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

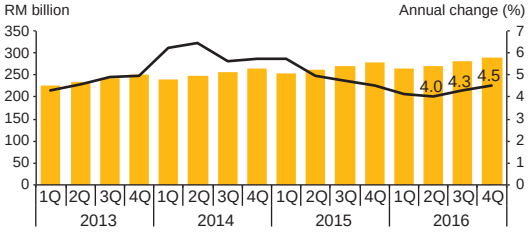
OVERVIEW

Global economic activity continued to expand in the fourth quarter of 2016. The advanced economies experienced divergent growth trends, in part, driven by differences in the strength of private consumption amid cyclical and structural weaknesses. In Asia, economic activity was supported mainly by domestic demand. Of importance, the external sector provided a small lift to growth in several economies, following consecutive quarters of negative growth. Financial market volatility increased due to concerns over major issues in the advanced economies, such as policy and political uncertainties following the outcome of the presidential election in the US and the UK's vote to exit the EU. Overall, global monetary conditions remained very accommodative, against a backdrop of continued growth concerns with rising, but still low inflation.

The Malaysian economy expanded by 4.5% in the fourth quarter of 2016

The Malaysian economy grew by 4.5% in the fourth quarter of 2016 (3Q 2016: 4.3%), underpinned by continued expansion in private sector expenditure. On the supply side, growth continues to be driven by the manufacturing and services sectors. On a quarter-on-quarter seasonally-adjusted basis, the economy recorded a sustained growth of 1.4% (3Q 2016: 1.4%).

The Economy Expanded by 4.5% in the Fourth Quarter (at constant 2010 prices)



Source: Department of Statistics, Malaysia

Overall, domestic demand expanded at a more moderate pace, as the sustained growth in private sector expenditure was partly offset by the decline in public expenditure. In the fourth quarter, private consumption grew by 6.2% (3Q 2016: 6.4%), supported by continued wage and employment growth. Private investment registered a growth of 4.9% (3Q 2016: 4.7%), following continued capital spending in the services and manufacturing sectors. Growth of public investment improved mainly on account of higher spending on fixed assets by public corporations, but nevertheless, remained in contraction during the quarter. Public consumption also declined by 4.2% (3Q 2016: +2.2%) arising from the rationalisation of spending on supplies and services and a moderation in the growth of spending on emoluments. On the external front, net exports contributed positively to growth as real exports expanded at a faster rate than real imports.

On the supply side, growth in the manufacturing, mining and agriculture sectors improved. The manufacturing sector expanded at a faster pace owing to higher growth in both domestic and export-oriented industries. The mining sector recorded an improvement due to the increase of natural gas production during the quarter. In the agriculture sector, economic activity contracted at a slower pace, reflecting the diminishing impact of El Niño on crude palm oil yields. Growth in the services sector continued to expand, albeit at a more moderate pace, supported mainly by consumption-related services. In the construction sector, growth remained driven by the civil engineering sub-sector.

Inflation, as measured by the annual change in the Consumer Price Index (CPI), increased to 1.7% in the fourth quarter of 2016 (3Q 2016: 1.3%), driven mainly by upward adjustments to domestic fuel prices during the quarter. Inflation in the *transport* category registered a smaller negative inflation of 2.6% during the quarter

(3Q 2016: -7.4%). The inflationary impact was, however, mitigated by the lower inflation in the *alcoholic beverages and tobacco* category (6.6%; 3Q 2016: 19.7%) due to the lapse in the impact of the upward revision in cigarette prices in the base period of 4Q 2015. For the year as a whole, inflation averaged 2.1% (2015: 2.1%).

In 4Q 2016, the current account surplus widened, due mainly to a higher trade surplus and narrower deficits in the income accounts.

As at 31 January 2017, the reserves position amounted to USD95.0 billion (equivalent to RM426.0 billion). The international reserves remain ample to facilitate international transactions. They are sufficient to finance 8.6 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 1.1 times. It is important to note that not all short-term external debt creates a claim on reserves given the availability of external assets and export earnings of borrowers.

Monetary conditions remain supportive of economic activity, with continued growth in financing to the private sector

The Monetary Policy Committee (MPC) maintained the Overnight Policy Rate (OPR) at 3.00% during the fourth quarter of 2016. At the prevailing level of the OPR, monetary conditions remained supportive of economic activity. Reflecting the unchanged OPR, interbank rates and the 3-month KLIBOR were relatively stable during the quarter. Correspondingly, retail lending rates were also stable. The weighted average base rate (BR) of commercial banks remained unchanged at 3.61% while the weighted average lending rate (ALR) on outstanding loans declined by five basis points from end-September to end-December.

M3, or broad money, increased by RM25.0 billion on a quarter-on-quarter basis to record an annual growth rate of 3% as at end-December (end-September: 2.2%). The increase in M3 during the quarter was driven mainly by the continued expansion of credit extended to the private sector by the banking system.

Total gross financing raised by the private sector through the banking system, development financial institutions (DFIs), and the capital market amounted to RM316.2 billion (3Q 2016: RM293.8 billion). On a net basis, the growth of loans extended by the banking system and DFIs, and the outstanding issuances of corporate bonds, moderated to 5.5% in 4Q 2016 (3Q 2016: 6.5%) due mainly to the lower growth in outstanding corporate bonds. On an annual basis, outstanding business loans extended by the banking system and DFIs grew by 4.8% in the fourth quarter (3Q 2016: 2.0%). The growth of outstanding household loans of the banking system and DFIs moderated to 5.5% in 4Q 2016 (3Q 2016: 5.8%), reflecting mainly the moderation in outstanding loans for the purchase of passenger cars and the *purchase of residential property*. Net funds raised in the capital market moderated to RM2.1 billion in the fourth quarter of 2016 (3Q 2016: RM13.5 billion). The decline was due mainly to lower net funds raised by the private sector.

The ringgit and all major and regional currencies depreciated against the US dollar during the quarter. The depreciation was driven mainly by portfolio investment outflows from emerging economies amid uncertainties arising from the outcome of the US Presidential Elections. Expectations of an interest rate increase, the actual increase in the US Federal Reserve's policy rate in December 2016, and the anticipation of a faster pace of US interest rate normalisation in 2017, exacerbated portfolio outflows and exerted further downward pressure on most major and regional currencies. The ringgit also faced additional adjustments during the quarter following speculative activity in the non-deliverable forward (NDF) market. The ringgit, along with regional currencies, however, began to stabilise towards the end of the quarter amidst higher stability in the global financial markets. The implementation of measures to develop, deepen, and address the rising imbalances in the domestic foreign exchange market, and the firmer global crude oil prices also lent stability to the domestic foreign exchange market towards the end of the quarter.

Overall, the ringgit depreciated by 7.6% against the US dollar during the quarter. The ringgit also depreciated against the euro (-1.6%), the pound sterling (-2.4%) and the Australian dollar (-2.5%), but appreciated against the Japanese yen (6.3%). The ringgit also depreciated against all regional currencies, with the exception of the Korean won, by between 2.1% and 5.6%.

Domestic financial system remains resilient

The Malaysian financial system remains resilient despite global uncertainties over policy adjustments in the major economies. The domestic banking system remains well-capitalised, with ample liquidity to support the financing needs of businesses and households. As businesses and households continue to adjust to the challenging economic outlook and higher cost of living, these financial buffers will support the resilience of the financial institutions. Going forward, external events will continue to weigh heavily on the volatility in domestic financial markets. These include increased uncertainty over political developments and growth in the major economies as well as volatile commodity prices. Domestic financial system stability is nonetheless expected to be preserved given the loss absorption capacity of financial institutions supported by strong capital and liquidity buffers.

Financial institutions remained well-capitalised. The combined capital buffers of banks, insurers and takaful operators stood at RM172.5 billion. Banks maintained a high level and quality of capitalisation. This is reflected in the high common equity tier-1, tier-1 and total capital ratios of banks which stood at 13.1%, 14.0% and 16.5%, respectively (3Q 2016: 13.3%, 14.2% and 16.7%, respectively). Similarly, the capital adequacy ratio for the insurance and takaful sectors remained high at 243.8% (3Q 2016: 226.3%).

Domestic demand will remain the key driver of growth

Going forward, the global economy is expected to improve but remain on a moderate growth path. While there are indications of more sustained growth in the major economies in 2017, downside risks to global growth continue to prevail, arising from the volatility in commodity prices, policy uncertainties and growth prospects of the major developed economies, heightened risk aversions in the global financial markets as well as geopolitical developments.

While the external environment may continue to remain challenging, the Malaysian economy will experience sustained growth with the primary driver being domestic demand. Private consumption is anticipated to remain supported by wage and employment growth, with additional impetus coming from announced Government measures to support disposable income of households. Investment activity will continue to be anchored by the on-going implementation of infrastructure projects and capital spending in the manufacturing and services sectors.