Developments in the Malaysian Economy

HIGHLIGHTS

- **The Malaysian economy grew by 5.8% in the second quarter.**
- **Headline inflation declined to 4.0% due mainly to lower domestic fuel prices.**
- **Current account surplus widened to 3.0% of GNI due to a higher goods surplus and smaller deficit in the services and primary income account.**

The Malaysian economy grew by 5.8% in the second quarter of 2017

The Malaysian economy recorded a stronger growth of 5.8% in the second quarter of 2017 (1Q 2017: 5.6%). Private sector spending continued to be the main driver of growth. On the external front, growth was further supported by the robust expansion in real exports of goods and services (9.6%; 1Q 2017: 9.8%) following strong demand for manufactured and commodity products. Real imports moderated slightly to 10.7% (1Q 2017: 12.9%) following more moderate expansion in investment. On a quarter-on-quarter seasonally-adjusted basis, the economy recorded a growth of 1.3% (1Q 2017: 1.8%).

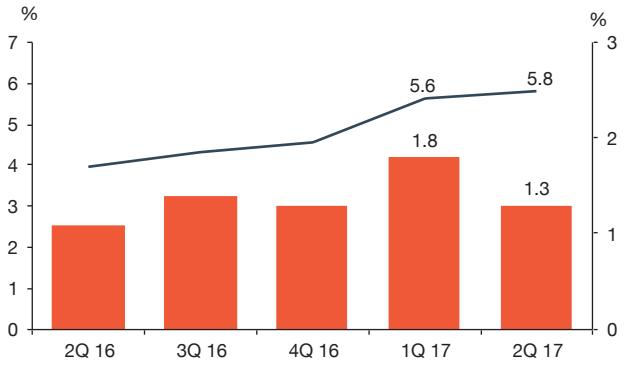
Domestic demand driven by the private sector

Domestic demand grew by 5.7% in the second quarter of the year (1Q 2017: 7.7%), supported by continued expansion in both private sector expenditure (7.2%; 1Q 2017: 8.2%) and public sector spending (0.2%; 1Q 2017: 5.8%).

Private consumption recorded a growth of 7.1% (1Q 2017: 6.6%), supported by the improvement in private sector wages amid continued strength in employment growth. During the quarter, consumer sentiments continued to improve, providing further impetus to household spending.

Stronger Growth in 2Q 2017

Chart 4: GDP Growth

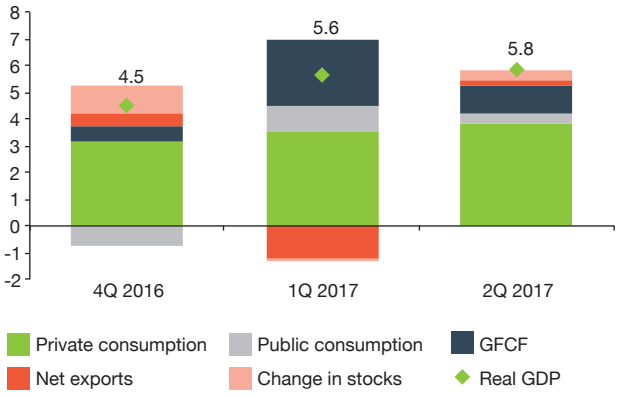


Source: Department of Statistics, Malaysia

Private Sector Demand Remained the Key Driver of Growth

Chart 5: Contribution of Expenditure Components to GDP Growth

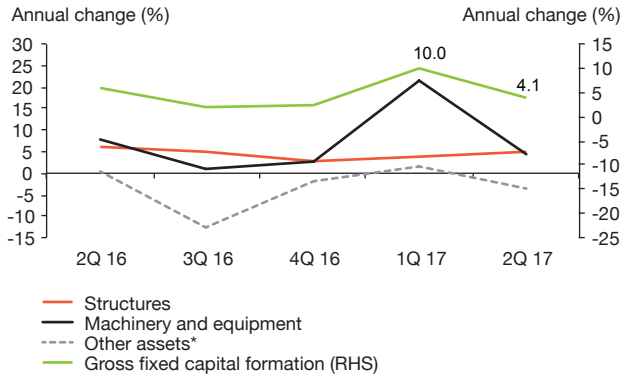
Annual change (%), Contribution to growth (percentage points)



Source: Department of Statistics, Malaysia

Gross Fixed Capital Formation Expanded More Moderately

Chart 6: GFCF Growth by Type of Assets



*Other assets include mineral exploration, research & development and capitalised planting

Source: Department of Statistics, Malaysia

Private investment expanded by 7.4% in the second quarter (1Q 2017: 12.9%), mainly in the services and manufacturing sectors. In line with the recovery in demand, manufacturers undertook capacity expansions, machinery and equipment (M&E) acquisitions and replacements to cater for new orders. This was evident across both the export- and domestic-oriented manufacturing sub-sectors. In the services sector, investment was supported mainly by expansions in the utilities, healthcare and food & beverage and accommodation sub-sectors. During the quarter, business sentiments continued to improve in tandem with better external and domestic conditions amid lower financial market volatility.

Public consumption growth moderated to 3.3% (1Q 2017: 7.5%) following slower growth in the spending on emoluments, and supplies and services.

Public investment declined by 5.0% in the second quarter (1Q 2017: 3.2%). This was attributable to the lower spending on fixed assets by public corporations, which more than offset the higher expenditure by the Federal Government.

Gross fixed capital formation (GFCF) expanded at a moderate pace of 4.1% (1Q 2017: 10.0%). This was due to lower growth in private investment and a decline in public sector capital spending. By type of assets, the moderation in machinery and equipment (4.4%; 1Q 2017: 21.8%) and contraction in other type of assets (-3.7%; 1Q 2017: 1.4%) more than offset the improvement in structures investment (5.1%; 1Q 2017: 3.8%).

Continued expansion across major economic sectors

On the supply side, all economic sectors continued to expand.

The services sector registered higher growth during the quarter. Growth in the wholesale and retail sub-sector improved, driven by higher household spending. The finance and insurance sub-sector also continued to benefit from the improvement in performance of the capital market and insurance segment. In the transportation and storage sub-sector, growth was principally supported by robust external trade and higher air passenger traffic.

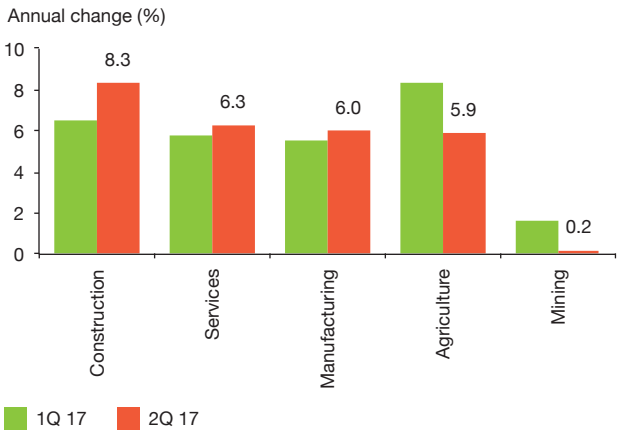
The manufacturing sector growth was driven by both the export- and domestic-oriented industries. The strong performance of electronics and electrical segment, in line with higher global demand for semiconductors, continued to spur the export-oriented industries. The domestic-oriented industries benefitted from the strength in demand for food-related products in view of the improved consumer sentiments, and higher production of construction-related materials supported by robust construction activity.

In the agriculture sector, growth remained firm as crude palm oil yields continued to recover from the negative impact of El Niño. Growth in the construction sector was higher, driven mainly by civil engineering activity in the transportation and power plant segments.

Growth in the mining sector moderated on lower crude oil production as part of the global initiative to reduce oil supply. The performance of the sector was also affected by lower natural gas production amid a major maintenance shutdown of a large gas field in Sabah.

Higher Growth Across Most Economic Sectors

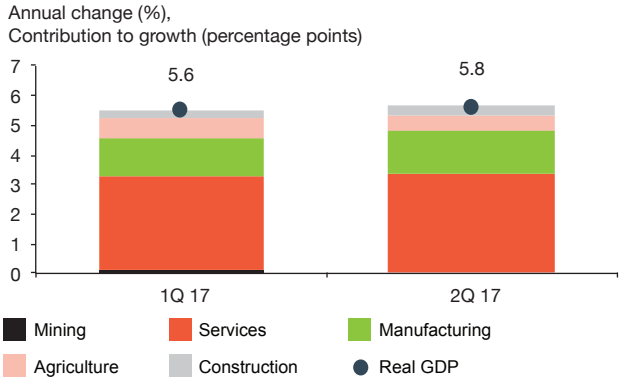
Chart 7: Growth by Sector



Source: Department of Statistics, Malaysia

Higher Contribution to Growth from Services, Manufacturing and Construction Sectors

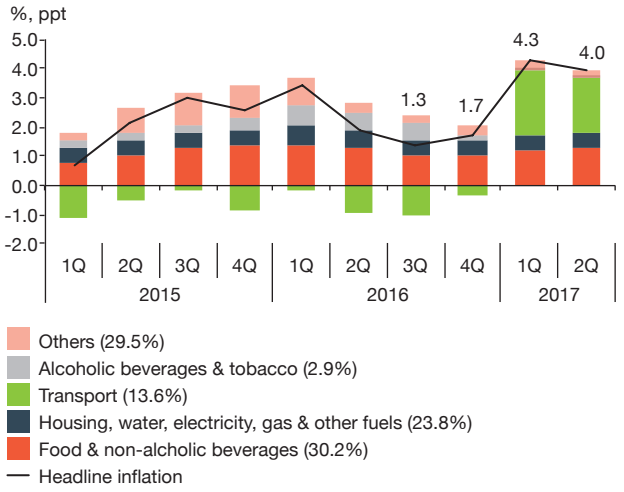
Chart 8: Real GDP by Economic Sector



Source: Department of Statistics, Malaysia

Lower Inflation Mainly Reflected the Decline in Domestic Fuel Prices

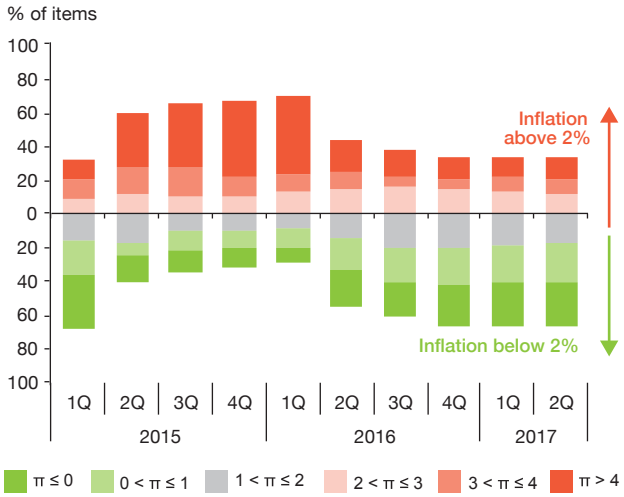
Chart 9: Headline Inflation



Source: Department of Statistics, Malaysia and BNM estimates

Inflation Pervasiveness Remained Broadly Stable

Chart 10: Inflation Pervasiveness



Source: Department of Statistics, Malaysia and BNM estimates

Headline inflation declined due to lower transport prices

Headline inflation[1] moderated to 4.0% in the second quarter of 2017 (1Q 2017: 4.3%) due mainly to lower *transport* inflation of 13.4% (1Q 2017: 16.2%). During the quarter, prices of RON95 petrol averaged RM2.10 per litre, lower than the average of RM2.23 per litre in 1Q 2017. The lower domestic fuel prices were due mainly to the lower global oil prices amid a stronger ringgit exchange rate during the quarter. However, inflation in the *food and non-alcoholic beverages* category was slightly higher at 4.3% (1Q 2017: 4.2%) reflecting the stronger demand during the festive season. Prices in the *meat* and *fish and seafood* sub-categories increased by 4.5% and 7.0%, respectively, during the quarter (1Q 2017: 3.4% and 5.3%, respectively).

Inflation during the quarter was not pervasive. The percentage of items in the CPI basket registering inflation of more than 2% remained unchanged at 33%. However, the sustained increase in the prices of *food away from home* and *rental* led to the slightly higher core inflation of 2.5% in second quarter of 2017 (1Q 2017: 2.4%).

[1] As measured by the annual change in the Consumer Price Index (CPI).

Labour market showed tentative signs of improvements

Labour market conditions showed tentative signs of improvements in the second quarter of 2017, as the labour force expansion of 56,300 persons was exceeded slightly by stronger net employment gain of 58,900 people. As such, the unemployment rate decreased to 3.4% of the labour force (1Q 2017: 3.5%). The labour force participation rate was sustained at 67.7% of the working age population (1Q 2017: 67.7%). Higher vacancies posted on a major job search website, at 65,478 positions, indicate increased demand for new hires (1Q 2017: 61,760 positions).

Private sector wages continued to rise, mainly due to stronger growth in manufacturing wages in the second quarter of 2017 (11.2%; 1Q 2017: 3.2%) and major services sub-sectors (5.4%, 1Q 2017: 5.1%). Wage growth during the quarter was broad-based, supported by both domestic- and export-oriented manufacturing and services industries.

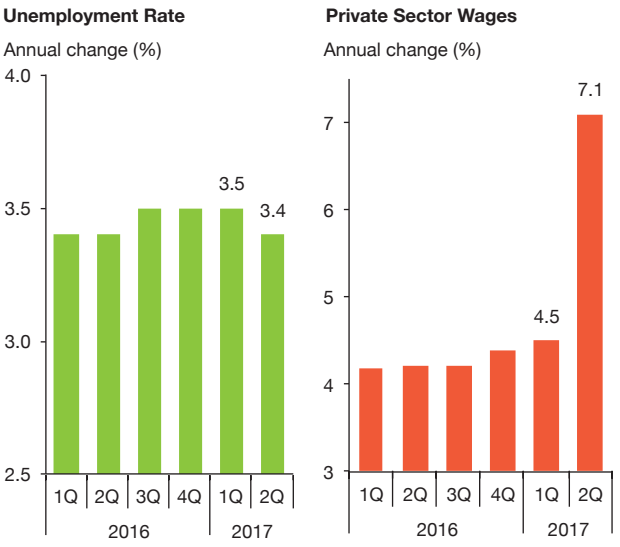
External sector performance remained strong

Gross exports continued to grow strongly by 20.6% in the second quarter of 2017 (1Q 2017: 21.3%). Robust gross exports growth was broad-based, driven by double-digit growth in manufactured and commodities exports.

Higher demand from Malaysia's key trading partners, particularly PR China, the EU and Japan, supported the strong growth in manufactured exports. E&E remained the key driver of gross exports, registering growth of 22.6%. This was driven by the 25.3% increase in semiconductor exports, which benefitted from strong global demand, particularly for semiconductors used in smartphones and storage devices.

Steady Unemployment Rate and Improvement in Wage Expansion

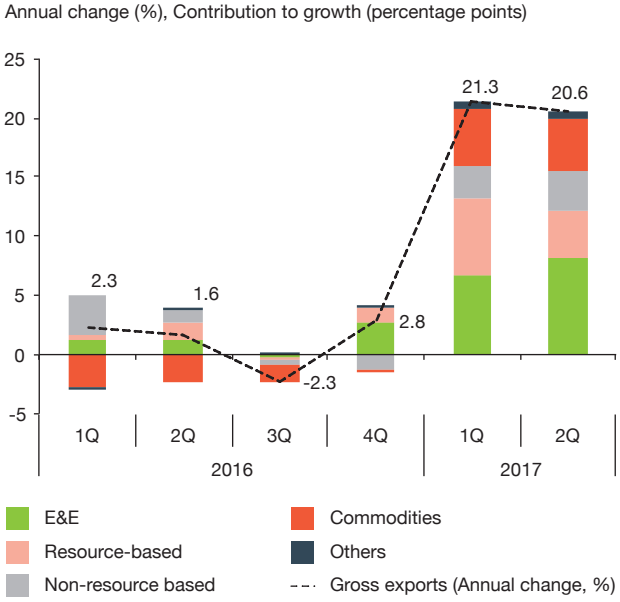
Chart 11: Labour Market Indicators



Source: Department of Statistics, Malaysia

Export Growth Supported Mainly by E&E Exports

Chart 12: Gross Exports by Products

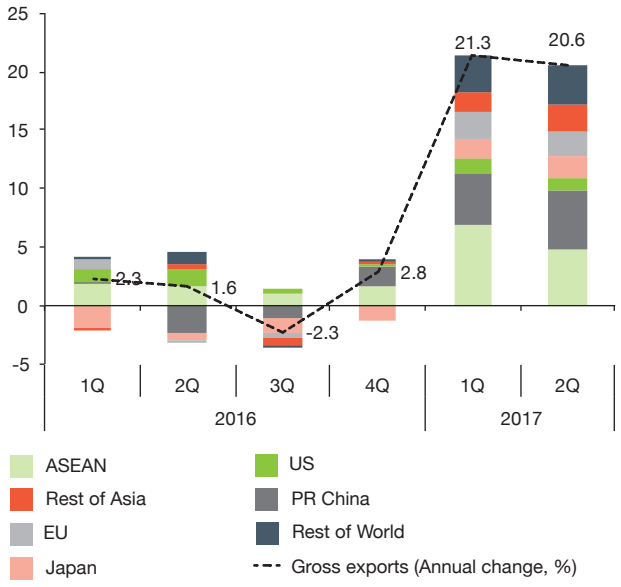


Source: Department of Statistics, Malaysia

Exports was Also Broad-based Across Markets

Chart 13: Gross Exports by Markets

Annual change (%), Contribution to growth (percentage points)

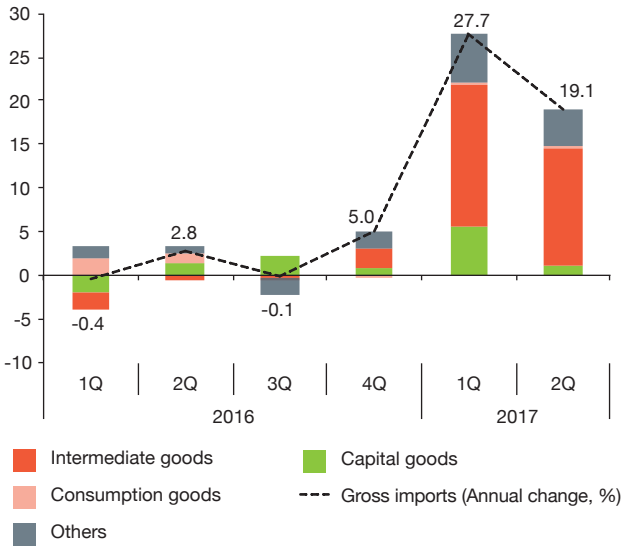


Source: Department of Statistics, Malaysia

Strong Imports, Particularly in Intermediate and Imports for Re-exports

Chart 14: Gross Imports by Products

Annual change (%), Contribution to growth (percentage points)



Source: Department of Statistics, Malaysia

Non-resource based manufactured exports expanded in the second quarter, largely on account of higher exports of iron and steel products, and manufactures of metals. Resource-based manufactured exports however, moderated due mainly to lower exports of petroleum products, and chemical products. Demand from PR China remained strong amid moderation in demand from the ASEAN region. Commodity exports were supported by higher production of crude oil and CPO, and stronger LNG prices.

Gross imports also remained strong, registering growth of 19.1% in the second quarter of 2017 (1Q 2017: 27.7%). Robust growth was underpinned by higher intermediate imports and imports for re-exports, in line with strong manufacturing export performance. Capital imports moderated to 6.9% in second quarter of 2017 from the exceptionally high growth recorded in first quarter of 2017 of 42.0%, on account of the delivery of significant high-value imports. As export growth outpaced import growth during the quarter, the trade surplus increased to RM24.1 billion (1Q 2017: RM18.9 billion).

Current account surplus increased

The current account surplus widened to RM9.6 billion in the second quarter of 2017 (1Q 2017: RM5.3 billion) accounting for 3.0% of GNI (1Q 2017: 1.7% of GNI). The higher surplus was due to a larger goods surplus and smaller deficit in the services and primary income account.

The goods surplus widened to RM27.0 billion in the second quarter of 2017 (1Q 2017: RM25.3 billion) as exports continued its robust pace, while intermediate and capital imports moderated from the first quarter of 2017. The deficit in the services account was lower at RM5.0 billion (1Q 2017: a deficit of RM6.2 billion). The travel account recorded a larger surplus of RM8.3 billion (1Q 2017: RM7.6 billion). During the quarter, construction services exports also increased, reflecting receipts from civil engineering construction projects in Cambodia, India, Qatar and Vietnam. This was partly offset by higher net payments for transportation services, and telecommunications, computer and information services.

The smaller deficit in the primary income account in the second quarter of 2017 (-RM8.2 billion; 1Q 2017: -RM9.9 billion) was largely attributable to higher income generated by Malaysian firms investing abroad (RM12.4 billion; 1Q 2017: RM11.4 billion). Profits accrued to foreign investors in Malaysia were broadly unchanged (RM19.4 billion; 1Q 2017: RM20.0 billion).

The deficit in the secondary income account was slightly higher at -RM4.2 billion (1Q 2017: -RM3.9 billion). Outward remittances increase to RM8.7 billion (1Q 2017: RM8.5 billion) while inward remittances slowed to RM4.4 billion (1Q 2017: RM4.6 billion).

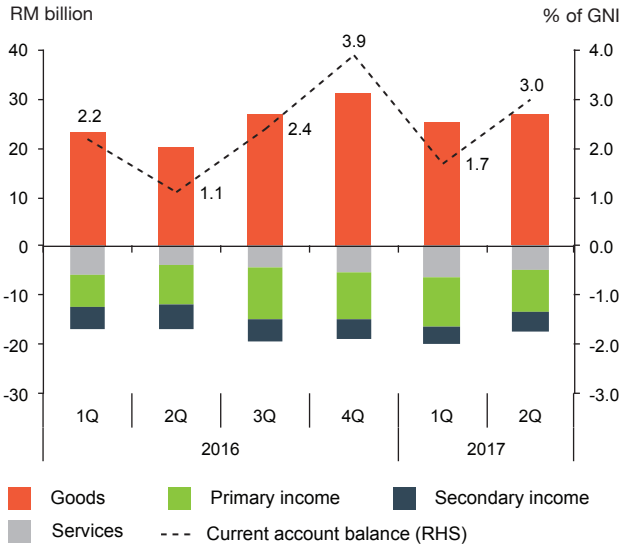
Financial account recorded net inflows

In the second quarter of 2017, the financial account registered a net inflow of RM7.3 billion (1Q 2017: net outflow of RM8.8 billion), attributed mainly to a turnaround in the portfolio investment account (net inflow of RM16.0 billion; 1Q 2017: net outflow of RM31.9 billion).

Portfolio investment by non-residents recorded a net inflow of RM18.8 billion (1Q 2017: net outflow of RM22.9 billion), due mainly to a resumption in purchases of Malaysian Government Securities (MGS) and higher participation in the equity market.

Larger Goods Surplus and Lower Deficits in the Services and Primary Income Accounts

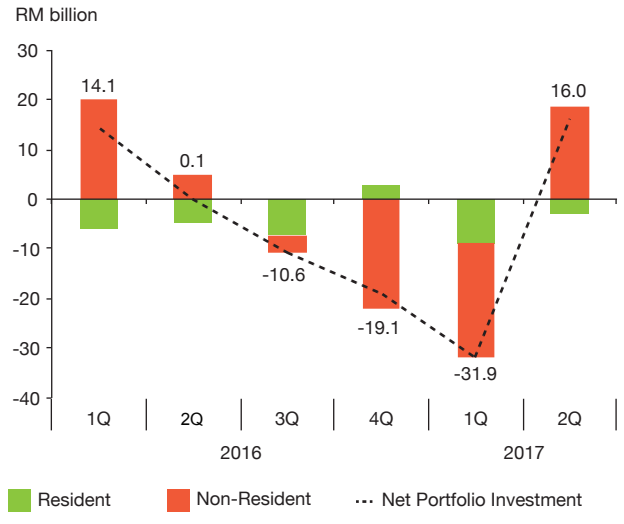
Chart 15: Current Account Balance



Source: Department of Statistics, Malaysia

Turnaround in Net Portfolio Flows, Mainly by Non-resident Investors

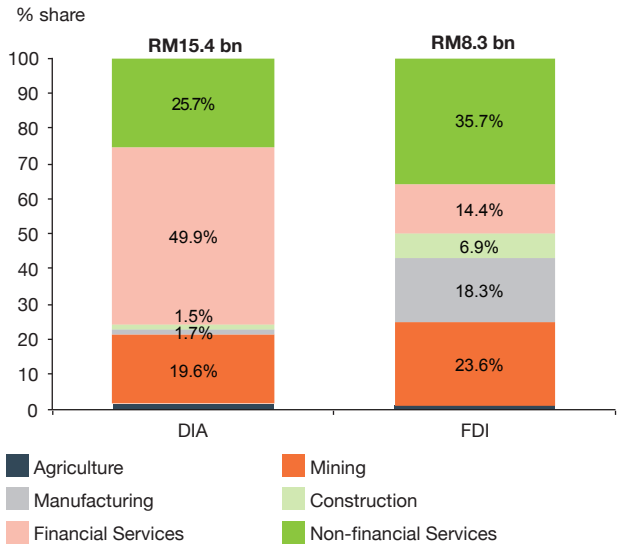
Chart 16: Portfolio Investments



Source: Department of Statistics, Malaysia

DIA and FDI Channeled Mostly into the Services Sector

Chart 17: Net Direct Investment Flows by Sector

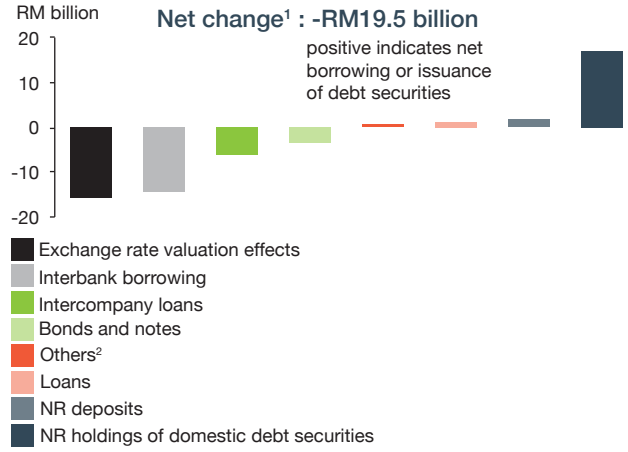


Note: Figures may not necessarily add to 100% due to rounding

Source: Department of Statistics, Malaysia

Lower External Debt in 2Q 2017

Chart 18: Changes in External Debt



[1] Changes in individual debt instruments exclude exchange rate valuation effects
[2] Comprises trade credits, IMF allocation of SDRs and other debt liabilities
Note: NR refers to non-residents

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Investor sentiments improved during the quarter, supported by the announcement of initiatives to develop the onshore financial market, stronger ringgit performance, expectations of better corporate earnings outlook and domestic growth prospects. Resident portfolio investment registered a lower net outflow of RM2.8 billion (1Q 2017: net outflow of RM9.0 billion), as the continued net acquisition of equity securities abroad by domestic fund managers was partially offset by net liquidation of debt securities overseas.

The direct investment account registered a net outflow of RM7.1 billion (1Q 2017: net inflow of RM8.3 billion), as the accumulation of direct investment assets more than offset the incurrence of direct investment liabilities during the quarter. Direct investment abroad (DIA) by Malaysian companies rose to RM15.4 billion (1Q 2017: net outflow of RM8.7 billion), on account of higher earnings retained for reinvestment and drawdown of intercompany loans by subsidiaries abroad. DIA was channeled mainly into the *financial services* sub-sector and the *mining* sector. Foreign direct investment (FDI) decreased to RM8.3 billion (1Q 2017: net inflow of RM17.0 billion), due mainly to lower reinvestment of earnings and injection of equity capital from parent companies. FDI inflows were concentrated in the *real estate activities* and *information and communication* sub-sectors, followed by the *mining* sector.

The other investments account recorded a net outflow of RM1.3 billion (1Q 2017: net inflow of RM14.2 billion), due mainly to the maturity of currency and deposits placed by foreign financial institutions in Malaysian banks and the net extension of trade credits by Malaysian exporters.

Following these developments, the overall balance of payments registered a surplus of RM2.7 billion in the second quarter (1Q 2017: a deficit of RM1.8 billion). Errors and omissions, which include the revaluation changes on reserves, amounted to -RM14.3 billion or -3.3% of total trade.

Manageable external debt

Malaysia's external debt amounted to RM877.5 billion, equivalent to USD202.3 billion or 66.9% of GDP as at end-June 2017 (end-March 2017: RM897.0 billion or USD200.8 billion). The lower external debt largely reflects the valuation effects following the strengthening of the ringgit against selected major and regional currencies and net repayment of interbank borrowing during the second quarter. There were also net repayment of intercompany loans and redemption of maturing bond and notes by the private sector. These declines were partly offset by an increase in

non-resident holdings of domestic debt securities, especially MGS, and a small increase in non-resident deposits.

Malaysia's external debt remains manageable given its currency and maturity profiles, as well as the availability of large external assets. About one-third of total external debt is denominated in ringgit (32.8%), mainly in the form of NR holdings of domestic debt securities and ringgit deposits in domestic banking institutions. As such, these liabilities are not subjected to valuation changes from the fluctuations in the ringgit exchange rate.

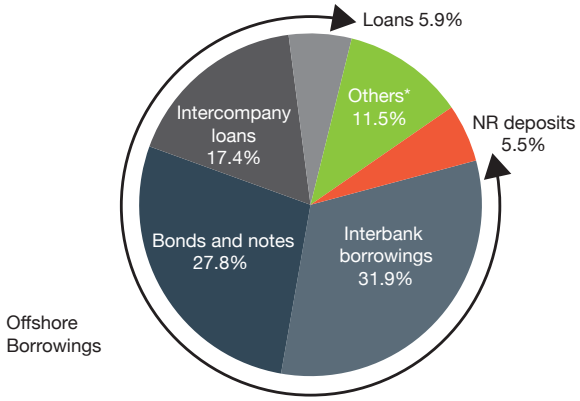
The remaining external debt of RM589.9 billion (67.2%) is denominated in foreign currency (FC) and most are hedged, either naturally through foreign currency earnings or through the use of financial instruments. The bulk of these obligations are offshore borrowings, raised mainly to expand productive capacity and to better manage financial resources within corporate groups. As at end-June 2017, the offshore borrowing remained low at 39.7% of GDP compared to 60.0% of GDP during the Asian Financial Crisis.

Of the total FC-denominated external debt (inclusive of valuation effects), more than one-third is accounted by interbank borrowing and FC deposits in the domestic banking system, which amounted to RM220.5 billion. This largely reflects the banks' intragroup liquidity management and placements of deposits from foreign parent entities, which are subjected to prudent liquidity management practices. Among these are internal limits on funding and maturity mismatches. This is then followed by long-term bonds and notes issued offshore which amounted to RM163.9 billion as at end-June 2017, primarily to finance asset acquisitions abroad that will generate future income. The intercompany loans are normally subjected to flexible and concessionary terms, such as no fixed repayment schedule or low interest rate.

From a maturity perspective, more than half of the total external debt is skewed towards medium- to long-term tenure (55.9% of total external debt), suggesting limited rollover risks. It is important to note that international reserves is not the only means in which banks and corporations rely on to meet their short-term external obligations, given the export earnings of borrowers and external assets. The latest reserves position of USD99.4 billion as at 31 July 2017 is only about a quarter of total external assets, with the remaining external assets being held by banks and corporations. International reserves is 1.1 times the short-term external debt and is sufficient to finance 7.9 months of retained imports.

About Half of FC-denominated Debt Subjected to Prudent Liquidity Management Practices and Flexible Terms

Chart 19: Breakdown of Foreign Currency-denominated External Debt (% of share)



*Includes trade credits and miscellaneous, such as insurance claims yet to be disbursed and interest payables on bonds and notes