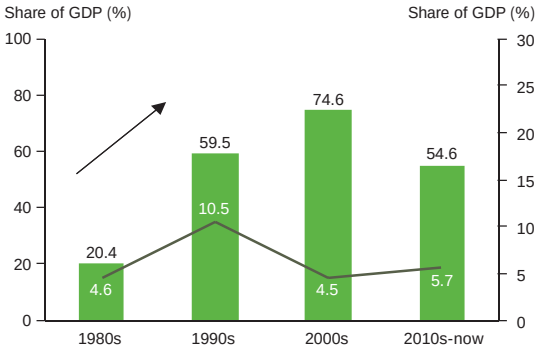
Source: Department of Statistics, Malaysia, Haver Analytics and Bank Negara Malaysia estimates

Assessing the benefits and costs of FDI

The presence of FDI was indeed a game-changer in transforming the Malaysian economy. FDI has been an important catalyst for manufactured exports, job creation and productivity. For example, the increase in FDI to 10.5% of GDP in the 1990s brought a corresponding rise in the share of manufactured exports (Chart 4). In 2015, exports generated by FDI firms amounted to RM290.2 billion or 35.5% of total exports of goods and services during the year. The rise in FDI has also been associated with greater employment opportunities, with FDI firms hiring about 848,000 workers or 5.8% of total employment in 2015 (Chart 5). Value added per worker in FDI firms is about three times higher than the national average (Chart 6).

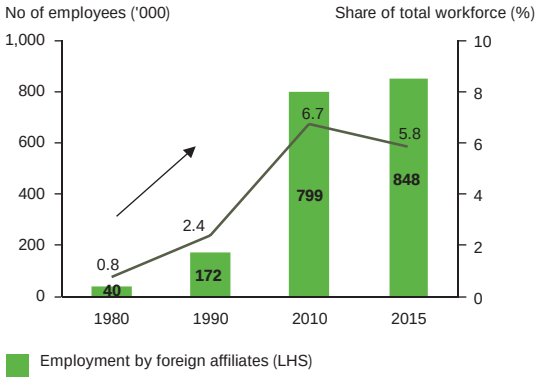
In recent years, however, there is evidence that the net benefits have been narrowing. While FDI has helped create jobs in the economy, the dependency on foreign workers and inputs needs to be addressed. Estimates indicate that among FDI manufacturing firms, as a proportion of total employment, the hiring of locals has declined from 74% share in 2011 to 68% share in 2014 amid greater hiring of low-skilled foreign workers (Chart 7). High dependence on foreign workers erodes the benefits of FDI by substituting employment away from Malaysians and dampening wage growth, particularly affecting low-income earners (bottom 40% or B40 of households). In terms of intermediate input, growth of domestic value added in

Chart 4: Manufactured Exports & FDI



Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

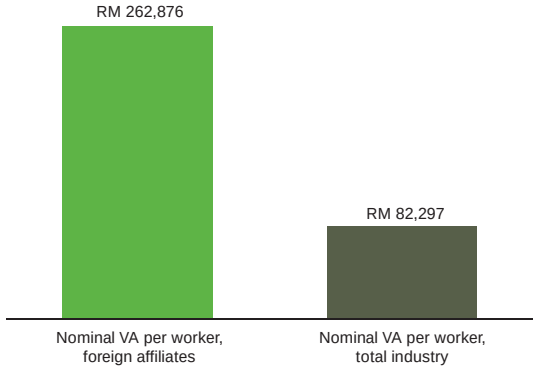
Chart 5: Employment by FDI Firms



Note: Employment by foreign affiliates was proxied for 1980 and 1990.

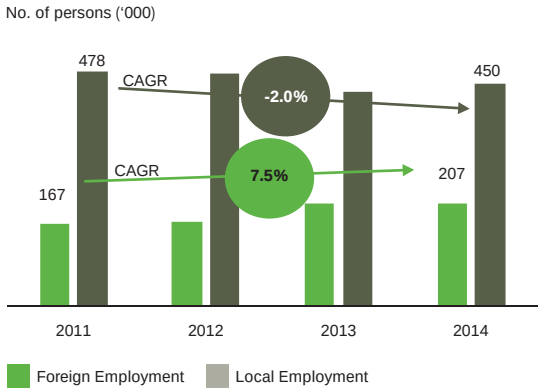
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Chart 6: Labour Productivity: Value Added (VA) per worker (2015)



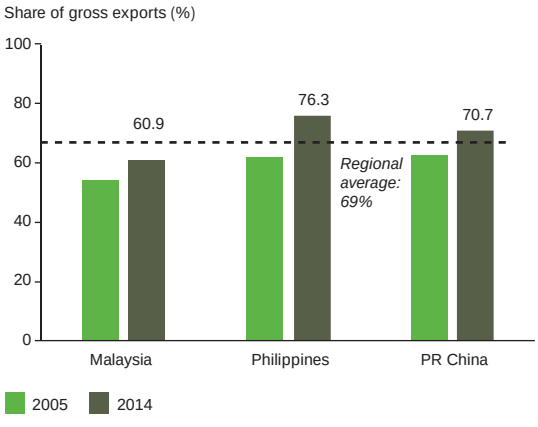
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Chart 7: Employment in Manufacturing FDI Firms



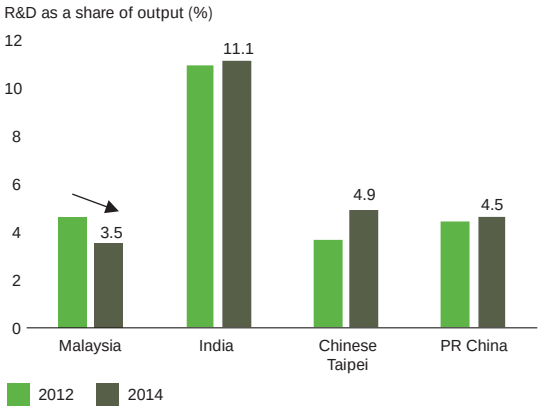
Source: Ministry of Home Affairs and Bank Negara Malaysia estimates

Chart 8: Domestic Content in Gross Exports, 2014 & 2010



Source: OECD

Chart 9: R&D Spending by US FDI Companies



Source: OECD

gross exports has stagnated relative to the regional economies (Chart 8). This indicates continued heavy dependence on imported inputs and foreign services (e.g. logistics), which reflects the slow development of deeper backward linkages and value creation among domestic suppliers and service providers. Further, the prevalence of labour-intensive production methods impedes adoption of technology, such as automation, and hence Malaysia's progress in moving up the production value chain. Technology transfer has plateaued, evidenced by the lower spending on R&D by the US MNCs in Malaysia relative to other countries in the region (Chart 9). The diminishing net benefits can also be observed at the firm level, based on a recent study conducted by the Bank (Refer to Sub-Box: Case Study on Selected MNCs). Therefore, resulting distortions created by the continued heavy reliance on foreign inputs, including wage and price distortions, inhibit the efficient functioning of market mechanisms in the Malaysian economy.

There are also high costs associated with attracting investments. The Government has deployed numerous incentives to attract investments as well as to encourage certain desired economic spillovers and activities. In 2010-2015, FDI made up close to 60% of the value of manufacturing investments that were given incentives. These incentives are mainly in the form of corporate tax exemptions, tax allowances for capital expenditure and financial assistance such as training and R&D grants. As tax exemptions and allowances reduce the corporate tax paid by firms, the cost of such incentives is quantified in terms of tax foregone. Estimated by comparing the gross operating surpluses of corporates against the corporate tax revenue collected in the manufacturing sector, the cost of incentives ranged between RM10-15 billion annually over the past five years. This is equivalent to 0.8-1.3% of GDP or 6.0-8.9% of Government tax revenue.

Foreign firms have also benefitted from the liberal foreign exchange administration policies and prevailing regulations on foreign workers. Non-residents are free to invest in ringgit assets in Malaysia, and are also free to remit divestment proceeds, profits, dividends or any income arising from these investments. The Bank's estimates suggest that up to 60% of dividends declared by FDI firms have been repatriated to their home country and shareholders abroad. The resulting outflows are likely to be even higher if repatriations in other forms are incorporated, such as charges imposed by head office for inter-company lending, royalty payments and outsourcing arrangement fees.

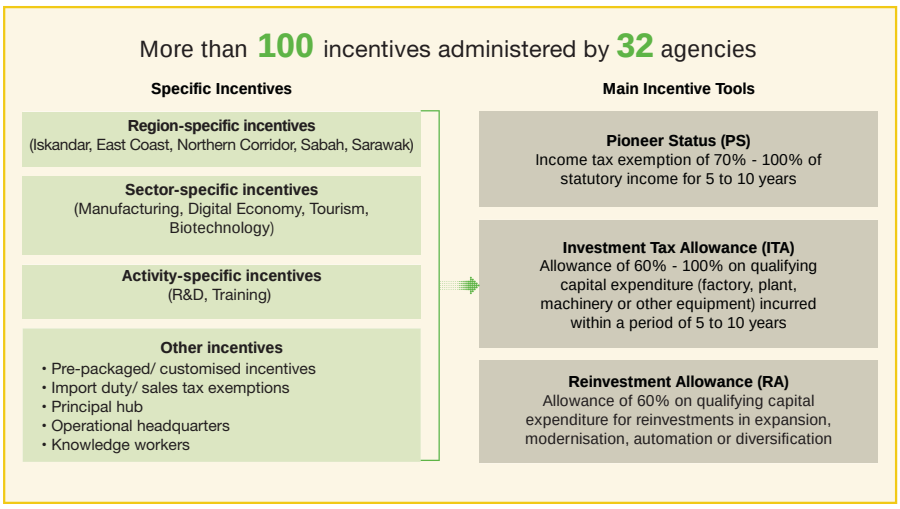
The Bank's estimates also show that MNCs directly employ 7% of all registered foreign workers. While this is a small proportion relative to local firms, it does not take into account the induced hiring of foreign workers by the domestic suppliers and service providers that are supporting these MNCs. As a result, the overall reliance on foreign workers within the manufacturing sector has led to large remittance outflows which have doubled in the past 15 years.

Effectiveness of current incentives landscape

Malaysia presently offers more than 100 different types of incentives to promote investment in the economy. These are disbursed in three main forms: Pioneer Status, Investment Tax Allowance and Reinvestment Allowance. One long-established incentive is the Pioneer Status, which provides corporate tax exemption for selected activities and products as published in a 'promoted list' accompanying the Promotion of Investments Act 1986. The promoted list has since become a guidepost among Investment Promotion Agencies (IPAs) in attracting investments and offering of incentives through the fulfilment of stipulated conditions. However, given its broad scope as well as the fast-changing global environment, in its current form the list risks obsolescence and may not adequately account for new growth areas, evolving business models and activities with higher economic complexity[3].

The fragmented nature of Malaysia's investment promotion landscape is also an area that can be improved. There are presently a total of 32 IPAs operating at the national, regional and state levels, each with their own objectives and criteria in assessing prospective investments, approving incentives and monitoring the results of investments. Recognising these challenges, the Government has reaffirmed the role of the Malaysian Investment Development Authority (MIDA) as the sole agency responsible to manage investments and incentive approvals for the country as a whole. Given its vast expertise, MIDA should be entrusted and emancipated with autonomy and authority in respect of other IPAs, thereby improving coordination and consistency in the investment promotion framework, including the monitoring of economic spillovers from investments.

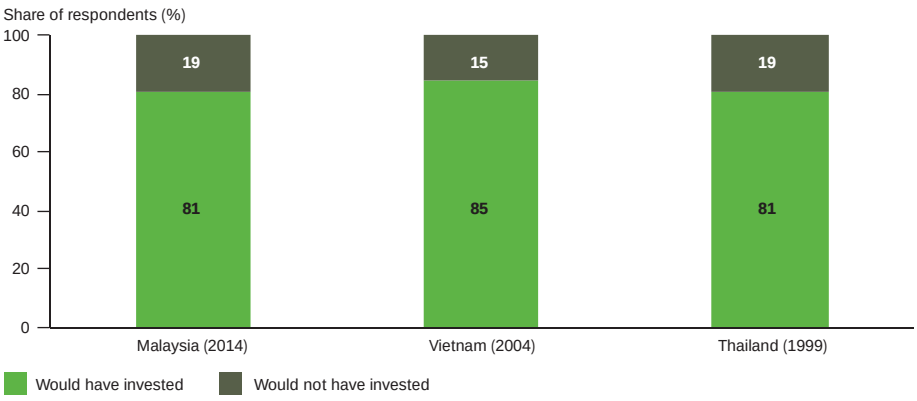
Diagram 1: Fragmentation of Incentives Landscape



Source: MIDA, state, sectoral and regional investment promotion agencies (IPAs), PwC "Doing Business in Malaysia 2017"

At the same time, there is growing evidence to suggest that the effectiveness of the current incentive instruments in attracting FDI may be diminished by growing regional competition and reforms in the international regulatory environment. As countries compete against each to attract FDI, they tend to offer similar incentive packages. This gives MNCs the upper hand in negotiating for even more generous incentives, leading to a 'race to the bottom'. A study by the World Bank has shown that competition for investments through tax-based incentives leads to tax competition and downward pressure on tax rates among regional peers[4]. In a separate study by the World Bank, four out of five firms surveyed in Malaysia indicated they would have still invested even if incentives were not provided. Also referred to as the 'redundancy ratio', the proportion of investments that would have occurred without incentives is similarly high in the regional economies such as Thailand and Vietnam (Chart 10). Nevertheless, the study on Malaysia, which covers about 200 firms, would yield greater insights from wider sampling and more granular firm-level indicators. Furthermore, practical experience suggests that for certain industries, the competition for FDI among countries is fierce and in a number of instances, the attractiveness of incentives offered could be the deciding factor in locating investments. On a wider scale, growing awareness of base erosion and profit shifting (BEPS) places greater international scrutiny on investment incentives, with the objective of discouraging potential harmful tax practices globally.

Chart 10: Redundancy Ratios of Investment Incentives in Selected Asian Economies



Source: The World Bank Facility for Investment Climate Advisory Services

[3] Economic and Product Complexity Indices are as published in "The Atlas of Economic Complexity," Center for International Development at Harvard University, http://www.atlas.cid.harvard.edu . In this article, "higher economic complexity" refers to products with Product Complexity Index higher than Malaysia's 2015 Economic Complexity Index of 1.08.

[4] World Bank, 2015; Klemm and Van Parys, 2012.

Policy considerations on rethinking the investment incentives framework

The highly-dynamic global environment and emergence of global trends such as technological disruptions, rapid urbanisation and climate change necessitate a rethink of the existing investments that would prepare the Malaysian economy for the future. In particular, prospective investments should exhibit desirable characteristics that would raise overall economic complexity, create high-value jobs, deepen linkages within the domestic supply chain and create new industrial clusters. These positive spillovers should be monitored comprehensively and reported on a timely basis.

A principles-based approach would ensure a more nimble and flexible evaluation of such characteristics in prospective investments, compared to a relatively static promoted list. Principles, which may be used to assess the quality of prospective investments include, among others, investments that are 'innovation and productivity driven', generates 'quality employment' and exhibit 'high economic complexity'. In this instance, only investments that adhere to these principles would be considered for incentives. The incentives should also be time-bound and tied to performance- and outcome-based indicators, such as R&D and technological intensity, creation of skilled jobs and ranking on the Product Complexity Index (see footnote 3).

In this regard, MIDA has implemented a new cost-benefit analysis (CBA) module in the evaluation of prospective manufacturing projects. The new CBA module is more holistic as it takes into account both the quantitative and qualitative cost and benefit aspects of the investment proposal and is benchmarked against international best practices. This provides for a more comprehensive and realistic assessment of the investment's intended benefit to the economy, thereby enhancing the incentives evaluation process to become more effective and performance-driven. MIDA is also in the process of designing a new generation of the promoted list. The new list would align promotional efforts of IPAs to attract investments in new and emerging economic activities, encourage an ecosystem approach by developing the supply chain and supporting clusters within each industry as well as provide greater clarity among investors.

There is further scope to review the type of instruments through which incentives are disbursed to ensure that benefits from investments materialise. A recent study by the World Bank states that incentives which lower the cost of investment (such as capital allowances) are less prone to profit shifting strategies as they are not contingent upon profitability[5], as compared to profit-based incentives (such as corporate income tax exemptions). At the same time, incentive instruments should also cater towards changing investor preferences, beyond tax considerations. Pivoting away from tax-based instruments, existing incentives may be complemented with lower personal income tax for highly-skilled knowledge workers, higher R&D and automation grants, and greater access to technology parks and co-working spaces.

Regardless, investment incentives should complement and should not detract from the importance of ensuring that the fundamental investment climate in Malaysia is attractive to quality investments. A conducive investment ecosystem includes elements beyond investment incentives. These include having world-class infrastructure and connectivity, efficient public service delivery and a dynamic education system which would produce a skilled workforce that is capable of undertaking high value-added activities.

Conclusion

A holistic review of the investment promotion strategy, instruments and landscape is critical in attracting quality investments going forward. More targeted, relevant and effective incentive instruments would ensure that the desired investments are attracted to Malaysia and that positive economic spillovers from these investments are maximised. It should be acknowledged, however, that investment incentives are one part of the investment landscape, and the review of incentives should be complemented with the enhancement of business enablers, such as infrastructure, public service delivery and talent. With all these in place, it is envisaged that Malaysia would stand the best chance to become a future-ready economy, and maximise the intended benefits for all Malaysians.

[5] World Bank, 2017.

Sub-Box: Case Study on Selected MNCs

Author: Loke Po Ling, Sarah Syamimi Mohd Suhaimi

Bank Negara Malaysia conducted a study on a sample of six MNCs in the E&E industry, which are also recipients of investment incentives, to assess their contributions to the domestic economy. These MNCs are among the largest manufacturers in Malaysia, with a combined revenue averaging RM63 billion per annum (9.7% of total manufacturing sales)[6]. The study shows that while these investments have generated benefits on an aggregate basis, the extent of positive spillovers have been offset by leakages at various stages of production. These leakages include the use of imported inputs, employment of foreign labour and tax foregone. The following are the key findings from the study:

1. **On an aggregate basis, the MNCs contributed positively to the domestic economy.** In the period 2013-2015, the six MNCs invested RM1.2 billion per year and generated average annual exports of RM46 billion (6.1% of total gross exports). After taking into account gross imports, these MNCs registered a trade surplus of RM16.5 billion (USD4.8 billion). These MNCs employed around 48,000 Malaysians, with a total wage bill of RM3.3 billion per year. They also collectively engaged with about 5,700 local suppliers, resulting in an overall spending on domestic inputs and services amounting to RM13.3 billion per annum.

2. **However, these positive spillovers have been offset by leakages and the degree of net benefits varies across firms.** Despite significant contributions to the gross exports of the country, spillovers generated by the sample MNCs to the domestic economy are limited by their high dependence on imported inputs and foreign services, which averages RM40 billion per annum. Consequently, net conversion of foreign currency into ringgit arising from trade only accounts for 36% of trade surplus at RM6.0 billion (USD1.75 billion). In addition, some of these MNCs register much lower net conversion of foreign currency into ringgit than the industry average[7].

3. While some firms have transitioned towards higher value added activity, **many continued to focus on low-cost business models with limited innovation capabilities.**
   - The six MNCs directly employ about 12,000 foreign workers, representing 20% of their total workforce, resulting in remittance outflows of RM0.8 billion[8] per year. Among the assembly operators, the share of foreign workers was as high as 48% of their workforce.
   - Jobs that are skewed towards the low-paying, lower-skill categories comprises 37% of total workforce. Among the assembly operators, this category could be as high as 60% share.
   - R&D intensity[9] is also relatively low, with most firms spending less than 2% of their revenue on R&D activity. Only one firm reported an R&D intensity of above 30%.

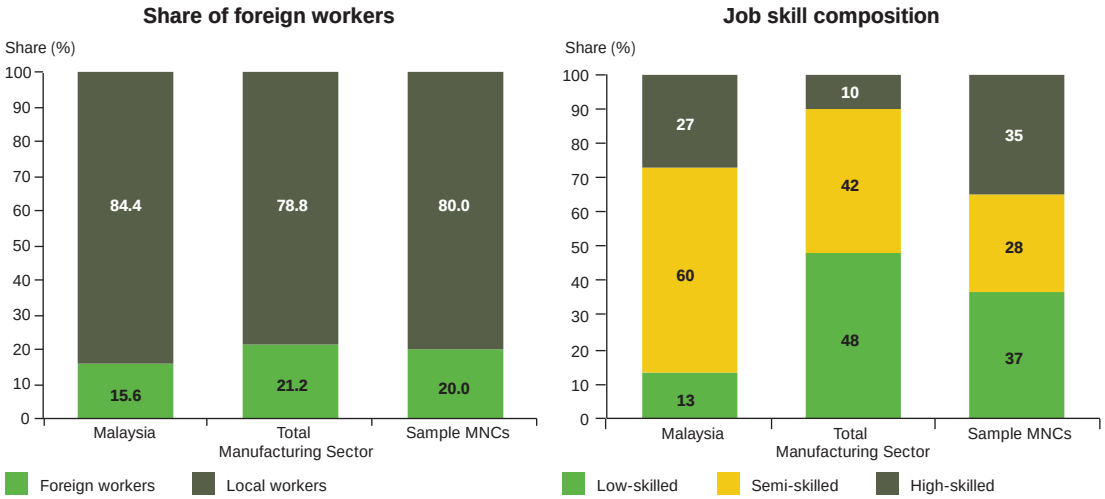
4. **The cost of investment incentives provided to the surveyed MNCs, in the form of tax foregone, is sizeable at an average of RM0.6 billion per annum.** This is equivalent to about 0.4% of Government tax revenue. Due to the incentives, these MNCs enjoy an average effective tax rate of 7.4%, significantly lower than the national corporate tax rate of 25% in 2015. This does not include other fiscal costs in the form of customs and duty exemptions, as well as subsidised rates for domestic resources[10].

It is important to note that while these findings should not be generalised to represent the E&E industry as whole, evidence does suggest that for some firms, the intended benefits are not commensurate with the associated leakages.

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[6] Data is based on 3-year average (2013-2015) to take into account data availability for all firms at the time of the survey.
[7] Refers to net foreign currency flows over net exports. The average net conversion for a group of 184 E&E companies is 56% of trade surplus.
[8] Upper limit based on assumptions that 20% of wages accrue to foreign workers, in line with proportion of employment, and that wages are fully repatriated.
[9] R&D intensity is estimated using R&D spending as a proportion of value added. As a global benchmark, R&D intensity among electronics manufacturers is 25%-35% (McKinsey, 2012).
[10] Subsidised domestic resources include electricity tariff, basic food necessities and transportation. Since May 1997, the Government, through PETRONAS, subsidised a cumulative amount of RM241.4 billion in terms of revenue foregone from the supply of gas to Peninsular Malaysia's power and non-power sectors (PETRONAS, 2016).

Chart 11: Composition of Employment in Surveyed MNCs



Source: Annual Manufacturing Survey (2015) Department of Statistics, Malaysia and firm-level survey

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Box Article 2

Imbalances in the Property Market

Authors: Cheah Su Ling, Stefanie Almeida, Muhamad Shukri, Lim Le Sze

HIGHLIGHTS

- **Supply-demand imbalances in the property market have increased since 2015.**
- **Unsold residential properties are at a decade-high, with the majority of unsold units being in the above RM250,000 price category.**
- **The oversupply of office space and shopping complexes in the major states will be exacerbated by incoming supply, potentially becoming more severe than during the Asian Financial Crisis.**

Introduction: Property market imbalances have increased

In Bank Negara Malaysia's 2015 Annual Report[1], the risks of property market imbalances in Malaysia were highlighted. Since then, the supply-demand imbalances in the residential and commercial property segments have increased. This article is aimed at providing an update on recent developments and to highlight existing and potential actions that may be taken to mitigate the risks.

Residential Market: Total unsold residential properties currently stand at a decade-high, primarily on account of the mismatch between the prices of new housing launches and what the households can afford to pay

In 1Q 2017, total unsold[2] residential properties stood at 130,690[3] units, the highest in a decade (Chart 1). This is close to double the historical average of 72,239 units per year between 2004 and 2016. About 83% of the total unsold units were in the above RM250,000 price category (Chart 2). 61% of total unsold units were high-rise properties, out of which 89% were priced above RM250,000. Johor has the largest share of unsold residential units (27% of total unsold properties in Malaysia), followed by Selangor (21%), Kuala Lumpur (14%) and Penang (8%).

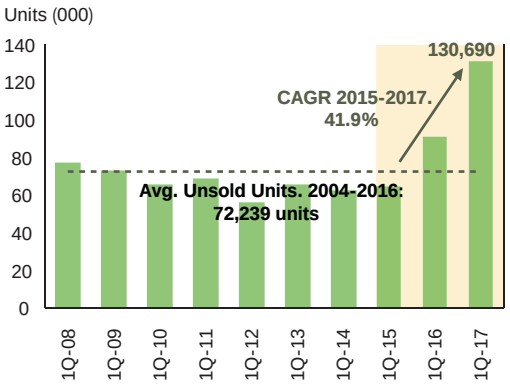
The large number of unsold properties is due to the mismatch between the prices of new launches and households' affordability[4]. Over the period 2016 to 1Q 2017, only 21% of new launches were for houses priced below RM250,000. This is insufficient to match the income affordability profile of about 35% of households in Malaysia (Chart 3). Secondly, the mismatch was exacerbated by the slower increase in median household incomes (CAGR 2012-2016: 9.6%) relative to median house prices (15.6%). These factors have resulted in median house prices in Malaysia being 5.0 times annual median household income in 2016, rendering house prices "seriously unaffordable"[5] in Malaysia. The housing affordability issue is even more acute in certain states, with house prices being "severely unaffordable" in Sabah and Penang (median multiple of 5.5). Such a wide disparity between the supply and demand of affordable homes has worsened the imbalances in the housing market.

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[1] Bank Negara Malaysia 2015 Annual Report box article "Assessing Demand-Supply Conditions in the Malaysian Property Market".
[2] Total unsold residential properties include unsold properties that have been completed (overhang) and unsold properties currently under construction (Source: National Property Information Centre).
[3] The figure includes small office/home office (SOHO) and serviced apartments (Source: NAPIC).
[4] For a more in-depth discussion on the topic, please refer to the Bank Negara Malaysia 2016 Annual Report box article "Demystifying the Affordable Housing Issue in Malaysia".
[5] Affordability thresholds are based on the Median Multiple approach by Demographia International (2017)

Chart 1: 130,690 unsold residential units, the highest in the decade

Total Unsold* Residential Properties

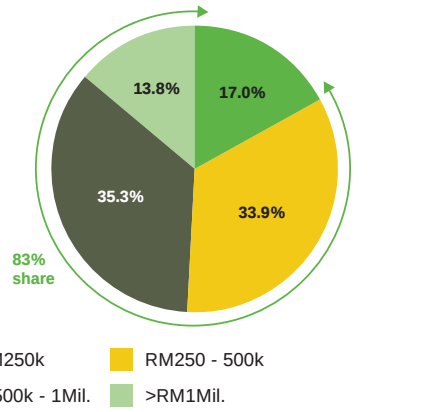


Note: *Includes overhang and unsold residential properties under construction. Includes Small Office/Home Office and serviced apartments

Source: National Property Information Centre

Chart 2: 83% of unsold residential units were in the above RM 250,000 category

Unsold* Residential Properties by Price Categories



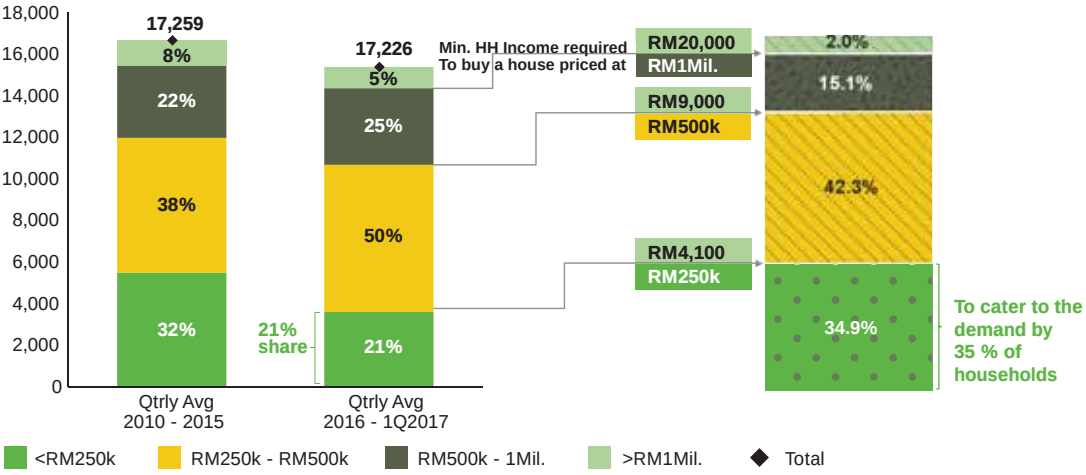
Note: *Includes overhang and unsold properties under construction, as well as Small Office/Home Office (SOHO) and serviced apartments.

Source: National Property Information Centre

Chart 3: 21% of new launches are for units priced below RM250,000. This is insufficient to cater to the demand by 35% of households

New residential launches by price category

Percentage of households and minimum gross household income required to purchase houses in the respective price segments



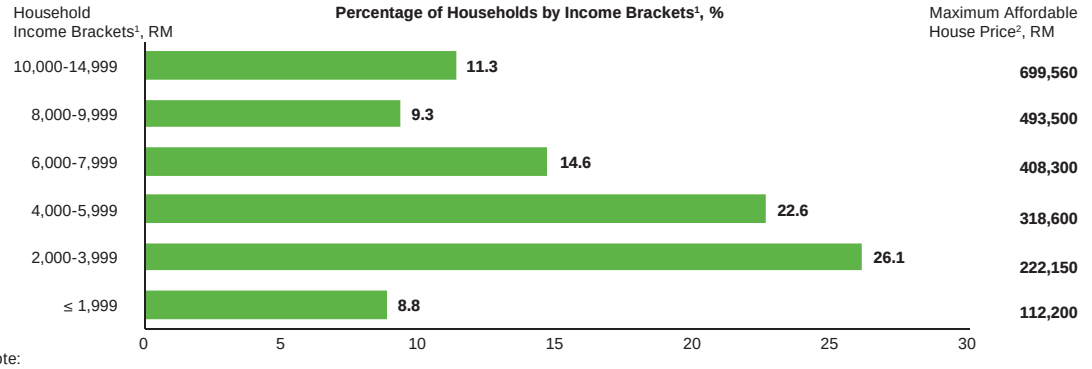
Note:
1. The above assumes households will purchase a house at the maximum price given their income levels.
2 Derived using the Housing Cost Burden Approach, in which a house is deemed affordable if the monthly housing repayment cost do not exceed 30% of household income. Estimates are based on prevailing interest rates and 35 year mortgage tenure.
3. Based on the 2016 Household Income and Expenditure Survey (HIES). Estimates for households earning above RM9,000 and RM20,000 are based on the HIES (2014), due to the lack of granular data at the point of analysis.
4. Data on new residential launches presented above uses final figures up to 1Q 2017. 2Q 2017 figures have not been included as they are preliminary, hence subject to revision.

Source: National Property Information Centre, Department of Statistics, Malaysia, Bank Negara Malaysia estimates

There are unsold residential units within the affordable price range of below RM250,000 (17% share). Several factors hamper the take-up of these properties. Firstly, this reflects the unattractive location of some affordable housing projects due to factors such as distance from work places and low transport connectivity. Secondly, the unsold affordable homes may reflect households' preference towards landed properties over high-rise properties. Thirdly, applicant registries maintained by providers of affordable housing may comprise many non-creditworthy[6] applicants, resulting in delays in the allocation of affordable homes.

[6] Applicants who do not have the financial means to even buy an affordable home.

Information Box: Housing Affordability by Income Levels



Note:
1 Based on the Household Income and Basic Amenities Survey Report 2016. Households earning RM15,000 and above account for 7.1% of total Malaysian households.
2 Estimates of maximum affordable house price is derived based on the upper-end of each income bracket, using the Housing Cost Burden Approach, in which a house is deemed affordable if the monthly housing repayment cost do not exceed 30% of household income. Estimates are based on prevailing interest rates and 35 year mortgage tenure.

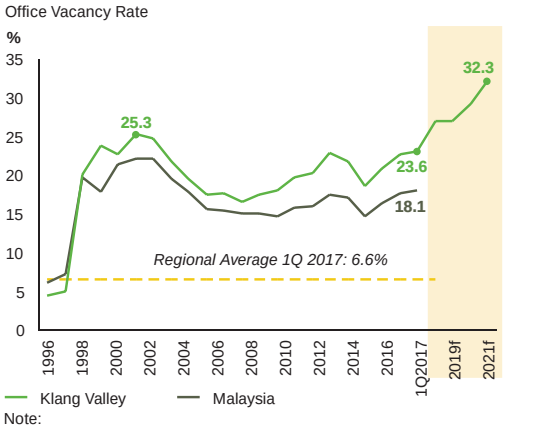
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Office Space: Incoming supply could exacerbate the glut in the Klang Valley

Since 1Q 2015, the office vacancy rate in the Klang Valley has increased steadily from 20.9% to 23.6% in 1Q 2017. This is higher than the national average of 18.1%, and more than three times the regional average of 6.6%[7] (Chart 4).

The incoming supply of 38 million square feet (msf) of office space could exacerbate the glut. The office vacancy rate is projected to reach an all-time high of 32%[8] by 2021, far surpassing levels[9] recorded during the Asian Financial Crisis. In other words, if current supply-demand dynamics persist, 1-in-3 offices in Klang Valley could be vacant in 2021. Total incoming supply could potentially be higher if future phases of the ongoing large development projects[10] are taken into account. This may result in further downward pressure on office rentals, which are already the lowest[11] in the region.

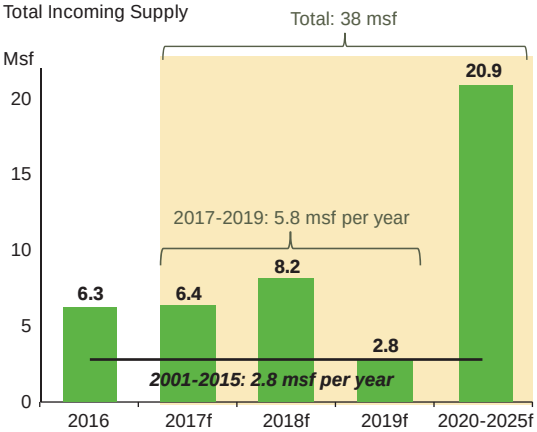
Chart 4: About 1-in-3 offices in Klang Valley projected to be vacant by 2021



Note:
1 Shaded area represents estimates of office vacancy rates going forward. For projects in the planning stage, new supply is assumed to enter the market by 2020 (45%) and 2021 (55%).
2 Regional average refers to the simple average for Hong Kong SAR, Beijing, Singapore, Shanghai, Seoul and Bangkok in 1Q 2017

Source: National Property Information Centre, Jones Lang Wootton, Jones Lang LaSalle and Bank Negara Malaysia estimates

Chart 5: Annual incoming supply from 2017-2019 to more than double the past 15 years



Note:
1 Shaded area represents estimates of incoming supply going forward. For projects in the planning stage, new supply is assumed to enter the market by 2020 (45%) and 2021 (55%).

Source: National Property Information Centre, Jones Lang Wootton and Bank Negara Malaysia estimates

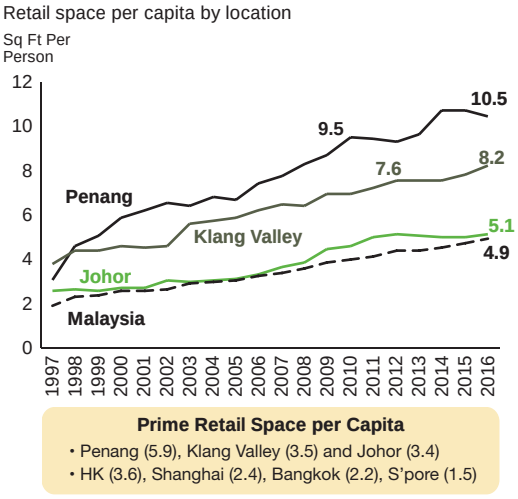
[7] Refers to prime office buildings. Corresponding vacancy rate is 22.6% in 1Q 2017 in the Klang Valley (Source: JLW).
[8] Projections assume all 38 msf of new supply enter the market by 2021, new demand of 2.6msf per year and GDP growth of 5.0-5.5%. Projections for new demand of office space are consistent with similar periods of economic growth during 2004-2016.
[9] Vacancy rate of 5.1% (1997), 20.1% (1998) and historical peak of 25.3% (2001).
[10] Tun Razak Exchange and Bukit Bintang City Centre.
[11] Monthly rents of prime offices in Kuala Lumpur (RM5.30 psf) are lower compared to Manila (RM7.40), Bangkok (RM11.10), Singapore (RM24.80) and Hong Kong (RM 85.00) (Source: Knight Frank Research).

Shopping Complexes: Large incoming supply to aggravate the oversupply across Klang Valley, Penang and Johor

Total retail space in the major states has increased sharply over the years. In 2016, Penang had the highest retail space per capita in the country (10.5 sq ft per person), followed by Klang Valley (8.2) and Johor (5.1). In higher-income regional cities such as Hong Kong SAR and Singapore, prime retail space per capita is only 3.6 and 1.5 respectively (Chart 6).

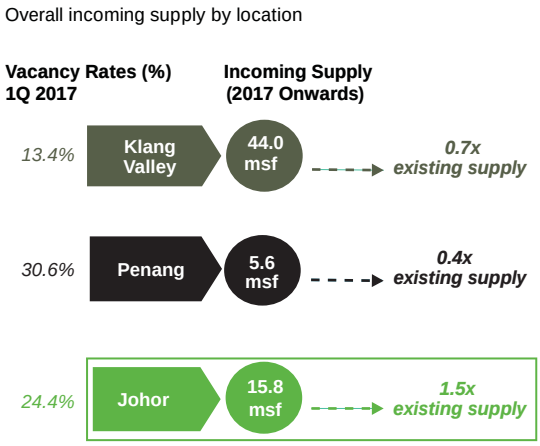
The incoming supply of 140 new shopping complexes by 2021 across the Klang Valley, Penang and Johor is expected to worsen the oversupply going forward (Chart 7). While Penang currently has the highest prime retail space per capita, it will be overtaken by Johor by 2018. The large incoming supply of 15.8 million square feet of retail space in Johor will be 1.5 times the existing supply.

Chart 6: Retail space per capita in key Malaysian states has increased sharply over the years, and is considerably higher than regional peers



Source: National Property Information Centre, Department of Statistics, Malaysia, Savills Research and Bank Negara Malaysia Estimates

Chart 7: Incoming supply of 140 shopping complexes in Klang Valley, Penang and Johor to worsen the oversupply situation going forward



Note: msf – million square feet

Source: National Property Information Centre, Jones Lang Wootton and Bank Negara Malaysia Estimates

Severe property market imbalances can pose risks to macroeconomic and financial stability

History has shown that excesses in the property market can pose risks to the wider economy. According to the IMF (2003), historically, housing booms have been followed by busts about 40% of the time, with housing busts being associated with longer economic downturns and larger output losses[12] compared to equity price busts. Given that there are imbalances in both the residential and commercial property markets in Malaysia, this is a source of concern as the property sector has linkages to more than 120 industries, collectively accounting for 10% of GDP and employing 1.4 million Malaysians.

Malaysia's own experience during the Asian Financial Crisis demonstrated that sharp corrections in the property market can have severe repercussions on the wider economy (Chart 8). In the years leading up to the Asian Financial Crisis, the Malaysian economy experienced a period of strong growth (1992-96: 9.6%). This fuelled exuberance in the property market, resulting in an increase in property prices and overdevelopment across the different property segments. This encouraged an increase in lending by banks to households for the purchase of properties and developers to fund the development of new projects. The ensuing construction frenzy also demanded large amounts of imports, which worsened

[12] On average, output loss following a housing bust was 8% of the level based on average growth rates before the bust (equity price bust: 4%), and lasted about 4 years (equity price bust: 1.5 years).

the current account of the Balance of Payments. When the crisis[13] struck and the property market crashed in 1998, projects were abandoned as developers' debt-servicing capacity weakened. Banks suffered losses as non-performing loans to the property sector doubled, resulting in a credit crunch. Spillovers to other industries then resulted in widespread layoffs and a severe economic recession. A similar story unfolded in Spain, Ireland and the US during the Global Financial Crisis – in these cases, large fiscal stimulus and bailouts had also strained the governments' balance sheets.

Chart 8: A vulnerable property sector poses risks to the economy



Source: Bank Negara Malaysia

The banking system has remained supportive of house financing, while becoming more cautious in the commercial property segment

Banks continue to play an important role in providing financing to house buyers, with more than 70% of all housing loans being given to first-time buyers. In the first nine months of 2017, RM121.6 billion of new housing loans were approved by banks, benefitting close to 300,000 borrowers. Of this, 60% were channelled for the purchase of houses priced below RM500,000.

With respect to the commercial property sector, banks have become more cautious in lending to this segment due to the oversupply situation, as shown by the lower loan approval rates for the construction and purchase of commercial properties. The banks' current exposure to the commercial property segment remains small, accounting for 5.1% of total bank loans.

These developments have reinforced the importance of existing micro- and macro-prudential regulations, such as the broad property sector concentration limit and single customer exposure limit as a means to ensure bank exposures to the overall property sector and individual property-related companies remain within prudent limits. Furthermore, current loan-to-value (LTV) ratio limits[14] also remain relevant to discourage speculative activity that drives up house prices and exacerbates the housing affordability problem. The Bank has also intensified monitoring of the banks' underwriting and credit risk management practices, particularly those related to the commercial property sector. In some instances, banks are required to enhance internal processes to ensure that related risks are effectively mitigated.

Overall, banks are assessed to be able to withstand a slowdown in the property segment as: (i) total loan exposures to segments with acute oversupply (i.e. commercial property and high-end high-rise residential) only account for 8% of total bank lending; and (ii) impaired loans ratio for the commercial property and housing segments remains low and stable at 1.2% and 1.1% respectively. Internal stress test simulations done on large corporate borrowers also indicate that banks' excess capital is sufficient to withstand potential credit losses from exposures to these borrowers, including large property developers.

[13] During the pre-AFC period (1992-96), property-related credit grew by 26%, construction activity by 14.8%, while house prices increased by 11.2%. During the AFC, real GDP contracted by 7.4% in 1998 (1997: 7.3%) with an increase in unemployment rate to 3.2% (1997: 2.5%). Private investment declined by 55.2% (1997:+9.4%), construction activity by 6.7% while fiscal deficit increased to 1.8% of GDP (1997: +2.4%). During the post-AFC period, there were continued weaknesses in house prices (1999-2003: 2.2%), fiscal balance (-4.8% of GDP), unemployment rate (3.4%), private investment (-4.1%) and construction activity (0.7%).

[14] LTV ratio limit of 70% on the third and above housing loans of individuals and 60% on all housing loans of non-individuals.

Policy considerations need to go beyond financial regulatory measures

A multi-faceted approach should be considered to address the imbalances in the property market (Table 1) as the effect of regulatory constraints on lending is limited. This is because developers also fund their projects using internal funds and proceeds from capital market issuances. There is a need for all parties, from the Federal and state governments, to property developers, to act in a concerted manner to manage the imbalances in the property market.

Table 1: Reducing Supply-Demand Imbalances in the Property Market

Issue	Segment	Policy Options	Details
High level of unsold residential properties	All price ranges	Encourage rental market	• Develop a strong rental market by enacting the Residential Tenancy Act and establish a Tenancy Tribunal to safeguard the rights of both tenants and landlords[15]
	Affordable housing	Increase efficiency in provision of affordable homes	• Establish a single entity for affordable housing to accelerate the rebalancing of supply towards the affordable range • Ensure that the development of new projects are in decent locations with good transport connectivity
		Increase efficiency in allocation of affordable homes	• Ensure applicant registries are regularly updated, verified and filtered to prioritise credit worthy households • Direct ineligible applicants to rental housing
Large incoming supply of commercial properties	Office and shopping complexes	Managing new incoming supply	• Commercial viability of any new project must be thoroughly assessed before it is commissioned. • Developers to be cognisant of current and future demand conditions: – Cannibalising effects on tenants and customers (from new malls and offices) – High costs of living – Rising e-commerce market
High vacancy rate and low rental rates in existing buildings		Repurposing vacant commercial buildings	• Vacant commercial spaces in prime locations could be repurposed into economically meaningful assets: – Corporate housing, en-bloc rental accommodation – Art centres – Indoor parks
		Increasing demand for existing space	• Intensify efforts to attract foreign companies to set up businesses and to expand their footprint in Malaysia • Encourage occupancy by start-ups by giving rental rebates

Conclusion

Over the past decade, property-related investments have risen significantly (2016: 25% share of total investments; 2005: 18%). Currently, the property market is characterised by an oversupply of non-affordable housing and idle commercial space, and conversely, an undersupply of affordable homes. This situation could worsen if the current supply-demand conditions persist. Within the country, Johor is poised to have the largest property market imbalances (highest number of unsold residential properties and potentially the largest excess supply of retail space). As such, it is timely for all parties to act now to mitigate any potential risks to macroeconomic and financial stability.

[15] Globally, governments have safeguarded the rights of tenants and landlords by enacting specific legislations such as Tenancy Act (Australia and New Zealand) or have incorporated these qualities into their Federal Law (Germany).

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Monetary and Financial Developments

HIGHLIGHTS

- **The ringgit continued to strengthen during the quarter.**
- **Bond yields remained stable amid steady demand from domestic institutional investors and non-resident inflows.**
- **Lending rates remained stable and supportive of private sector financing.**

The ringgit continued to record gains in the third quarter of 2017

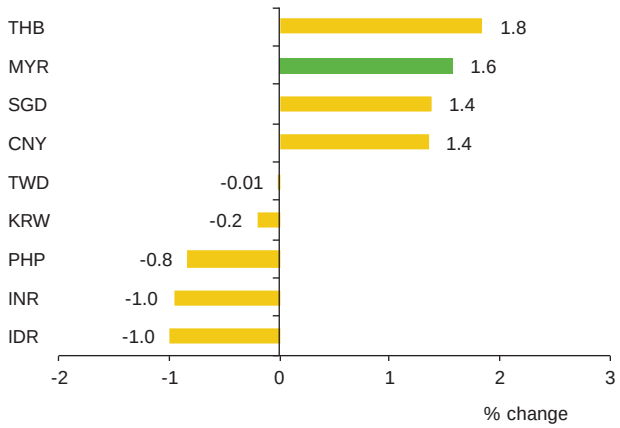
After being the best performer in the region in the second quarter of 2017, the ringgit continued to appreciate against the US dollar and most regional currencies in the third quarter. The ringgit was supported mainly by trade and non-resident portfolio inflows. The positive outlook on the Malaysian economy was driven by the better-than-expected second quarter GDP growth and strong exports performance, which led to increased investor interest in domestic financial assets. Going forward, the ringgit will continue to be driven by a confluence of external and domestic factors. These include the timing and pace of monetary policy normalisation by major central banks, global geopolitical developments, and the domestic economic performance.

Domestic monetary and financial conditions remained supportive of economic activity

Domestic monetary and financial conditions remained supportive of economic activity during the quarter. Bond yields remained stable amid ongoing support from domestic institutional investors. Banking system liquidity remained sufficient to facilitate financial intermediation, while stable retail funding costs continued to support private sector financing.

Mixed regional currencies performance against the US dollar

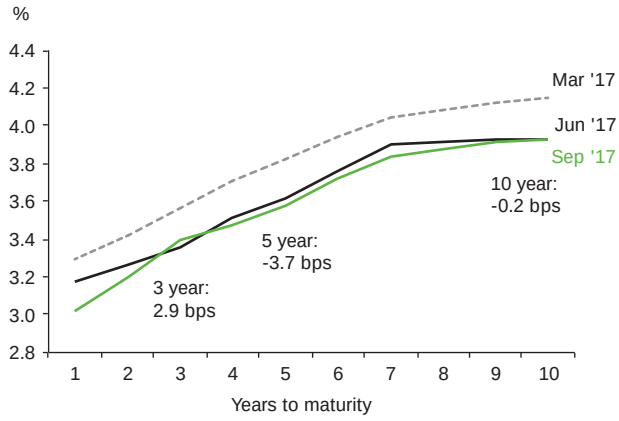
Chart 20: Summary of Performance of Regional Currencies Against the US Dollar in 3Q 2017



Source: Bank Negara Malaysia

Bond yields experienced marginal movements during the third quarter

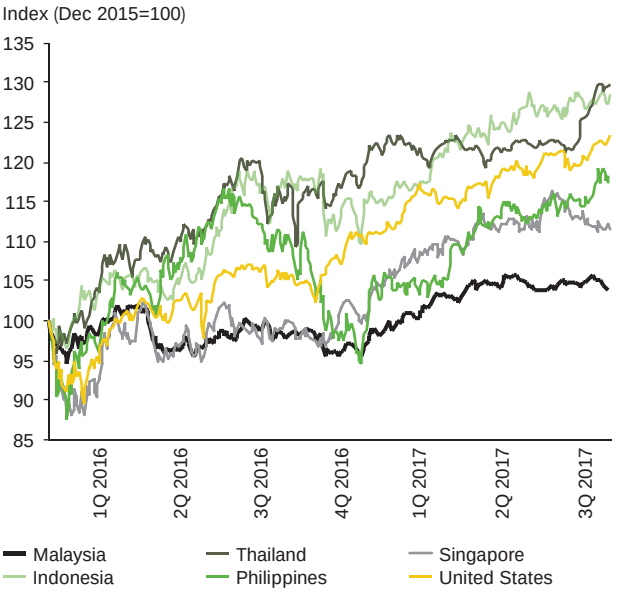
Chart 21: Trend in MGS Yields



Source: Bank Negara Malaysia

Domestic equity market declined during the third quarter

Chart 22: Regional Equity Indices



Source: Bloomberg

Bond yields remained stable amid steady demand from domestic institutional investors and non-resident inflows

Bond yields were stable during the third quarter. Investor sentiments were to a certain extent affected earlier in the quarter by external factors such as global geopolitical developments and uncertainties over the timing of further policy rate increases in the US. However, the bond market and in particular, MGS yields, were supported by strong demand from domestic institutional investors following the better-than-expected second quarter GDP growth and a resumption of non-resident inflows since August. This resulted in marginal movements in 3-year, 5-year and 10-year MGS yields of 3, -4 and 0 basis points, respectively.

The domestic equity market, however, declined amid non-resident outflows

During the third quarter, the FBM KLCI declined by 0.5% to close at 1,755.6 points as at end-September (end-June 2017: 1,763.7 points). The decline was due mainly to net selling activities by foreign investors, particularly towards the end of the quarter, in an environment of relatively low liquidity in the domestic equity market. This was the result of cautious investor sentiments that were driven by external factors, including heightened geopolitical concerns and uncertainties surrounding US monetary policy and political developments.

Interest rates remained stable during the quarter

Both nominal wholesale and retail borrowing costs were broadly stable throughout the quarter. The 3-month KLIBOR was unchanged at 3.43%. In the retail market, the weighted average base rate (BR) of commercial banks was slightly higher at 3.63% (2Q 2017: 3.61%) due to upward revisions by five banks. Consequently, the weighted average lending rate (ALR) on outstanding loans increased slightly to 5.22% towards the end of the third quarter of 2017 (2Q 2017: 5.20%).

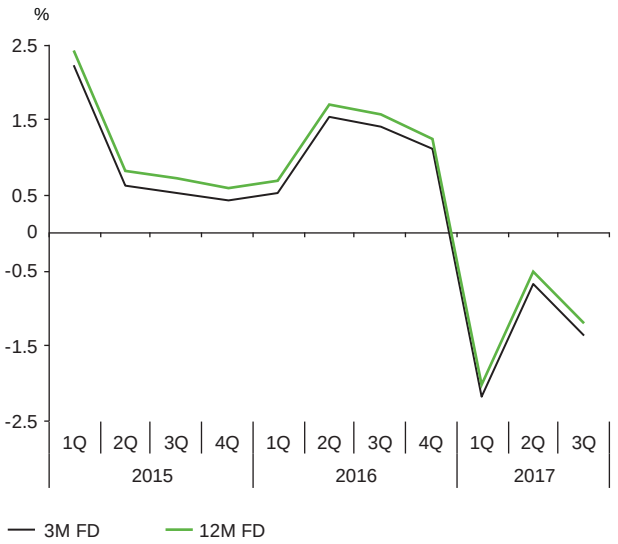
Real fixed deposit (FD) rates remained negative during the quarter. In particular, the real 12-month FD rate declined to -1.20% in September (June 2017: -0.50%) given the relatively higher headline inflation in September.

Liquidity conditions remained sufficient to facilitate financial intermediation

In the banking system, liquidity conditions remained sufficient at both the institutional and system-wide levels. The level of surplus liquidity placed with BNM increased during the quarter due to higher net inflows, which also led to the reduction in liquidity injection operations. At the institutional level, most banks continued to maintain surplus liquidity positions.

Real deposit rates remained negative during the third quarter

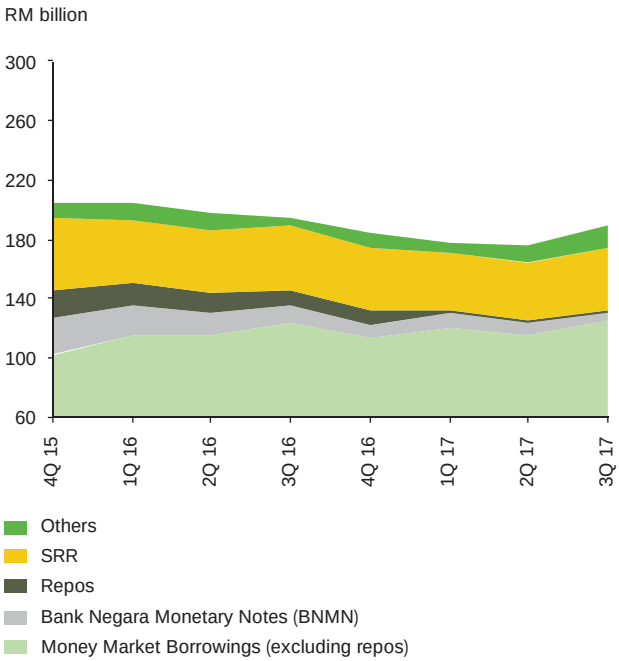
Chart 23: Real FD Rates (by maturity), as at end-period



Source: Bank Negara Malaysia

Outstanding surplus liquidity placed with BNM increased during the third quarter

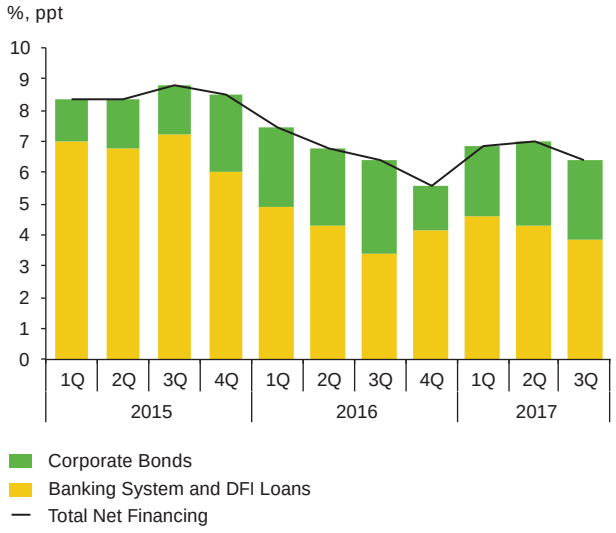
Chart 24: Outstanding Liquidity Placed with Bank Negara Malaysia (At end-period, RM billion)



Source: Bank Negara Malaysia

Moderation in net financing growth was driven by lower growth in outstanding loans and corporate bonds

Chart 25: Contribution to Net Financing* Growth



* Net financing comprises outstanding banking system and DFI loans, and outstanding corporate bonds

Source: Bank Negara Malaysia

Net financing moderated during the quarter

The growth of net financing moderated to 6.4% during the quarter (2Q 2017: 7.0%) due to lower growth for both outstanding loans[3] (3Q 2017: 5.0%; 2Q 2017: 5.6%) and corporate bonds (3Q 2017: 10.9%; 2Q 2017: 11.8%). The lower loan growth was due mainly to the slower growth in outstanding loans of businesses other than SMEs (3Q 2017: 4.0%; 2Q 2017: 6.3%), which partly reflected the higher repayment by a few large firms (3Q 2017: RM115.3 billion; 2Q 2017: RM112.9 billion). Loan growth to SMEs, however, was stable at 7.0% (2Q 2017: 7.0%), with higher loans disbursed during the quarter (3Q 2017: RM76.8 billion; 2Q 2017: RM69.3 billion). Household loans grew at a slightly slower pace of 4.9% during the period (2Q 2017: 5.1%), mainly reflecting the moderation in loans for *passenger cars; personal financing;* and *purchase of non-residential property.*

[3] Loans extended by both banking system and development financial institutions (DFIs)

Box Article 3

Financial Conditions Index for Malaysia

Authors[1]: Zul-Fadzli Abu Bakar and Iman Badrudin

HIGHLIGHTS

- The Financial Conditions Index (FCI) has gained prominence in the last decade among policymakers and market participants due to its ability to summarise the current state of overall financial conditions.
- The estimated FCI for Malaysia can provide useful insights about domestic financial conditions. The latest assessment of the FCI indicates improving financial conditions since 2016.
- Given the highly complex financial environment, no single indicator should be solely relied upon to inform policymakers of financial conditions. However, as a summary indicator, the FCI provides a glimpse into the current state of financial conditions.

As financial systems develop beyond the traditional banking channel to meet the needs of expanding economies, it has become increasingly necessary to have a broader perspective of financial conditions in the conduct of monetary policy. In general, there are two ways in which financial conditions can be used to inform monetary policy. Firstly, while trends in central bank policy rates have tended to be gradual, financial conditions in the last decade have become more volatile. As a result, these frequent changes in financial conditions can influence overall economic conditions even without changes in monetary policy, especially when financial market volatility is large and persistent. Secondly, in the run-up to financial crises, prolonged stretches of economic growth have tended to be accompanied by an underlying increase in leverage and risk-taking. While the longer-term implications to macroeconomic stability may be less apparent during an economic upswing, the subsequent correction could entail extended periods of balance sheet repair and longer periods of subdued inflation (Dudley, 2010). The 2008 Global Financial Crisis is one such example which highlighted the importance of assessing macro-financial linkages between the financial system and the real economy. In recognising the significance of the financial system to overall macroeconomic stability, the Financial Conditions Index (FCI) has gained prominence in the last decade among policymakers, international market analysts and professional forecasters alike for its potential to summarise overall financial conditions in the economy (Figure 1) (Hatzius et al, 2010).

Figure 1: Selected Institutions that Have Developed the FCI



Source: Staff compilation from various literature

[1] The authors would like to thank Teh Tian Huey and Rubin Sivabalan for their significant contribution in developing the FCI for Malaysia.

Formally, the FCI is defined as a statistically-driven composite indicator that aggregates a wide range of financial variables to summarise the current state of domestic financial conditions. This concept is not new. Prior to the construction of the FCI, the Monetary Conditions Index (MCI) – a weighted[2] two-variable aggregator of the exchange rate and a money market interest rate against a base period – was introduced and popularised during the early nineties by the Bank of Canada (Debuque-Gonzales and Gochoco-Bautista, 2013). Back then, the MCI was used by central banks as both an operational target of policy and to signal divergence between actual and desired monetary conditions that could warrant a monetary policy adjustment. The FCI is perceived as a natural extension of the MCI, focusing on a much broader range of financial variables. Such breadth has the advantage of summarising comprehensive variables from different segments of the financial system.

At least two important applications have driven the rapid adoption of the FCI. Firstly, the FCI provides a significant addition to the macro-financial surveillance toolkit; it encapsulates and consolidates information from a broad array of financial variables, and indicates whether overall financial conditions are tightening or loosening relative to a base period. Insofar as these financial variables reflect conditions that enable economic activity, the FCI could provide some information about potential risks to the economy in the near future. Secondly, the FCI provides complementary information that is observable in real-time. These characteristics distinguish it from macroeconomic variables that are either unobservable, such as the output gap and neutral rate, or available with a substantial time lag, such as GDP growth and unemployment (Osario et al, 2011).

Construction of the FCI captures common variation in financial variables

A prominent approach in constructing the FCI is the principal-components analysis, which extracts a common underlying variation in the financial variables[3]. Using this method, each financial variable is assigned a weight based on its relative importance in driving this variation; the more correlated a variable is with the other variables, the higher the weight it receives. The benefits of this approach have been well-documented[4] and include allowing for a wider range of relevant financial indicators to which their respective systemic importance can be identified and interpreted (Debuque-Gonzales and Gochoco-Bautista, 2013; Brave and Butters, 2011).

Figure 2: List of Financial Variables Included in the FCI for Malaysia

List of Variables		Treatment
Banking System	Banking sector credit spread: 3M KLIBOR – 3M Malaysian Treasury Bills (MTB)	Level
	Retail credit spread: Average lending rate – 10Y Malaysian Government Security (MGS)	Level
	Broad money, M3	Log first-difference, seasonally adjusted
Foreign Exchange (FX)	Real effective exchange rate: USDMYR	Log first-difference
	Exchange rate volatility: Intra-month USDMYR standard deviation	Level
	International Reserves	Log first-difference
Bond	Short term yield: 3M MTB	First-difference
	Long term yield: 10Y MGS	First-difference
	Sovereign spread: 10Y MGS – 10Y US Treasury Note	Level
Equity	KLCI Index	Log first-difference
	KLCI volatility: Intra-month KLCI index standard deviation	Level
	Market Capitalisation	Log first-difference

Source: Staff research

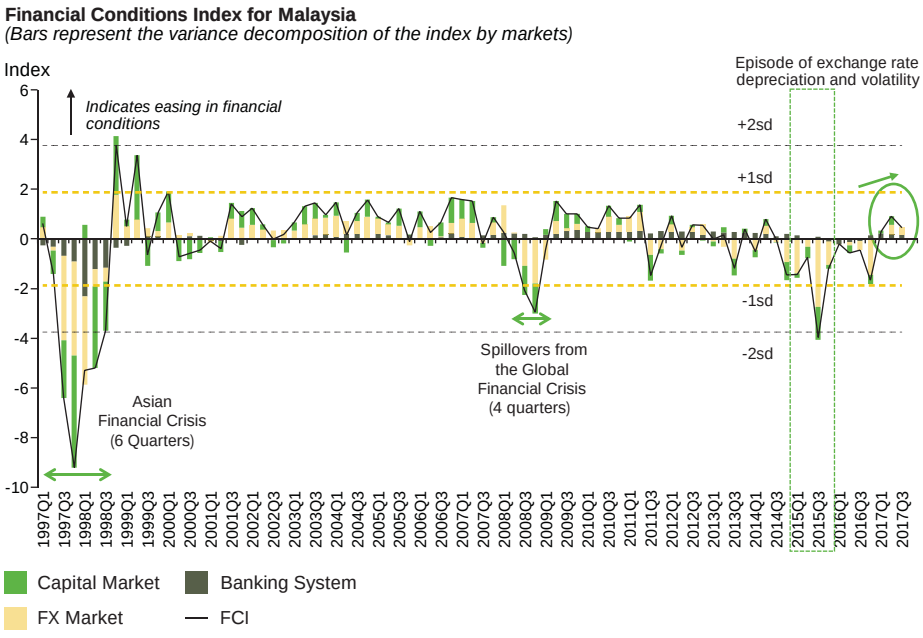
[2] MCI weights are based on the relative effects of the exchange rate and money market interest rate on aggregate demand.
[3] Another popular method in constructing the FCI is the weighted-sum approach. Using this approach, the weights on each financial variable are assigned based on its relative impact of its changes on real GDP (Hatzius et al, 2010).
[4] For a review on the benefits of the principal-component approach, refer to Hatzius et al (2010).

The choice of financial variables to be included in the FCI is also important. Ideally, the variables must be representative of the different components of the financial system. In the construction of the FCI for Malaysia, 12 financial variables are used (Figure 2). The variables satisfy three additional criteria; they are available from 1993 in order to capture the cycle leading to the Asian Financial Crisis (AFC), they cover indicators commonly used in the literature and they do not exhibit counterintuitive trends.

Financial Conditions Index for Malaysia

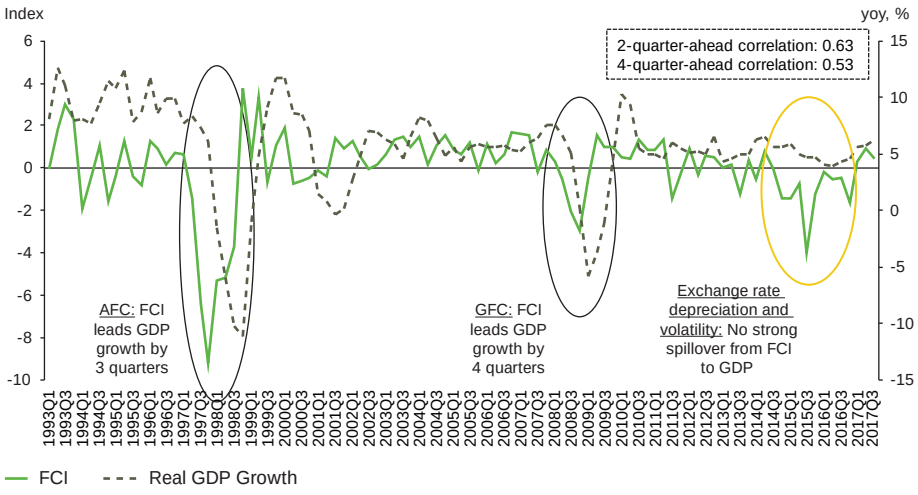
The estimated FCI for Malaysia is comprised of three broad components covering the banking system, capital market and foreign exchange market (Figure 3). This categorisation enables the identification of the time-varying drivers of domestic financial conditions. An increasingly positive index indicates easing in financial conditions while a decreasing index implies potential stresses. For example during the Asian Financial Crisis (AFC), the FCI declined significantly. In this period, the stresses were identified to be widespread across all segments of the financial system. This situation stood in contrast to the Global Financial Crisis (GFC), where shocks emanated mainly from external sources, with limited signs of stress in the banking system. The latest assessment of the FCI at end-September 2017 indicates that financial conditions have eased relative to 2016, reflecting decreased volatility in the foreign exchange and equity markets.

Figure 3: Financial Conditions Index for Malaysia



Source: Staff estimation

Figure 4: Estimated FCI vs Real GDP Growth



Source: Staff estimation

The FCI reflects the overall enabling conditions for future economic activity and therefore suggests that it could provide complementary information about future economic activity (Figure 4). (Debuque-Gonzales and Gochoco-Bautista, 2013; Hatzius et al, 2010). For policymakers, the different drivers of financial conditions revealed by the FCI provide important information when it comes to deciding on appropriate policy responses. The empirical estimation shows that the FCI for Malaysia tends to lead real GDP growth by two to four quarters[5].

However, careful interpretation of the implication of the FCI on future growth is needed as changes in the FCI do not always translate into co-movement with economic activity. In essence, movements in the financial variables driving the FCI are not necessarily rooted in changes due to economic fundamentals. The FCI tightening episode in 2015 is a clear example of external shocks being contained within the domestic financial market without major implications on the real economy. This difference in the pass-through to the real economy is critical, for it underscores the uniqueness that characterises different financial stress periods. In the 2015 example, the absence of a significant global downturn during this period made it possible for the exchange rate depreciation to act as a shock absorber to prevent spillovers to the real economy (BNM Annual Report, 2015). In the same view, the variables in the FCI may also overlook other sources of vulnerabilities.

Additionally, the FCI is not underpinned by a structural model derived from stable underlying economic foundations, and as such, limiting the predictive power of the FCI (Hatzius et al, 2010; Kocherlakota, 2010)[6]. Another limitation of the FCI is that it may not be able to adequately capture the evolution of the financial system (Dudley, 2010). Over time, the financial variables that form the underlying trend of the FCI would naturally evolve with the structure of the financial system. This may result in some key variables becoming less important in explaining overall financial conditions. For example, as the Malaysian financial markets deepen and increase their tolerance to exchange rate volatility, the variability of the exchange rate may become less important relative to other variables included in the FCI. Furthermore, each financial variable in the FCI affects the real economy in a complex manner, making the economic interpretation of the FCI potentially challenging (IMF Global Financial Stability Report, 2017). For example, asset prices tend to be more dominant drivers of risk in the short run, while measures of credit and liquidity are more indicative of medium-term risks to economic growth.

[5] This is consistent with what is commonly found in the literature (Debuque-Gonzales and Gochoco-Bautista, 2013).
[6] Among others, an important implication of a model not underpinned by a structural model is its vulnerability to the Lucas critique.

Given the highly complex financial environment, the FCI is just one of many indicators to facilitate the assessment on financial conditions

The Bank has incorporated the use of the FCI in its analysis of financial conditions. However, the development of reliable economic models remains an on-going process in monetary policy research. At the Bank, no single indicator or model is used exclusively in our assessment of financial and economic conditions. Rather, the Bank recognises the models' strengths and limits, and has adopted a more holistic approach to policy-making by considering important structural features of the economy that may not be adequately captured by these models.

A wide range of tools is used by the Bank to analyse domestic financial conditions. To this end, information from various segments within the financial system is assessed thoroughly to ensure a robust assessment on financial conditions. Typically, the assessment covers various indicators of both price and quantity that can provide additional insights on conditions in the banking system and financial markets. Such indicators, including movements in funding costs, liquidity adequacy and trading volatility, are critical to evaluate potential stresses that may arise from the price discovery and intermediation process in financial markets. The Bank also undertakes frequent engagements with industry players to validate and understand potential risks to financial markets. Other tools including the foreign exchange market pressure index has been used to assess developments in the exchange rate markets, while the financial cycle indicator has been constructed to assess potential signs of credit excesses. In addition, the Bank has further advanced its analysis by utilising granular data on household and corporate debt to enrich the assessment on distributional risks that may have important implications on overall financial conditions. Ultimately, the Bank relies on a comprehensive assessment of the financial system and economy to ensure appropriate, well-informed policy decisions.

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Managing Risks to Financial Stability

HIGHLIGHTS

- **Businesses and households continued to demonstrate sound debt servicing capacity.**
- **Long-term domestic and foreign investors continued to provide stability to the domestic bond market.**
- **Domestic financial stability is expected to be preserved amidst sound financial institutions and orderly markets and liquidity conditions.**

Domestic financial stability remains intact

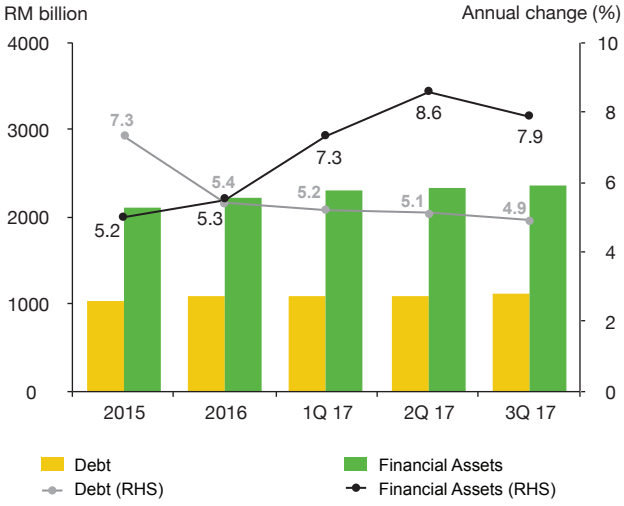
Domestic financial stability was preserved amidst strong support from resilient institutions and orderly market conditions. Overall volatility in domestic financial markets remained low amid improved domestic sentiments. Asset quality and profitability of domestic financial institutions remained sound while liquidity was sufficient to support intermediation activities and meet real economic needs.

Sustained debt servicing capacity of households and businesses

The expansion in household debt continued its moderating trend in the third quarter of 2017 (+4.9%; 2Q 2017: +5.1%). Housing loans remained the prime driver of growth (+8.5%; 2Q 2017: +8.8%). This resulted in a lower household debt of 84.6% of GDP at the end of the quarter (2Q 2017: 85.6%). Households continued to demonstrate sustained debt repayment capacity supported by adequate financial buffers and stable labour market conditions. The financial assets and liquid financial assets remained high at 2.1 and 1.5 times of debt, respectively. Further, growth of household financial assets (+7.9%) continued to outpace debt (+4.9%).

Annual growth of household financial assets continued to outpace that of debt

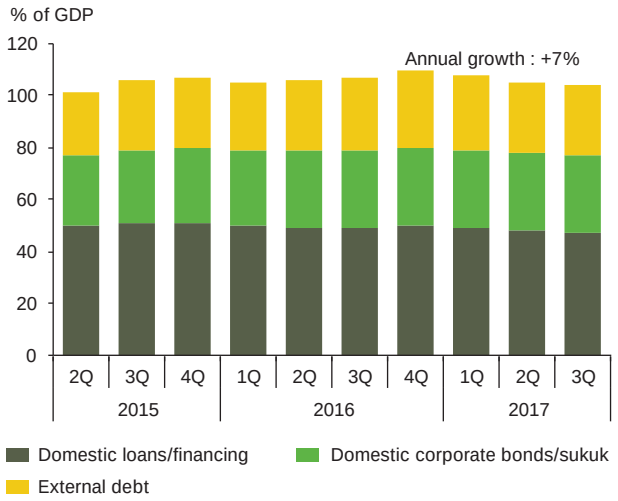
Chart 26: Household Sector Debt and Financial Assets



Source: Bank Negara Malaysia, Bloomberg, Department of Statistics, Malaysia, Securities Commission Malaysia and internal computation

Total business borrowings in the quarter was driven by sustained corporate issuances in the capital market

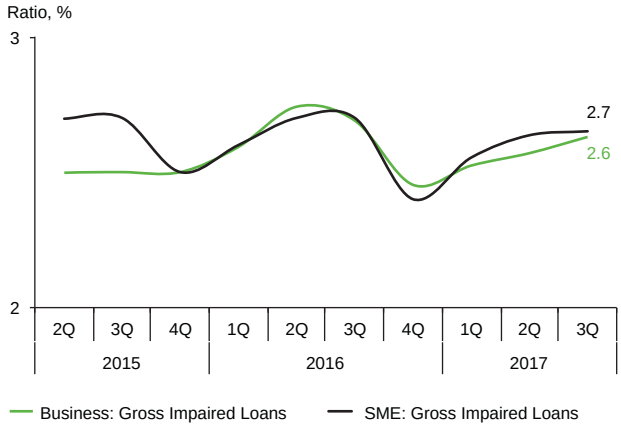
Chart 27: Business Sector NFC-Debt-to-GDP



Source: Bank Negara Malaysia

Overall banking system business loans portfolio remains sound

Chart 28: Business Sector Gross Impaired Loans



Source: Bank Negara Malaysia

Aggregate impairment ratio for banks and non-banks was sustained at 1.6% while delinquency ratio improved marginally to 1.4% (2Q 2017: 1.5%). Nonetheless, difficulty in repayment continued to be observed among borrowers in the vulnerable income segments (earning less than RM3,000 per month) living in urban areas given cost of living pressures. Of importance, potential systemic risks from financial institutions' exposure to the household sector are assessed to be limited given the following reasons. First, the majority of new household borrowers have prudent debt service ratios (DSR) (<60%), with 41% of borrowers having DSR of below 40%. Second, the share of borrowings by vulnerable borrowers declined further to account for 20.6% (2016: 21.9%) of total household debt. Third, under a simulated scenario using an assumption of a tripling of prevailing probabilities of default and severe loss given default, potential losses to banks from vulnerable households were estimated at less than 10% of banks' excess capital buffers (above regulatory minimum).

Business borrowings grew annually at 7% in the third quarter of 2017 (2Q 2017: +9%). This was driven by fund raising in the corporate bond and sukuk markets which grew by 10.2% (2Q 2017: 9.6%). Recent issuances were raised by the real estate, utilities and telecommunication sectors. Corporate external borrowings remained relatively stable as the positive exchange rate valuation effects from a stronger ringgit offset new borrowings. These borrowings mainly took the form of intercompany borrowings by businesses in the manufacturing, real estate and oil and gas (O&G) sectors. Financing by banks and development financial institutions (DFIs) to businesses continued to grow moderately with an annual growth of 5.4% (2Q 2017: +6.6%), due to slower growth in financing to all sectors. The growth of total financing by banks and DFIs to SMEs remained unchanged at 7% (2Q 2017: +7%).

Financial health of firms remained intact, given improving domestic and external demand. The aggregate leverage of Malaysian non-financial corporations (NFCs)[4] as measured by the median debt-to-equity ratio increased in 2Q 2017 (48.6%; 1Q 2017: 45.4%) due partly to lower earnings attributed to several firm-specific factors. Despite this, the aggregate debt servicing capacity and liquidity positions remained sound.

[4] Based on 120 listed firms on Bursa Malaysia with 85% market capitalisation (excluding financial institutions).

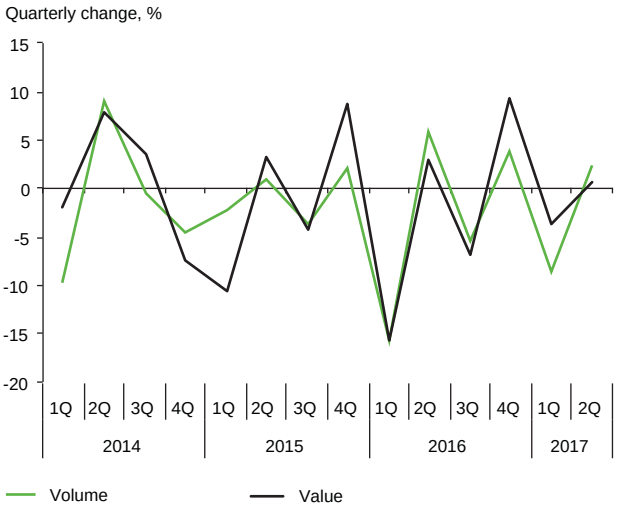
The median interest coverage ratio (ICR) remained significantly above the prudent threshold of two times (2Q 2017: 8.3 times). The median current assets-to-current liabilities ratio (current ratio) and cash-to-short-term debt ratio (CASTD) stood stable at 1.6 times and 1.4 times, respectively (1Q 2017: 1.6 times and 1.2 times, respectively), above the prudent threshold of one time. Overall, the ratio of impaired and delinquent loans remained low at 2.6% and 0.4% of total bank lending to businesses, respectively (2Q 2017: 2.6% and 0.4%, respectively). Higher impairment and delinquencies were observed in the real estate activities and O&G related sectors.

Despite oil price recovery in the third quarter supported by improvements in market sentiment, prices are expected to remain low amid expectations of higher supply. Certain segments of the O&G sector will continue to face challenges given this outlook. Nevertheless, the overall debt servicing capacity and liquidity positions of O&G companies recorded significant improvement from the first quarter, with the median ICR at 29.6 times (1Q 2017: 23.4 times) and median CASTD ratio at 4.7 times (1Q 2017: 3.4 times). This was driven mainly by companies in the downstream segment. Delinquent loans ratio stood at 0.1% (2Q 2017: 0.2%) while impaired loans ratio increased to 5% (2Q 2017: 4.5%) in the third quarter of 2017, due mainly to cashflow issues observed in service providers in certain upstream segments. However, risks to the banking system remained limited as exposures to the O&G sector accounted for about 6.5% of total exposures.

The housing market continued to exhibit signs of recovery in tandem with developments in the residential property market. During 2Q 2017, the housing transaction volume and value increased, on a quarter to quarter basis, by 2.5% and 0.5%, respectively (1Q 2017: -8.7% and -3.8%, respectively). The increase in activity was contributed mainly by transactions for the purchase of houses priced at RM500,000 and below, reflecting the sustained demand for affordable housing from the general public. House prices (as measured by the Malaysian House Price Index) continued to increase at a moderate annual pace of 6.7% in 1Q 2017 (4Q 2016: +7%), well below the previous peaks last observed during the 2012-2013 period (average growth of 12.3%).

Housing transactions were higher in 2Q 2017

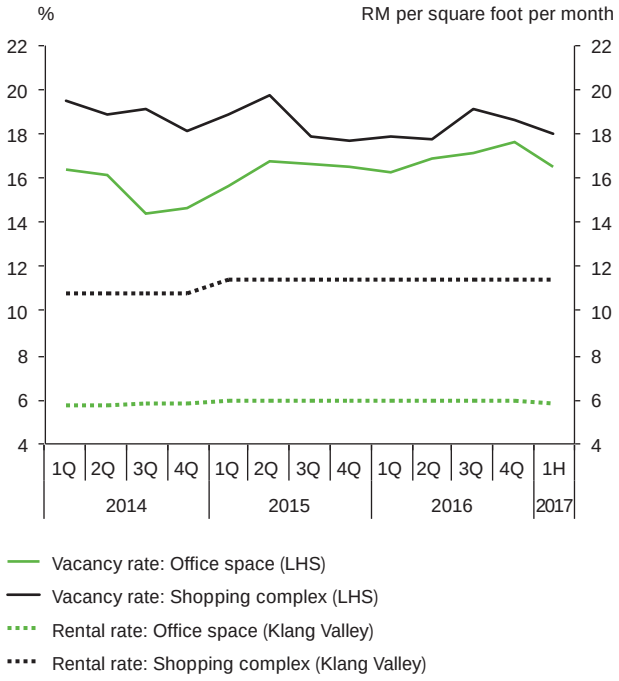
Chart 29: Property Sector Transaction Volume and Value



Source: National Property Information Centre

Rental rates of office space and shopping complex remained depressed

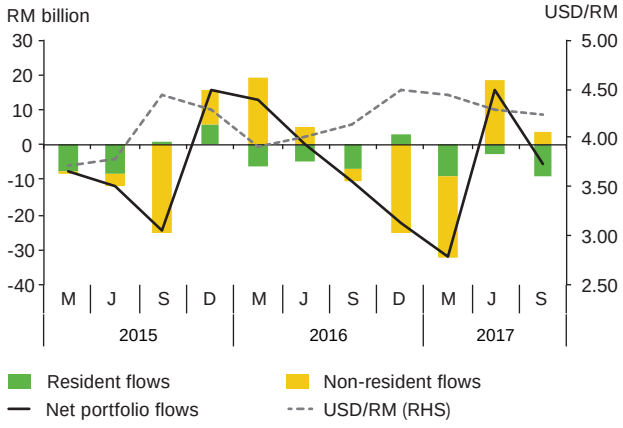
Chart 30: Office Space and Shopping Complex Vacancy and Rental Rates



Source: National Property Information Centre, Knight Frank, Jones Lang Wootton and internal computation

Net portfolio investment outflows mainly driven by residents' investment abroad

Chart 31: Financial Market Net and Gross Portfolio Flows and Ringgit Exchange Rate Movement



Source: Department of Statistics, Malaysia

Borrowers continue to have access to home financing, especially among first-time house buyers. The growth in outstanding house financing was sustained at 8.8% (2Q 2017: +8.9%), while the housing loan approval rate for the purchase of houses priced below RM500,000 remained high at 72.6% (2Q 2017: 74.1%).

Demand for financing for speculative house purchases remained muted. The share of the number of housing loans settled within three years (the typical duration required to complete construction after a property is acquired) stood at 10.5% (2Q 2017: 11%) of total settled housing loans. The annual growth in the number of borrowers with three or more outstanding housing loans (a proxy for speculative buyers) remained low at 0.8% (2Q 2017: +0.8%).

Rental rates in the office space and shopping complex segments remained depressed in 2Q 2017 amid the excess supply. This situation, if left unchecked, could become a long-term structural issue with wide implications to the greater economy. Direct risks to banks from end-financing exposures to the office space and shopping complex segments remained small at 3.2% of total bank loans, supported by sound lending and valuation practices. The delinquency and impairment ratios for these exposures remained low at 0.6% and 1.2 %, respectively (2Q 2017: 0.8% and 1.2%, respectively). Further discussion on this subject can be found in a box article entitled 'Imbalances in the Property Market' published in this report.

Domestic financial market conditions remained orderly

Investor sentiments remained affected by developments on the external front. These include concerns on the potential changes to economic policies under the Trump administration, increasing geopolitical tension in some countries and uncertainties surrounding the pace and timing of the US Federal Reserve interest rate and balance sheet normalisation. Despite these developments, overall volatility in the domestic financial markets remained low. This was attributed partly to improved domestic sentiments amid better-than-expected GDP growth in the second quarter. Average volatility of 10-year MGS yields and the FBM KLCI declined to 8.5% and 5.1% in the third quarter, respectively (2Q 2017: 10.2% and 6.4%, respectively). Average volatility of the ringgit increased slightly to 2.8% (2Q 2017: 2.6%).

In the third quarter, there were net portfolio investment outflows of RM5.1 billion (2Q 2017: net inflows of RM16 billion), mainly from residents due to continued investments in both equity and debt securities abroad by domestic fund managers and financial institutions. Despite some maturity-driven outflows from GII and MGS in August and September 2017, non-residents recorded net inflows of RM3.7 billion into both the government bond and equity markets. Non-resident investor holdings remained stable at 26.6% (2Q 2017: 26.0%) of total outstanding Malaysian government bonds. The bulk of the holdings is attributed to the long-term investors such as central banks, governments, pension funds and insurance companies (50% of total non-resident holdings). The stability of non-resident holdings can also be attributed to the distribution of holdings across different maturities. Of total non-resident holdings, 65% is in medium and longer-dated bonds of more than 3 years.

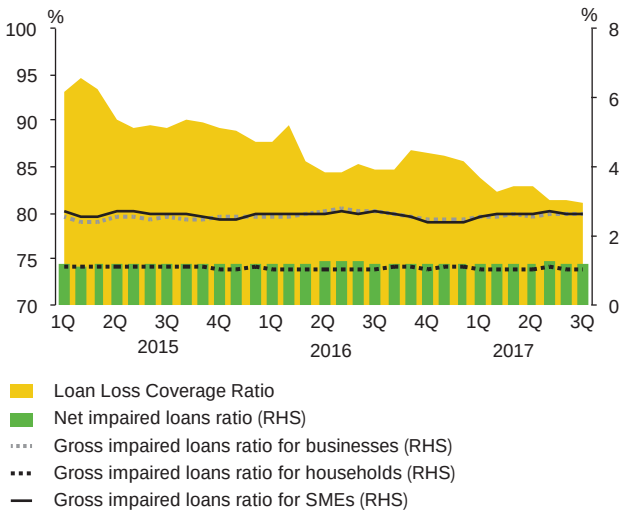
Non-resident participation in the domestic equity market remained stable at 23.3% of total equity market capitalisation (2Q 2017: 23%). The FBM KLCI ended the quarter slightly lower at 1755.58 points (2Q 2017: 1763.67 points). The average price-to-earnings (PE) ratio for the FBM KLCI stood at 16.7 times (2Q 2017: 17 times; 2010-2016 average: 16.8 times).

Trading liquidity in the financial markets remained intact. The bid-ask spread for MGS was stable at 0.1%, while the bid-ask spread for FBM KLCI improved to 0.3% of the mid-price (2Q 2017: 0.1% and 0.4%, respectively). Daily average USD/MYR bid-ask spread narrowed to 23.3 pips (2Q 2017: 26.1 pips). The monthly turnover ratios for MGS and FBM KLCI were slightly lower at 10.3% and 1.6%, respectively (2Q 2017: 11.3 % and 2%, respectively). Liquidity in the foreign exchange market improved with volume of transactions for ringgit pairs increased to a daily average of USD6.1 billion (2Q 2017: USD5.8 billion) of which spot and forward transactions accounted for USD2.7 billion (2Q 2017: USD2.6 billion).

The ringgit appreciated by 1.6% against the US dollar to end the quarter at RM4.2275 per US dollar (2Q 2017: RM4.2940). A similar trend was observed against other major currencies. The spreads on long-term onshore USD liquidity, as reflected by the 5-year cross-currency basis swap spreads, stood at 54 basis points (bps) (2Q 2017: 59 bps), lower than the average of 100 bps recorded during 2010-2016. Similarly, the 5-year sovereign credit default swap spread narrowed to 68.7 bps (2Q 2017: 85.5 bps).

Healthy asset quality observed in the banking system

Chart 32: Banking System Loan Quality



Source: Bank Negara Malaysia

Market risk exposures supported by risk management and hedging strategies

Banks' aggregate market risk exposures eased to 7.7% of total capital as at September 2017, due mainly to the reduction in foreign exchange (FX) risk (2Q 2017: 9.2%). FX risk, measured in terms of the net open position of foreign currency denominated exposures, eased to 5.7% of total capital (2Q 2017: 7%). Interest rate risk in the trading book and equity risk remained low at 1.1% and 0.9% of total capital, respectively (2Q 2017: 1.1% and 1.1%, respectively). For the insurance and takaful industry, market risk exposures remained unchanged at 14.9% (2Q 2017: 14.9%) of total capital available. Equity risk, which formed the bulk of insurers' market risk exposures, declined slightly to 8.8% (2Q 2017: 9.1%) of total capital available.

Sound profitability and sustained liquidity position of financial institutions

In the third quarter of 2017, the banking system financing (including interest) margin net of operating costs and loss provisions increased slightly to 0.69 percentage points (ppts) (2Q 2017: 0.65 ppts) as banks continued to extend financing to eligible borrowers. The banking system recorded lower pre-tax profits of RM9 billion (2Q 2017: RM9.2 billion), driven by lower dividend contributions from subsidiaries.

In the insurance and takaful sector, general insurers and takaful operators recorded lower operating profit of RM655.1 million in the third quarter (2Q 2017: RM762 million) on account of higher claims paid particularly in the motor segment. Correspondingly, industry claims ratio deteriorated to 61.2% (2Q 2017: 55.3%). Similarly, life insurers and family takaful operators recorded a reduction in profitability with excess income over outgo decreasing to RM3.5 billion (2Q 2017: RM4.4 billion). This was attributed largely to net capital losses of RM176.2 million (2Q 2017: RM953.6 million). The reduction was driven particularly by equity holdings, as the FBM KLCI index performed weaker towards the end of the quarter.

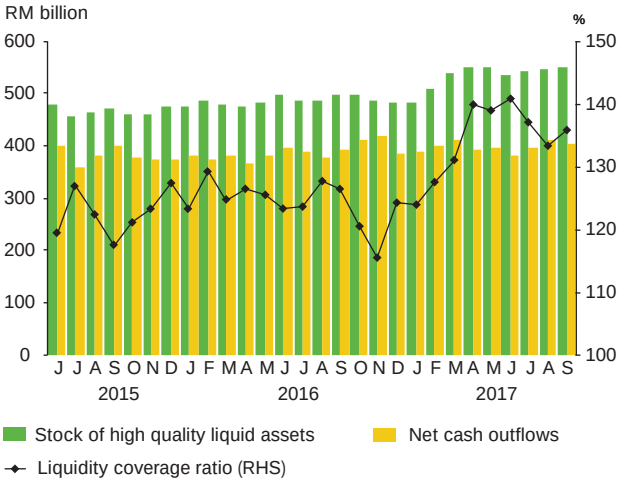
Banking system liquidity remained sufficient to support intermediation activity. Outstanding ringgit surplus liquidity placed with Bank Negara Malaysia in the form of placements, reverse repos and statutory reserves which can be unwound to meet liquidity needs, stood at RM189.4 billion. The banking system Basel III Liquidity Coverage Ratio (LCR)[5] stood at 136% as at end-September 2017 (2Q 2017: 141%). More than 95% of banks recorded LCR levels above 100%.

During the quarter, domestic funding conditions remained stable. Both the average cost of deposits[6] for banks and the 3-month KLIBOR were almost unchanged at 2.5% and 3.43%, respectively as at end-September 2017 (2Q 2017: 2.51% and 3.43%). The funding structure of banks continues to be predominantly deposit-based (70% of total funding) and in local currency. On aggregate, banking system deposits recorded a higher annual growth of +4.6% (2Q 2017: +3%), contributed by the continued expansion in household (+3.7%) and business sector deposits (+11.3%) (2Q 2017: +3.9% and +5.5%, respectively).

Banks continued to maintain diversification in their funding structure through the utilisation of medium-term ringgit and foreign currency denominated funding instruments. At the end of the third quarter, the loan-to-funds ratio[7] (LTF) remained stable at 83.1% (2Q 2017: 83.3%).

Banking system liquidity sufficient to buffer for adverse liquidity shocks

Chart 33: Banking System Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

[5] 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. As of 1 January 2017, the minimum requirement is set at 80%.
[6] The average cost of deposit is computed based on rolling 12-months average of interest expense on deposit over total deposit.
[7] Funds comprise deposits and all debt instruments issued (including subordinated debt, debt certificates/sukuk, commercial papers and structured notes).

Access to Financing for SMEs: Perception vs. Reality

Recent findings of OECD[1] and domestic surveys conducted have shown increased access to financing by Malaysian SMEs. Nevertheless, common perceptions of financing difficulties faced by SMEs still persist. This article examines the perceptions based on available demand and supply side data, along with feedback from financial institutions (FIs) and SME chambers and associations:

Perception 1: Financing is a key constraint for Malaysian SMEs

According to the latest bi-annual survey by SME Corporation Malaysia (SME Corp), 97% of SMEs which applied for financing from FIs affirmed that they were able to obtain financing. Of this, 27% were first-time borrowers and 23% were without collateral and credit guarantee.

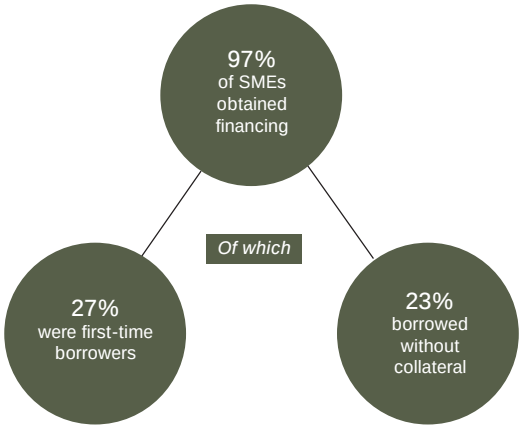
The key challenges cited by SMEs were non financing-related[2] and primarily focused on cyclical business challenges and the higher cost of doing business.

Supply side data from FIs further support the findings of the SME Corp survey:

1. Financing to SMEs by FIs continues to grow above 7%, outpacing households (5.1%) and large corporations (6.3%);
2. The approval rate for financing applications by SMEs, at 76.4%, is consistently higher than that for all consumer segments (62.3%); and
3. FIs' share of SME financing over total business financing has continued to trend upwards, accounting for 50% of total business financing by FIs as at September 2017 (2010: 38%).

FIs remain the primary source of financing for SMEs, with financing outstanding amounting to RM310.6 billion as at end-September 2017, or 97% of total financing outstanding to SMEs. This is complemented by various Government funds and schemes for SMEs. An allocation of RM10.4 billion is further provided under BNM's special funds for financing to SMEs.

Diagram 1
Reality: Majority of SMEs which require financing were able to obtain financing



Top concerns of SMEs are non-financing related	
High cost of doing business	64%
Ringgit depreciation	53%
Reduced domestic demand	40%
Low sales due to GST	38%
Weak business sentiment	29%

Source: 1Q 2017 SME Corp Survey

[1] Malaysia is cited as having sustainable SME financing growth among 39 countries, based on the report *Financing SMEs and Entrepreneurs 2017: An OECD Scoreboard (April 2017).*

[2] Only 10% of SMEs reported difficulties with current financing facilities mainly linked to delays in loan approvals/ disbursement, requests for additional guarantors or collateral and higher interest charged.

Perception 2: Applying for financing is an opaque and complicated process

In practice, banks have streamlined and simplified the application process for SME financing. The processing time for unsecured financing applications has improved significantly, from 70 days previously to 7-16 days[3] on average. The improvement has been driven largely by:

1. the PARTNER programme, under which banks adopt standardised loan application forms and provide a checklist of required documents to applicants;
2. dedicated SME desks at FIs to assist and advise applicants on the preparation of financing documents and measures that they can take to improve their eligibility for financing; and
3. the mobilisation of 20,363 bank officers nationwide to increase the capabilities, awareness and knowledge of SMEs on financing matters. Areas covered include credit application requirements and processes, financial management and business planning.

Perception 3: Banks do not extend financing to start-ups

Data on bank financing to SMEs show that 20% of SME financing approvals are for newly established SMEs (three years or younger), broadly in line with the share of applications received[4]. The rejection rate for new SMEs is also observed to be only marginally higher than the average rejection rate for all SMEs. Liaison with FIs indicates an increased appetite for financing younger SMEs, in line with ongoing improvements in approaches to assess risk and viability. These developments are consistent with the increasing focus by FIs on SMEs as a strategic growth segment.

Diagram 2
Reality: Simplified application process has improved processing time significantly

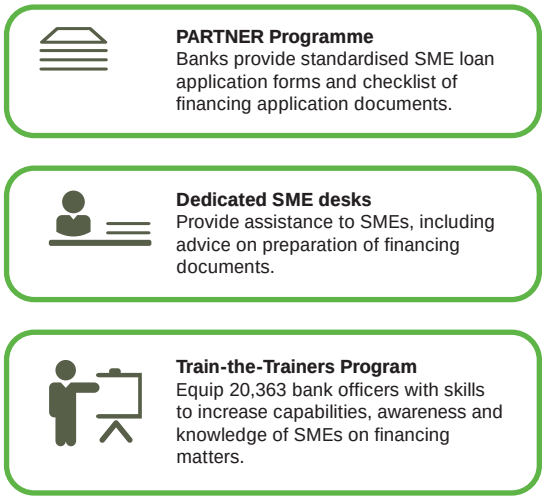
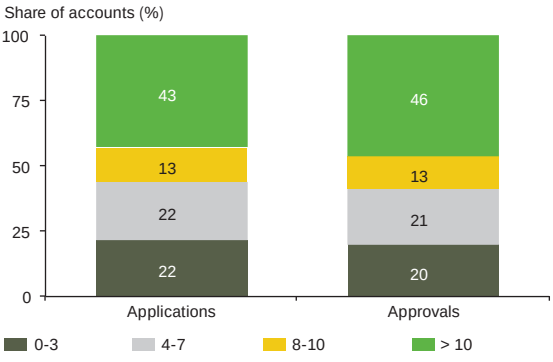


Diagram 3
Reality: Start-ups receive financing from FIs with similar approval rate

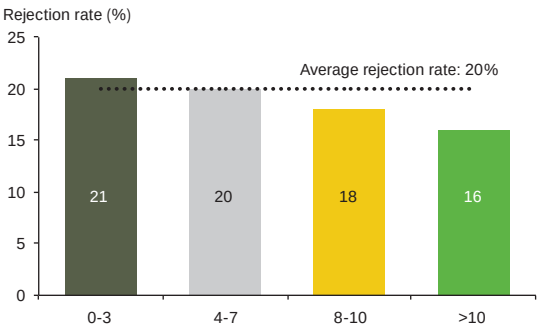
Banks lend across a broad spectrum of companies, including newly established SMEs (20% of total approvals)

Chart: Share of financing approvals and applications by years in operation



Rejection rate for young SMEs is only slightly higher than overall average

Chart: Financing rejection rate by years in operation

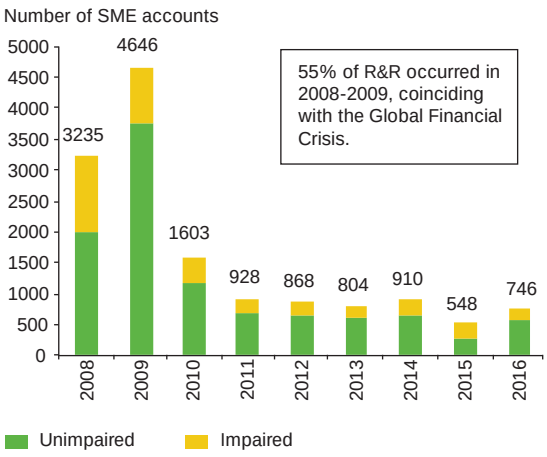


[3] Processing time is seven days for financing up to RM500,000 and 16 days for financing above RM500,000 on average.
[4] Based on CCRIS data (2016).

Perception 4: Banks are quick to withdraw financing lines and/or reduce credit limits of SMEs during economic downturns

Less than 2% of SMEs surveyed by SME Corp with existing financing from FIs reported difficulties due to reduced credit limits or a withdrawal of credit facilities. On the contrary, debt restructuring and rescheduling (R&R) assistance provided to viable but financially distressed SMEs generally increased during economic down-cycle, helping SMEs maintain their credit facilities. More than 14,000 SME accounts were restructured or rescheduled between 2008 and 2016, of which 73% were initiated on performing accounts, underscoring pre-emptive actions taken by FIs to assist SMEs.

Diagram 4
Reality: Pre-emptive assistance is actively provided to financially distressed SMEs



Conclusion

The evident differences between perception and reality underscore the need for continuing education and engagement programmes to reach more SMEs with information on financing sources available and avenues that they can approach to obtain assistance. The Bank continues to work with its partners to achieve this. The Bank is also pursuing additional initiatives to enhance financing to SMEs, including:

1. the development of an online SME Financing Platform by Credit Guarantee Corporation (CGC) to enable SMEs to source suitable financial solutions from multiple FIs and SME funds more efficiently and seamlessly; and
2. the implementation of a Financial Accelerator Lab that will work with key collaborators to deliver an end-to-end solution for SMEs that face higher hurdles to obtain financing.

Moving forward, the development of alternative financing avenues (e.g. equity crowdfunding, P2P, private equity and venture capital) to complement the banking system remains key to support SMEs, particularly in new growth areas. Bank financing will remain ill-suited to some businesses in such areas, given the fiduciary responsibility of banks to ensure the safety of the public's deposits and avoid excessive risk-taking.

The Bank's Policy Considerations

HIGHLIGHTS

- **Monetary policy will ensure the sustainability of growth prospects.**
- **Current macroprudential measures to manage financial imbalances emanating from households, businesses and property market remained appropriate.**

The OPR remained accommodative at 3.00%

At the July and September Monetary Policy Committee (MPC) meetings, the Overnight Policy Rate (OPR) was maintained at 3.00%. At the most recent meeting in November, the MPC also decided to leave the policy rate unchanged. At this level of the OPR, the stance of monetary policy remains accommodative and supportive of economic activity.

The Malaysian economy continued on a positive growth momentum, amid further strengthening of global growth conditions. Growth was higher than anticipated, leading to an improved outlook for the domestic economy. The more positive outlook is supported by stronger spillovers from the external sector to the domestic economy. Domestic demand will be supported by improving labour market conditions and sustained investments, particularly in the manufacturing and services sectors. While downside risks have receded, risks from the external environment remain from political and policy developments in major economies and geopolitical risks. A materialisation of these risks would have ramifications on both global growth and the financial markets.

Headline inflation is expected to be at the upper end of the forecast range of 3 - 4% for the year. Headline inflation is projected to moderate in 2018 on expectations of smaller effects from global cost factors. The trend of headline inflation will, however, continue to be dependent on movements in global oil prices. Underlying inflation, while sustained by the robust domestic demand, is expected to be contained as continued expansion in productive capacity will allow the economy to meet the higher demand.

Monetary and liquidity conditions remained stable and supportive of economic activity. The ringgit strengthened over the quarter to better reflect the economic fundamentals. The growth of financing to the private sector has been sustained and total banking system liquidity remained sufficient. The risks of destabilising financial imbalances remained contained, with the prevailing macroprudential measures effective in managing any incipient risks.

The strength in global and domestic macroeconomic conditions has allowed greater flexibility for the MPC to reassess the degree of monetary accommodation. This is to ensure the sustainability of the growth prospects of the Malaysian economy.

The Bank's Financial Stability Committee assessed that domestic financial stability remains preserved

The 52nd Financial Stability Committee (FSC) meeting was held on 7 November 2017. The FSC assessed that domestic financial stability continues to be preserved and well-supported by sound financial institutions. The FSC observed that key sources of risks to domestic financial stability continued to stem from highly leveraged borrowers and oversupply of office space, shopping complex and high-end high-rise residential property.

The FSC assessed that the risks to financial stability associated with household debt and corporate sector leverage are largely contained, with current macroprudential measures remaining appropriate. Oversupply of office space and shopping complexes is expected to be exacerbated by an influx of incoming supply. Together with the increasing number of unsold high-end condominiums, this could pose risks to macroeconomic and financial stability if left unchecked. Currently, banks are assessed to be able to withstand a slowdown in the property market as direct exposures are limited with low and stable impairment. Financing activity remain supportive of economic growth due to favourable funding and liquidity conditions in the banking system.

The outlook for domestic financial stability is expected to remain stable going into 2018. The Bank will continue to assess the effects of the motor tariff liberalisation and migration to PIN & PAY. In addition, the Bank will remain vigilant against risks from cyber security, illegal financial schemes and market conduct developments. Beginning January 2018, the names of financial institutions subject to enforcement actions due to non-compliance with the Bank's regulations will be published in line with greater transparency and disclosure.

Other policy highlights in third quarter of 2017

The FSC activated the SME Disaster Relief Facility of RM500 million on 8 November 2017 to alleviate the financial burden of SMEs affected by the flood in the northern states of Peninsular Malaysia and to assist the resumption of their business operations[8].

During the quarter, the Bank revised the eligibility criteria for companies to apply for assistance from the Corporate Debt Restructuring Committee (CDRC). The revision provides support to a broader range of companies, particularly those that persistently face challenging business conditions in specific economic sectors. The revision aims to ensure viable companies continue to be able to contribute to real economic growth.

[8] http://www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=4538&lang=en

Macroeconomic Outlook

HIGHLIGHTS

- **Global growth on track to expand at a faster pace in 2017, supported by improvements in both advanced and emerging market economies.**
- **The Malaysian economy will record a stronger growth in 2017.**
- **Headline inflation is expected to average at the upper end of the forecast range of 3 - 4% for 2017 as a whole.**

Global growth on track to expand at a faster pace, supported by improvements across regions

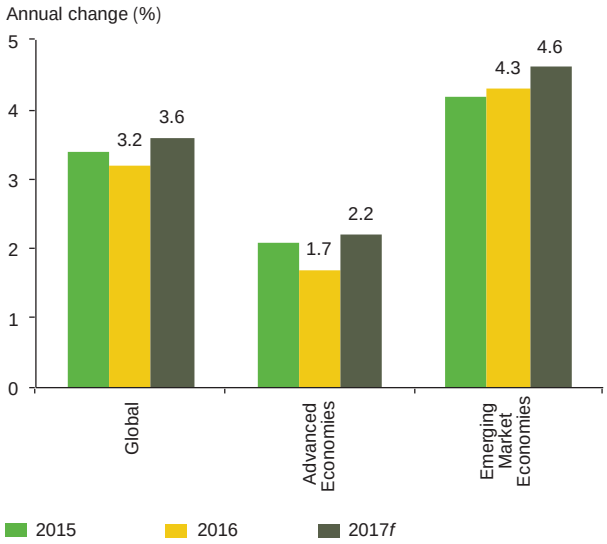
The strong performance of the global economy in the third quarter reiterates the positive global growth outlook in 2017. The IMF has revised upward its global growth projections twice (in April and October), to reflect the stronger-than-expected growth momentum, as growth becomes more synchronised and entrenched across countries.

In the advanced economies, consumption continues to anchor growth, with additional impetus from investments. Of significance, the rise in investment growth has been mainly supported by stronger demand amid lower spare capacity. Labour market conditions are projected to improve further, providing impetus to private consumption. Growth in the emerging market economies will continue to benefit from strong external demand, particularly from the advanced economies, and continued expansion in domestic activity.

Nevertheless, the growth outlook remains vulnerable to several risks. These arise mainly from uncertainty regarding the timing, pace and magnitude of the monetary policy normalisation in major economies, protectionism, and political uncertainty in parts of Europe. Geopolitical tensions and volatility in oil price also pose risks to global growth prospects.

Growth improvements projected across regions

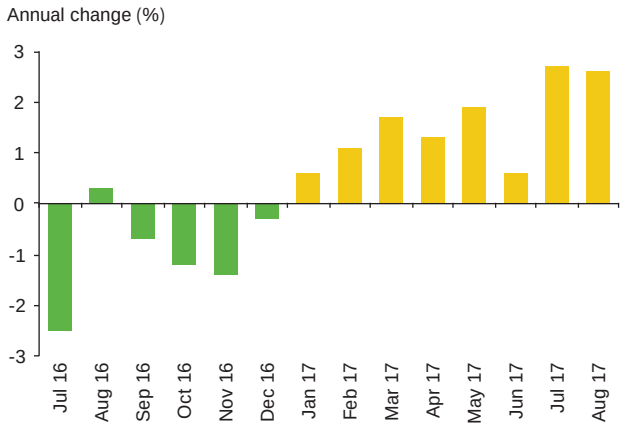
Chart 34: GDP Growth



Source: IMF World Economic Outlook (October 2017)

Leading indicators suggest continued expansion in the domestic economy

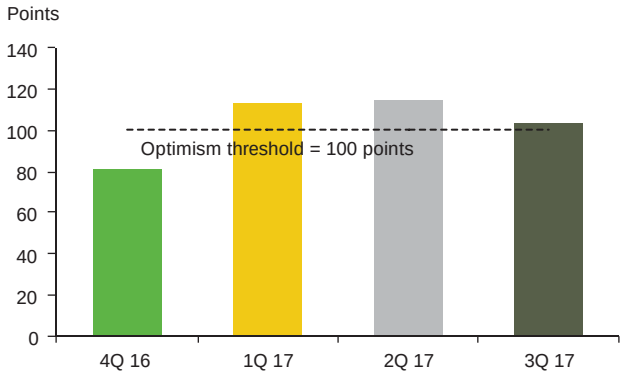
Chart 35: Composite Leading Index



Source: Department of Statistics, Malaysia

Business sentiments remained above the optimism threshold in 3Q 2017

Chart 36: MIER Business Conditions Index



Source: Malaysian Institute of Economic Research (MIER)

The Malaysian economy will register higher growth in 2017

Given the continued strong performance in the third quarter, the Malaysian economy is on track to register stronger growth in 2017. Looking ahead, the economy is poised to register a strong growth that is close to the upper end of the official forecast range of 5.2 – 5.7% in 2017. Growth momentum has been lifted by stronger spillovers from the external sector to the domestic economy. The operating environment has also improved significantly as households and businesses have steadily acclimatised to the adjustments in the global and domestic economic conditions in the past few years.

Leading indicators such as the Department of Statistics Malaysia's composite leading index and MIER Business Conditions Index corroborate expectations for continued expansion of the domestic economy. For 2018, domestic demand is expected to remain the key source of growth. Private consumption will remain the largest driver of growth, supported by continued improvements in income and overall labour market conditions. Investment will be sustained by infrastructure projects and higher capital investment in the manufacturing and services sectors. The external sector will provide additional impetus to the economy, benefitting from the improvement in global growth. Overall, the assessment is for growth to remain strong in 2018.

On the supply side, the improvement in both external and domestic demand will benefit the manufacturing and services sectors. The agriculture sector's growth will be driven by a recovery in CPO yields post-El Niño. Growth in the mining sector is projected to be supported by output from the ramping up of production in new oil and gas facilities. In the construction sector, growth will be supported by new and existing civil engineering projects.

Going forward, inflation could remain elevated over the coming months amid rising global oil prices but is projected to moderate thereafter

Since the end of October 2017, there have been significant shifts in the development of cost factors. Global oil prices have risen rapidly following reports of stronger oil demand and geopolitical tensions in the Middle East. This has led to increases in domestic fuel prices, which translate into higher upside risks to inflation outlook in the near term. Should the high level of global oil prices be sustained, domestic fuel prices and in turn, headline inflation, would remain elevated over the coming months. For 2017 as a whole, inflation is expected to be at the upper end of the forecast range of 3 – 4%.

Going forward, while underlying inflation will be sustained by robust domestic demand, continued expansion in productive capacity is expected to contain further increases. Along with expectations of smaller effects from global cost factors, headline inflation is projected to moderate in 2018. However, the trend will depend on future global oil prices, which are highly uncertain.

1 Feature Article

Better Boards - The Path Towards Stronger Corporate Governance in Financial Institutions

Authors: Mohammad Khairul Ismail and Atikah Abd Aziz

HIGHLIGHTS

- Boards of financial institutions are responsible for ensuring all decisions and actions made are in the best interest of the financial institutions, depositors and insurance policyholders.
- The boards set the right 'tone from the top' to reinforce ethical, prudent and professional behaviour.
- The changing financial landscape coupled with growing focus on social responsibility and stakeholders' activism will continue to change the role of boards.
- Boards must keep pace and continue to steer the financial institutions with impeccable integrity and conduct.

Sound corporate governance - the key to institutional soundness leading to financial stability and sustainable economic growth

Unlike other companies, a banking institution performs the role of facilitating the functions of the economy by intermediating funds to support the real economy. Likewise, insurers and takaful operators provide safety nets to individuals to reduce their hardship following loss events such as accidents and natural disasters. Underpinned by these factors, a sound corporate governance standard in financial institutions is important to ensure that intermediation activities are conducted effectively and responsibly, while all obligations are met on a timely basis. Sound corporate governance standards must be institutionalised and become a way of life in the organisational context of a financial institution. Ultimately, the realisation of these expectations lies with the boards of financial institutions.

Past global financial crises show that among the key contributing factors to financial losses suffered by financial institutions and consumers were ineffective boards that exercised inadequate oversight on executive and senior management who are responsible and accountable for the soundness of the financial institutions' day-to-day management activities. These significant losses caused erosion in public confidence, disruption in financial markets and in some cases, destabilisation within the wider economy. Learning from these costly and painful episodes, regulators in advanced economies and many others across the globe have cast their focus and attention on the strengthening of financial institutions' corporate governance standards.

In Malaysia, the Bank's efforts to improve financial institutions' corporate governance standards were first directed towards enhancing the governance arrangements at the board level, strengthening board evaluation policies and practices and complemented by continuous training programmes to ensure the boards are effective in providing stewardship, oversight and direction. The Bank also saw the need to hard code the boards' fiduciary duties into law so as to elevate and give prominence to the role of directors in tandem with their growing accountability and responsibility. The duties and responsibilities of the boards and directors have therefore been codified into the Financial Services Act 2013 and Islamic Financial Services Act 2013.

Regulatory framework provides conducive environment for boards to perform their roles effectively

(i) Stronger independence and improved board competency profile

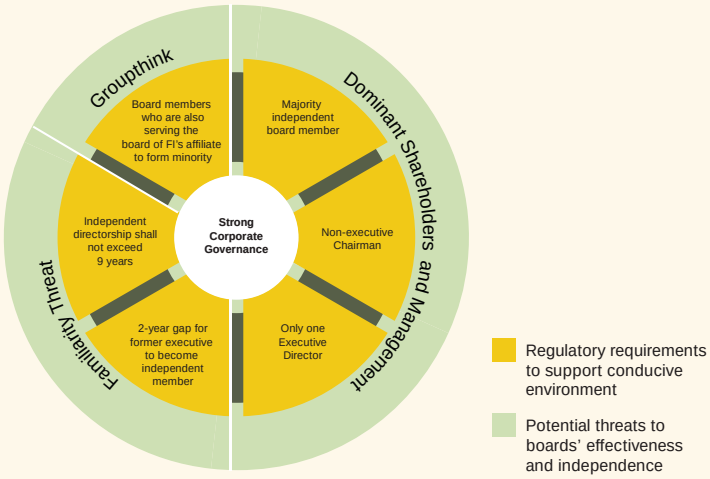
Since the Asian Financial Crisis 1997/1998, boards' independence and composition in terms of size, diversity and skills have improved significantly. To ensure robust checks and balances, the number of independent directors required on the boards of financial institutions was initially increased to one-third and more recently to form a majority of the board. These requirements have since been complied with underlining the industry's recognition of the importance of board independence from elements of excessive influence that may be exerted by significant shareholders and dominant management.

As financial institutions become larger and more complex, the boards must have the requisite skills and capacity to assess material risks and emerging developments affecting the business and operating environment. This entails the need for boards to have a diverse set of skills, experience and competencies to identify and deliberate on current and emerging risks as well as challenges faced by financial institutions. Today, boards of financial institutions have evolved into having members with diverse skill sets including in areas such as risk management, accounting, law, human capital, information technology, Islamic finance and Shariah. Financial institutions with regional presence have also appointed board members with regional exposure to better manage inherent risks related to cross border business. The increasing diversity in skills and background have also enhanced the boards' strategic and technical capabilities to meet the challenges associated with an environment of increasing uncertainty and complexity.

(ii) Clear separation of management and board

As part of the reforms made post crisis, the Bank has introduced a number of prudential measures to reduce the involvement and influence of management on the boards of financial institutions. A significant milestone was achieved when the Bank directed financial institutions to separate the roles of executive function from the chairman in 2005. Subsequently, the number of executive directors was restricted to a maximum of two in 2013 and further reduced to one in 2016. In addition, the definition of executive directors has been expanded to include any individual who has management responsibilities in the financial institution's affiliates[1]. A former executive of a financial institution must also serve a two-year cooling off period before being eligible as an independent director of the same institution. These developments represent a forward leap towards making boards' judgement and decision-making more independent of management influence and also lead towards more objective scrutiny of management's performance.

Chart 1: Regulatory requirements have created conducive environment for boards to effectively discharge their fiduciary duties



Source: Bank Negara Malaysia

[1] The definition for affiliates includes a corporation that controls, is controlled by, or is under common control with the financial institution.

(iii) Greater oversight over risk, internal controls, remuneration, succession planning, directors and senior management appointments and performance assessment

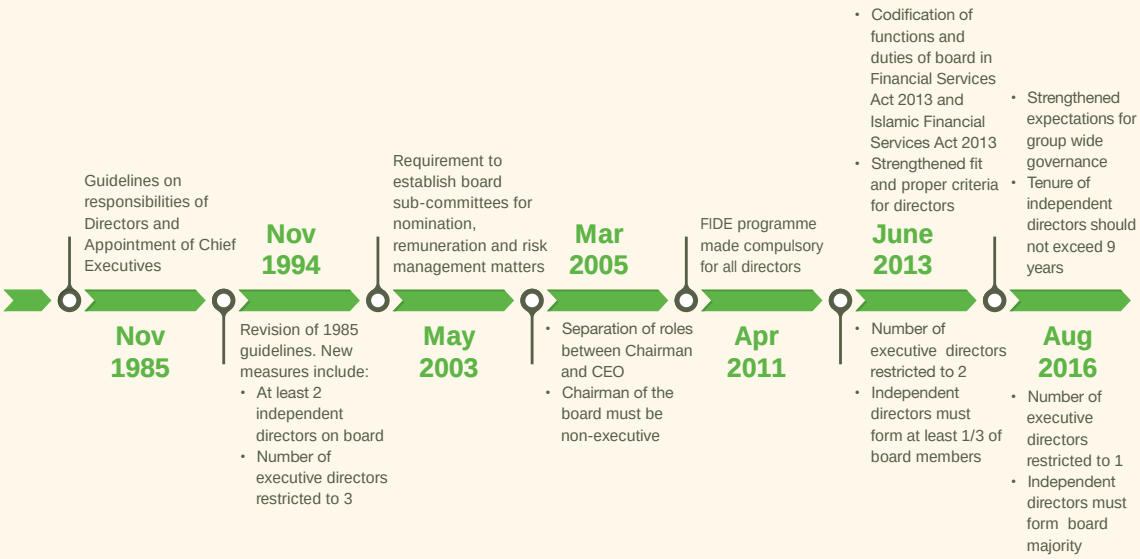
A sound board oversight structure is key to good governance. In line with the Bank's expectation, financial institutions have established dedicated board oversight functions through audit, risk management, nomination and remuneration committees. Some large financial institutions have also established other board committees to provide enhanced oversight on compliance and information technology, in tandem with the nature and complexity of their institutions.

Dedicated committees ensure key matters are given sufficient focus and in-depth deliberation to ensure informed decision-making. The empowerment to the dedicated committees enables the boards to sharpen their focus on strategic matters concerning the financial institutions. This structure also promotes efficient management of boards' resources.

(iv) Enhanced directors' competencies through on-going training regime

In order to be able to constructively challenge and guide the management team, boards must be in a position to understand and evaluate the risks emerging from the activities and operations of the financial institutions. Recognising this need, the Bank, together with the financial institutions have taken concerted measures to ensure that boards collectively possess the requisite experience and expertise to steer the financial institutions in the right direction. Financial institutions have established bespoke on-boarding programmes to further expose board members to the regulatory framework governing the financial institutions, as well as to expedite their institutional understanding. In addition, it has also been made compulsory for board members to complete the Financial Institution Directors' Education (FIDE) Programme[2]. Through such structured training programmes, directors have been given further exposure to deepen their understanding on boardroom governance, examine the interlinkages between risk dimensions and capital management, and explore key issues facing financial institutions in areas such as business strategy, risk management, succession planning and stakeholders' management.

Chart 2: Evolution of corporate governance standards has elevated the effectiveness of board stewardships in financial institutions



Source: Bank Negara Malaysia

[2] FIDE programme is jointly organised by Bank Negara Malaysia, Perbadanan Insurans Deposit Malaysia and The Iclif Leadership and Governance Centre.

Expectations on boards will continue to evolve along with changes in operating landscape and regulatory demands

It is imperative that board members of financial institutions uphold the highest level of integrity as boards set the tone and culture of an organisation. With the right tone and culture from the top, business dealings and decision-making will be guided by sound judgment and ethical values. Financial institutions with sound risk cultures are more likely to grow their business in a sustainable manner while observing greater standards of risk management and compliance to regulatory expectations.

The corporate governance standards of Malaysian financial institutions have been significantly enhanced over the years. Nevertheless, the evolution of sound corporate governance is far from over. In the era of innovation and digitalisation, the rising leverage of global financial services on information technology such as Big Data and cryptocurrency widens the range of risks facing financial institutions. In navigating this uncharted territory, higher expectations will be put upon the boards for their oversight of technology risk such as data management and cyber security. In this regard, financial institutions are expected to be proactive in prepping the boards with the required expertise.

The Bank is now accelerating efforts to elevate the level of professionalism, ethical standards and integrity of the financial industry. For instance, enforcement actions taken against financial institutions and intermediaries for non-compliance to rules and regulations will be published starting from January 2018. With greater repercussion and higher reputational risk at stake, matters such as compliance and risk management are expected to be given greater prominence by the boards. Regardless of the forces of change, the relentless pursuit of a strong corporate governance foundation by financial institutions remains; to protect the critical role of financial institutions in supporting the real economy and preserving financial stability.

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Bank Negara Malaysia's "Guidelines on Directorship in the Banking Institutions", issued on 28 November 1994.

Bank Negara Malaysia's policy document on "Fit and Proper Criteria", issued on 28 June 2013.

Bank Negara Malaysia's "Guidelines on the Establishment of Board Committees, Minimum Qualifications and Training Requirements for Directors and Definition and Responsibilities of Independent Directors", issued on 29 May 2003.

Annex

Table 1

GDP by Expenditure Components (at constant 2010 prices)

	Share 2016 (%)	2016		2017		
		3Q	4Q	1Q	2Q	3Q
		Annual growth (%)				
Aggregate Domestic Demand (excluding stocks)	91.6	4.5	3.2	7.7	5.7	6.6
Private sector	*70.1*	5.9	5.9	8.2	7.2	7.3
Consumption	*53.2*	*6.3*	*6.1*	*6.6*	*7.1*	*7.2*
Investment	*16.9*	*4.8*	*4.9*	*12.9*	*7.4*	*7.9*
Public sector	21.5	-0.3	-2.6	5.8	0.2	4.1
Consumption	*13.1*	*2.1*	*-4.2*	*7.5*	*3.3*	*4.2*
Investment	*8.5*	*-3.8*	*-0.4*	*3.2*	*-5.0*	*4.1*
Net Exports	8.4	8.2	6.4	-14.5	1.4	1.7
Exports of Goods and Services	*70.4*	*-0.6*	*2.2*	*9.8*	*9.6*	*11.8*
Imports of Goods and Services	*62.1*	*-1.8*	*1.6*	*12.9*	*10.7*	*13.4*
GDP	**100.0**	**4.3**	**4.5**	**5.6**	**5.8**	**6.2**
GDP (q-o-q growth, seasonally adjusted)	**-**	**1.4**	**1.3**	**1.8**	**1.3**	**1.8**

Source: Department of Statistics, Malaysia

Table 2

GDP by Economic Activity (at constant 2010 prices)

Annual growth (%)	Share 2016 (%)	2016		2017		
		3Q	4Q	1Q	2Q	3Q
Services	54.3	6.2	5.5	5.8	6.3	6.6
Manufacturing	23.0	4.3	4.7	5.6	6.0	7.0
Mining	8.8	2.9	5.0	1.6	0.2	3.1
Agriculture	8.1	-6.1	-2.5	8.3	5.9	4.1
Construction	4.5	7.9	5.1	6.5	8.3	6.1
Real GDP	**100.0**[1]	**4.3**	**4.5**	**5.6**	**5.8**	**6.2**

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

Source: Department of Statistics, Malaysia

Table 3

Trade Account

	Share 2016 (%)	2016		2017		
		3Q	4Q	1Q	2Q	3Q
		Annual growth (%)				
Gross Exports	**100.0**	**-2.1**	**3.1**	**21.4**	**20.5**	**22.1**
Manufactured	82.1	-1.2	3.5	19.5	18.7	23.7
E&E	*36.6*	*-0.6*	*7.7*	*18.4*	*22.6*	*21.7*
Non-E&E	*45.5*	*-1.6*	*0.2*	*20.3*	*15.8*	*25.4*
Resource based	*22.9*	*-0.5*	*5.9*	*29.9*	*17.1*	*22.2*
Non-resource based	*22.6*	*-2.8*	*-5.2*	*11.4*	*14.5*	*28.7*
Commodities	17.2	-7.1	-0.1	27.7	28.2	12.5
Agriculture	*8.9*	*1.2*	*14.1*	*29.6*	*17.9*	*3.1*
Minerals	*8.3*	*-15.5*	*-11.3*	*25.9*	*41.1*	*23.9*
Gross Imports	**100.0**	**-0.1**	**5.1**	**27.7**	**19.0**	**19.8**
Intermediate goods	57.1	-0.3	3.8	27.8	23.9	20.9
Capital goods	14.3	15.7	6.6	42.1	7.0	0.0
Consumption goods	9.6	-0.8	-0.2	4.0	1.5	14.9
Re-exports and dual-use goods	19.0	-9.4	10.7	29.5	23.3	34.8
Trade balance (RM billion)	**-**	**18.4**	**28.0**	**18.9**	**24.1**	**26.7**

Source: Department of Statistics, Malaysia

Table 4

Malaysia's Direction of Exports

	Share 2016 (%)	2016		2017		
		3Q	4Q	1Q	2Q	3Q
		Annual change (%)				
European Union (EU)	**10.1**	**-3.5**	**1.0**	**22.2**	**21.7**	**23.6**
Japan	**8.1**	**-11.7**	**-12.3**	**18.4**	**26.4**	**16.5**
United States	**10.2**	**4.7**	**2.3**	**11.9**	**9.4**	**13.2**
ASEAN[1]	**29.4**	**3.5**	**6.3**	**23.8**	**16.1**	**20.7**
North East Asia	**22.9**	**-7.3**	**5.8**	**23.9**	**30.0**	**27.0**
People's Republic of China	*12.5*	*-8.3*	*12.3*	*39.8*	*42.6*	*25.4*
Hong Kong SAR	*4.8*	*-1.4*	*10.4*	*10.0*	*12.3*	*30.8*
Korea	*2.9*	*-16.2*	*-6.9*	*-2.1*	*30.5*	*40.4*
Chinese Taipei	*2.7*	*-3.2*	*-12.9*	*13.8*	*9.9*	*15.9*
West Asia[2]	**2.9**	**-9.4**	**11.4**	**6.8**	**13.4**	**22.2**
India	**4.1**	**-1.4**	**1.1**	**13.8**	**16.1**	**8.7**
Total exports	**100.0**	**-2.1**	**3.1**	**21.4**	**20.5**	**22.1**

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

Source: Department of Statistics, Malaysia

Table 5

Balance of Payments[1]

	2016		2017		
	3Q	4Q	1Q	2Q	3Q
	RM billion				
Current Account	**7.3**	**12.5**	**5.3**	**9.6**	**12.5**
(% of GNI)	*2.4*	*3.9*	*1.7*	*3.0*	*3.7*
Goods	26.8	31.2	25.3	27.0	31.7
Services	-4.2	-5.4	-6.2	-5.0	-4.9
Primary income	-10.7	-9.2	-9.9	-8.2	-8.6
Secondary income	-4.6	-4.1	-3.9	-4.2	-5.7
Financial Account	**-5.8**	**-14.2**	**-8.8**	**7.3**	**-1.2**
Direct investment	2.7	1.0	8.3	-7.1	6.2
Assets	*-11.6*	*-15.1*	*-2.7*	*-15.6*	-7.7
Liabilities	*14.3*	*16.1*	*10.9*	*8.4*	13.9
Portfolio investment	-10.6	-19.1	-31.9	16.0	-5.1
Assets	*-7.1*	*2.7*	*-9.0*	*-2.8*	-8.8
Liabilities	*-3.5*	*-21.8*	*-22.9*	*18.8*	3.7
Financial derivatives	-0.1	-1.2	0.6	-0.3	1.0
Other investment	2.1	5.0	14.2	-1.3	-3.3
Errors & omissions[2]	13.2	20.7	1.7	-14.3	-8.5
Overall Balance	**14.6**	**19.0**	**-1.8**	**2.7**	**2.9**

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 on gains/losses made on international reserves

Source: Department of Statistics, Malaysia

Table 6

Outstanding External Debt

	2016	2017	
	end-Sept	end-June	end-Sept
	RM billion		
Total External Debt	**868.7**	**877.5**	**873.8**
USD billion equivalent	*207.4*	*202.3*	*204.7*
By instrument			
Bond and notes[1]	151.2	164.1	162.3
Interbank borrowing[1]	148.9	192.3	166.5
Intercompany loans[1]	124.2	128.1	127.7
Loans[1]	51.1	36.2	38.3
NR holdings of domestic debt securities	237.1	194.9	200.7
NR deposits	82.6	78.8	90.8
Others[2]	73.6	83.1	87.6
Maturity profile			
Medium and long-term	534.4	490.6	489.5
Short-term	334.3	386.9	384.4
Currency denomination			
Ringgit	331.0	287.6	296.9
Foreign	537.4	589.9	577.0
Total debt/GDP (%)	70.6	65.2	65.0
Short-term debt/Total debt (%)	38.5	44.1	44.0
Reserves/Short-term debt (times)	1.2	1.1	1.1[3]

[1] These debt instruments constitute the offshore borrowing.
[2] Comprise trade credits, IMF allocation of SDRs and miscellaneous.
[3] Based on international reserves as at 31 October 2017.
Note: NR refers to non-residents

Source: Ministry of Finance and Bank Negara Malaysia

Table 7

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

	2016		2017			2016		2017		
	2Q	3Q	1Q	2Q	3Q	2Q	3Q	1Q	2Q	3Q
	During the period (RM billion)					Annual growth (%)				
Net total financing	**24.8**	**39.6**	**36.8**	**29.8**	**29.1**	**6.8**	**6.4**	**6.8**	**7.0**	**6.4**
Outstanding loans*[1]	17.2	21.9	15.4	12.0	13.6	5.5	4.3	6.0	5.6	5.0
Of which:										
Business enterprises	3.3	7.4	8.7	1.0	0.8	3.8	2.1	7.1	6.6	5.4
SMEs	*8.0*	*5.1*	*3.5*	*2.1*	*5.2*	*9.2*	*8.2*	*9.3*	*7.0*	*7.0*
Non-SMEs	*-4.7*	*2.4*	*5.3*	*-1.2*	*-4.5*	*-0.8*	*-3.1*	*5.0*	*6.3*	*4.0*
Households	12.4	12.1	8.2	10.4	11.3	6.2	5.8	5.4	5.1	4.9
Outstanding corporate bond	7.6	17.7	21.4	17.9	15.5	11.3	13.9	9.8	11.8	10.9

* Include loans sold to Cagamas
[1] Banking system and development financial institutions (DFIs)
Note: Numbers may not add up due to rounding

Source: Bank Negara Malaysia

Table 8

Loan Indicators

	2016		2017			2016		2017		
	2Q	3Q	1Q	2Q	3Q	2Q	3Q	1Q	2Q	3Q
	During the period (RM billion)					Annual growth (%)				
Total										
Loan applications[1]	211.4	204.0	197.5	204.8	221.2	2.4	-8.6	5.9	-3.1	8.5
Loan approvals[1]	88.4	87.6	87.4	91.8	96.8	-12.3	-7.8	15.0	3.9	10.5
Loan disbursements[2]	270.8	263.6	292.4	274.1	284.6	-0.5	-6.6	7.6	1.2	7.9
Loan repayments[2]	264.2	256.6	289.4	274.4	285.6	4.8	-3.1	5.4	3.8	11.3
Of which:										
Business enterprises[3]										
Loan applications	101.4	93.9	86.4	86.6	97.0	5.7	-15.6	-0.1	-14.6	3.4
Loan approvals	42.5	40.0	40.9	40.9	44.3	-6.0	-6.2	17.0	-3.9	10.7
Loan disbursements	195.2	187.1	213.8	196.9	204.6	0.5	-8.9	9.1	0.8	9.4
Loan repayments	192.0	183.9	210.2	198.9	208.0	5.4	-5.8	5.2	3.6	13.1
SMEs										
Loan applications	47.1	48.3	41.1	42.1	46.4	-7.2	-6.0	1.8	-10.6	-4.0
Loan approvals	16.4	17.1	13.9	15.2	16.9	-1.2	0.9	4.2	-7.8	-0.7
Loan disbursements	66.3	66.7	71.8	69.3	76.8	1.3	-4.8	15.3	4.5	15.2
Loan repayments	66.1	65.9	69.8	68.5	74.3	5.8	-1.5	15.4	3.6	12.8
Non-SMEs[3]										
Loan applications	54.4	45.6	45.2	44.5	50.7	20.3	-23.8	-1.8	-18.1	11.2
Loan approvals	26.1	23.0	27.0	25.7	27.3	-8.8	-10.8	24.8	-1.5	19.1
Loan disbursements	129.0	120.4	142.0	127.6	127.8	0.1	-11.0	6.3	-1.1	6.1
Loan repayments	125.9	118.0	140.4	130.4	133.7	5.2	-8.0	0.8	3.5	13.3
Households										
Loan applications	109.9	110.1	111.1	118.2	124.2	-0.4	-1.7	11.1	7.5	12.8
Loan approvals	45.8	47.6	46.5	50.9	52.5	-17.4	-9.1	13.3	11.1	10.3
Loan disbursements	75.5	76.5	78.6	77.2	79.9	-3.0	-0.5	3.6	2.2	4.4
Loan repayments	72.2	72.7	79.1	75.5	77.6	3.5	4.4	5.9	4.5	6.8

[1] Loan applications and approvals for all segments include only banking system loans
[2] Loan disbursements and repayments for all segments includes banking system and development financial institutions (DFIs)
[3] Includes domestic non-bank financial institutions, domestic financial institutions, government, domestic other entities and foreign entities
Note: Numbers may not add up due to rounding

Source: Bank Negara Malaysia

Table 9

Banking System Profitability Indicators

	2016		2017		
	3Q	4Q	1Q	2Q	3Q
Return on equity (%)	12.8	12.5	11.8	12.7	12.8
Return on assets (%)	1.4	1.3	1.3	1.4	1.4
	RM million				
Net interest income	10,658	11,087	11,314	11,622	11,705
Add: Fee-based income	2,181	2,527	2,538	2,527	2,452
Less: Operating cost	7,290	7,554	7,610	7,670	7,589
Gross operating profit	5,550	6,060	6,242	6,478	6,568
Less: Impairment and other provisions	450	683	301	822	529
Gross operating profit after provision	5,100	5,378	5,941	5,656	6,039
Add: Other income	2,849	2,284	2,021	3,578	2,999
Pre-tax profit	**7,949**	**7,662**	**7,962**	**9,234**	**9,038**
	Annual change (%)				
Return on equity *(percentage points)*	1.2	1.3	-4.3	-3.4	0.0
Return on assets *(percentage points)*	9.0	5.9	-1.5	-0.6	2.1
Net interest income	-0.2	1.9	6.5	9.6	9.8
Add: Fee-based income	1.2	3.5	4.3	13.0	12.4
Less: Operating cost	0.0	-9.8	4.6	4.6	4.1
Gross operating profit	0.1	22.6	8.0	17.7	18.3
Less: Impairment and other provisions	-69.0	74.3	-63.2	11.0	17.5
Gross operating profit after provision	24.7	18.1	19.7	18.8	18.4
Add: Other income	-11.3	-13.0	-26.3	-13.4	5.2
Pre-tax profit	**8.9**	**6.7**	**3.3**	**3.8**	**13.7**

Source: Bank Negara Malaysia

Table 10

Insurance and Takaful Sector Indicators

	2016		2017		
	3Q	4Q	1Q	2Q	3Q
	RM million				
Life Insurance & Family Takaful					
Excess of Income Over Outgo	5,348	658	6,122	4,413	3,518
General Insurance & General Takaful					
Operating profit	*885*	*891*	*495*	*762*	*655*
Claims ratio (%)	*56*	*57*	*63*	*55*	*61*
	Annual change (%)				
Life Insurance & Family Takaful					
Excess of Income Over Outgo	*1382*	*-87.5*	*32.4*	67.8	-34.2
General Insurance & General Takaful					
Operating profit	*59.6*	*31.3*	*-36.3*	*-10.6*	*-26*
Claims ratio (percentage points)	*-9.1*	*-4.0*	*8.8*	*-1.2*	*4.8*

Source: Bank Negara Malaysia

Table 11

Federal Government Finance

	2016		2017[p]		
	3Q	4Q	1Q	2Q	3Q
	RM billion				
Revenue	56.3	59.8	46.6	50.4	58.7
% annual growth	*0.1*	*6.8*	*-4.4*	*6.2*	*4.3*
Operating expenditure	50.7	50.0	57.6	53.5	48.3
% annual growth	*-3.0*	*-13.0*	*0.3*	*2.8*	*-4.8*
Current account	**5.6**	**9.8**	**-10.9**	**-3.1**	**10.5**
% of GDP	**1.8**	**3.0**	**-3.4**	**-0.9**	**3.1**
Net development expenditure	*7.4*	*13.7*	*9.3*	*10.6*	*9.7*
% annual growth	*-15.1*	*-11.5*	*1.7*	*2.0*	*30.9*
Overall balance	***-1.8***	***-3.8***	***-20.2***	***-13.8***	***0.8***
% of GDP	***-0.6***	***-1.2***	***-6.2***	***-4.2***	***0.2***
Memo:					
Total net expenditure	58.1	63.7	66.9	64.2	57.9
% annual growth	*-4.7*	*-12.7*	*0.5*	*2.7*	*-0.3*
Total Federal Government debt (as at end-period)	643.6	648.5	664.5	685.1	687.4
% of GDP	*52.3*	*52.7*	*49.4*	*50.9*	*51.1*
Domestic Debt	413.9	438.2	489.5	496.3	492.3
% of GDP	*33.6*	*35.6*	*36.4*	*36.9*	*36.6*
External Debt	229.7	210.2	175.0	188.8	195.1
% of GDP	*18.7*	*17.1*	*13.0*	*14.0*	*14.5*
Non-resident holdings of RM-denominated Federal Government debt	*211.8*	*191.8*	*156.7*	*171.1*	*177.8*
% of GDP	*17.2*	*15.6*	*11.7*	*12.7*	*13.2*
Offshore borrowing	*18.0*	*18.5*	*18.3*	*17.7*	*17.3*
% of GDP	*1.5*	*1.5*	*1.4*	*1.3*	*1.3*

[p] Preliminary

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia