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

OVERVIEW

In the third quarter of 2016, the global economy continued to experience moderate growth. The latest data pointed to modest economic activity in the advanced economies. In Asia, domestic demand remained an important source of growth amid persistent weakness in external demand. While pressures in the international financial markets receded following major central banks' easing actions, a number of important policy issues in major economies continued to pose uncertainties to global growth prospects. Amid subdued growth outlook and low inflation, several major and regional central banks increased the degree of monetary accommodation.

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The Malaysian economy expanded by 4.3% in the third quarter of 2016 (2Q 2016: 4.0%), underpinned mainly by continued expansion in private sector spending and additional support from net exports. 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 1.5% (2Q 2016: 0.7%).

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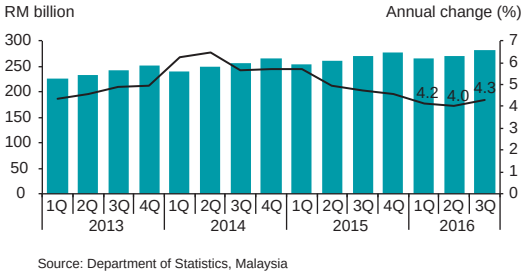

Source: Department of Statistics, Malaysia

Overall, domestic demand grew at a more moderate pace, as the sustained growth in private sector activity was more than offset by the slower growth in public spending. Private consumption grew by 6.4% (2Q 2016: 6.3%), supported by continued wage and employment growth as well as the increase in minimum wage effective 1 July 2016. Private investment registered a growth of 4.7% in the third quarter (2Q 2016: 5.6%), supported primarily by continued capital spending in the services and manufacturing sectors. Growth of public consumption moderated to 3.1% during the quarter (2Q 2016: 6.5%) due to lower spending on supplies and services, which partially offset the higher spending on emoluments. Public investment growth contracted by 3.8% (2Q 2016: 7.5%), attributable mainly to lower spending on fixed assets by the Federal Government.

On the supply side, growth in the third quarter was supported mainly by the services and manufacturing sectors, while the agriculture sector remained weak. The expansion in the services sector was underpinned primarily by private consumption activity, while growth in the manufacturing sector was supported by export-oriented industries. In the construction sector, growth continued to be driven by civil engineering activity, while the mining sector expanded at a faster pace on account of higher crude oil production. Growth in the agriculture sector, however, remained in contraction, attributable largely to the lagged impact of El Niño on crude palm oil (CPO) yields.

Inflation, as measured by the annual change in the Consumer Price Index (CPI), moderated further to 1.3% in the third quarter of 2016 (2Q 2016: 1.9%). During the quarter, inflation in the *food and non-alcoholic beverages* category was lower at 3.4% (2Q 2016: 4.2%). Inflation in the *transport* category also registered a larger decline of 7.4% in the third quarter of 2016 (2Q 2016: -6.6%).

In 3Q 2016, the current account surplus of the balance of payments widened due mainly to a larger goods surplus, which more than offset the higher deficit in the services and investment income accounts.

As at 31 October 2016, the reserves position amounted to USD97.8 billion (equivalent to RM405.5 billion). The international reserves remain ample to facilitate international transactions. They are sufficient to finance 8.4 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 a claim on reserves given the availability of external assets and export earnings of borrowers.

Interest rates lowered in line with OPR reduction

The Monetary Policy Committee (MPC) reduced the Overnight Policy Rate (OPR) by 25 bps to 3.00% in July 2016 and subsequently kept the policy rate unchanged in September 2016. The adjustment to the OPR was intended to ensure that the degree of monetary accommodativeness remained consistent with the policy stance for the domestic economy to continue on a steady growth path amid stable inflation, supported by continued healthy financial intermediation in the economy. Reflecting the reduction in the OPR, interbank rates trended lower during the quarter and the 3-month KLIBOR decreased from 3.65% to 3.40%. Correspondingly, the weighted average base rate (BR) of commercial banks ended the third quarter lower at 3.60% (end-June 2016: 3.83%). The weighted average lending rate (ALR) on outstanding loans was lower at 5.27% as at end-September 2016, compared to 5.42% at end-June 2016. In addition, fixed deposit (FD) rates declined during the quarter by an average of 21 bps for tenures 1-year and below.

M3, or broad money, increased by RM6.4 billion on a quarter-on-quarter basis to record an annual growth rate of 2.2% as at end-September (end-June: 1.9%). 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. 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 RM293.8 billion (2Q 2016: RM292.9 billion). On a net basis, the growth of loans extended by the banking system, DFIs, and outstanding issuances of corporate bonds expanded by 6.5% as at end-September (end- June 2016: 6.9%). On an annual basis, although outstanding business loans grew at a slower pace of 2.0% as at end-September (end-June 2016: 3.8%), the annual growth in outstanding SME loans was sustained at 8.2% (end-June 2016: 9.2%). The growth of outstanding household loans moderated to 5.8% as at end-September (end-June 2016: 6.2%), reflecting mainly the moderation in outstanding loans for the *purchase of passenger cars; purchase of non-residential property; purchase of residential property; and personal financing*. Net funds raised in the capital market moderated to RM13.5 billion in the third quarter of 2016 (2Q 2016: RM33.4 billion) due mainly to the large redemptions of Government debt securities.

The ringgit depreciated against most major and regional currencies during the quarter. This was a reflection of the shift in investor sentiments and the rebalancing activity of portfolio investors throughout the quarter, driven mainly by external events. While all regional currencies were affected by the continued uncertainty over the timing of US interest rate normalisation, the ringgit and the currencies of other commodity-exporting countries were faced with additional adjustments due to the highly volatile global crude oil prices during the quarter.

Overall, the ringgit depreciated by 3.0% against the US dollar during the quarter. The ringgit also depreciated against the euro (-3.9%), the Japanese yen (-4.2%) and the Australian dollar (-5.5%), but appreciated against the pound sterling (0.2%). The ringgit also depreciated against all regional currencies except the Philippine peso, by between 1.8% and 7.3%.

Domestic financial stability continued to be preserved

The Malaysian financial system remains resilient. This resilience is expected to be maintained in the period ahead. While businesses and households continue to adjust to the more challenging operating conditions and higher cost of living, these adjustments are expected to have modest impact on financial institutions' earnings and asset quality. Supported by strong capital and liquidity positions, the Malaysian financial system is well-positioned to continue performing its intermediation function in an effective and efficient manner. Going forward, external events will continue to weigh heavily on investor sentiments and volatility in the domestic financial markets. These include increased uncertainty over policy adjustments and growth in the major economies, volatile commodity prices and developments in the United Kingdom (UK) post the European Union (EU) referendum. Domestic financial system stability is nonetheless expected to be maintained.

Financial institutions are well-capitalised with combined capital buffers of RM160.8 billion. For banks, more than 90% of total capital consists of retained earnings, paid-up capital and reserves which have strong loss-absorbing quality. This reflects the high capital ratios – common equity tier-1, tier-1 and total capital ratios of banks stood at 13.3%, 14.2% and 16.7%, respectively (2Q 2016: 13.4%, 14.3% and 16.8% respectively). Similarly, the capital adequacy ratio for the insurance and takaful sectors remained high at 226.4% (2Q 2016: 228.1%).

Domestic demand will remain the key driver of growth

Looking ahead, overall global economic conditions will likely continue to be challenging, with subdued growth prospects 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. Downside risks remain high, arising from the uncertainties over the timing and outcome of the UK-EU negotiations following the UK's EU referendum, persistence of low energy and commodity prices as well as possible disorderly market conditions arising from policy shifts in major economies. Against this backdrop, international financial market conditions will likely continue to be vulnerable to setbacks and changes in sentiments.

The Malaysian economy is expected to expand by 4-4.5% in 2016. Domestic demand, particularly private sector activity will continue to be the key driver of growth. Private consumption is expected to remain supported by wage and employment growth, with additional impetus coming from announced Government measures to increase disposable income. Investment activity will continue to be anchored by the on-going implementation of infrastructure projects and capital spending in the manufacturing and services sectors. On the external front, export growth is expected to remain weak following subdued demand from Malaysia's key trading partners. Overall, while domestic conditions remain resilient, uncertainties in the external environment may pose downside risks to Malaysia's growth prospects.