ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE THIRD QUARTER OF 2015

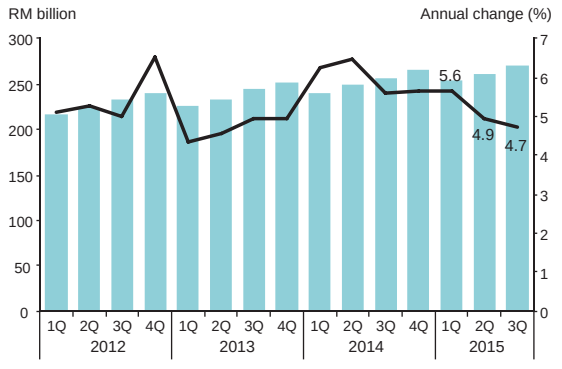
OVERVIEW

The global economy continued to expand at a moderate pace in the third quarter of 2015, with diverging growth momentum across economies. While the US and the UK economies registered moderate growth, economic activity in the euro area and Japan improved at a more gradual pace. In Asia, growth was supported by the continued expansion of domestic demand amid weak export performance. Against a backdrop of moderate growth and low inflation, several major and regional central banks lowered policy rates. In addition, a number of economies in the region have also announced fiscal measures to support domestic demand activity.

The Malaysian economy expanded by 4.7% in the third quarter of 2015

The Malaysian economy recorded a growth of 4.7% in the third quarter of 2015 (2Q 2015: 4.9%), supported mainly by private sector demand. On the supply side, all economic sectors continued to expand during the quarter. On a quarter-on-quarter seasonally-adjusted basis, the economy grew by 0.7% (2Q 2015: 1.1%).

The economy expanded in the third quarter
(at constant 2010 prices)



Source: Department of Statistics, Malaysia

The private sector continued to be the key driver of growth during the quarter. Private investment grew by 5.5% (2Q 2015: 3.9%), driven by capital spending in the manufacturing and services sectors. Private consumption expanded at a more moderate rate of 4.1% (2Q 2015: 6.4%) as households continued to adjust to the implementation of the Goods and Services Tax (GST). Public investment turned around to record a positive growth due to the improvement in spending on fixed assets by both the Federal Government and public enterprises Meanwhile, public consumption growth moderated to 3.5% (2Q 2015: 6.8%) following the slower growth in both emoluments and supplies and services expenditure.

On the supply side, all economic sectors continued to expand during the quarter. Growth was led by the construction and manufacturing sectors. Construction sector growth improved due mainly to a faster expansion in the civil engineering and specialised construction activities sub-sectors. Similarly, the manufacturing sector registered higher growth, supported in particular by an improvement in the export-oriented industries. The services sector registered lower growth due to a moderation in household spending and slower capital market activity. The mining and agriculture sectors expanded at a slower pace due to a moderation in crude oil and palm oil production, respectively.

Inflation, as measured by the annual change in the Consumer Price Index (CPI), increased to 3.0% in the third quarter of 2015 (2Q 2015: 2.2%) largely reflecting the higher inflation in the *food and non-alcoholic beverages* category amid shortages in supplies arising from adverse weather conditions. The *transport* category also contributed to the increase in inflation following the higher domestic fuel prices during the quarter.

The trade surplus amounted to RM22.2 billion in the third quarter of 2015 (2Q 2015: RM20.4 billion). Gross exports turned around to register an expansion of 5.5% (2Q 2015: -3.7%), supported mainly by the broad-based expansion in manufactured exports. Meanwhile, gross imports grew by 2.9% (2Q 2015: -5.2%), reflecting an improvement in most major import categories.

The international reserves of BNM amounted to RM415.1 billion (equivalent to USD93.3 billion) as at 30 September 2015. This reserves level has taken into account the quarterly adjustment for foreign exchange revaluation changes.

As at 30 October 2015, the reserves position amounted to RM417.9 billion (equivalent to USD94.0 billion). The international reserves remain ample to facilitate international transactions without disruptions. It is sufficient to finance 8.7 months of retained imports, significantly higher than the 3-month international threshold. It is also adequate to meet external obligations with the reserves to short-term external debt coverage of 1.1 times. It is important to note that not all short-term external debt pose an immediate 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 third quarter of 2015. At the prevailing level of the OPR, monetary conditions remained supportive of economic activity. Despite increased volatility in international financial markets and domestic uncertainties, interest rates in the domestic money market remained broadly stable during the quarter. However, interbank rates beyond the 1-month tenure trended higher towards the end of the quarter, reflecting the shift in liquidity towards the shorter tenures amid the greater preference of corporates and banks for shorter-term placements. In terms of retail rates, both deposit and lending rates were broadly unchanged throughout the quarter. The average base rate (BR) of banks at the end of the third quarter was slightly lower at 3.85%.

The monetary aggregates increased in the third quarter. M3, or broad money, increased by RM0.5 billion on a quarter-on-quarter basis to record an annual growth rate of 5.3% as at end-September (2Q 2015: 6.0%). 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 expansion was also on account of lower net claims on the Government, reflecting the redemption of Government bonds during the quarter. The growth in broad money, however, was partially offset by the lower net foreign assets due to external sector outflows during the quarter. In the banking system, ample liquidity conditions prevailed at both the institutional and system-wide levels. While the level of surplus liquidity placed with BNM was lower arising from external sector outflows, it remained high at above RM200 billion as at end-September.

Total gross financing raised by the private sector through the banking system and the capital market amounted to RM287.9 billion (2Q 2015: RM287.1 billion). On a net basis, outstanding banking system loans and PDS expanded at a higher growth rate of 8.8% as at end-September (2Q 2015: 8.3%). Outstanding business loans grew at a stronger pace with higher level of credit extended mainly to the *manufacturing; wholesale and retail trade, and restaurants and hotels; real estate* and *finance, insurance and business services* sectors. In particular, outstanding SME loans continued to grow at a strong rate of 17.6% (2Q 2015: 17.1%). Outstanding household loans growth moderated to 8.1% in the third quarter (2Q 2015: 8.7%). While fund raising activity in the capital market continued to be supported by gross funds raised by both private and public sectors, large redemptions of Government debt securities more than offset the net funds raised by the private sector, resulting in an overall position of net redemptions of RM2.6 billion during the quarter.

The ringgit and other regional currencies continued to face volatility during the quarter due to uncertainty in global growth and monetary conditions. Overall, the ringgit depreciated by 14.8% against the US dollar during the quarter. The ringgit also depreciated

against the Australian dollar (-6.8%), the pound sterling (-11.7%), the euro (-15.4%), and the Japanese yen (-16.6%). Against all regional currencies, the ringgit depreciated by between 6.3% and 12.8%.

Between 1 October and 11 November 2015, the ringgit appreciated against all major currencies. The ringgit appreciated against the US dollar (1.8%), the euro (6.5%), the Japanese yen (4.4%), the pound sterling (1.8%), and the Australian dollar (0.9%). The ringgit also appreciated against most regional currencies, except for the Korean won (-1.2%) and the Indonesian rupiah (-5.7%).

Domestic financial stability continued to be preserved

The Malaysian financial system remained resilient despite heightened volatility during the quarter. The domestic financial markets demonstrated continued resilience and orderly conditions, while sound financial institutions and ample banking system liquidity continued to lend support for financing to businesses and households. Fragile investor sentiment is expected to persist in the period ahead, with prospects of a repricing of risks continuing to weigh on sentiment. Domestic financial system stability is nonetheless expected to be maintained. This is underpinned by the strong financial buffers of financial institutions, a sustained focus on prudent risk-taking, especially among banks, and deep domestic financial markets. Debt servicing capacity of most borrowers remained intact, with the net impaired loans ratio unchanged at 1.2%.

The capitalisation of financial institutions remained strong and is sufficient to absorb potential losses from adverse developments in financial and economic conditions. For banks, the common equity tier-1 capital, tier-1 capital and total capital ratios were sustained well above the minimum regulatory levels at 12.1%, 12.8% and 14.8% respectively. More than 80% of banks' total capital is of high quality, comprising retained earnings, paid-up capital and reserves. The capital adequacy ratio for the insurance sector was similarly healthy at 243.8% (2Q 2015: 239.0%). In aggregate, financial institutions have capital buffers totalling RM132 billion (banks: RM100.2 billion; insurers/ takaful operators: RM31.8 billion), that can be used to absorb potential losses from adverse credit and market events.

Domestic demand will remain the key driver of growth

Going forward, global growth is expected to remain moderate. While the major advanced economies continue to improve, the pace of recovery will be modest. In Asia, domestic demand is expected to continue to support growth. Downside risks to global growth remain high arising from the moderating growth momentum in a number of major economies, uncertainty surrounding energy and commodity prices and possible disorderly market conditions arising from policy shifts in major economies.

While downside risks to growth remain, the Malaysian economy is expected to expand within the region of 4.5 – 5.5% this year and 4 – 5% in 2016. As a result of structural adjustments that have been steadily undertaken over the years, the economy is now supported by diversified sources of growth. With the external sector performance expected to be modest, domestic demand will continue to be the main driver of growth, supported mainly by the private sector activity. In addition, the flexible exchange rate, deep and more mature financial markets and solid financial institutions will support this trend and ensure that shocks such as volatile capital flows are well intermediated, therefore minimising spillovers to the real economy.