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

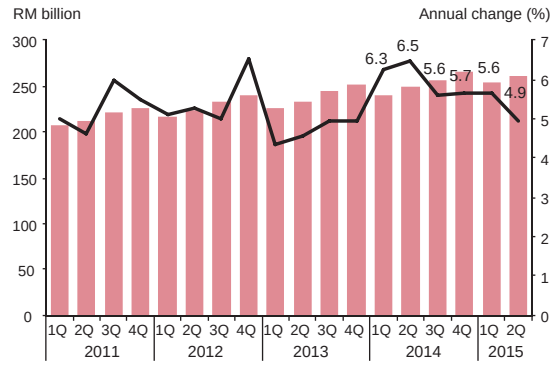
OVERVIEW

The global economy expanded at a moderate pace in the second quarter of 2015. In the major advanced economies, growth in the US and the UK continued to improve while the pace of economic activity in the euro area and Japan was more modest. Growth in most Asian economies moderated in the second quarter. Domestic demand continued to support growth in an environment of weak export performance. Several central banks in major and emerging economies lowered policy rates amid rising growth concerns and low inflation.

The Malaysian economy grew by 4.9% in the second quarter of 2015

The Malaysian economy recorded a growth of 4.9% in the second quarter of 2015 (1Q 2015: 5.6%), driven mainly by private sector demand. On the supply side, growth was underpinned by the major economic sectors. On a quarter-on-quarter seasonally-adjusted basis, the economy grew by 1.1% (1Q 2015: 1.2%).

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



Source: Department of Statistics, Malaysia

The private sector remained the key driver of growth during the quarter. Private consumption expanded at a more moderate rate of 6.4% (1Q 2015: 8.8%) as households adjust to the implementation of the Goods and Services Tax (GST). Private investment grew more moderately by 3.9% (1Q 2015: 11.7%), due to a decline in spending on machinery and equipment, especially in the transportation segment, and slower investment in dwelling services. Growth in public investment turned negative in the second quarter (-8.0%; 1Q 2015: 0.5%), attributed mainly to the near completion of a few projects by public enterprises, which more than offset the positive growth of capital expenditure by the Federal Government. Meanwhile, public consumption recorded a higher growth of 6.8%; (1Q 2015: 4.1%) following the stronger expansion in supplies and services expenditure amid sustained growth in emoluments.

On the supply side, the major economic sectors registered more moderate growth during the quarter. The lower growth in the services sector was the outcome of a slower expansion in most sub-sectors while the moderation in manufacturing sector was due to the more modest performance in export oriented industries. Growth in the mining sector was affected mainly by the lower production of natural gas. The construction sector also recorded lower growth due to a moderation in real activity in the residential, non-residential and civil engineering sub-sectors. The agriculture sector turned around to record positive growth amid higher production of palm oil.

Inflation, as measured by the annual change in the Consumer Price Index (CPI), increased to 2.2% in the second quarter of 2015 (1Q 2015: 0.7%) reflecting mainly the impact of the implementation of the Goods and Services Tax (GST) on 1 April. The price increases were broad-based, with all twelve categories of the CPI basket registering higher inflation in the second quarter compared to the first quarter. Meanwhile, prices in the *transport* category declined at a lower rate of 3.6% in the second quarter (1Q 2015: -7.6%), reflecting the upward adjustment of domestic fuel prices.

The trade surplus amounted to RM20.4 billion in the second quarter of 2015 (1Q 2015: RM21.3 billion). Gross exports declined by 3.7% (1Q 2015: -2.5%), due mainly to the contraction in the exports of commodities and resource-based manufactured products. Similarly, gross imports recorded a contraction of 5.2% during the quarter (1Q 2015: +0.2%), weighed down by weaker performance of all import categories, except for consumption imports.

The international reserves of BNM amounted to RM389.1 billion (equivalent to USD105.5 billion) as at 30 June 2015. This reserves level has taken into account the quarterly adjustment for foreign exchange revaluation changes.

As at 31 July 2015, the reserves position amounted to RM364.7 billion (equivalent to USD96.7 billion). It is sufficient to finance 7.6 months of retained imports, significantly higher than the 3-month international threshold. The reserves to short-term external debt coverage of 1.1 times is adequate for a country with a relatively high degree of financial openness.

Interest rates remained stable

The Monetary Policy Committee (MPC) maintained the Overnight Policy Rate (OPR) at 3.25% at its meetings during the second quarter of 2015. At the prevailing level of the OPR, monetary conditions remained supportive of economic activity. Despite increased volatility in international financial markets, interest rates in the domestic money market have remained stable. The average overnight interbank rate traded within a range of 3.16% and 3.25% during the quarter, while interbank rates for other short-term maturities (less than 1 month) were relatively steady. For the quarter as a whole, while the 3-month Kuala Lumpur Interbank Offered Rates (KLIBOR) declined from 3.73% to 3.69%, 3-month KLIBOR futures remained relatively stable, reflecting market expectation for the policy interest rate to be unchanged. In terms of retail rates, both deposit and lending rates to the economy were broadly stable throughout the quarter. The average base rate (BR) of banks at the end of the second quarter was slightly lower at 3.88%, as two banks revised their BR downwards in June following the downward trend in KLIBOR.

The monetary aggregates moderated in the second quarter. M3, or broad money, declined by RM7.2 billion on a quarter-on-quarter basis while still recording an annual growth rate of 6.0% as at end-June (end-March 2015: 7.9%). The decrease in M3 during the quarter was driven mainly by lower net claims on the Government, reflecting private sector purchase of Malaysian Government Securities (MGS) and Government Investment Issues (GII), which were raised in anticipation of the maturity of Government bonds in 2H 2015. The moderation in M3 was also on account of lower net foreign assets of the financial system following net external outflows during the quarter. Nevertheless, the decrease in M3 was partially offset by the continued extension of credit to households and businesses. In the banking system, liquidity conditions remained ample at both the institutional and system-wide levels. The level of surplus liquidity placed with BNM was relatively stable during the quarter.

Total gross financing raised by the private sector through the banking system and the capital market amounted to RM290.1 billion (1Q 2015: RM282.6 billion). On a net basis, outstanding banking system loans and PDS expanded at a stable growth rate of 8.3% during the quarter (1Q 2015: 8.3%). The amount of loans disbursed to businesses increased during the quarter with a higher level of credit being extended mainly to the w*holesale and retail trade, and restaurants and hotels; manufacturing; agriculture* and *transport, storage and communication* sectors. In particular, financing for SMEs continued to be strong, with outstanding SME loans growing at a steady growth rate of 17.2% (1Q 2015: 17.2%). Outstanding household loans growth moderated to 8.7% in the second quarter (1Q 2015: 9.8%). Net funds raised in the capital market increased to RM39.3 billion (1Q 2015: RM21.0 billion), due mainly to higher net issuances of government and private debt securities.

The ringgit and other regional currencies continued to be driven by shifts in investor sentiments and portfolio investments throughout the quarter. Overall, the ringgit depreciated by 1.8% against the US dollar during the quarter. The ringgit also depreciated against the Japanese yen (-0.1%), the Australian

dollar (-2.5%), the euro (-5.2%), and the pound sterling (-7.7%). Against all regional currencies except the Thai baht (2.0%), the ringgit depreciated by between 0.1% and 3.9%.

Between 1 July and 11 August 2015, the ringgit depreciated against the US dollar by 4.2%. Against other major currencies, the ringgit also depreciated against the euro (-2.4%), the Japanese yen (-2.4%) and the pound sterling (-3.3%), but appreciated against the Australian dollar (0.3%). The ringgit depreciated against most regional currencies.

Domestic financial stability continues to be preserved

Financial system resilience remained intact despite persistent volatility in the global and domestic financial markets during the quarter. The domestic financial markets continued to function in an orderly manner. Combined with continued ample domestic liquidity and institutional soundness, financial intermediation activities continued to function efficiently to support the financial and financing needs of the domestic economy. In the near term, domestic financial system stability is expected to be maintained, thus providing continued support to real sector activities amidst challenging operating environment. Stress tests[1] conducted by the Bank have also shown that banks' and insurers' are expected to remain well capitalised under a simulated scenario of significant portfolio outflows.

Banks' capitalisation was maintained at strong levels. At end-2Q 2015, the common equity tier-1 capital ratio, tier-1 capital ratio and total capital ratio stood well above the minimum regulatory levels at 12.3%, 13.1% and 15.2% respectively. More than 80% of banks' total capital consists of high quality capital comprising retained earnings, paid-up capital and reserves. The capital buffer of the banking system was sustained in excess of RM100 billion. Similarly, the capital adequacy ratio for the insurance sector remained strong at 239.1% (1Q 2015: 245.7%) with an excess capital buffer above RM28.5 billion.

Domestic demand will remain the key driver of growth

Going forward, the global economy is projected to remain on a moderate growth path, with diverging growth momentum across major economies. Overall global growth is expected to continue to benefit from low oil prices, but the impact will vary across economies. In Asia, with export growth remaining moderate, domestic demand is expected to remain the key driver of growth. Global growth, however, has become more vulnerable to increased downside risks. Any adverse developments in Europe, increased uncertainty over policy adjustments in the advanced and emerging economies and a re-emergence of geopolitical tensions could result in further international financial market volatility.

The Malaysian economy is expected to remain on a steady growth path, with domestic demand continuing to be the key driver of growth. Private consumption is expected to continue to adjust to the introduction of the Goods and Services Tax (GST), although wage growth and stable labour market conditions would provide support to household spending. Investment activity will be supported by capital spending in the manufacturing and services sectors, as well as for infrastructure projects. These developments will contribute towards offsetting the weaker performance of the external sector.

[1] This assessment has incorporated a range of extreme shock parameters, including mark-to-market losses from holdings of equities, interest rate risk in the trading books and foreign currency exposures in the balance sheets and credit losses from businesses affected by significant exchange rate volatility.