Developments in the Malaysian Economy

HIGHLIGHTS

- **The Malaysian economy expanded by 4.4% in the third quarter.**
- **Headline and core inflation declined to 0.5% and 1.4%, respectively.**
- **Current account surplus was sustained at RM3.9bn in the third quarter.**

The Malaysian economy registered a growth of 4.4%

The Malaysian economy recorded a sustained growth of 4.4% in the third quarter of 2018 (2Q 2018: 4.5%), supported by expansion in domestic demand amid a decline in net exports growth. Private sector expenditure remained the key driver of growth, expanding at a faster pace of 8.5% (2Q 2018: 7.5%), while public sector expenditure turned around to register a positive growth of 1.1% (2Q 2018: -1.4%). On a quarter-on-quarter seasonally-adjusted basis, the economy grew by 1.6% (2Q 2018: 0.3%).

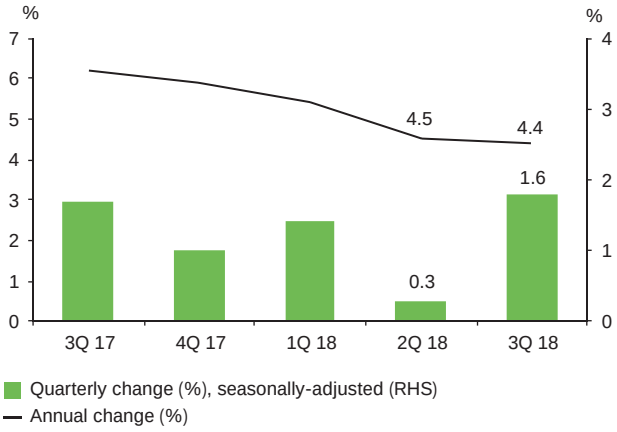
Domestic demand continued to be driven by the private sector

Domestic demand expanded at a faster pace during the quarter (6.9%; 2Q 2018: 5.6%), driven by private sector activity.

Private consumption growth accelerated to 9.0% (2Q 2018: 8.0%). Household spending was boosted in July and August 2018, following the zerorisation of the Goods and Services Tax (GST) rate[1], particularly on durable goods such as motor vehicles and furnishings, as well as food and beverages. Continued expansion in income and employment provided key support to household spending.

Sustained growth in 3Q 2018

Chart 4: Real GDP Growth

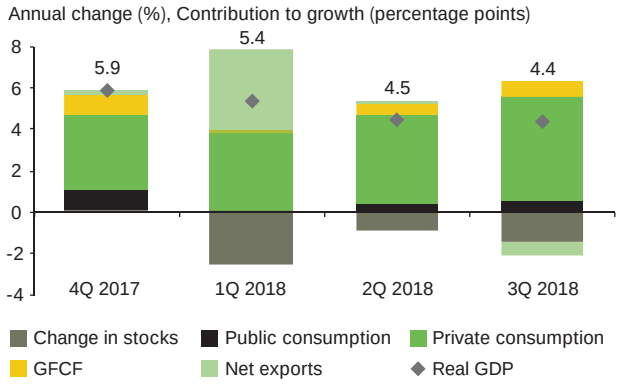


Source: Department of Statistics Malaysia

[1] The reduction in the GST rate from 6% to 0% beginning 1 June 2018 to 31 August 2018. The Sales and Services Tax (SST) was implemented beginning 1 September 2018.

Private activity supported growth

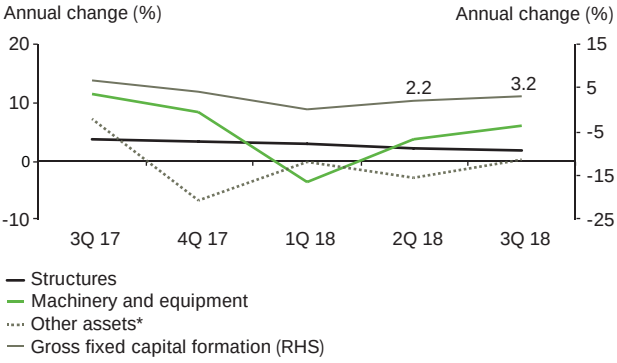
Chart 5: Contribution of Expenditure Components to Real GDP Growth



Source: Department of Statistics Malaysia

Further improvement in gross fixed capital formation

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 growth edged higher to 6.9% (2Q 2018: 6.1%), underpinned mainly by capital spending in the manufacturing and services sectors. During the quarter, firms further expanded their capacity through increased machinery and equipment spending to cater to positive demand.

Public consumption grew at a faster pace (5.2%; 2Q 2018: 3.1%). This was attributable to a higher spending on supplies and services, which more than offset the moderation in emoluments growth.

Public investment registered a smaller decline during the quarter (-5.5%; 2Q 2018: -9.8%), due to improvements in General Government capital spending. However, capital spending by public corporations was lower as some projects were near completion.

Gross fixed capital formation (GFCF) increased at a faster pace of 3.2% (2Q 2018: 2.2%), supported by continued private sector capital spending. By type of assets, capital spending on machinery and equipment was higher at 5.9% (2Q 2018: 3.6%). Investment in other types of assets turned around to register a marginal positive growth of 0.1% (2Q 2018: -2.9%). Investment in structures grew at a moderate pace of 1.8% (2Q 2018: 2.1%), due mainly to continued weak investments in residential property.

Slower growth in commodity-related sectors offset by faster expansion in other sectors

On the sectoral front, growth was mainly affected by lingering commodity-specific supply shocks. Nevertheless, the impact on overall growth was mitigated by expansions in the other economic sectors, mainly the services, manufacturing and construction sectors which account for 82% of the economy.

Growth in the mining sector contracted further as natural gas production continued to be affected by unplanned supply outages and pipeline repairs in East Malaysian facilities. Meanwhile, agriculture sector growth remained weak due to the protracted recovery in crude palm oil production from adverse weather and production constraints in the previous quarter.

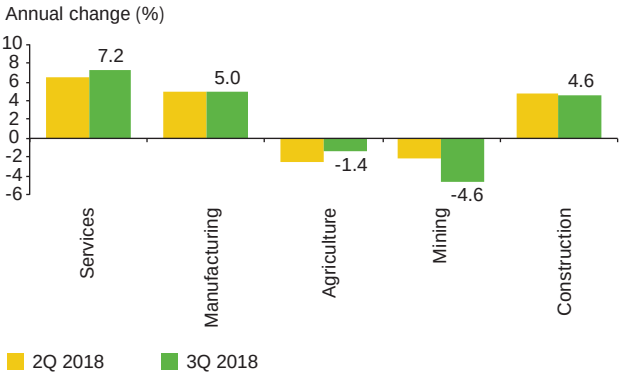
Growth in the services sector rose further during the quarter, driven mainly by the wholesale and retail trade sub-sector on account of higher consumer spending during the tax holiday period. The finance and insurance sub-sector also benefitted from the zerorisation of GST as seen in higher consumer loans disbursements and insurance premium payments, particularly in the motor vehicle segment. Growth in the transport and storage sub-sector improved, supported by higher air passenger traffic. The information and communications sub-sector continued to expand, amid continued demand for data communication services.

During the quarter, the manufacturing sector registered sustained growth, as improvements in the E&E and consumer-related clusters offset softer growth in primary-related output. Faster expansion in the E&E and consumer-related cluster was accounted by higher production of consumer-based electronics, household appliances, passenger cars and auto parts, following higher spending on durable goods during the tax holiday period. Manufacture of construction-related materials was sustained in line with activity in the construction sector. Primary-related output growth, however, slowed further during the quarter, weighed by lower output of natural feedstocks such as crude palm oil and natural gas.

The construction sector registered sustained growth in the third quarter. Despite the on-going review of several mega projects, construction activity in the civil engineering sub-sector remained supportive of growth, underpinned by steady progress in existing transportation, petrochemical and power plant projects. Growth in the non-residential sub-sector improved slightly, while growth in the residential sub-sector remained weak amidst the high number of unsold residential properties.

Faster expansions in other sectors, slower growth in commodity-related sectors

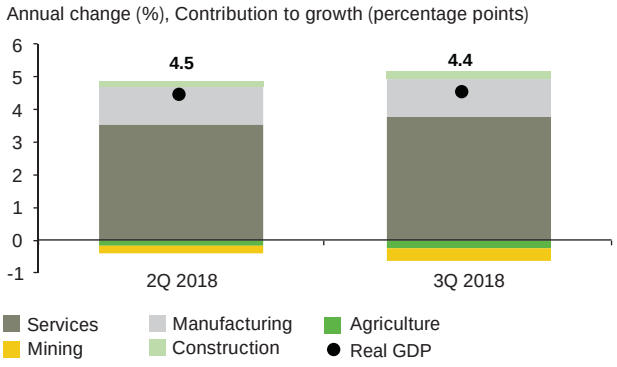
Chart 7: Growth by Sector



Source: Department of Statistics Malaysia

Services and manufacturing sectors remained the key drivers of growth

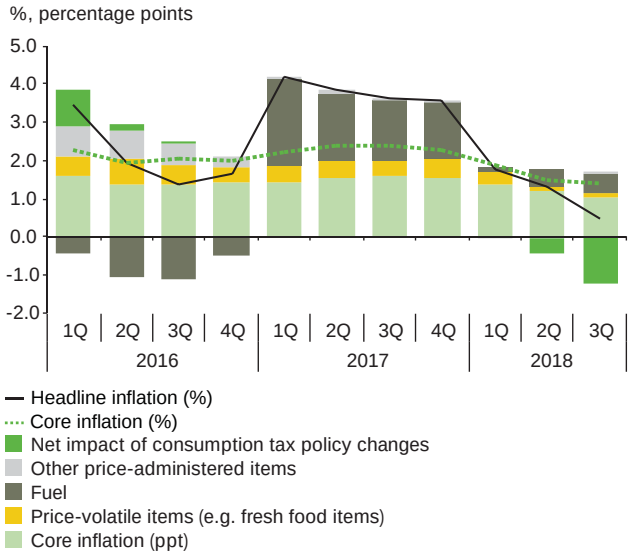
Chart 8: Real GDP by Economic Sector



Source: Department of Statistics Malaysia

The decline in inflation was mainly due to the impact from the GST zerorisation

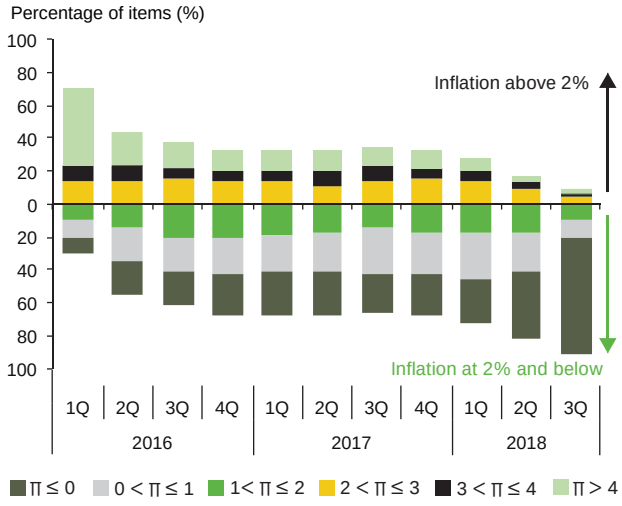
Chart 9: Contribution to Headline Inflation by Components



Source: Department of Statistics Malaysia and Bank Negara Malaysia estimates

Inflation pervasiveness continued to decline in 3Q 2018

Chart 10: Inflation Pervasiveness



Source: Department of Statistics Malaysia and Bank Negara Malaysia estimates

Lower inflation during the quarter mainly reflected the GST zerorisation

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), declined to 0.5% in 3Q 2018 (2Q 2018: 1.3%).

The lower inflation mainly reflected the impact from the GST zerorisation. By category, the impact was broad-based and particularly evident for *communication services* and *recreational and cultural services*. The percentage of items in the CPI basket that had an inflation of more than 2% declined to 9% in the third quarter (2Q 2018: 18%). This was despite the implementation of the Sales and Services Tax (SST) beginning 1 September 2018. With the small average price increase for SST-taxable items in September, the SST impact on inflation during the quarter has been limited.

Core inflation, excluding the impact of consumption tax policy changes, moderated slightly to 1.4% (2Q 2018: 1.5%). Demand-driven inflationary pressures in the economy remained contained in the absence of excessive wage pressure and some degree of spare capacity in the capital stock.

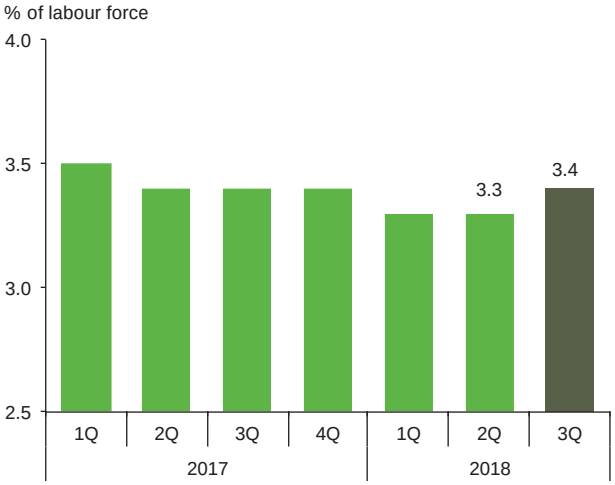
Positive labour market conditions

Labour market conditions remained supportive of economic activity. Although the unemployment rate edged higher in the third quarter (3.4%; 2Q 2018: 3.3%), this was mainly on account of higher labour force participation (68.5%; 2Q 2018: 68.4%) which offset improvements in employment growth (2.6%; 2Q 2018: 2.4%). Stronger net employment gains were recorded in the services and manufacturing sectors in the third quarter.

Private sector wages registered sustained growth of 5.7% (2Q 2018: 5.7%). This was driven mainly by higher wage growth in the services sector 3.9% (2Q 2018: 3.7%), supported by the wholesale and retail trade sub-sector. The manufacturing sector registered slower wage growth (9.6%; 2Q 2018: 10.1%), weighed by the more moderate wage growth in the domestic-oriented industries (6.1%; 2Q 2018: 8.6%). Nonetheless, wages in the export-oriented sub-sectors grew at a faster pace (10.9%; 2Q 2018: 10.6%), supported by continued growth in the E&E segment.

Marginal increase in unemployment rate

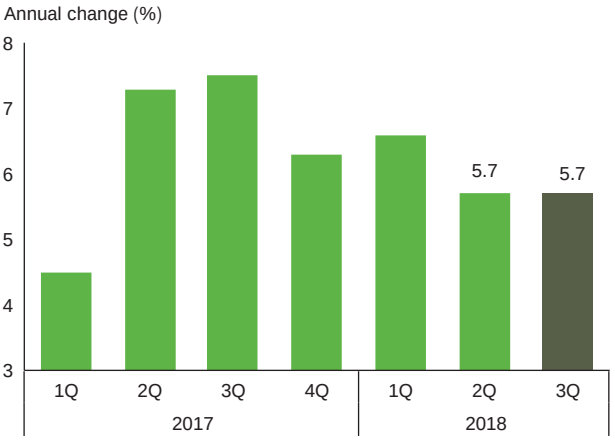
Chart 11: Unemployment rate



Source: Department of Statistics Malaysia

Sustained private sector wage growth

Chart 12: Private sector wages



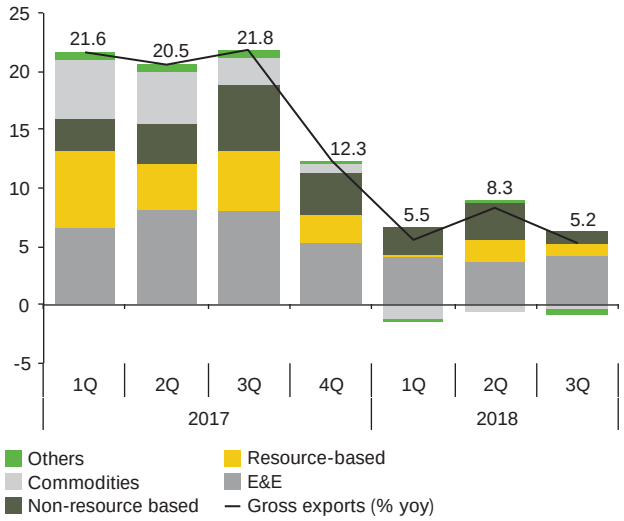
* Private sector wages is derived from the salaries and wages data published in the Monthly Manufacturing Statistics and Quarterly Services Statistics by the Department of Statistics, Malaysia (DOSM). It covers 62% of total employment.

Source: Department of Statistics Malaysia and BNM estimates

E&E remained the key driver of exports

Chart 13: Gross Exports by Products

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

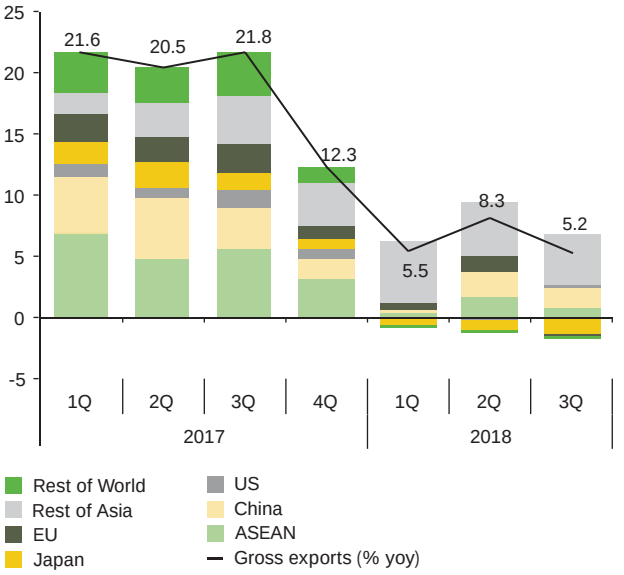


Source: Department of Statistics Malaysia

Continued growth in exports to most major markets

Chart 14: Gross Exports by Markets

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



Source: Department of Statistics Malaysia

Moderation in exports and imports

In the third quarter of 2018, gross exports expanded by 5.2% (2Q 2018: 8.3%), supported mainly by manufactured exports. Domestic exports[2] declined by -0.2% (2Q 2018: 0.2%) due to the contraction in commodity exports. The trade surplus stood at RM25.2 billion (2Q 2018: RM27.1 billion).

Manufactured exports grew by 7.4% (2Q 2018: 10.7%), supported by higher E&E exports (10.7%; 2Q 2018: 9.8%), with continued demand from major trading partners, particularly in the Asian region. Of significance, growth of semiconductor exports remained robust at 24.2% (2Q 2018: 21.0%), reflecting continued expansion in the global technology cycle. However, non-E&E exports moderated, particularly in petroleum products, and manufactures of metal and transport equipment. Commodities exports registered a smaller contraction of -3.0% (2Q 2018: -3.8%) as the continued decline in crude palm oil exports was partly offset by the stronger growth in mineral exports (9.3%; 2Q 2018: 8.1%), particularly in crude petroleum exports.

Gross imports growth moderated to 6.3% during the quarter (2Q 2018: 8.5%) following a deceleration in capital imports and lower imports for re-exports. Consumption imports rebounded to 5.5% (2Q 2018: -2.8%) due to the surge in domestic spending during the tax holiday period and a smaller contraction in intermediate imports.

[2] Domestic exports is defined as gross exports excluding re-export activity.

Sustained current account surplus

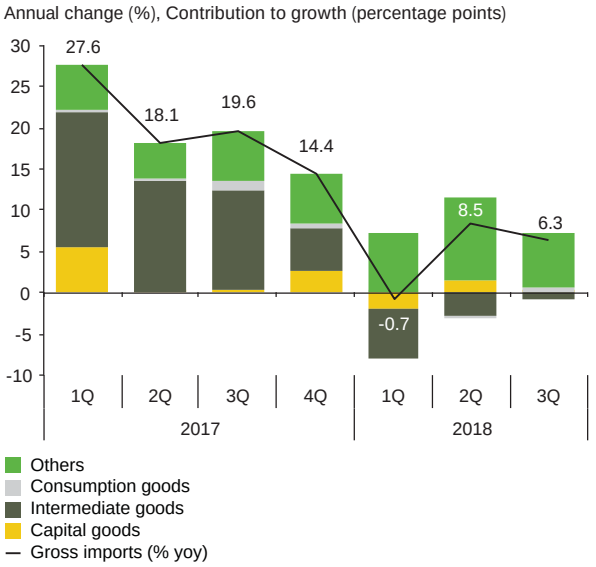
The current account surplus was broadly sustained at RM3.8 billion in the third quarter of 2018 (2Q 2018: RM3.9 billion), or 1.1% of GNI (2Q 2018: 1.2% of GNI). This was due a higher goods surplus[3] and lower services deficit, amid a larger deficit in the primary income account.

The goods surplus increased to RM26.6 billion (2Q 2018: RM26.1 billion), owing to higher E&E exports. The deficit in the services account narrowed to RM3.3 billion (2Q 2018: -RM6.2 billion). This was attributable mainly to a larger surplus in the travel account (RM8.0 billion; 2Q 2018: RM6.6 billion) due to higher tourist arrivals and lower construction services deficit (-RM1.3 billion; 2Q 2018: -RM3.2 billion) following the cancellation and deferment of selected major projects.

The primary income account recorded a larger deficit of RM15.0 billion (2Q 2018: -RM11.2 billion) as profits earned by foreign investors in Malaysia continued to outpace that of Malaysian firms investing abroad (RM16.3 billion; 2Q 2018: RM13.8 billion), particularly in the mining and manufacturing sectors. Of note, 26.4% of the profits earned by the foreign investors were reinvested (2Q 2018: 10.7%). The secondary income account recorded a sustained deficit of RM4.5 billion (2Q 2018:-RM4.7 billion), reflecting continued outward remittances by foreign workers.

Imports moderated on account of slower capital goods and re-export activity

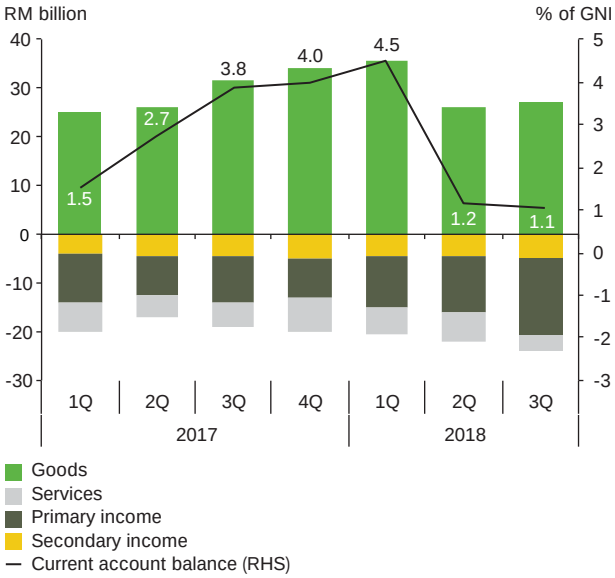
Chart 15: Gross Imports by Products



Source: Department of Statistics Malaysia

Current account surplus sustained

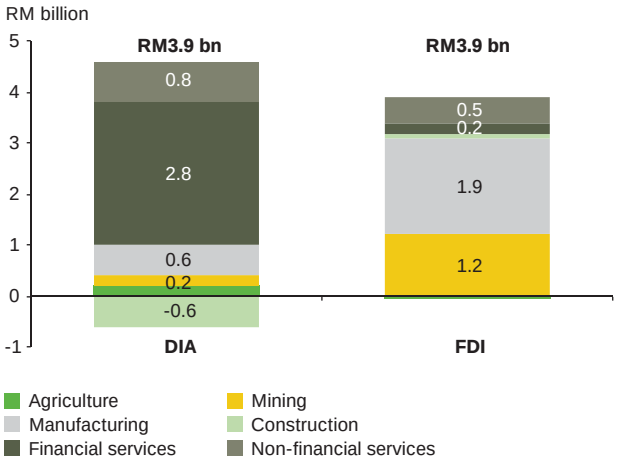
Chart 16: Current account balance



Source: Department of Statistics Malaysia

Marginal net inflows in the direct investment account

Chart 17: Net Direct Investment Flows by Sector

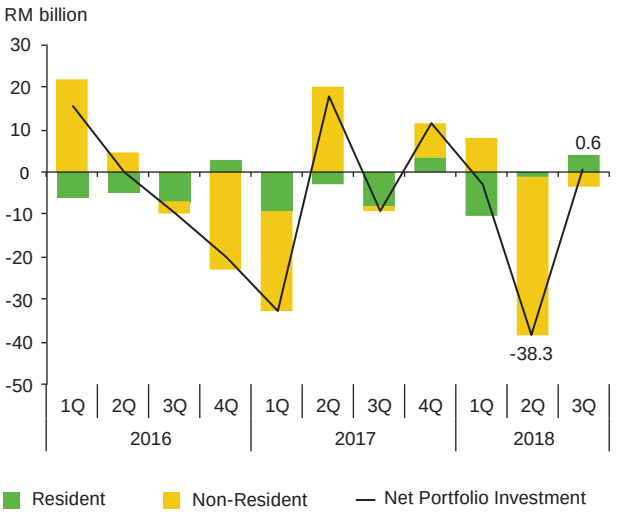


Note: For DIA, positive values refer to net outflows while negative values refer to net inflows

Source: Department of Statistics Malaysia and Bank Negara Malaysia

Net inflow in portfolio investment account attributable to residents

Chart 18: Portfolio Investments



Source: Department of Statistics Malaysia and Bank Negara Malaysia

Financial account recorded a small net inflow

In the third quarter of 2018, the financial account registered a small net inflow of RM0.2 billion (2Q 2018: net inflow of RM9.2 billion). Net inflows in portfolio and direct investment were partially offset by net outflows in other investments.

The direct investment account registered a marginal net inflow of RM0.06 billion (2Q 2018: net outflow of RM0.7 billion). During the quarter, foreign direct investments (FDI) registered a larger net inflow of RM3.9 billion (2Q 2018: net inflow of RM2.8 billion). FDI inflows were mainly channeled into the manufacturing and mining sectors. Meanwhile direct investments abroad (DIA) by Malaysian companies recorded a higher outflow of RM3.9 billion (2Q 2018: net outflow of RM3.6 billion). DIA outflows were channeled mainly into the services sector, particularly the financial services sub-sector.

The portfolio investment account registered a net inflow of RM0.6 billion, a significant turnaround from a net outflow of RM38.3 billion in 2Q 2018. This reflected the net liquidation of residents' portfolio investment holdings abroad (3Q 2018: net inflow of RM4.3 billion; 2Q 2018: net outflow of RM1.0 billion). Portfolio investment by non-residents recorded a smaller outflow of RM3.6 billion (2Q 2018: net outflow RM37.2 billion) following the net liquidation of non-resident holdings of ringgit-denominated domestic debt securities. This took place amid significant financial market volatility globally.

The other investment account recorded a net outflow of RM0.8 billion (2Q 2018: net inflow of RM48.4 billion). The banking sector's reduction of their interbank placements abroad was offset by a net outflow from the non-bank private sector, particularly deposits. Net errors and omissions amounted to -RM7.4 billion, or -1.5% of total trade. The international reserves of Bank Negara Malaysia amounted to USD103.0 billion as at end-September 2018, compared to USD104.6 billion as at end-June 2018.

Manageable external debt

Malaysia's external debt stood at RM947.9 billion or 66.2% of GDP as at end-September 2018 (end-June: RM936.5 billion or 65.4% of GDP). The higher external debt reflects largely the revaluation adjustment from the lower ringgit against major and regional currencies in the third quarter of 2018 and an increase in non-resident (NR) deposits in the domestic banking system. These were partly offset by some repayment of interbank borrowing.

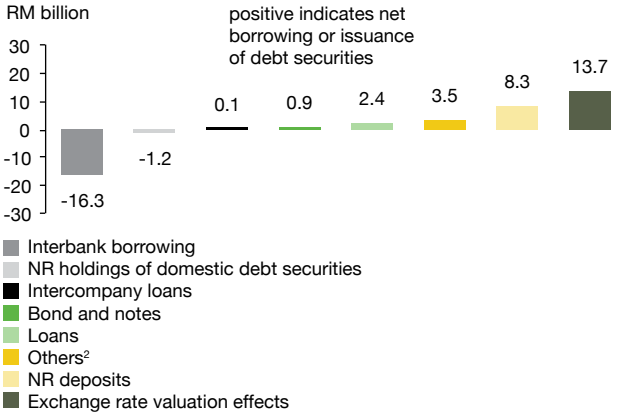
Malaysia's external debt remains manageable given its currency and maturity profiles, and the availability of large external assets. Close to one-third of external debt is denominated in ringgit (30.6%; end-June: 31.2%), mainly in the form of NR holdings of domestic debt securities (63.4% share) and in ringgit deposits (17.7% share) 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 RM657.9 billion or 69.4% of total external debt is denominated in foreign currency (FC), the bulk of which comprises offshore borrowings. As at end-September 2018, offshore borrowing declined to RM584.9 billion or 40.9% of GDP (end-June: RM586.5 billion or 41% of GDP), much lower compared to 60% of GDP during the Asian Financial Crisis in 1997-98. The corporate sector accounted for slightly more than half of FC-denominated external debt. Of which, about three-quarters were hedged, either naturally through FC-denominated revenue streams or financially-hedged with onshore banks.

Of the total FC-denominated external debt (inclusive of valuation effects), 38.1% (or amounting to RM250.4 billion) represents interbank borrowings and FC deposits in the domestic banking system. 76.2% of interbank borrowings are intra-group borrowings. The interbank borrowings largely reflect banks' centralised liquidity and funding management practices. Notably, banks' FC-denominated external debt remained stable during the quarter as reduced interbank borrowings was offset by increases in debt issuances abroad and non-resident deposits. Banks remained vigilant and proactive in managing their funding and liquidity risks. Foreign-currency risk, measured in net open position of FC denominated exposures stood at 5.3% of banks' total capital. Of this, USD net open position was low at 3.4% of banks' total capital.

Higher external debt in 3Q 2018

Chart 19: Changes in External debt
Net change[1]: +RM11.4 billion

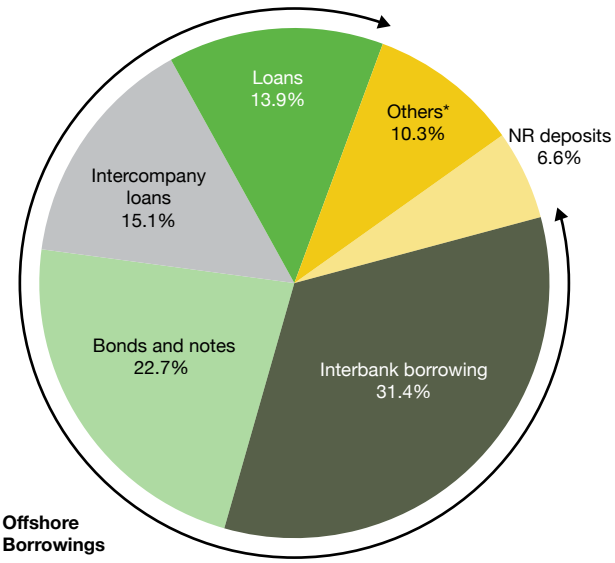


[1] Changes in individual debt instruments exclude exchange rate valuation effects
[2] Comprises trade credits, IMF allocation of SDRs and other debt liabilities
Note: NR refers to non-residents

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

FC-denominated debt subjected to prudent liquidity management practices and hedging requirements

Chart 20: Breakdown of Foreign Currency-denominated External Debt (% share)



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

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Long-term bonds and notes issued offshore stood at RM149.3 billion as at end-September 2018, accounting for 22.7% of total FC-denominated external debt. These were mainly by non-financial corporations and channeled primarily to finance asset acquisitions abroad. Intercompany loans (RM99.0 billion or 15.1% of FC-denominated external debt) are typically on flexible and concessionary terms, such as no fixed repayment schedule or low interest rate. Close to 70% of intercompany loans were obtained by non-resident controlled companies (MNCs) from parents or affiliates abroad.

From a maturity perspective, more than half of the total external debt is skewed towards medium- to long-term tenure (54.0% of total external debt; end-June: 52.0%), suggesting limited rollover risks. Short-term external debt accounts for the remaining 46% of external debt. Of which, 36.1% is accounted by stable intragroup placements among banks, thus less susceptible to sudden withdrawal. About another 13% is accounted by trade credits, largely backed by export earnings and are self-liquidating. 4% are intercompany loans, which are typically on flexible and concessionary terms *(For more granular breakdown of external debt, please refer to the Box Article on 'Profile of Malaysia's External Debt').*

As at 31 October 2018, international reserves stood at USD101.7 billion. The reserves position is sufficient to finance 7.5 months of retained imports and is 1.0 time the short-term external debt.

Reserves are not the only means for banks and corporations to meet their external obligations. The progressive liberalisation of foreign exchange administration rules has resulted in greater decentralisation of reserves. In particular, banks and corporations hold three-quarters of Malaysia's external assets (as at end-3Q 2018: RM1.3 trillion). These external assets can be drawn upon to meet banks' and corporations' external debt obligations (RM752.4 billion), without creating a claim on international reserves. The adequate level of international reserves, together with the availability of substantial foreign currency and external assets by banks and corporations, and a flexible exchange rate, will continue to serve as important policy buffers against potential external shocks.