Developments in the Malaysian Economy

HIGHLIGHTS

- **Growth rose to 5.6%, lifted by stronger domestic demand activity.**
- **Headline inflation rose and was driven mainly by higher transport prices.**
- **Current account balance narrowed to 1.7% of GNI amid lower goods surplus, as import growth outpaced export growth during the quarter.**

The Malaysian economy advanced by 5.6% in the first quarter of 2017

The Malaysian economy recorded a higher growth of 5.6% in the first quarter of 2017 (4Q 2016: 4.5%). Private sector activity was higher and remained as the main driver of growth. Growth was further lifted by higher exports, as increased demand for manufactured products led to a strong growth in real exports (9.8%; 4Q 2016: 2.2%). Real imports also increased at a faster rate of 12.9% (4Q 2016: 1.6%) on account of higher growth of capital and intermediate goods. On a quarter-on-quarter seasonally-adjusted basis, the economy recorded a growth of 1.8% (4Q 2016: 1.3%).

Domestic demand driven by private activity

Domestic demand growth increased to 7.7% in the first quarter of the year (4Q 2016: 3.2%), supported by continued expansion in private sector expenditure (8.2%; 4Q 2016: 5.9%) and the turnaround in public sector expenditure.

Private consumption grew by 6.6% (4Q 2016: 6.1%). Household spending remained supported by continued expansion in employment and wage growth. The implementation of selected Government measures, including the higher amount of Bantuan Rakyat 1Malaysia cash transfers, also provided additional impetus to household spending.

Chart 6: GDP Growth



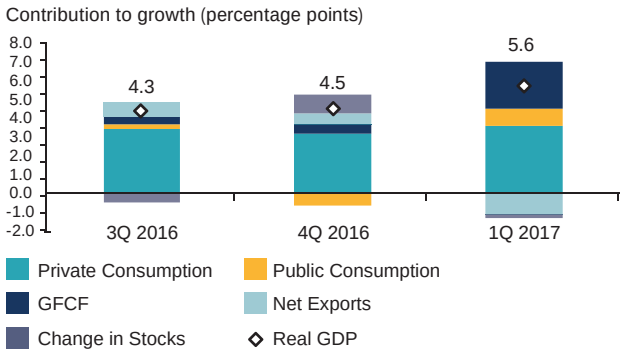
Source: Department of Statistics, Malaysia

Public consumption recorded a stronger growth of 7.5% (4Q 2016: -4.2%) attributed to higher spending on both emoluments and supplies and services.

Private investment grew at a robust pace of 12.9% (4Q 2016: 4.9%), following continued capital spending in the services and manufacturing sectors. Investments in machinery and equipment were higher during the quarter, supported by the implementation of several large-scale projects in the manufacturing sector.

Chart 7: Contribution of Expenditure Components to GDP Growth

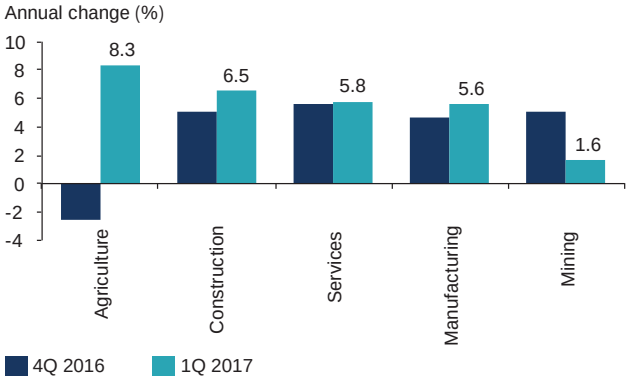
Private Sector Demand Remained the Principal Driver of Growth



Source: Department of Statistics, Malaysia

Chart 8: Growth by Sector

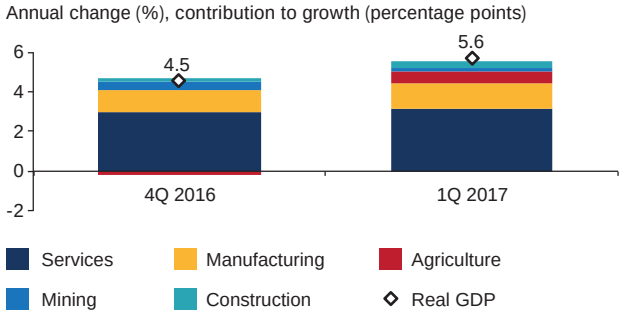
Strong Rebound in Agriculture Sector Growth



Source: Department of Statistics, Malaysia

Chart 9: Real GDP by Economic Sector

Contribution to Growth from Agriculture Sector Turned Positive post-El Niño



Source: Department of Statistics, Malaysia

Business sentiments improved during the quarter amid the better international economic environment and more stable financial markets.

Public investment registered a higher growth of 3.2% (4Q 2016: -0.4%), driven mainly by higher spending on fixed assets by public corporations.

Gross fixed capital formation (GFCF) rose by 10.0% (4Q 2016: 2.4%), due to a turnaround in public investment and higher private investment growth. The stronger growth in total investment was due to broad-based increases in capital spending in machinery and equipment (21.8%; 4Q 2016: 2.9%), structures (3.8%; 4Q 2016: 2.8%) and other types of assets (1.4%; 4Q 2016: -2.0%).

Higher growth across major economic sectors

On the supply side, most economic sectors expanded at a faster pace. The improvement in the overall growth was contributed primarily by the turnaround in the agriculture sector and higher growth in the manufacturing and services sectors.

Growth in the agriculture sector rebounded as crude palm oil yields recovered from the negative impact of El Niño. The performance of the sector was also supported by a double-digit expansion in rubber production. In the manufacturing sector, growth was driven mainly by the electronics and electrical segment, in line with the continued favourable global demand for semiconductors. The domestic-oriented industries were supported by the continued demand for food-related products and a rebound in the motor vehicle production.

The services sector expanded at a faster pace in the first quarter. Growth in the wholesale and retail sub-sector improved in line with higher household spending. The finance and insurance sub-sector also registered higher growth, supported by improvements in loan growth and capital market activity amid higher issuance of IPOs. Growth in the construction sector was stronger, supported by civil engineering activity in the petrochemical, power plant and transportation segments.

In the mining sector, growth moderated on lower crude oil production, particularly in Sarawak and Peninsular Malaysia, as part of the global initiative to reduce oil production.

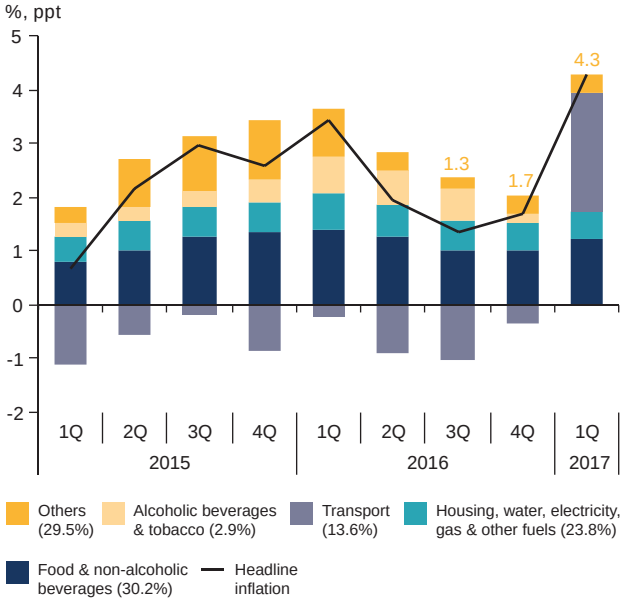
Headline inflation increased due to higher transport prices

Headline inflation[2] was higher at 4.3% in the first quarter of 2017 (4Q 2016: 1.7%) driven mainly by cost factors. During the quarter, prices of RON95 petrol averaged higher at RM2.23 per litre compared to an average of RM1.73 per litre during its base period in the 1Q 2016. This resulted in significantly higher inflation in the ***transport*** category at 16.2% (4Q 2016: -2.6%). Higher domestic fuel prices were primarily an outcome of the increase in global oil prices following OPEC's agreement to cut production effective 1 January 2017. Inflation in the ***food and non-alcoholic beverages*** category was higher at 4.2% (4Q 2016: 3.3%) with the ***food away from home*** sub-category registering a growth of 4.0% (4Q 2016: 3.4%). The increase in food inflation was due to shortages in fresh food supplies amid adverse weather conditions, which were also transmitted into the higher prices for ***food away from home***. However, in March 2017, food inflation started to moderate as supply conditions improved.

The higher prices for ***food away from home*** amidst an increase in rental inflation led to higher core inflation of 2.4% in 1Q 2017 (4Q 2016: 2.1%). However, the transmission of higher prices remained contained. This was reflected in the inflation pervasiveness[3] which remained broadly stable. The limited transmission was attributed partly to the small share of ***transportation, energy*** and ***basic chemicals*** (10.4%)[4] in the production cost of most items in the CPI basket. Domestic production and consumption also have relatively modest import content (about 20% and 6.7%, respectively), containing the pass-through of the weaker ringgit exchange rate to domestic inflation.

Chart 10: Headline Inflation

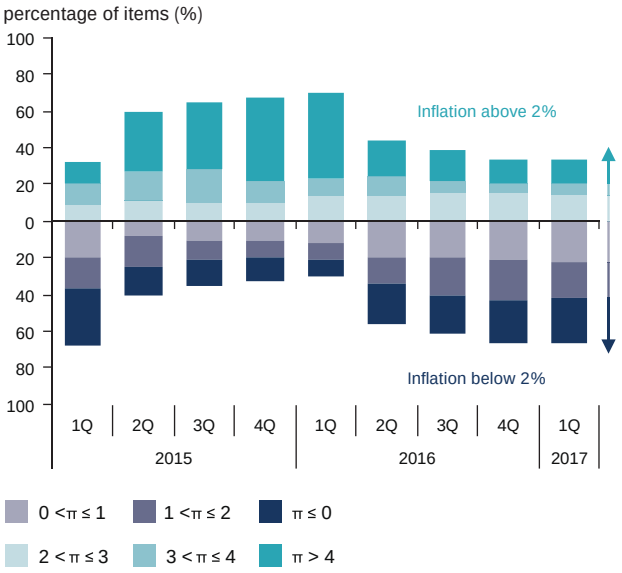
Higher Inflation Reflected Primarily the Pass-Through of Higher Global Oil Prices



Source: Department of Statistics, Malaysia and BNM estimates

Chart 11: Inflation Pervasiveness

However, Inflation Pervasiveness Remained Broadly Stable

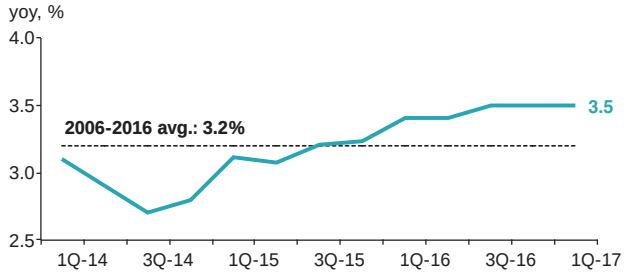


Source: Department of Statistics, Malaysia and BNM estimates

[2] As measured by the annual change in the Consumer Price Index (CPI).
[3] Inflation pervasiveness captures the share of items in the CPI basket which is rising at a given pace. Inflation is more pervasive if a larger number of items are registering a faster rate of price increase. It is useful in distinguishing increases in headline inflation which is driven by relative price changes from general price ones.
[4] This share is derived from an analysis of the Input-Output table.

Chart 12: Unemployment Rate

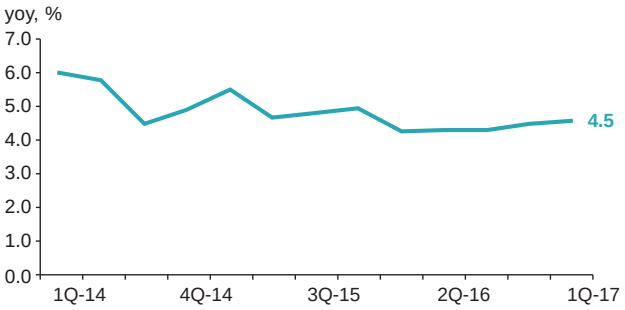
Unemployment Rate Held Steady



Source: Department of Statistics, Malaysia

Chart 13: Private Sector Wages

Sustained Wage Growth



Source: Department of Statistics, Malaysia

Stable labour market conditions

Labour market conditions remained stable in the first quarter, with slightly higher labour force participation, at 67.7% of the working age population (4Q 2016: 67.6%). During the quarter, the labour force expansion of 98,700 people was met with a corresponding net employment gain of 95,300 people. As such, the unemployment rate remained unchanged at 3.5% of the labour force (4Q 2016: 3.5%). Higher vacancies posted on a major job search website at 61,760 positions suggest increasing demand for new hires (4Q 2016: 53,214).

Private sector wages continued to expand at a sustained pace of 4.5% in 1Q 2017 (4Q 2016: 4.4%), as the stronger wage growth in the major services sub-sectors (5.1%; 4Q 2016: 3.7%) offset the moderating wage growth in the manufacturing sector during the quarter (3.2%; 4Q 2016: 5.9%). Wage expansion during the quarter was supported by both domestic- and export-oriented manufacturing and services industries.

Box Article 1

Inflation: Perception vs. Reality

Authors: Loke Po Ling and Farina Adam Khong

HIGHLIGHTS

- **Public scepticism on the CPI has increased as their personal experiences suggest larger increase in cost of living. However, cost of living and inflation are two different concepts, and public perceptions of inflation are subject to biases.**
- **Due to the biases, measures of perceived inflation were higher than CPI inflation, especially at times of rising inflationary pressures. This could influence public's expectations of future inflation, and in turn might change their consumption and investment decisions.**

"Perception is real, even when it is not reality" ~ Edward de Bono

In economics, there is always a fine line between perception and reality. Whether the official CPI inflation is a reflection of the actual change in cost of living is one of those pertinent issues. Despite the relatively low CPI inflation in the past two years (2016: 2.1%; 2015: 2.1%), the experiences of the general public suggest that the cost of living has risen more significantly. Hence, the ability of the CPI as a good indicator of changes in cost of living in the country is subject to scepticism.

The disconnect between the cost of living and the reported CPI inflation arises due to three factors. First, cost of living and inflation are two different concepts as highlighted in the Box Article: Inflation and Cost of Living in the Annual Report 2015. CPI inflation is computed based on a single basket of goods and services which reflects average consumption patterns of the Malaysian households, and average prices in the economy. To the extent there are differences in spending patterns and variations in prices at various locations, the overall CPI inflation would not reflect the individual cost of living. Based on staffs' estimates, the inflation rates across income groups and states were indeed different from the national average.

- Comparing across states, households in Kuala Lumpur experienced the highest inflation rate of 2.8% in 2016, which is higher than the national average of 2.1%.
- Comparing across income groups, households in the bottom 20% of the income group experienced inflation rates that were 0.12 to 1.12 percentage points higher than households in the top 20% of the income group. This is due to their higher share of expenditure on food, which generally experienced a higher rate of inflation compared to other goods and services[1].

As the CPI provides a good measure of the changes in the overall consumer price level in the economy, it is a relevant indicator for the conduct of macroeconomic policies, such as monetary policy, that aim to affect the broader economy.

Second, while CPI only considers the annual rate of change in prices of goods and services, the discussions on the issue of cost of living also take into account the income perspective. Households feel the pressure of rising cost of living not solely when costs increase, but when incomes do not rise in tandem, leading to an erosion of purchasing power.

[1] This is not unique to Malaysia and has been observed in other countries

Third, the public perceptions on price increases are also subject to several natural biases. This is because consumers have different information sets than the ones used to compute the CPI when forming perceptions. These information sets comprise initial beliefs, social interaction with other economic agents and life-time experiences. The biased perceptions could influence consumer's expectations of future inflation, and in turn would change consumption and investment decisions. In this regard, understanding public inflation perceptions is important so that central banks are able to develop effective strategies to anchor inflation expectations.

This article lists some of the factors driving the public's perception of inflation and subsequently provides quantitative measures of the perceived inflation. It also explains factors that led to divergence between the perceived and CPI inflation in the recent period.

Public perception of inflation is subject to biases

Public's perception of inflation is shaped by their personal experiences and is subject to two biases, namely, frequency and memory bias.

- Frequency bias: Consumers' views on inflation are predominantly driven by the price changes in items that are more frequently purchased. The frequently purchased items are non-durable items such as food and personal care items that typically experience higher rate of inflation.
- Memory bias: Consumers tend to remember price increases and disregard price declines.

To quantitatively gauge the level of inflation perceived by the public, two measures of perceived inflation are constructed, namely the Everyday Price Index (EPI)[2] and Perceived Price Index (PePI)[3]. These indices incorporate the frequency and memory biases.

i. **Everyday Price Index (EPI)** is an index that comprises frequently purchased goods and services (at least once a month) that incorporate the frequency bias. The index accounts for 60% of the CPI basket. It excludes infrequently purchased and big tickets items such as clothing, household appliances and holiday expenses. Items, for which prices are contractually fixed, such as rentals, are also excluded due to the less frequent variations in prices.

   In the reweighted EPI basket, the food and non-alcoholic beverages category accounts for more than half (50.2%). Together with the transport category, these goods and services collectively account for 66% of the EPI basket. As a result, changes in prices of food and fuel products will greatly affect the EPI inflation.

Table 1: Weights in the CPI and the EPI baskets

Categories	CPI Weights	EPI Weights
Food & non-alcoholic beverages	30.2	50.2
Transport	13.7	15.8
Communication	5.2	7.8
Housing & utility	23.8	7.0
Recreation	4.9	5.9
Alcoholic beverages & tobacco	2.9	4.1
Restaurant & hotel	2.9	4.1
Miscellaneous	6.5	2.0
Education	1.1	1.6
Furnishing	3.8	1.5
Clothing & footwear	3.3	0.0
Health	1.7	0.0
Total	**100.0**	**100.0**

Source: Department of Statistics, Malaysia and staff calculation

[2] Vlasenko and Cunningham (2015).
[3] By employing similar concept highlighted by Brachinger (2006).

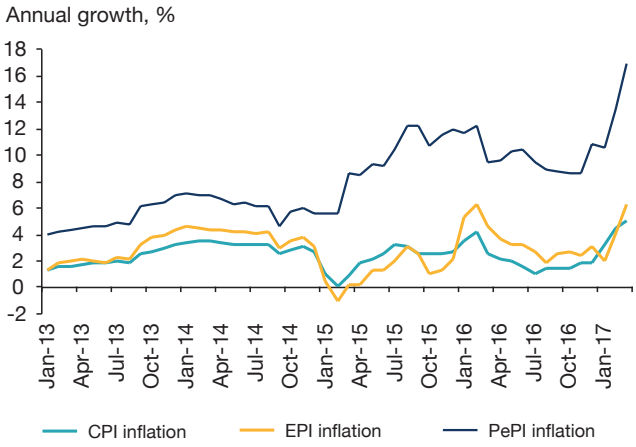
ii. Perceived Price Index (PePI) is a further refinement to the EPI, where it attempts to incorporate the memory bias in addition to the frequency bias. Items in PePI are exactly the same as EPI. However, the index will only capture price increases, as consumers tend to disregard price declines. Price indices that are registering declines are assumed to be unchanged.

Even in a low inflation environment, public perception of inflation has remained high given the perception bias

Comparing the measures of perceived inflation and the CPI inflation, EPI inflation was generally higher than the CPI inflation, indicating that prices of frequently purchased items were rising at a faster rate than the infrequently purchased items.

- Between July 2013 and December 2014, there were series of upward adjustments to administered prices such as prices of cigarettes, sugar and domestic fuel.
- In 2016, food inflation was exceptionally higher following the El-Nino phenomenon.
- The exception was in 2015 where the larger weight for the transport category exacerbated the negative impact from lower fuel prices, driving EPI inflation lower than CPI inflation.

Chart 1: Headline Inflation, EPI Inflation and Perceived Inflation



Source: Department of Statistics, Malaysia and staff calculation

PePI, inarguably, registers the highest rate of inflation.

- PePI was significantly higher than CPI inflation and EPI inflation. In 2015, the PePI inflation increased at a much faster pace due to the implementation of GST that led to broad-based price increases.
- In contrast, while CPI inflation and EPI inflation also increased during this period, the increase was relatively more modest as fuel prices were lower. The lower fuel prices, however, were not captured in PePI inflation.

Table 2: CPI, EPI and Perceived Inflation

Average annual growth, %	CPI	EPI	PePI
5-year average: 2012-2016	2.2	2.6	7.0
Increase in admin prices: July 2013 – December 2014	3.0	3.8	6.1
GST implementation: April 2015 – March 2016 November 2016 – March 2017	2.8 3.3	2.6 3.6	10.8 12.1

Source: Department of Statistics, Malaysia and staff calculation

Educating the public on inflation and clear communication on inflation outlook is important to anchor inflation expectations

By incorporating frequency and memory bias, the perceived inflation measures provides support to why the general public views actual inflation to be higher than the official CPI inflation. While this perception may not necessarily be the reality, the impact can be real as economic agents act upon their beliefs and make decisions on consumption and investment, which in turn would affect the economy. For example, expecting a significant increase in inflation, households may demand for higher wages beyond their productivity growth. This will lead to a second-round increase in prices and the consequent wage-price spiral. Alternatively, households could also cut down current consumption markedly in view of higher cost of living in the future. This, in turn, will lead to a slowdown in the overall economic activity.

Thus, correcting the perception biases is important to anchor inflation expectations. In this regard, efforts would be focused towards educating the public on inflation, how it is different from the cost of living, its computation as well as the importance of validating information used in making consumption and investment decisions. Information on the outlook and future trends of inflation would also be communicated to reassure the public that inflation will be kept low over the medium-term horizon.

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External position remained resilient

Gross exports accelerated by 21.4% in the first quarter of 2017 (4Q 2016: 2.8%). The growth performance was broad-based, driven by manufactured and commodities exports, both of which recorded double-digit growth.

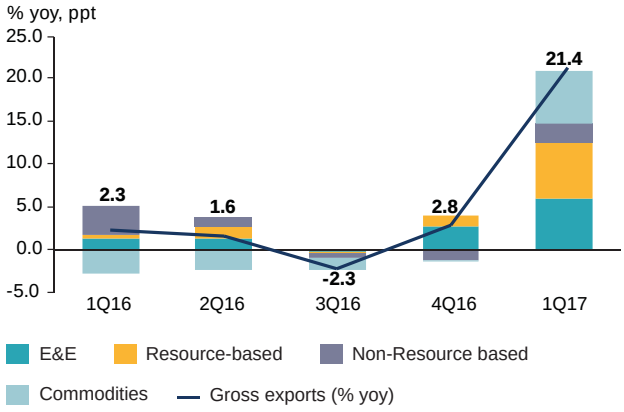
Strong growth in manufactured exports was attributable to higher demand from all major trading partners particularly the US, PR China and regional economies. Demand for E&E products increased, particularly for semiconductors. In terms of destination, E&E exports were supported primarily by the higher demand from PR China and the US.

Resource-based manufactured exports were also higher in the first quarter of 2017 due mainly to petroleum products, and chemicals and chemical products. Exports of these products were mainly concentrated to PR China and the region. Commodity exports were supported by the improvement in commodity prices and higher export volumes of crude oil, CPO and LNG.

Gross imports grew robustly by 27.7% in the first quarter of 2017 (4Q 2016: 5%), underpinned by higher intermediate goods and imports of capital and transport equipment. Of significance, capital imports were driven mainly by high-value items, including a floating structure, oil and gas vessels and several aircrafts. Intermediate imports registered higher growth, in line with strong manufacturing export performance. As import growth outpaced export growth during the quarter, the trade surplus was lower at RM18.9 billion (4Q 2016: RM27.5 billion).

Chart 14: Gross Exports by Products

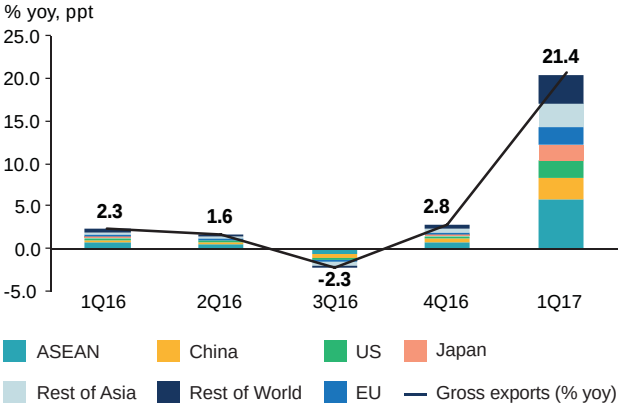
Higher Exports Growth Across Major Products



Source: Department of Statistics, Malaysia

Chart 15: Gross Exports by Markets

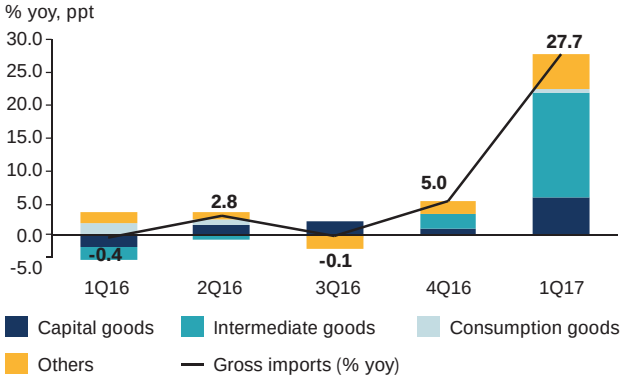
Exports was Also Broad-based Across Markets



Source: Department of Statistics, Malaysia

Chart 16: Gross Imports by Products

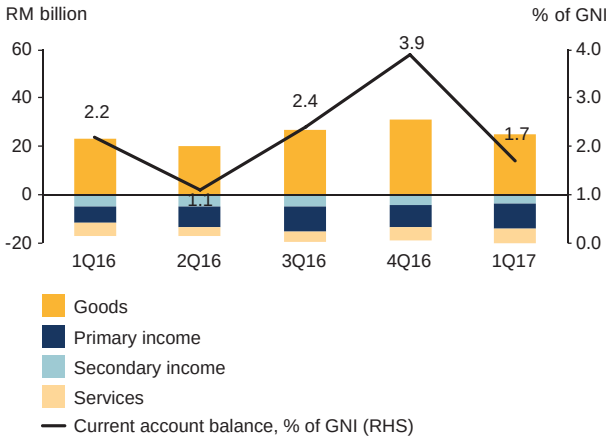
Higher Gross Imports, Particularly in Intermediate and Capital Goods



Source: Department of Statistics, Malaysia

Chart 17: Current Account Balance

Lower Current Account Surplus due to Smaller Goods Balance



Source: Department of Statistics, Malaysia

Current account surplus narrowed

In the first quarter of 2017, the current account surplus narrowed due to a lower goods surplus and higher deficit in the services account. The goods surplus narrowed to RM25.3 billion in the first quarter of 2017 (4Q 2016: RM31.2 billion), as robust import growth outpaced export growth.

The deficit in the services account widened to RM6.2 billion in the first quarter of 2017 (4Q 2016: deficit of RM5.4 billion), attributable mainly to higher payments for transportation services. This is in tandem with the increase in trade. In addition, net payment for construction services was higher in the first quarter of 2017 as reflected in the pick-up in investments. The deficit in those categories was partly offset by a sustained net travel surplus of RM7.6 billion (4Q 2016: RM7.6 billion).

The deficit in the primary income account was higher at RM9.9 billion in the first quarter of 2017 (4Q 2016: deficit of RM9.2 billion). Profits accrued to foreign investors in Malaysia (RM20.0 billion; 4Q 2016: RM19.4 billion) continued to outpace the profits generated by Malaysian investments abroad (RM11.4 billion; 4Q 2016: RM11.5 billion).

The net payment in the secondary income account was lower at RM3.9 billion in the first quarter of 2017 (4Q 2016: net payment of RM4.1 billion). This was due mainly to the moderation in outward remittances (RM8.5 billion; 4Q 2016: RM8.6 billion).

Financial account recorded lower net outflows

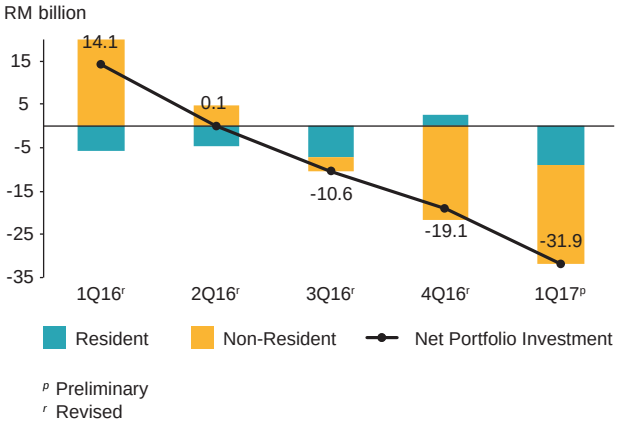
In the first quarter of 2017, the financial account recorded a lower net outflow of RM8.8 billion (4Q 2016: net outflow of RM14.2 billion), attributed mainly to net outflows in the portfolio investment account.

Portfolio investment by non-residents recorded a net outflow of RM22.9 billion (4Q 2016: net outflow of RM21.8 billion). Non-resident holdings of debt securities were lower, primarily concentrated in short-term papers with maturities of less than 3 years. This mainly reflected the maturity of Malaysian Government Securities (MGS) during the quarter and a rebalancing of exposures by international asset managers. Contributing factors were the Federal Reserve's decision to raise the federal funds rate in March 2017, renewed volatility in global oil prices and the reduction of Malaysia's weightage in the JP Morgan GBI-EM Index. The sale of non-residents' portfolios were smoothly intermediated by domestic institutions. As a result, the bond market remained relatively stable. In contrast to the net outflows from debt securities, foreign purchases of equity securities resumed amid stronger corporate earnings and the better ringgit performance. Resident portfolio investment registered a net outflow of RM9 billion (4Q 2016: net inflow of RM2.7 billion), attributed to a net acquisition of foreign financial assets by domestic fund managers and institutional investors.

The direct investment account registered a net inflow of RM8.3 billion (4Q 2016: net inflow of RM1 billion), as the incurrence of direct investment liabilities more than offset the accumulation of direct investment assets during the quarter. Direct investment abroad (DIA) by Malaysian companies declined to RM8.7 billion (4Q 2016: net outflow of RM12 billion), due mainly to lower injection of equity capital to subsidiaries abroad. Most of DIA was undertaken by companies in the services sector, particularly the financial services and utilities sub-sectors, followed by the mining sector. Foreign direct investment (FDI) rose to RM17 billion (4Q 2016: net inflow of RM13 billion), on account of higher earnings retained for reinvestment and the drawdown of intercompany loans. FDI inflows were mainly channeled into the services sector, primarily the real estate and information and telecommunication sub-sectors, followed by the mining sector.

Chart 18: Portfolio Investments

Higher Net Portfolio Outflows, Mainly by Non-Residents

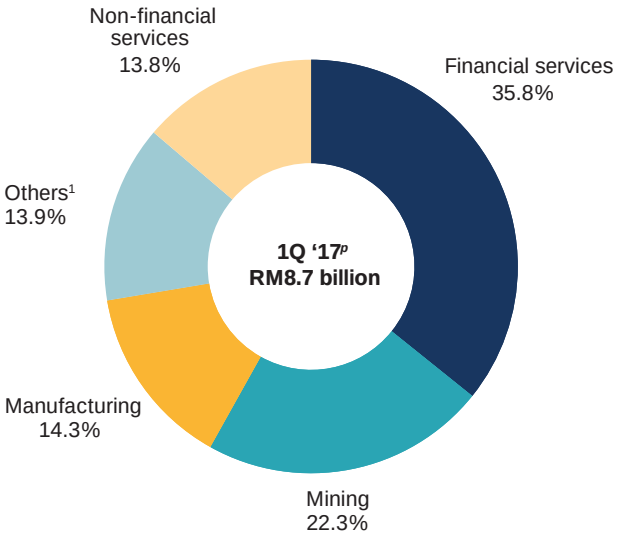


p Preliminary
r Revised

Source: Department of Statistics, Malaysia

Chart 19: Net DIA by Sector

DIA Channeled Mostly into the Services Sector



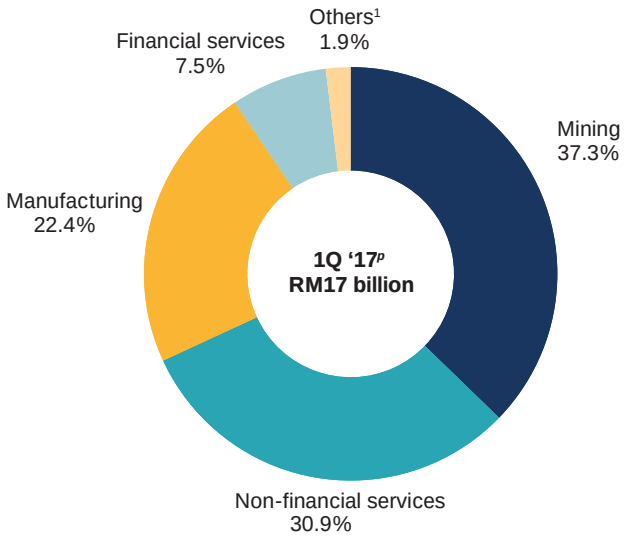
1 Refers to agriculture and construction sectors
p Preliminary

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

Source: Department of Statistics, Malaysia

Chart 20: Net FDI by Sector

FDI Channeled Mostly into the Services and Mining Sectors



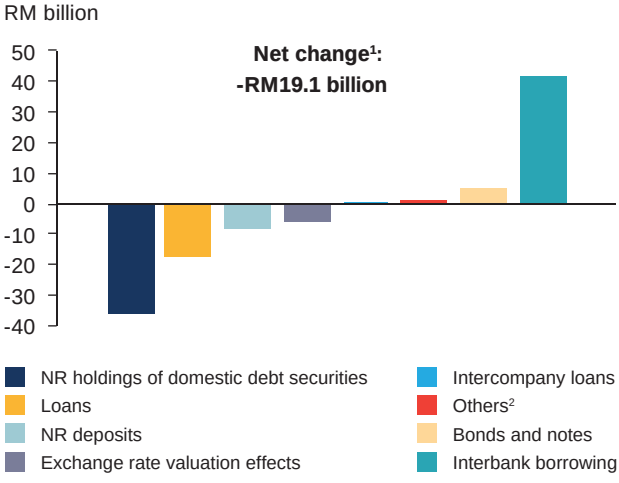
[1] Refers to agriculture and construction sectors
[p] Preliminary

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

Source: Department of Statistics, Malaysia

Chart 21: Changes in External Debt

Lower External Debt in 1Q 2017



[1] Changes in individual debt instrument 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

The other investments account recorded a higher net inflow of RM14.2 billion (4Q 2016: net inflow of RM5 billion), due mainly to both the larger placements of currency and deposits by foreign financial institutions in Malaysian banks and the repayment of trade credits which were previously extended by Malaysian exporters.

Following these developments, the overall balance of payments registered a deficit of RM1.8 billion in the first quarter (4Q 2016: a surplus of RM19 billion). Errors and omissions amounted to RM1.7 billion or 0.4% of total trade.

Manageable external debt

Malaysia's external debt amounted to RM897.0 billion, equivalent to USD200.8 billion or 68.4% of GDP as at end-March 2017 (end-December 2016: RM916.1 billion or USD202.3 billion). The lower external debt largely reflects the decline in holdings of domestic debt securities and deposits in domestic banking institutions by non-residents (NR), and a net repayment of loans. There were also valuation effects following the strengthening of the ringgit against selected major and regional currencies during the quarter. These were partly offset, in particular, by a significant increase in interbank borrowing during the quarter for liquidity management within related entities, investment and financing purposes.

Malaysia's external debt remains manageable given its currency and maturity profiles, and the availability of larger external assets. Close to one-third of total external debt is denominated in ringgit (30.3%), 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.

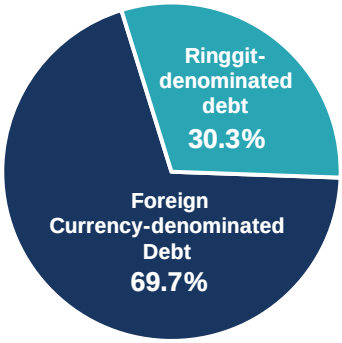
The remaining external debt of RM624.9 billion (69.7%) is denominated in foreign currency (FC) and is mostly hedged, either naturally through foreign currency earnings or through the use of financial instruments. The bulk of these obligations are offshore borrowings, raised mainly to expand productive capacity and to better manage financial resources within corporate groups. As at end-March 2017, offshore borrowing remained low at 42.5% 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 in the form of interbank borrowing and FC deposits with the domestic banking system, which amounted to RM237.9 billion. This largely reflects 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 RM172.2 billion as at end-March 2017, primarily to finance asset acquisitions abroad that will generate future income. The intercompany loans are normally subject 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 (54.9%) of total external debt), suggesting limited roll over risks. It is important to note that international reserves are not the only means in which the 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 USD96.1 billion as at 28 April 2017 is only about a quarter of total external assets, with the remaining being held by banks and corporations. International reserves are 1.1 times the short-term external debt and are sufficient to finance 7.9 months of retained imports.

Chart 22: Breakdown by Currency (% share)

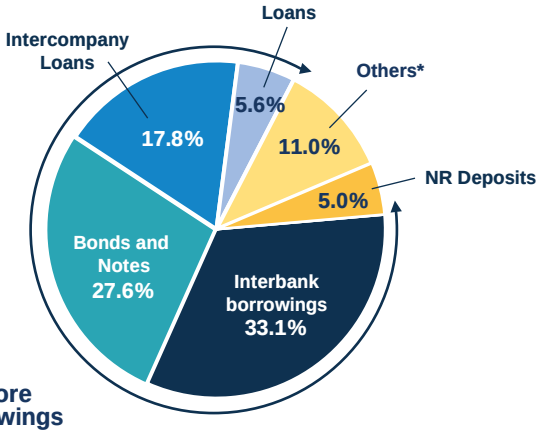
FC-Denominated Debt Largely Hedged



Source: Bank Negara Malaysia

Chart 23: Breakdown of Foreign Currency-denominated External Debt (% of Share)

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

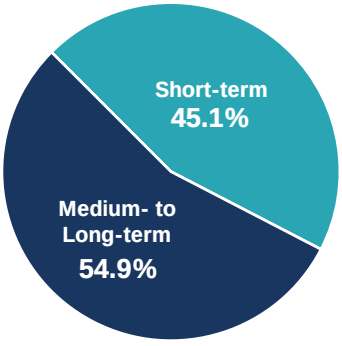


* Includes trade credits and miscellaneous, such as insurance claims yet to be disbursed and interest payables on bonds and notes

Source: Bank Negara Malaysia

Chart 24: Breakdown by Maturity (% share)

Limited Roll Over Risks



Source: Bank Negara Malaysia