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

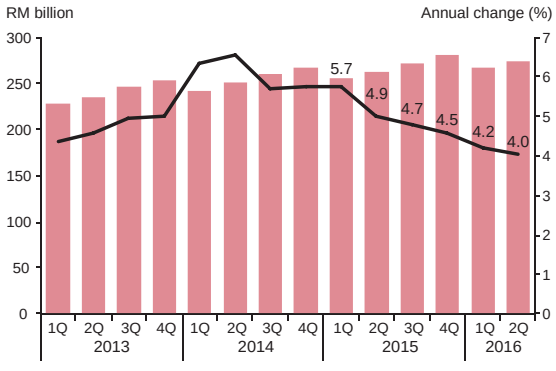
OVERVIEW

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

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

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

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



Source: Department of Statistics, Malaysia

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

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

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

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

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

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

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

Interest rates remained stable

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

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

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

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

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

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

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

Domestic financial system remains resilient

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

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

Domestic demand will remain the key driver of growth

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

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