BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

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Bank Negara Malaysia Annual Report 2017

2017 marked a year of strong economic rebound, with the global economy recording its highest growth rate since 2011. Growth in world trade exceeded that of global GDP for the first time in three years. The pickup in economic growth was broad-based across the advanced and emerging market economies. In the advanced economies, economic growth was driven mainly by robust investment activity amid stronger domestic demand, while political uncertainties that had lingered throughout the year had little impact on the growth trajectory. In Asia, the growth momentum was supported by the recovery in global trade and was anchored by strong domestic demand. Reflecting the resurgence in global growth, international financial markets performed strongly, while market volatility remained low despite uncertainties surrounding geopolitical tensions. While global headline inflation rates edged up during the year, reflecting improved global demand conditions and the recovery in commodity prices, underlying inflation remained muted in many countries.

Despite the synchronised nature of the global growth recovery, the stance of monetary policies globally diverged. In the advanced economies, monetary policy was generally tilted towards gradual normalisation, permitted by the climate of strong economic growth. The US Federal Reserve and the Bank of England raised their respective policy rates while the European Central Bank announced a reduction in its asset purchases. Contrary to the advanced economies, several Asian economies, such as Indonesia and India, turned to a more accommodative stance amid waning inflation. Alongside monetary policy, some advanced economies also deployed fiscal policies to bolster macroeconomic fundamentals. In Asia, policymakers continued to pursue structural reforms to strengthen resilience and fortify sustainable growth prospects.

Against a background of broad-based global recovery and the relatively low volatility in the international financial markets, the Malaysian economy performed strongly in 2017. The Annual Report provides an analysis of the developments in the Malaysian economy and outlines the future challenges. The report also sheds light on the Bank's continuous efforts to strengthen its governance, organisational development and communications.

The Malaysian Economy in 2017

In 2017, the Malaysian economy recorded a robust growth of 5.9% (2016: 4.2%), supported by faster expansion in both private and public sector spending. A key highlight for the year was the rebound in gross exports growth as global demand strengthened. This was due mainly to higher demand from major trading partners following the upswing in the global technology cycle, investment expansion in the advanced economies and the turnaround in commodity prices. Altogether, the global technology upturn translated into robust demand for electronics and electrical (E&E) products while the stronger regional demand and the revival in investment activity in the advanced economies lifted exports of non-E&E products. Commodity exports also turned around in 2017, supported largely by the recovery in major commodity prices.

While real GDP growth was boosted by the external sector, domestic demand continued to anchor growth. In particular, private consumption growth strengthened to 7.0% in 2017 (2016: 6.0%), supported mainly by continued wage and employment growth, with additional impetus from Government measures. Public consumption grew by 5.4% (2016: 0.9%) due to higher spending on supplies and services by the Federal Government amid sustained growth of emoluments. Gross fixed capital formation (GFCF) grew at a faster pace of 6.2% (2016: 2.7%), driven by improvements in both public and private investments. Public investment recovered to grow at 0.1% (2016: -0.5%), supported by continued spending by the General Government and public corporations. Private investment growth accelerated to 9.3% (2016: 4.3%), as firms benefited from the conducive external and domestic operating environment.

On the supply side, most sectors registered higher growth in 2017. The performance of the two largest sectors, services and manufacturing, benefited from marked improvements in domestic and external conditions, growing at 6.2% and 6.0%, respectively (2016: 5.6% and 4.4%). The construction sector recorded a moderate growth of 6.7% (2016: 7.4%), while growth in agriculture production rebounded to 7.2% (2016: -5.1%). Growth in the mining sector, however, moderated to 1.1% (2016: 2.2%), reflecting the voluntary crude oil supply adjustments by PETRONAS, in line with the Organization of the Petroleum Exporting Countries (OPEC) agreement to limit oil production until end-2018.

Labour market conditions improved with stronger employment gains keeping pace with labour force expansion. The labour force expanded by 303,000 people, while net employment gains amounted to 295,000 jobs, mostly driven by high- and mid-skilled workers. The unemployment rate during the year remained stable at 3.4% (2016: 3.4%). The labour force participation rate edged higher to 67.8% (2016: 67.7%) and employment growth tripled to 2.1% (2016: 0.7%), as employers were optimistic about the business outlook and thus continued to expand their workforce accordingly. The number of documented unskilled and semi-skilled foreign workers in Malaysia decreased during the year, with its share of the labour force correspondingly declining to 12.0% from 12.7% at end-2016. Aggregate nominal wages in the private and public sectors grew by 6.4% and 6.2%, respectively in 2017 (2016: 4.3% and 6.4%).

Headline inflation increased to 3.7% in 2017 (2016: 2.1%). Inflation remained volatile during the year and was primarily driven by higher domestic fuel prices. Higher global commodity prices and disruptions in domestic food supplies also contributed to the higher inflation. This, however, was mitigated by the stronger ringgit exchange rate since April 2017, which helped contain the rise in production costs for domestic goods. Core inflation was also higher in 2017, averaging at 2.3% for the year (2016: 2.1%). Nevertheless, demand-driven inflationary pressures remained largely stable given the lack of persistent tightness in capital stock and the absence of significant wage pressures.

Malaysia's external position improved considerably in 2017, benefiting from the favourable global economic landscape and relatively lower volatility in the international financial markets. Malaysia recorded a higher current account surplus, largely due to a higher goods surplus following the strong export performance, which more than offset widening deficits in the services and primary income accounts. Gross exports rebounded to grow strongly by 18.9% (2016: 1.2%), driven mainly by export volumes, particularly in manufactured exports. Gross imports also registered double-digit growth of 19.9% (2016: 1.9%), mainly reflecting higher imports of intermediate goods, capital goods, and goods for re-exports. The increase in imports was in line with the robust manufacturing exports, more rapid investment in the manufacturing and services sectors, and robust global demand.

During the year, the financial account of the balance of payments registered a net inflow of RM2.3 billion (2016: net outflow of RM1.1 billion). These inflows were driven mainly by continued foreign direct investment (FDI) inflows, and a resumption of portfolio investments by non-residents, amid continued acquisitions of financial assets abroad and long-term investments by resident banks, institutional investors, and fund managers. These developments reflected significant cross-border capital flows driven by robust domestic growth, improvement in global growth prospects and lower volatility in the financial markets during the year.

The international reserves of Bank Negara Malaysia amounted to USD102.4 billion as at end-2017 compared to USD94.5 billion as at end-2016. As at 15 March 2018, international reserves amounted to USD103.9 billion. The international reserves remained adequate to facilitate international transactions and sufficient to finance 7.3 months of retained imports and is 1.1 times the short-term external debt. Of note, the wide range of monetary policy instruments, exchange rate flexibility and resilient financial markets have enabled the economy to reduce its reliance on the Bank's international reserves in managing external pressures.

Malaysia's external debt declined to RM883.4 billion as at end-2017, equivalent to USD215.5 billion or 65.3% of GDP (2016: RM 916.1 billion, equivalent to USD202.3 billion or 74.5% of GDP). The decline was mainly attributed to valuation effects following the strengthening of the ringgit against most currencies during the year. Excluding valuation effects, Malaysia's external debt increased by 1.4% of GDP, mainly on account of increases in interbank borrowing and non-resident deposits. Risks arising from external debt remained manageable, mitigated by its currency and maturity profiles. More than a third of external debt is denominated in ringgit (34.3%), mainly in the form of non-resident holdings of domestic ringgit debt securities and ringgit deposits in domestic banking institutions. These liabilities are not subject to valuation changes from the fluctuations in the exchange rate. The remaining portion of total external debt of RM580.7 billion (65.7% share) is denominated in foreign currency, and is subject to prudential and hedging requirements on banking institutions and corporations. In terms of maturity, more than half of the total external debt is skewed towards medium- to long-term tenures (57.3% of total external debt), indicating limited rollover risks. Additionally, not all short-term external debt poses a claim on reserves.

Overall, the fundamentals of the Malaysian economy continued to strengthen. Structural policies carried out over the decades have resulted in a highly open and diversified economy with multiple sources of growth. Improving labour market conditions amid faster wage growth continued to support household spending. Healthy financial institutions and sufficient domestic liquidity also ensured orderly financial intermediation. Furthermore, Malaysia's external position remained strong and well-protected from a sharper depreciation, supported by sufficient international reserves and manageable levels of external debt.

Despite the strong growth in 2017, structural reforms remained a priority to strengthen economic fundamentals and to safeguard the sustainability of the growth momentum. These include efforts to enhance domestic value-added in production and exports, promote higher quality domestic and foreign investments, raise productivity and cultivate a future-ready quality labour force.

Economic and Monetary Management in 2017

The Monetary Policy Committee (MPC) kept the Overnight Policy Rate (OPR) unchanged at 3.00% throughout 2017, with the focus on ensuring that the growth of the Malaysian economy remained entrenched amid contained inflation. During the year, the MPC actively assessed the stance of monetary policy to ensure it remained consistent with the evolving prospects of growth and inflation. In particular, the downside risks to domestic growth from the external environment that was prevalent in the beginning of the year receded over time amid a more broad-based and synchronised upturn in global growth. This resulted in a stronger domestic economic growth compared to the initial forecast. Inflation remained contained as the robust domestic demand was mitigated by some degree of spare capacity in the labour market and capital stock.

The MPC was also vigilant against a build-up of risks that could arise from a prolonged period of low interest rates. During the course of the year, it became increasingly evident that economic conditions that warranted the previous OPR reduction in 2016 had vastly improved. Consequently, in November, the MPC communicated in the Monetary Policy Statement its consideration for a potential review of the degree of monetary accommodation, which would reflect a normalisation from the previous monetary accommodation in July 2016, rather than a tightening of monetary conditions.

The ringgit, along with most major and regional currencies, strengthened against the US dollar in 2017. The ringgit appreciated by 10.4% to end the year at RM4.0620 against the US dollar after experiencing four consecutive years of depreciation. The ringgit was also one of the best-performing regional currencies despite intermittent depreciation due to “risk-off” events during the year. The strength of the ringgit reflected the better-than-expected GDP growth performance, positive investor sentiments following further liberalisation of the Malaysian financial markets, and positive global developments. In the first quarter of 2017, the appreciation of the ringgit was limited due to lingering investor concerns over the prospects of the Malaysian financial markets. The uncertainties mainly reflected the misperceptions regarding the liberalisation measures introduced by the Financial Markets Committee (FMC) in December 2016, and the lack of understanding of the onshore hedging facilities by foreign investors. In the subsequent periods, sentiments on the ringgit and the Malaysian financial markets improved significantly, driven mainly by positive domestic developments. The ringgit appreciated 9.0% against the US dollar from the second quarter onwards.

In addition, the ringgit was one of the least volatile regional currencies despite intermittent periods of depreciation pressure due to the occasional prevalence of "risk-off" sentiments in the global financial markets. The stability of the ringgit was a manifestation of the effectiveness of the financial market development measures introduced by the FMC in late 2016 and 2017. These measures resulted in improved liquidity in the domestic foreign exchange market and the decline in the volatility of the ringgit against the US dollar. The ringgit also experienced more balanced demand and supply after the introduction of the export conversion measure. The Bank also took steps to address some of the misperceptions and concerns about Malaysia that have resulted in excessive movements of the ringgit, in particular regarding its oil-dependency, adequacy of international reserves, and the Government's fiscal position.

In 2017, Malaysian Government Securities (MGS) yields declined amid sustained non-resident inflows and strong support from domestic institutional investors, underpinned by Malaysia's strong economic performance during the year. During the first quarter of 2017, the bond market experienced large non-resident outflows due mainly to the unwinding of short-term speculative positions held by non-resident financial institutions and short-term asset managers following the introduction of the FMC measures and the US presidential election in late 2016. The subsequent quarters saw a resumption of non-resident inflows to the domestic bond market amid improved investor sentiments following Malaysia's strong economic performance as the year progressed. The second series of FMC initiatives introduced in April 2017 to improve market accessibility and hedging flexibilities, coupled with active engagements by the Bank with market participants to reduce misperceptions on earlier measures, also supported the bond market. This resulted in a downward trend in MGS yields during the period.

Monetary operations in 2017 remained focused on maintaining stability in the interbank market. In the first quarter, the slight moderation in domestic liquidity arising from capital outflows was offset by liquidity injection operations through the reverse repo and foreign exchange swap facilities. Following the resumption of capital inflows from the second quarter onwards, the Bank was able to reduce its liquidity injection operations. Overall banking system liquidity remained sufficient to support the financial intermediation process.

Net financing to the private sector expanded by a faster pace of 6.4% in 2017 (2016: 5.5%), driven by financing through the corporate bond market, which recorded the strongest growth since 2012. However, growth of outstanding loans to both households and businesses moderated during the year. The lower business loan growth was broad-based, reflecting a larger increase in loan repayments relative to the increase in disbursements. Growth in household debt continued its moderating trend.

Outlook for the Malaysian Economy in 2018

The global economy is projected to expand at a faster pace in 2018, driven largely by private consumption and boosted by investment activity in the advanced economies. In Asia, trade activity will continue to expand, albeit at a more moderate pace. Financing conditions are likely to remain accommodative despite the ongoing normalisation of global monetary policy. In the advanced economies, the strength of investments is likely to persist through 2018 and Asian economies will continue to benefit from positive spillovers from the external sector. Other emerging market economies are also likely to see a pickup in growth, while commodity exporters will observe a rebound in domestic demand due to higher global crude oil prices. Overall, risks to the global outlook are poised to become more broadly balanced. Nevertheless, several downside risks stemming from 2017 linger. These include uncertainties surrounding the effects of a synchronised monetary policy normalisation across major economies, the inward-looking trade policies that threaten international trade, in addition to geopolitical risks that could adversely affect sentiments in global financial markets.

Amid the stronger global economic conditions, the Malaysian economy is projected to grow by 5.5% - 6.0% in 2018. Domestic demand will continue to be the anchor of growth, underpinned by private sector activity. Private consumption growth is expected to remain sustained, supported by continued growth in employment and income, lower inflation and improving sentiments. Income growth will be supported by a robust export performance and continued Government measures, such as the continuation of *Bantuan Rakyat 1Malaysia* cash transfers, individual income tax reduction, and the special payment to all civil servants and retirees. Private investment growth will also be sustained, underpinned by ongoing and new capital spending in both the manufacturing and services sectors, and strengthened by continued positive business sentiments. Public sector expenditure is projected to decline due to the contraction in public investment amid more moderate growth in public consumption.

Apart from domestic demand, GDP growth will also be supported by the favourable external demand conditions. Both gross exports and imports are forecasted to grow at above-average trends in 2018. Exports will be lifted by favourable demand from major trading partners, the continued expansion in the global technology upcycle, increase in domestic productive capacity and broadly sustained global commodity prices. Despite the projected higher goods surplus of the current account, deficits in the services and income accounts will continue to weigh on the current account balance. Overall, the current account balance is expected to record a surplus of between 2.0% – 3.0% of GNI in 2018.

Labour market conditions are expected to remain favourable and supportive of growth, driven by continued robust economic activity and better hiring sentiments. Employment will continue to expand while the growth in job creation will be sufficiently robust to accommodate new entrants into the workforce. As such, the unemployment rate is expected to be relatively unchanged. Looking ahead, several reforms undertaken such as the implementation of the Employment Insurance System and the Employers Undertaking, and an impending review of the minimum wage, will position the nation's labour market on a more competitive and resilient path, and improve the overall well-being of Malaysia's workforce.

On the supply side, all economic sectors are forecasted to expand in 2018. The services and manufacturing sectors will continue to be the key drivers of overall growth. The construction sector is expected to register a stronger expansion, driven by large new and existing multi-year civil engineering projects. Growth in the mining sector is also projected to be higher, reflecting the continued pickup in natural gas production. The agriculture sector is expected to register a more moderate growth, following the exceptional post-El Niño crude palm oil production recovery in 2017.

Headline inflation is projected to moderate in 2018, averaging between 2.0% – 3.0%. The lower inflation compared to 2017 is due mainly to an expected smaller contribution from global energy and commodity prices. A stronger ringgit exchange rate compared to 2017 would also mitigate import costs. Inflationary pressure from domestic demand factors will be contained by improving labour productivity and ongoing investments for capacity expansion. The inflation outlook, however, depends on the trajectory of global oil prices, which remains highly uncertain.

Overall, the economic outlook is marked by several upside risks to growth. This includes stronger-than-expected global demand, which in turn would improve the prospects for export-oriented industries. The potential increase in minimum wage and a faster-than-expected pickup of existing and new production facilities in various industries would also support a more favourable growth outlook. Nevertheless, several downside risks to growth remain. The strength of Malaysia's exports to major trading partners could be impacted by unfavourable effects arising from monetary and regulatory policy shifts in the advanced economies, rising trade protectionism by major trading partners and a sharper-than-expected growth moderation in PR China. In addition, a re-emergence of volatile global commodity prices or abrupt corrections in the global financial markets could weigh down sentiments, which in turn could dampen the strength of domestic economic activity.

Malaysia is, however, well-positioned to withstand these headwinds should these downside risks materialise. The structural reforms that were undertaken over the years have endowed the Malaysian economy with multiple sources of growth, ample buffers and robust policy frameworks. Going forward, the positive economic environment will provide policymakers with ample policy space to continue with the necessary reforms. The domestic financial markets are resilient and well-positioned to intermediate large swings of capital flows in the event of heightened financial market volatility. Fundamentally, policymakers have the tools, capacity and flexibility to undertake the necessary measures to steer the economy along a steady growth path.

Economic and Monetary Management in 2018

Monetary policy in 2018 will focus on ensuring the sustainable growth of the Malaysian economy with price stability. Given the continuing positive macroeconomic outlook and firm growth path, the MPC decided to normalise the degree of monetary accommodation at the January 2018 MPC meeting. The MPC raised the OPR by 25 basis points to 3.25%. The MPC also recognises the need to prevent the build-up of risks that could arise from a prolonged period of low interest rates, even as the risks of financial imbalances currently remain contained. The MPC will monitor closely the evolving economic outlook, including the impact of the OPR adjustment in January 2018. The Bank's monetary operations will continue to ensure that domestic liquidity in the financial system will remain sufficient to support the orderly functioning of the domestic financial markets.

Fiscal policy in 2018 will continue to focus on strengthening the Government's fiscal position while ensuring sustainable and more inclusive economic growth. The Federal Government's fiscal deficit is expected to narrow further, supported by initiatives to optimise expenditures and enhance revenues. As delineated in the 2018 Budget, fiscal spending will prioritise high-impact infrastructure projects and initiatives that build capacity and raise productivity. Consistent with the efforts to ensure an inclusive economic growth, welfare enhancement programmes and fiscal transfers will provide support to the lower- and middle-income segments to cope with the higher cost of living.

Bank Negara Malaysia's Audited Financial Statements for 2017

As audited and certified by the Auditor General, the financial position of Bank Negara Malaysia remained strong in 2017. Bank Negara Malaysia's total assets amounted to RM449.8 billion, with a net profit of RM7.5 billion for the financial year ending 31 December 2017. Bank Negara Malaysia declared a dividend of RM2.5 billion to the Government for the year 2017.

Bank Negara Malaysia
28 March 2018

Malaysia - Key Economic Indicators

	2015	2016	2017*p*	2018*f*
Population (million persons)	31.2	31.6	32.1	32.9
Labour force (million persons)	14.5	14.7	15.0	15.3
Employment (million persons)	14.1	14.2	14.5	14.8
Unemployment (as % of labour force)	3.1	3.4	3.4	3.2 ~ 3.5
Per Capita Income (RM)	36,093	37,792	41,072	42,834
(USD)	9,242	9,110	9,551	10,885[3]
NATIONAL PRODUCT (% change)				
Real GDP at 2010 prices	5.0	4.2	5.9	5.5 ~ 6.0
(RM billion)	1,063.4	1,108.2	1,173.6	1,240.1
Agriculture, forestry and fishery	1.3	-5.1	7.2	3.6
Mining and quarrying	5.3	2.2	1.1	1.8
Manufacturing	4.9	4.4	6.0	5.9
Construction	8.2	7.4	6.7	7.3
Services	5.1	5.6	6.2	6.1
Nominal GNI	5.2	6.2	10.1	6.9
(RM billion)	1,125.6	1,195.5	1,316.3	1,407.6
Real GNI	6.8	4.4	6.1	5.6
(RM billion)	1,039.0	1,084.9	1,150.8	1,215.0
Real aggregate domestic demand[1]	5.1	4.3	6.5	5.7
Private expenditure	6.1	5.6	7.5	7.6
Consumption	6.0	6.0	7.0	7.2
Investment	6.3	4.3	9.3	9.1
Public expenditure	2.1	0.4	3.3	-0.9
Consumption	4.4	0.9	5.4	0.6
Investment	-1.1	-0.5	0.1	-3.2
Gross national savings (as % of GNI)	29.0	29.1	29.2	28.8
BALANCE OF PAYMENTS (RM billion)				
Goods balance	109.2	101.4	118.1	120.5
Exports	681.3	686.1	808.9	865.9
Imports	572.1	584.7	690.8	745.3
Services balance	-20.6	-19.1	-23.1	-23.2
Primary income, net	-32.1	-34.6	-36.1	-39.1
Secondary income, net	-21.3	-18.6	-18.6	-19.3
Current account balance	35.2	29.0	40.3	38.9
(as % of GNI)	3.1	2.4	3.1	2.0 ~ 3.0
Bank Negara Malaysia international reserves, net[2]	409.1	423.9	414.6	-
(in months of retained imports)	8.4	8.7	7.2	-
PRICES (% change)				
CPI (2010=100)	2.1	2.1	3.7	2.0 ~ 3.0
PPI (2010=100)	-7.4	-1.1	6.7	-
Real wage per employee in the manufacturing sector	3.7	4.1	2.2	-

[1] Exclude stocks
[2] All assets and liabilities in foreign currencies have been revalued into ringgit at rates of exchange ruling on the balance sheet date and the gain/loss has been reflected accordingly in the Bank's account
[3] Based on average USD exchange rate for the period of January-February 2018
p Preliminary
f Forecast

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia, Ministry of Finance, Malaysia and Bank Negara Malaysia