BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Statutory Requirements

In accordance with section 13 of the Central Bank of Malaysia Act 2009, Bank Negara Malaysia hereby publishes and has transmitted to the Minister of Finance a copy of this Annual Report 2018 together with a copy of its Financial Statements for the year ended 31 December 2018, which have been examined and certified by the Auditor General. The Financial Statements will also be published in the Gazette.

For the purposes of section 115 of the Development Financial Institutions Act 2002, the annual report on the administration of the Development Financial Institutions Act 2002 and other related matters for the year ended 31 December 2018 is incorporated in Bank Negara Malaysia's Financial Stability and Payment Systems Report 2018 which forms an integral part of this Annual Report 2018.

Nor Shamsiah Yunus
Chairman
Board of Directors
27 March 2019

Contents

Contents

BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Governor's Statement

The year ahead is being shaped by significant developments in the operating environment, both globally and domestically. In a marked departure from the optimistic start in 2018, the global economy is set to enter a period of moderating growth, with continued volatility in the financial markets. Domestically, the unprecedented change of government entails new fiscal, economic and reform priorities. Amid these shifts that are continuing to unfold, the Malaysian economy remains resilient, supported by strong fundamentals and policy flexibility.

Prospects for global growth will be contingent upon the outcome of several key risk factors. Trade tensions, if unresolved, will have a material impact on global trade and investments. Prolonged political and policy uncertainties could further weigh on global growth prospects. Meanwhile, lower commodity prices will continue to exert pressure on commodity-exporting countries. In this environment of heightened uncertainties, global financial markets could be subject to shifts in investor sentiments and bouts of volatile capital flows, with emerging market economies inevitably caught in the crosshairs.

As a highly open economy with an internationally integrated financial system, Malaysia will also be affected by these developments. Nevertheless, we face these headwinds from a position of strength, reinforced by a diversified economy, a resilient external position and a strong financial system. The Malaysian economy is expected to remain on a steady growth path, expanding between 4.3% – 4.8% in 2019. This growth will continue to be anchored by private sector activity, supported by stable income and employment growth, as well as sustained capacity expansion by businesses. The well-diversified export structure, in terms of products and markets, will help soften the impact of moderating global growth on external demand. New production facilities and the recovery from the supply disruptions in the commodity sector will provide additional impetus to domestic economic activity. The well-developed financial system with strong financial institutions will ensure that domestic financing conditions remain supportive of the changing needs of the economy.

In this environment of heightened risks, the focus of the Bank's policy is on preserving monetary and financial stability by reinforcing the resilience of the economy and addressing vulnerabilities. The Bank strives to identify and manage risks before they become destabilising, while building policy space and buffers pre-emptively. The broad range of policy instruments available, which includes targeted prudential policies and financial market measures, provides the Bank with policy flexibility while avoiding an over-reliance on any particular policy tool. This in turn supports a forward-looking approach to macroeconomic management, with due regard to the multifaceted and complex nature of risks.

Recognising the downside risks to domestic growth, the thrust of monetary policy in 2019 is to remain accommodative to ensure supportive conditions for sustainable economic growth amid the subdued inflation outlook. Average headline inflation in 2019 is expected to be broadly stable relative to 2018. The current period of low headline inflation is due largely to key policy measures, rather than a sharp deterioration in demand conditions. Inflation expectations also remain well anchored. These policy measures would therefore have a transitory effect on headline inflation.

The flexible exchange rate regime continues to be a key source of strength for the Malaysian economy in managing more volatile capital flows and their effects on domestic financial conditions. The exchange rate flexibility acts as a shock absorber for the economy, increasing its resilience when faced with external shocks. Nevertheless, as the exchange rate represents an important price for economic and financial market activities, the Bank continues to ensure orderly market conditions and manage excessive volatility so that the intermediation process is not disrupted. The sustained current account surplus and adequate international reserves accord crucial buffers to flexibly manage the impact of volatile capital flows on the exchange rate and the overall economy. In addition, ongoing measures to deepen the onshore foreign exchange market have supported more efficient hedging activities by economic and financial market participants to better manage their foreign exchange risks.

The Government's commitment to further strengthen fiscal management and reduce the fiscal deficit and debt, with clear outcomes, actions and timeline, will solidify the foundations for sustainable growth. Critically, the ongoing fiscal reforms to governance and institutional frameworks will serve to reinforce responsible and sustainable financial management. These reforms remain supportive of growth, while allowing fiscal consolidation efforts to continue.

At the same time, there is an urgent need to reinvigorate private investment, which is essential for Malaysia's economic progress. Attracting high-quality investments should be a key focus of policy to enhance the productive capacity of the economy and create the right kind of jobs for people from all walks of life. This calls for a clear national investment policy thrust, supported by effective incentives, a coordinated promotional strategy, and efficient business-friendly regulatory and approval regimes. Such policies should encourage the exploration, cultivation and development of new growth areas, including the digital economy and green technology.

It is equally important that Malaysia's economic progress is accompanied by inclusive growth, where the dividends accrue to all segments of society and vulnerable groups are appropriately protected. Within the boundaries of its mandate, the Bank has continued to focus on promoting the financial resilience and financial wellbeing of Malaysian households, and providing economic advice to the Government in areas concerning the rising cost of living, affordable housing and access to financial protection.

There are also ongoing collaborative efforts on the international front to further promote regional macroeconomic and financial stability. In an integrated global economy and financial system, these arrangements are necessary to build collective resilience. Such initiatives are being pursued with strategic bilateral partners and through global and regional platforms. This will enhance our capacity to manage potential spillover risks from external developments through closer cooperation in macroeconomic and financial surveillance and strengthened financial safety net arrangements. Amid adjustments in the global trade configuration, the Bank remains committed to support the deepening of regional economic interlinkages and financial integration. This will be achieved through effective participation in a number of trade and investment agreements, closer banking and payment linkages, as well as increased settlement of trade and investment in local currencies. In response to the growing challenges and risks posed by environmental and climate change, the Bank became a member of the Central Banks and Supervisors Network for Greening the Financial System with a view to working collaboratively with other central banks and supervisors to support the transition towards a sustainable economy.

The Bank also continues to further strengthen the internal governance structure and practices to preserve the credibility of, and confidence in, the Bank. The Bank's corporate culture is being actively enhanced to foster an open, agile and collaborative environment. Grounded by the values and traditions of trust, integrity and professionalism, the Bank also strives to position itself at the forefront of change. Business strategies are being reviewed and resources optimised to sharpen our focus and ensure we remain steadfast in the delivery of our mandates. At the same time, the Bank places high priority on the continued enhancement and modernisation of the internal organisational capacity, both in human capital and infrastructure development. Having a cohesive and talented workforce, equipped with progressive technology, is key in ensuring that the Bank is able to carry out its responsibilities effectively, efficiently and in a sustainable manner.

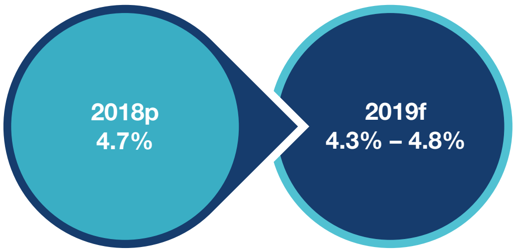
In 2019, we celebrate the 60th anniversary of Bank Negara Malaysia at a time of transformative change. While the operating environment continues to evolve, the Bank has remained steadfast throughout the years in serving the interest of the nation. The Malaysian economy has also consistently demonstrated the dynamism and agility to thrive and flourish in an ever-changing environment. As we move forward, the collective strength of our economic resilience and institutional arrangements will serve as an anchor in these testing times. At the heart of the Bank's ability to fulfil our responsibilities is the expertise and commitment of our staff. On behalf of the Board and the management, I wish to express our utmost appreciation to all the staff of the Bank for their professionalism, dedication and hard work. I would also like to extend my gratitude to the Board of Directors for their support and guidance. The Bank will continue to strive towards achieving the highest standards of excellence in delivering our mandates and upholding the trust that is placed upon us.

Nor Shamsiah Yunus
Governor
27 March 2019

Key Highlights on Economic Developments and Outlook

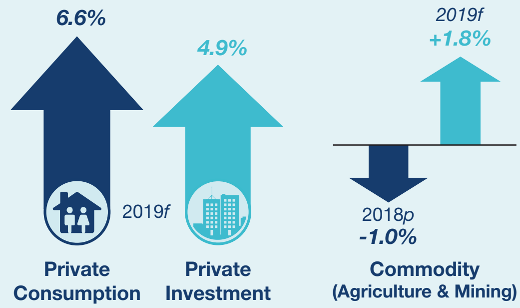
Sustained growth momentum in 2019

The economy to expand by 4.3% – 4.8% in 2019...



Real GDP (Annual growth, %)

...supported by firm private sector activity and recovery in commodity sectors

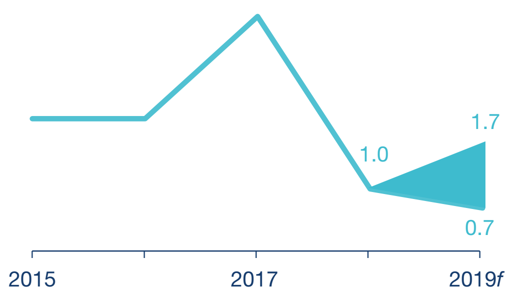


(Annual growth, %)

Broadly stable average headline inflation in 2019

Upward impact from cost factors offset by lower domestic retail fuel prices

Headline inflation (Annual growth, %)



Some cost pass-through from:

Domestic cost factors, including those arising from policy developments

Offset by impact from:

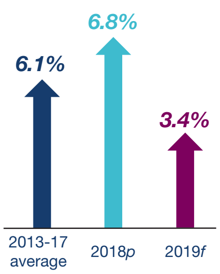
Lower global oil prices

Price ceilings for RON95 petrol and diesel until mid-year

Exports and current account balance to remain positive in 2019

Export growth supported by manufactured exports

Gross Exports (Annual growth, %)



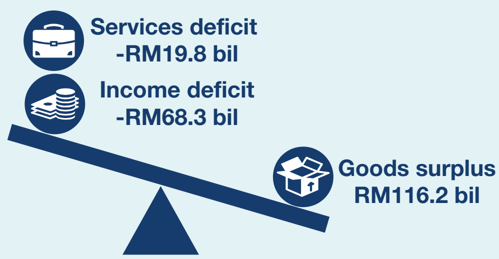
Continued demand from key trade partners

Diversified manufactured export base

New production capacity

Current account surplus driven by goods surplus

Current account balance at RM28.0 bil or 1.5% – 2.5% of GNI (2018*p*: 2.4%)

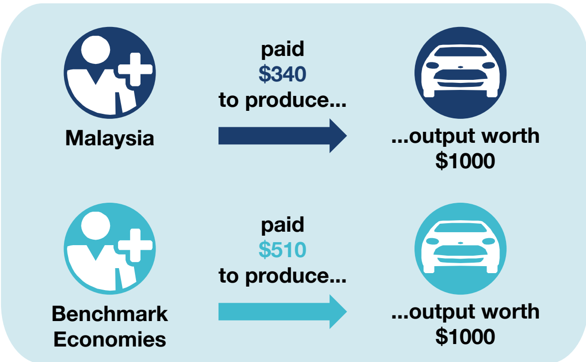


p Preliminary
f Forecast

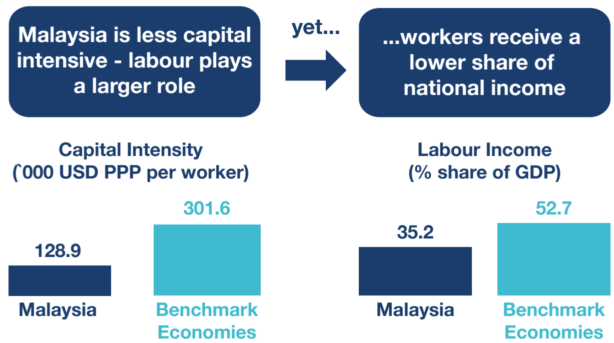
Key Highlights on Box Articles

Are Malaysian Workers Paid Fairly? : An Assessment of Productivity and Equity

Productivity: Malaysian incomes are not commensurate with productivity ...

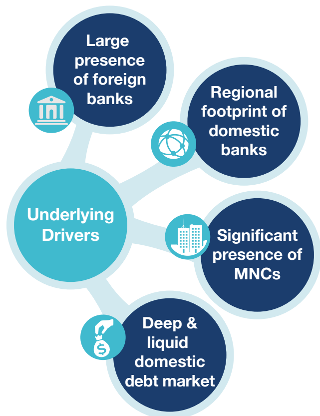


Equity: ...and workers receive a lower share of national income

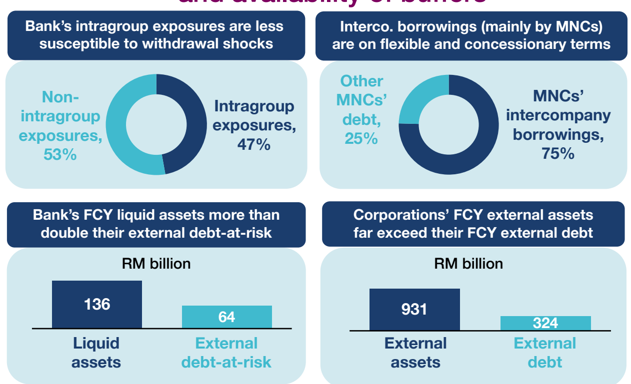


Malaysia's Resilience in Managing External Debt Obligations and Adequacy of International Reserves

External debt driven by country-specific factors

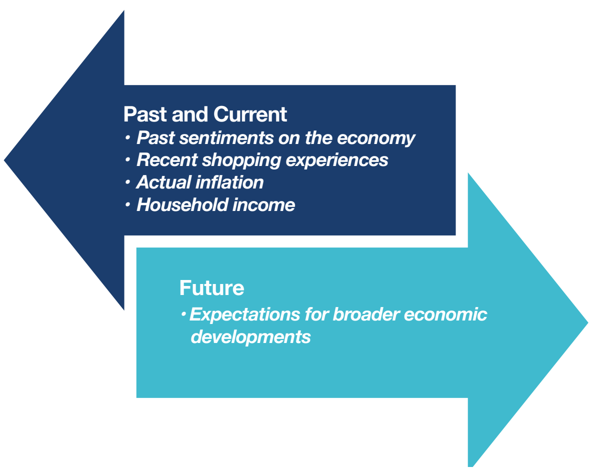


Risks are well mitigated by debt profile and availability of buffers



When the Future Starts Today: Inflation Expectations of Malaysian Households

Inflation expectations are influenced by past, current and forward-looking beliefs



Certain households have greater tendency towards higher inflation expectations

Executive Summary

Executive Summary

The global economy started the year 2018 on a positive note following expectations for a stronger growth momentum from the previous year. In the earlier part of the year, both global trade and growth continued the upward trajectory which began since end-2016. As the year progressed, however, the global economy was confronted with multiple headwinds such as the escalation of trade conflicts, renewed volatility in commodity prices, and bouts of volatility in global financial markets. As a result, most major advanced and regional economies experienced a more moderate expansion during the year. In the advanced economies, improving labour market conditions lifted consumption activity. In Asian economies, GDP growth was predicated on continued resilience in domestic demand amid waning support from external demand. Global headline inflation in 2018 was higher, driven mainly by supply-related factors. Core inflation rates remained modest across both advanced and emerging market economies, reflecting moderating demand pressures.

Overall global financial conditions tightened in 2018, reflecting the normalisation of global monetary policy and heightened financial market volatility due to ongoing policy and economic uncertainties. Monetary policies in most advanced economies, particularly the US, remained on their normalisation paths. Emerging market economies also experienced tighter financial conditions as the monetary policy normalisation in advanced economies led to large portfolio outflows from emerging market financial assets. At the same time, ongoing risk-off developments such as the global trade tensions further contributed to sudden shifts in investor sentiments and episodes of financial market volatility. As funds shifted away from emerging market economies, pockets of vulnerabilities also emerged in some of these economies, which culminated in the currency sell-offs in Argentina and Turkey. A number of central banks in emerging market economies also tightened monetary policy due to concerns on higher inflation arising from the depreciation of their currencies and the earlier increases in commodity prices. As a result of these developments, financial market performances in advanced economies, particularly the US, and emerging market economies diverged during the year.

Despite the challenging global economic and financial environment, the Malaysian economy demonstrated resilience and recorded a respectable growth of 4.7% in 2018. The Annual Report provides an analysis of the development in the Malaysian economy and outlines the future challenges. The report also highlights the Bank's continuous efforts to strengthen its governance and organisational development.

The Malaysian Economy in 2018

The Malaysian economy expanded at a more moderate pace of 4.7% in 2018 (2017: 5.9%). Despite a positive start to 2018, the economy subsequently was confronted with several external and domestic challenges. Major policy and political shifts, arising partly from the global trade tensions and the historic change of government in Malaysia, became sources of uncertainty for the economy. Unanticipated supply disruptions in the mining and agriculture sectors, as well as commodity exports adversely affected Malaysia's economic performance, resulting in a larger-than-expected moderation in growth.

Domestic demand continued to anchor growth, supported mainly by private sector expenditure. Private consumption growth, in particular, recorded the fastest rate since 2012 at 8.1% (2017: 7.0%). Favourable wage and employment growth continued to drive household spending with additional support from the three-month tax holiday (1 June – 31 August) following the zerorisation of the Goods and Services Tax (GST) rate, as well as other Government measures such as the fixing of the retail fuel price of RON95 petrol and special payments to civil servants and pensioners.

In line with the Government's commitment to reprioritise expenditures, public consumption growth moderated to 3.3% (2017: 5.4%). Gross fixed capital formation (GFCF) expanded at a slower pace of 1.4% (2017: 6.2%) due to a contraction in public investment and the slower expansion in private investment. Public investment declined by 5.2% (2017: 0.1%) following lower spending by public corporations. Private investment grew at a slower pace of 4.5% (2017: 9.3%) amid heightened uncertainty stemming from both external and domestic developments. However, firms, particularly in the export-oriented sectors, continued to increase production capacity and improve efficiency to meet demand.

On the supply side, most economic sectors recorded an expansion, with the exception of commodity-related sectors. The services sector's growth improved to 6.8% (2017: 6.2%), the highest since 2011, as better consumer sentiments and favourable labour market conditions spurred spending, in particular during the tax holiday period. The manufacturing sector expanded by 5.0% (2017: 6.0%) supported primarily by a continued expansion in the electrical and electronics (E&E) cluster. The construction sector recorded a moderate growth of 4.2% (2017: 6.7%) due to weaknesses in the property segment. Growth in the mining sector, however, contracted by 1.5% (2017: 1.0%) due to the decline in natural gas production, while adverse weather and production constraints that affected palm oil and rubber production led to a decline in growth in the agriculture sector (2018: -0.4%, 2017: 7.2%).

In the labour market, employment growth was strong at 2.5% (2017: 2.0%), amounting to an additional employment gain of 360,250 persons. Meanwhile, the labour force grew by 2.5% (2017: 1.9%), which amounted to 372,875 persons entering the labour force. The labour force participation rate also rose to 68.4% (2017: 68.0%). As a result, the unemployment rate remained unchanged at 3.4%. Net employment gains were driven mainly by high- and mid-skilled workers, which grew by 1.6% and 4.2% respectively. Reported retrenchments continued on its decreasing trend (23,168 persons; 2017: 35,097 persons), below the long-run average of 29,628 persons per annum. Aggregate nominal wages in the private and public sectors grew by 6.0% and 4.5% respectively (2017: 6.4% and 6.2%, respectively).

In 2018, headline inflation declined to 1.0% (2017: 3.7%). The moderation mainly reflected the impact of the fixing of retail fuel prices and the zerorisation of the GST rate. These factors more than offset upward cost pressures that remained present for some parts of 2018. Core inflation averaged lower at 1.6% (2017: 2.3%) amid smaller cost pass-through to retail prices and the absence of excessive demand pressures.

Malaysia's external position remained resilient amid an increasingly challenging global economic environment. The current account of the balance of payments continued to register a healthy surplus of 2.4% of GNI (2017: 3.1% of GNI), contributed by a higher goods surplus and a smaller services deficit, which more than offset the deficit in the income accounts. Gross exports registered a more moderate growth of 6.8% in 2018 (2017: 18.8%) driven by manufactured exports which helped to partially offset the decline in commodity exports. Gross imports growth also moderated to 4.9% (2017: 19.7%), on account of weaker intermediate and capital imports.

During the year, movements in short-term flows dominated capital flow developments as the financial account of the balance of payments recorded a net inflow of RM18.6 billion (2017: net outflow of RM4.7 billion). A reversal of portfolio investments by non-residents, which took place amid increasingly more volatile global financial market conditions, were offset by substantial inflows in the other investment account. Meanwhile, long-term foreign direct investment (FDI) flows resumed at a more moderate pace, while domestic firms and institutional investors continued to undertake direct investments abroad (DIA).

The international reserves of Bank Negara Malaysia amounted to USD101.4 billion as at end-2018 compared to USD102.4 billion as at end-2017. As at 28 February 2019, international reserves amounted to USD102.4 billion and remain adequate to facilitate international transactions. The reserves position is sufficient to finance 7.4 months of retained imports and is 1.0 time the short-term external debt.

Malaysia's external debt stood at RM924.9 billion as at end-2018, equivalent to USD221.0 billion or 64.7% of GDP (end-2017: RM885.2 billion, equivalent to USD215.9 billion or 65.4% of GDP). The higher external debt was driven mainly by the increase in interbank borrowings and corporate loans to finance investment activity as well as valuation effects following the weakening of ringgit against selected regional and major currencies, in particular, during the second and third quarters of the year. Malaysia's external debt exposure remained manageable. Favourable external balance sheet profiles across instruments, maturity and currency were reinforced by external asset holdings of the domestic banks and corporates, further mitigating potential risks.

Overall, the strong fundamentals and highly diversified structure of the Malaysian economy have accorded Malaysia the ability to weather the headwinds and challenges. Policies were flexible and pre-emptive to ensure risks were minimised. Malaysia's external position remained healthy, with a current account surplus, adequate international reserves and manageable external debt exposure. These strengths in the external position, along with a flexible exchange rate and a well-developed financial system, effectively mitigated the impact of volatile shifts in capital flows on domestic financial markets. Appropriate foreign exchange intervention and the implementation of financial market measures during this period of volatility also underscored the importance of pragmatic, timely policy responses in managing risks and supporting growth.

Economic and Monetary Management in 2018

The Monetary Policy Committee (MPC) normalised the degree of monetary accommodation at the January 2018 MPC meeting and raised the Overnight Policy Rate (OPR) by 25 basis points to 3.25%. In the MPC's assessment, the economic conditions that had called for the previous OPR reduction in July 2016 had vastly improved. The OPR adjustment, however, did not constitute a tightening of monetary conditions, as the overall stance of monetary policy remained supportive of economic growth. The normalisation of the degree of monetary accommodation contributed towards preserving the sustainability of growth, while ensuring ample policy space in the event of shocks to the economy in the future. The MPC also recognised the need to prevent the build-up of risks that could arise from interest rates being too low for a prolonged period of time even as the risks of financial imbalances remained contained.

By mid-year, however, the prospects to both the global and domestic growth outlook shifted. Even though global economic expansion continued, there was increasing divergence across economies and signs of moderating global growth momentum. Domestically, unanticipated commodity supply-side shocks and lower public sector spending led to slower GDP growth. However, better private consumption growth following increased household spending due to the zerorisation of the GST rate supported domestic growth during the period. On balance, the Malaysian economy was expected to remain on a steady growth path. Throughout 2018, underlying inflation was expected to moderate following expectations of smaller pass-through from external and domestic cost factors, and the absence of excessive demand pressures. Subsequent to the OPR increase in January, the OPR was maintained at the prevailing level for the remainder of the year. The degree of monetary accommodativeness was assessed to be consistent with the intended policy stance of ensuring that the domestic economy continued on a steady growth path with price stability.

Throughout the year, domestic financial markets experienced shifts in non-resident portfolio flows, largely reflecting changes in investor sentiments and risk appetite. In the first quarter, global financial markets continued their strong momentum from 2017 and investor sentiments remained buoyed by the positive economic outlook in emerging market economies. As a result, the demand for ringgit investment assets provided support to the ringgit exchange rate, as well as domestic bond and equity prices. However, this trend reversed from the second quarter onwards as global and domestic policy uncertainties weighed down on investor sentiments. For the year as a whole, the ringgit depreciated by 1.8% to end the year at RM4.1385 against the US dollar and remained as one of the better performing currencies in the region. The benchmark Malaysian Government Securities (MGS) yield curve shifted upwards, reflecting an increase in bond yields across all maturities.

The domestic financial markets performed relatively well and continued to intermediate shifts in capital flows in a stable and orderly manner. This was partly attributed to policies introduced by the Bank and the Financial Markets Committee (FMC) at end-2016. Foreign exchange liquidity improved following the introduction of the export conversion measure. In addition, the reinforcement of the non-facilitation of non-deliverable forward (NDF) transactions limited the spillovers from speculative activities in opaque offshore markets. The magnitude of adjustments in the domestic capital markets also remained contained during the year due to sustained demand from domestic institutional investors, which partially offset the impact from these outflows.

During the year, domestic monetary and financial conditions, and continued healthy growth in financing to the private sector were supportive of economic activity. The Bank's monetary operations ensured sufficient liquidity to support the orderly functioning of money and foreign exchange markets. The contractionary impact on liquidity arising from large capital outflows was offset by the Bank's liquidity injection operations undertaken through the reverse repo and foreign exchange swap facilities. As a result, price discovery in the domestic money market remained uninterrupted and money market rates remained stable during the year. Overall banking system liquidity remained sufficient to support the financial intermediation process. Net financing to the private sector recorded an annual growth of 5.6% as at end-2018 (2017: 6.3%). Higher growth in outstanding loans of 4.8% was mainly driven by the business segment.

Outlook for the Malaysian Economy in 2019

In 2019, the global economy is projected to expand moderately, following slower growth in both advanced and major emerging market economies. In the advanced economies, economic activity is projected to moderate. While labour market strength will continue to support domestic demand, moderating investments and external demand will affect overall growth. In PR China, ongoing structural reforms to rebalance the economy are leading to slower, but more sustainable growth. In other Asian economies, growth will likely moderate despite stable domestic demand, as exports react to the slowdown in the advanced economies and PR China. Global trade developments will remain a key factor affecting the 2019 outlook. Prolonged policy uncertainty could adversely affect investment decisions and thus, longer-term productivity growth. Elevated investor uncertainty and bouts of volatility in the financial markets will pose further risks of greater volatility in capital flows to emerging market economies. Overall, the balance of risks to the global growth outlook is tilted to the downside.

Against the backdrop of a challenging global environment, the Malaysian economy is expected to sustain its growth momentum, expanding by 4.3% – 4.8% in 2019 (2018: 4.7%). Domestic demand will remain the anchor of growth, underpinned by continued expansion in private sector activity. Private consumption growth is expected to moderate, but remain firm supported by stable labour market conditions and continued wage growth. The implementation of several government measures, particularly aimed at alleviating rising cost of living, is expected to further support consumption spending, especially by lower income households. Private investment activity will be supported by the implementation of on-going multi-year projects, particularly in the manufacturing and services sectors. The normalisation of destocking activities by firms after the strong demand during the tax holiday period in 2018 will serve as an additional support to growth. Public sector expenditure, however, is expected to weigh on growth. The projected contraction in public investment will be due mainly to lower investment by public corporations following the completion of large-scale projects, while the expectations for a moderate growth in public consumption reflect the continued reprioritisation of government spending.

The external sector is expected to register a more moderate growth. While the export sector will soften in line with the more moderate expansion in global growth and trade activity, Malaysia's well-diversified export structure will contribute to sustain gross exports expansion. Gross imports are also expected to expand on account of a turnaround in intermediate and capital imports. Overall, the current account of the balance of payments is projected to remain in surplus, albeit narrowing to 1.5% – 2.5% of GNI.

On the supply side, all economic sectors are expected to expand with the services and manufacturing sectors remaining the key contributors to overall growth. Both the mining and agriculture sectors are projected to record positive growth rates amid recovery in natural gas production and higher palm oil output. Growth in the construction sector is expected to moderate due to the completion of large petrochemical projects in the civil engineering sub-sector.

Labour market conditions are expected to be stable, with continued employment and income growth, underpinned by steady expansion in services and manufacturing sectors. The unemployment rate is projected to be relatively unchanged. In the long run, the rollout of government policies such as the tiered levy and social security contribution for foreign workers is a positive step in reducing the reliance on foreign labour and spurring the creation of higher skilled, higher income jobs in the economy.

Headline inflation is expected to be broadly stable, with a projected annual average of 0.7% – 1.7% in 2019. The inflation projection incorporates some cost pass-through from domestic cost factors, but the upward impact will be offset by the expected lower global oil prices and the implementation of price ceilings on domestic retail fuel prices. Underlying inflation, as measured by core inflation, is expected to be sustained amid the steady expansion in economic activity and in the absence of excessive demand pressure.

Overall, the domestic growth projection is subject to several downside risks. As a small open economy, the unresolved trade tensions between the US and PR China, and a slower-than-expected global growth will affect Malaysia primarily via the trade and investment channel. The uncertain pace of the monetary policy normalisation in the US could heighten financial market volatility across emerging market economies, leading to volatile two-way capital flows and currency fluctuations. Volatility in global oil prices would also affect export performance and mining sector investment. On the domestic front, a re-occurrence of commodity supply disruptions, partly from unanticipated weather patterns, could affect the recovery in the mining and agriculture sectors. In addition, the oversupply situation in the property market could dampen activity in the construction sector.

Malaysia's strong fundamentals and the diversified nature of the economy will help to weather these risks and vulnerabilities while preserving macroeconomic and financial stability. These strong fundamentals include a healthy labour market, stable inflation rate, continued surplus in the current account of the balance of payments, deep financial markets as well as a strong financial sector. Exchange rate flexibility and sufficient level of international reserves further enhance the economy's capability to withstand external shocks. Moreover, commitment by the Government to fiscal, structural and institutional reforms will contribute to inclusive and sustainable growth going forward.

Economic and Monetary Management in 2019

Monetary policy in 2019 will focus on supporting the steady growth of the Malaysian economy amid an environment of relatively low inflation. At the same time, monetary policy will also consider the prevailing monetary and financial conditions. While risks of financial imbalances are expected to remain contained, the MPC is cognisant of challenges emanating from potential continued volatility in global capital flows. In this regard, the Bank will continue to ensure sufficient liquidity and orderly market conditions that remain supportive of financial intermediation activity. The broad range of policy options available that includes monetary policy, micro- and macroprudential measures provide the Bank with flexibility to manage emerging risks. Measures to further deepen the domestic financial markets will also contribute to orderly market conditions. The combined effect of these policies will ensure that the Bank's policy efficacy is maintained without overburdening any single policy tool.

Fiscal policy in 2019 aims to strengthen the Government's fiscal position by pursuing gradual fiscal consolidation while lending continued support for growth, paring down debt and liabilities, as well as promoting economic inclusiveness. Correspondingly, the medium term fiscal plan outlined the path towards consolidation with fiscal balances targeted at -3.4% and -3.0% of GDP in 2019 and 2020 respectively. The path towards fiscal consolidation is anchored in several key reform initiatives which include enhancing expenditure effectiveness, diversify and broaden the revenue base and encourage holistic and transparent debt management. The 2019 Budget also accorded emphasis to improving socio-economic wellbeing, strengthening social protection programmes, improving employability and initiatives to raise productivity, particularly for the Small and Medium Enterprises (SMEs). Going forward, the Government has indicated its commitment towards ensuring fiscal sustainability and a stronger governance framework through the implementation of holistic fiscal reforms.

Governance and Organisational Development

As the Central Bank for Malaysia, the Bank is mandated to promote monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy.

The Bank therefore places priority in strengthening its governance and internal capabilities to ensure it is effective in discharging its principal objects and functions under the laws it administers, and that it is responsible in managing its resources.

The Board of Directors is responsible for overseeing the management and operations of the Bank and reviews the performance of the Bank in delivering its mandates. The Board comprises the Governor as Chairman, the Deputy Governors, the Secretary General of the Treasury and independent non-executive members, with the latter forming the majority within the Board. The year saw the appointment of a new Governor, Nor Shamsiah Yunus, on 1 July 2018, after Muhammad bin Ibrahim stepped down as Governor on 15 June 2018. Governor Nor Shamsiah was a Deputy Governor between 2010 and 2016, and was subsequently at the International Monetary Fund. During the year, the Board deliberated on a number of legislative reforms to facilitate the currency management operations and enforcement activities of the Bank. The Board also reviewed the overall performance of the Bank, and discussed the Bank's corporate performance indicators for 2019. Additionally, the Board deliberated on various organisational development priorities including new demands on the Bank's management of human capital, digital transformation journey, defences against cyberthreats, and initiatives to reinforce a strong culture of integrity, ethical conduct and professionalism among the Bank's employees. The Bank also initiated an internal review to further strengthen its overall framework for governance. Accordingly, the Bank will take this opportunity to examine the efficacy of decision-making structures within the Bank and ensure its operations and priorities remain consistent with its mandates.

The Bank ensures prudent and responsible conduct of its operations and activities through effective risk management. In 2018, the enterprise risk appetite and tolerance statement was reviewed to give greater prominence to global digitalisation and the increased sophistication of cyberthreats. Adherence to high ethical standards underpins the Bank's risk culture. This is reinforced through a whistleblowing framework that provides an avenue for reporting improper conduct involving the Bank. The framework was revised during the year to align it with the Whistleblower Protection Act 2010 and best practice. The Internal Audit Department conducts regular assessments on the activities of departments and entities related to the Bank to identify and address risks. Audits in 2018 were conducted in a number of areas, which include cybersecurity, data protection, treasury and reserve management, business continuity management, procurement and risk governance.

In 2018, the Bank initiated a five-pronged cybersecurity strategy to further strengthen the protection of the organisation's critical information assets. These efforts are supported by strengthened governance and operating structures that have been put in place to drive and oversee cybersecurity risk management across the Bank. Specifically, the Bank has established the Cybersecurity and Data Protection unit within the Digital and Technology Department to undertake enterprise-wide cybersecurity management function. In addition, a Cyber and Information Security Working Group was formalised to drive the implementation of the Bank's cyber and information security initiatives.

Digital technologies are reshaping industries and organisations all over the world. On its part, the Bank began work to draw up a digital transformation strategy and roadmap to fully harness the potential and value of technology in supporting the effective delivery of the Bank's mandates. In the near-term, enhancements are being made to the Bank's technology infrastructure and services to support digital workplace improvements. At the same time, the Bank continues to lay the groundwork to modernise and put in place next generation technology infrastructure to form the core digital platform for the organisation to build on.

The Bank is committed to attracting and developing the best talents to deliver on its mandates. In keeping with this commitment, the Bank conducted a survey to ascertain employee engagement and enablement levels across the organisation. The Bank is committed to upholding the highest standards of professionalism. This involves ongoing efforts to promote organisation's ethics and culture. In 2018, the Bank undertook specific initiatives to reinforce a positive culture of engagement at all levels of the organisation, centred on norms such as transparency and objectivity, constructive challenge and candid communication.

A key objective of the Bank's communications and outreach agenda is to sustain the confidence of its external stakeholders in the Bank's delivery of its mandates. This involves helping external stakeholders understand the Bank's work and mission. The Bank also listens to and receives feedback on issues involving the economy and financial system through regular engagements and briefings conducted with the Government and other public sector agencies, Bank's regulatees, investors and analysts, and the media.

The general public is an important stakeholder. The Bank therefore engages them closely on multiple fronts, and across a range of topics and issues including the promotion of financial knowledge and literacy, and to educate the public about financial scams and crimes. They are conducted through a range of traditional and digital channels, including through social media. The Bank also directly engages with the general public and businesses across the country through a network of five BNM Offices in Penang, Kuala Terengganu, Johor Bahru, Kuching and Kota Kinabalu. While traditionally serving as regional hubs for managing currency operations, BNM Offices have since evolved to enable the Bank to have a clearer view on economic and financial conditions around the country.

Bank Negara Malaysia's Audited Financial Statements for 2018

As audited and certified by the Auditor General, the financial position of Bank Negara Malaysia remained strong in 2018. Bank Negara Malaysia's total assets amounted to RM447.6 billion, with a net profit of RM7.5 billion for the financial year ending 31 December 2018. Bank Negara Malaysia declared a dividend of RM2.5 billion to the Government for the year 2018.

Economic Developments in 2018

Economic Developments in 2018

THE INTERNATIONAL ECONOMIC ENVIRONMENT

Positive start to global economic expansion in 2018 before moderating towards the second half

In 2018, there were expectations for a stronger growth momentum in the global economy from the previous year. At the beginning of the year, the International Monetary Fund (IMF) projected a global growth of 3.9%, marking the fastest expansion since 2011. As the year progressed, however, the global economy was confronted by multiple headwinds. First, the escalation of trade conflicts, which resulted in higher tariffs and generated greater uncertainties. This weighed on global trade and investment. Second, renewed volatility in commodity prices had some repercussions for the global growth momentum, as well as global inflation. Third, as central banks in advanced economies recalibrated their monetary policies, financial markets experienced bouts of volatility amid major uncertainties in key economies. Global financial conditions tightened. Some emerging market economies experienced large and persistent capital outflows. With the exception of the US, economic growth for most major advanced and emerging economies expanded at a slower pace. As a result, in October 2018, the IMF revised global growth for 2018 downward to 3.7%. This forecast, nonetheless, remained above the long-term average (1980-2017: 3.5%).

Moderating global economic growth

Global economic developments in 2018 could be characterised by two distinct phases. In the earlier part of the year, both global trade and growth continued the upward trajectory which began since the end of 2016. This trend reversed towards the second half of the year, due to a myriad of issues which included the escalation of global trade tensions, continued policy uncertainty such as the outcome of Brexit negotiations and the degree and pace of US monetary policy normalisation, as well as volatile commodity prices. As a result, most major advanced and regional economies experienced a more moderate expansion during the year.

In the advanced economies, improving labour market conditions, as reflected by higher wage and employment growth, lifted consumption activity. Importantly, the unemployment rate in major advanced economies reached record-low levels, while consumer confidence remained upbeat during the year. The US economy was supported by robust labour market conditions and investment activity. Wage growth accelerated close to its peak before the Global Financial Crisis, as vacancies and hiring rates continued on an upward trajectory in 2018. In addition, tax reforms in 2017 boosted business spending and capital investment, including on industrial and transport equipment. In the euro area, favourable business sentiment and a continued need to expand capacity drove higher investments. However, in the second half of 2018, the euro area experienced a slowdown as some country-specific developments began to impact growth outcome. Regulatory changes in light vehicle emissions standards led to contractions in motor vehicle production during the second half of the year. Tensions over Italy's budget reversed the improvement in consumer sentiments, leading to a slowdown in consumer spending. Likewise, external demand lost momentum as trade conflicts began to escalate, weighing on exports and industrial production growth in the euro area. In the UK, uncertainties surrounding the Brexit negotiations persisted throughout the year, affecting business sentiments and investment. Major corporates, especially UK-based operations of multinational companies reportedly deferred investments in 2018, leading to a sustained contraction in investments in the second half of the year.

In the Asian economies, GDP growth was predicated on continued domestic demand. Support from external demand waned as the year progressed, as the global technology cycle slowed from its peak, while demand from advanced economies turned more moderate. The cyclical slowdown in external demand was exacerbated by the escalation of trade tensions among major economies beginning April 2018. While the implementation of higher tariffs by the US and subsequent retaliation by major trade partners directly affected only about 1% of global trade, it led to higher uncertainty for businesses. As a result, export growth in most Asian economies more than halved in 2018 compared to the previous year. Shipments of electronics and electrical (E&E) products slowed. Major Asian E&E exporters such as PR China, C. Taipei, South Korea and Hong Kong SAR experienced weaker growth in E&E exports, especially in the fourth quarter of 2018. Nevertheless, domestic demand among Asian economies remained resilient, lending support to sustained momentum in headline GDP growth. Domestic demand was supported by strong employment and was augmented by spending on infrastructure, particularly in ASEAN countries. Thailand and the Philippines increased infrastructure spending through the "East Economic Corridor" and "Build, Build, Build" programmes, respectively. While the on-going structural reforms in PR China continued to lead to a more moderate expansion, counter-cyclical fiscal and monetary policies helped to prevent economic activity from slowing too quickly.

Table 1.1: World Economy: Key Economic Indicators

	Real GDP Growth (Annual change, %)		Inflation (Annual change, %)	
	2017	2018*e*	2017	2018*e*
World Growth	**3.8**	**3.7**	-	-
World Trade	**5.3**	**4.0**	-	-
Advanced Economies				
United States	2.2	2.9	2.1	2.4
Japan	1.9	0.8	0.5	1.0
Euro area	2.4	1.8	1.5	1.8
United Kingdom	1.8	1.4	2.7	2.5
Other Advanced Asian Economies				
Korea	3.1	2.7	1.9	1.5
Chinese Taipei	3.1	2.6	1.1	1.5
Singapore	3.9	3.2	0.6	0.5
Hong Kong SAR	3.8	3.0	1.5	2.4
The People's Republic of China	**6.8**	**6.6**	**1.6**	**2.1**
ASEAN-4				
Malaysia	5.9	4.7	3.7	1.0
Thailand	4.0	4.1	0.7	1.1
Indonesia	5.1	5.2	3.8	3.2
Philippines	6.7	6.2	2.9	5.3
India[1]	**7.2**	**7.0**	**3.3**	**3.9**

[1] For India, GDP data are presented on a fiscal year basis
e Estimate

Source: International Monetary Fund (IMF) and National Authorities

Higher global headline inflation in 2018 due mainly to supply factors

Despite moderating global demand conditions, global headline inflation accelerated to 3.7% in 2018 (2017: 3.2%), reflecting mainly supply-related factors. Global commodity supply conditions tightened due to geopolitical tensions in Latin America and the Middle East, pipeline constraints in the Permian Basin and output cuts made by OPEC. With prices being mostly affected by supply side factors, core inflation rates remained modest across both advanced and emerging market economies, reflecting moderating demand pressures.

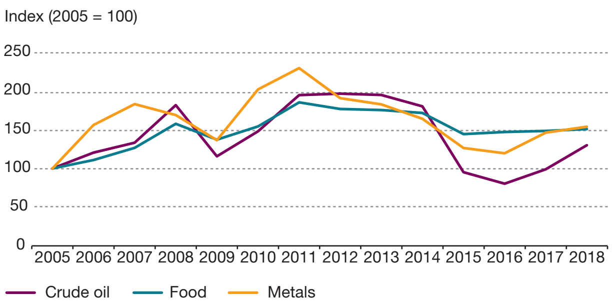
The IMF commodity price indices continued their upward trend in 2018. The higher commodity prices were attributed mainly to global crude oil supply pressures, cyclical mismatches in supply and demand as well as weather disruptions to food production.

The extension of OPEC output cuts, re-imposition of US sanctions on Iran and lower-than-expected Iranian oil exports lifted the oil price index for most of 2018. Towards the end of the year, however, Brent crude oil prices declined from a peak of USD76 per barrel to USD67 per barrel due mainly to a rebound in US oil production and sanction waivers for Iran's trade partners. For the year 2018 as a whole, Brent crude oil price averaged higher at USD72 per barrel (2017: USD55 per barrel). A supply glut in global sugar and dairy markets, as well as moderating demand for palm oil led to a slower increase in the food price index. Adverse weather conditions in 2018 led to disruptions in the supply of cereal grains and livestock. Nevertheless, the supply of major cereal grains such as wheat remained mainly sufficient, leading to a more subdued increase in food prices. In the metals market, continued policy-driven reduction of production capacity in PR China as part of its supply-side reforms and targeted closures of obsolete facilities led to higher prices. Moreover, tariffs imposed on US imports of steel and aluminium in March 2018 partly contributed to the increased metal prices.

Headline inflation in the advanced economies edged higher to 1.9% (2017: 1.7%) while in emerging market economies, headline inflation rose to 4.9% in 2018 (2017: 4.3%). In some emerging markets, concerns over external and domestic vulnerabilities contributed to substantial inflationary pressures. For example, Turkey and Argentina experienced large capital outflows and weaker currencies, resulting in higher import prices. Inflation in the ASEAN region was influenced by domestic policy actions. In Thailand, the reintroduction of transportation and cooking fuel subsidies in the second half of 2018 partly offset some upward pressure from higher oil prices and demand-pull factors. In the Philippines, the introduction of the excise tax on petroleum and transportation products increased costs faced by producers, accelerating the headline inflation rate in 2018. In contrast, Indonesia's expansion of diesel subsidies alleviated cost pressures, leading to a more subdued inflation rate in 2018. On balance, the ASEAN region remained an exception to the global inflationary trend, recording a marginally lower headline inflation at 2.9% (2017: 3.1%).

Chart 1.1: Indices of Primary Commodity Prices

Major commodity price indices continued to trend upwards in 2018



Source: IMF

Mixed monetary and fiscal policy actions

In 2018, monetary policies in advanced and Asian economies were mixed, driven by different factors. Monetary policy in most advanced economies continued to normalise. Improved labour market conditions, which supported wage growth and domestic demand, allowed for the continuation of monetary policy normalisation. Of note, the US Federal Reserve raised the target range for the federal funds rate four times in 2018 by a total of 100 basis points to 2.25% – 2.50%. Similarly, the Bank of England raised the Bank Rate by 25 basis points to 0.75% due to stronger inflation, amid higher cost pressures from energy prices and a weaker currency. The European Central Bank reduced net asset purchases to zero by December 2018. In contrast, the Bank of Japan diverged from its counterparts among advanced economies by expanding its monetary stimulus programme, in an effort to raise inflation which has continued to fall short of the official target of 2% since the first quarter of 2015. On balance, interest rate differentials between advanced economies and emerging market economies narrowed, which contributed to tighter global financial conditions in 2018. In some Asian economies, such as the Philippines, Indonesia and India, the subsequent large reversals of capital flows, higher inflation from commodity prices and upward domestic demand pressures led to hikes in their benchmark interest rates. The People's Bank of China, however, loosened liquidity and lending conditions for banks to promote stronger growth amid weaker global economic conditions. Swift monetary policy responses and deep capital markets allowed regional economies to weather through the tighter financial conditions.

Fiscal policy continued to assume an important role in shaping macroeconomic developments in advanced economies. In the US, the Tax Cuts and Jobs Act 2017 continued to support private investments, further boosting domestic demand-driven growth in 2018. In the euro area, France introduced tax adjustments for investors and middle income-earners, and raised the national minimum wage to support investment and consumption. Moreover, reforms were also implemented to improve the efficiency in France's labour market. These measures included the decentralisation of wage bargaining for SMEs, lowered ceilings on damages for unfair dismissals, mandated publication of gender pay gap indicators for medium and large companies, as well as expansions for on-the-job skills training.

Authorities in Asia continued to pursue structural reforms in earnest, with strong emphasis on investments. In the ASEAN region, policy makers introduced measures that prioritised infrastructure investments and coping with climate change. For example, measures in Singapore that promoted adoption of digital technology, intellectual property investments and R&D in improving energy efficiency continued to support sustainable economic growth via improving productivity. In PR China, to reduce systemic financial stability risks, the government continued to tighten regulations on local government financing and public-private partnerships, leading to more moderate investments made by state-owned enterprises.

THE MALAYSIAN ECONOMY

Following a robust growth in 2017, Malaysia's economic growth was expected to normalise in 2018. The economy, however, was confronted with several external and domestic challenges during the year. Major policy and political shifts, arising partly from the global trade tensions and the historic change of government in Malaysia, became sources of uncertainty for the economy. Unanticipated supply disruptions in the commodity sectors adversely affected Malaysia's economic performance, resulting in a larger-than-expected moderation in growth. Overall, the Malaysian economy recorded a respectable growth of 4.7% in 2018 (Chart 1.2), demonstrating considerable resilience in the face of multiple headwinds.

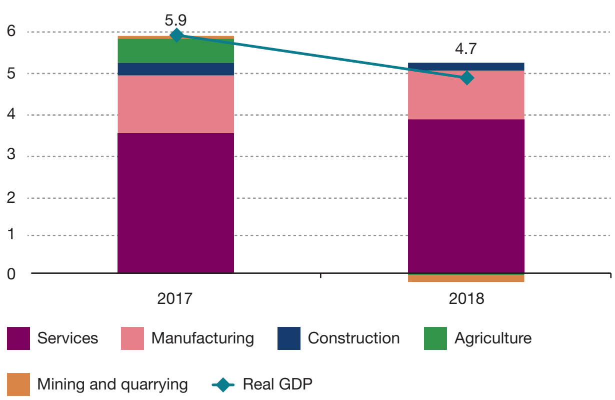
The Malaysian economy demonstrated resilience in the face of multiple headwinds, recording a respectable growth of 4.7% in 2018

Despite a positive start to 2018, support from global demand began to wane in the latter half of the year. Escalating trade tensions and policy uncertainties

Chart 1.2: Real GDP Growth

More moderate GDP growth in 2018

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



Source: Department of Statistics, Malaysia

dampened sentiments and surpressed investment spending in several major economies. Monetary policy adjustments in advanced economies also contributed to heightened global financial market volatility and induced large capital reversals from the emerging economies.

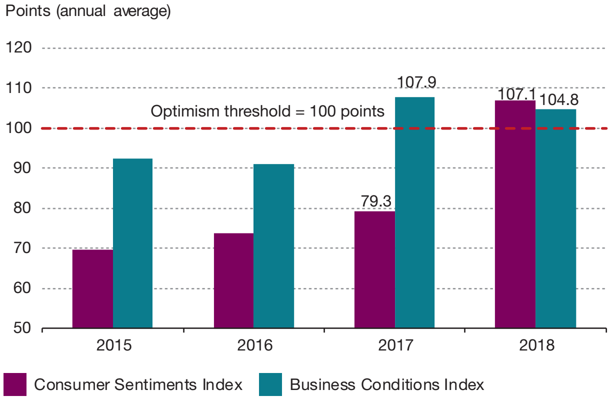
On the domestic front, supply disruptions adversely impacted activity in the mining and agriculture sectors, as well as commodity exports. In particular, unplanned maintenance shutdown and pipeline repairs resulted in declining natural gas output, while production constraints and adverse weather conditions affected rubber and palm oil production. This led to a slowdown in headline GDP growth to below 5%. While the conclusion of the 14th General Election in May 2018 saw a smooth political transition to a new government, transitory policy uncertainty affected growth in the few months after the General Election. Under the new Government, policy emphasis shifted towards expenditure reprioritisation and reforms on institutional and governance framework. This change in policy focus, while imperative for long-term sustainability, entailed inevitable short-term economic growth trade-offs through lower public sector spending. In particular, public investment weighed on overall GDP growth, following the near-completion of a few large infrastructure projects and the review of several developmental projects.

Despite these challenges, private sector spending continued to anchor the expansion in domestic demand. This was underpinned by solid economic and financial fundamentals and positive consumer and business sentiments (Chart 1.3). Private consumption growth accelerated to its fastest rate since 2012, driven by favourable wage and employment growth. Household spending also received a temporary boost during the three-month tax holiday (1 June – 31 August), following the zerorisation of the Goods and Services Tax (GST) rate. Supported by positive demand and favourable financing conditions, private investment activity was geared towards capacity expansions and efficiency enhancements. Nevertheless, global trade tensions and some policy uncertainty following the political transition resulted in a moderation in private capital expenditure growth during the year.

On the external sector, exports continued to provide an additional lift to growth, albeit to a lesser extent when compared to the exceptional performance in 2017, due mainly to the moderating global growth momentum. Despite the normalisation from

Chart 1.3: MIER Consumer Sentiments and Business Conditions Index

Strong consumer and business sentiments supported private sector spending



Source: Malaysian Institute of Economic Research (MIER) and Bank Negara Malaysia

the 2017 global technology upcycle, manufactured exports was buttressed by the underlying demand for semiconductors. The operationalisation of new export-oriented manufacturing plants and the establishment of a global E&E distribution hub in Malaysia provided further impetus to manufactured exports. This, in turn, partially offset the weakness in commodity exports affected by supply disruptions. Import growth also slowed, particularly weighed down by lower capital and intermediate imports. The lower imports was in tandem with the more moderate expansion in overall exports and investment. As a result, the overall trade surplus widened during the year.

The current account of the balance of payments remained in surplus, as the income deficit was more than offset by a sizeable goods surplus and smaller services deficit. Malaysia maintained its attractiveness as an investment profit centre and continued to receive foreign direct investment (FDI) inflows despite reversals of non-resident portfolio flows during the year.

Overall, the commendable growth performance in 2018 in the face of several headwinds and challenges owes in large part to the strong fundamentals and highly diversified structure of the Malaysian economy. Policies were flexible and pre-emptive to ensure risks were minimised. At the same time, Malaysia continued to possess a healthy external position, with a current account surplus and adequate international reserves. External debt exposure remained manageable, reflected by its favourable maturity and currency profiles, as well as resilient repayment capacity (For further details, please refer to the Box Article on 'Malaysia's Resilience in Managing External Debt Obligations and the Adequacy of International Reserves'). These strengths in the external position, along with a flexible exchange rate and a well-developed financial system, effectively mitigated the impact of volatile shifts in capital flows on domestic financial markets. Appropriate foreign exchange intervention and the implementation of financial market measures during this period of volatility also underscored the importance of pragmatic, timely policy responses in managing risks and supporting growth.

Domestic Demand Continued to Anchor Growth in 2018

Following the robust growth of 5.9% in 2017, the Malaysian economy expanded at a more moderate pace of 4.7% in 2018. Domestic demand continued to anchor growth, supported mainly by private sector expenditure. Public sector spending moderated following the expenditure rationalisation undertaken by the Government and lower spending by public corporations. Net exports turned expansionary for the economy as the growth in real exports outpaced real imports.

Private consumption recorded its fastest pace of expansion since 2012 at 8.1% (2017: 7.0%), benefitting from several one-off factors amid favourable income and labour market conditions. Of note, household spending was buoyed by the zerorisation of the GST rate for three months, particularly on durable goods such as motor vehicles and furnishings, as well as food and beverages. Aggregate nominal wages in the private sector grew by 6.0% (2017: 6.4%), while employment growth was strong at 2.5% (2017: 2.0%). Other government measures to alleviate cost of living pressures, such as the fixing of the retail fuel price of RON95 petrol and special payments to civil servants and pensioners, lent further support to consumer spending.

Public consumption growth moderated to 3.3% (2017: 5.4%) due to slower growth in spending on both emoluments and supplies and services. This is in line with the Government's commitment to rationalise and reduce expenses on non-critical items.

Table 1.2

Malaysia - Key Economic Indicators

	2016	2017	2018*p*	2019*f*
Population (million persons)	31.6	32.0	32.4	32.7
Labour force (million persons)	14.7	15.0	15.3	15.6
Employment (million persons)	14.2	14.5	14.8	15.1
Unemployment (as % of labour force)	3.4	3.4	3.4	3.3 ~ 3.5
Per Capita Income (RM)	37,822	41,128	42,627	44,275
(USD)	9,117	9,564	10,564	10,809[3]
NATIONAL PRODUCT (% change)				
Real GDP at 2010 prices	4.2	5.9	4.7	4.3 ~ 4.8
(RM billion)	1,108.9	1,174.3	1,229.8	1,287.9
Agriculture, forestry and fishery	-5.2	7.2	-0.4	2.8
Mining and quarrying	2.1	1.0	-1.5	0.8
Manufacturing	4.4	6.0	5.0	4.8
Construction	7.4	6.7	4.2	3.0
Services	5.7	6.2	6.8	5.7
Nominal GNI	6.2	10.1	4.8	5.0
(RM billion)	1,196.4	1,317.0	1,380.5	1,449.6
Real GNI	4.4	6.0	3.5	4.9
(RM billion)	1,085.7	1,151.3	1,191.5	1,249.5
Real aggregate domestic demand[1]	4.3	6.5	5.6	4.4
Private expenditure	5.6	7.5	7.2	6.2
Consumption	6.0	7.0	8.1	6.6
Investment	4.3	9.3	4.5	4.9
Public expenditure	0.3	3.3	0.1	-1.8
Consumption	0.9	5.4	3.3	1.2
Investment	-0.5	0.1	-5.2	-7.1
Gross national savings (as % of GNI)	29.1	29.3	26.9	26.0
BALANCE OF PAYMENTS (RM billion)				
Goods balance	102.0	116.8	121.4	116.2
Exports	686.9	807.0	836.4	845.5
Imports	584.8	690.2	715.0	729.3
Services balance	-18.9	-22.8	-19.7	-19.8
Primary income, net	-34.6	-36.4	-49.4	-50.2
Secondary income, net	-18.6	-17.3	-18.8	-18.2
Current account balance	29.9	40.3	33.5	28.0
(as % of GNI)	2.5	3.1	2.4	1.5 ~ 2.5
Bank Negara Malaysia international reserves, net[2]	423.9	414.6	419.5	-
(in months of retained imports)	8.7	7.2	7.4	-
PRICES (% change)				
CPI (2010=100)	2.1	3.7	1.0	0.7 ~ 1.7
PPI (2010=100)	-1.1	6.7	-1.1	-

[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 Negara Malaysia's audited accounts
[3] Based on average USD exchange rate for the period of January-February 2019
p Preliminary
f Forecast

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 1.3

Malaysia - Financial and Monetary Indicators

FEDERAL GOVERNMENT FINANCE (RM BILLION)	2016		2017		2018*p*	
Revenue	212.4		220.4		232.9	
Operating expenditure	210.2		217.7		231.0	
Net development expenditure	40.6		43.0		55.3	
Overall balance	-38.4		-40.3		-53.4	
Overall balance (% of GDP)	-3.1		-3.0		-3.7	
Public sector net development expenditure	139.1		139.5		143.3	
Public sector overall balance (% of GDP)	-5.1		-3.2		-5.6	
EXTERNAL DEBT						
Total debt (RM billion)	914.5		885.2		924.9	
Medium- and long-term debt	536.4		533.4		519.6	
Short-term debt	378.0		351.8		405.3	
Debt service ratio[1] (% of exports of goods and services)						
Total debt	24.8		14.7		11.2	
Medium- and long-term debt	24.5		14.4		10.7	
MONEY AND BANKING	**Change in 2016**		**Change in 2017**		**Change in 2018**	
	RM billion	**%**	**RM billion**	**%**	**RM billion**	**%**
Money supply M1	20.4	5.6	42.0	11.0	4.7	1.1
M3	51.3	3.2	81.2	4.9	139.2	8.0
Banking system deposits	28.6	1.7	70.6	4.1	134.3	7.5
Banking system loans[2]	76.3	5.3	62.9	4.1	89.1	5.6
Loan to fund ratio (%, end of year)[3,4]	84.2		83.9		82.7	
Loan to fund and equity ratio (%, end of year)[3,4,5]	75.2		73.5		72.4	
INTEREST RATES (%, AS AT END-YEAR)	**2016**		**2017**		**2018**	
Overnight Policy Rate (OPR)	3.00		3.00		3.25	
Interbank rates (1-month)	3.10		3.08		3.45	
Commercial banks						
Fixed deposit 3-month	2.92		2.94		3.15	
12-month	3.06		3.10		3.33	
Savings deposit	0.99		0.97		1.07	
Weighted average base rate (BR)	3.62		3.64		3.91	
Base lending rate (BLR)	6.65		6.68		6.91	
Treasury bill (3-month)	3.06		2.86		3.29	
Malaysian Government Securities (1-year)[6]	3.26		2.89		3.45	
Malaysian Government Securities (5-year)[6]	3.70		3.56		3.78	
EXCHANGE RATES (AS AT END-YEAR)	**2016**		**2017**		**2018**	
Movement of Ringgit (%)						
Change against SDR	-0.8		5.2		-0.2	
Change against USD	-4.3		10.4		-1.8	

1 Includes prepayment of medium- and long-term debt
2 Includes loans sold to Cagamas
3 Loans exclude loans sold to Cagamas and loans extended to banking institutions. Beginning July 2015, loans exclude financing funded by Islamic Investment accounts.
4 Funds comprise deposits (excluding deposits accepted from banking institutions) and all debt instruments (including subordinated debt, debt certificates/sukuk issued, commercial papers and structured notes)
5 Equities comprise ordinary and preferred shares, share premium and retained earnings
6 Refers to data from Fully Automated System for Issuing/Tendering (FAST), Bank Negara Malaysia

p Preliminary

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Table 1

Real GDP by Expenditure (2010=100)

	2018*p*	2017	2018*p*	2017	2018*p*
	% of GDP	Annual change (%)		Contribution to growth (ppt)	
Domestic Demand[1]	**92.9**	**6.5**	**5.6**	**6.0**	**5.2**
Private sector expenditure	72.8	7.5	7.2	5.3	5.1
Consumption	55.5	7.0	8.1	3.7	4.4
Investment	17.4	9.3	4.5	1.6	0.8
Public sector expenditure	20.1	3.3	0.1	0.7	0.0
Consumption	12.8	5.4	3.3	0.7	0.4
Investment	7.3	0.1	-5.2	0.0	-0.4
Gross Fixed Capital Formation	24.6	6.2	1.4	1.6	0.4
Change in stocks	**-1.3**			**0.1**	**-1.5**
Net Exports of Goods and Services	**8.4**	**-1.9**	**13.4**	**-0.2**	**1.0**
Exports	70.6	9.4	1.5	6.6	1.1
Imports	62.2	10.9	0.1	6.8	0.1
Real Gross Domestic Product (GDP)	**100.0**	**5.9**	**4.7**	**5.9**	**4.7**

[1] Excluding stocks
p Preliminary

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

Gross fixed capital formation expanded at a slower pace of 1.4% in 2018 (2017: 6.2%). The overall performance was weighed down by a contraction in public investment and slower expansion in private investment.

Public investment declined by 5.2% in 2018 (2017: 0.1%). The decline was mainly attributed to lower spending by public corporations as large projects in the downstream oil and gas and utilities industries were nearing completion. Capital expenditure by the Federal Government was higher in 2018, supported by continued spending in transportation infrastructure, public utilities and agricultural and rural development.

Private investment grew at a slower pace of 4.5% (2017: 9.3%) amid heightened uncertainty stemming from both external and domestic developments. However, firms, particularly in the export-oriented sectors, continued to increase production capacity and improve efficiency to meet demand. On a sectoral basis, the overall investment performance remained supported by the implementation of new and ongoing projects in the manufacturing and services sectors.

By type of asset, investment growth on machinery and equipment (M&E) slowed to 1.0%, following a strong double-digit expansion registered in 2017 (11.3%). Growth in M&E investment was supported by capital spending in transport equipment. Investment in structures grew by 1.9% (2017: 4.0%), on account of lower residential and non-residential investment amidst continued imbalances in the property market. Meanwhile, investment in other assets expanded by 0.4% (2017: -0.8%), following higher capital expenditure in cultivated biological products (e.g. livestock and crops) and research and development.

During the year, gross national savings (GNS) contracted by 3.8% (2017: 11.0%), with the share decreasing to 26.9% of GNI (2017: 29.3%). Gross capital formation declined as both public and private sector capital formation was lower during the year. As a result, the savings-investment gap narrowed further to 2.4% of GNI in 2018 compared to 3.1% of GNI in 2017.

Continued Expansion Across Most Economic Sectors

Most economic sectors recorded an expansion in 2018, with the exception of commodity-related sectors. The services and manufacturing sectors remained the principal drivers of growth. Growth in the mining sector contracted due to supply disruptions in natural gas production, while adverse weather conditions led to a decline in growth in the agriculture sector.

Table 1

Real GDP by Kind of Economic Activity (2010=100)

	2018*p*	**2017**	**2018*p***	**2017**	**2018*p***
	% of GDP	Annual change (%)		Contribution to growth (ppt)[1]	
Services	55.5	6.2	6.8	3.4	3.7
Manufacturing	23.0	6.0	5.0	1.4	1.2
Mining and quarrying	7.9	1.0	-1.5	0.1	-0.1
Agriculture	7.8	7.2	-0.4	0.6	0.0
Construction	4.5	6.7	4.2	0.3	0.2
Real Gross Domestic Product (GDP)	**100.0[1]**	**5.9**	**4.7**	**5.9**	**4.7**

[1] Figures may not necessarily add up due to rounding and exclusion of the import duties component
p Preliminary

Source: Department of Statistics, Malaysia

The services sector registered a marked improvement in growth of 6.8% in 2018 (2017: 6.2%), the highest since 2011, driven primarily by the wholesale and retail trade, food and beverages and accommodation sub-sectors as better consumer sentiments and favourable labour market conditions spurred spending, in particular during the tax holiday period. In the information and communication sub-sector, growth was supported by continued demand for data communication and computer services. Growth in the finance and insurance sub-sector also improved, supported by stronger financing activity in both household and business segments. Growth in the transport and storage sub-sector was more moderate amid slower trade and air passenger traffic growth.

Growth in the agriculture sector declined by 0.4% (2017: 7.2%) as adverse weather and production constraints affected palm oil and rubber production. Nevertheless, the growth contraction was partially eased by higher production in the livestock and other agriculture sub-sectors amid higher domestic demand.

In the mining sector, growth contracted by 1.5% (2017: 1.0%), attributable mainly to the decline in natural gas production as operations in East Malaysia were affected by pipeline repairs and unplanned maintenance shutdown.

The manufacturing sector expanded by 5.0% in 2018 (2017: 6.0%). Growth was supported primarily by a continued expansion in the E&E cluster, despite a normalisation from the global technology upcycle in 2017. The steady performance of the E&E cluster was largely attributable to the presence of Malaysian E&E firms in diversified and fast growing product segments such as automotive, Internet of Things (IoT) and healthcare. However, the primary-related cluster was weighed down by supply disruptions in the production of natural gas and crude palm oil (CPO), which had negative spill-over effects to the production of refined petroleum and palm-oil based products.

Growth in the construction sector moderated to 4.2% in 2018 (2017: 6.7%). The moderation was on account of weaknesses in the property segment, as the higher levels of unsold residential properties and the oversupply in commercial property weighed on growth in the residential and non-residential sub-sectors respectively. Nevertheless, the civil engineering sub-sector remained the key driver of growth for the construction sector, supported by continued progress of large petrochemical, transportation, and utility projects. The special trade sub-sector benefited from early works activity from large transportation projects and additional support from solar projects.

Favourable Labour Market Conditions in 2018

Labour market conditions remained favourable in 2018. Employment growth was strong at 2.5% (2017: 2.0%), amounting to an additional employment gain of 360,250 persons. Meanwhile, the labour force grew at the same pace of 2.5% (2017: 1.9%), which amounted to 372,875 persons entering the labour force. The labour force participation rate also rose to 68.4% (2017: 68.0%). As a result, the unemployment rate remained unchanged at 3.4%.

Table 1

Selected Labour Market Indicators

	2014	2015	2016	2017	2018*p*
Labour force ('000 persons)	14,264	14,518	14,668	14,953	15,325
Employment ('000 persons)	13,853	14,068	14,164	14,450	14,810
Unemployment rate (% of labour force)	2.9	3.1	3.4	3.4	3.4
Retrenchments (persons)	25,917	38,499	37,699	35,097	23,168
Foreign workers ('000 persons)	2,073	2,135	1,866	1,797	2,015

p Preliminary

Note: 2018 numbers for labour force, employment and unemployment rate were estimated based on a mean average of quartery level figures in 2018 from the Labour Force Survey Report

Source: Department of Statistics, Malaysia and Ministry of Human Resources, Malaysia

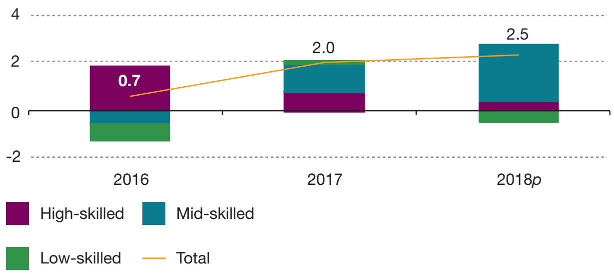
Net employment gains[1] were driven mainly by high- and mid-skilled workers, which grew by 1.6% and 4.2% respectively. Mid-skilled workers continued to command the largest share of total employed persons at 60.6% (2017: 59.6%), followed by high-skilled workers at 27.3% (2017: 27.5%) and lastly low-skilled workers at 12.1% (2017: 12.8%). Latest salaries and wages data[2] suggest that high-skilled workers experienced the lowest median wage growth at 1.8% to RM3,908, compared to that of mid-skilled (7.9%, RM1,716) and low-skilled (14.3%, RM1,200) workers.

From a sectoral perspective, net employment gains were mainly in the services and manufacturing sectors. In particular, the wholesale and retail trade as well as the food and beverages and accommodation services sub-sectors cumulatively recorded strong employment growth of 5.9% in 2018 (2017: 2.9%). Meanwhile, reported retrenchments continued on its decreasing trend (23,168 persons; 2017: 35,097 persons), below the long-run average[3] of 29,628 persons per annum.

Chart 1: Net Employment Gains by Skill Level, 2016 - 2018*p*

Net employment gains were driven by high- and mid-skilled workers...

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



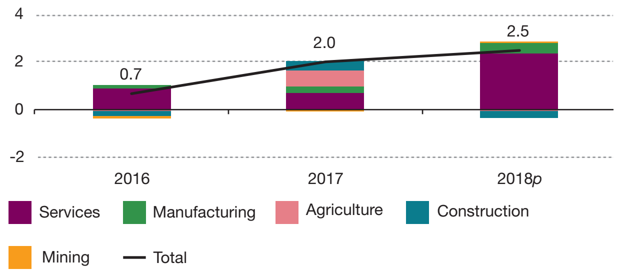
p Preliminary

Source: Bank Negara Malaysia estimates using data published by the Department of Statistics, Malaysia

Chart 2: Net Employment Gains by Sector, 2016 - 2018*p*

...as well as the services and manufacturing sectors

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



p Preliminary

Source: Bank Negara Malaysia estimates using data published by the Department of Statistics, Malaysia

[1] Refers to the difference between employment level in a given year compared to the previous year.
[2] Bank Negara Malaysia estimates using data from the 2017 Salaries and Wages Survey Report published by the Department of Statistics, Malaysia which only represents Malaysian citizen workers.
[3] The long-run average is the average annual retrenchments from 2000 – 2017, excluding the crisis period of 2008 – 2009.

Aggregate nominal wages in the private[4] and public sectors grew by 6.0% and 4.5% respectively in 2018 (2017: 6.4% and 6.2%, respectively). Growth of wages in major services sub-sectors[5] was relatively modest (3.8%; 2017: 5.4%), as the ratio of vacancies to total positions in the sector continued to trend lower suggesting persistent labour market slack in the services sector. The manufacturing sector registered a higher wage growth of 10.8% (2017: 8.6%), supported by faster increases in export-oriented manufacturing wages, particularly in the E&E and petroleum manufacturing segment. Wage per worker growth in the manufacturing sector remained higher than that in the services sector. In 2018, 5.0% of total positions in the manufacturing sector was vacant compared to 0.8% in the services sector.[6]

Labour productivity, as measured by real value-added per hour worked, increased by 3.4% in 2018 (2017: 3.5%), driven by productivity gains in the services and mining sectors (5.1% and 4.0%, respectively; 2017: 3.7% and -3.3%, respectively). Despite real wage growth keeping pace with labour productivity growth, concerns over low income levels amid rising cost of living continue to dominate public discourse, increasing the urgency of comprehensive policy reforms to raise incomes (See Box Article on 'Are Malaysian Workers Paid Fairly?: An Assessment of Productivity and Equity').

[4] 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. It covers 63.5% of total employment.

[5] 'Major services sub-sectors' includes wholesale and retail trade, food and beverages and accommodation, information and communication, transportation and storage, health, education, arts, entertainment and recreation, and professional and real estate services sub-sectors.

[6] Imputed by taking the share of vacancies over total positions, using data from the Quarterly Employment Statistics published by the Department of Statistics, Malaysia.

EXTERNAL SECTOR

Resilient external sector performance

The year 2018 began on a positive note, but subsequently turned into an increasingly challenging global economic environment amid volatile international financial markets. Multiple headwinds in the global economy led to slower export growth, while subdued sentiments towards emerging markets contributed to reversals of capital flows. As an economy with a high degree of openness, Malaysia is not insulated from global headwinds and tightening financial conditions. The external sector, nevertheless, withstood these challenges from a position of strength, with a current account surplus, continued FDI inflows and orderly financial markets conditions. External debt exposure remained manageable. Favourable external balance sheet profiles across instruments, maturity and currency was reinforced by external asset holdings of the domestic banks and corporates, further mitigating potential risks. International reserves continued to serve as a key buffer against potential external shocks. This is complemented with a flexible exchange rate, well-developed capital markets and a strong financial system. On the whole, the Malaysian economy was safeguarded from excessive volatility emanating from the global economic and financial landscape, fortified by a broad range of policy tools.

Following exceptionally robust exports performance in 2017 (18.8%, highest since 2004), gross exports registered a more moderate growth of 6.8% in 2018 (1980 - 2017: 10.4%). Exports performance was driven by manufactured exports (9.1%; 2017: 18.6%), with continued demand from major trade partners, including PR China, EU and the US, and the underlying industry demand for semiconductors. The enduring exports performance was a reflection of the diversity of Malaysia's exports, as the strength in manufactured exports helped to partially offset the decline in commodity exports during the year (-3.2%; 2017: 18.0%). The latter was negatively affected by production disruptions.

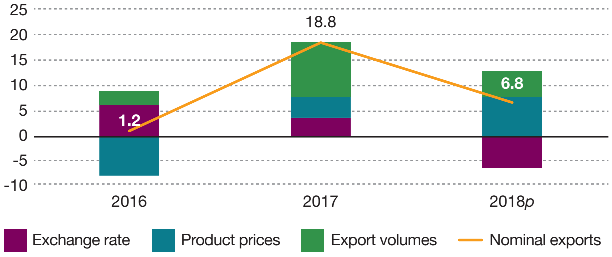
Gross exports moderated to more sustainable levels, following the exceptionally strong growth in 2017

Gross export growth was driven by both volumes and product prices, both indicating Malaysia's exports competitiveness and continued external demand (Chart 1.4). Export volume growth (5.0%; 2017: 11.0%) was primarily due to manufactured exports. In the E&E segment, semiconductor products remained the key driver of E&E export volumes (11.0%; 2017: 16.3%). While the support from the 2017 global technology upcycle waned in 2018, the greater use of semiconductors in the automotive, medical technology and consumer electronics industries continued to generate strong underlying demand for E&E products. The establishment

Chart 1.4: Contribution of Export Volumes, Product Prices and Exchange Rate to Gross Export Growth

Gross export growth driven by export volumes and prices

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



p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

of a global E&E distribution hub in Malaysia in late-2017 also contributed to a significant increase in E&E re-exports, thus providing additional support to export volumes. In the non-E&E manufactures segment, export volumes (6.7%: 2017: 11.2%) were driven by sustained demand for chemicals, petroleum and metal products, as well as optical and scientific equipment. The operationalisation of new export-oriented manufacturing plants and capacity expansion of existing plants in sectors such as petrochemicals and rubber gloves helped to meet demand from key trade partners, including the EU and regional economies. For commodities, export volumes declined by 5.6% (2017: 2.7%), due mainly to supply disruptions. During the year, export product prices registered a higher growth of 8.0% (2017: 4.0%), providing a further lift to gross export growth. Prices of manufactured exports increased by 5.6% after recording flat growth in 2017 (0.0%), primarily supported by higher selling prices for electronic components, such as semiconductors. This development was attributed to continued global demand and tighter supply conditions, as evidenced by high capacity utilisation rates in the manufacturing sector of many major economies including the US, EU and PR China. Commodity export prices recorded a slower growth of 8.6% (2017: 11.5%) due to lower growth in CPO and LNG prices.

Gross import growth moderated to 4.9% (2017: 19.7%), on account of weaker intermediate and capital imports. The decline in imports of intermediate goods (2018: -3.9%; 2017: 20.0%) was in line with the moderation in manufactured exports, as well as a reflection of the high base in 2017. Weaker imports of capital goods, particularly in machinery equipment, was in tandem with the more moderate investment activity. The near completion of several major projects during the year also contributed to the decline in capital imports. Imports of goods for re-export, however, grew at a stronger pace of 40.0% (2017: 25.3%) owing to the increase in E&E re-export activity, attributable to the newly established global E&E distribution hub, and continued regional demand for petroleum products.

Consequently, Malaysia's trade surplus widened to RM120.5 billion (2017: RM98.5 billion), supported by higher surplus from manufactured exports, particularly for E&E and optical and scientific equipment (Chart 1.5). These products offset the deficits in other non-E&E manufactured goods such as machinery, equipment and parts, chemicals and transport equipment.

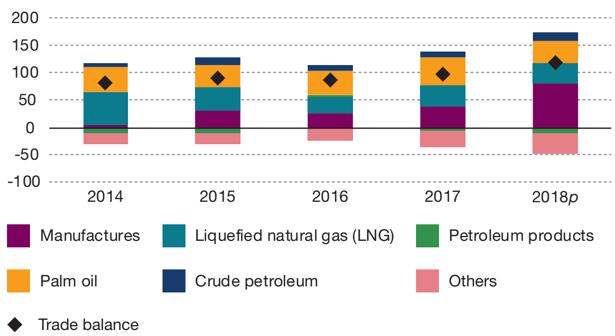
Following these developments, Malaysia's current account balance continued to register a healthy surplus of RM33.5 billion or 2.4% of GNI in 2018 (2017: RM40.3 billion or 3.1% of GNI), contributed by a higher goods surplus and a smaller services deficit, which more than offset the deficit in the income accounts (Chart 1.6). The smaller current account surplus in 2018 also reflected moderating gross national savings, which more than offset the lower investment activity.

The services account recorded a smaller deficit of RM19.7 billion (2017: -RM22.8 billion), due mainly to lower net payments for transportation, construction and insurance services. While the transportation deficit was lower following more moderate trade activity, it remained sizeable, reflecting Malaysia's high reliance on

Chart 1.5: Trade Balance by Products

Higher trade balance supported by larger surplus in E&E

RM billion

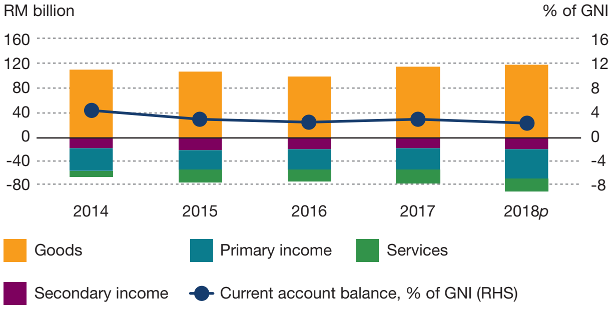


p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.6: Current Account Balance

Current account surplus attributable mainly to a larger goods surplus and a smaller services deficit



p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

foreign service providers. In the travel account, a lower surplus of RM28.9 billion (2017: RM32.9 billion) was recorded due to higher number of Malaysians spending abroad and lower number of tourist arrivals to Malaysia (25.8 million; 2017: 25.9 million).

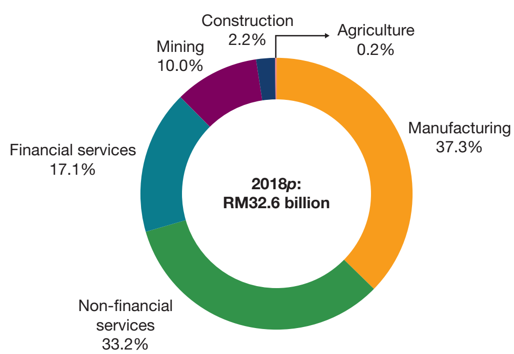
In the income account, the primary income deficit widened to RM49.4 billion (2017: -RM36.4 billion), due to the larger net payments in portfolio and direct investment income, as well as a lower net receipts from other investments. In particular, the widening deficit in the direct investment income account mainly reflected lower income receipts accrued to Malaysian companies investing abroad in the mining and manufacturing sectors following lower global oil prices and more moderate global trade activity. At the same time, multinational companies in Malaysia continued to record large investment income of RM59.5 billion (2017: RM59.1 billion), reflecting Malaysia's attractiveness as a profit centre for FDI. The secondary income account recorded a larger deficit of RM18.8 billion (2017: -RM17.3 billion), due to a significant decline in inward remittances, amid sustained outward remittances by foreign workers.

Capital flow developments were dominated by movements in short-term flows for much of the year, as the financial account recorded a net inflow of RM18.6 billion (2017: net outflow of RM4.7 billion). A reversal of portfolio investments by non-residents, which took place amid increasingly more volatile global financial market conditions, were offset by substantial inflows in the other investment account. Meanwhile, long-term FDI flows resumed at a more moderate pace, while domestic firms and institutional investors continued to undertake direct investments abroad (DIA).

The direct investment account registered a net inflow of RM11.3 billion (2017: net inflow of RM16.2 billion), as FDI exceeded DIA. Malaysia's resilient growth prospects and long-term fundamentals continued to attract FDI, but uncertainties stemming mainly from challenging global economic conditions and in particular, the trade tensions, resulted in more subdued investment activities. In 2018, FDI inflows amounted to RM32.6 billion, equivalent to 2.4% of GNI (2017: net inflow of RM40.4 billion; 3.1% of GNI). A major investment undertaken during the year include the successful realisation of the joint venture for the Refinery and Petrochemical Integrated Development (RAPID) project in the first quarter. By economic sectors, FDI remained broad-based, of which the largest recipients were the manufacturing sector, and the non-financial services sub-sectors (Chart 1.7). Advanced economies like the US (20% of total FDI flows for the year), Hong Kong SAR (19.6%) and Japan (14.9%) were also major contributors of FDI. Global headwinds and subdued investment sentiments also affected Malaysian companies' investments abroad, as DIA recorded slightly lower net outflows of RM21.3 billion, equivalent to -1.5% of GNI (2017: net outflow of RM24.2 billion; -1.8% of GNI). Notable investments include the incorporation of a subsidiary of a domestic banking conglomerate in Singapore, and the acquisition of interests in an oil field in Oman by the national oil and gas company. Domestic institutional investors also continued to undertake investments in the financial services,

Chart 1.7: Net Foreign Direct Investment by Sectors

Foreign direct investment[1] largely concentrated in the manufacturing and non-financial services sectors



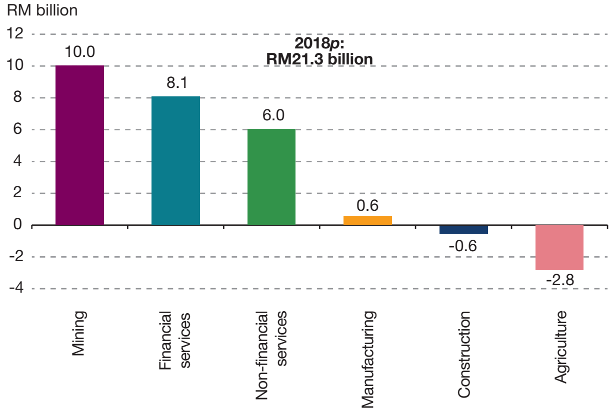
[1] Foreign direct investment as defined according to the 5th Edition of the Balance of Payments Manual by the IMF

p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.8: Net Direct Investment Abroad by Sectors

Direct investment abroad[1] mainly focused in the mining and financial services sectors



[1] Direct investment abroad as defined according to the 5th Edition of the Balance of payments Manual by the IMF. Negative values refer to net inflows.

p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

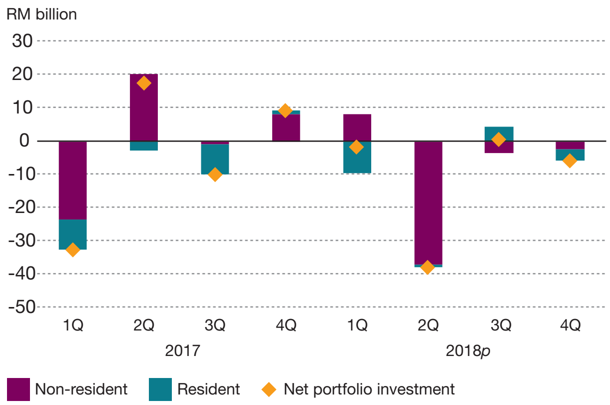
retail and property sectors abroad. By sector, DIA was mainly channelled into the mining sectors, followed by the financial services sub-sector (Chart 1.8). Asian countries like Singapore (30.2% of total DIA flows for the year) and Indonesia (12.8%) remained major beneficiaries of DIA.

The portfolio investment account recorded a net outflow of RM44.4 billion (2017: net outflow of RM15.4 billion), attributed mainly to higher non-resident portfolio investment outflows (Chart 1.9). The yearly figure masked considerable movements in short-term flows during the quarters, particularly by non-residents. The year began with a continuation of relatively optimistic market sentiments, leading to inflows of non-resident portfolio investments in 1Q 2018. However, these reversed in subsequent quarters, following changing investors' expectations on the pace of monetary policy normalisation by the US Fed, the escalation of trade tensions between the US and its major trade partners, commodity price volatility, and concerns over contagion from the deterioration in financial conditions in Turkey and Argentina. Uncertainties surrounding domestic policy after the 14th General Election also affected investor sentiments (For more details, refer to Chapter 2 on Monetary and Financial Conditions in 2018). Thus, for the whole year, non-resident portfolio investments recorded a net outflow of RM35.3 billion (2017: net inflow of RM4.1 billion). By instrument, this was accounted mainly by a liquidation of debt securities, particularly of Malaysian Government Securities (MGS). Domestic institutional investors' acquisition of foreign financial assets were also affected by the heightened uncertainty and risk aversion in global financial markets, as resident fund managers and banks registered a significantly lower net outflow of RM9.1 billion during the year (2017: net outflow of RM19.4 billion). Despite large portfolio outflows, financial markets continued to function with minimal disruption, a testimony to the strength of the financial system and depth and breadth of the domestic financial markets. Declines in non-resident holdings of domestic financial securities were met with continued demand from domestic institutional investors, tempering movements in bond yields and equity prices. Malaysia's resilient financial system facilitated the orderly intermediation of these flows. Deep capital markets and the broad base of domestic institutional investors provided additional buffers.

The other investment account recorded a net inflow of RM50.7 billion (2017: net outflow of RM5.3 billion), on account of deposit placements by foreign banks in the domestic financial system, and a net drawdown of foreign currency loans by the corporate sector from non-resident creditors. Banking inflows reflect interbank transactions, underscoring liquidity and treasury management strategies of the Malaysian banks. In the meantime, loan inflows to the private sector reflected mainly the drawdown of short-term loans and trade credits by resident companies, to facilitate trade and investment transactions. The public sector registered net outflows, mainly attributable to a net repayment of long-term loans by the Federal Government. Excluding revaluation losses, errors and omissions (E&O) stood at -RM44.3 billion, or

Chart 1.9: Portfolio Investments

Net outflow in portfolio investment account mainly due to non-residents



p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

-2.4% of total trade (2017:-RM19.1 billion, or -1.1% of total trade). The large E&O is fundamentally due to statistical discrepancies arising from differences in sources of data, valuations, timings and other measurement issues.

Sufficient reserves and manageable external debt amid more volatile capital flows

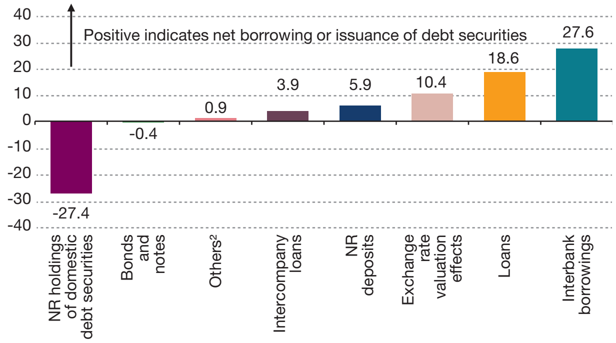
The international reserves of Bank Negara Malaysia amounted to USD101.4 billion as at end-2018 compared to USD102.4 billion as at end-2017. The lower international reserves level was largely attributable to foreign exchange revaluation changes. Despite the diversified foreign currency reserves, the US dollar appreciation against most major currencies during the year resulted in the revaluation losses. As at 28 February 2019, the reserves level amounted to USD102.4 billion. The international reserves remain adequate to facilitate international transactions, sufficient to finance 7.4 months of retained imports and is 1.0 time the short-term external debt.

Malaysia's external debt stood at RM924.9 billion as at end-2018, equivalent to USD221.0 billion or 64.7% of GDP (end-2017: RM885.2 billion, equivalent to USD215.9 billion or 65.4% of GDP). The increase in external debt was driven mainly by the increase in interbank borrowings and corporate loans to finance investment activity. The higher external debt was also partly attributed to valuation effects following the weakening of ringgit against selected regional and major currencies, in particular, during the second and third quarters of the year. These were partially offset by some liquidation of domestic debt securities by non-resident investors, culminating in outflows on non-resident portfolio investments. Malaysia's external debt continued to reflect underlying economic activity and financial market developments. These comprise external financing raised primarily to further expand productive capacity and to better manage financial resources within corporate groups, as well as the intermediation activities of the domestic banking sector and the Labuan International Business and Financial Centre (LIBFC).

Concerns surrounding external debt typically centre on currency and maturity mismatches. On both accounts, Malaysia's external debt remains manageable. More than half of total external debt is skewed towards medium- to long-term tenures, suggesting limited rollover risks. In terms of currency composition,

Chart 1.10: Changes in Total External Debt in 2018

Higher external debt in 2018
Net change[1]: +RM39.7 billion



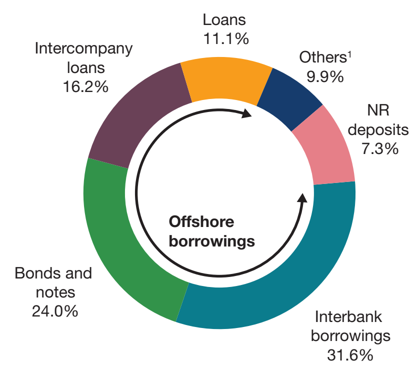
[1] Changes in individual debt instruments exclude exchange rate valuation effects
[2] Comprises trade credits, IMF allocation of SDRs and other debt liabilities

Note: NR refers to non-residents
Figures may not necessarily add up due to rounding

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Chart 1.11: Breakdown of Foreign Currency-denominated External Debt (% share)

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



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

Note: Figures may not necessarily add up due to rounding

Source: Bank Negara Malaysia

31.1% of the total external debt is denominated in ringgit and, essentially, not affected by exchange rate fluctuations. The remaining 68.9% of external debt, denominated in foreign currency, is supported by a set of risk-mitigating factors. First, three-quarters of foreign currency-denominated external debt is subjected to Bank Negara Malaysia's prudential requirements and external debt approval framework. Banks' exposure in the form of interbank borrowings, non-resident deposits and debt issuances are subjected to prudential requirements on liquidity and funding risk management. Meanwhile, corporate external borrowings in the form of bonds and loans are subjected to approval framework. This is to ensure that these borrowings are supported by foreign currency earnings or sufficiently hedged. Second, about three-quarters of corporate external debt is hedged, through foreign currency revenues or financial hedging instruments. Third, the intercompany loans, which accounted for 16.2% of foreign currency-denominated external debt, are generally available on flexible and concessionary terms, while trade credits are self-liquidating (Chart 1.12). (For detailed analysis, please refer to the Box Article on 'Malaysia's Resilience in Managing External Debt Obligations and the Adequacy of International Reserves').

Malaysia's international investment position recorded a larger net liability of RM77.7 billion as at end-2018, equivalent to -5.6% of GNI (end-2017: -RM30.4 billion or -2.3% of GNI). This reflects, in part, downward revaluations of investment assets by several direct investors abroad following a more difficult business environment globally and the increase in external debt. These were partly cushioned by exchange rate effects, which are complemented by the structure of external assets and liabilities. As most external assets are denominated in foreign currency while more than half of total external liabilities are denominated in ringgit, the depreciation of the ringgit during the year resulted in a larger increase of the value of external assets in ringgit terms, compared to the value of external liabilities.

The strength of the external sector is a result of various structural measures put in place over the years to diversify the structure of Malaysia's economy, enhance the depth of financial markets, and build strong financial institutions since the Asian Financial Crisis. As a consequence, Malaysia's exports remain competitive and the country's attractiveness as an investment destination is preserved even during trying conditions. As a buffer against external shocks, the flexibility of the exchange rate remains as an

Chart 1.12: Breakdown of Malaysia's Total External Debt (% share)

Favourable external debt profile

[1] Includes trade credits, IMF allocation of SDRs and miscellaneous, such as insurance claims yet to be disbursed and interest payables on bonds and notes

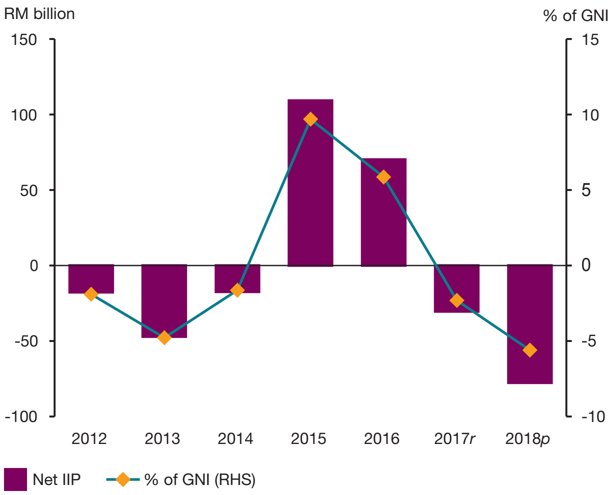
Note: Figures may not necessarily add up due to rounding

Source: Bank Negara Malaysia

important shock absorber. The long standing policy of decentralisation of international reserves has resulted in substantial accumulation of external assets by domestic corporations and banks. These entities now account for approximately 75% of Malaysia's RM1.7 trillion external assets. Malaysia continued to register a net short-term external asset position of RM304.6 billion, which strengthened the repayment capacity of Malaysian borrowers to service short-term external debt falling due. Malaysia also maintained a net foreign currency asset position, indicating that the risk emanating from a sharp exchange rate depreciation on the country's external sector is well mitigated. These factors further underscore borrowers' repayment capabilities. In addition, the availability of a wide range of liquidity management instruments provides flexibility and agility in managing volatile financial market conditions. This reduces the reliance on Bank Negara Malaysia's international reserves in managing external pressures, and helps to bolster the resilience of Malaysia's external sector.

Chart 1.13: Net International Investment Position (IIP)

IIP registered a larger net liability in 2018



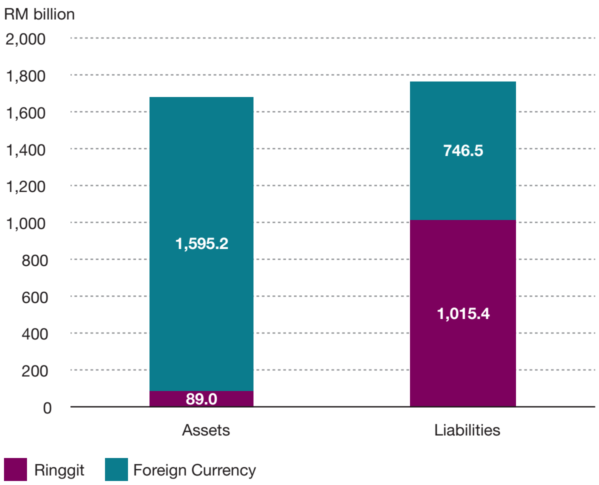
p Preliminary

r Revised

Source: Department of Statistics, Malaysia

Chart 1.14: International Investment Position (IIP) by Currency

Foreign currency external assets exceeded foreign currency external liabilities



Source: Bank Negara Malaysia

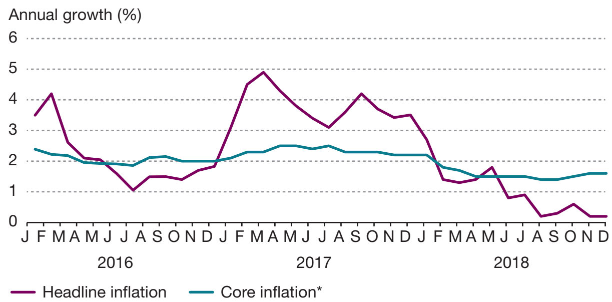
INFLATION DEVELOPMENTS

Headline inflation was low in 2018

Headline inflation, as measured by the annual growth of the Consumer Price Index (CPI), declined to 1.0% in 2018 (2017: 3.7%). The moderation mainly reflected the impact of the fixing of retail fuel prices and the zerorisation of the Goods and Services Tax (GST) rate.[1] These factors more than offset upward cost pressures that remained present for some parts of 2018, stemming primarily from elevated global oil prices, the relatively weaker ringgit exchange rate and the implementation of the Sales and Services Tax (SST). Underlying inflation, as indicated by core inflation,[2] averaged lower at 1.6% (2017: 2.3%) amid smaller cost pass-through to retail prices and the absence of excessive demand pressures.

Chart 1.15 Consumer Price Inflation

Headline inflation declined to 1.0% in 2018



* Core inflation excludes the estimated direct impact of consumption tax policy changes

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

[1] The zerorisation of the GST rate was between 1 June 2018 and 31 August 2018. Subsequently, the GST was replaced by the Sales and Services Tax (SST) effective 1 September 2018.

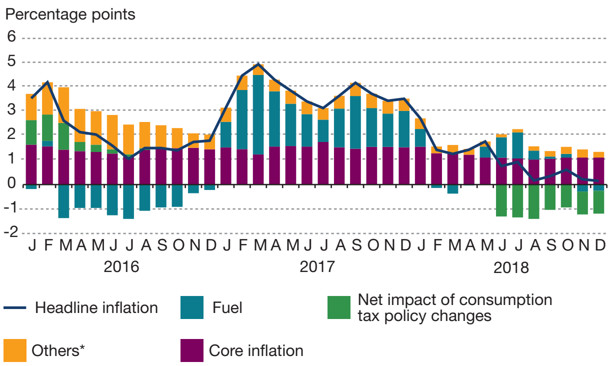
[2] Core inflation excludes price-volatile and price-administered items, whose price movements are not likely to be related to changes in demand conditions. Core inflation also excludes the estimated direct impact of consumption tax policy changes.

In the beginning of the year, the decline in headline inflation was primarily influenced by global factors. With a stronger ringgit exchange rate and the relatively small increase in global oil prices, domestic fuel prices experienced a declining trend. By 15 March 2018, the prices of RON97 petrol, RON95 petrol and diesel were lower at RM2.45, RM2.18 and RM2.16 per litre, respectively (December 2017: RM2.55, RM2.27 and RM2.23 per litre, respectively). Consequently, transport inflation declined significantly from 11.5% in December 2017 to 5.7% in January 2018, turning negative in February and March 2018. Notably, favourable supply conditions also helped contain food price increases as weather conditions were considerably better during the quarter as compared to the corresponding quarter in the previous year. Together, these factors led to a decline in overall headline inflation (1Q 2018: 1.8%; 4Q 2017: 3.5%).

Beginning 22 March 2018, retail fuel prices of RON95 petrol and diesel were maintained at RM2.20 and RM2.18 per litre, respectively, for the remainder of 2018.[3] As the year unfolded, the stable domestic retail fuel prices helped mitigate cost pressures amid elevated global oil prices and the weaker ringgit exchange rate. This was followed by the zerorisation of the GST rate effective 1 June 2018 which led to a broad-based decline in prices of goods and services that were previously subjected to the GST. There were, however, other domestic factors that contributed to upward pressure on inflation. First, the revision to the electricity tariff on

Chart 1.16: Contribution to Headline Inflation by Components

Low headline inflation reflected the lower fuel contribution and the impact from consumption tax policy changes



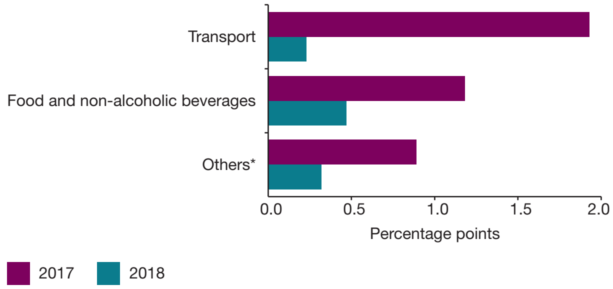
* Others include price-volatile items and other price-administered items

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

[3] The retail fuel price of RON97 petrol was at RM2.47 per litre from 22 March 2018 to 6 June 2018.

Chart 1.17: Contribution to Inflation by Categories

Contributions from the transport, and food and non-alcoholic beverages categories were lower



* Others include alcoholic beverages and tobacco, clothing and footwear, housing, water, electricity, gas and other fuels, furnishings, household equipment and routine household maintenance, health, communication, recreation services and culture, education, restaurants and hotels and miscellaneous goods and services categories

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

1 July 2018 led to a one-off increase in utility prices for certain households.[4] Second, the implementation of the SST effective 1 September 2018 resulted in marginal price adjustments. The SST impact on inflation during the year remained relatively low as businesses utilised their existing stock. The low impact also reflected stiff competition among firms, with some firms pursuing active promotion and discounting schemes as part of a broader strategy to maintain market share. Overall, the downward pressure from the zerorisation of the GST rate amid stable retail fuel prices more than offset the upward pressure from the electricity tariff adjustment and the impact from the SST.

Notwithstanding the low inflation environment for consumers, some firms reported some input cost pressures throughout the year. As indicated by the Bank's industrial engagements,[5] the input cost pressures faced by these firms arose mainly from rising prices of raw materials and commodities such as aluminium, coupled with higher import costs from the weaker ringgit exchange rate. However, this development did not translate into broad-based inflationary pressures for firms. Specifically, overall prices for producers, as indicated by the Producer Price Index (PPI), averaged lower during the year (PPI inflation; 2018: -1.1%; 2017: 6.7%). The decline was mainly due to the manufacturing sector (PPI inflation in the manufacturing sector; 2018: -1.8%; 2017: 5.3%), reflecting the significantly lower price of CPO in 2018 (2018: RM2,232/tonne; 2017: RM2,793/tonne).

[4] Effective 1 July 2018, the 1.52 sen/kWh Imbalance Cost Pass-Through (ICPT) electricity tariff rebate was removed, leading to higher electricity costs for consumers with monthly consumption of more than 300kWh.

[5] The industrial engagements were undertaken by the Bank's Regional Economic Surveillance (RES) team throughout the year.

This trend, together with strong competition among firms, supported the low inflation environment for consumers during the year.

In 2018, labour market indicators, such as the growth in real wage per worker in the private sector, improved amid a sustained unemployment rate (2018: 3.4%; 2017: 3.4%), while the capacity utilisation rate in the manufacturing sector was relatively stable (2018: 81.3%; 2017: 82.6%). Yet, these developments did not translate into excessive demand pressures given the stronger growth in the labour force and continued investment for capacity expansion during the year. Against this backdrop, core inflation was lower for the year as a whole.

Inflation, the Cost of Living and the Living Wage

Globally, concerns surrounding living standards continue to attract much attention, as real income growth slowed or stagnated for some segments of society. In Malaysia, although headline inflation has been relatively low, concerns about the rising cost of living have been increasing and will likely persist over the near term. These pressures are wide-ranging, from housing to food, childcare, healthcare and education. For the lower-income households in particular, limited income buffers will render them more vulnerable to increases in living costs.[1]

This box aims to discuss the key concepts of the cost of living, inflation and the living wage, as well as how these concepts interrelate. It draws from the various analyses on households' cost of living and income that the Bank has, since 2016, published in its Annual Reports and Quarterly Bulletins.

The **cost of living** reflects household expenditure on goods and services, including financial obligations, to maintain a certain standard of living. This expenditure is determined by each household's spending patterns and prices, which are affected by factors such as household income, demography, family structure, area of residence and geographical factors (Bank Negara Malaysia, 2016). The cost of living therefore differs across different types of households.

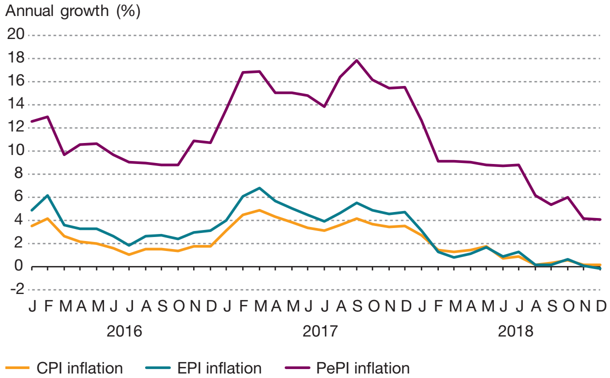
The **inflation rate**, as measured by the change in the Consumer Price Index (CPI), measures the price increase for a basket of items that represents the average pattern of purchases among households in Malaysia. The CPI assumes homogenous spending patterns across households and holds the quantity and quality of the goods and services in the consumption basket constant over a fixed period of time (Bank Negara Malaysia, 2016). It can be used to approximate the change in the cost of living if there are little dispersions in the spending patterns and price changes faced by households across a country. However, in a situation where the dispersion in spending patterns and price changes are large, the inflation rate could be a weak approximation of the change in cost of living. Using the inflation rate as a proxy could consequently understate or overstate the change in cost of living for some segments of households. Therefore, it is very likely for different households to experience significant variations in the cost of living depending on the households' composition and location as well as the prices of goods and services that pertain to the expenditure pattern of these households.

An added complexity is that households may also perceive that the increase in cost of living is vastly different (usually higher) than CPI inflation (Chart 1). This is because consumers use different sets of information when assessing the cost of living compared to that used to compute CPI inflation. Households' views on the cost of living are mainly driven by the price changes on frequently purchased items, as compared to the full basket of goods and services that comprise the CPI. These frequent expenditures, such as fresh food items and eating out, typically experience higher inflation rates. This is called frequency bias, and it can be measured by the Everyday Price Index (EPI). It is an index that comprises households' frequently purchased goods and services (at least once a month). There is also a tendency for households to only remember price increases and not decreases. This is called memory bias. Memory bias is measured by the Perceived Price Index (PePI). It is a further refinement to the EPI, where it attempts to incorporate memory bias in addition to frequency bias. Items in the PePI basket are exactly the same as in the EPI basket. However, the PePI only considers price increases, as consumers

[1] See the Box Article titled 'Divergence of Economic Performance and Public Sentiments' in the Second Quarter 2018 BNM Quarterly Bulletin for more information.

Chart 1: Consumer Price Index (CPI), Everyday Price Index (EPI) and Perceived Price Index (PePI)

The EPI inflation and PePI inflation are generally higher than CPI inflation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

tend to disregard price declines. Items that registered price declines are assumed to be unchanged in the measurement of the PePI.[2]

When faced with living costs in a particular location, households would need to earn a level of income that would enable them to have a standard of living that meets a minimum acceptable standard. Elements of this minimum acceptable standard include having the ability to meaningfully participate in society, the opportunity for personal and family development and freedom from severe financial stress.[3] This level of income is known as the **living wage** or living income.[4] The living wage is meant to be sufficient to pay for minimum acceptable needs, and not for aspirational lifestyles. As the cost of living may vary considerably across regions, the living wage is not necessarily uniform throughout a country.[5] The Bank estimated the living wage in Kuala Lumpur in 2016 to be RM2,700 for a single adult household, RM4,500 for a household comprising a couple without children and RM6,500 for a couple with two children.[6] In computing these living wage estimates, the Bank constructed broad representative consumption baskets for these three types of households and estimated the costs of these baskets. These include assumptions about the dwellings, dining habits, transport usage, recreation activities, education, healthcare and childcare expenditure, as well as contributions to the Employees Provident Fund (EPF), income tax and savings (Chart 2).

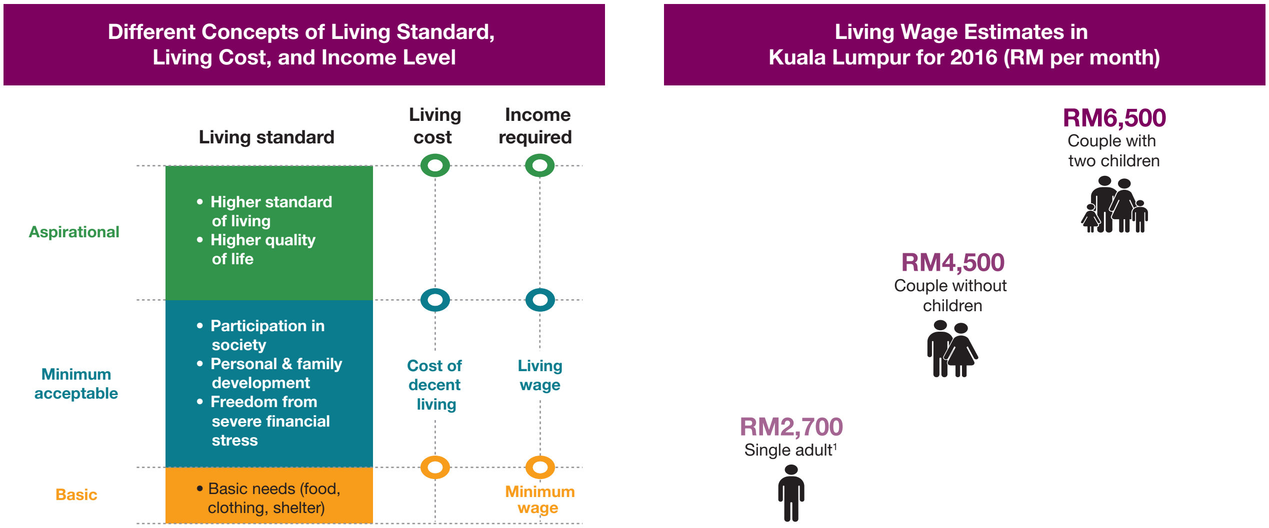
Over the medium term, the cost of living in Malaysia will continue to be a factor in impacting households' well-being and sentiments, especially since wages remain low. Approximately half of Malaysian workers, or 4.4 million people, earn RM2,160 or less a month.[7] A moderate pace of aggregate price increases in the economy is to be expected as it reflects economic expansion. But, improvements in households' living standards are predicated on the growth in household income. Households at the bottom 40% of the income distribution experienced slower income growth over the 2014 - 2016 period relative to the higher-income households, and the income increase was almost

[2] See the Box Article titled 'Inflation: Perception vs. Reality' in the First Quarter 2017 BNM Quarterly Bulletin for more information.
[3] This is beyond a basic standard of living that would only comprise being able to afford food, clothing and shelter; but less than an aspirational living standard that reflects "wants" rather than "needs".
[4] Although the standard terminology is 'living wage', it encompasses income from all sources besides wages, such as non-wage work benefits and social assistance.
[5] The minimum wage (currently at RM1,100 in Malaysia), is typically a statutory requirement, focused on a minimum level of remuneration and may consider additional factors such as its effect on employment and job creation. The living wage is typically higher than the minimum wage. See the Box Article titled 'The Living Wage: Beyond Making Ends Meet' in the Bank Negara Malaysia Annual Report 2017 for more details.
[6] These estimates are derived based on specific assumptions and price levels that prevailed at the time, following the standard approach for the calculations as described in the Box Article titled 'The Living Wage: Beyond Making Ends Meet' in the Bank Negara Malaysia Annual Report 2017 and have important caveats.
[7] Estimated by taking half of total Malaysian employees in 2017 from the Labour Force Survey, published by the Department of Statistics, Malaysia.

completely offset by the increase in expenditure, leaving little room to accumulate savings (Chart 3).[8] Policies designed to address the above issues will need to reflect and address households' salient concerns in concrete terms. Near-term measures can be put in place to help contain any sharp increases in the cost of living especially for the lower-income households. These include measures to improve market structure and distribution in order to improve efficiencies and competition and thus lower prices, and measures to improve public transport connectivity. However, more importantly, longer-term structural policies that would boost productivity and income growth are key in supporting households' ultimate pursuit of a higher standard of living.

Chart 2: Concepts of Living Standard, Living Cost and Income Level, and Living Wage Estimates in Kuala Lumpur for 2016

The living wage is the wage level that could afford the minimum acceptable living standard



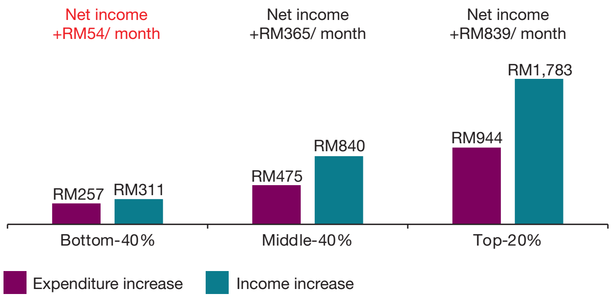
Note: Bank Negara Malaysia uses the term 'living wage' to mean income from all sources besides wages, such as non-wage work benefits and social assistance

[1] Single-adult households include adults who live alone and those who live together with non-related members of a household

Source: Bank Negara Malaysia estimates as published in the Box Article titled 'The Living Wage: Beyond Making Ends Meet' in the Bank Negara Malaysia Annual Report 2017

Chart 3: Change in Mean Household Income and Expenditure, 2014 - 2016

Households at the bottom 40% of the income distribution experienced slower income growth over the 2014 - 2016 period



Source: Report of Household Income and Basic Amenities Surveys 2014 and 2016, Report on Household Expenditure Surveys 2014 and 2016, Department of Statistics, Malaysia and Bank Negara Malaysia estimates

[8] See the Box Article titled 'Divergence of Economic Performance and Public Sentiments' in the Second Quarter 2018 BNM Quarterly Bulletin for more information.

References

Bank Negara Malaysia (2016). 'Updated Box Article: Inflation and the Cost of Living', Annual Report 2015.

Bank Negara Malaysia (2017). 'Box Article: Inflation: Perception vs. Reality', BNM Quarterly Bulletin, First Quarter 2017.

Bank Negara Malaysia (2018). 'Box Article: The Living Wage: Beyond Making Ends Meet', Annual Report 2017.

Bank Negara Malaysia (2018). 'Box Article: Divergence of Economic Performance and Public Sentiments', BNM Quarterly Bulletin, Second Quarter 2018.

Are Malaysian Workers Paid Fairly?: An Assessment of Productivity and Equity

By Athreya Murugasu, Mohamad Ishaq Hakim and Yeam Shin Yau

A. Introduction: Aspirations, Perceptions and Assertions of Incomes in Malaysia

As we draw closer to 2020, conversations on incomes of Malaysians increasingly dominate the public sphere. First mooted in 1991, Vision 2020 was seen as a notable milestone for Malaysia to achieve, with 2020 deemed as the year that the country will attain the coveted "high-income nation" status. Partly motivated by a shared national aspiration, the growing dialogue also reflects rising public angst over the rising cost of living, housing unaffordability and household indebtedness. Ensuring a reasonable income level and sustainable income growth is integral to manage these issues, especially for those in the lower and middle-income brackets.

Previous work done by Bank Negara Malaysia on the living wage[1] highlighted that in 2016, up to 27% of households in Kuala Lumpur earned below a level of income that allows a meaningful participation in society, opportunities for personal and family development, and freedom from severe financial stress. While the assessment of income against expenditure reveals some degree of inadequacy in incomes from a consumption perspective, this article aims to assess the appropriateness of income levels from productivity and equity perspectives. The findings suggest that incomes received by Malaysian employees are not commensurate with the value of output they produce. This article then discusses policy ideas to complement existing national strategies in ensuring equitable and sustainable income gains.

B. Benchmarking Income against Productivity: Are Wages Reflective of Workers' Efficiency?

The relationship between wages[2] and productivity mainly reflects the dynamics of the interrelationship between employees and their respective employers. Employees contribute to the production process by providing labour input (i.e. skills, ideas, manual labour) to produce goods and services. The amount of value-add generated per employee is commonly referred to as labour productivity.[3] Employees are in turn compensated with wages. Thus, the wage that employees earn should fairly reflect their productivity.

Comparing productivity and wage levels across economies shows that wages broadly exhibit a positive correlation with labour productivity (Chart 1). Countries with higher labour productivity levels tend to have higher wages. While Malaysia's productivity level is comparable to other middle-income countries, it is still well below that of advanced economies. This is due to a number of factors, including the slower pace of technological advancements[4] and human capital development[5] that lag behind those of advanced economies. Thus, on the surface, the lower wage rate earned by Malaysian workers relative to those in the advanced economies seems consistent with their relative productivity.

To enable a deeper assessment of Malaysia's wage level vis-à-vis the advanced economies, the article seeks to determine how much Malaysians would earn if they were as productive as workers in the advanced economies. In doing so, a ratio of wages to productivity per worker[6] is calculated to measure the wage rate paid to an employee for generating a dollar's worth of output.[7] This allows for cross-country comparison, as the value of the output produced is kept constant. The economies used as benchmarks in this analysis are the United States of America, United Kingdom, Australia, Germany and Singapore. These economies were chosen based on two factors - the more advanced state of economic development (for aspirational comparisons) and availability of data.

---

[1] The Living Wage: Beyond Making Ends Meet, Bank Negara Malaysia's 2017 Annual Report.
[2] The term 'wages' is used instead of 'income' in the following sections as the analysis utilises wage statistics. In contrast, the term 'income' is used when narrating the broader context of compensation in the economy.
[3] Labour productivity is formally defined as the ratio of gross domestic product to the total number of employed persons in the economy.
[4] Robot density in the Malaysian manufacturing sector was approximately 50% lower than the Asian average and 93% lower than that of Singapore (International Federation of Robotics, 2017).
[5] Malaysia ranked 55th out of 157 countries in the Human Capital Index (HCI). Malaysia's HCI score at 0.62 (high-income economies: 0.74) indicates that children in Malaysia will be only 62% as productive as they could be in adulthood (World Bank, 2018).
[6] All nominal values are deflated by the GDP deflator.
[7] This article attempts to analyse wage **levels** in order to understand where Malaysian wages currently stand relative to productivity levels. This contrasts with the existing literature largely dedicated to comparing wage and productivity **growth**.

Chart 1: Cross-Country Labour Productivity and Average Wages (2016)

Higher labour productivity is often accompanied by higher wages

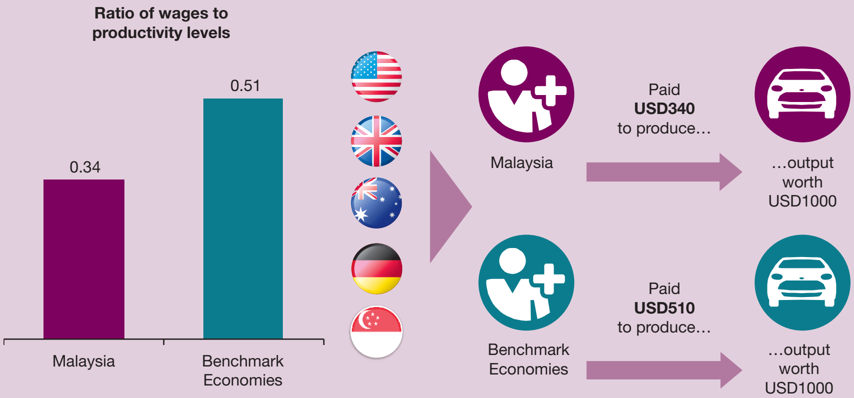
Note: Productivity is computed by taking a ratio of nominal GDP to the total number of employed persons in the economy

Source: Bank Negara Malaysia estimates using data from United Nations Statistics Division, International Labour Organisation (ILO) and World Bank

Analysis of the wage to productivity ratio shows that Malaysian workers are still being paid less than workers in benchmark economies, even after accounting for the different productivity levels across countries (Chart 2). This suggests that Malaysia's current wage productivity levels are misaligned. To illustrate this point, if a Malaysian worker produces output worth USD1,000, the worker will be paid USD340 for it. The corresponding wage received by a worker in benchmark economies for producing the same output worth USD1,000 is, however, higher at USD510.[8]

Chart 2: Cross-Country Comparison of Productivity and Wages in 2017

Malaysian workers are paid less than workers in benchmark economies even after accounting for differences in productivity



Note: 1) The figures are derived by taking the ratio of wages to productivity, with productivity being defined as GDP per worker
2) Data for all countries are as at 2017 except for Malaysia (2016) as Malaysia's 2017 salaries and wage data only represent citizens (instead of both citizens and non-citizens as per previous years)

Source: Bank Negara Malaysia estimates using data from National Account Statistics, Labour Force Survey Report and Salaries and Wages Survey Report published by Department of Statistics, Malaysia, CEIC and national accounts of respective countries

[8] While workers in benchmark economies would produce higher output in a given time due to better technology (and hence earn a higher wage), holding the value of output constant would have controlled for this technological effect.

Further analysis reveals that most industries in Malaysia compensate workers less than those in the benchmark economies, even after adjusting for productivity (Chart 3). This is particularly evident in the wholesale and retail trade, food and beverage and accommodation industries that make up 19% of economic activity and 27% of total employment in Malaysia. These industries are generally more labour-intensive, and dependent on low-skilled workers.

Several factors could explain this. The workforce in these industries typically lacks bargaining power, particularly due to the abundance of low-skilled workers, including foreign workers.[9] As a result, the mean wage in these industries, at RM1,727 in 2016, was nearly 30% below the national average of RM2,463. On the other hand, the disparity against benchmark economies is considerably lower for the information and communication and utilities industries that typically hire more high-skilled workers who are able to command a wage premium due to their specialised skillset and expertise. The average wage level in these industries was RM3,556 in 2016, more than 40% higher than the national average.

Chart 3: Ratio of Wages to Productivity by Sector, Malaysia Against Benchmark Economies in 2017

Malaysian workers are compensated less across most economic activities

Note: 1. The figures are derived by taking the ratio of wages to productivity, with productivity being defined as output per worker
2. Data for all countries are as at 2017 except for Malaysia (2016) as Malaysia's 2017 salaries and wage data only represent citizens (instead of both citizens and non-citizens as per previous years)

Source: Bank Negara Malaysia estimates using data from National Account Statistics, Labour Force Survey Report and Salaries and Wages Survey Report published by Department of Statistics, Malaysia, CEIC and national accounts of respective countries

A Deeper Analysis of the Wage-Productivity Growth Link: Employer versus Employee

Real wage growth in Malaysia has outpaced productivity growth in recent years (Chart 4). The recent strength in wage growth in Malaysia suggests that employers are compensating workers more appropriately for the output produced, improving the wage to productivity ratio. However, public sentiments continue to suggest otherwise. To validate these diverging sentiments, wage growth was adjusted through the lens of employers and employees.[10] Specifically, wages were adjusted using the output deflator to reflect employers' perspective that wages are costs of production. On the other hand, for employees, wages are compared to prices of goods and services consumed (Table 1).

Table 1

Adjusting wage growth to account for changes in price levels in the economy (Employer vs. Employee Perspective)

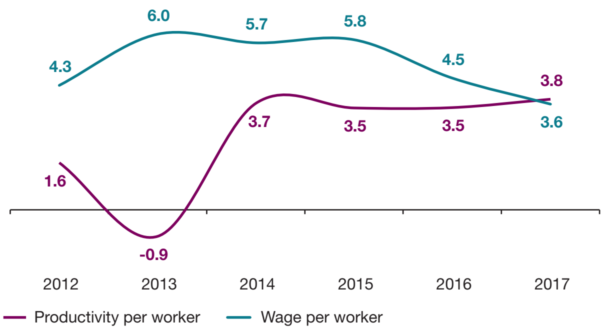
Agents	Perspective of Wages	Wage Deflator	Rationale
Employer	Cost of producing goods and services	Output Deflator	Change in the market value of goods and services sold by the firms
Employee	Means to purchase goods and services	Consumer Price Index	Change in prices of purchasing a "basket of goods and services"

[10] Wages in this analysis are calculated in *real terms* by adjusting nominal values to exclude changes in prices over time. The price indexes that are used to adjust for changes in prices are referred to as *deflators*.

[9] Share of foreign workers in the wholesale retail trade, food and beverage and accommodation industries was 12% in 2017, nearly double the share for the rest of the services sub-sectors in the economy.

Chart 4: Real Productivity and Wage Growth in Malaysia (annual change, %)

Real wage growth has outpaced productivity growth in recent years

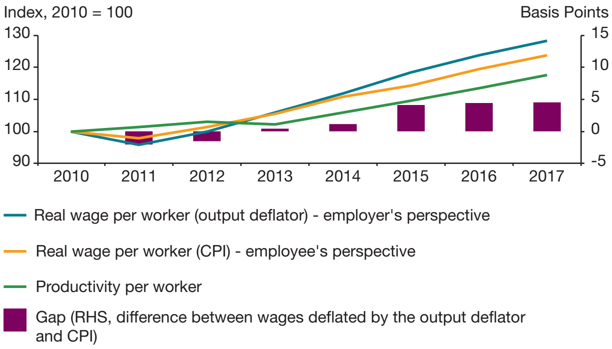


Source: Bank Negara Malaysia estimates using data from Labour Productivity Statistics and Salaries and Wages Survey Report published by Department of Statistics, Malaysia

Contrasting the two perspectives, the gap between real wage growth from a firm's and worker's perspective has significantly widened, particularly since 2015 (Chart 5). Wages have increased faster from an employer's perspective than a worker's perspective as the market price of goods and services sold by firms (output deflator) increased at a slower pace than the price of goods and services consumed by employees (CPI).[11] In the Bank's engagements with industries, firms often cite rising wages as a squeeze to business margins, while workers complain about "stagnant wages" and rising cost of living. This broadly captures the sharply differing sentiments on sluggish wage growth between employers and employees in recent years.

Chart 5: Comparison between Productivity per Worker and Real Wage per Worker Index (2010=100)

Real wage has grown faster from a firm's perspective than from a worker's perspective since 2015



Source: Bank Negara Malaysia estimates using data from Labour Productivity Statistics and Salaries and Wages Survey Report published by Department of Statistics, Malaysia

[11] Divergence in CPI and output deflator could arise due to differences in coverage. While CPI only captures price movements of items bought by consumers (both imported and domestically-produced items), output deflator covers all domestically-produced items (for both exports and domestic consumption). Thus, the output deflator could be more affected by movements in prices of exports, including commodities.

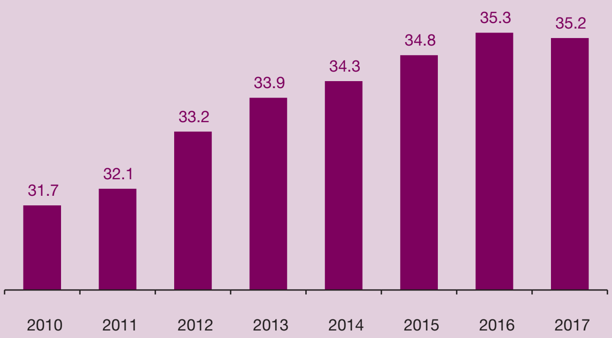
C. Benchmarking Incomes against Equity: Workers vs. Capital Owners

In the production process, labour is only one of the factor inputs, in addition to factor inputs provided by the employer (i.e. capital, land) in producing goods and services. From this perspective, one way of measuring equity is to analyse the labour share of income[12] as it represents the share of national income accrued to labour rather than capital owners (i.e. firms).[13]

The labour share of income has been on the rise in Malaysia, from 31.7% in 2010 to 35.2% of GDP in 2017 (Chart 6). This bucks the global trend where the labour income share has trended lower in recent years. However, Malaysia's labour share of income still lags behind most advanced economies (Chart 7). This implies that a larger fraction of national income in Malaysia goes to capital owners rather than workers, that is capital owners benefit much more than workers in Malaysia.

Chart 6: Labour Share of Income in Malaysia (2010-2017), % of GDP

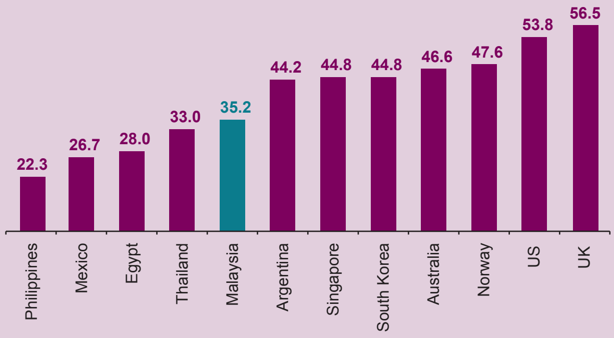
Malaysian labour share of income has risen over the years



Source: Bank Negara Malaysia estimates using data from Department of Statistics, Malaysia

Chart 7: Cross Country Comparison of Labour Income Share (Latest Year Available), % of GDP

Nonetheless, the level of labour income share still lags that of advanced countries



Source: Bank Negara Malaysia estimates using data from Department of Statistics, Malaysia and ILO

Intuitively, the lower share of income accrued to labour may suggest that capital is playing a bigger role in the production process. Accordingly, a lower share of labour income should be associated with a relatively higher level of capital intensity. For example, in a highly capital-intensive industry, capital inputs such as machinery and equipment play a bigger role in the production process and capital owners (rather than workers) should receive a larger share of income generated.

However, this relationship does not hold true for Malaysia. Malaysia's capital intensity is significantly lower than the benchmark economies (Chart 8) signalling that workers play a relatively larger role in the production process in the Malaysian economy compared to benchmark economies. Yet, the labour income share in Malaysia is relatively lower.

A similar trend is observed at the industry level (Chart 9). Most Malaysian industries fall in the bottom-left quadrant characterised by lower capital intensity and lower labour share of income relative to benchmark economies. Notably, labour income shares in the wholesale and retail trade, food and beverage as well as accommodation industries were only about half of benchmark economies despite capital intensity being far lower at only about 40%. Only two industries fall outside this quadrant. First, the mining sector has a relatively higher capital-intensity. Hence, the lower labour share of income of 7% is to be expected. In contrast, the construction sector is characterised by higher labour-intensity, and thus correspondingly exhibits a higher labour share of income (73%).

[12] The labour share of income is derived from the GDP by Income Approach that serves as an essential reference in gauging the economy from the perspective of income provided by factors of production. The labour share of income comprises salaries, wages, allowances, bonuses, commissions, gratuities and payment in kind.

[13] The calculation of the labour share of income is broadly similar to the derivation of the wage to productivity ratio. However, they differ in terms of concept, treatment of varying means of compensation and derivation. While the wage to productivity ratio motivates an assessment of the workers' productivity, the labour share of income addresses an assessment of the distribution of income.

Chart 8: Capital Intensity (USD `000 PPP per worker) vs. Labour Income Share (% of GDP) in 2017

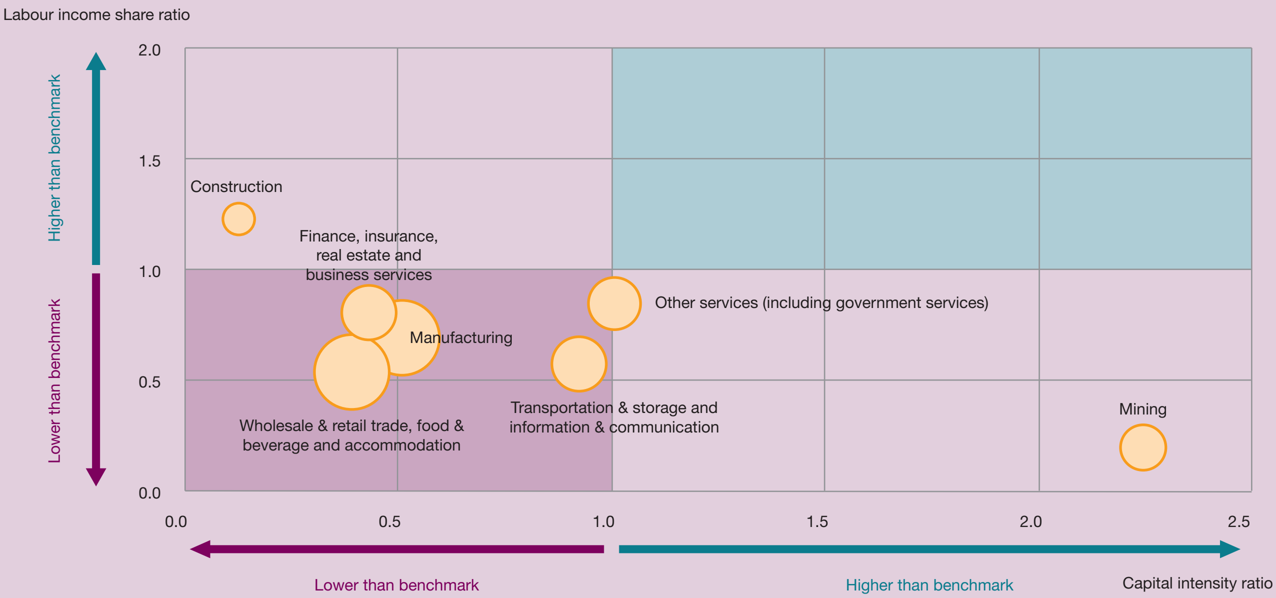
Despite being less capital intensive (more labour intensive), Malaysian labour share of income is lower

Note: 1. Capital intensity is measured by the ratio of net capital stock per employed person
2. The benchmark economies here consist of the US, UK, Australia, Germany and Singapore

Source: Bank Negara Malaysia estimates using data from the Capital Stock Statistics, Gross Domestic Product by Income Approach and the Labour Force Survey Report published by Department of Statistics, Malaysia, national accounts of respective countries and ILO

Chart 9: Malaysia's Sectoral Labour Share of Income and Capital Intensity to Benchmark Ratio in 2017

Most Malaysian industries have lower capital intensity (higher labour intensity) and lower labour income shares



Note: Size of the circles represent the share of respective sectors in overall economic activity (share of total GDP). The benchmark economies consist of the US, UK, Australia, Germany and Singapore

Source: Bank Negara Malaysia estimates using data from the Capital Stock Statistics, Gross Domestic Product by Income Approach and the Labour Force Survey Report published by Department of Statistics, Malaysia, national accounts of respective countries and ILO

D. Labour Income Developments in Malaysia

The article has thus far largely focused on establishing the relationship between Malaysian wages, productivity and equity vis-à-vis selected benchmark economies. This section seeks to analyse two trends observed in the Malaysian labour market in recent years.

I. The Rising Labour Income Share: Driven by Disquieting Factors?

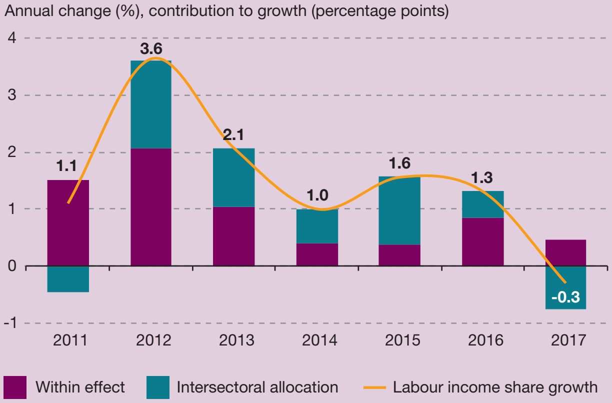
Overall, Malaysia's labour income share has been on an upward trend. While this is a positive step in ensuring better income distribution, it masks some unsettling developments. A shift-share analysis[14] reveals that 36% of the improvements in Malaysia's labour income share between 2010 and 2017 was driven by the reallocation of economic activity into more labour-intensive sectors rather than gains in labour income share within each sector[15] (Chart 10).

Specifically, between 2010 and 2017, the share of income accounted for by low- and mid- skilled workers has increased[16] (Chart 11) due to stronger expansion and employment growth in the wholesale and retail trade, food, beverage and accommodation as well as construction industries. While faster growth in these labour-intensive industries has contributed towards improvements in the headline labour income share, these industries continue to provide lower wages (Chart 12), negating ongoing efforts to achieve the "high-income nation" status.

This development highlights that higher labour income share does not necessarily imply higher incomes for workers. Therefore, it is critical that the Eleventh Malaysia Plan target for a labour income share of 38% by 2020 be achieved through higher wages instead of the creation of more low paid, labour-intensive jobs. This would require a transition away from its labour-intensive structure through increased capital-[17] and knowledge-based investments that will result in a much needed demand for highly educated and skilled workers who can command high wages.

Chart 10: Sectoral Shift-Share Analysis on Labour Income Share Growth (2011 – 2017)

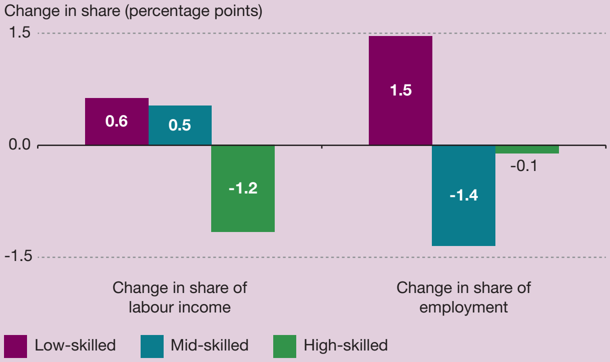
Movement of workers into more labour-intensive industries drove growth in labour income share



Source: Bank Negara Malaysia estimates using data from Gross Domestic Product Income Approach published by Department of Statistics, Malaysia

Chart 11: Changes in Share of Employees Compensation and Employment by Skill-Level (2010 – 2017)

Larger share of labour income accounted by low- and mid-skilled workers



Source: Bank Negara Malaysia estimates using data from Gross Domestic Product Income Approach, Labour Force Survey Report and Salaries and Wages Survey Report published by Department of Statistics, Malaysia

14 The rise in labour income share is analysed to disaggregate the impact of inherent labour share gains within each sector (known as 'within effect') and the movement of economic activity (and presumably employment) across sectors (known as 'intersectoral allocation').

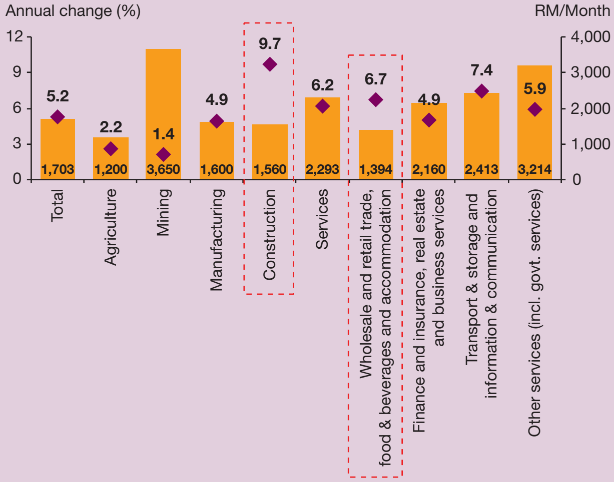
15 This corroborates with findings from "What Explains the Increase in Labour Income Share in Malaysia?" published by Khazanah Research Institute in 2017.

16 Despite the rise in share of low- and mid-skilled workers since 2010, it was partially offset by a decline in share of both low- and mid-skilled workers since 2016.

17 While this may reduce the labour income share in the short run due to the higher capital intensity, it will lead to higher-skilled occupations and higher per capita income levels in the longer run.

Chart 12: Sectoral GDP Growth and Median Wage Levels (2011 – 2017)

The construction and wholesale retail trade, food and beverage and accommodation industries expanded faster than most other sectors. However, they provide workers with lower wage levels



Share of Total GDP (%)

100.0	8.2	8.4	23.0	4.6	54.5	18.0	11.2	9.6	15.6

Median wages (RHS) ◆ GDP growth

Note: Data for median wage levels are as at 2016 as Malaysia's 2017 salaries and wage data only represents citizens (instead of both citizens and non-citizens as per previous years)

Source: Bank Negara Malaysia estimates using data from National Accounts Gross Domestic Product by Economic Activity, Salaries and Wages Survey Report published by Department of Statistics, Malaysia

II. Rising Share of Graduates in the Workforce: Is the Education Premium Narrowing?

Over the past decades, there have been concerted efforts to raise the quality and skills of the nation's workforce. The proportion of graduates[18] in the labour force increased from 23.5% in 2010 to 28.3% in 2017 (Chart 13), a level comparable to a number of developed economies. However, a salary survey published by the Malaysian Employers Federation suggests that nominal starting salaries for graduates remain at modest levels. In fact, after adjusting for inflation, real starting monthly salaries for most fresh graduates has declined since 2010. A fresh graduate with a diploma earned a real salary of only RM1,376 in 2018 (2010: RM1,458) while a Masters degree holder earned a real salary of RM2,707, a significant decline from RM2,923 in 2010 (Chart 14).

Evidence suggests that the lack of high-skilled job creation could have played an integral role in this. Between 2010 and 2017, the number of diploma and degree holders in the labour force increased by an average of 173,457 persons per annum, much higher than the net employment gains in high-skilled jobs of 98,514 persons per annum.[19] This suggests that the economy has not created sufficient high-skilled jobs to absorb the number of graduates entering the labour force. In addition, a study by Khazanah Research Institute also found that 95% of young workers in unskilled jobs and 50% of those in low-skilled manual jobs are over-qualified for these occupations.[20]

[18] Graduates refer to diploma and degree holders derived from the variable 'highest certificate obtained' within the Labour Force Survey published by the Department of Statistics, Malaysia.

[19] Net employment gains are estimated as changes in the number of high-skilled persons employed as reported in the Labour Force Survey (LFS) published by the Department of Statistics, Malaysia. While job creation data are available in the Quarterly Employment Statistics (QES), the LFS data are utilised instead due to availability of longer time series and to allow for comparability with the graduate statistics which are also derived from the LFS.

[20] The School-to-Work Transition of Young Malaysians published by Khazanah Research Institute (2018).

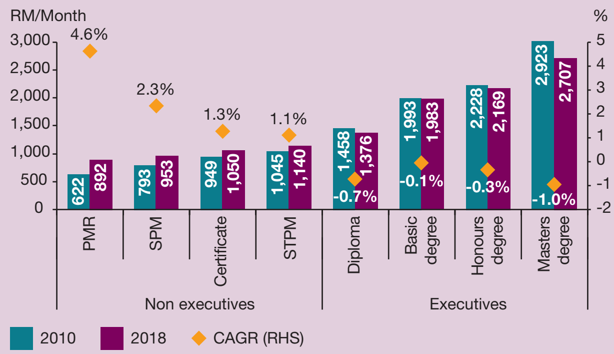
Chart 13: Labour Force with Tertiary Education (2010 – 2017)

Number of graduates in the Malaysian labour force continue to increase

Source: Bank Negara Malaysia estimates using data from Labour Force Survey Report published by Department of Statistics, Malaysia

Chart 14: Real Minimum Monthly Basic Salary for Employees Recruited Without Prior Working Experience (2010 and 2018)

However, real starting salaries for graduates have declined



Source: Bank Negara Malaysia estimates using data from MEF Salary Survey for Non Executives and Executives 2010 and 2018 published by Malaysian Employers Federation

Thus, despite obtaining a high level of education, employees had to settle for jobs that typically do not require such education levels. Consequently, with an ample supply of graduates and limited demand for them by firms, graduate salaries have faced downward pressures.

Interestingly, this is in stark contrast to their peers without a tertiary education. The implementation of the minimum wage has supported increases in the salaries of lower-skilled workers in recent years, allowing for starting salaries for those at the bottom-end of the education attainment spectrum to catch up. While starting salaries of graduates have declined in real terms, the real starting salaries of PMR and SPM educated employees have risen by 4.6% and 2.3% respectively (Chart 14). This divergence in growth trends across education levels alludes to a more serious phenomenon – the income premium for education has narrowed in Malaysia. If left unaddressed, this could reduce the incentive for the younger population to pursue higher levels of education and potentially exacerbate the “brain drain” issue in Malaysia.

E. Enhancing Policy Potency and Efficacy

Malaysia has made significant progress in transforming the economy from that of a low-income agrarian country to an upper-middle-income country. Significant reduction in poverty was achieved while big strides were made in improving living standards across the population.

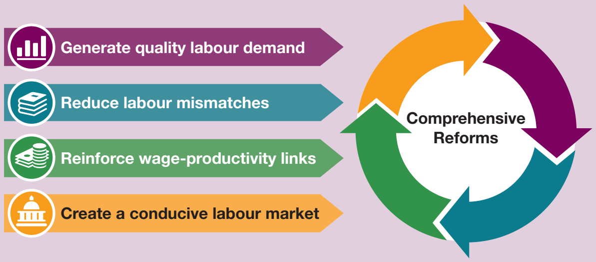
Notwithstanding these achievements, more can be done to build on the progress made to ensure sustainable increases in income. This entails generating quality labour demand, reducing labour mismatches, reinforcing wage-productivity links and creating a conducive labour market through regulatory and legislative interventions (Diagram 1).

First, there is an urgent need to generate higher demand for quality labour through the creation of high-skilled jobs. In this regard, it is vital to attract new quality investments from both foreign and domestic firms, pivoting away from the low-cost business model. Among existing firms, this can be generated through automation and moving up the value-chain, with higher reliance on knowledge and technology. Doing so requires coherent investment policies, which likely involves reviewing and enhancing existing investment incentives.

The Government has recognised the need to enhance the investment incentives framework to attract quality investments and spur automation. However, most incentives are largely confined to the manufacturing and manufacturing-related services industries. Importantly, given the overall significance of the services sector to

Diagram 1: Labour Market Reforms to Raise Incomes

Comprehensive labour market reforms necessary to raise incomes



the economy,[21] the coverage should be extended into new modern services. Amid rising labour costs and the high proportion of low-skilled positions in the services sector (20%; total economy: 13%), targeted investment policies can transform the services sector into a knowledge-led and technology-driven industry. Policy considerations should also involve a critical review of incentive instruments.[22]

Second, it is critical to reduce clear mismatches between labour demand and supply. Policies could include reducing labour recruitment costs and skill mismatches, as well as increasing the employability of the incoming and existing workforce. The proposed addition of one-stop job centres at Urban Transformation Centres (UTCs) and Rural Transformation Centres (RTCs)[23] is a welcome development and could be further supported by linking them with existing career services in higher education institutions.

Greater collaborations between the industry and educational institutions have proven successful in easing the transition of students into the workforce. Models similar to the Collaborative Research in Engineering, Science and Technology (CREST) in Penang could be emulated for other sectors throughout the nation. Concerted efforts should also be channelled towards upskilling and reskilling initiatives for the existing workforce. The Human Resources Development Fund (HRDF) should expand its coverage of sectors and through more targeted use of the funds to address critical skills gaps. Studies have also shown that 74% of Malaysian firms do not allocate internal funds for education and training of staff.[24] There is a need for employer organisations, trade unions and respective chambers of commerce to urge, nudge and persuade businesses to invest more in enhancing the capacities and capabilities of their workforce.

Third, the relationship between wage and productivity must be reinforced to ensure that workers' wages are commensurate with their respective productivity levels and growth. While this has been advocated by the Productivity Linked Wage System (PLWS) since 1996, its outreach remains suboptimal (Chart 15), hampered by the lack of legislative power, low transparency on the part of employers and resistance by trade unions.[25]

Going forward, several key initiatives can strengthen the role of PLWS. These include strengthening its legislative and enforcement capabilities, actively publicising successful case studies and promoting PLWS among Government-Linked Corporations (GLCs), including their suppliers and vendors. Components of PLWS could also include mandatory disclosure of factors underpinning employees' compensation and increment, allowing for more open and direct discourse on compensation packages.

[21] The services sector accounted for 55% of economic activity (GDP) and 62% of total employment in 2017.
[22] Rethinking Investment Incentives, 3Q 2017 BNM Quarterly Bulletin.
[23] This was outlined in the Mid-Term Review of the Eleventh Malaysia Plan.
[24] The School-to-Work Transition of Young Malaysians published by Khazanah Research Institute (2018).
[25] The resistance could stem from the uncertainty in income prospects, once wages are linked with productivity. Based on news flows, trade unions want contractual bonuses and annual increments in collective agreements to remain the same. Source: http://www.mef.org.my/news/mefitn_article.aspx?ID=160&article=nst070321a [Accessed 14 February 2019].

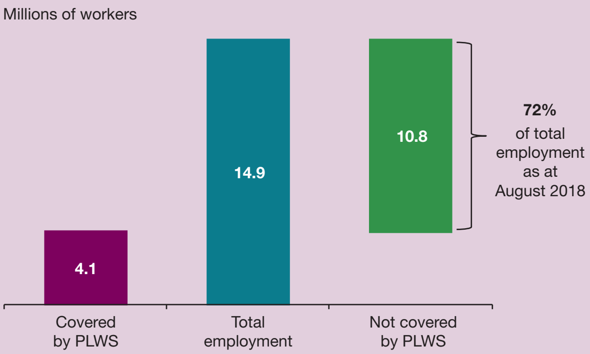
Beyond PLWS, the link between productivity and wages could be enhanced through closer collaboration between the National Productivity Council (NPC)[26] and the National Wage Consultative Council, with the mandate to strengthen the link between productivity and wages in Malaysia, in both level and growth terms. There is also scope to further engage small and medium enterprises (SMEs) on micro-level productivity enhancements, involving changes to work processes and automation. Leveraging on the WayUp portal and the ezBE Assessment Tool developed by the Malaysia Productivity Corporation, more relatable measures of productivity could be introduced to improve outreach and encourage the adoption of accessible productivity enhancement approaches among SMEs (e.g. number of plates washed by staff per hour).

Lastly, a concerted effort is necessary to advance regulatory and legislative labour reforms. There remains ample room to promote better treatment of workers. This may include the freedom of association and elimination of forced labour and discrimination. Some key labour market legislations in Malaysia have yet to undergo comprehensive review in recent decades. For instance, the Industrial Relations Act was first enacted in 1967 and last revised in 1976. The on-going effort by the Ministry of Human Resources to review nine labour-related acts[27] is timely.

The growing sharing economy, the advent of technologies and increasing demand for flexible working arrangements are transforming the intrinsic nature of Malaysia's labour market. Own-account workers[28] in urban areas as a share of total employment rose from 10.9% in 2010 to 15.4% in 2017 (Chart 16). Public discourse and legislative action are necessary to ensure that all types of workers are accorded the protection they deserve. For example, the United Kingdom, New Zealand and Singapore have already launched formal reviews into their existing legal structures to accord self-employed workers greater protection. In Malaysia, the passing of the Self Employment Social Security Act in 2017 was a right step forward and should be expanded to other self-employment sectors, beyond taxi drivers and e-hailing service providers.

Chart 15: PLWS Coverage Gap (as at August 2018)

Large proportion of workers in Malaysia still not covered by PLWS



Source: Bank Negara Malaysia estimates using data from the Ministry of Human Resources* and the Labour Force Survey Report published by Department of Statistics, Malaysia

* The Edge Markets. 2018. Productivity Linked Wage System to lure overseas-based skilled Malaysians. Available at: http://www.theedgemarkets.com/article/productivity-linked-wage-system-lure-overseasbased-skilled-malaysians. [Accessed 22 December 2018].

Chart 16: Share of Own Account Workers in Urban Areas (% of total employment)

Share of own-account workers have risen in urban areas

Source: Bank Negara Malaysia estimates using data from Labour Force Survey Report published by Department of Statistics, Malaysia

[26] In its current iteration, the main mandate of the NPC is to provide leadership, set the strategic direction and drive the national productivity agenda – this includes the implementation of initiatives proposed in the Malaysia Productivity Blueprint. However, its mandate is limited to advancing initiatives to raise national productivity, rather than linking it with wages.

[27] The nine acts refer to the *Employment Act 1955 (amended 2012), Sabah Labour Ordinance 1950, Sarawak Labour Ordinance 1952, Industrial Relations Act 1967 (revised 1976), Trade Unions Act 1959 (amended 2008), Children and Young Persons Act (Employment) Act 1966 (amended 2011), Occupational Safety & Health Act 1994, Workers' Minimum Standards of Housing & Amenities Act 1990*, and *Private Employment Agencies Act 1981 (amended 2018)*.

[28] Refers to a person operating his own business without employing any paid workers.

Conclusion: Preserving and Enhancing the Welfare of Workers for the Future

In the current environment, income levels in Malaysia remain a highly contentious subject. Workers face significant pressures due to the rise in living costs while firms continue to contend that the level of incomes remains appropriate and reflective of productivity.

This article has highlighted that Malaysian workers receive lower compensations relative to their contribution to national income from productivity and equity perspectives. First, Malaysians are paid a lower wage compared to benchmark countries, even after taking into account productivity differences. Second, Malaysia has a lower labour share of income despite its labour-intensive nature. This suggests workers are not adequately compensated for their contributions.

While employers need to be fairly compensated for their respective factor inputs, the question remains, why is the share of compensation accrued to employers instead of employees higher relative to our aspirational peers? How can Malaysia's taxation and distributive policies positively impact and enhance the division of incomes? These are hard questions that require judicious deliberation and committed action.

In totality, while these policy challenges seem daunting, the responsibility of advocating for a more equitable distribution of incomes among all economic agents remains. Over the past decades, the nation has successfully navigated its passage from a factor-driven to an efficiency-driven economy.[29] In its next evolutionary step towards an innovation-driven economy, it is important that the welfare of Malaysia's labour force is well preserved, if not enhanced. This will ensure that workers continue to be properly incentivised to raise their productivity, thus achieving greater value creation in the economy.

References

Bank Negara Malaysia (2017). "Rethinking Investment Incentives". Box article in 3Q 2017 BNM Quarterly Bulletin. Kuala Lumpur.

Bank Negara Malaysia (2018). "Divergence of Economics Performance and Public Sentiments". Box article in 2Q 2018 BNM Quarterly Bulletin. Kuala Lumpur.

Bank Negara Malaysia (2018). "The Living Wage: Beyond Making Ends Meet". Box article in Annual Report 2017. Kuala Lumpur.

International Federation of Robotic (2017). "World Robotics Report 2017". Germany.

Khazanah Research Institute (2018). "The School-to-Work Transition of Young Malaysians". Kuala Lumpur.

Khazanah Research Institute (2017). "What Explains the Increase in Labour Income Share in Malaysia?". Kuala Lumpur.

Malaysian Employers Federation (2010). "MEF Salary Survey for Executives 2010". Kuala Lumpur.

Malaysian Employers Federation (2010). "MEF Salary Survey for Non Executives 2010". Kuala Lumpur.

Malaysian Employers Federation (2018). "MEF Salary Survey for Executives 2018". Kuala Lumpur.

Malaysian Employers Federation (2018). "MEF Salary Survey for Non Executives 2018". Kuala Lumpur.

---

[29] Factor-driven economies are dominated by subsistence agriculture and extraction businesses, reliant on natural resources; Efficiency-driven economies are increasingly competitive, with more efficient production processes and increased product quality. Innovation-driven economies are the most developed. In this phase, businesses are more knowledge-intensive, and the service sector expands. According to the World Economic Forum (WEF), Malaysia is currently transitioning from an efficiency-driven to an innovation-driven economy.

Ministry of Economic Affairs, Malaysia (2018). "Mid-Term Review of the Eleventh Malaysia Plan 2016 - 2020". Putrajaya.

New Straits Times (2007). MTUC 'agreed to productivity wage system in 1996'. Available at: www.mef.org.my/news/mefitn_article.aspx?ID=160&article=nst070321a. [Accessed 14 February 2019].

The Edge Markets (2018). Productivity Linked Wage System to lure overseas-based skilled Malaysians. Available at: http://www.theedgemarkets.com/article/productivity-linked-wage-system-lure-overseasbased-skilled-malaysians. [Accessed 22 December 2018].

Tun Dr. Mahathir Mohamad (1991), "Malaysia: The Way Forward *(Vision 2020)*". Kuala Lumpur.

World Bank (2018). "Malaysian Economic Monitor: Realising Human Potential".

Malaysia's Resilience in Managing External Debt Obligations and the Adequacy of International Reserves

By Ahmad Faisal Rozimi, CFA and Harikumara Sababathy

Introduction

External debt of emerging market economies (EMEs) has risen significantly in the aftermath of the global financial crisis (GFC). This was facilitated by supportive global liquidity conditions (IMF, 2018) driven partly by the highly accommodative monetary policy stance in the advanced economies (AEs). Since 2013, however, more entrenched growth, particularly in the US, has led to monetary policy normalisation and increasingly tighter global financial conditions. These developments have resulted in a re-orientation of global capital flows and depreciation of EMEs' currencies, raising concerns on external financing vulnerabilities of the EMEs.

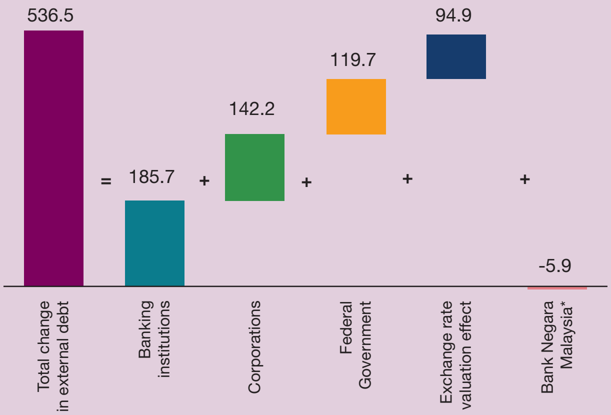
Malaysia has also experienced an increase in external debt. Malaysia's external debt is higher relative to the EMEs[1] median peer countries. This article examines the underlying drivers of Malaysia's external debt and mitigating factors that contain the risks emanating from external shocks. A medium-term projection and stress testing of Malaysia's external debt further underpin the sustainability and robustness of the country's external debt. This article also features an information box on the adequacy of reserves to facilitate international transactions which further strengthens Malaysia's external position.

Malaysia's external debt stood at 64.7% of GDP

Post GFC, Malaysia's external debt has risen from RM388.3 billion or 54.5% of GDP as at end-2009 to RM924.9 billion or 64.7% of GDP as at end-2018. The higher external debt is mostly accounted for by banks, corporations and the Federal Government. In aggregate, these institutions contribute about 83.4% of the rise in external debt (Chart 1). By instrument, the increase in external debt reflects higher non-resident (NR) holdings of domestic debt securities, interbank borrowings, intercompany loans, NR deposits and bonds and notes issued internationally (Chart 2).

Chart 1: Contribution to Total Change in External Debt by Institution from end-2009 to end-2018 (RM billion)

Banks, corporations and the Federal Government account for 83.4% of the rise in external debt

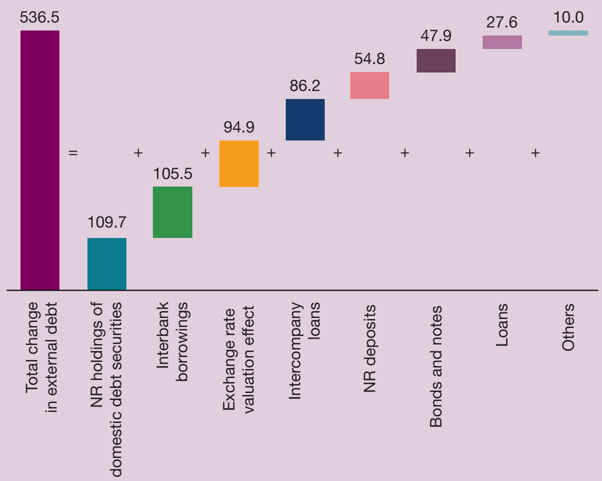


* The decline reflects largely liquidation of NR holdings of Bank Negara Monetary Notes

Source: Bank Negara Malaysia

Chart 2: Contribution to Total Change in External Debt by Instrument from end-2009 to end-2018 (RM billion)

The rise in external debt spreads across debt instruments



Source: Bank Negara Malaysia

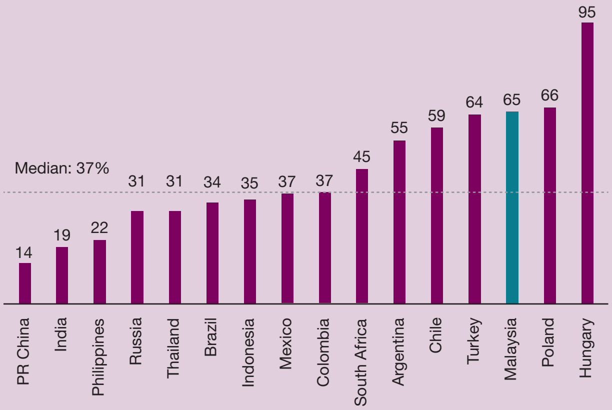
[1] Median of peer countries of Malaysia, i.e. Argentina, Brazil, Chile, Colombia, Hungary, India, Indonesia, Mexico, Philippines, Poland, PR China, Russia, South Africa, Thailand and Turkey. This composition of countries applies throughout this article.

The relatively higher external debt (Chart 3) has attracted focus on Malaysia’s external position. The IMF in its 2018 Article IV Consultation report argues that Malaysia’s external financing vulnerabilities are higher than its median peer countries. Meanwhile, Moody's Investors Service in its 2017 report assesses that a large share of short-term and foreign-currency denominated portion in Malaysia’s total external debt posed rollover and exchange rate risks. These analyses, however, mostly focus on headline external debt figures without further analysing the underlying drivers and mitigating factors against debt-related vulnerabilities.

Malaysia has been able to withstand external shocks considerably well. These include the episodes of large capital outflows triggered by the US Federal Reserve’s Taper Tantrum in 2013, followed by a collapse in commodity export prices towards the end of 2014. Since 2015, the US Federal Reserve has increased its policy rate nine times, equivalent to 225 basis points. In addition, ringgit depreciated by about 50% from RM2.9675 per US dollar in May 2013 to the trough of RM4.4995 per US dollar in January 2017. Despite these shocks, domestic banks and corporations continued to be able to meet their external obligations and to access new borrowings. Underpinned by healthy debt servicing capacity, these entities experienced a relatively small increase in the cost of foreign currency (FCY) borrowings (Chart 4).

Chart 3: External Debt across EMEs (% of GDP)

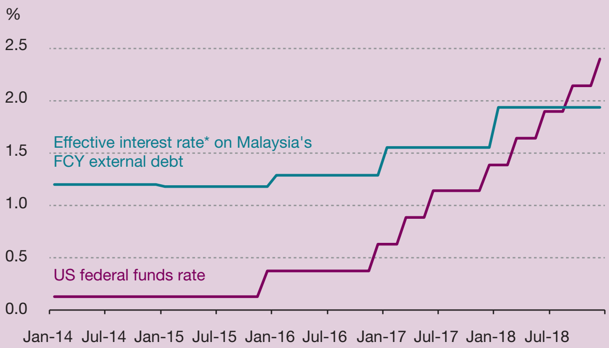
Malaysia's external debt relative to the size of the economy is higher than the EMEs median



Source: Bank Negara Malaysia, the IMF and World Bank

Chart 4: Interest Rate on Malaysia's FCY External Debt and US Federal Funds Rate

Smaller increase in interest rate on Malaysia’s FCY external debt compared to the rise in US interest rate



* Derived from the actual interest payments on FCY external debt divided by the average FCY external debt outstanding during the year

Source: Bank Negara Malaysia and US Federal Reserve Board

Part I: Underlying drivers of Malaysia’s external debt and factors reinforcing resilience against external shocks

This section examines factors driving Malaysia’s external debt by institutions, namely; (A) Banks; (B) Corporations; and (C) The Federal Government. As assessed in the following sections, the nature of Malaysia’s external debt accumulation in itself presents a considerable mitigation against attendant risks.

A. Underlying drivers of banking institutions’ external debt: Large presence of foreign banks in Malaysia and extensive regional footprint of domestic banks

Banks’ external debt[2] is notably higher than that of the emerging Asia Pacific peers[3] (Chart 5).This reflects the sizeable presence of foreign banks in Malaysia (Chart 6), including those operating in the Labuan International Business and Financial Centre (LIBFC) and the sizeable regional operations of domestic banking groups (DBGs) (Chart 7).

[2] Banks' external debt in this context includes external debt of banks in Labuan International Business and Financial Centre.
[3] Refer to all economies in the Asia Pacific region excluding Australia, Hong Kong SAR, Japan, New Zealand and Singapore.

Chart 5: Cross-country Comparison of Banks' External Debt

Banks' external debt, while higher than emerging Asia Pacific peers, is comparable to its rating peers

Note: Data for peer countries as at end-3Q 2018 except for Australia, India, Israel and Thailand, which refer to end-2Q 2018 figures. Banking system rating peers are based on S&P Banking Industry Country Risk Assesment methodology. Malaysia is in group 4 along with Israel, Mexico, Spain, New Zealand, Saudi Arabia, Estonia and Iceland

Source: Bank Negara Malaysia, Haver Analytics, World Bank's Quarterly External Debt Statistics Database and IMF World Economic Outlook

External debt of foreign banks primarily reflects intragroup placements from parent institutions, which render the debt less susceptible to sudden withdrawal shocks

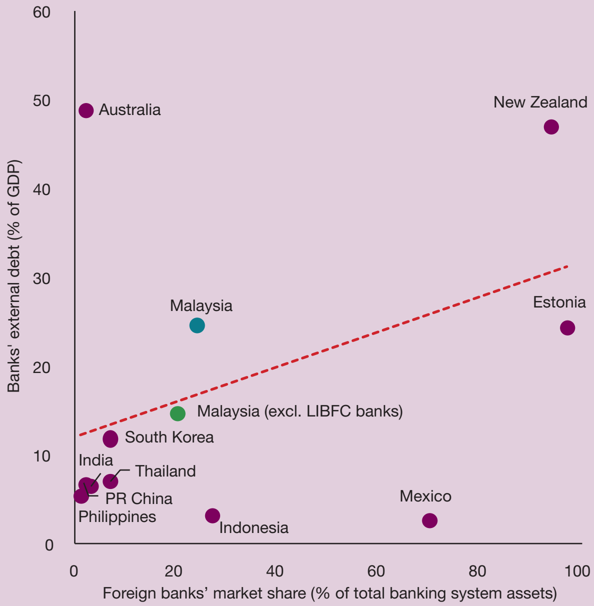
About 41% of banks' external debt is attributable to banks operating in LIBFC, predominantly in the form of intragroup placements from foreign[4] parent banks and regional offices (83% of total LIBFC banks' external debt) (Chart 9). Given LIBFC's position as an international financial centre, banks in LIBFC typically operate as booking centres for transactions arranged and managed by the head office. Funds received by LIBFC banks are substantially lent out to non-resident clients (also known as 'out-out' transactions), which comprise 60% of LIBFC banks' total assets. A sizeable portion of these funds is also placed with related parties in the interbank market. Liquidity, funding and foreign exchange (FX) risks associated with these exposures are assessed to be low as these transactions are 'back-to-back' in nature, i.e. the amount, tenure and currency of the funding received from related entities typically match that of the transaction with the ultimate beneficiary of such funds. Therefore, banks are less susceptible to sudden funding reversals before the associated assets mature and also to potential volatility in the FX market.

Another 20% of banks' external debt is driven by the sizeable presence of locally-incorporated foreign banks (LIFBs) in Malaysia (Chart 9). LIFBs leverage on the stronger credit rating of their internationally-active parent banks to source cheaper and longer-term FCY funding from abroad. Such funds are then utilised primarily in three ways: (i) Manage any immediate liquidity mismatches in the FCY balance sheet; (ii) Extend FCY lending in the domestic interbank market; and/or (iii) Pursue short-term ringgit investments in highly liquid and low credit risk assets such as placements with Bank Negara Malaysia or holdings of Malaysian Government Securities. For smaller LIFBs that serve niche segments or clientele, parent placements serve as an important source of funding. Such banks also operate a 'back-to-back' model, thereby limiting potential risks.

[4] As DBGs are resident entities, their transactions and exposures to affiliates in LIBFC are not deemed as external exposures.

Chart 6: Banks' External Debt and Market Share of Foreign Banks

Size of banking system external debt is generally commensurate with presence of foreign banks



Note: Foreign banks' market share data refers to proportion of total banking sector assets held by foreign banks

Source: Bank Negara Malaysia, Bloomberg, Global Financial Development Database, Haver Analytics and IMF World Economic Outlook

Chart 7: Total Foreign Claims of Domestic Banks (% of GDP)

Domestic banking groups have sizeable overseas presence

Note: Refers to total foreign claims of domestic banks in all currencies. Data for peer countries as at end-3Q 2018

Source: Bank Negara Malaysia, BIS International Banking Statistics, Bloomberg, Haver Analytics and IMF World Economic Outlook

Domestic banking groups with regional operations typically adopt centralised liquidity management, with external borrowings broadly matched with external assets

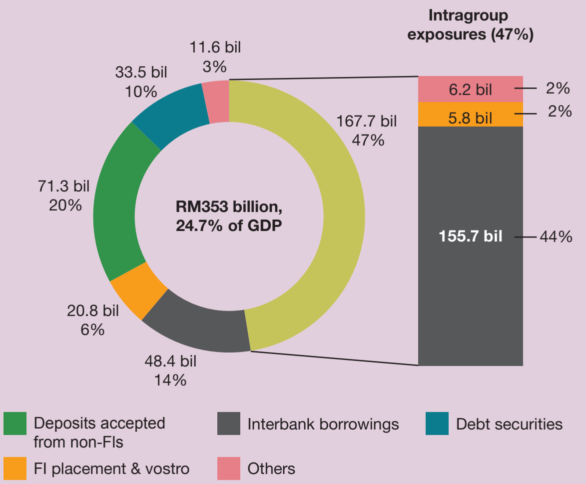
The remaining 39% of banks' external debt is attributable to domestic banking groups (DBGs) (Chart 9), particularly those with extensive regional operations. These DBGs typically adopt centralised liquidity management[5] (CLM) in order to optimise funding cost advantages across various overseas operations within the group. More specifically, excess liquidity from overseas branches and subsidiaries as well as medium- to long-term funding raised in international wholesale and capital markets are pooled at the head office in Malaysia, and strategically channelled back to related offices. The composition of DBGs' external debt reflects such activities, with 53% of the external debt consisting of interbank borrowings and debt securities issuances. In the first half of 2018, several DBGs notably tapped overseas wholesale funding markets to capitalise on more favourable market conditions.[6] DBGs also sought to reinforce FCY liquidity buffers amid rising uncertainties in the domestic and international markets following the 14th Malaysian General Election and uncertainties over the pace of US Federal Reserve's monetary policy normalisation. This led to a significantly higher-than-average growth in banks' external debt for the year (2018: 11.5%; 2014-17 CAGR: 6.0%). These funds were largely placed in the domestic interbank market and in ringgit or FCY short-term investments, with borrowings observed to be broadly matched with assets in terms of amount, currency and tenure, thereby limiting the risks arising from tenure or currency mismatches. As market uncertainties subsided in the later part of 2018, such precautionary borrowings were significantly unwound. This resulted in a decline in DBGs' interbank borrowings by RM15.2 billion or 27%. This trend is expected to continue as market conditions improve further.

[5] For further information on the CLM practices of Malaysian banks, please refer to the information box on page 33 of Bank Negara Malaysia Financial Stability and Payment Systems Report 2017.

[6] The implied cost of raising FCY funds abroad and swapping it into ringgit is cheaper than marginal cost of raising ringgit funds from domestic sources.

Chart 8: Banks' External Debt by Type of Exposure and Instrument (RM billion, % share)

47% of banks' external debt is intragroup exposures which are less susceptible to sudden withdrawal shocks

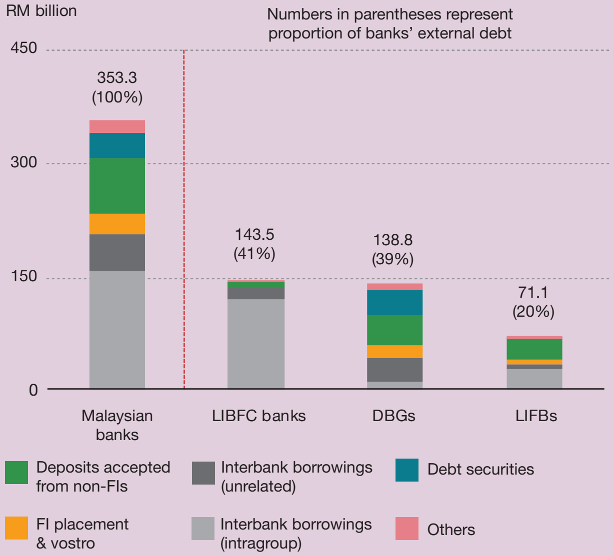


Note: Figures may not necessarily add up due to rounding

Source: Bank Negara Malaysia

Chart 9: Banks' External Debt by Type of Banks and Instruments

41% of banks' external debt is attributable to foreign banks operating in LIBFC



Source: Bank Negara Malaysia

Domestic banking system is self-sufficient in supporting intermediation needs with no undue reliance on external and cross-currency funding

While onshore banks[7] cumulatively account for 59% of banks' total external debt, no signs of undue reliance on external or cross-currency funding are being observed. The domestic banking system continues to be self-sufficient in supporting domestic intermediation needs with financing activities of onshore banks primarily funded by stable sources in the form of non-bank deposits and medium- to long-term funds (Chart 10). Onshore banks' external debt accounts for less than 8% of total domestic banking system funding liabilities, while non-residents account for only 6.1% of total domestic banking system deposits.

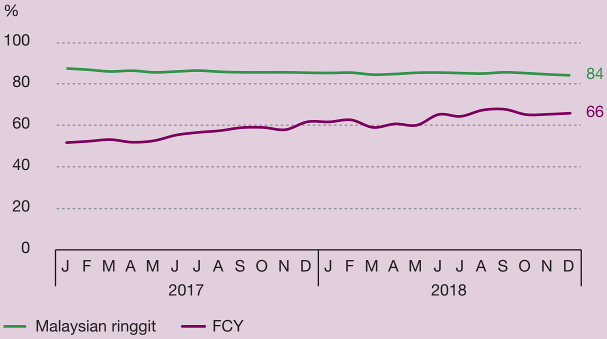
Sound risk management practices mitigate risks associated with external debt

Current macro- and micro-stress tests conducted by Bank Negara Malaysia and individual banking institutions, respectively, also assess the capacity of onshore banks to withstand adverse liquidity and funding shocks, including assessing the adequacy of FCY liquidity buffers. Of note, onshore banks hold substantial FCY liquid asset buffers[8] amounting to RM135.8 billion, bolstering their capacity to mitigate the impact of sudden external funding withdrawal shocks. Such liquid FCY assets are able to cover 54% of total FCY short-term external debt and more than two times the proportion of FCY external debt that is considered more susceptible to sudden withdrawal shocks (also referred to as external 'debt-at-risk'[9]), respectively. This is further supported by banks' risk management practices which include: (i) Prudent internal limits observed for funding and liquidity positions, market risk exposures and mismatch positions; (ii) Minimising open positions through financial derivative hedging instruments; and (iii) Contingency plans in meeting FCY obligations.[10] In line with such practices, onshore banks have maintained relatively low and stable levels of FX net open position across significant currencies (Chart 11).

7 The term 'domestic banking system' and 'onshore banks' shall be used interchangeably in this article, both refer to DBGs and LIFBs.
8 FCY liquid assets comprise cash and cash equivalents, interbank placements and unencumbered debt securities.
9 Banks' external 'debt-at-risk' comprise unstable exposures such as interbank borrowings and short-term loans from unrelated counterparties. As at end-2018, FCY external 'debt-at-risk' amounted to RM64.2 billion or 18.2% of banks' total external debt.
10 For further information on FCY liquidity management practices of banks, refer to Bank Negara Malaysia Financial Stability and Payment Systems Report 2018, Chapter 1: Risk Developments and Assessment of Financial Stability in 2018.

Chart 10: Banking System – Malaysian Ringgit and FCY Loan-to-Fund Ratios

Banks maintain sufficient stable funds to support intermediation activities

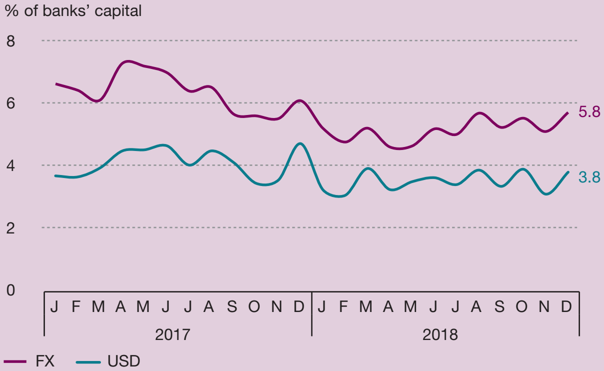


Note: Funds comprise deposits accepted from non-banks and all debt instruments

Source: Bank Negara Malaysia

Chart 11: Banking System - FX and USD Net Open Positions

Overall FX and USD net open positions of banks remain low



Source: Bank Negara Malaysia

B. Underlying drivers of corporate external debt: Significant presence of foreign MNCs

External debt of multinational corporations (MNCs) is predominantly in the form of intercompany loans. These loans are generally on flexible and concessionary terms

As a highly open economy with attractive growth prospects and business-friendly operating environment, Malaysia is the beneficiary of substantial and consistent inflows of foreign direct investment (FDI). Since 2001, growth of FDI stock averaged 10% per annum and the outstanding position stood at 44.1% of GDP as at end-2018. Due to the nature of business strategy and operations, FDI investors, primarily MNCs, rely heavily on their parent companies for funding (Eiteman et al, 1991). Chart 12 corroborates this relationship across a group of selected economies.

Notably, for Malaysia, close to half of corporate external debt is accounted for by MNCs (Chart 13). Three quarters of this debt consists of intercompany borrowings, reflecting extension of financing from parent/affiliate companies overseas to their subsidiaries/affiliates operating in Malaysia (Chart 13). These loans are generally on flexible or no contractual fixed repayment schedules and zero or very low interest rates that are well below the prevailing market interest rates (Bank Negara Malaysia, 2015). Despite the ongoing global financial tightening and rising external interest rate environment, the effective interest rate on Malaysia's FCY intercompany loans has remained very low (Chart 14). These favourable terms largely mitigate the corporates' risk exposure to a sharp rise in interest rates and thereby sustain their debt repayment capability.

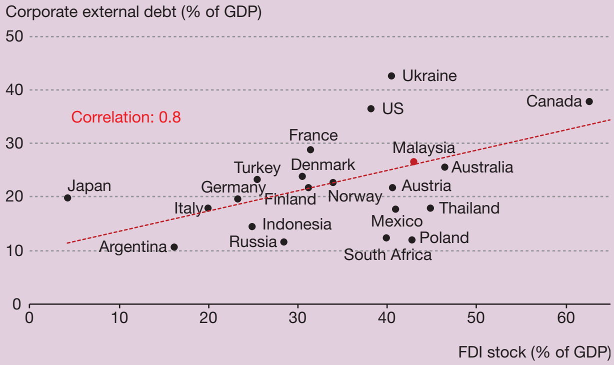
Public corporations account for about one third of the corporate external debt (Chart 13). A significant share of this is held by the national petroleum company which has a solid financial position as affirmed by major international credit rating agencies. A few other public corporations with external borrowings also have FCY earnings that mitigate currency mismatch. Thus, the strong repayment capability of these public corporations attenuates potential risks emanating from their external debt.

More than sufficient FCY earnings and assets to naturally hedge FCY risk of corporate external debt

Exporters account for more than half of corporates with external borrowings (Chart 15). Essentially, with the export proceeds, exporters are naturally hedged. After accounting for imports, net foreign-currency earnings from trade are more than sufficient to meet total corporate FCY external debt servicing obligations (Chart 16), even during periods of large ringgit depreciations. Moreover, Malaysia's diversified export structure across products and markets cushions export earnings against sharp external demand deteriorations. In addition, the sustained current account surplus since 1998 has contributed to the accumulation of RM931 billion of corporations' FCY external assets. This is more than double the corporate FCY external borrowings (Chart 17) thus further reinforcing corporates' repayment capacity.

Chart 12: FDI and Corporate External Debt across Selected Economies

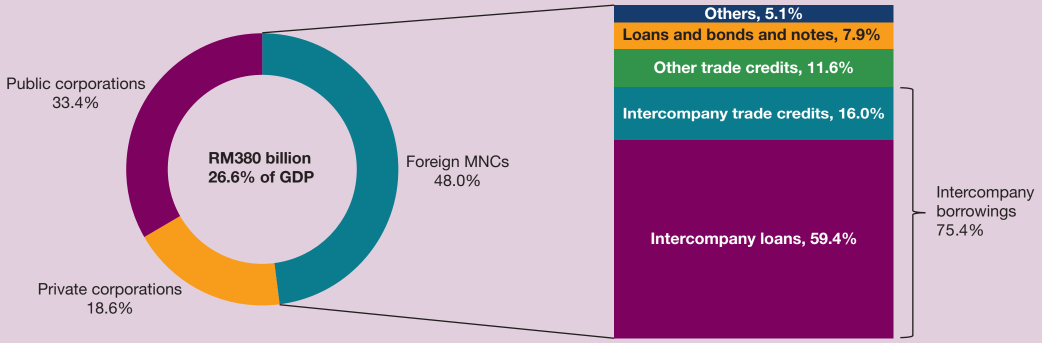
Positive correlation between FDI stock and corporate external debt



Source: Bank Negara Malaysia, World Bank's Quarterly External Debt Statistics Database and United Nations Conference on Trade and Development (UNCTAD)

Chart 13: Profile of Malaysia's Corporate External Debt by Institution (% share)

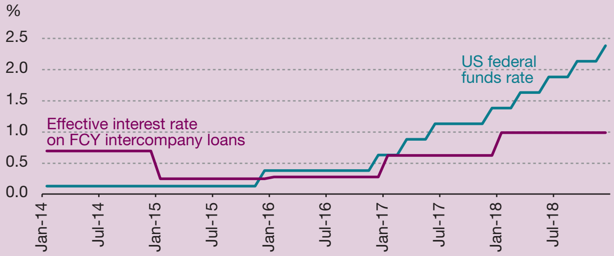
MNCs account for the bulk of Malaysia's corporate external debt



Source: Bank Negara Malaysia

Chart 14: Interest Rate on Malaysia's FCY Intercompany Loans and US Federal Funds Rate

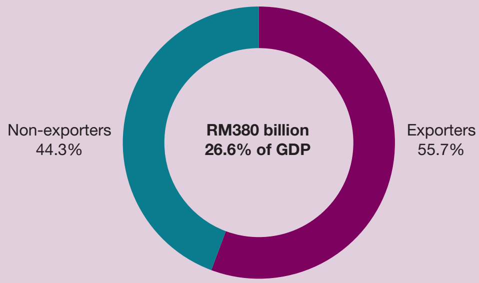
Interest rate on Malaysia's FCY intercompany loans remains very low and stable despite higher US federal funds rate



Source: Bank Negara Malaysia and US Federal Reserve Board

Chart 15: Corporate External Debt in Malaysia by Borrower (% share)

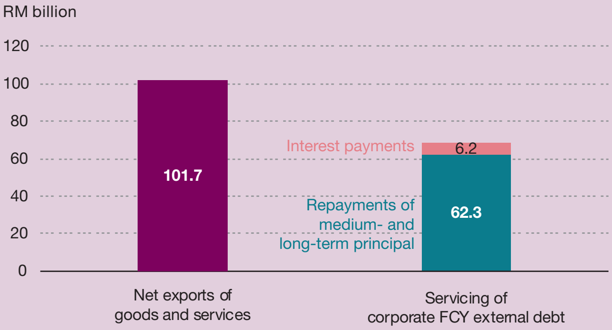
Exporters account for more than half of Malaysia's corporate external debt exposure



Source: Bank Negara Malaysia

Chart 16: Corporate FCY External Debt Servicing and Net Exports

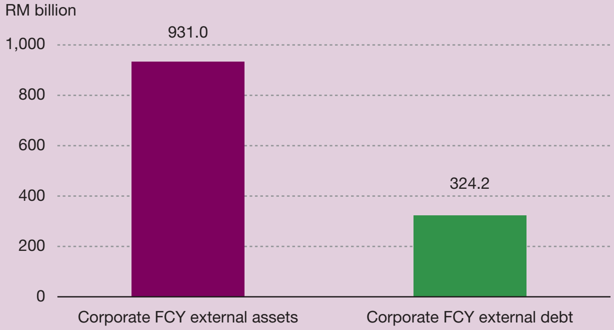
Net exports are sufficient to cover the servicing of corporate FCY external debt



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 17: Corporate FCY External Assets and FCY External Debt

Corporate FCY external assets far exceed its FCY external debt



Source: Bank Negara Malaysia

Prudential safeguards further enhance corporate borrowers' repayment capacity

Malaysia has always maintained a balanced need to ensure adequate prudential safeguards while creating a conducive business environment that enhances the competitiveness and flexibility of the economy. This is clearly outlined in Bank Negara Malaysia's Foreign Exchange Administration (FEA) framework designed to support the country's monetary and financial stability as well as ensuring external sector resilience. In this regard, corporate external borrowings from non-related parties require Bank Negara Malaysia's approval to, among others, ascertain that the debt is supported by FCY earnings or sufficiently hedged and that the borrowings are utilised to finance productive investments. This prudential measure is critical in ensuring that corporate offshore borrowings are self-sustaining and do not pose a material risk to the economy. Of note, the favourable profile of corporate external borrowings as deliberated in the preceding section reflects to some extent the prudent stance of Bank Negara Malaysia. This is corroborated by Bank Negara Malaysia's survey of approved corporate borrowings from 2015 to 2018 which indicates that three quarters of corporate's foreign-currency external borrowings are hedged, either naturally or through financial derivatives. Overall, given these mitigating factors, risks surrounding corporate FCY external debt are largely contained.

C. Underlying driver of ringgit-denominated external debt: Deep and liquid domestic debt market

Malaysia has been highly successful in developing its domestic debt market. In Asia, Malaysia's debt market relative to its economic size is the third largest[11] after Japan and South Korea. The country's deep, liquid and investor-friendly bond market attracts a high level of non-resident participation, primarily in the MGS market. This partly reflects non-resident investors' confidence in the country's economic prospects. Consequently, the share of domestic-currency external borrowings is comparatively high at almost one-third of external debt (Chart 18). This directly reduces the exchange rate mismatch of Malaysia's external debt.

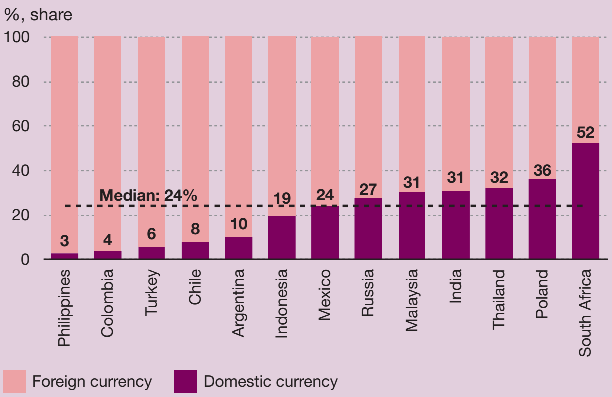
Large and sophisticated domestic institutional investor base attenuates rollover risk

The stability of Malaysia's domestic debt market is observed during episodes of large capital outflows, namely the Taper Tantrum and commodity price shocks in 2013 and 2014-2015, respectively. Between 2015 and 2018 as the US Federal Reserve began normalising its policy rate, the 5-year MGS remained broadly stable (Chart 19). Ample capacity accorded by the large and diverse domestic institutional investor base (Chart 20) facilitated smooth absorption during periods of heightened risk aversion towards EMEs' securities, thus containing rollover risk.

[11] Size of local currency bond market as a % of GDP as at end-3Q 2018 (Malaysia: 96.7%; South Korea: 127.0%; and Japan: 207.6%) (Source: Asia Bond Monitor, Asian Development Bank, November 2018).

Chart 18: External Debt by Currency across EMEs

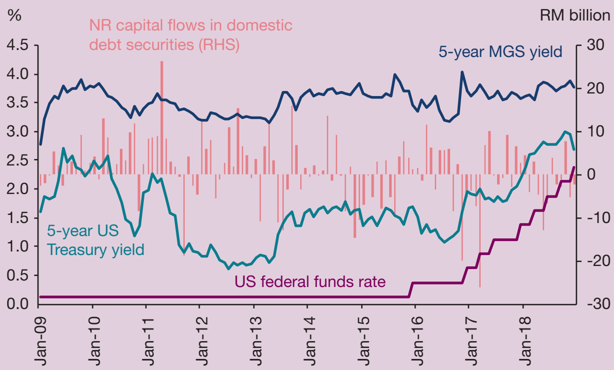
Malaysia has a higher proportion of domestic currency external debt than the EMEs median



Source: Bank Negara Malaysia, World Bank's Quarterly External Debt Statistics Database and Bank Indonesia

Chart 19: US Interest Rate, Malaysia's Debt Market Flows and MGS Yield

Despite higher US interest rate and NR capital outflows in Malaysia's debt market, MGS yield remains steady



Source: Bank Negara Malaysia, US Department of the Treasury and US Federal Reserve Board

Chart 20: Domestic Institutional Investor Base (Asset Size % of GDP as at end-2017) across EMEs

Malaysia's institutional investor base is larger compared to the EMEs Median

Source: IMF's October 2018 Global Financial Stability Report and Bank Negara Malaysia

Part II: Assessing medium-term sustainability of Malaysia's external debt

The preceding sections provide support that given its nature and composition, Malaysia's external debt position remains manageable and resilient to shocks in the near term. Looking ahead, the challenging international financial conditions necessitate a thorough assessment of debt resilience against stronger and more persistent shocks. This section provides an assessment on Malaysia's external debt sustainability and resilience over the medium-term horizon.

Macroeconomic background

The strong macroeconomic fundamentals provide for a firm starting point for the ensuing analysis. Under the baseline, the external debt is projected to be lower over the medium term at 56.2% of GDP by end-2023 (Chart 21), supported by continued current account surplus and sustained economic growth. Despite being narrower, relative to the 10-year historical average (2009-2018), the current account surplus which mirrors the excess savings of the economy, will facilitate the repayment of external debt. Sustained economic performance will contribute to the country's ability to meet its external debt obligations (Table 1). These are more than sufficient to offset the impact of higher global interest rates.

Table 1: Assumptions of the External Debt Projection and Stress Testing

Large and persistent shocks are built in to simulate the external debt stress testing

Variables	2009-2018 average	2019-2023 average	
		Baseline	Shock
Real GDP growth (%)	4.7	4.9	2.5
Non-interest current account[1] (% of GDP)	7.1	3.2	-1.1
Exchange rate (RM per USD)	3.6498	4.1385	4.8617
Interest rate (%)	1.9	3.2	3.9

[1] Current account excluding interest payments to non-residents

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Rigorous stress testing on external debt determinants

The following sections elaborate on a set of simulations on the impact of large and persistent adverse shocks to the determinants of external debt dynamics. This exercise, however, does not take into account mitigating factors and shock absorbers, which will be explored in the subsequent section.

In the first stage of the stress testing, a varying degree of selected shocks are applied to individual variables of external debt determinants while holding other variables constant:

1) **Current account and growth shocks:** A one-standard deviation[12] of negative permanent shock is applied throughout the simulation horizon (Table 2). Under this shock, the current account will turn into deficit for the first time since 1998. Meanwhile, growth is simulated to decelerate sharply to an average of 2.5% over the next five years. Historically, the slowest pace of 5-year average GDP growth of 2.7% was registered between 1998 and 2002, when growth was dragged by the Asian Financial Crisis and the bursting of the dot-com bubble. Based on these considerations, the level of imputed shock is assessed to be rigorous and realistic.
2) **External interest rate shock:** A three-standard deviation magnitude of adverse permanent shock is built in throughout the horizon. Note that a larger shock has to be imputed in the simulation as to contrast against the very low and stable effective external interest rate[13] in the past 10 years. The shock is considered to be considerably exacting given the highly accommodative global monetary policy and structure of Malaysia's external debt which comprises a significant portion of intercompany external debt.

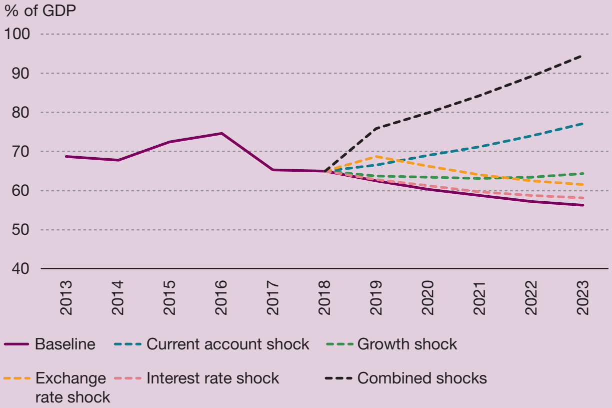
[12] 10-year standard deviation, utilising annual data from 2009 to 2018.
[13] Derived from the actual interest payments on external debt divided by the average external debt outstanding during the year.

3) **Exchange rate shock:** A one-time two-standard deviation of depreciation shock is applied in 2019, resulting in the ringgit to be at its new weakest level of RM4.8617 to the US dollar. Historically, this depreciation shock is quite close in terms of magnitude with the episode of large ringgit depreciation experienced in 2015 following the collapse of commodity prices.

In the second stage of the stress testing, the impact of the combined shocks is simulated.

Chart 21: Projection and Stress Testing of Malaysia's External Debt (2019 – 2023)

External debt (% of GDP) is projected to decline over the medium term



Source: Bank Negara Malaysia

Under large and persistent adverse shocks, external debt will rise above the baseline projection, albeit by varying degrees

Under the first stage of the stress testing, the most significant impact from applying the individual shocks is observed in the case of the current account shock (Chart 21). A deficit in the current account of the balance of payments results in increased external financing requirement, thus higher external debt. Meanwhile, the interest rate shock is found to have a limited impact on external debt. The large exchange rate depreciation in 2019 will increase external debt to 68.6% of GDP, before declining to 61.2% of GDP by end-2023. This decline is driven by continued current account surplus and sustained economic performance which facilitate the repayment of external debt. In the worst case scenario of all the shocks happening simultaneously, the combined shocks result in external debt rising to 94.4% of GDP by the end of the simulation horizon.

Mitigating factors reinforce the resilience of Malaysia's external debt against shocks

The simulation exercise established the various scenarios for the evolution of the country's external debt over the next five years. Importantly, the stress test exercise does not take into account the mitigating factors and in-built stabilisers which would substantially mitigate the risks surrounding Malaysia's external debt (Table 2). Considering these factors, there are two major implications on the sustainability of external debt. Firstly, the external debt will continue to remain manageable given its profile, nature and composition as deliberated in Part I. This includes large banking intragroup placements which are less susceptible to withdrawal shocks, sizeable corporate intercompany loans which are generally on flexible and concessionary terms and a considerable amount of ringgit-denominated external debt. Secondly, Malaysia's external buffers, particularly the value of external assets will rise faster than the increase in external debt. The current account will also improve under the exchange rate depreciation shock. This underscores the role of exchange rate flexibility as the first line of defence against shocks. Given that most of these factors are structural in nature, they will continue to accord Malaysia with resilience against potential shocks, over the medium term.

Table 2: Mitigating Factors and Shock Absorbers Fortifying the Robustness of Malaysia's External Debt

Mitigating factors and shock absorbers accord Malaysia with resilience against potential shocks

Potential Shocks	Mitigating Factors and Shock Absorbers
Exchange rate depreciation	• About one-third of external debt is ringgit denominated, thereby not affected by exchange rate depreciation;
	• Exports, current account and growth to benefit from a ringgit depreciation, thus enhancing debt dynamics; and
	• As a net FCY creditor, the increase in value of FCY external assets will far outweigh the increase in FCY external debt or FCY external liabilities.
Global financial conditions tightening	• More than half of external debt is skewed towards medium- and long-term tenures;
	• Close to half of banks' external debt consists of intragroup exposures which are less susceptible to sudden withdrawal shocks;
	• More than one-third of corporate external debt consists of intercompany loans which are generally on flexible and concessionary terms; and
	• Large domestic institutional investor base has ample capacity and buying interest to absorb the outflows and ensure orderly market conditions.
Domestic and global growth slowdowns	• Diversified economic structure and sources of growth, mitigating sector-specific shocks; and
	• Diversified export sector across products and markets, mitigating product-specific and region-specific shocks.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Information Box: Adequacy of Bank Negara Malaysia's International Reserves

The Bank's international reserves further reinforce the strength of Malaysia's external sector. The primary driver of international reserves is to act as a liquidity buffer in ensuring orderly adjustment in the exchange rate particularly during periods of large and volatile capital flows. With the rise in sophistication of reserve adequacy assessment, conventional indicators including the ratio of reserves to short-term external debt must evolve to take into account other liquidity avenues available.

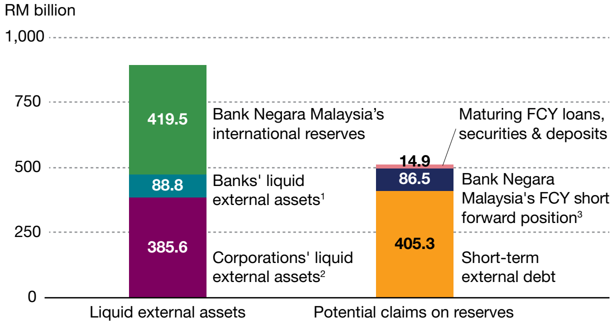
The international reserves are not the primary means in meeting external obligations. The long-standing policy of decentralisation of international reserves has enabled resident banks and corporations to accumulate sizeable external assets which stood at RM1.3 trillion as at end-2018. This is equivalent to about three-quarters of Malaysia's RM1.7 trillion external assets. These assets, particularly the liquid portion, can be drawn upon immediately to meet resident entities' external debt obligations without creating a claim on international reserves. It is important to note that the resident banks and corporations' liquid external assets are more than sufficient to cover the short-term external debt (Chart 1). This further underscores the country's prudent and responsible external debt management which ensures resident entities' external debt is self-sustaining. In addition, the availability of wide ranging financial instruments, including hedging derivatives in domestic market allows the domestic entities to manage their external exposures more effectively, without relying on international reserves.

The potential claims on international reserves are not limited to the short-term external debt. For comprehensiveness, it also includes Bank Negara Malaysia's FCY short position in the forward market and potential short-term net drains of maturing FCY loans, securities and deposits. Even accounting for these potential claims, the total liquid external assets stood at a comfortable level to facilitate international transactions (Chart 1).

While the international reserves provide a buffer to facilitate liquidity needs, a number of bilateral and regional cooperation initiatives stand ready to be called upon to provide additional safety net as and when needed.

Chart 1: Liquid External Assets and Potential Claims on International Reserves

Liquid external assets are 1.8 times higher than potential claims on reserves



[1] Consist of deposits and interbank placements, bonds and notes and money market instruments
[2] Consist of portfolio investments and currency and deposits
[3] Including the forward leg of currency swaps

Source: Bank Negara Malaysia

This includes the bilateral currency swap arrangements with PR China, Japan and South Korea, Chiang Mai Initiative Multilateralisations (CMIM), ASEAN Swap Arrangement and Executives' Meeting of Asia-Pacific Central Banks (EMEAP) repo lines, totalling USD28.4 billion or equivalent to RM117.5 billion.

Conclusion

Although Malaysia's external debt is relatively higher in comparison to the EMEs median peer countries, it is manageable, has proven to be resilient to adverse shocks and is likely to remain so even when the shocks are magnified. This development is driven by the country-centric factors, including the high presence of foreign banks and MNCs, extensive regional network of domestic banks and a highly developed domestic debt market. The nature and profile of Malaysia's external debt accumulation in themselves have accorded natural risk attenuating factors, enabling the economy to absorb large external shocks.

Looking ahead, the sustainable evolution of external debt is important given the more challenging outlook for the global economy and international financial conditions. In this regard, the projection of external debt provides clarity that Malaysia's external debt will remain manageable over the medium term. This prognosis is supported by rigorous stress testing on external debt, which re-affirms the robustness of Malaysia's external debt sustainability under large and persistent adverse shocks.

The international reserves position provides another layer of strength to the external sector position. Importantly, Bank Negara Malaysia's international reserves are not the primary means in meeting external obligations. Resident banks and corporations' liquid external assets are more than sufficient to cover the short-term external debt. These liquid assets can be drawn upon immediately to meet resident entities' external debt obligations without creating a claim on international reserves. Beyond this, the availability of a number of bilateral and regional cooperation initiatives can be called upon to provide additional safety net as and when needed by the country.

In essence, the prudent management of Malaysia's external debt, reinforced by relevant prudential requirements, has accorded Malaysia with considerable resilience to face potential adverse shocks. This assessment on the country's external debt has taken into account the nature and composition of debt as well as the availability of external buffers, and further stress tested against various and more severe external shocks that could hit the economy. While this is reassuring, it is recognised that the nature of the shocks could shift and are highly dynamic. Vigilance, as always, remains paramount.

References

Bank Negara Malaysia (2015). 'Deciphering Short-term External Debt', Bank Negara Malaysia Annual Report.

Bank Negara Malaysia (2018). 'Profile of Malaysia's External Debt', 3Q 2018 Bank Negara Malaysia Quarterly Bulletin.

David Hargreaves and Elizabeth Watson (2011). 'Sudden Stops, External Debt and the Exchange Rate', Reserve Bank of New Zealand: Bulletin, Vol. 74, No. 4.

IMF (2018). 'A Decade After the Global Financial Crisis: Are We Safer?', IMF Global Financial Stability Report, Chapter 1.

IMF (2018). 'Malaysia: 2018 Article IV Consultation', IMF Country Report.

OECD (2017). 'Resilience in a Time of High Debt', OECD Economic Outlook, Volume 2017 Issue 2, Chapter 2.

Monetary and Financial Conditions in 2018

Monetary and Financial Conditions in 2018

INTERNATIONAL MONETARY AND FINANCIAL CONDITIONS

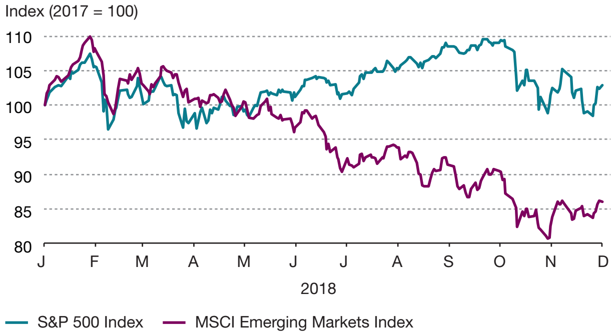
Global financial conditions tightened in 2018 due to global monetary policy normalisation and financial market volatility

Overall global financial conditions tightened in 2018, reflecting the normalisation of global monetary policy and heightened financial market volatility due to ongoing policy and economic uncertainties. Monetary policy in most advanced economies, particularly the US, remained on their normalisation path. Emerging market economies also experienced tighter financial conditions as the monetary policy normalisation in advanced economies led to large portfolio outflows from emerging market financial assets. At the same time, ongoing risk-off developments such as the global trade tensions further contributed to sudden shifts in investor sentiments and episodes of financial market volatility. As funds shifted away from emerging market economies, pockets of vulnerabilities also emerged in some of these economies, which culminated in the currency sell-offs in Argentina and Turkey. A number of central banks in emerging market economies[1] also tightened monetary policy due to concerns on higher inflation arising from the depreciation of their currencies and the earlier increases in commodity prices. As a result of these developments, financial market performances in advanced economies, particularly the US, and emerging market economies diverged during the year. While US equity indices sustained a strong upward trend before reversing in the fourth quarter, equity markets in emerging market economies declined for the most part of the year. The US dollar also strengthened against most other currencies during the year, while emerging market currencies faced sharp depreciation pressures. Global bond yields, however, trended upwards across both advanced economies and emerging market economies.

[1] In the second half of 2018, central banks in Argentina, Chile, India, Indonesia, Mexico, the Philippines, Russia, South Africa, Thailand and Turkey raised their policy rates.

Chart 2.1: S&P 500 Index and MSCI Emerging Markets Index*

Equity markets performance in the US and emerging market economies diverged during the year



* A benchmark index compiled by MSCI which tracks the equity market performance of 24 emerging market economies weighted by their respective market capitalisation

Source: Bloomberg

Global financial markets began the year with a continuation of the upward momentum, as investor optimism remained buoyed by expectations of sustained global economic expansion following the strong economic performance in 2017. Global equity markets experienced a strong rally in January, with the S&P 500 Index and Morgan Stanley Capital International Emerging Markets (MSCI EM) Index increasing by 5.6% and 8.3%, respectively. At the same time, bond yields in the advanced economies trended higher as investors began to price in expectations of tighter monetary policy. The higher investor risk appetite, however, proved to be temporary as concerns on tightening global financial conditions began to outweigh the positive economic outlook.

The ongoing monetary policy normalisation in the advanced economies was a key contributing factor towards tighter global financial conditions, both in terms of the shifting market expectations on the pace of US Federal Reserve (Fed) interest rate increases and the actual outcome of monetary policy adjustments. In February, the releases of strong US wage and employment data[2] led to market expectations for a faster pace of interest rate hikes, which spurred a temporary sharp decline in investors' risk appetite in global equity markets. As the Chicago Board Options Exchange Volatility Index (VIX) spiked, an unwinding of "short-volatility" derivatives positions[3] led to a technical correction in US equity indices which spilled over into other equity markets. Investor sentiments subsequently eased following the Fed's affirmation that monetary policy normalisation would continue at a gradual pace. As the US economy continued to improve, the Fed raised the target range for the federal funds rate four times during the year, beginning in March. Central banks in other advanced economies[4] continued on a more moderate normalisation path, which helped to partially offset the effects of the Fed tightening on global financial conditions.[5]

The confluence of strong US economic conditions and narrowing interest rate differentials subsequently led to a rebalancing of funds away from emerging market economies towards US dollar assets. During the second quarter, emerging market economies experienced large portfolio outflows amounting to USD10.3 billion[6] and the US dollar strengthened against most currencies.[7] Despite the higher demand for US financial assets, yields on US Treasuries remained on an upward trend, driven by continued market expectations of tighter monetary policy. The 10-year US Treasury yield breached the key resistance level of 3.0% several times during the year, and recorded a peak of 3.2% in November, its highest level since 2011. The continued signaling of further rate increases by the Fed contributed to repricing of US financial assets in October, which led to broad-based declines in global equity markets, as reflected by the 8.8% decline in the MSCI EM Index during the month.

Towards the end of the year, divergence between market expectations and the Fed's communicated trajectory on the pace of US monetary policy normalisation contributed to higher financial market volatility. The Fed's decision to increase interest rates in December, despite moderating US growth prospects, resulted in a sell-off in US equities, with the S&P 500 Index declining by 9.2% during the month. The 10-year US Treasury yield, however, declined to 2.7% reflecting

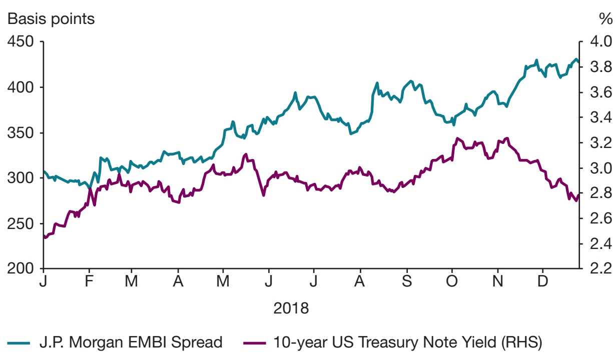
Chart 2.2: US Dollar Index

US dollar remained on an appreciating trend throughout 2018

Source: Bloomberg

Chart 2.3: J.P. Morgan Emerging Market Bond Index (EMBI) Spread* and 10-year US Treasury Note Yield

Global bond yields trended upwards reflecting tighter financial conditions



* The spread refers to the difference in yields between US dollar-denominated emerging market sovereign bonds and US Treasury notes

Source: Bloomberg

[2] Growth in US nonfarm payrolls beat expectations at 200,000 in January 2018 (Analysts' forecast: 180,000), while average US hourly earnings increased by 2.9% on an annual basis, the strongest growth since 2009.

[3] Short VIX contracts (also known as Inverse VIX contracts) are derivatives contracts that gain value when volatility remains low and lose value as volatility spikes. On 5 February 2018, the sharp increase in the VIX caused large losses to holders of these contracts. To hedge this short position, investors rapidly sold US equities, which resulted in the sharp decline in US equity indices.

[4] During the year, the Bank of England (BOE) raised its policy rate by 25 basis points and the European Central Bank (ECB) gradually tapered down its large-scale asset purchase programme. The Bank of Japan (BOJ), however, continued on its negative interest rate policy and expanded its monetary stimulus programme during the year.

[5] Source: BIS Annual Economic Report 2018.

[6] Source: EPFR Global.

[7] The US Dollar Index, a measure of the value of the US dollar against a basket of US major trading partners' currencies, increased by 5.0% during this period.

the shift in sentiments as investors began pricing in a higher probability for a pause to further US monetary policy normalisation following the Fed's lower growth and inflation forecast for 2019.

In addition to the ongoing US monetary policy normalisation, the heightened trade tensions further amplified risk aversion towards emerging market financial assets. The introduction of protectionist policies by a number of major economies[8] was a key concern in global financial markets as investors expected the disruptions to global value chains to weigh on global growth prospects. The tariffs already implemented, along with the corresponding retaliatory measures, were estimated to result in a reduction in annual global growth by 0.3 percentage points, with a large portion of the impact to manifest in 2019.[9]

Amid concerns on moderating global growth, investors also began to place increased scrutiny on country-specific vulnerabilities within emerging market economies. A key concern was the sustainability of their US dollar-denominated debt. As a result, several emerging market economies with perceived vulnerabilities experienced sharp sell-offs of financial assets, which generated vicious cycles of portfolio outflows and exchange rate depreciation pressures. In August, the Argentine peso experienced a sharp depreciation of 26% against the US dollar as concerns on the country's growing current account deficit, high inflation and large US dollar-denominated debt resulted in non-resident outflows. The Turkish lira also experienced a sell-off, depreciating by 25% against the US dollar in August due to similar concerns, which were further exacerbated by geopolitical tensions and sanctions imposed by the US. These episodes of currency sell-offs led to growing concerns on potential contagion risks among other vulnerable emerging market economies. Regional economies with twin deficits, such as India and Indonesia, were particularly affected and experienced sharp declines in their respective currencies and equity indices. As a result, some central banks in emerging market economies tightened monetary policy to address the impact of currency depreciation and earlier oil price increases on inflation prospects.[10] For the year as whole, the MSCI EM Index declined by 16.6% and the J.P. Morgan Emerging Markets Bond Index spread widened by 123.6 basis points.

Going forward, global financial markets will continue to face bouts of volatility, as many of the uncertainties that contributed to past episodes of volatility remain as potential risk factors in 2019. The materialisation of these downside risks could lead to a tightening of financial conditions globally, with implications on growth prospects. Firstly, moderating global growth conditions have led to diverging expectations on the trajectory of Fed interest rate hikes[11] and increases the risks of disorderly financial market adjustments in response to potential policy surprises. Second, the ongoing trade tensions between the US and PR China will likely come into focus again following the end of a 90-day trade truce agreed upon at the 2018 G20 Summit.[12] Escalation of tariff actions could cause further weakening in global growth prospects. Third, political developments in 2019 such as Brexit could lead to episodes of heightened volatility. Fourth, higher volatility in global crude oil prices could cast uncertainties in financial markets, particularly for commodity-exporting economies. For emerging market economies, the attractive valuations following the portfolio outflows in 2018 could support a reallocation of flows back into the asset class. This, however, could be limited by continued risk aversion amid tightening financial conditions and moderating macroeconomic conditions.

DOMESTIC MONETARY AND FINANCIAL CONDITIONS

Domestic financial markets were affected by shifts in non-resident portfolio flows, driven mainly by external developments

Amid the developments in global financial markets, the domestic financial markets experienced shifts in non-resident portfolio flows, largely reflecting changes in investor sentiments and risk appetite throughout the year. The trends observed in domestic financial markets

[8] On 1 March 2018, the Trump administration announced a 25% tariff on steel and a 10% tariff on aluminium imports. Since then, additional tariffs were levied on USD250 billion worth of Chinese goods. Following these measures, several US trading partners responded with retaliatory tariffs, including PR China, which has applied tariffs on USD110 billion of US imports.

[9] The impact of trade tensions to global growth in 2018 and 2019 was estimated as -0.02 and -0.26 percentage points, respectively. Source: BNM Quarterly Bulletin, Third Quarter 2018.

[10] Source: IMF World Economic Outlook, January 2019.

[11] As at January 2019, the Federal Open Market Committee (FOMC) Dot Plot projected that the Fed will raise the target range for the federal funds rate two times in 2019, whereas the Federal Funds Futures market priced in no policy rate changes for the year.

[12] On 1 December 2018, the US and PR China agreed on a temporary 90-day truce with the intention of de-escalating the trade tensions, which ended on 1 March 2019. During this period, the US and PR China agreed not to increase or introduce new tariffs while the two countries negotiate on a new deal.

were largely in line with most regional financial markets, driven mainly by external developments. Domestic policy uncertainties also affected investor sentiments following the results of the 14th General Election. For 2018 as a whole, non-resident outflows from the bond and equity markets amounted to USD5.5 billion and USD2.9 billion, respectively. As a result, the ringgit depreciated by 1.8% to end the year at RM4.1385 against the US dollar. The benchmark Malaysian Government Securities (MGS) yield curve shifted upwards, reflecting an increase in bond yields across all maturities. The 3-year, 5-year and 10-year MGS yields increased by 29, 22 and 17 basis points, respectively. The FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) declined by 5.9% (2017: 9.4%) to close at 1,690.6 points.

Developments in the domestic financial markets can be delineated into two distinct phases. In the first quarter, global financial markets continued their strong momentum from 2017 and investor sentiments remained buoyed by the positive economic outlook in emerging market economies. This led to broad-based non-resident portfolio flows into the region, including Malaysia. As a result, the demand for ringgit investment assets provided support to the ringgit exchange rate, as well as domestic bond and equity prices. However, this trend reversed from the second quarter onwards as global uncertainties, particularly related to US monetary policy normalisation, escalating global trade tensions and contagion risks from vulnerable emerging market economies, began to weigh on investor sentiments.

In the first quarter of the year, Malaysia's bond and equity markets experienced non-resident inflows amounting to USD0.9 billion and USD0.6 billion, respectively, as investors maintained a favourable outlook on emerging market economies, including Malaysia. This was amid continued optimism on global growth and market expectations for a gradual pace of monetary policy normalisation in the US. Investor sentiments were also buoyed by the strong domestic economic performance and growth prospects.[13] Following this, the ringgit appreciated by 5.2% against the US dollar in the first quarter, with the ringgit reaching an annual high of RM3.8580 per US dollar at end-March. In the bond market, while MGS yields adjusted in line with the 25 basis point Overnight Policy Rate (OPR) increase during the period, this was partially offset by the non-resident inflows. As a result, the 3-year and 10-year MGS yields increased by 10 and 3 basis points, respectively, and the 5-year MGS yield declined by 1 basis point. The equity market maintained its upward momentum well into April, supported by active buying by non-resident investors during the month.[14] As a result, the FBM KLCI increased by 4.1% during the first four months of the year.

Several external developments took centre stage from the second quarter onwards, which led to shifting investor sentiments. These included investor expectations for a faster pace of monetary policy normalisation in the US, an escalation in global trade tensions and volatile global crude oil prices. Furthermore, incidences of currency sell-offs in several vulnerable emerging market economies contributed to the deterioration of sentiments as investors were concerned over contagion risks. Beyond these external factors, domestic policy uncertainties further weighed on investor sentiments, particularly following the unprecedented outcome of the 14th General Election. Nevertheless, the effects of domestic factors were temporary following improved policy clarity by the Government and expectations of supportive economic conditions.

This confluence of external and domestic factors led investors to rebalance their portfolios out of emerging market financial markets, including Malaysia. From April to December 2018, non-resident outflows from the domestic capital markets amounted to USD9.8 billion. As a result, the ringgit depreciated by 6.7% against the US dollar. Despite the outflows, bond market adjustments remained orderly due to sustained demand from domestic institutional investors, which partially offset the impact from these outflows. Notably, banks increased their holdings of MGS by RM22.8 billion during this period. The 3-year, 5-year and 10-year MGS yields increased by 19, 23 and 13 basis points, respectively.

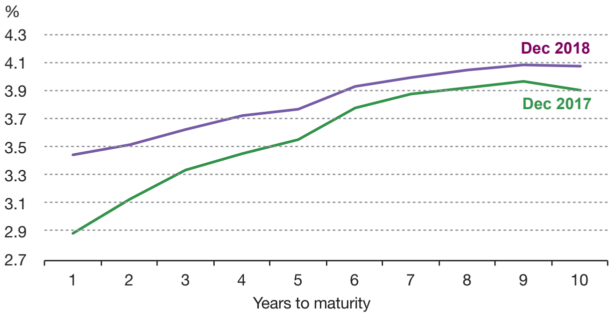
The domestic equity market, however, only started to trend lower from May onwards. Along with the global investor risk aversion arising from the external factors, domestic policy uncertainties following the 14th General Election also contributed to the cautious sentiments. Consequently, domestic equities experienced declines as investors waited

13 In 2017, Malaysia's GDP growth increased to 5.9% from 4.2% in 2016.

14 Unlike the bond market, the equity market continued to experience non-resident inflows in April amounting to USD0.4 billion.

Chart 2.4: MGS Benchmark Yield Curve

The MGS yield curve shifted upwards during the year

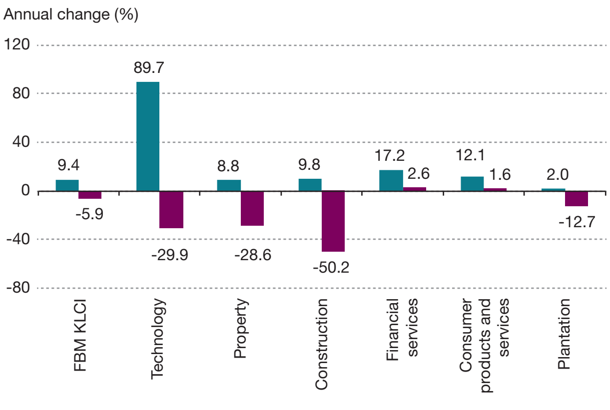


Source: Bank Negara Malaysia

for clarity on the status of major infrastructure projects,[15] the potential impact of proposed fiscal reforms and introduction of new taxes. These losses, however, were partially retraced when there was greater policy clarity by the Government as the year progressed and positive earnings results in selected large-cap companies. Concerns on potential risks of contagion effects in emerging market economies following the currency sell-off in Turkey also caused selling pressure on domestic equities, particularly on Malaysian companies with exposure to the Turkish economy. For the period May to December 2018, the FBM KLCI declined by 9.6% to close the year at 1,690.6 points.

Chart 2.5: Performance of Sectoral Equity Indices

Domestic policy uncertainties resulted in sharp declines in selected sectors



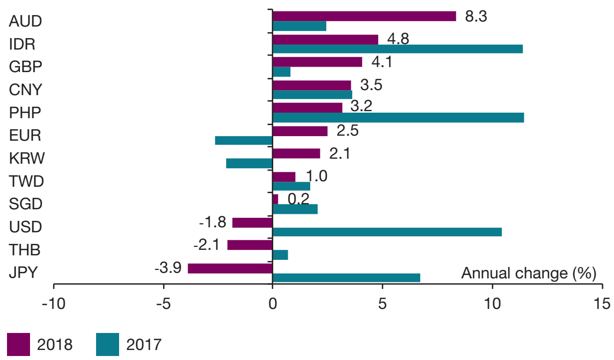
Source: Bloomberg

[15] During the year, the FBM Construction index fell by 50.2% due mainly to the announcements of reviews on selected large infrastructure projects.

For the year as a whole, domestic financial markets performed relatively well and continued to intermediate shifts in capital flows in a stable and orderly manner. The ringgit remained as one of the better performing currencies in the region, depreciating by 1.8% against the US dollar compared to regional currencies which moved between -6.3% and +0.3% against the US dollar. The ringgit also appreciated against the euro (2.5%) and the British pound (4.1%), but depreciated against the Japanese yen (-3.9%). Against regional currencies, the ringgit was broadly stronger, with the biggest gains registered against the Indonesian rupiah (4.8%) and the Chinese renminbi (3.5%).

Chart 2.6 : Malaysian Ringgit (RM) Performance against Major and Regional Currencies

The ringgit appreciated against most major and regional currencies in 2018

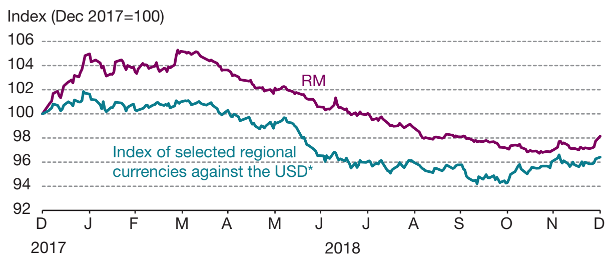


Note: (+) indicates an appreciation of the ringgit against foreign currency

Source: Bank Negara Malaysia

Chart 2.7: Exchange Rate of the Malaysian Ringgit (RM) and Selected Regional Currencies against the US Dollar (USD)

The ringgit depreciated less compared to regional currencies in 2018



* Regional currencies: Chinese renminbi, Indonesian rupiah, Korean won, Philippine peso, Singapore dollar, New Taiwan dollar and Thai baht. Each currency carries equal weight.

Note: An increase in the index represents an appreciation of the ringgit or of selected regional currencies against the US dollar

Source: Bank Negara Malaysia

As a result, the ringgit's Nominal Effective Exchange Rate (NEER), a measure of ringgit performance against the currencies of Malaysia's major trading partners, appreciated by 1.1%.

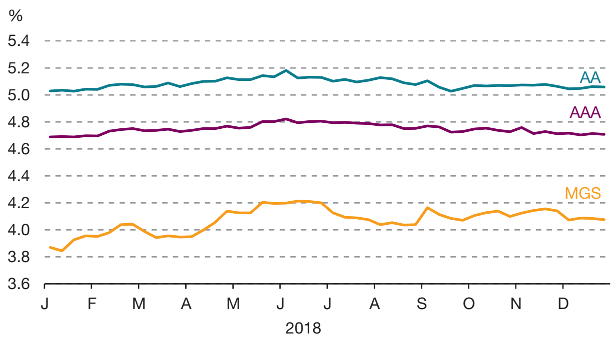
Conditions in the domestic foreign exchange market remained orderly despite the large non-resident capital outflows and environment of uncertainty during the year. This was partly attributed to policies introduced by Bank Negara Malaysia and the Financial Markets Committee (FMC) at end-2016. Foreign exchange liquidity improved following the introduction of the export conversion measure, as reflected in the average daily foreign exchange turnover which increased to USD11.5 billion in 2018 (2016: USD8.1 billion). In addition, the reinforcement of the non-facilitation of non-deliverable forward (NDF) transactions limited the spillovers from speculative activities in opaque offshore markets. By severing the link between offshore speculative outlets and the onshore foreign exchange market, the average daily gap between the domestic spot rate and 3-month NDF rate narrowed to 91 percentage in points (pips) as at end-2018 (2016: 211 pips). Overall, these measures supported orderly market conditions and better price discovery in the domestic foreign exchange market, thus contributing to greater market stability and minimised potential spillovers to the broader economy. Furthermore, the structure of the domestic economy and financial sector limits Malaysia from adverse spillovers arising from large exchange rate movements.

The magnitude of adjustments in the domestic capital markets also remained contained during the year despite the capital outflows. The upward movement in the MGS yield curve and the decline in the KLCI were relatively less sharp when compared to regional peers,[16] owing to the large domestic investor base. Spillovers to the corporate bond market from non-resident outflows in the MGS market were limited, with yields on the 10-year AAA- and AA-rated papers increasing only marginally by 2 and 3 basis points, respectively. Orderly adjustments also contributed to healthy liquidity conditions. In the bond markets, annual trading value of government and corporate bonds remained stable at RM597.9 billion (5-year average: RM680.6 billion) and RM113.5 billion (5-year average: RM123.1 billion), respectively.

[16] 10-year MGS yield increased by 17 basis points in 2018, while regional 10-year sovereign bond yields increased by between 16 and 171 basis points. FBM KLCI declined by 5.9% during the year, compared to the regional average decline of 8.4%.

Chart 2.8: 10-year MGS and 10-year Corporate Bond Yields

Domestic bond yields remained stable supported by domestic institutional investors



Source: Bank Negara Malaysia

Equity market liquidity also remained resilient, with an average monthly turnover ratio for the year of 2.8% (5-year average: 2.6%).

Going into 2019, external uncertainties will continue to affect the outlook for domestic financial markets. These include uncertainties surrounding the Fed's monetary policy normalisation path, a potential further escalation in global trade tensions, the unravelling of geopolitical developments such as Brexit and the resurgence of volatility in global crude oil prices. Under this uncertain environment, periods of heightened volatility will become part and parcel of domestic financial market developments as international investors' portfolio rebalancing and flight-to-safety motives are expected to continue.

In light of this, it is important for Malaysia to maintain a policy configuration that is both flexible and pragmatic. A flexible and market-determined ringgit exchange rate remains a key policy to ensure that the economy is capable of withstanding external shocks. In this regard, the Bank will continue to ensure that exchange rate adjustments are orderly and do not disrupt real economic activity. The Bank also maintains a broad policy toolkit in managing emerging risks. Efforts to develop the domestic financial markets will continue, especially in developing hedging instruments and allowing greater flexibility to manage foreign exchange exposures so that businesses can undertake better risk management. The Bank's monetary operations remains focused on ensuring sufficient liquidity to support the orderly functioning of the domestic financial markets through the judicious use of international reserves and a wide range of liquidity instruments. On the domestic front, efforts to strengthen economic fundamentals and greater policy clarity on the direction of the economy and structural reforms will help to provide support to domestic financial markets amid these global uncertainties. All these efforts combined will ensure that domestic financial markets will continue to support sustainable growth.

Nominal interest rates increased in early 2018, reflecting the pass-through from the normalisation of the degree of monetary accommodation

Domestic interbank rates, retail lending rates and fixed deposit rates increased in early 2018, reflecting the pass-through from the increase in the OPR on 25 January 2018. For the rest of the year, funding costs remained relatively stable despite portfolio outflows, supported by sufficient aggregate liquidity in both the wholesale and retail markets of the banking system. This was in part due to the Bank's liquidity injection operations in the interbank market.

The transmission of the 25 basis point increase in the OPR to the money market was rapid. The average overnight interbank rate (AOIR) rose by 21 basis points on 25 January 2018 from 2.94% to 3.15% and subsequently stabilised within a narrow range of 3.14% – 3.25% for the remainder of the year. Interbank rates for longer tenures also increased in line with the increase in the OPR. The 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) rose by 24 basis points within a day of the OPR increase. For the year, the 3-month KLIBOR increased by 25 basis points.

Following the increase in the interbank rates, retail lending and deposit rates adjusted accordingly. The weighted average base rate (BR) of commercial banks initially increased by 12 basis points in January 2018 to 3.76% following the increase in the OPR and subsequently by another 13 basis points in February 2018 as more banks

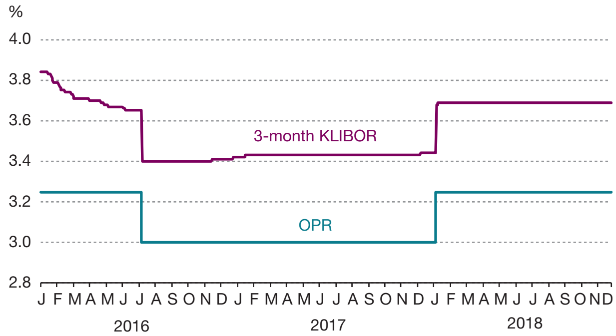
Table 2.1: Policy, Interbank and Lending Rates

	Dec-16	Dec-17	Jan-18	Dec-18
	%, as at end period			
Overnight Policy Rate (OPR)	3.00	3.00	3.25	3.25
3-month KLIBOR	3.41	3.44	3.69	3.69
Weighted average base rate (BR)	3.62	3.64	3.76	3.91
Weighted average lending rate (ALR)	5.22	5.22	5.27	5.42

Source: Bank Negara Malaysia

Chart 2.9: Policy and Interbank Market Rates

Money market rates increased in line with the increase in the OPR



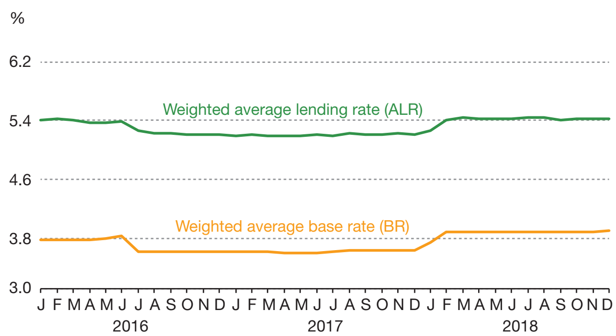
Source: Bank Negara Malaysia and Bloomberg

revised their respective BR. By end-2018, the weighted average BR stood at 3.91%. Correspondingly, the weighted average lending rate (ALR) on outstanding loans to both households and businesses increased by 20 basis points to 5.42% (2017: 5.22%).

The increase in the OPR also resulted in an upward revision to retail deposit rates, compensating savers with a higher rate of return. For the 1 to 12 months tenures, the average quoted fixed deposit (FD) rates of commercial banks rose by an average of 7 basis points in January 2018 following the increase in the OPR. By end-2018, the average quoted FD rates had risen by 22 basis points, ending the year within a range of 3.09% – 3.33%. Apart from higher nominal deposit rates, real deposit rates turned positive in January 2018 and increased steadily during the year due to the increase in nominal interest rates and moderating headline inflation.

Chart 2.10: Commercial Banks' Lending Rates (at end-period)

Retail lending rates adjusted upwards, reflecting the pass-through from the increase in the OPR



Source: Bank Negara Malaysia

Overall liquidity conditions remained sufficient to facilitate financial intermediation

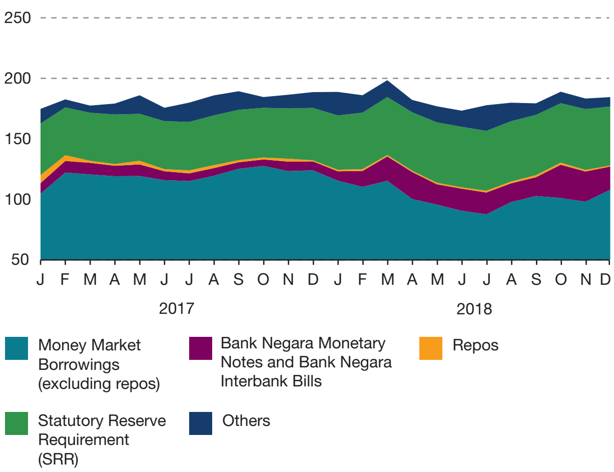
In 2018, overall banking system liquidity remained sufficient to support the financial intermediation process. At the system level, aggregate outstanding liquidity placed with the Bank remained stable despite portfolio outflows during the year. At the institutional level, most banking institutions continued to maintain surplus liquidity positions with the Bank.

Throughout the year, the Bank's monetary operations were focused on maintaining stability in the interbank market. The contractionary impact on liquidity arising from large portfolio outflows was offset by the Bank's liquidity injection operations undertaken through the reverse repo and foreign exchange swap facilities. As a result, price discovery in the domestic money market remained uninterrupted and money market rates remained stable during the year.

Private sector liquidity, as measured by broad money (M3), grew at a much faster pace of 8.0% in 2018 (2017: 4.9%). The expansion in M3 was supported by credit extended by banks to the private sector through loans and purchases of corporate bonds. The annual growth rate of total deposits in the banking system recorded a three-year high of 7.5%, due mainly to an increase

Chart 2.11: Outstanding Ringgit Liquidity Placed with Bank Negara Malaysia (at end-period)

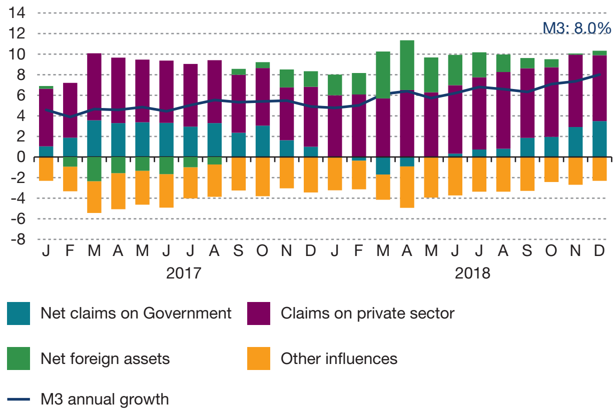
Outstanding ringgit liquidity placed with Bank Negara Malaysia remained stable



Source: Bank Negara Malaysia

Chart 2.12: Contribution to M3 Growth

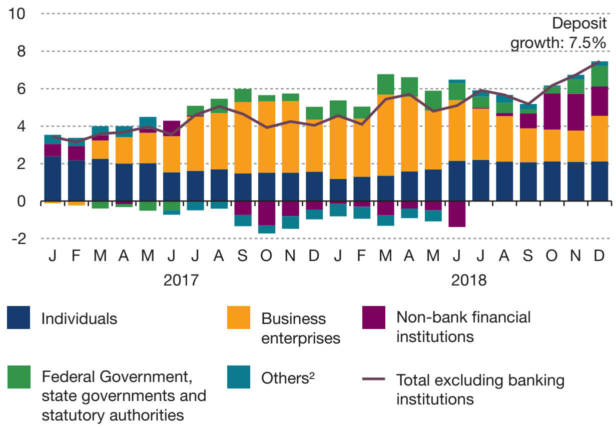
Private sector liquidity increased in 2018



Source: Bank Negara Malaysia

Chart 2.13: Contribution to Banking System Deposit[1] Growth by Holder

Deposit growth was driven by non-bank financial institutions' placements



[1] Excludes deposits accepted from banking institutions
[2] Includes domestic other entities and non-bank foreign entities

Source: Bank Negara Malaysia

in deposits placed by non-bank financial institutions. Household deposits also grew at a faster rate of 5.3% (2017: 3.9%) during the year.

Financing to the private sector was driven by stronger loan growth

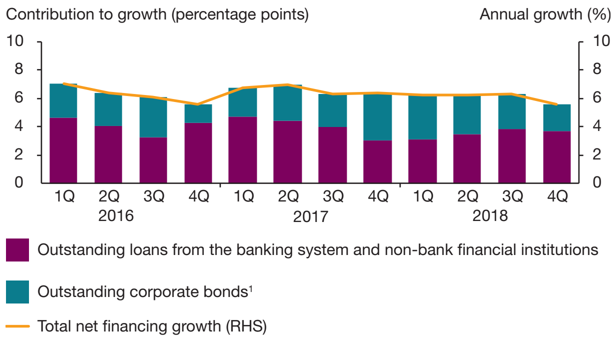
Net financing through the banking system, non-bank financial institutions[17] and the corporate bond[18]

[17] Non-bank financial institutions comprise development financial institutions (DFIs) and major non-bank financial institutions.
[18] Excludes issuances by Cagamas and non-residents.

market recorded an annual growth of 5.6% as at end-2018 (2017: 6.3%). During the year, higher growth was recorded in outstanding loans[19] (2018: 4.8%; 2017: 3.9%), driven mainly by the business segment. However, outstanding corporate bonds grew at a slower pace of 8.0% as at end-2018 (2017: 15.4%), reflecting a moderation from the high level of issuances in 2017.

Chart 2.14: Total Net Financing to the Private Sector through Banks, Non-Bank Financial Institutions and Corporate Bonds

Net financing moderated as higher loan growth was offset by the lower growth in outstanding corporate bonds

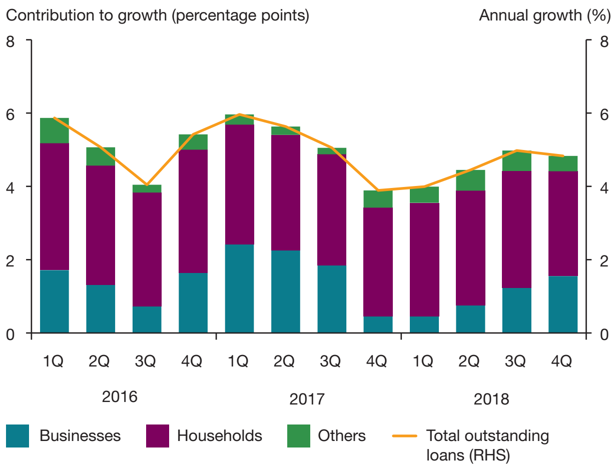


[1] Excludes issuances by Cagamas and non-residents

Source: Bank Negara Malaysia

Chart 2.15: Outstanding Loans by Borrowers[1]

Higher growth in outstanding loans as at end-2018



[1] Comprises outstanding loans from the banking system and non-bank financial institutions

Source: Bank Negara Malaysia

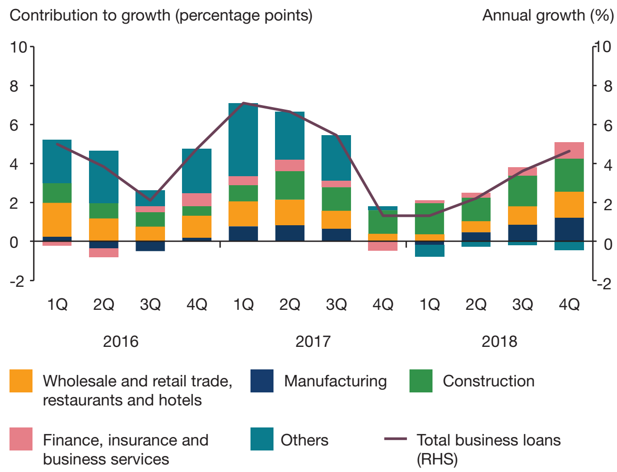
[19] Comprises outstanding loans extended by the banking system (both conventional and Islamic banks) and non-bank financial institutions.

Outstanding business loans[20] increased steadily during the year, growing by 4.6% as at end-2018 (2017: 1.3%). The increase was driven mainly by the wholesale and retail trade, restaurants and hotels (WRRH); manufacturing; finance, insurance and business services; and construction sectors, collectively comprising a 61% share of business loans. The higher loan growth for the WRRH sector was in line with its improved performance amid greater consumer spending, especially during the zerorisation of the Goods and Services Tax (GST) rate. Higher loan growth for the manufacturing sector reflected, in part, capacity expansion activity by firms. By purpose, the growth of loans was higher for investment-related purposes, specifically for construction and the purchase of non-residential properties, and for working capital. The expansion in outstanding business loans was driven by higher levels of loan disbursements (2018: RM794.4 billion; 2017: RM749.9 billion) relative to repayments (2018: RM787.1 billion; 2017: RM755.5 billion). For small and medium enterprises (SMEs), the amount of loans disbursed increased for the year as a whole (2018: RM307.3 billion; 2017: RM296.3 billion).

Business demand for funding from the capital markets moderated, with issuances of corporate bonds[21] at

Chart 2.16: Outstanding Business Loans by Sector[1]

Business loans increased steadily during the year



[1] Comprises outstanding loans from the banking system and development financial institutions (DFIs)

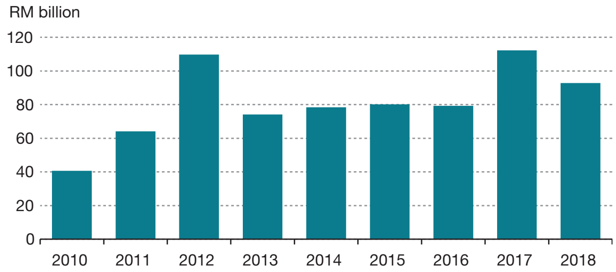
Source: Bank Negara Malaysia

[20] Includes outstanding loans of public enterprises (PEs), but excludes outstanding loans of domestic financial institutions, domestic non-bank financial institutions, Government, domestic other entities, and foreign entities with the banking system and DFIs.

[21] Excludes issuances by Cagamas and non-residents.

Chart 2.17: Gross Corporate Bond Issuances[1]

Corporate bond issuances moderated in 2018



[1] Excludes issuances by Cagamas and non-residents

Source: Bank Negara Malaysia

RM92.8 billion[22] in 2018 (2017: RM112.2 billion). In particular, Government Guaranteed bond issuances were lower amid reviews on major public infrastructure projects from mid-year onwards. The bulk of the bond issuances was from the finance, insurance and real estate; electricity, gas and water supply; and construction sectors. These funds were used to finance infrastructure projects, and for working capital and capital expenditure purposes. Financing through the equity market,[23] however, was marginal at RM2.4 billion (2017: RM12.2 billion) as investor sentiments remained cautious amid external and domestic uncertainties.

Outstanding household loans[24] recorded an annual growth of 4.7% as at end-2018 (2017: 4.9%), supported mainly by loans for the purchase of residential properties; purchase of securities; and personal use.[25] The growth in residential property loans, which accounted for 53.2% of total household debt, moderated to 7.7% by end-year (2017: 8.4%), partly reflecting lower demand for housing loans as applications[26] for residential property loans declined by 0.2% in 2018 (2017: 12.8%). Eligible households with the capacity to service their debt continued to have access to home financing during the year. Higher growth in loans for the purchase of securities (2018: 8.0%; 2017: 1.8%) was driven by both stronger consumer demand and higher supply of loans for purchase of unit trust funds[27] (2018: 10.5%; 2017: -0.7%). Of note, passenger car loans recorded positive annual growth from August to November 2018, for the first time since the second half of 2016 (2017: -0.5%),[28] driven by the higher demand for financing during the period of the zerorisation of the GST rate.

[22] At this level, issuances remained robust compared to the 2013 – 2016 average of RM78.0 billion (excluding issuances by Cagamas and non-residents).

[23] Excludes issuances by non-residents.

[24] Loans from the banking system and non-bank financial institutions.

[25] The loans for these purposes grew at a sustainable pace, remaining significantly below their historical peaks during the period of 2013 – 2016.

[26] Refers to loan applications to the banking system only.

[27] Refers to banking system loans for purchase of unit trust funds, which accounted for 87% of the outstanding loans for the purchase of securities.

[28] Refers to loans from the banking system and DFIs only.

Monetary Policy in 2018

Monetary Policy in 2018

MONETARY POLICY AND MONETARY OPERATIONS

Monetary policy in 2018 focused on ensuring price stability that was supportive of the sustainable growth of the Malaysian economy

The Monetary Policy Committee (MPC) normalised the degree of monetary accommodation at the January 2018 MPC meeting and raised the Overnight Policy Rate (OPR) by 25 basis points to 3.25%. In the MPC's assessment, the economic conditions that had called for the previous OPR reduction in July 2016 had vastly improved. The MPC had earlier communicated its consideration for a review of the degree of monetary accommodation in the November 2017 Monetary Policy Statement.

In early 2018, the domestic economy continued to show signs of strength and resilience, after a strong expansion of 5.9% in the previous year. Domestic growth was expected to be within the range of 5.5% - 6.0%.[1] Global growth was also expected to continue being broad-based across regions. This, in turn, would benefit Malaysia's trade performance, with positive spillovers to the domestic economy. Domestic demand was projected to remain the key driver of growth, underpinned by favourable income and labour market conditions; coupled with spending on new and ongoing infrastructure projects and sustained capital investments in the manufacturing and services sectors. Risks to the global growth outlook were assessed to be balanced, and prospects for the Malaysian economy remained strong. Headline inflation was projected to average at 2.0% - 3.0% in 2018[2] (2017: 3.7%). Higher global oil prices were expected to result in higher domestic retail fuel prices for the year, although the impact would be partly offset by a stronger ringgit exchange rate.

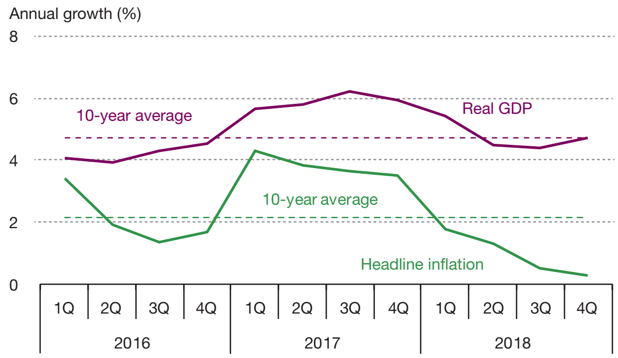
[1,2] This forecast was published in the Bank Negara Malaysia Annual Report 2017.

The OPR adjustment, however, did not constitute a tightening of monetary conditions, as the overall stance of monetary policy remained supportive of economic growth. The normalisation of the degree of monetary accommodation contributed towards preserving the sustainability of growth, while ensuring ample policy space in the event of shocks to the economy in the future. The MPC also recognised the need to prevent the build-up of risks that could arise from interest rates being too low for a prolonged period of time even as the risks of financial imbalances remained contained.

By mid-year, however, the prospects to both the global and domestic growth outlook shifted as economic and financial conditions evolved. Even though the global economic expansion continued, there was increasing divergence across economies and signs of moderating growth momentum,[3] mainly reflecting the weaker performance in several major economies and the materialisation of downside risks from global trade tensions. Domestically, unanticipated commodity supply-side shocks led

Chart 3.1: Real GDP and Headline Inflation

Monetary policy focused on ensuring price stability that was supportive of sustainable growth

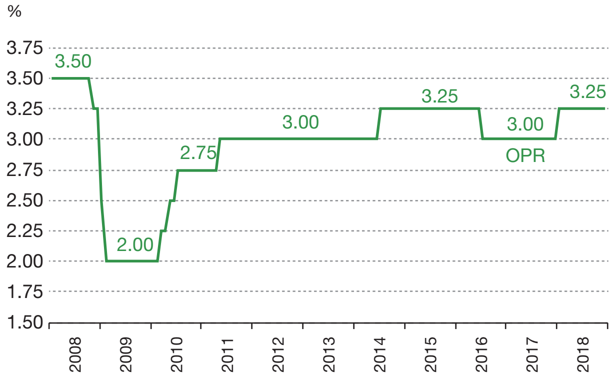


Source: Department of Statistics, Malaysia and Bank Negara Malaysia

[3] The International Monetary Fund (IMF), for example, revised downwards its global growth forecast in October 2018 to 3.7% for both 2018 and 2019, compared to the July 2018 forecast of 3.9% for both years.

Chart 3.2: Overnight Policy Rate (OPR)

The stance of monetary policy remained accommodative



Source: Bank Negara Malaysia

to slower GDP growth in the second and third quarters of the year. In addition, public sector spending was lower arising from the reprioritisation of expenditure by the new Government. Domestic growth was, however, supported by better-than-expected private consumption growth as household spending increased due to the zerorisation of the Goods and Services Tax (GST) rate.[4] On balance, taking all of these factors into account, the Malaysian economy was expected to remain on a steady growth path, but with the growth outlook revised downwards to 4.8% for 2018 and 4.9% for 2019.[5] Nevertheless, risks to the global growth outlook were now tilted to the downside, which could cause headwinds to the domestic economy. These included the escalating trade tensions, and spillover effects to emerging market economies from global liquidity shifts due to monetary policy normalisation in the advanced economies. Domestically, risks remained from any prolonged weakness in the mining and agriculture sectors, and policy uncertainties.

Headline inflation for 2018 was projected to be lower[6] compared to the forecast at the beginning of the year, due mainly to the net impact of consumption tax policy changes[7] amid stable retail fuel prices.[8] A key challenge in forecasting headline inflation in 2018 was in ascertaining the extent of the pass-through by firms to the changes in costs following the zerorisation of the GST rate and the implementation of the Sales and Services Tax (SST). Throughout the year, headline inflation projections were also highly dependent on the trend and forecast of global oil prices, which in itself were highly uncertain.[9] Headline inflation for 2019 at that time was projected to increase primarily due to higher projected global oil prices, the prospective floating of retail fuel prices[10] and the impact from the consumption tax policy, although the net impact of the consumption tax policy changes was expected to start to lapse towards the end of 2019.

Throughout 2018, underlying inflation, which excludes the impact of changes in the consumption tax policy, was expected to moderate following expectations of smaller pass-through from external and domestic cost factors, and the absence of excessive demand pressures.

Subsequent to the OPR increase in January, the OPR was maintained at the prevailing level throughout 2018. The degree of monetary accommodativeness was assessed to be consistent with the intended policy stance of ensuring that the domestic economy continued on a steady growth path with price stability. The MPC was also cognisant of the need to ensure sufficient liquidity to support financial intermediation. However, in assessing the role of monetary policy in supporting growth, the MPC was mindful that other measures are needed to further support and sustain domestic growth in the medium term, most pertinently structural reforms that would boost potential growth.

Monetary operations remained focused on ensuring sufficient liquidity to support the orderly functioning of the domestic financial markets

Domestic monetary and financial conditions, and continued healthy growth in financing to the private sector were supportive of economic activity. The Bank's monetary operations ensured sufficient liquidity to support the orderly functioning of money and foreign exchange markets. During the year, domestic financial markets were affected by capital flow volatility arising from external and domestic developments. Nevertheless, domestic financial

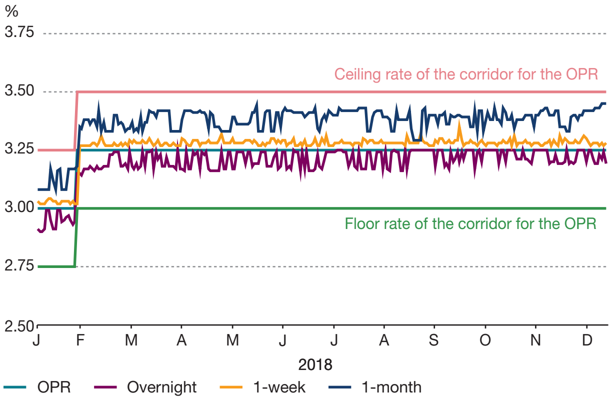
4 This refers to the reduction in the GST rate from 6% to 0% between 1 June 2018 to 31 August 2018.
5 This was reflected in the growth projections for 2018 and 2019 by the Ministry of Finance Malaysia in the Economic Report 2018/2019 published on 2 November 2018.
6 This was reflected in the headline inflation projection for 2018 by the Ministry of Finance Malaysia of between 1.5% - 2.5% in the Economic Report 2018/2019 published on 2 November 2018.
7 Subsequent to the zerorisation of the GST rate, it was replaced by the Sales and Services Tax (SST) effective 1 September 2018.
8 The Government in June 2018 announced the fixing of the retail fuel price of RON95 petrol at RM2.20 per litre for the remainder of the year, with the price itself unchanged from 22 March 2018.
9 Brent crude oil prices (ICE Brent Futures) started the year at USD66.6 per barrel, peaked at USD86.3 per barrel on 3 October 2018, troughed at USD50.5 per barrel on 24 December 2018 and ended the year at USD53.8 per barrel.
10 The Government in the 2019 Budget announced that the retail fuel price of RON95 petrol would be floated in the second quarter of 2019.

markets remained resilient and adjusted to the capital flows in an orderly manner, ensuring uninterrupted intermediation activity to the real economy.

During the year, the average overnight interbank rate (AOIR) was stable and closely tracked the OPR despite the heightened uncertainty and market volatility. In January, the AOIR adjusted higher following the 25 basis point increase in the OPR from 3.00% to 3.25% and traded within the range of 3.14% - 3.25% thereafter. Similarly, the Kuala Lumpur Interbank Offered Rate (KLIBOR) rates were stable across the tenures following the increase in the OPR, with the 3-month KLIBOR having increased by 25 basis points to 3.69% in January 2018.

Chart 3.3: OPR and Interbank Rates

Interbank rates remained stable



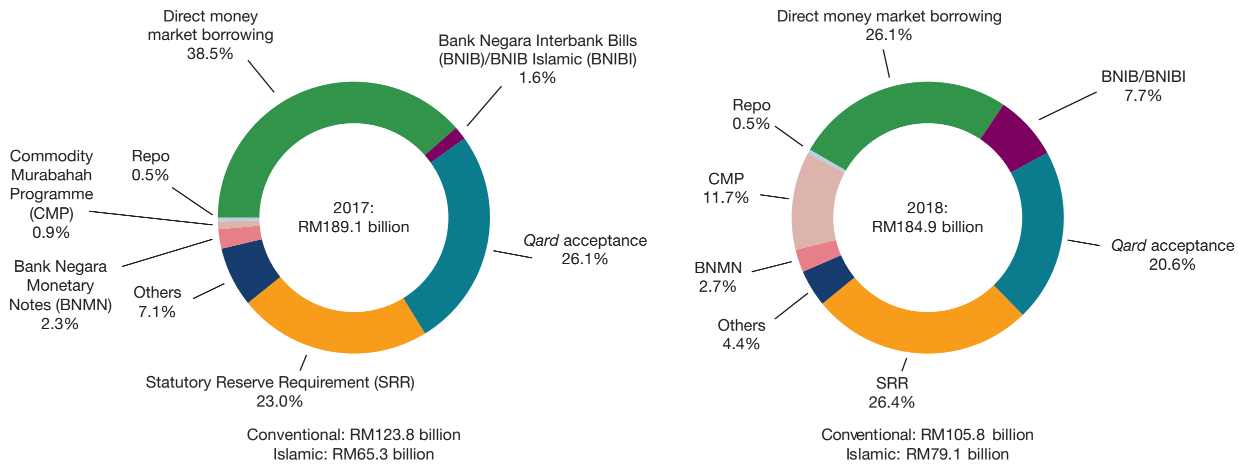
Source: Bank Negara Malaysia

The wide range of both conventional and Islamic liquidity instruments accorded flexibility to the Bank in meeting the liquidity needs of the banking system. The Bank actively adjusted its monetary operations through the various liquidity instruments and tenures. In the first quarter of the year, during periods of higher banking system liquidity arising from capital inflows, the Bank lengthened the maturity profile of its monetary operations. As banking institutions shifted their funding preference towards shorter maturities during episodes of capital reversals, the Bank responded likewise. The Bank facilitated these requirements by increasing the frequency of the Range Maturity Auction (RMA), from a weekly operation to two to three times a week. The Bank also conducted liquidity injection operations through reverse repos and foreign exchange swap facilities to ensure liquidity conditions remained conducive to support financial intermediation despite heightened financial market volatility.

The liquidity instruments used in the Bank's monetary operations were varied accordingly during the year. While direct money market borrowing and *Qard* acceptance continued to be the main instruments for conventional and Islamic financial institutions respectively, the use of Commodity Murabahah Programme (CMP) increased following the introduction of overnight CMP[11] in October 2018 to replace the existing instrument which was

Chart 3.4: Composition of Outstanding Ringgit Liquidity Placed with Bank Negara Malaysia (as at end-period)

Direct money market borrowing and *Qard* acceptance were the main liquidity absorption instruments



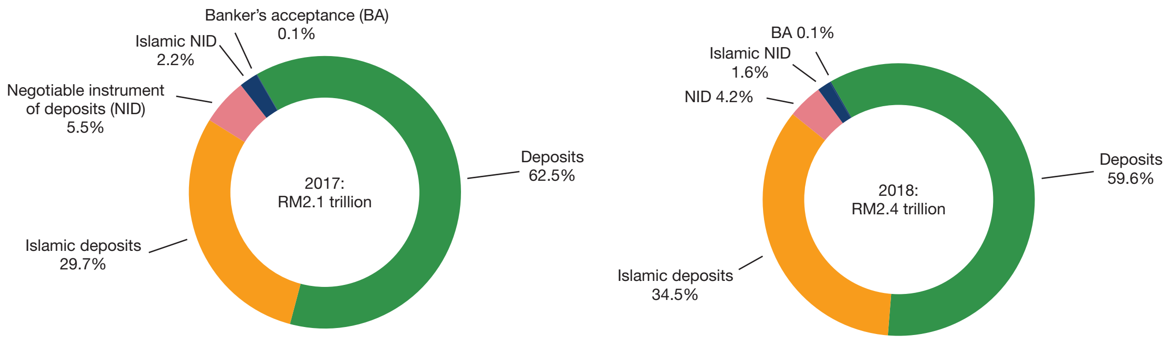
Note: Figures may not necessarily add up due to rounding

Source: Bank Negara Malaysia

[11] Previously, the CMP was offered for Islamic term placements only.

Chart 3.5: Breakdown of Volume of Interbank Money Market Transactions

Interbank money market transactions were mainly in conventional and Islamic deposits



Source: Bank Negara Malaysia

based on *qard*. This was reflected in the increased CMP composition from 0.9% in 2017 to 11.7% in 2018 of total outstanding ringgit liquidity absorbed through monetary operations. In comparison to *qard*, where *hibah* is declared upon maturity at the Bank's discretion, the CMP rate is made transparent upfront, thus providing impetus for a competitive and efficient price discovery mechanism in the Islamic money market.

In March 2018, the Bank introduced ringgit Bank Negara Interbank Bills Islamic (BNIBI) under the Shariah principle of *murabahah* to complement the existing conventional ringgit Bank Negara Interbank Bills (BNIB) which was introduced in November 2017. Since the introduction, the ringgit BNIB and BNIBI issuances have been well-received as their tradability features offer flexibility for banking institutions to manage their short-term liquidity needs efficiently. The interbank demand for BNIB and BNIBI was reflected by their pricings which were, on average, 6 basis points lower than other monetary instruments of similar tenures. The Bank gradually increased the issuance of BNIB and BNIBI to accommodate the stronger demand. As at end-2018, the outstanding amount reached RM14.2 billion (7.7% of total outstanding ringgit liquidity absorbed through monetary operations).

Total interbank money market transactions, which comprised both conventional and Islamic instruments of deposits, banker's acceptance (BA) and negotiable instrument of deposits (NID), recorded a marginally higher volume of RM2.4 trillion (2017: RM2.1 trillion). Conventional money market deposits remained the major instrument for liquidity management, representing 59.6% of the total volume traded, followed by Islamic deposits and NIDs.

Outlook and Policy in 2019

Outlook and Policy in 2019

THE INTERNATIONAL ECONOMIC OUTLOOK

In 2019, the global economy is projected to moderate towards its long-term trend, characterised by slower growth in both advanced and major emerging economies. In the advanced economies, labour market strength will continue to support domestic demand, and improvements among selected emerging markets such as Brazil and India will provide some impetus to global growth. Nevertheless, uncertainty is likely to remain elevated, given the persistence of key risks, notably from global trade disputes, political uncertainty and sudden shifts in investor sentiment. These risks will pose headwinds to growth.

Global economy to expand moderately in 2019

In the advanced economies, economic activity is projected to moderate in 2019. Labour market conditions remain mixed. While unemployment rates in the United States and euro area are hovering at 50-year and decade lows respectively, wage growth has remained modest. Nevertheless, in the low inflation environment, this will support consumer confidence and household spending. Moderating investments and external demand will affect overall growth. In the US, fiscal policy will provide less support, while the accumulated effects of gradual monetary policy normalisation are expected to have an impact on economic activity. In the United Kingdom, the prolonged uncertainty surrounding Brexit developments will likely affect both consumer spending and investment decisions. In PR China, ongoing structural reforms to rebalance the economy are leading to slower, but more sustainable growth. Trade disputes, if unresolved, are expected to further dampen business sentiment in PR China. Proactive counter-cyclical monetary and fiscal policy interventions should help forestall the risk of a sharp slowdown in growth. In other Asian economies, growth will likely moderate despite stable domestic demand, as exports react to the slowdown in the advanced economies and PR China.

Lower crude oil prices will reduce the energy import bill and pressure on inflation, which will support higher spending especially in net oil importing economies. Some economies will benefit from country-specific tailwinds. In India, the negative effects from past domestic policy adjustments (e.g. demonetisation and GST implementation) will continue to fade, while Brazil continues on a gradual recovery since 2017.

Despite the projected growth, prospects for the global economy will be contingent upon the outcome of several key risk factors. Central banks in major advanced economies are adopting a more patient and cautious approach to monetary policy normalisation given the uncertain growth prospects. Global trade developments will remain a key factor affecting the 2019 outlook. Beyond the economic impact of higher trade tariffs, prolonged policy uncertainty could adversely affect investment decisions and thus, longer-term productivity growth. In this environment, investor uncertainty will remain elevated and financial markets will likely experience bouts of volatility. This poses further risks of greater volatility in capital flows to emerging market economies. The overall balance of risks to the global growth outlook is tilted to the downside.

THE MALAYSIAN ECONOMY

Against the backdrop of a challenging global environment, the Malaysian economy is expected to sustain its growth momentum, expanding by 4.3% – 4.8% in 2019 (2018: 4.7%). The external sector is expected to register a more moderate expansion in tandem with the moderation in global growth. Private sector activity will remain the anchor of growth amid continued rationalisation in the public sector. Labour market conditions are expected to remain supportive of growth, while inflation is projected to be broadly stable compared to 2018.

The Malaysian economy is projected to grow by 4.3% – 4.8% in 2019

Growth will be supported by the gradual recovery from the unanticipated commodity disruptions in 2018, which will also benefit the manufacturing sector and trade activity. In addition, output from new manufacturing production facilities that will begin operating in 2019 will lend further support to growth. These facilities include large oil refinery and petrochemical facilities, as well as E&E, chemicals and rubber plants. On the demand side, private sector spending will continue to drive growth. Following the lapse of one-off factors in 2018, private consumption growth is expected to moderate, but remain firm. Household spending will benefit from continued employment and income growth. Employers surveys indicate that salary increments are expected to be sustained between 4.9% – 5.2%[1] in 2019 while the unemployment rate is projected to remain relatively unchanged (3.3% – 3.5%; 2018: 3.4%). Policy measures such as the price ceiling on retail fuel prices, minimum wage adjustment and targeted cash transfers will lend further support to household expenditure. The normalisation of destocking activities by firms will serve as an additional support to growth in 2019. This is partly due to firms readjusting their inventories after the strong demand during the tax holiday period in 2018, which led to firms drawing down from their inventories. In addition, E&E firms which had large stock drawdown towards the end of 2018 in anticipation of weak demand, are less likely to have another significant drawdown in their inventories.

The growth projection is subject to several downside risks, mainly from the global environment. Unresolved trade tensions between the US and PR China, and a slower-than-expected global growth will affect Malaysia primarily via the trade and investment channel. The uncertain pace of the monetary policy normalisation in the US could heighten financial market volatility across emerging market economies, leading to volatile two-way capital flows and currency fluctuations. Volatility in the global oil price could also affect export performance and mining sector investment. On the domestic front, a re-occurrence of the commodity supply disruption, partly from unanticipated weather patterns, could affect the recovery in the mining and agriculture sectors. In addition, the oversupply situation in the property market could dampen activity in the construction sector.

The strong fundamentals and the diversified nature of the economy will help Malaysia weather these risks and vulnerabilities while preserving macroeconomic and financial stability. These include a healthy labour market, stable inflation rate, continued surplus in the current account of the balance of payments, deep financial markets, as well as a strong financial sector. Exchange rate flexibility and sufficient level of international reserves further enhance the economy's capability to withstand external shocks. Moreover, commitment by the Government to fiscal, structural and institutional reforms will contribute to inclusive and sustainable growth going forward.

Domestic Demand to Continue to be the Key Driver of Growth

Domestic demand will remain the anchor of growth in 2019, underpinned by continued expansion in private sector activity. Public sector expenditure, however, is expected to weigh on growth amid the completion of large-scale projects by public corporations and continued reprioritisation of government spending. The external sector is projected to register a more moderate growth in line with modest global growth and trade activity.

Private consumption is projected to expand by 6.6% in 2019. After recording a strong growth in 2018, household spending is expected to normalise closer to its long term average of 6.7%.[1] Although consumer sentiments have moderated from the recent peak, growth will remain firm supported by key fundamental drivers, namely stable labour market conditions and continued wage growth. The implementation of several government measures, particularly in alleviating rising cost of living, is expected to lend further support to

[1] The long term average of 6.7% refers to the period from 1990 to 2018.

[1] Based on Malaysian Employers Federation Salary Survey, as well as Korn Ferry's and Mercer's Total Remuneration Surveys.

Table 1

Real GDP by Expenditure (2010=100)

	2018*p*	2018*p*	2019*f*	2018*p*	2019*f*
	% of GDP	Annual change (%)		Contribution to growth (ppt)	
Domestic Demand[1]	**92.9**	**5.6**	**4.4**	**5.2**	**4.1**
Private sector expenditure	72.8	7.2	6.2	5.1	4.5
Consumption	55.5	8.1	6.6	4.4	3.7
Investment	17.4	4.5	4.9	0.8	0.8
Public sector expenditure	20.1	0.1	-1.8	0.0	-0.4
Consumption	12.8	3.3	1.2	0.4	0.2
Investment	7.3	-5.2	-7.1	-0.4	-0.5
Gross Fixed Capital Formation	24.6	1.4	1.3	0.4	0.3
Change in Stocks	**-1.3**			**-1.5**	**0.6**
Net Exports of Goods and Services	**8.4**	**13.4**	**0.1**	**1.0**	**0.0**
Exports	70.6	1.5	0.1	1.1	0.0
Imports	62.2	0.1	0.0	0.1	0.0
Real Gross Domestic Product (GDP)	**100.0**	**4.7**	**4.3 ~ 4.8**	**4.7**	**4.3 ~ 4.8**

[1] Excluding stocks
p Preliminary
f Forecast

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

consumption spending, especially by lower income households. These measures include the price ceiling on retail fuel prices, higher minimum wage and *Bantuan Sara Hidup* cash transfers.

Labour market conditions are expected to be stable in 2019, with continued employment and income growth. This is underpinned by steady expansion in services and manufacturing sectors, reinforced by the recovery from commodity supply disruptions. As such, unemployment rate is projected to be relatively unchanged (3.3% – 3.5%; 2018: 3.4%) while salary increments are expected to be sustained between 4.9% – 5.2%[2] in 2019. In the long run, the rollout of government policies such as the tiered levy and social security contribution for foreign workers is a positive step in reducing the reliance on foreign labour and spurring the creation of higher skilled, higher income jobs in the economy.

Private investment is projected to register a growth of 4.9% in 2019. The ongoing multi-year projects would continue to support investment activity, particularly in the manufacturing and services sectors. This includes capital spending in the E&E and primary-related manufacturing sub-sectors as well as the transport, storage and communication services sub-sectors. By type of asset, investments in machinery and equipment are expected to benefit from firms' efforts to enhance automation and efficiency. Nonetheless, the moderating global economic conditions and softening business sentiments could affect investment activity. In addition, investments in structures would likely remain moderate amid the oversupply in the broad property segment.

Public consumption is expected to expand at a moderate pace of 1.2%, attributable to a decline in spending on supplies and services amid stable emoluments growth. This is in line with the Government's continued commitment to rationalise non-critical spending without affecting public service delivery and to increase efficiency through cost reduction in the public sector.

Public investment is projected to contract by 7.1% due mainly to lower investment by public corporations following the completion of large-scale projects. Capital spending by the General Government is expected to be mainly channeled towards upgrading and improving public infrastructure and amenities.

[2] Based on Malaysian Employers Federation Salary Survey, as well as Korn Ferry's and Mercer's Total Remuneration Surveys.

All Economic Sectors are Projected to Expand

On the supply side, all economic sectors would continue to expand in 2019, with the services and manufacturing sectors remaining the key contributors to overall growth.

Table 1

Real GDP by Kind of Economic Activity (2010=100)

	2018*p*	2018*p*	2019*f*	2018*p*	2019*f*
	% of GDP	Annual change (%)		Contribution to growth (ppt)[1]	
Services	55.5	6.8	5.7	3.7	3.2
Manufacturing	23.0	5.0	4.8	1.2	1.1
Mining and quarrying	7.9	-1.5	0.8	-0.1	0.1
Agriculture	7.8	-0.4	2.8	0.0	0.2
Construction	4.5	4.2	3.0	0.2	0.1
Real GDP	**100.0**[1]	**4.7**	**4.3 ~ 4.8**	**4.7**	**4.3 ~ 4.8**

[1] Figures may not necessarily add up due to rounding and exclusion of import duties component
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Economic activity in the services sector will expand at a more moderate pace. Growth in wages and employment will support expansion in the wholesale and retail trade, food and beverages and accommodation sub-sectors. The information and communication sub-sector will be driven by higher demand for broadband services, due to lower subscription prices. Sustained financing activity will continue to benefit the finance and insurance sub-sector. Nevertheless, slower global trade activity would impact growth in the transport and storage sub-sector.

The manufacturing sector is projected to record a slightly lower growth. The primary-related cluster will benefit from the recovery of commodity supply disruptions. The operationalisation of the large oil refinery and petrochemical facilities in Johor will boost production of refined petroleum and petrochemical products. Growth in the E&E cluster, however, is expected to moderate due to lower external demand for semiconductors. Nevertheless, additional production from new manufacturing plants and modernisation of existing facilities will provide continued support for the growth of the E&E cluster.

Growth in the construction sector is expected to moderate in 2019, due to the completion of large petrochemical projects in the civil engineering sub-sector. Continued progress of large transportation and utility projects will provide support to growth. The residential and non-residential sub-sectors, however, are expected to remain subdued amid the oversupply of residential and commercial properties.

Growth in both the mining and agriculture sectors is projected to register a turnaround in 2019. The recovery in natural gas production in East Malaysia will support growth in the mining sector. This will more than offset the decline in crude oil output due to production constraints and extension of voluntary supply adjustments by PETRONAS. Meanwhile, higher palm oil output amid the recovery in palm oil yield and continued expansion in mature oil palm areas will contribute to growth in the agriculture sector.

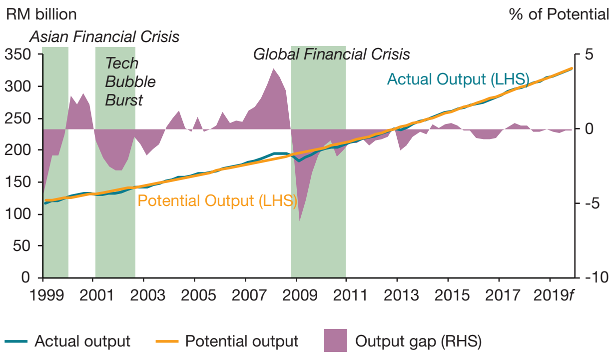
Potential Output and the Output Gap of the Malaysian Economy

Potential output is the highest level of output that an economy can produce with efficient deployment of its existing resources – comprising capital, labour and technology. Producing output beyond this potential level risks overheating in the economy and the subsequent onset of inflationary pressures, while the converse reflects an underutilisation of resources and disinflationary pressures. Thus, the level of potential output and its relation to actual output (also known as the output gap[1]), aids the Bank in carrying out its mandate of maintaining price stability for sustainable economic growth.[2]

In 2018, potential output expanded by 5.0% (2011-2017 average: 5.0%). There was a moderation in capital expenditure growth, particularly from the public sector, following the near-completion of a few large infrastructure projects and the review of several development projects. Nonetheless, this trend was offset by stronger labour force expansion during the year (2.4%; 2017: 2.0%) to meet the sustained production strength in the services and manufacturing sectors.

Chart 1: Actual and Potential Output

Output gap to turn marginally negative in 2019



Year	Annual Growth in Potential Output (%)
2017	5.0
2018*e*	5.0
2019*f*	4.6 ~ 5.1

e Estimate
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

In 2018, actual GDP growth trailed potential output growth, mainly due to supply disruptions in the agriculture and mining sectors that led to an underutilisation of resources. The output gap remained negligible during the year, contributing to relatively benign price pressures in the economy. This is consistent with the stable inflation rate of 1.0% (core inflation: 1.6%) registered during the year.

Going forward, the output gap is expected to turn marginally negative in 2019, as actual output continues to be impacted by both domestic and external headwinds. Potential output growth is also expected to slow slightly in 2019 owing to a slower pace of capital expenditure and labour force expansion. Inflationary pressure in 2019 is therefore expected to remain subdued.

[1] More formally, the output gap as a percentage of potential output is defined as $\frac{\text{(Actual output level - Potential output level)}}{\text{Potential output level}} \times 100\%$.
[2] Central Bank of Malaysia Act 2009.

EXTERNAL SECTOR

External sector to register a more moderate growth

While the export sector will soften in 2019 in line with the more moderate expansion in the global economy and trade activity, Malaysia's well-diversified export structure, in terms of both products and markets will contribute to sustain the expansion in gross exports. The current account balance is projected to remain in surplus, albeit narrowing to 1.5% – 2.5% of GNI.

Export growth to remain positive

Malaysia's exports are expected to record a positive growth of 3.4% in 2019 (2018: 6.8%). The impact of the trade tensions and moderating demand from major economies will be significant. There are, however, mitigating factors. These include sustained demand from selected emerging economies, especially among ASEAN countries. Positive growth in manufactured exports will cushion the impact of an expected decline in commodity exports. This decline is attributable to lower mineral prices and crude oil production.

Manufactured exports are projected to expand by 4.8% in 2019 (2018: 9.1%) supported by continued, albeit moderating demand from key trade partners. Capacity expansions and the commencement of new production from several approved investments, particularly in the export-oriented manufacturing sector, will allow firms to tap into the continued global demand for growth segments in specific products. In the E&E sector, the operationalisation of new manufacturing plants, as well as modernisation and automation of existing facilities allow firms to gain from industry demand for semiconductors in the automotive and medical industries. In the non-E&E manufactures segment, the announced expansion and operations of new plants, particularly for the production of rubber and chemical products, will also provide support to growth in these export segments.

There are, however, factors which will weigh on exports performance in 2019. Lower mineral prices and crude oil production are expected to more than offset the increase in LNG and CPO output, resulting in continued contraction in commodity exports. The ongoing trade tensions between the US and PR China will also affect export growth both directly through lower demand from affected countries and indirectly through slower

Table 4.1

External Trade

	2013-2017 average	2018*p*	2019*f*
	Annual change (%)		
Gross exports	**6.1**	**6.8**	**3.4**
of which:			
Manufactured	8.1	9.1	4.8
Agriculture	-0.2	-14.2	-2.2
Minerals	-1.2	7.2	-6.5
Gross imports	**6.8**	**4.9**	**4.5**
of which:			
Capital goods	3.9	-3.3	2.7
Intermediate goods	5.9	-3.9	3.7
Consumption goods	10.4	2.5	1.4
Trade balance (RM billion)	**86.4**	**120.5**	**114.9**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

production in the global value chains. While the trade actions implemented so far[2] are expected to lower export growth by 0.6 – 1.0 ppt in 2019, there could be some offsetting effects from trade diversion of US' imports away from PR China to Malaysia. The potential for this to occur is more likely if these products already account for a significant share of US import market and manufacturers have the capacity to ramp up production. The trade diversion could therefore reduce the negative impact of trade tensions on export growth, potentially by about 0.1 – 0.4 ppt.

Imports supported by continued domestic demand

Gross imports are projected to expand by 4.5% in 2019 (2018: 4.9%) on account of a turnaround in intermediate and capital imports. Higher imports of crude petroleum as input for the large oil refinery facility and continued growth in manufactured exports will support the increase in intermediate imports. Capital import growth is expected to rebound due to a low base effect in 2018 and continued investment activity in the manufacturing and services sectors. Consumption imports will be driven primarily by demand for imported food and beverages.

[2] Trade actions that have already been implemented since early 2018 include (i) blanket tariffs on solar panels, steel and aluminium; (ii) +25% tariff on USD50 billion worth of PR China imports and subsequent retaliation by PR China; (iii) +10% on USD200 billion worth of PR China imports and subsequent retaliation by PR China.

The services deficit is expected to be sustained, reflecting continued deficit in several major components of the services account. In particular, the transportation deficit is expected to remain sizeable as firms continue to rely heavily on foreign freight providers for trade activity. Payments for professional and technical services are expected to rise as businesses automate their operations. Payments for construction services, however, are expected to be lower following the completion of several large-scale projects. The travel account surplus will increase in tandem with projected higher tourist arrivals and per capita spending. Tourism Malaysia targets tourist arrivals to increase to 28.1 million in 2019, from 25.8 million in 2018.

The income account is projected to record a wider deficit, attributable to the increase in the number of locally-incorporated foreign firms which continue to earn sizeable profits. This reflects Malaysia's continued position as an attractive profit centre for foreign direct investments. The higher FDI income payment is expected to outweigh the income accrued to Malaysian firms investing abroad. DIA income in the mining sector[3] would most likely decline due to lower oil prices. The deficit in the secondary income account is expected to be sustained amid continued outward remittances by foreign workers.

Overall, the current account is projected to continue registering a surplus in 2019, albeit narrowing to 1.5% – 2.5% of GNI. Of significance, the current account is expected to remain in surplus in the absence of significant and persistent shocks, including a sharp slowdown in the global economy and a decline in commodity prices. This is due in large part to Malaysia's diversified export base which helps to mitigate the impact of shocks to the external sector.

Table 4.2

Current Account of Balance of Payments[1]

Item (Net)	*2018p*	*2019f*
	RM billion	
Goods	121.4	116.2
Services	-19.7	-19.8
Primary income	-49.4	-50.2
Secondary income	-18.8	-18.2
Current account balance	**33.5**	**28.0**
% of GNI	*2.4*	*1.5 ~ 2.5*

[1] The data are compiled in accordance with the Sixth Edition of the International Monetary Fund (IMF)'s Balance of Payments and International Investment Position Manual (BPM6)
p Preliminary
f Forecast

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

[3] The mining sector constituted one-third of investment income receipts in 2018.

INFLATION OUTLOOK

Broadly stable average headline inflation in 2019

Headline inflation is expected to average between 0.7% – 1.7% in 2019 (2018: 1.0%). The inflation projection incorporates some cost pass-through from domestic cost factors, but the upward impact will be offset by the expected lower global oil prices and the implementation of price ceilings on domestic retail fuel prices. Underlying inflation, as measured by core inflation,[4] is expected to be sustained amid the steady expansion in economic activity and in the absence of strong demand pressures.

For 2019 as a whole, several domestic cost factors including those arising from policy developments are expected to lead to moderate upward pressure on headline inflation compared to 2018. These factors include the lapse in the combined impact of the changes in consumption tax policy[5] towards the end of the year. In addition, other domestic cost factors, including the increase in the minimum wage and higher electricity tariff surcharge for businesses, could raise input costs for firms and thus, be passed on to retail prices. Externally, tighter supply conditions amid sustained global demand for key food commodities such as corn[6] are projected to sustain global food prices, and in turn, domestic food prices through higher input costs.

The impact of the higher cost factors on headline inflation will, however, be offset by the expected lower global oil prices. Although the Organization of the Petroleum Exporting Countries (OPEC) and several non-OPEC producers agreed in December 2018 to

[4] Core inflation excludes price-volatile and price-administered items whose price movements are not likely to be related to changes in demand conditions. Core inflation also excludes the estimated direct impact of consumption tax policy changes.
[5] Refers to the combined impact of the zerorisation of the Goods and Services Tax (GST) rate and the implementation of the Sales and Services Tax (SST).
[6] Based on the Food and Agriculture Organization of the United Nations (FAO) Cereal Supply and Demand Brief in March 2019.

cut oil production, the growth in global oil supply is expected to be supported by an expansion in US shale oil production. With moderate growth in global oil demand, the International Monetary Fund (IMF) projects crude oil prices to average at USD59 per barrel in 2019, a 14% decline from the 2018 average price of USD69 per barrel (2018: +30%).[7] Along with the implementation of price ceilings for RON95 petrol and diesel until mid-2019,[8] domestic fuel prices are expected to average lower in 2019 and have a downward impact on headline inflation.

Headline inflation declined to -0.7% in January 2019, reflecting mainly the lower domestic fuel prices. While headline inflation could remain low in the near term due to key policy measures, underlying inflation is expected to be sustained, supported by the steady expansion in economic activity. Meanwhile, improving labour productivity and ongoing investments for capacity expansion will help contain any excessive demand pressure on inflation. In the labour market, the unemployment rate is expected to be relatively unchanged at 3.3% – 3.5% in 2019 (2018: 3.4%) as employment growth will be matched by the expansion in the labour force. Nominal wage growth is also expected to remain stable. The Malaysian Employers Federation (MEF) reports that employers expect salary increments to average at 4.9% in 2019 (2018: 4.9%).[9] Firms' productive capacity will continue to expand, supported by sustained private investment growth of 4.9% in 2019 (2018: 4.5%).

There are several risks to the inflation outlook. First, the trajectory of headline inflation will be dependent on global oil prices. Second, domestic food prices are subject to the potential expansion in the list of controlled food items, weather conditions which could affect food supply, and the cost of imported inputs to food production. Third, the strength of growth in both Malaysia and its trading partners could affect the extent of demand pressure on domestic inflation.

[7] Average price of UK Brent, West Texas Intermediate (WTI) and Dubai Fateh crude oil, equally weighted, as published by the IMF in the January 2019 update to the World Economic Outlook.

[8] Since March 2019, retail fuel prices are subject to price ceilings of RM2.08 per litre for RON95 petrol and RM2.18 per litre for diesel, until the implementation of the targeted fuel subsidy.

[9] Based on the 2018 MEF Salary Surveys for Executives and Non-Executives. The salary increment figures used are simple averages of employers' expectations of salary increments for both executives and non-executives.

MONETARY POLICY

Monetary policy in 2019 will focus on promoting steady growth of the Malaysian economy and price stability

Monetary policy in 2019 will focus on supporting the steady growth of the Malaysian economy amid an environment of relatively low inflation. Growth of the domestic economy is expected to be sustained with continued support from private sector spending. However, there remain downside risks to the domestic growth outlook. In addition to the downside risks emanating from the global environment, commodity-related supply disruptions could continue to weigh on domestic growth prospects. Headline inflation is projected to be broadly stable. Underlying inflation, as measured by core inflation, is expected to be sustained amid the steady expansion in economic activity and in the absence of strong demand pressures. The priority of the Monetary Policy Committee (MPC) would thus be to ensure that the stance of monetary policy remains accommodative and supportive of real economic activity amid relatively contained risks to inflation.

At the same time, monetary policy will also consider the prevailing monetary and financial conditions. While risks of financial imbalances are expected to remain contained, the MPC is cognisant of challenges emanating from potential continued volatility in global capital flows. In this regard, the Bank will continue to ensure sufficient liquidity and orderly market conditions that remain supportive of financial intermediation activity.

The broad range of policy options available provide the Bank with flexibility to manage emerging risks. This policy toolkit includes monetary policy, micro- and macroprudential measures. Measures to further deepen the domestic financial markets will also contribute to orderly market conditions. The combined effect of these policies will ensure that policy efficacy is maintained without the overburdening of any single policy tool.

FISCAL POLICY

The Government remains committed to fiscal consolidation

Fiscal policy in 2019 aims to strengthen the Government's fiscal position by pursuing gradual fiscal consolidation while lending continued support for growth, paring down debt and liabilities as well as promoting economic inclusiveness. Correspondingly, the medium term fiscal plan outlined the path towards consolidation with fiscal balances targeted at -3.4% and -3.0% of GDP in 2019 and 2020 respectively. The path towards fiscal consolidation is anchored by several key reform initiatives. First, the Government is committed towards enhancing expenditure effectiveness in the public sector through the implementation of zero-based budgeting[10] and the announcement of the Government Procurement Act. Second, priority was also given to diversify and broaden the revenue base. The Tax Reform Committee (TRC), which was formed to comprehensively review the taxation system, has proposed various strategies in the 2019 Budget.[11] Third, to encourage holistic and transparent debt management, the Government established a Debt and Liabilities Management Committee, announced the formation of a Debt Management Office and pledged to adopt accrual accounting by 2021.

The 2019 Budget accorded emphasis to improving socio-economic wellbeing, strengthening social protection programmes, improving employability and initiatives to raise productivity, particularly for Small and Medium Enterprises (SMEs). Assistance for the lower and middle income segments to cope with the rising cost of living is provided through affordable housing programmes[12] and fiscal transfers[13] while social protection programmes have been further expanded.[14] Human capital development remains a key priority of the Government, where efforts will continue to focus on education, up-skilling and matching programmes through industrial training[15] to cultivate a competent labour force and enhance employability. To further enhance Malaysia's overall economic competitiveness, the Government will also continue to provide funds and incentives to accelerate SMEs' adoption of digital technology and transition towards the fourth industrial revolution.[16]

Table 4.3

Federal Government Finance

	RM billion		Annual change (%)	
	2018*p*	2019*B*	2018*p*	2019*B*
Revenue	232.9	261.8	5.7	12.4
Total expenditure	287.1	314.6	9.3	9.6
Operating expenditure	*231.0*	*259.9*	*6.1*	*12.5*
Gross development expenditure	*56.1*	*54.7*	*25.0*	*-2.5*
Loan recoveries	0.8	0.7		
Overall balance	**-53.4**	**-52.1**		
% of GDP	**-3.7**	**-3.4**		
Sources of financing:				
Net domestic borrowing	52.0	-		
Net external borrowing	-0.3	-		
Realisable assets[1] and adjustments	1.7	-		

[1] A negative (-) sign indicates a build-up in assets
p Preliminary
B Budget
Note: Numbers may not add up due to rounding

Source: Ministry of Finance, Malaysia

[10] Savings from zero-based budgeting were evidenced by the reduction in key operating expenditure items. For example, subsidies are expected to record a contraction of 19.8% on annual basis (2019 Budget: RM22.3 billion, 2018 preliminary: RM27.8 billion).

[11] In the 2019 Budget, the Tax Reform Committee proposed measures which include a Special Voluntary Disclosure Programme, service tax on imported services, departure levy and revision to the Real Property Gains Tax (RPGT) for disposals after the fifth year.

[12] Includes *Perumahan Penjawat Awam Malaysia* and *Perumahan Rakyat 1Malaysia* (PR1MA).

[13] Includes *Bantuan Sara Hidup* (BSH), i-SURI and targeted fuel subsidy.

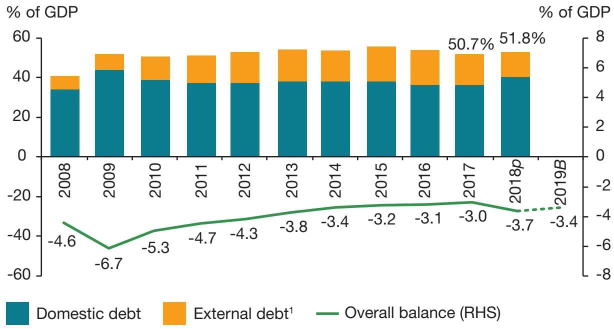
[14] Includes mySalam and *Skim Perlindungan Kesihatan* (PEKA).

[15] Includes the Human Resources Development Fund's apprenticeship and Graduate Enhancement Programme for Employability programmes, and Technical and Vocational Education and Training (TVET) contestable fund.

[16] Includes matching funds from venture capital funds managed by government agencies.

Chart 4.1: Federal Government Fiscal Balance and Debt

The Government remains committed to fiscal consolidation and reforms



[1] External debt comprises foreign currency debt (offshore borrowing) and non-resident holdings of RM-denominated debt (MGS, GII, T-bills and *Sukuk Perumahan Kerajaan*)

p Preliminary
B Budget

Source: Ministry of Finance, Malaysia

Going forward, the Government has indicated its commitment towards ensuring fiscal sustainability and a stronger governance framework through the implementation of holistic fiscal reforms. The Fiscal Policy Committee (FPC) and the Public Finance Committee (PFC) were tasked to assess and strike a balance between being fiscally prudent and ensuring efficient spending and investment for economic growth. The introduction of a Fiscal Responsibility Act in 2021 is another step towards more progressive fiscal reforms. It will further solidify fiscal discipline, strengthen governance and accountability, and promote greater transparency.

When the Future Starts Today: Inflation Expectations of Malaysian Households

By Zul-Fadzli Abu Bakar and Nur Aimi Abdul Ghani

Assessments on inflation expectations are of great importance in central banking, both in advanced and emerging market economies. Central banks care about inflation expectations given their prospective influence on key economic and financial variables such as actual inflation, households' consumption and saving decisions, firms' price- and wage-setting decisions, as well as financial asset valuations.

The concept of inflation expectations applies to households, firms, professional forecasters and financial markets. While the beliefs of future inflation hold across these different economic agents, their expectations are not interchangeable as they provide different insights (Table 1) (Coibion et al., 2018).

Table 1: Differences between Inflation Expectations of Households, Firms, Professional Forecasters and Financial Markets

	What are they?	How are they commonly measured?	What insights do they provide?
Households	Households' view of how prices will evolve in the future	Survey of households	Consumption & saving decisions, wage bargaining
Firms	Inflationary sentiments of firms	Survey of firms	Pricing strategy, investment, hiring and wage-setting decisions
Professional forecasters	Expected inflation rate of professional economic forecasters	Survey of professional economic forecasters	View on broader economic conditions
Financial markets	Financial markets' expectations of future prices	Market-implied, i.e. derived from prices of financial instruments	Financial asset valuations

Source: Coibion et al. (2018)

Given these different types of inflation expectations, this article focuses specifically on inflation expectations of households[1] in Malaysia, using data from the Bank Negara Malaysia Consumer Sentiment Survey (BNM CSS). It aims to explain the formation of these expectations, seeking insights into how households process information to inform their future price outlook. It then explores factors that contribute to biases in inflation expectations. As inflation expectations may influence households' spending decisions, the article also examines the relationship between inflation expectations and households' spending decisions.

[1] In the BNM CSS, a household is defined as related and/or unrelated persons who usually live together and make common provisions for food and other living essentials.

1. Why are inflation expectations important?

"Looks like prices are going to go up by quite a lot… I'd better buy this TV now before it gets even more expensive!"

"Yes you're right, but I think I'll start saving up in case there is an emergency in the future"

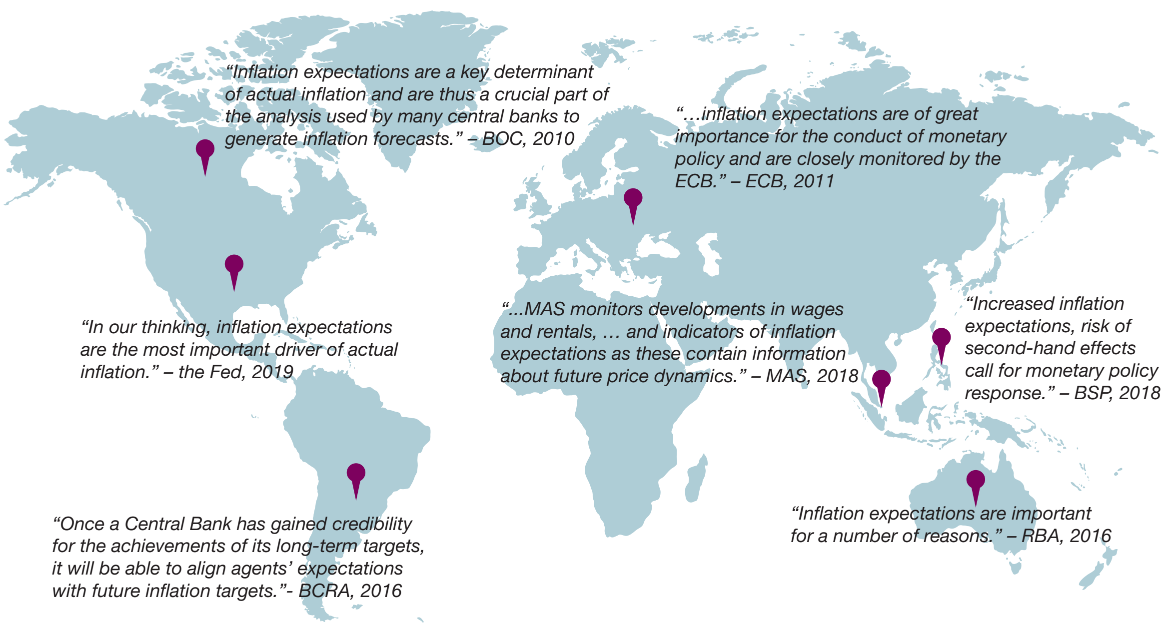
Often, we may hear statements like these from friends, families, or strangers in our daily lives. In essence, these statements are based on what is referred to as inflation expectations: the belief of how much prices will change in the future. In the modern economy, where every household is affected by price changes, it is reasonable to infer that each decision-maker holds some belief about future inflation (Mohanty, 2012).

Understanding inflation expectations is important because they affect the real economy in a number of ways (Moore, 2016). First, for firms, inflation expectations affect price-setting decisions. If firms expect higher inflation, they may be more inclined to set higher prices, which would lead to higher actual inflation. Second, in countries with strong labour bargaining power, inflation expectations affect wage negotiations. If inflation is expected to be persistently higher, workers bargain for higher wages, which places upward pressure on firms to increase prices. Third, for households in general, inflation expectations affect current spending decisions.

Inflation Expectations, Inflation Dynamics and the Conduct of Central Banking

Over the years, there has been a marked increase in the number of central banks that factor inflation expectations into their monetary policy considerations (Diagram 1). This trend is largely grounded upon economic theory which posits that inflation expectations are salient in influencing the behaviour of economic agents, making them a key driving force of actual inflation. The New Keynesian Phillips Curve (NKPC), which is a theoretical framework for inflation dynamics, explicitly incorporates this forward-looking expectations component. A property of the NKPC is that inflation is a forward-looking process, driven by expectations of future inflation and not merely past and current shocks.

Diagram 1: Statements on Inflation Expectations among Policymakers Across the Globe



Source: The Federal Reserve System (the Fed), Bank of Canada (BOC), European Central Bank (ECB), Banco Central de la República Argentina (BCRA), Bangko Sentral ng Pilipinas (BSP), Reserve Bank of Australia (RBA) and Monetary Authority of Singapore (MAS)

Inflation expectations affect actual inflation because they influence spending, price- and wage-setting decisions. They can cause a long-lasting impact to actual inflation, whereby one round of price increases triggers further rounds as inflationary psychology takes hold. Consequently, modern central banking practices involve anticipating future inflation and managing inflation expectations to ensure price stability. From a policy perspective, this forward-looking element opens the door to expectations management and communications as added tools of monetary policy.

Notwithstanding this, the sources of inflation expectations, as well as the actual drivers of inflation itself, need to be assessed holistically for monetary policy considerations. Notably, whether inflation expectations and actual inflation are demand- or supply-driven. The early 2007 – July 2008 period provides a good example, a time when global commodity prices, as measured by the IMF Commodity Price Index, increased by 83%, leading to rising global inflation. In the euro area, concerns of rising inflation expectations were at the forefront of policy discussions as there were risks of second-round effects to actual prices from price- and wage-setting behaviour. In other words, if rising inflation expectations were not managed, the commodity price shock may have had longer-lasting effects to actual inflation if firms were setting higher prices and households were bargaining for higher wages in anticipation of the higher future inflation. This, along with other considerations, led the European Central Bank (ECB) to increase its policy rate by 25 basis points in July 2008.

In Malaysia, the monetary policy stance was maintained during this period despite the increase in supply-driven inflation pressures. While the risks to inflation were on the upside, it was assessed that the risks to growth were on the downside given the weakening global growth, and thus reduced the likelihood of second-round effects to inflation. As the global financial crisis intensified, policy rates were consequently reduced by 150 basis points from October 2008 to February 2009.

Inflation expectations are only one of the many determinants of inflation. Ultimately, monetary policy must give due consideration to the overall inflation outlook, in addition to economic growth prospects and risks of financial imbalances.

2. How are household inflation expectations measured?

Household inflation expectations are measured through surveys

Unlike actual inflation itself, inflation expectations are unobserved. As such, their measurements rely on inference. A standard approach globally is to directly question households what they expect inflation to be in the following year through periodic surveys catered to extract household economic information (Table 2). There are variations to this question, which may be in qualitative or quantitative form, and either general or specific:[2]

Qualitative and general: "*During the next 12 months, do you think that* ***prices in general*** *will go up, go down, or remain the same?*"

Quantitative and specific: "*During the next 12 months,* ***how much*** *do you think prices of* ***fuel*** *will go up, go down, or do you think they will remain the same?*"

For Malaysia, similar questions are featured as part of the BNM CSS. Each month, around 1,000 respondents are interviewed from samples designed to be representative of the Malaysian population, with respondents ranging from 18 to 74 years old. The BNM CSS commenced in 2013 to bridge information gaps pertaining to consumer expectations on economic growth, inflation, wage growth and borrowing cost.[3] This survey also gathers households' demographics such as their household size, income and location.

[2] These questions are adapted from the University of Michigan Survey of Consumers for American households (Meyer and Venkatu, 2011).

[3] The Malaysian Institute of Economic Research (MIER) also conducts a similar survey on consumer sentiments in Malaysia. The main differences between MIER's survey and that of BNM's are the coverage of topics and frequency of survey.

Table 2: Surveys on Inflation Expectations of Households in Various Countries

Country	Survey	Year started	Frequency	Coverage	Expectation horizon
United States	University of Michigan, Survey of Consumers	1946	Monthly	Minimum of 500 households	1-year & 5-year ahead
EU	European Commission, Business and Consumer Survey	1961	Monthly	More than 41,000 households	1-year ahead
Australia	Melbourne Institute, Consumer Attitudes, Sentiments and Expectations in Australia Survey	1974	Monthly	1,200 households	1-year ahead
Japan	Bank of Japan, Opinion Survey on the General Public's Views and Behavior	1993	Quarterly	4,000 households	1-year & 5-year ahead
New Zealand	Reserve Bank of New Zealand, Household Inflation Expectations Survey	1995	Quarterly	1,000 households	1-year & 5-year ahead
Canada	Bank of Canada, the Canadian Survey of Consumer Expectations	2015	Quarterly	1,000 households	1-year, 2-year & 5-year ahead
Indonesia	Bank Indonesia, Consumer Expectation Survey	1999	Monthly	4,600 households	6-month ahead
India	Reserve Bank of India, Inflation Expectations Survey of Households	2005	Quarterly	6,000 households	3-month & 1-year ahead
Singapore	SKBI-MasterCard Index of Inflation Expectations Survey	2011	Quarterly	400 households	1-year & 5-year ahead
Malaysia	BNM Consumer Sentiment Survey	2013	Monthly	1,000 households	1-year & 2- to 3-year ahead

Source: University of Michigan, European Commission, Melbourne Institute, Bank of Japan, Reserve Bank of New Zealand, Bank of Canada, Bank Indonesia, Reserve Bank of India, Singapore Management University, and Bank Negara Malaysia

3. How do Malaysian households form their inflation expectations?

Households form their inflation expectations through a combination of past, current and forward-looking beliefs

To interpret the level and changes of inflation expectations, it is useful to understand how they are formed. Households place different weights on a host of factors when constructing their inflation expectations (Rowe, 2016). On the one hand, "backward-looking" households develop inflation expectations by extrapolating past and current inflation experiences into the future. These past and current inflation experiences are also referred to as inflation perceptions, which are the beliefs of how much prices have changed (Table 3). Sentiments surrounding income also shape inflation perceptions because changes in income relative to price affect the perceived impact of price changes, and thereby households' views toward affordability (Ranyard et al., 2008; Gärling and Gamble, 2006; Gamble, 2006).

Table 3: Differences Between Inflation Expectations, Inflation Perceptions and Actual Inflation

	Inflation expectations	Inflation perceptions	Actual inflation
Definition	The belief of how much prices will change in the future	The belief of how much prices have changed from the past	How much prices have changed from last year, based on a single basket of goods and services in the Consumer Price Index (CPI)
Influenced by	Individual's information sets of the past, present and future	Individual's information sets of the past and present	Average consumption patterns of Malaysian households and average prices in the economy

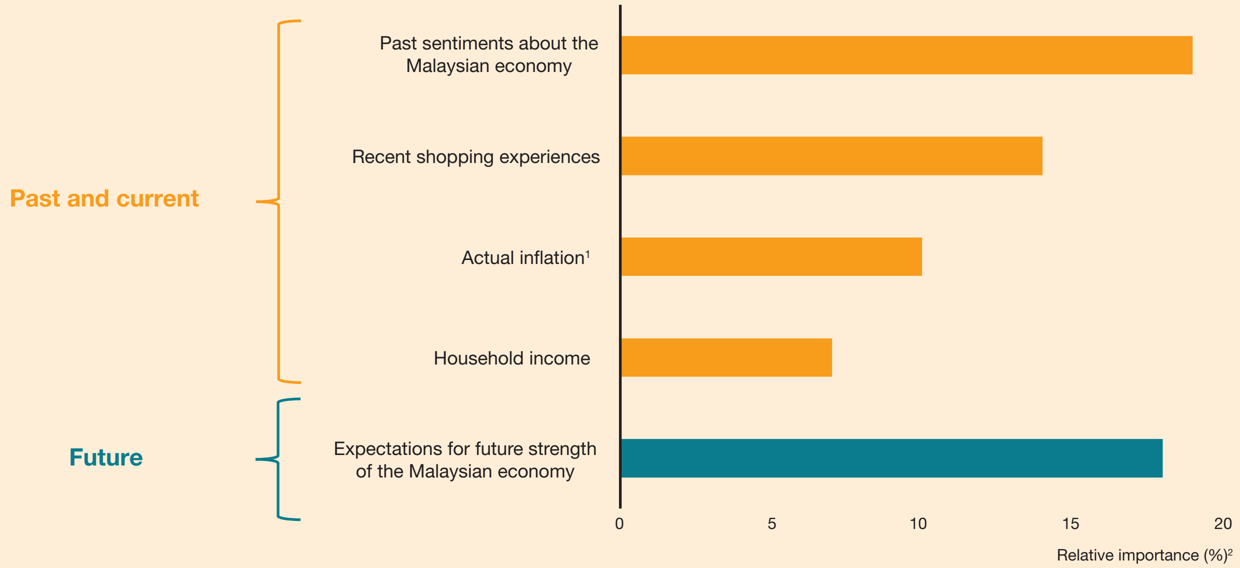
Source: Bank Negara Malaysia, Arioli et al. (2017)

On the other hand, "forward-looking" households consider expectations of future broader economic developments, such as their sentiments on the economy. In reality, households can integrate both backward- and forward-looking factors in shaping their inflation expectations.

On average, Malaysian households place weights on both backward- and forward-looking factors (Chart 1).[4] Past sentiments on the domestic economy, recent shopping experiences and current income levels are important backward-looking factors, reflecting their role as easy, accessible and personal ways to form predictions. The forward-looking aspect is also important, with households also considering their expectations of the future strength of the Malaysian economy when forming inflation expectations.

Chart 1: Selected Factors Estimated to Determine Inflation Expectations of Malaysian Households

Households consider both backward- and forward-looking factors when forming inflation expectations



[1] Actual inflation refers to Consumer Price Index (CPI) inflation of the current and past three months
[2] Relative importance refers to how much the factors contribute to the movements in inflation expectations relative to other factors considered

Note: Other factors that are considered include expectations for future interest rate on savings, expectations for future interest rates on loans and various sources of inflation information such as the mass media and internet. The factors chosen are based on Rowe (2016).

Source: Bank Negara Malaysia estimates using data from the Bank Negara Malaysia Consumer Sentiment Survey and Department of Statistics, Malaysia

[4] The estimates are derived using an Ordinary Least Squares (OLS) regression of inflation expectations against factors identified in the literature to affect inflation expectations. The regression also controls for time effects. The estimates shown are statistically significant at the 1% level.

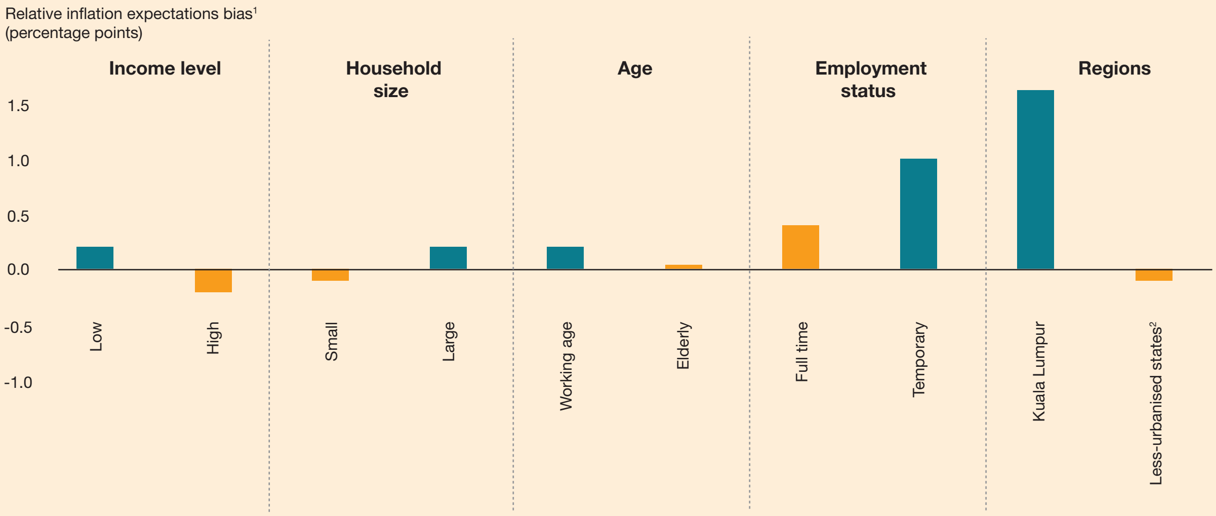
Households who are pessimistic on economic or financial conditions may be more likely to have higher inflation expectations. As these households struggle to make ends meet, either due to insufficient income or rising prices, they are likely to anticipate higher future inflation (Ehrmann et al., 2015). In other countries, it was found that financially constrained households also pay more attention to price changes compared to less constrained households, and that households in general are more receptive to bad news than good news. In totality, this could lead to higher inflation expectations (Ehrmann et al., 2015; Snir and Levy, 2011, Baumeister et al., 2001).

Most Malaysian households' inflation expectations are anchored at a relatively stable rate of 1 – 4%, though disparity is still observed

Some households tend to over-predict future inflation, which is also referred to as positive expectations bias, while others may be more inclined to under-predict, which is called negative inflation expectations bias. This disparity is evident in Malaysia when the inflation expectations bias is grouped by demographic groups (Chart 2). Lower-income households, large households, working age individuals, households with less job security, and households in Kuala Lumpur have greater tendency for higher inflation expectations.[5] Some of the groups, such as lower-income households, consume more necessities (e.g. food) which typically exhibit higher rates of inflation. The tendency for upward bias for these groups may also reflect their cost of living burden and concerns about insufficient income. Indeed, a common grievance voiced by these groups is that the actual inflation rate is not reflective of the actual price increases they experience on the ground.

Chart 2: Contribution of Main Demographic Characteristics to Inflation Expectations Bias

Certain households have greater tendency towards higher inflation expectations



Note: For income level, low refers to monthly household income below RM5,000 while high, above RM8,000. For household (HH) size, small refers to number of HH members below four while large, above seven. For age, working age refers to respondents aged between 20-59 while elderly, 60-74. For employment status, full time refers to permanent employees working eight hours a day or five days a week, while temporary refers to employees under a short-term, non-contractual or ad-hoc work arrangement. The methodology is based on Leung (2009)

[1] The bias refers to 1-year ahead inflation expectations minus actual inflation outcomes. The relative inflation expectations bias should be interpreted relative to a baseline respondent who represents a HH that earns RM5,000-RM8,000, has a HH size of between 4-7 members, is aged between 18-19, is self-employed (e.g. sole proprietor or independent professional) and is residing outside Kuala Lumpur and less-urbanised states

[2] Less-urbanised states are states with urbanisation levels of below 55%, according to the 2010 Population and Housing Census of Malaysia. These states include Sabah, Sarawak, Pahang and Kelantan

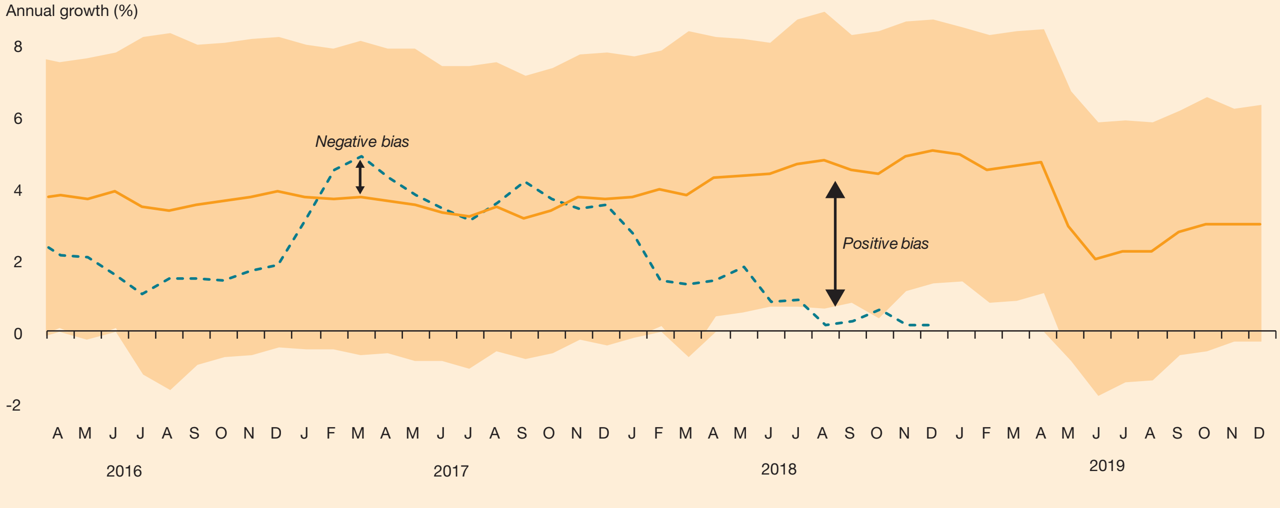
Source: Bank Negara Malaysia estimates using data from the Bank Negara Malaysia Consumer Sentiment Survey and Department of Statistics, Malaysia

[5] The estimates are derived using an Ordinary Least Squares (OLS) regression of inflation expectations bias against demographic characteristics to quantify their contributions to the over-prediction or under-prediction of future inflation. All the estimates shown are statistically significant at the 10% level, except for elderly respondents and respondents residing in less-urbanised states.

Notwithstanding the disparity across groups, for most periods, overall households' inflation expectations deviate on the upside from the actual inflation outcomes (Chart 3). This observation is not unique to Malaysia. Households, in both advanced and emerging economies, commonly display deviations in inflation expectations from the actual inflation outcomes (Coibion et al. 2018, Kliesen, 2015, Mohanty, 2012, Gnan et al. 2009, Deutsche Bundesbank, 2001). For countries with a longer history of household survey data, namely the United States, Australia, Japan and the Philippines, the positive bias can range between 1 and 4 percentage points. On average, most households' inflation expectations in Malaysia are broadly anchored at a relatively stable rate of 1 – 4%, close to the actual inflation long-run average of 3% (1980 – 2018).

Chart 3: Inflation Expectations of Malaysian Households

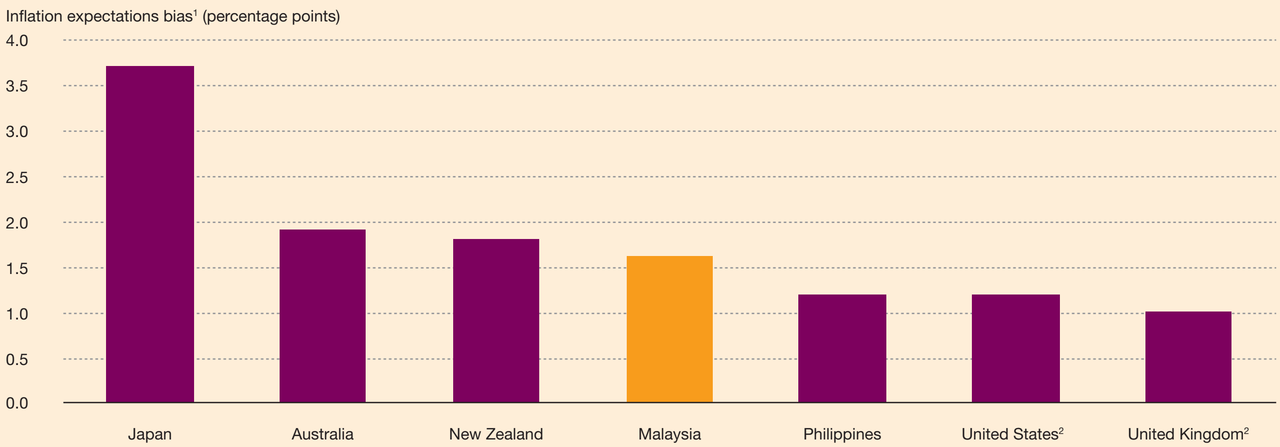
In line with experiences of other countries, inflation expectations of Malaysian households are typically different from the actual inflation outcomes



Note: The shaded area refers to the 1 standard deviation above and below the mean inflation expectations

Source: Bank Negara Malaysia estimates using data from the Bank Negara Malaysia Consumer Sentiment Survey and Department of Statistics, Malaysia

Average Household Inflation Expectations Bias Across Selected Countries Since 2015



[1] The bias is calculated by taking 1-year ahead mean inflation expectations minus actual inflation outcomes
[2] Inflation expectations for the United States and the United Kingdom are based on the median instead of the mean

Source: Bank Negara Malaysia estimates using data from the Bank Negara Malaysia Consumer Sentiment Survey, Department of Statistics, Malaysia and the respective household surveys

Outlook and Policy in 2019

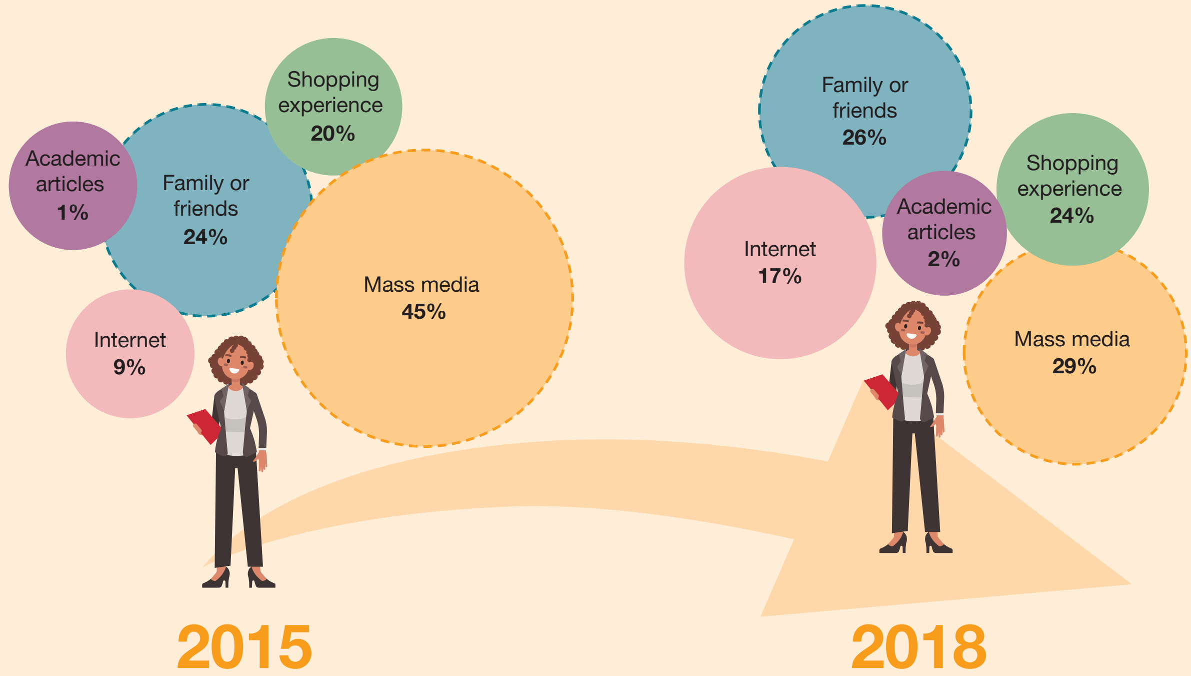
4. Why do inflation expectations differ from actual inflation?

Inflation expectations are unlikely to be the same as the actual inflation outcomes because forming accurate beliefs about future prices is challenging and costly, even for professional forecasters. It is found that in countries with extremely high inflation such as Argentina, households appear to be much more well-informed on inflation as its impact is acutely felt; whereas in countries with low inflation, households pay less attention to inflation given the relatively lower potential financial cost of ignoring inflation (Cavallo et al., 2017). In Malaysia, when respondents were asked whether they understood what the term “inflation” means, 77% of them answered no. The low awareness among households would likely contribute to biases in their inflation expectations. The wedge between inflation expectations and actual inflation outturns is driven by diverse information sets, different spending patterns and unanticipated shocks.

First, diverse information sets. Households rely on various information sources in informing their views on price developments. In Malaysia, households appear to be largely dependent on information sources that are relatively accessible when forming inflation expectations. These include mass media, family and friends, as well as recent shopping experiences (Diagram 2).

Diagram 2: Household Sources of Information about Inflation

The role of the internet as a source of infomation on inflation has markedly increased over time



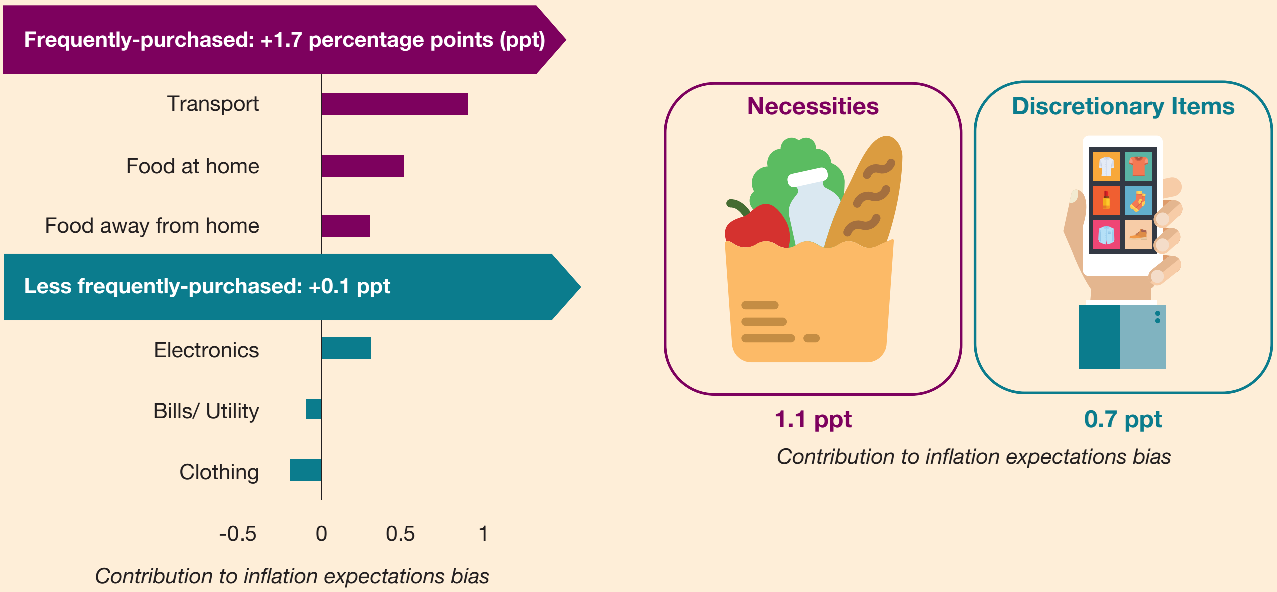
Source: Bank Negara Malaysia Consumer Sentiment Survey

These information sets and their importance are different from those used to construct the actual inflation rate, which is measured by the Consumer Price Index. This could lead to inflation expectations being different from the actual inflation outcome.

Second, the different types of items consumed. Households typically over-estimate future inflation of frequently-purchased items and necessities, such as transport and food (Diagram 3). Repeated shopping experiences of the same items (usually non-durable necessities), coupled with their corresponding price increases are more easily recalled and are therefore vivid in one’s recollection when forming expectations. It was estimated that households in Malaysia who rely on recent shopping experiences as an information source tend to over-predict inflation by 1.2 percentage points (ppt) compared to households who do not rely on recent shopping experiences. This is compounded by memory bias, whereby increases in prices are more easily recalled rather than price declines (Loke and Khong, 2017).

Diagram 3: Contribution of Key Consumer Items to Inflation Expectations Bias

Households have a higher tendency to over-predict the future inflation of frequently-purchased and necessity items

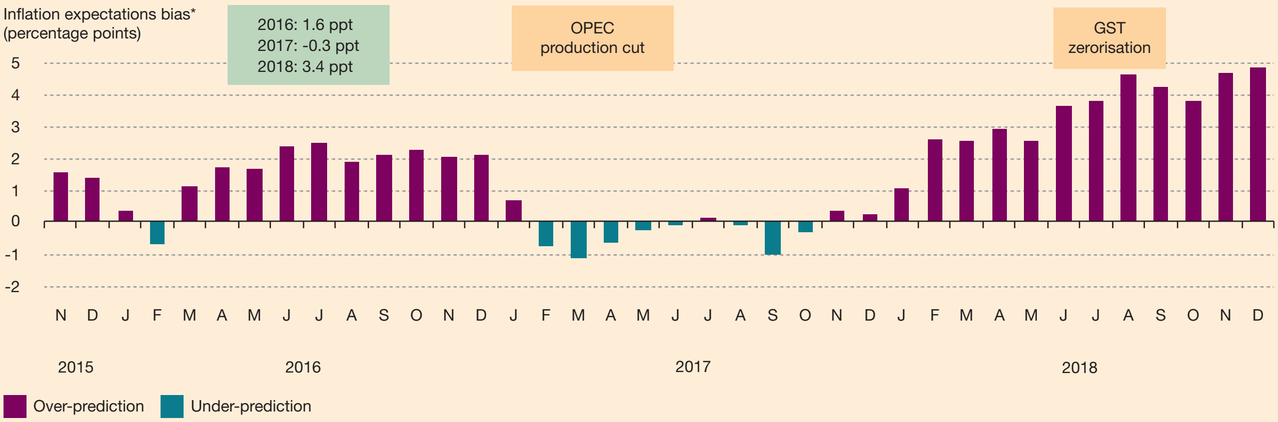


Source: Bank Negara Malaysia estimates using data from the Bank Negara Malaysia Consumer Sentiment Survey and Department of Statistics, Malaysia

Third, unanticipated shocks. Even if households are able to use all existing information to inform future inflation expectations, there remains a possibility of unforeseen events. In 2018, the actual inflation outcome was lower than expected mainly due to the zerorisation of the Goods and Services Tax (GST) rate,[6] which led to a broad-based decline in the prices of goods and services that were previously subjected to the GST. As a result, there was a positive bias as inflation expectations of households over-predicted actual inflation outcomes by an average of 3.4 ppt (Chart 4).

Chart 4: Inflation Expectations Bias: Over- and Under-Predictions Relative to Actual Inflation

Inflation expectations bias is subject to unanticipated shocks to the actual inflation outcomes



*The bias is calculated by taking 1-year ahead inflation expectations minus actual inflation outcomes

Source: Bank Negara Malaysia estimates using data from the Bank Negara Malaysia Consumer Sentiment Survey and Department of Statistics, Malaysia

[6] The zerorisation of the GST rate was between 1 June 2018 and 31 August 2018. Subsequently, the GST was replaced by the Sales and Services Tax (SST) effective 1 September 2018.

In 2017, the actual inflation outcome was higher than anticipated due to global oil prices that increased unexpectedly following the Organization of the Petroleum Exporting Countries (OPEC)'s agreement to cut production from 1 January 2017.[7] Subsequently, the inflation expectations of households under-predicted actual inflation, with a negative bias of -0.3 ppt.

5. Do inflation expectations of households affect spending decisions?

Higher inflation expectations could increase or decrease households' current spending (Table 4). Higher inflation expectations would lead to higher current real spending when households decide to frontload future purchases to protect themselves against a costlier future environment. In addition, assuming unchanged nominal interest rates, higher inflation expectations would lower real interest rates, thereby encouraging borrowers to spend.

Table 4: The Impact of Higher Inflation Expectations to Current Real Spending

Higher current real spending from higher inflation expectations:

Type of households	Reasons
General	**Frontloading of future purchases** *Higher inflation expectations signal that it is costlier to spend in the future, so it is favourable to frontload future spending today*
Borrowers	**Lower real interest rates for debt repayments** *The lower real interest rates lead to a perceived increase in wealth for borrowers. If borrowers have higher propensity to consume out of wealth than lenders, aggregate spending will increase*

Lower current real spending from higher inflation expectations:

Type of households	Reasons
General	**Uncertainty and increased precaution** *Higher inflation expectations may signal an environment of economic uncertainty, whereby households will tend to withhold spending and increase savings for precautionary purposes*
Financial investors	**Lower real income from financial assets** *Higher inflation expectations are a tax on real financial income due to the lower expected real returns. For households that rely on financial income, this discourages spending*

Source: Mian et al. (2013), Bachmann et al. (2015) and Coibion et al. (2018)

On the other hand, higher inflation expectations could lead to a decline in current real spending if households associate the higher inflation expectations with broader economic uncertainty, thereby preferring to save for precautionary reasons. For financial investors, the lower real interest rates also reduce expected real income from financial assets, discouraging spending. Overall, the effect of inflation expectations on real spending would depend on which of these factors dominate.

Households' sentiments on current prices, income, the overall economy, and their debt burden also influence their spending decisions (Diagram 4). For Malaysian households, while sentiments on income and current prices are the major factors that influence reported current real spending, there is still a role for inflation expectations, though small. Notably, there are other more prominent determinants of real spending decisions in Malaysia that are not captured by the BNM CSS, such as wealth (Bank Negara Malaysia, 2013).

[7] The stronger-than-expected global oil demand since the second quarter of 2017 amid production cuts led to falling inventories, which also supported the increase in oil prices. The rise in global oil prices was further compounded by unexpected supply disruptions in the US Gulf Coast due to Hurricane Harvey at the end of August and geopolitical tensions in the Middle East towards the end of the year.

Diagram 4: Relative Importance* of Various Types of Sentiments to Reported Current Real Spending

Households consider, among others, their sentiments on current prices and income when making spending decisions

* Relative importance refers to how much the sentiments contribute to reported current real spending, relative to the other sentiments considered

Note: The methodology is based on Ichiue and Nishiguchi (2013)

Source: Bank Negara Malaysia estimates using data from the Bank Negara Malaysia Consumer Sentiment Survey

6. Conclusion and policy discussions

Inflation expectations matter because they affect key economic and financial variables such as actual inflation, wage, spending and financial asset valuations. Looking specifically at inflation expectations of households in Malaysia, households form their inflation expectations by considering both backward- and forward-looking factors, such as recent shopping experiences and current income levels, as well as the future outlook of the domestic economy. Nevertheless, inflation expectations differ across households, given the different compositions, priorities and experiences. Certain demographic groups that typically experience higher cost of living burden, such as lower-income and large households, tend to display higher inflation expectations.

As commonly experienced by other countries, there is evidence of a wedge between households' inflation expectations and actual inflation outturns. This reflects households' broad inattention to inflation, varied information sets used to gain information about inflation, different consumption patterns, as well as unanticipated shocks to the economy.

However, the impact of households' inflation expectations on their current spending decisions is small, reflecting other more prominent determinants such as sentiments on income and current prices in driving consumption. The implication of this finding, therefore, needs to be considered with care and in the broader context of factors driving household consumption spending. Separately from consumption, higher inflation expectations could result in higher actual future inflation if they become entrenched, whereby one round of price increase triggers further rounds as inflationary psychology takes hold. As such, it is important for central banks to place focus on ensuring that these expectations are stable and anchored, rather than engineering higher expectations to meet short-term economic goals. This goes back to the need for having a solid understanding of how households form inflation expectations, in order for any expectation anchoring strategies to be effective.

To gain a complete understanding of the impact of inflation expectations on the Malaysian economy, inflation expectations of firms and financial markets should also be assessed in order to obtain a comprehensive picture that includes insights on price- and wage-setting decisions, as well as financial market valuations.

As ruminated by Tan Sri Dato' Abdul Aziz bin Haji Taha, the second Malaysian Governor of Bank Negara Malaysia, nearly four decades ago – "*Once businessmen and consumers discern an absence of will by the authorities to resist inflation, their expectations of rising inflation will be strengthened and they begin to act in a way that will make these expectations self-fulfilling*" (Bank Negara Malaysia, 1989).

Today, this statement remains highly relevant. For central banks, continuous research on the drivers of inflation expectations, clarity in communication and educational pursuit in addressing inattention to inflation – from the concept of inflation to the technicalities of its formulation – will go a long way in preventing the unhinging of inflation expectations.

References

Arioli, Rodolfo, Colm Bates, Heinz Dieden, Ioana Duca, Roberta Friz, Christian Gayer, Geoff Kenny, Aidan Meyler, Iskra Pavlova, "EU Consumers' Quantitative Inflation Perceptions and Expectations: An Evaluation," *European Central Bank Occasional Paper Series*, 2017.

Bachmann, Rüdiger, Tim O. Berg, and Eric R. Sims, "Inflation Expectations and Readiness to Spend: Cross-Sectional Evidence," *American Economic Journal: Economic Policy,* 7(1), 1-35, 2015.

Bank Negara Malaysia, "Central Banking In An Era of Change, Landmark Speeches: 1959 –1988," 1989.

Bank Negara Malaysia, "Evolving Household Balance Sheets and Implication for Private Consumption," *Annual Report*, pages 70-73, 2013.

Baumeister, Roy F., Ellen Bratslavsky, Catrin Finkenauer, and Kathleen D. Vohs, "Bad is Stronger Than Good," *Review of General Psychology* 5(4): 323-70, 2001.

Cavallo, Alberto, Guillermo Cruces, and Ricardo Perez-Truglia, "Inflation Expectations, Learning, and Supermarket Prices: Evidence from Survey Experiments," *American Economic Journal: Macroeconomics* 9(3): 1-35, 2017.

Coibion, Olivier, Yuriy Gorodnichenko, Saten Kumar, and Mathieu Pedemonte, "Inflation Expectation as a Policy Tool?," *NBER Working Paper* No. 24788, 2018.

Deutsche Bundesbank, "The Information Content of Survey Data on Expected Price Developments for Monetary Policy," *January Monthly Report* 53(1), 35–49, 2001.

Doepke, Matthias, and Martin Schneider, "Inflation and the Redistribution of Nominal Wealth," *Journal of Political Economy*, Volume 114, (Number 6), 1069-109, 2006.

Ehrmann, Michael, Damjan Pfajar, and Emiliano Santoro, "Consumers' Attitudes and Their Inflation Expectations," *Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board*, 2015.

Gamble, Amelie, "Euro Illusion or the Reverse? Effects of Currency and Income on Evaluation of Prices of Consumer Products," *Journal of Economics Psychology*, 27(4), 531-540, 2006.

Gärling, Tommy, and Amelie Gamble, "Change in Perceived Value of Money without Change in Nominal Representation," Göteborg Psychological Report No. 36:4, *Göteborg University, Department of Psychology*, 2006.

Gnan, Ernest, Johann Scharler, and Maria Antoinette Silgoner, “Inflation Expectations – Role and Measurement for Monetary Policy,” *Monetary Policy & the Economy, Oesterreichische Nationalbank (Austrian Central Bank)*, Issue 2, pages 41-67, 2009.

Hoover, Kevin D, “Phillips Curve,” *The Concise Encyclopedia of Economics*, 2008.

Ichiue, Hibiki, and Shusaku Nishiguchi, “Inflation Expectations and Consumer Spending at the Zero Bound,” *Bank of Japan Working Paper Series*, 2013.

Kliesen, Kevin, “How Accurate Are Measures of Long-Term Inflation Expectations?,” *Federal Reserve Bank of St. Louis*, 2015.

Leung, Christina, “The Demographics of Household Inflation Perceptions and Expectations,” *Reserve Bank of New Zealand*, 2009.

Loke, Po Ling and Farina Adam Khong, “Inflation: Perception vs. Reality,” *Bank Negara Malaysia First Quarter 2017 Quarterly Bulletin*, 2017.

Meyer, Brent, and Guhan Venkatu, “Demographic Differences in Inflation Expectations: What Do They Really Mean?,” *Federal Reserve Bank of Cleveland*, 2011.

Mian, Atif, Rao Kamalesh, and Amir Sufi, “Household Balance Sheets, Consumption, and the Economic Slump,” *The Quarterly Journal of Economics*, Volume 128, Issue 4, Pages 1687–1726, 2013.

Mohanty, Deepak, “The Importance of Inflation Expectations,” Speech at the S P Jain Institute of Management & Research, Mumbai, 2012.

Moore, Angus, “Measures of Inflation Expectations in Australia,” *Reserve Bank of Australia Bulletin*, December 23-31, 2016.

Pasaogullari, Mehmet, and Timothy Bianco, “Survey-Based Measures of Inflation Expectations,” *Federal Reserve Bank of Cleveland*, 2010.

Ranyard, Rob, Fabio Del Missier, Nicolao Bonini, Darren Duxbury, and Barbara Summers, “Perceptions and Expectations of Price Changes and Inflation: A Review and Conceptual Framework,” *Journal of Economic Psychology* 29.4: 378-400, 2008.

Rowe, Jeremy, “How Are Households’ Inflation Expectations Formed?,” *Bank of England Quarterly Bulletin*, vol. 56(2), pages 82-86, 2016.

Snir, Avichai and Daniel Levy, “Shrinking Goods and Sticky Prices: Theory and Evidence,” *Working Paper Series 17/11, The Rimini Centre for Economic Analysis,* 2011.

Governance and Organisational Development

Governance and Organisational Development

As the Central Bank for Malaysia, the Bank is mandated to promote monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy. The Bank therefore places priority in strengthening its governance and internal capabilities to ensure it is effective in discharging its principal objects and functions under the laws it administers, and that it is responsible in managing its resources.

The Bank places priority in strengthening its governance and internal capabilities to ensure it is effective in discharging its principal objects and functions under the laws it administers, and that it is responsible in managing its resources

THE BOARD OF DIRECTORS

The Board of Directors is responsible for overseeing the management and operations of the Bank. It also reviews the performance of the Bank in delivering its mandates. The Board comprises the Governor as Chairman, the Deputy Governors, the Secretary General of the Treasury and independent non-executive members, with the latter forming the majority within the Board. The Board is further supported by three committees, namely the Board Governance Committee, Board Audit Committee and Board Risk Committee (Diagram 5.1). These committees – comprising solely of independent members – assist the Board in providing oversight of the administration of the Bank.

The year saw the appointment of a new Governor, Nor Shamsiah Yunus, on 1 July 2018, after Muhammad bin Ibrahim stepped down as Governor on 15 June 2018. Governor Nor Shamsiah was a Deputy Governor between 2010 and 2016, and was subsequently at the International Monetary Fund.

In discharging its responsibility, the Board engaged extensively with the Bank's senior management on key economic and financial developments during the year that related to the Bank's mandate. These included the economic challenges and priorities facing the country, the rising cost of living (and its implications for growth and the management of inflation), issues surrounding access to financing and insurance in particular for lower income households and innovative firms, and the Bank's management of developments in financial technology. The Board also deliberated on a number of legislative reforms to facilitate the currency management operations and enforcement activities of the Bank.

The Board also reviewed the overall performance of the Bank, and discussed the Bank's corporate performance indicators for 2019. Additionally, the Board deliberated on various organisational development priorities, including new demands on the Bank's management of human capital, the Bank's digital transformation journey, the Bank's defences against cyberthreats, and initiatives to reinforce a strong culture of integrity, ethical conduct and professionalism among the Bank's employees. The Board also deliberated on ways to strengthen project management within the Bank, including in project budgeting.

During the year, the Bank initiated an internal review to further strengthen the Bank's overall framework for governance. The review will consider areas in which current practices of the Bank can be further enhanced to reflect global best practice, taking into account lessons from the Bank's involvement in transactions that have come under scrutiny during the past year. As a central bank, confidence in the Bank is paramount to the effective performance of its mandate. Accordingly, the Bank will take this opportunity to examine the efficacy of decision-making structures within the Bank and ensure its operations and priorities remain consistent with its mandates.

Diagram 5.1: Board Committees

Board Governance Committee	Board Audit Committee	Board Risk Committee
6 meetings in 2018	**7** meetings in 2018	**4** meetings in 2018
Chaired by Tan Sri Dato' Sri Dr. Sulaiman bin Mahbob (Independent Non-Executive Director)	Chaired by Datuk Chin Kwai Yoong (Independent Non-Executive Director)	Chaired by Dato Sri Lim Haw Kuang (Independent Non-Executive Director)
Members: · Datuk Chin Kwai Yoong · Dato' N.N. Sadasivan a/l N.N. Pillay · Tan Sri Dato' Seri Siti Norma binti Yaakob	Members: · Dato' N.N. Sadasivan a/l N.N. Pillay · Tan Sri Dato' Sri Dr. Sulaiman bin Mahbob	Members: · Tan Sri Dato' Seri Siti Norma binti Yaakob · Dato' Wee Hoe Soon @ Gooi Hoe Soon
Responsible for overseeing the Bank's governance principles and practices	Responsible for the integrity of the Bank's accounts and financial statements	Responsible for oversight of financial, operational and reputational risks
Reviews and makes recommendations to the Board on the Bank's budget, operating plan and remuneration policies and proposals	Provides oversight over the adequacy of the Bank's internal controls and compliance with legal requirements	Oversees the implementation of the Bank's enterprise risk management framework
Recommends to the Board on the appointment and reappointment of members of the Board and other committees of the Bank	Reviews and approves the Bank's audit framework, audit charter, internal audit plan and audit reports, and oversees management actions to address material findings	Makes recommendations to the Board on the risk appetite statement and key risk policies of the Bank

Source: Bank Negara Malaysia

RISK MANAGEMENT AND INTERNAL CONTROLS

Enterprise risk management

The Bank has in place an Enterprise Risk Management Framework (Table 5.1) that helps ensure that it conducts its operations and activities prudently and responsibly. The framework calls for an integrated and cohesive approach towards risk management, ensuring that the most significant risks confronting the organisation are identified, assessed, monitored, and managed effectively. The framework is also benchmarked against ISO standards and the practices of other central banks within the International Operational Risk Working Group (IORWG), of which the Bank is a member.

The Bank's risk governance structure emphasises a shared responsibility for risk that begins with business units and is reinforced through strong risk management control functions. The Board is responsible for overseeing the risk governance structure, and is supported by the Board Risk Committee. The Bank's management is responsible for implementing sound risk management frameworks and practices across the functions and operations of the Bank. This is discharged through the Risk Management Committee and Reserve Management Committee (Diagram 5.2).

A "three lines of defence" model is adopted to support effective risk governance. The first line of defence comprises the line departments, which are responsible for identifying, assessing, mitigating and managing risks

Table 5.1

The Bank's Enterprise Risk Management Framework

Governance	Principle 1:	Clearly defined roles and responsibilities over risk management
	Principle 2:	Integrated risk reporting framework for effective decision making
Policy & Process	Principle 3:	Clearly defined policies to guide the risk management process
	Principle 4:	Consistent approach to the identification; assessment and measurement; prioritisation and treatment; monitoring and reporting of risks
Tool & Methodology	Principle 5:	Effective use of risk management tools to facilitate the process and implementation of Enterprise Risk Management practices
	Principle 6:	Clearly defined methodology to evaluate the effectiveness of key controls and formulate risk management strategies
Effective Practices	Principle 7:	Strong risk culture at all levels of the organisation
	Principle 8:	High standards of transparency to internal and external stakeholders
	Principle 9:	Clear and tested protocols for the activation of business continuity arrangements to ensure continuity of operations in times of crisis
	Principle 10:	Timely reporting of emerging risks and incidents to faciliate pre-emptive responses

Source: Bank Negara Malaysia

within their business areas. The second line of defence resides at the Risk Management Department, which acts as a central risk management function to develop and oversee the implementation of risk frameworks. The department is responsible for ensuring that risk management policies are implemented effectively. The Internal Audit Department acts as the third line of defence and provides independent assurance on the effectiveness of risk management practices, tools and methodologies.

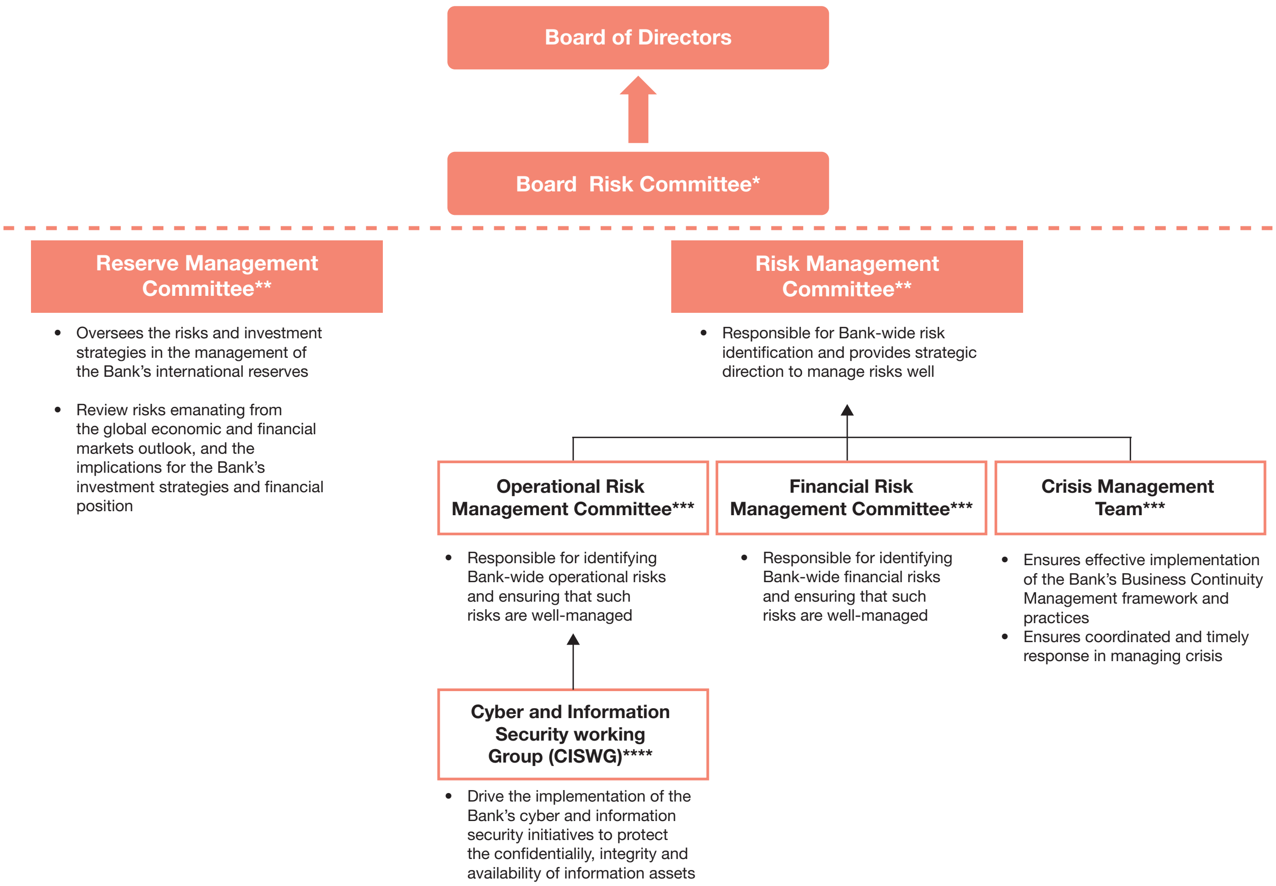
The Bank's enterprise risk appetite and tolerance statements guide the Bank's management of its reputational, operational and financial risks. To ensure it remains current in light of the changing risk landscape, the statements were reviewed in 2018 to give greater prominence to global digitalisation and the increased sophistication of cyberthreats.

During the year, the Bank also continued to strengthen the role of Department Risk Officers (DRO). First introduced in 2017, DROs serve as risk officers embedded at the first line of defence tasked with responsibility for advocating improvements in risk management practices within the business. The year saw the roll out of a learning curriculum and risk roadmap to build the capacity of DROs. Engagement sessions relating to cybersecurity and big data were also conducted to enhance awareness on these emerging risk areas.

Business continuity management (BCM) is a critical aspect of the Bank's risk management to build organisational resilience to adverse circumstances and ensure the Bank's continuing ability to perform its statutory functions. To ensure that its BCM plans remain current, the Bank regularly identifies and reviews scenarios which may give rise to operational disruptions. Possible scenarios include civil unrest, natural disasters, cyberattacks and physical threats, which are used to develop and test the Bank's BCM arrangements. During the year, focus was directed at developing an invacuation[1] plan to strengthen preparedness and ensure the safety of the Bank's employees, vendors and visitors during emergency situations. Work has been initiated to clarify linkages

[1] The movement of building occupants into a sheltered area *inside* the building when there are threats emanating from *outside* the premises.

Diagram 5.2: Risk Management Governance Structure



* Chaired by an Independent Non-Executive Director of the Bank
** Chaired by the Governor
*** Chaired by a Deputy Governor
**** Chaired by an Assistant Governor

Source: Bank Negara Malaysia

between the BCM plans of the Bank, the industry and other stakeholders, and to test the operational readiness of these plans in a system-wide event.

Adherence to high ethical standards underpins the Bank's risk culture. The Bank does not tolerate unethical behaviour, fraud and corruption. This is reinforced through a whistleblowing framework that provides an avenue for reporting improper conduct involving the Bank. During the year, the Bank revised its whistleblowing framework to align it with the Whistleblower Protection Act 2010 and best practice. The amendments include enhanced protections for whistleblowers, and improvements to procedures for reporting misconduct involving the Bank's Board, senior management, vendors and regulatees. The channels for reporting improper conduct were also expanded.

Cybersecurity

Rapidly evolving cybersecurity threats present a growing challenge for organisations all over the world and in Malaysia, including the Bank.

In 2018, the Bank initiated a five-pronged cybersecurity strategy to further strengthen the protection of the organisation's critical information assets. As part of the strategy, the Bank has committed to significant investments in security technology solutions and robust processes over the next three years to achieve the aspired cybersecurity maturity stage. This will also involve building the Bank's internal capabilities to manage cybersecurity operations based on credible data, and undertake pre-emptive actions to protect the Bank's assets. These efforts are supported by strengthened governance and operating structures

Enterprise Risk Appetite and Tolerance Statements

"The Bank is committed to excellence in promoting monetary and financial system stability and fostering a sound and progressive financial sector, to achieve sustained economic growth for the nation.

In pursuing the mandates, the Bank faces risks arising from changes in domestic and external environment, inevitability of crisis, proliferation of global digitalisation and more sophisticated cyberattacks. The Bank also faces greater expectations from stakeholders demanding higher standards of transparency and engagement.

In fulfilling its mandates as entrusted under the law, the Bank is committed to uphold high standards of integrity and professionalism, and maintain public confidence and trust.

The Bank does not tolerate operational failures that can undermine the confidence in the Bank's ability in carrying out its functions or cause systemic disruptions in the functioning of the financial system and markets for which the Bank is primarily responsible. The Bank accepts some risk for non-critical business areas to ensure efficiency and promote innovation within the Bank. However, these risks will be managed prudently.

The Bank is exposed to potential financial risks arising mainly from the holding and management of international reserves. It manages this risk carefully to ensure financial sustainability, but not at the expense of its policy responsibility.

These risks are managed through the effective implementation of internal frameworks, policies and processes, a sustained focus on a strong risk culture and a competent and professional workforce."

Source: Bank Negara Malaysia

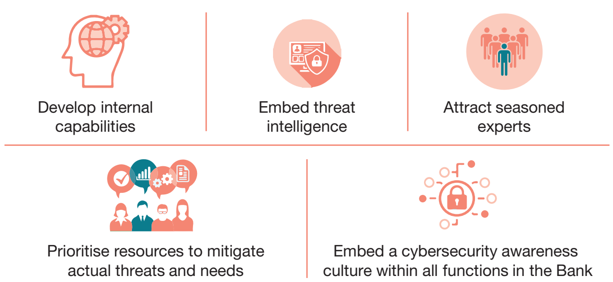
that have been put in place to drive and oversee cybersecurity risk management across the Bank. Specifically, the Bank has established the Cybersecurity and Data Protection unit within the Digital and Technology Department as the enterprise-wide cybersecurity management function. In addition, a Cyber and Information Security Working Group was formalised to drive the implementation of the Bank's cyber and information security initiatives (Diagram 5.3). At the same time, the Bank recognises that technology, structures and processes alone cannot address all cybersecurity risks. As part of efforts to promote a strong culture within the Bank, various programmes to improve cyber hygiene and increase awareness and knowledge on cyber risks and security measures continued to be undertaken during the year.

The Bank has initiated a cybersecurity strategy to further strengthen the protection of critical information assets

As a regulatory body, the Bank generates, processes and stores large volumes of critical and sensitive information. In safeguarding this information, the Bank regularly benchmarks its information security practices against international best practice and standards, such as ISO 27001. In 2018, the Bank reviewed its practices to address the risk of information leakage through the use of personal devices. Protection of information assets of the Bank will also be enhanced through the development and implementation of a comprehensive Data Protection Roadmap.

During the year, the Bank commissioned an independent assessment by an external security consultant to assess the Bank's adherence to the mandatory and advisory security controls specified by the Society for Worldwide Interbank Financial Telecommunication (SWIFT). The assessment confirmed the Bank's full compliance with all relevant mandatory and advisory controls, and provided an independent validation of the Bank's attestation which is submitted annually to SWIFT. Ensuring robust systems and controls in the Bank's IT environment is

Diagram 5.3: The Bank's Cybersecurity Strategies



Source: Bank Negara Malaysia

an ongoing process as underscored by an incident in March 2018 involving an unauthorised attempt to send fund transfer instructions through the Bank's SWIFT platform. The attempt was foiled by the Bank, with no resulting operational disruption or financial loss. Key observations of the incident were shared with SWIFT and other relevant parties in order to strengthen industry resilience against cyberthreats.

Internal audit

The Board Audit Committee is responsible for reviewing the effectiveness of the Bank's internal controls and compliance with legal and regulatory requirements. It also provides oversight over the internal audit function of the Bank. It is also responsible for the integrity of the Bank's financial statements.

The Internal Audit Department provides independent assurance to the Board Audit Committee on the adequacy and effectiveness of the Bank's governance, risk management and internal control processes. The department conducts regular assessments on the activities of departments and entities related to the Bank to identify and address risks. An audit plan is developed each year and reviewed quarterly to ensure that audit activities reflect changes in the Bank's risk profile and emerging risks. Apart from providing assurance, the department also participates as an independent observer in several of the Bank's key projects and committees. This allows the department to provide timely feedback for continuous enhancements of internal controls and governance to mitigate potential risks. The department also provides the Minister of Finance with an independent quarterly report on the Bank's international reserve management activities. This is to assure the Minister that the reserves have been managed in accordance with the established policies and guidelines approved by the Board.

Audit activities are conducted in conformance with the requirements of the Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing. The principles espoused by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) are embedded in the audit approaches for assessing the Bank's control environment. The department further undertakes continuous efforts to implement quality assurance and improvement measures covering all aspects of the internal audit function. In 2018, these measures focused on increasing the efficiency and rigour of the audit process, and leveraging on technology to improve audit documentation.

Audits conducted in 2018 are set out in Diagram 5.4 and include cybersecurity, data protection, treasury and reserve management, business continuity management, procurement and risk governance.

OUR PEOPLE

Sustaining a positive, progressive and productive work environment

The Bank is committed to attracting and developing the best people to deliver on its mandates. In keeping with this commitment, the Bank embarked on a number of initiatives in 2018 to create and sustain a positive, progressive and productive environment for its workforce of over 3,000 employees (Diagram 5.5).

During the year, the Bank conducted a survey to ascertain employee engagement and enablement levels across the organisation. While employee engagement and enablement were at satisfactory levels, the survey also helped check the pulse of the organisation's culture. The survey uncovered, among others, perspectives on the performance evaluation framework, career development, decision making processes and organisational climate. Following the conclusion of the exercise, a townhall was conducted to inform employees of the survey results and to set out the Bank's near-term organisational priorities to create a more open and supportive work climate.

The Bank is enhancing its performance evaluation framework for employees to encourage a more holistic approach to performance, rewards and promotions

The Bank is committed to upholding the highest standards of professionalism. This involves ongoing efforts to promote the organisation's ethics and culture. In 2018, the Bank undertook specific initiatives to reinforce a positive culture of engagement at all levels of the organisation, centred on norms such as transparency and objectivity, constructive challenge and candid communication. While strengthening culture involves changing deeply entrenched behaviours, beliefs and mindsets, measures are being introduced to further strengthen the alignment between the desired norms of the Bank, and its human capital processes, including in leadership competency assessments, code of conduct, and the Bank's core shared values.

The Bank also during the year introduced revisions to the performance evaluation framework for employees, with the view to encourage employees to spend more time engaged in feedback conversations. A 360-degree feedback system – which will allow for climate and culture to be more systematically assessed throughout the organisation – will also be introduced in 2019 as part of efforts to encourage a more holistic approach to performance, rewards and promotions.

Developing our people

A key priority of the Bank is equipping its people with the right skills, competencies and knowledge to carry on its mission. Accordingly, the Bank devotes substantial attention to developing and maintaining healthy succession and feeder pools with deep expertise in central banking and other related areas. Various learning and development opportunities

Diagram 5.4: Focus and Coverage of Internal Audit in 2018

Focus

- Control Environment
- Risk Assessment
- Control Activities
- Information & Communication
- Monitoring Activities

Coverage

Information Technology and Cyber Resilience:
- RENTAS Host Infrastructure Audit and SLA arrangement with Paynet
- Readiness Audit - Mini RENTS and eSPICK
- Currency Management Related Systems
- Data Centre Operations
- Bring Your Own Device (BYOD)
- RENTAS ISMS Audit - compliance with ISO27001:2013
- Cybersecurity
- SWIFT Investigation

Treasury and Investment Operations:
- Exchange Rate Intervention and Liquidity Management
- Equities and Market Risk Management
- New York Representative Office

Regulatory:
- Prudential Financial Policy
- Financial Development and Innovation
- Development Finance and Inclusion
- Islamic Banking and Takaful

Finance:
- Finance Operations and Settlements

Economics:
- International Department-Management of Global Trade and Economic Interlinkages

Related Entities:
- International Centre for Education in Islamic Finance (INCEIF)
- The South East Asian Central Banks Research and Training Centre (SEACEN)
- Islamic Financial Services Board (IFSB)
- Financial Accreditation Agency (FAA)
- The Iclif Leadership and Governance Centre

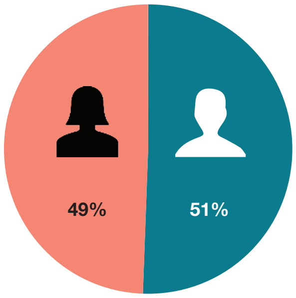
Currency Management:
- Currency Management
- BNM Offices
- Automated Cash Centre

Projects:
- Financial Education Hub
- Integrated Treasury Management System
- MINT Modernisation

Support Functions:
- LINK
- Museum and Knowledge Management Centre
- Administrative Support Functions

Source: Bank Negara Malaysia

Diagram 5.5: Our People



Headcount: 3,076

Job level	Gender composition		Headcount
Senior Management	57%	43%	169
Managers	45%	55%	596
First Level Executives	43%	57%	1,217
Non Executives	62%	38%	1,094

Source: Bank Negara Malaysia

are provided to build strong capabilities required of employees to meet the demands of their jobs.

Being a knowledge-based organisation, the Bank invests significantly in its people (Diagram 5.6). In 2018, the Bank spent an amount equivalent to an average of RM8,257 per executive on learning and development (total training budget equivalent to 6.53% of total gross salaries) on learning and development. Employees at all levels attend a wide variety of leadership and technical programmes, conducted in-house or externally, through traditional and digital formats. The Bank also provides a supportive environment for employees to pursue professional qualifications. The Bank reimburses employees for costs involved in acquiring or maintaining their professional qualifications and offers paid study leave for exam preparation. In 2018, 24% of the Bank's executives hold or are actively pursuing professional credentials and certifications. These investments are important to drive performance and accelerate the time to competence in delivering the Bank's mandates.

Aside from formal learning programmes, the Bank provides on-the-job growth opportunities for its people. Opportunities are provided for employees to participate in a variety of Bank-wide projects and initiatives, including "stretch assignments" and international engagements. This is complemented by the Bank's Leadership Development Blueprint which guides leadership development interventions to hone technical, leadership and professional effectiveness of employees in – or identified for – management roles. The Bank is also in the midst of rolling out an internally-developed programme designed to sharpen the business acumen of its leadership pool in areas of executive management, such as negotiations, strategic planning, procurement and project management.

Diagram 5.6: Learning and Development in 2018

6.53%

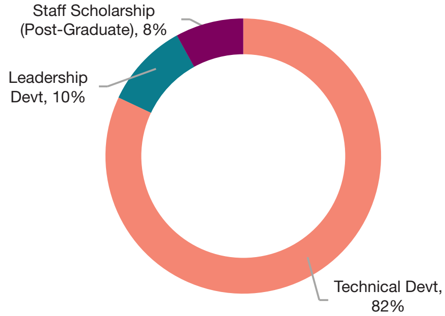
% of learning investment over total gross salary

RM8,257

Average learning investment per executive

58 hours

Average learning hours staff spent on formal learning



Distribution of learning investment

% of staff trained in technical and leadership development

Source: Bank Negara Malaysia

The priority going forward is for the Bank to create a future-ready workforce that remains effective in carrying on the Bank's mission in a rapidly evolving environment. This requires the Bank to further raise its efficiency and productivity. This will involve the Bank further optimising the composition and deployment of its workforce by promoting greater internal and external mobility, as well as through enhancements to the career progression framework. Key to this will also be the increased and effective adoption of technology.

TECHNOLOGY

Digital technologies are reshaping industries and organisations all over the world. This is no different for the Bank. In 2018, the Bank began work to draw up a digital transformation strategy and roadmap to fully harness the potential and value of technology in supporting the effective delivery of the Bank's mandates (Diagram 5.7). In addition to addressing existing "pain points" and optimising existing processes, the Bank is actively exploring "proofs-of-concepts" in a variety of use cases, such as in forecasting, policy-making, supervision and other internal business processes. The digital transformation will also look at promoting and embracing a digital mindset and culture, and identifying digital enablers and capabilities that are key to the Bank. The digital transformation journey of the Bank aims to raise productivity and efficiency, encourage innovation, and enable the Bank to manage its risk better.

A digital transformation strategy and roadmap is being drawn up to fully harness the potential and value of technology in supporting the Bank's mandates

In the near-term, enhancements are being made to the Bank's technology infrastructure and services to support digital workplace improvements. Initiatives include the deployment of ultraportable laptops and tablet devices, faster Internet and WiFi connectivity, implementation of personal storage through private cloud, and documentation management workflow solutions. These are expected to encourage further collaboration and support remote working capabilities.

At the same time, the Bank continues to lay the groundwork to modernise and put in place next generation technology infrastructure to form the

Diagram 5.7: Digital Initiatives

Source: Bank Negara Malaysia

core digital platform for the organisation to build on. In 2018, this involved the technology refresh of critical infrastructure such as servers, storage, network devices and databases.

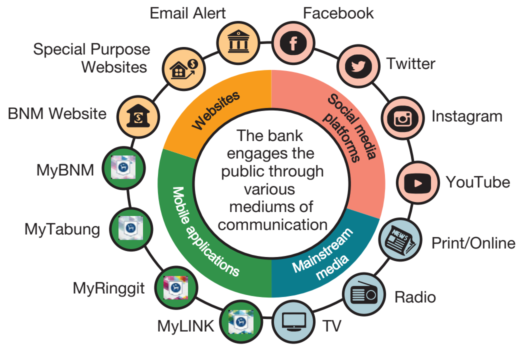
ENGAGING WITH OUR STAKEHOLDERS

A key objective of the Bank's communications and outreach agenda is to sustain the confidence of its external stakeholders in the Bank's delivery of its mandates. This involves the Bank helping external stakeholders understand our work and mission. The Bank also listens to and receives feedback on issues involving the economy and financial system through regular engagements and briefings conducted with the Government and other public sector agencies, our regulatees, investors and analysts, and the media.

The general public is an important stakeholder. We therefore engage them closely on multiple fronts, and across a range of topics and issues. Among others, these engagements aim to promote financial knowledge and literacy, and to educate the public about financial scams and crimes. They are conducted through a range of traditional and digital channels, including through social media (Diagram 5.8).

The Bank also directly engages with the general public and businesses across the country. We operate a network of five BNM Offices (Diagram 5.9) in Penang, Kuala Terengganu, Johor Bahru, Kuching and Kota Kinabalu which carry out several roles. While traditionally serving as regional hubs for managing currency operations, BNM Offices have since evolved to enable the Bank to have a clearer view on economic and financial conditions around the country. The BNM Offices meet and connect

Diagram 5.8: Engaging the Public through Multiple Channels



Source: Bank Negara Malaysia

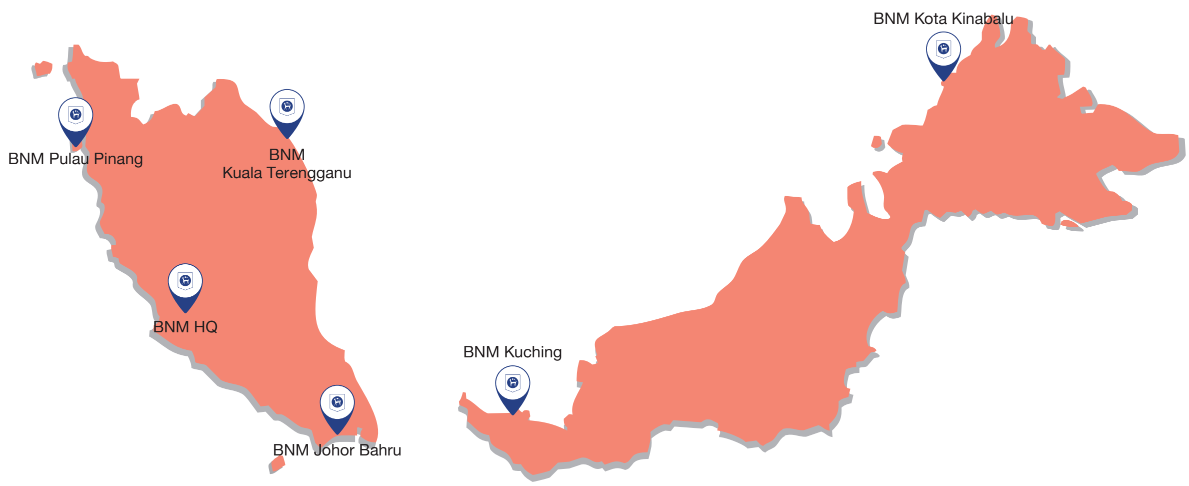
with local businesses and communities, providing us with valuable feedback on economic and financial developments. This allows the Bank to develop a more holistic view of economic and financial conditions, with insights to make better-informed policy decisions.

Situated in each of these BNM Offices and that of the Bank's head office in Kuala Lumpur is BNMLINK, a platform for the public to seek a wide range of services. These include getting help and advice on the rights and obligations of financial consumers, or lodging a complaint against a financial institution. SMEs and micro entrepreneurs in particular, can learn and enquire about various financing schemes and assistance available to help them grow their businesses. BNMLINK also holds events – including in rural communities, small towns and other underserved areas – to remain closely engaged with local communities.

In addition, the Bank's Museum and Art Gallery in Kuala Lumpur serves as an important platform for engaging the public. Six permanent galleries are situated in the Museum. The Museum also holds temporary exhibitions and education programmes. The Museum not only encourages an appreciation for numismatic and art heritage, but also promotes public awareness and understanding on the Bank's role in the economy and financial sector (Diagram 5.10).

In support of regional and international cooperation in promoting monetary and financial stability, the Bank engages with other central banks and financial regulators, and participates in a wide variety of international platforms. For example, the Bank engages with other regulatory authorities through supervisory colleges and bilateral meetings to exchange information and to coordinate supervisory responses. The Bank is also an active participant in the global standard setting process through its participation on global standard setting bodies such as the Basel Committee on Banking Supervision (BCBS), the Islamic Financial Services Board (IFSB) and the International Association of Insurance Supervisors (IAIS), or indirectly through regional groupings such as the Executives' Meeting of East Asia Pacific Central Banks (EMEAP). The Bank further conducts a range of technical cooperation

Diagram 5.9: BNM Offices



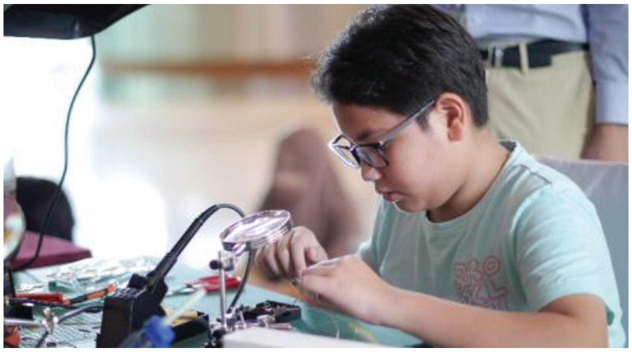
Source: Bank Negara Malaysia

Diagram 5.10: The Museum and Art Gallery in 2018

Tun Ismail Ali: Paragon of Trust and Integrity Exhibition

The Art of Printmaking Exhibition

Children's Festival

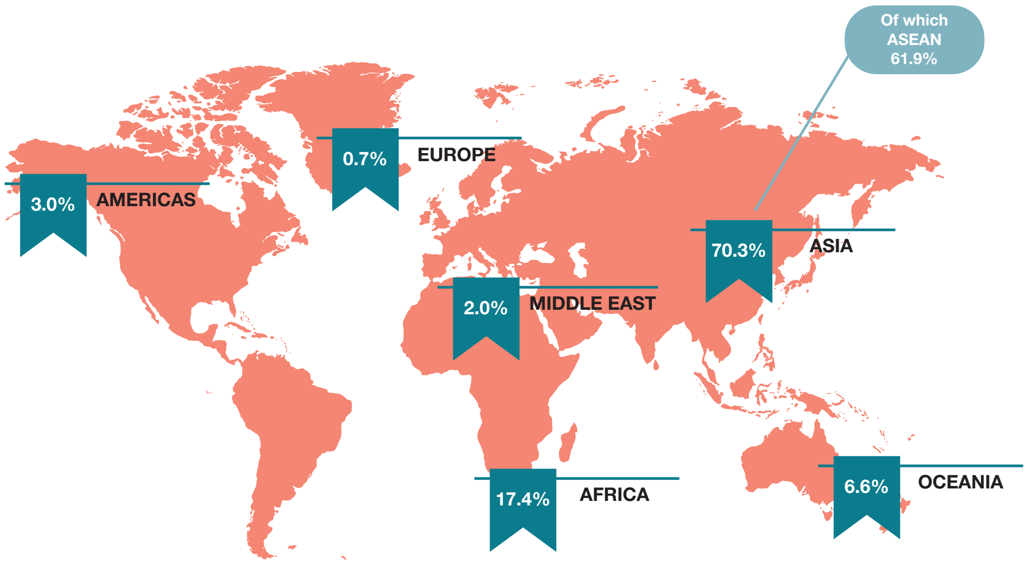


Financial LATeracy Exhibition at Muzium Darul Ridzuan

Source: Bank Negara Malaysia

Diagram 5.11: The Bank's Technical Cooperation Programmes in 2018

Attended by more than 500 officials from 69 countries



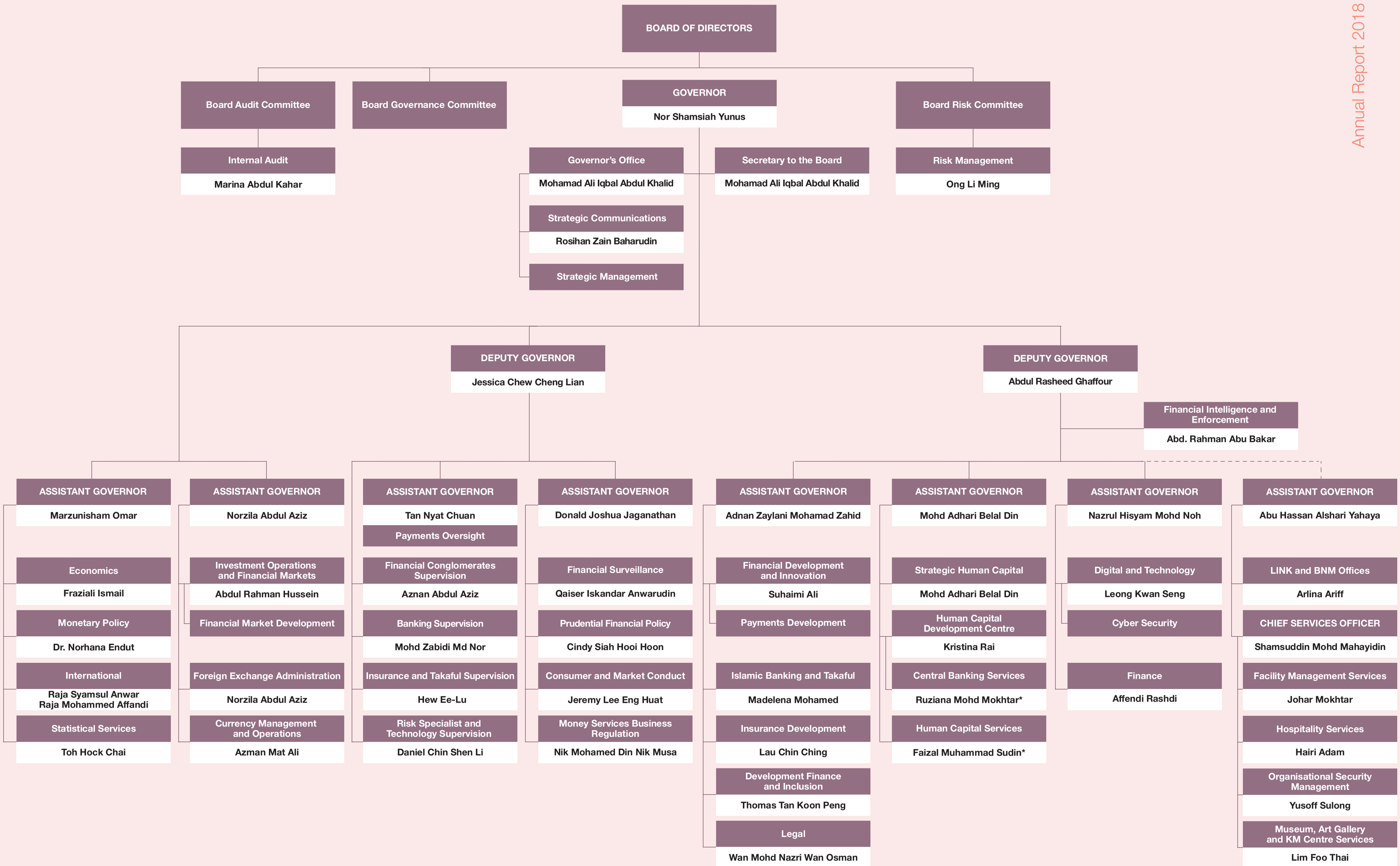
Source: Bank Negara Malaysia

programmes and events to share its knowledge and experience within the central banking and financial regulatory community. In 2018, over 500 individuals from 69 countries participated in these programmes (Diagram 5.11). These covered areas such as financial inclusion, banking supervision, payment systems, currency management, Islamic finance and human capital management (Diagram 5.12).

Diagram 5.12: Sharing the Bank's Experience and Expertise

Source: Bank Negara Malaysia

BANK NEGARA MALAYSIA
Organisation Structure



* Deputy Director

Governor	Nor Shamsiah Yunus
Deputy Governor	Abdul Rasheed Ghaffour
Deputy Governor	Jessica Chew Cheng Lian
Secretary to the Board	Mohamad Ali Iqbal Abdul Khalid
Assistant Governor	Norzila Abdul Aziz
Assistant Governor	Donald Joshua Jaganathan
Assistant Governor	Abu Hassan Alshari Yahaya
Assistant Governor	Marzunisham Omar
Assistant Governor	Mohd Adhari Belal Din
Assistant Governor	Adnan Zaylani Mohamad Zahid
Assistant Governor	Nazrul Hisyam Mohd Noh
Assistant Governor	Tan Nyat Chuan
Director	
Governor's Office	Mohamad Ali Iqbal Abdul Khalid
Strategic Communications	Rosihan Zain Baharudin
Strategic Management	–
Internal Audit	Marina Abdul Kahar
Risk Management	Ong Li Ming
Financial Intelligence and Enforcement	Abd. Rahman Abu Bakar
Economics	
Economics	Fraziali Ismail
Monetary Policy	Dr. Norhana Endut
International	Raja Syamsul Anwar Raja Mohammed Affandi
Statistical Services	Toh Hock Chai
Financial Markets and Currency	
Investment Operations and Financial Markets	Abdul Rahman Hussein
Foreign Exchange Administration	Norzila Abdul Aziz
Currency Management and Operations	Azman Mat Ali
Supervision	
Financial Conglomerates Supervision	Aznan Abdul Aziz
Banking Supervision	Mohd Zabidi Md Nor
Insurance and Takaful Supervision	Hew Ee-Lu
Risk Specialist and Technology Supervision	Daniel Chin Shen Li
Payments Oversight	Tan Nyat Chuan
Regulation	
Financial Surveillance	Qaiser Iskandar Anwarudin
Prudential Financial Policy	Cindy Siah Hooi Hoon
Consumer and Market Conduct	Jeremy Lee Eng Huat
Money Services Business Regulation	Nik Mohamed Din Nik Musa
Development	
Financial Development and Innovation	Suhaimi Ali
Islamic Banking and Takaful	Madelena Mohamed
Insurance Development	Lau Chin Ching
Development Finance and Inclusion	Thomas Tan Koon Peng
Legal	Wan Mohd Nazri Wan Osman
Human Capital	
Strategic Human Capital	Mohd Adhari Belal Din
Human Capital Development Centre	Kristina Rai
Central Banking Services	Ruziana Mohd Mokhtar*
Human Capital Services	Faizal Muhammad Sudin*
IT and Finance	
Digital and Technology	Leong Kwan Seng
Finance	Affendi Rashdi
Corporate Services	
LINK and BNM Offices	Arlina Ariff
Chief Services Officer	Shamsuddin Mohd Mahayidin
Facility Management Services	Johar Mokhtar
Hospitality Services	Hairi Adam
Organisational Security Management	Yusoff Sulong
Museum, Art Gallery and KM Centre Services	Lim Foo Thai
Chief Representative	
Beijing Representative Office	Alvin Ong Heng Kiat*
London Representative Office	Muhamad Jamil Fathi Jamaludin*
New York Representative Office	Azizul Sabri Abdullah**
Head	
BNM Office Johor Bahru	Nor Rafidz Nazri*
BNM Office Pulau Pinang	Hasjun Hashim*
BNM Office Kuching	Rosnani Mahamad Zain*
BNM Office Kota Kinabalu	Zambre Ismail*
BNM Office Kuala Terengganu	Adlis Khairil Sazli Mohd Zaini*

* Deputy Director
** Manager

Board of Directors, Senior Management and Committees of the Bank

Board of Directors

Standing from left to right

Datuk Chin Kwai Yoong[1]

Dato' Paduka Sulaiman bin Mustafa
Member, Board Governance Committee
Member, Board Risk Committee

Tan Sri Dato' Seri Siti Norma binti Yaakob
Member, Board Governance Committee
Member, Board Risk Committee

Tan Sri Dato' Sri Dr. Sulaiman bin Mahbob
Chairman, Board Governance Committee
Member, Board Audit Committee

Datuk Ahmad Badri bin Mohd Zahir
Secretary-General of the Treasury

Nor Shamsiah Yunus
Governor and Chairman

Dato' N. Sadasivan a/l N.N. Pillay
Member, Board Audit Committee
Member, Board Governance Committee

Jessica Chew Cheng Lian
Deputy Governor

Abdul Rasheed Ghaffour
Deputy Governor

Dato Sri Lim Haw Kuang
Chairman, Board Risk Committee

Dato' Wee Hoe Soon @ Gooi Hoe Soon
Chairman, Board Audit Committee
Member, Board Risk Committee

The Board of Directors wishes to extend its appreciation and gratitude to Datuk Chin Kwai Yoong for his nine years of service since March 2010.

[1] Datuk Chin Kwai Yoong completed his term on 28 February 2019.

Senior Management

Senior Management Members

Nor Shamsiah Yunus
Governor

Abdul Rasheed Ghaffour
Deputy Governor

Jessica Chew Cheng Lian
Deputy Governor

Norzila Abdul Aziz
Assistant Governor

Donald Joshua Jaganathan
Assistant Governor

Abu Hassan Alshari Yahaya
Assistant Governor

Marzunisham Omar
Assistant Governor

Mohd. Adhari Belal Din
Assistant Governor

Adnan Zaylani Mohamad Zahid
Assistant Governor

Nazrul Hisyam Mohd Noh
Assistant Governor

Tan Nyat Chuan
Assistant Governor

Monetary Policy Committee

Monetary policy is formulated independently by the Monetary Policy Committee based on a sound governance framework

The primary objective of monetary policy in Malaysia is to maintain price stability while giving due regard to developments in the economy. Under the Central Bank of Malaysia Act 2009 (CBA 2009), the Monetary Policy Committee (MPC) of Bank Negara Malaysia is charged with the responsibility of formulating monetary policy and the policies for the conduct of monetary policy operations.[1] In this regard, the MPC decides on the policy interest rate, the Overnight Policy Rate (OPR), to influence other interest rates in the economy.

In carrying out this mandate, the MPC determines the direction of monetary policy based on its assessment of the balance of risks to the outlook for both domestic growth and inflation. The MPC also monitors risks of destabilising financial imbalances given their implications for the prospects of the economy. The Committee meets at least six times a year to decide on the OPR and publishes the Monetary Policy Statement (MPS) following each meeting to explain its decisions.

The MPC comprises the Governor, the Deputy Governors, and not less than three but not more than seven other members, including external members who are appointed by the Minister of Finance upon recommendation by the Bank's Board Governance Committee. At present, the MPC has seven members, two of which are external members. The membership of the MPC is intended to bring together a diversity of expertise and experiences that is critical for sound decision-making on monetary policy.

Monetary Policy Committee Members

Nor Shamsiah Yunus
Governor and Chairman

Abdul Rasheed Ghaffour
Deputy Governor

Jessica Chew Cheng Lian
Deputy Governor

Norzila Abdul Aziz
Assistant Governor

Marzunisham Omar
Assistant Governor

Prof. Tan Sri Dato' Seri Dr. Noor Azlan Ghazali
Professor of Economics, Universiti Kebangsaan Malaysia

Prof. Dr. Yeah Kim Leng
Professor of Economics, Sunway University Business School, Sunway University

[1] For a detailed account of the evolution of the MPC, and its governance and processes, refer to the 'Box Article: Evolution of the Monetary Policy Committee of Bank Negara Malaysia: Key Milestones over the Years' in the Bank Negara Malaysia Annual Report 2015.

Financial Stability Executive Committee

The Financial Stability Executive Committee (Executive Committee) was established in 2010 pursuant to Section 37 of the Central Bank of Malaysia Act 2009 (CBA 2009). Its primary purpose is to contribute to the fulfilment of the Bank's statutory mandate of preserving financial stability through its powers to decide on specific policy measures that may be taken by the Bank to avert or reduce risks to financial stability. These measures are:

- the issuance of orders to a person or financial institution that is not supervised by the Bank to undertake specific measures;
- the extension of liquidity assistance to a financial institution that is not supervised by the Bank, or to overseas operations of a licensed financial institution in Malaysia; and
- the provision of capital support to a non-viable licensed financial institution in Malaysia.

The Executive Committee is a key component of the accountability framework that has been institutionalised for the exercise of the broad financial stability powers accorded to the Bank under the CBA 2009. It is responsible to ensure that proposed measures within its purview are appropriate, having regard to the Bank's assessment of risks to financial stability. The Executive Committee meets at least twice a year.

The Executive Committee consists of seven members, a majority of whom must be non-executive members who are independent of the Bank's Management. Members are subject to the Executive Committee's Code of Ethics and Conflict of Interest, which serve to preserve the integrity of the Executive Committee's decisions.

Financial Stability Executive Committee Members

Nor Shamsiah Yunus
Governor and Chairman

Abdul Rasheed Ghaffour
Deputy Governor

Datuk Ahmad Badri bin Mohd Zahir
Secretary General to the Treasury

Datuk Syed Zaid Albar
Chairman of Securities Commission Malaysia

Rafiz Azuan Abdullah
Chief Executive Officer of Perbadanan Insurans Deposit Malaysia

Datuk Johan bin Idris
External Expert

Yoong Sin Min
External Expert

Shariah Advisory Council

The Shariah Advisory Council of Bank Negara Malaysia (SAC) was established in May 1997 as the highest Shariah authority in Islamic banking and takaful in Malaysia. In the Central Bank of Malaysia Act 2009 (CBA 2009), the roles and functions of the SAC were further reinforced as the authority for the ascertainment of Islamic law for the purposes of Islamic financial activities which are supervised and regulated by the Bank.

The SAC assumes a pivotal role in ensuring the consistency of Shariah rulings applied in the Islamic banking and takaful industry. The Shariah rulings by the SAC serve as a main reference for Islamic financial institutions to ensure end-to-end Shariah compliance in the structure and implementation of their financial products and services. In addition, the CBA 2009 provides that, any questions on Shariah matters in a court or arbitration proceeding must be referred to the SAC, whose opinions shall be binding.

The SAC provides the Shariah basis for the development of a comprehensive Shariah contract-based regulatory framework for Islamic banking and takaful in Malaysia. In this regard, the SAC defines the essential features of the contracts taking into consideration the various Shariah views, research findings, as well as custom and market practices. Moving forward, the SAC, through its members, individually and collectively, will expand its sphere of influence to support more product innovation and encourage harmonisation of Shariah interpretation locally and globally.

The appointment of the SAC members is made upon approval by the Yang di-Pertuan Agong, on the advice of the Minister of Finance after consultation with the Bank. Currently, the SAC has ten (10) members consisting of prominent Shariah scholars, jurists and legal experts.

Shariah Advisory Council Members

Datuk Dr. Mohd Daud bin Bakar (Chairman)
Founder and Executive Chairman, Amanie Group

Prof. Dr. Ashraf bin Md. Hashim (Deputy Chairman)
Chief Executive Officer, ISRA Consultancy

Tan Sri Sheikh Ghazali bin Abdul Rahman
Council of Experts (Shariah), Attorney General Chambers

Sahibus Samahah Dato' Seri Dr. Hj. Zulkifli bin Mohamad Al-Bakri
Mufti of Wilayah Persekutuan

Dato' A. Aziz bin A. Rahim
Chairman, Enforcement Agencies Integrity Commission

Prof. Dr. Mohamad Akram bin Laldin
Executive Director, ISRA

Prof. Dr. Engku Rabiah Adawiah binti Engku Ali
Professor, IIUM Institute of Islamic Banking and Finance (IIiBF), International Islamic University Malaysia (IIUM)

Prof. Dr. Asmadi bin Mohamed Naim
Professor, Islamic Business School, Universiti Utara Malaysia

Dr. Shamsiah binti Mohamad
Senior Researcher, ISRA

Burhanuddin bin Lukman
Head of Takaful Unit, International Shariah Research Academy for Islamic Finance (ISRA)

Financial Stability Committee

The Financial Stability Committee (FSC) is a high-level internal committee of the Bank. It is responsible for monitoring and taking actions to reduce or avert risks to financial stability stemming from both system-wide and institutional developments. Section 29 of the Central Bank of Malaysia Act 2009 defines "risk to financial stability" as a "risk which in the opinion of the Bank disrupts, or is likely to disrupt, the financial intermediation process including the orderly functioning of the money market and foreign exchange market, or affects, or is likely to affect, public confidence in the financial system or the stability of the financial system".

The FSC reviews and decides on:
- macroprudential policies to reduce or avert identified risks to the financial system as a whole;
- significant supervisory responses to address risks arising in individual financial institutions which are regulated by the Bank;
- actions to resolve a financial institution that has ceased, or is about to cease, to be viable. This includes notifying Perbadanan Insurans Deposit Malaysia (PIDM) for the purpose of resolution actions by PIDM where applicable; and
- recommendations to the Financial Stability Executive Committee on the exercise of powers within its remit.

An important part of the FSC's role is to monitor the effectiveness of policies and actions taken; and ensure they remain appropriate, taking into account risk developments.

The FSC is chaired by the Governor and its members comprise all Deputy Governors and the Assistant Governors responsible for regulation, supervision, development and financial market and currency sectors. The meeting is generally held four times a year and is also attended by selected senior officers of the Bank.

Financial Stability Committee Members

Nor Shamsiah Yunus
Governor and Chairman

Abdul Rasheed Ghaffour
Deputy Governor

Jessica Chew Cheng Lian
Deputy Governor

Norzila Abdul Aziz
Assistant Governor

Donald Joshua Jaganathan
Assistant Governor

Adnan Zaylani Mohamad Zahid
Assistant Governor

Tan Nyat Chuan
Assistant Governor

Annual Financial Statements

REPORT OF THE AUDITOR GENERAL ON THE FINANCIAL STATEMENTS OF BANK NEGARA MALAYSIA FOR THE YEAR ENDED 31 DECEMBER 2018

Report on the Financial Statements

Opinion

I have audited the Financial Statements of Bank Negara Malaysia which comprise the Statement of Financial Position as at 31 December 2018 and Income Statement for the year then ended, a summary of significant accounting policies and other explanatory information.

In my opinion, the accompanying financial statements give a true and fair view of the financial position of Bank Negara Malaysia as at 31 December 2018 and of their financial performance for the year then ended, in accordance with the Central Bank of Malaysia Act 2009 and Malaysian Financial Reporting Standards to the extent that it is, in the opinion of the Directors, appropriate to do so, having regard to the objects and functions of the Bank.

Basis for Opinion

I conducted the audit in accordance with the Audit Act 1957 and the International Standards of Supreme Audit Institutions. My responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of my report. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

Independence and Other Ethical Responsibilities

I am independent of Bank Negara Malaysia and have fulfilled other ethical responsibilities in accordance with the International Standards of Supreme Audit Institutions.

Information Other Than the Financial Statements and Auditor General's Report Thereon

The Directors of Bank Negara Malaysia are responsible for other information in the Annual Report. My opinion on the Financial Statements of Bank Negara Malaysia does not cover the information other than the Financial Statements and the Auditor General's Report thereon and I do not express any form of assurance conclusion thereon.

Responsibilities of the Directors' for the Financial Statements

The Directors are responsible for the preparation of Financial Statements of BNM that give a true and fair view in accordance with the Central Bank of Malaysia Act 2009 and Malaysian Financial Reporting Standards to the extent that it is, in the opinion of the Directors, appropriate to do so, having regard to the objects and functions of the Bank. The Directors are also responsible for such internal control as the Directors determine is necessary to enable the preparation of the Financial Statements of BNM that are free from material misstatement, whether due to fraud or error.

In preparing the Financial Statements of Bank Negara Malaysia, the Directors are responsible for assessing Bank Negara Malaysia's ability to continue as a going concern, disclosing as applicable matters related to going concern, and using the going concern basis of accounting.

Auditor's Responsibilities for the Audit of the Financial Statements

My objectives are to obtain reasonable assurance about whether the Financial Statements of Bank Negara Malaysia as a whole are free from material misstatement, whether due to fraud or error, and to issue Auditor General's Report that includes my opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the International Standards of Supreme Audit Institutions will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these Financial Statements.

As part of an audit in accordance with the International Standards of Supreme Audit Institutions, I exercise professional judgement and maintain professional skepticism throughout the audit. I also:

a. Identify and assess the risks of material misstatement of the Financial Statements of Bank Negara Malaysia, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for my opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

b. Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Bank Negara Malaysia's internal control.

c. Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the Directors.

d. Conclude on the appropriateness of the Directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on Bank Negara Malaysia's ability to continue as a going concern. If I conclude that a material uncertainty exists, I have to draw attention in my Auditor General's Report to the related disclosures in the Financial Statements of Bank Negara Malaysia if such disclosures are inadequate, to modify my opinion. My conclusions are based on the audit evidence obtained up to the date of the Auditor General's Report.

e. Evaluate the overall presentation of the Financial Statement of BNM including the disclosures that achieve fair presentation.

I communicate with the Directors regarding, among other matters, the planned scope, timing of the audit, and significant audit findings including internal control identified during my audit.

Report on Other Legal and Regulatory Requirements

In accordance with the requirements of Section 9, Central Bank of Malaysia Act 2009, I also report that in my opinion, the accounting and other records required by the Act to be kept by Bank Negara Malaysia have been properly kept in accordance with the provisions of the Act.

Other Matters

This report is made solely to the Directors and for no other purpose. I do not assume responsibility to any other person for the content of this report.

(DATO' NIK AZMAN NIK ABDUL MAJID)
AUDITOR GENERAL
MALAYSIA

PUTRAJAYA
18 MARCH 2019

STATEMENT BY CHAIRMAN AND ONE OF THE DIRECTORS

We, Nor Shamsiah Yunus and Chin Kwai Yoong, being the Chairman and one of the Directors of Bank Negara Malaysia, do hereby state that in the opinion of the Directors, the financial statements are drawn up so as to give a true and fair view of the state of affairs of Bank Negara Malaysia as at 31 December 2018 and of the results of operations for the year ended on that date, in accordance with the Central Bank of Malaysia Act 2009 and the applicable Malaysian Financial Reporting Standards (MFRS) to the extent that it is, in the opinion of the Directors, appropriate to do so, having regard to the objects and functions of the Bank.

On behalf of the Board,

NOR SHAMSIAH YUNUS
CHAIRMAN

28 FEBRUARY 2019
KUALA LUMPUR

On behalf of the Board,

CHIN KWAI YOONG
DIRECTOR

28 FEBRUARY 2019
KUALA LUMPUR

DECLARATION BY THE OFFICER PRIMARILY RESPONSIBLE FOR THE FINANCIAL MANAGEMENT OF BANK NEGARA MALAYSIA

I, Affendi bin Rashdi, being the officer primarily responsible for the financial management of Bank Negara Malaysia, do solemnly and sincerely declare that the financial statements for the year ended 31 December 2018, are to the best of my knowledge and belief, correct and I make this solemn declaration conscientiously believing the same to be true and by virtue of the provisions of the Statutory Declarations Act, 1960.

Subscribed and solemnly declared)
by the abovenamed at Kuala Lumpur)
this 28 February 2019.)

Before me,

PESURUHJAYA SUMPAH
W 703
MOHD FITRY ABDUL GHANI
01/01/2019 - 31/12/2021
MALAYSIA
NO. 58A, JALAN BUKIT RAJA
TAMAN SEPUTEH, 58000 KUALA LUMPUR

BANK NEGARA MALAYSIA

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2018

	Note	2018 RM million	2017 RM million
ASSETS			
Gold and Foreign Exchange	3	411,042	406,798
International Monetary Fund Reserve Position	4	3,802	3,116
Holdings of Special Drawing Rights	4	4,728	4,737
Malaysian Government Papers	5	3,392	4,226
Deposits with Financial Institutions	6	132	8,913
Loans and Advances	7	6,874	7,593
Land and Buildings	8	4,175	4,180
Other Assets	9	13,492	10,283
Total Assets		**447,637**	**449,846**
LIABILITIES AND CAPITAL			
Currency in Circulation		106,405	103,585
Deposits from: Financial Institutions		169,133	181,718
Federal Government		7,956	7,479
Others	10	859	1,456
Bank Negara Papers	11	21,746	7,268
Allocation of Special Drawing Rights	4	7,743	7,759
Other Liabilities	12	2,138	3,762
Total Liabilities		315,980	313,027
Capital	13	100	100
General Reserve Fund	14	14,810	14,744
Risk Reserve	15	113,477	118,657
Land Revaluation Reserve	16	749	752
Unappropriated Profits	17	2,521	2,566
Total Capital		131,657	136,819
Total Liabilities and Capital		**447,637**	**449,846**

Notes on the following pages form part of these financial statements.

BANK NEGARA MALAYSIA

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2018

	Note	2018 RM million	2017 RM million
Total Income	18	**9,334**	**10,043**
Less:			
Recurring Expenditure	19	(1,354)	(1,287)
Development Expenditure	20	(418)	(1,247)
Total Expenditure		**(1,772)**	**(2,534)**
Net Profit Before Tax		**7,562**	**7,509**
Less: Taxation	21	(41)	(43)
Net Profit After Tax		**7,521**	**7,466**
Less: Transfer to Risk Reserve	15	(5,000)	(4,900)
Unappropriated Profits of the year	17	**2,521**	**2,566**

Notes on the following pages form part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

1. **General Information**

Bank Negara Malaysia (the Bank) is a statutory body established under the Central Bank of Malaysia Act 1958 which has been repealed by the Central Bank of Malaysia Act 2009. The principal place of business is located at Bank Negara Malaysia, Jalan Dato' Onn, 50480 Kuala Lumpur.

The principal objects of the Bank are to promote monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy. In this regard, the Bank's primary functions are as follows:

(a) to formulate and conduct monetary policy in Malaysia;
(b) to issue currency in Malaysia;
(c) to regulate and supervise financial institutions which are subject to the laws enforced by the Bank;
(d) to provide oversight over money and foreign exchange markets;
(e) to exercise oversight over payment systems;
(f) to promote a sound, progressive and inclusive financial system;
(g) to hold and manage the foreign reserves of Malaysia;
(h) to promote an exchange rate regime consistent with the fundamentals of the economy; and
(i) to act as financial adviser, banker and financial agent of the Government.

The Board of Directors approved the annual financial statements on 28 February 2019.

2. **Accounting Policies**

The principal accounting policies applied in the preparation of these financial statements are set out below. These accounting policies are consistently applied to both of the financial years presented, unless otherwise stated.

2.1 **Basis of Preparation of Financial Statements**

(a) These financial statements have been prepared in accordance with the Central Bank of Malaysia Act 2009 and the applicable Malaysian Financial Reporting Standards (MFRS). Section 10 of the Central Bank of Malaysia Act 2009 provides that the Bank, in preparing its financial statements, shall comply with the applicable accounting standards to the extent that it is, in the opinion of the Directors, appropriate to do so, having regard to the objects and functions of the Bank. The Directors, having considered the Bank's responsibilities for the formulation and conduct of effective monetary policy and promoting financial stability, are of the opinion that, it is appropriate to differ, in certain aspects, from the applicable accounting standards.

(b) The preparation of the financial statements on the basis stated in 2.1 (a) requires the management to make judgements, estimates and assumptions based on available information that may affect the application of accounting policies and the reported amounts of assets and liabilities as well as disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the financial year. Although these estimates are based on the management's best knowledge of current events and actions, the actual results could differ from those estimates.

2.2 **Measurement Base and Accounting Basis**

The financial statements have been prepared on an accrual basis, using the historical cost convention, except as otherwise disclosed.

2.3 **Foreign Currency Translation**

(a) The financial statements have been prepared using Ringgit Malaysia, the currency of the primary economic environment in which the Bank operates.

(b) Assets and liabilities in foreign currencies are translated into Ringgit Malaysia using the exchange rate prevailing as at the end of the financial year. Transactions in foreign currencies during the year are translated into Ringgit Malaysia using the exchange rate prevailing at the transaction dates.

(c) All foreign exchange gains or losses arising from translation of foreign currency assets and liabilities are recognised in Risk Reserve while realised gains or losses upon settlement on Other Assets and Other Liabilities are recognised in the Income Statement.

2.4 **Gold**

Gold is carried at fair value. Unrealised gains and losses from changes in the fair value on gold are recognised in Risk Reserve. Realised gains or losses from the sale of gold are recognised in the Income Statement.

2.5 **Foreign Securities**

Foreign securities comprising fixed income securities and equities are stated at amortised cost or fair value. Fair value changes are recognised in Risk Reserve or in the Income Statement. Upon derecognition, realised gains or losses are recognised in the Income Statement.

2.6 **Net Profit**

The net profit of the Bank is appropriated in accordance with section 7 of the Central Bank of Malaysia Act 2009 and only realised gains are available for distribution to shareholder.

2.7 **Repurchase and Reverse Repurchase Agreements**

The amount under repurchase agreements is reported under Other Liabilities and the difference between the sale and repurchase price is recognised as interest expense in the Income Statement. Conversely, the amount under reverse repurchase agreements is reported under Other Assets and the difference between purchase and resale price is recognised as interest income in the Income Statement.

2.8 **Land and Buildings**

(a) The Bank capitalises all its land while buildings are maintained at nominal cost of RM10 each.

(b) The amount of land capitalised at initial recognition is the purchase price along with any further costs incurred in bringing the land to its present condition.

(c) After initial recognition, land is stated at revalued amount. Professional valuations of the Bank's land will be carried out once every 10 years with any surplus arising on revaluation to be recognised directly in the Land Revaluation Reserve.

(d) Freehold land is not depreciated. With effect from 2018, leasehold land is amortised over its remaining life. Land (freehold and leasehold) is revalued once in 10 years and fair value is determined from market based evidence undertaken by professionally qualified valuer. Buildings are not depreciated but revalued to a nominal value in the year of acquisition.

(e) Gain or loss arising from the disposal of land is determined as the difference between the net disposal proceeds and the carrying amount of the land. Upon disposal of land, any surplus previously recorded in Land Revaluation Reserve is transferred to Unappropriated Profit.

2.9 **Other Fixed Assets**
All other fixed assets are completely written-off in the year of acquisition.

2.10 **Impairment of Assets**
All assets are periodically assessed for impairment losses whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If such an indication exists, an impairment review is performed to assess whether the carrying amount of the asset is fully recoverable.

3. **Gold and Foreign Exchange**

	2018 RM million	**2017 RM million**
Gold	6,590	6,348
Foreign Securities	361,885	373,925
Foreign Deposits	5,470	4,999
Balances with Other Central Banks	28,326	9,507
Others	8,771	12,019
	411,042	406,798

4. **International Monetary Fund (IMF) Reserve Position, Holdings of Special Drawing Rights (SDR) and Allocation of Special Drawing Rights**
The IMF objectives are to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth and reduce poverty around the world. The IMF also provides advice and temporary funding to member countries in the event of balance of payments difficulties.

IMF Reserve Position
This consists of the reserve tranche position of Malaysia's quota, lending under the Financial Transaction Plan (FTP) and New Arrangements to Borrow (NAB). The IMF quota determines the member country's voting strength, the financial contributions to the IMF, the amount of financing the member can access in the event of balance of payment difficulties and the amount of SDRs allocated to the member. Both FTP and NAB programmes are used to provide loans to members.

Holdings of Special Drawing Rights
Holdings of Special Drawing Rights (SDR) are an international reserve asset created by the IMF. SDR is periodically allocated to IMF member countries on the basis of the size of member countries' quota. A member may use SDR to obtain foreign exchange reserves from other members and to make international payments, including to the IMF.

Allocation of Special Drawing Rights
This liability to the IMF represents an equivalent amount of SDR received since its inception.

	2018 RM million	2017 RM million
IMF Reserve Position	3,802	3,116
Holdings of Special Drawing Rights	4,728	4,737
Allocation of Special Drawing Rights	(7,743)	(7,759)
Net position with IMF	787	94

5. **Malaysian Government Papers**

Malaysian Government Papers refer to holdings of Government debt instruments that are among the instruments that can be used in the Bank's monetary policy operations.

	2018 RM million	2017 RM million
Malaysian Government Securities	3,024	3,859
Malaysian Government Investment Certificates	368	367
	3,392	4,226

6. **Deposits with Financial Institutions**

Deposits with financial institutions comprise deposits placed by the Bank with financial institutions under section 75(i) and section 100 of the Central Bank of Malaysia Act 2009.

7. **Loans and Advances**

Net loans and advances comprise mainly advances extended by the Bank to the participating institutions under various schemes aimed at promoting growth and development of small and medium business establishments. The extensions of these advances are provided under section 48, section 49 and section 100 of the Central Bank of Malaysia Act 2009.

	2018 RM million	2017 RM million
Funds for Small and Medium Industries	6,492	7,174
Others	382	419
	6,874	7,593

8. **Land and Buildings**

	2018 RM million	2017 RM million
Land, at cost		
Freehold	3,314	3,316
Land, at revaluation		
Freehold	694	694
Leasehold	167	170
	4,175	4,180

	2018 RM million	2017 RM million
Leasehold land		
As at 1 January	170	170
Less: Accumulated Amortisation	(3)	-
As at 31 December	167	170

	2018 RM	2017 RM
Buildings, at nominal value		
Freehold	2,230	2,230
Leasehold	1,380	1,380
	3,610	3,610

Freehold and leasehold land, at revaluation, were revalued by an independent valuer on 1 August 2014.

9. **Other Assets**

Included in Other Assets are securities purchased under reverse repurchase agreements and investments in shares and bonds acquired under section 48(1) and section 100 of the Central Bank of Malaysia Act 2009.

	2018 RM million	2017 RM million
Reverse Repurchase Agreements	8,266	4,735
Investments in Shares and Bonds	4,401	4,602
Others	825	946
	13,492	10,283

10. **Deposits from Others**

A substantial part of these deposits comprises deposits from national institutions, government agencies and public authorities.

11. **Bank Negara Papers**

Bank Negara Papers are papers issued by the Bank as an additional monetary policy tool to manage liquidity in the domestic money market. It also includes Bank Negara Interbank Bills (BNIB) in foreign currency and this is part of the Bank's market operations to manage foreign currency liquidity in the domestic money market.

12. **Other Liabilities**

Other Liabilities include securities sold under repurchase agreements of RM863 million (2017: RM876 million).

	2018 RM million	2017 RM million
Repurchase Agreements	863	876
Accruals	917	1,474
Others	358	1,412
	2,138	3,762

13. **Capital**

In accordance with section 6 of the Central Banking Act 2009, the capital of the Bank shall be RM100,000,000 and is owned by the Government of Malaysia.

14. **General Reserve Fund**

	2018 RM million	2017 RM million
As at 1 January	14,744	14,666
Amount approved and transferred to the General Reserve Fund during the year	66	78
As at 31 December	14,810	14,744

Appropriations of net profits to the General Reserve Fund and dividends to the Government are recognised upon the approval by the Minister as provided under section 7 of the Central Bank of Malaysia Act 2009.

The transfer to the General Reserve Fund for the year ended 2017 of RM66 million was approved by the Minister on 14 February 2018.

15. **Risk Reserve**

The Risk Reserve are financial buffers comprising cumulative transfers of net profits, unrealised gains or losses on translation of foreign currency assets and liabilities and fair value changes from securities carried at fair value.

A market risk measurement framework is used to estimate financial buffers required to cushion unexpected loss arising from unfavourable circumstances not within the control of the Bank.

	2018 RM million	2017 RM million
As at 1 January	118,657	126,741
Movements during the year	(10,180)	(12,984)
Transfer from net profits	5,000	4,900
As at 31 December	113,477	118,657

16. **Land Revaluation Reserve**
Land Revaluation Reserve relates to unrealised surplus of land (freehold and leasehold) upon their revaluation. Upon disposal, the realised surplus relating to the realised asset is transferred to Unappropriated Profits.

17. **Unappropriated Profits**

	2018 RM million	**2017 RM million**
Balance 1 January	2,566	2,578
Less: Appropriations approved during the year		
Transfer to General Reserve Fund	(66)	(78)
Dividend paid to the Government	(2,500)	(2,500)
	-	-
Current year's unappropriated profits	2,521	2,566
Balance 31 December	2,521	2,566

In accordance with section 7 of the Central Bank of Malaysia Act 2009, appropriations to the General Reserve Fund and declaration of dividends to the Government are subject to the approval of the Minister, and if approved will be recognised in the next financial year ending 31 December 2019.

The dividend paid to the Government for the year ended 2017 amounted to RM2.5 billion was approved by the Minister on 14 February 2018.

For the year ended 31 December 2018, the Board recommends a transfer to the General Reserve Fund of RM21 million and dividend payable of RM2.5 billion to the Government.

18. **Total Income**
Total income comprises revenue from foreign reserves management which includes interest and dividends, non-treasury income, realised capital gains or losses, and is stated at net of amortisation/accretion of premiums/discounts and monetary policy cost.

19. **Recurring Expenditure**
Recurring expenditure are expenses incurred in the management and administration of day-to-day operations of the Bank.

20. **Development Expenditure**
Development expenditure are expenses incurred mainly to finance developmental and long term projects undertaken by the Bank that are in line with its principal objects and functions.

21. **Taxation**
The Bank is exempted from payment of income tax and supplementary income tax as set out in the Income Tax (Exemption) (No. 7) Order 1989. Tax expenses relates to unclaimable withholding taxes on income from foreign dividend and interest and capital gains taxes on sale of foreign investments.

22. **Contingencies and Commitments**

22.1 **Contingent Assets**

Total contingent assets as at 31 December 2018 amounted to RM1,400 million. These comprise the Bank's total contributions to International Centre for Leadership in Finance (ICLIF) Trust Fund of RM800 million and International Centre for Education in Islamic Finance (INCEIF) Trust Fund of RM600 million to finance activities related to training, research and development of human resource in banking and financial services managed by The ICLIF Leadership and Governance Centre and INCEIF, respectively. It is provided in the Trust Deeds that the total contributions will be returned to the Bank when the Centres become self-sufficient in the future.

22.2 **Commitments**

Total commitments as at 31 December 2018 comprise the following:

	Note	2018 RM million	2017 RM million
Total Commitments			
International Monetary Fund (IMF)	(a)		
Unpaid Quota	(i)	17,300	18,050
New Arrangement to Borrow (NAB)	(ii)	1,790	1,743
Bilateral Contribution	(iii)	4,136	4,048
Investment with Bank for International Settlements (BIS)	(b)	69	70
Liquidity Investment Arrangement with IILM	(c)	-	2,429
Swap Arrangements	(d)		
ASEAN Swap Arrangement	(i)	1,241	1,214
Bilateral Currency Swap Arrangement with			
People's Bank of China (PBOC)	(ii)(a)	110,000	90,000
Bank of Korea (BOK)	(ii)(b)	15,000	15,000
Chiang Mai Initiative Multilateralisation	(iii)	37,654	37,000
Repurchase Agreement with EMEAP Members	(iv)	20,680	20,000
		207,870	189,554

(a) **Membership with IMF**

(i) The Bank has an obligation to pay to IMF SDR3,007 million, equivalent to RM17,300 million (2017: SDR3,131 million, equivalent to RM18,050 million) or in other convertible currencies which represents the unpaid portion of Malaysia's quota in the IMF under the Articles of Agreement.

(ii) The Bank has participated in the New Arrangements to Borrow (NAB), a set of credit arrangements between the IMF and its member countries to provide a supplementary source of financing to IMF for the purpose of safeguarding the stability of the international monetary system. As at 31 December 2018, the amount of undrawn credit under the NAB is SDR311 million, equivalent to RM1,790 million (2017: SDR302 million, equivalent to RM1,743 million).

(iii) On 23 July 2012, the Bank has pledged a USD1,000 million, equivalent to RM4,136 million (2017: USD1,000 million, equivalent to RM4,048 million) bilateral contribution to the IMF for precautionary and financial crisis resolution purposes.

(b) **Investment with Bank for International Settlements (BIS)**

The Bank has a commitment of SDR12 million, equivalent to RM69 million (2017: SDR12 million, equivalent to RM70 million) which refers to the uncalled portion of the 3,220 units of shares held by the Bank in the BIS based on the nominal value of SDR5,000 each using the SDR rate at the date of the Statement of Financial Position.

(c) **Liquidity Investment Arrangement (LIA) with International Islamic Liquidity Management Corporation (IILM)**

As at 31 December 2018, the Bank's commitment is nil due to termination of the arrangement with effect from 31 May 2018 (2017: USD600 million, equivalent to RM 2,429 million). As IILM's issuances were well supported by investors, the liquidity arrangement was never triggered since its inception in December 2016.

(d) **Swap Arrangements**

(i) **ASEAN Swap Arrangement**

The Bank has participated in the multilateral ASEAN Swap Arrangement (ASA) together with other ASEAN central banks and monetary authorities to provide short-term foreign currency liquidity support to member countries with balance of payments difficulties. As at 31 December 2018, the Bank's total commitment amounted to USD300 million, equivalent to RM1,241 million (2017: USD300 million, equivalent to RM1,214 million) and there was no request for liquidity support under ASA from any member country during the financial year.

(ii) **Bilateral Currency Swap Arrangement**

(a) On 20 August 2018, the Bank renewed the Bilateral Currency Swap Arrangement (BCSA) agreement with the People's Bank of China (PBOC) with the objective of promoting and facilitating trade settlement in the local currency between the two countries. As at 31 December 2018, the Bank's total commitment under the BCSA is RM110 billion (2017: RM90 billion) and there has been no request to activate the BCSA during the financial year.

(b) On 25 January 2017, the Bank renewed the Bilateral Currency Swap Arrangement (BCSA) agreement with the Bank of Korea (BOK) with the objective of promoting bilateral trade and facilitating trade settlement in local currency between the two countries. As at 31 December 2018, the Bank's total commitment under the BCSA is RM15 billion (2017: RM15 billion) and there has been no request to activate the BCSA during the financial year.

(iii) **Chiang Mai Initiative Multilateralisation Arrangement**
The Bank has participated in the Chiang Mai Initiative Multilateralisation (CMIM) arrangement to provide financial support to ASEAN+3 member countries facing balance of payments and short-term liquidity difficulties. The effective date of the CMIM Agreement is 24 March 2010. Under the CMIM arrangement, member countries facing balance of payments and short-term liquidity constraints can obtain financial support in US dollar through swap arrangements against their respective local currencies. As at 31 December 2018, the Bank's total commitment is USD9.1 billion, equivalent to RM37.7 billion (2017: USD9.1 billion, equivalent to RM37 billion) and there was no request for liquidity support from any member country.

(iv) **Repurchase Agreement with Central Banks and Monetary Authorities**
The Bank has entered into repurchase agreements totalling USD5 billion, equivalent to RM20.7 billion (2017: USD5 billion, equivalent to RM20 billion) with various central banks and monetary authorities under the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) to provide liquidity assistance in times of emergency. As at 31 December 2018, there was no request for liquidity assistance from any counterpart.

23. **Financial Risk Management**
The Reserve Management Committee oversees the assessment, measurement and the control of the investment risks in the management of reserves to be within acceptable levels to ensure that the objectives of capital preservation, liquidity and reasonable returns are met. In undertaking this function, the major risks of the investments fall into the following areas:

(a) **Market Risk**
Market risk is the exposure of the Bank's investments to adverse movements in market prices related to foreign exchange rates, interest rates and prices of bonds and equities. Market risk is assessed and monitored on a daily basis. A benchmark policy approved by the Board of Directors reflects the long-term objectives and acceptable risk-return profile of the investments. Investments may be made in instruments that are different from those in the benchmark. This deviation in investment is controlled through a set of risk management limits, governance arrangements and investment guidelines that are also approved by the Board of Directors. Sensitivity analysis and stress testing are undertaken to assess emerging risks and potential marked-to-market losses from adverse movements and volatility in the market, as well as liquidity conditions.

(b) **Credit Risk**
Credit risk is the risk of default of the issuer of the debt or failure of the counterparty to perform its contractual obligation to the Bank resulting in the Bank not receiving its principal and/or interest that has fallen due in a timely manner. A comprehensive credit risk framework governs the permissible investments and the risk appetite of the Bank, thus ensuring investments in issuers and with counterparties of good credit standing. The framework, which is approved by the Board, also incorporates market-based credit indicators such as ratings implied from financial market prices, and internal credit assessment. This enhances the credit risk framework by providing a more dynamic and forward-looking credit assessment.

(c) **Operational Risk**
Operational risk is the risk of financial losses due to failed internal processes, inadequate controls and procedures, or any other internal or external events that impede operations. Operational risk is mitigated through a governance framework and effective implementation of risk controls and limits. A comprehensive operational risk surveillance mechanism is in place to support the identification of emerging risks in the Bank's operations to allow for action to be taken in managing gaps and in mitigating financial losses.

24. **Bank Negara Malaysia Staff Welfare Account (SWA) and Bank Negara Malaysia Staff Welfare Account (Medical Fund) (termed as the 'Medical Fund Account')**
The SWA was established on 1 March 1991 under section 15 (5) and (6) of the Central Bank of Malaysia Act 1958 while the Medical Fund Account was established on 21 June 2006 under section 15 (6) of the Central Bank of Malaysia Act 1958. Both the SWA and the Medical Fund continue to exist under section 83 (4) and (5) of the Central Bank of Malaysia Act 2009.

The SWA is governed under the Bank Negara Malaysia Staff Welfare Account Trust Directions 1991. As stipulated in the Trust Directions 1991, the SWA shall be administered by a committee authorised by the Board (Authorised Committee of the Board). The accounts of the SWA are to be maintained separately from the other accounts of the Bank and shall be audited in the same manner of the Bank's Account. The objective of the SWA is to provide loans to the staff for certain allowable activities, finance the activities of the staff associations and give education excellence awards to the children of staff. The SWA also manages the insurance compensation of the deceased staff received by beneficiaries who have yet to attain the legal age.

The Medical Fund Account is governed under the Bank Negara Malaysia Staff Welfare Account (Medical Fund) Trust Directions 2006 and Supplementary Trust Directions 2017. The objective is to assist the Bank to meet the medical expenses of eligible retirees and their dependents. As stipulated in the Staff Welfare Account (Medical Fund) Trust Directions 2006, the Medical Fund shall be administered by a Medical Fund Committee. The Medical Fund Account is to be maintained separately under the Staff Welfare Account and shall be audited in the same manner of the Staff Welfare Account.

Annex

Annex

CONTENTS

Key Economic and Financial Statistics

Table A.1

Gross Domestic Product by Kind of Economic Activity at Constant 2010 Prices

	2014	2015	2016	2017	2018*p*	2019*f*
	RM million					
Agriculture	93,048	94,396	89,509	95,968	95,545	98,205
Mining and quarrying	90,707	95,508	97,468	98,436	96,971	97,707
Manufacturing	232,527	243,703	254,472	269,804	283,337	296,897
Construction	43,115	46,719	50,197	53,574	55,835	57,504
Services	541,412	569,865	602,261	639,568	683,080	721,971
Plus: Import duties	11,639	13,808	15,030	16,980	15,031	15,653
GDP at purchasers' prices[1]	**1,012,449**	**1,063,998**	**1,108,935**	**1,174,329**	**1,229,800**	**1,287,936**
	Annual change (%)					
Agriculture	2.0	1.4	-5.2	7.2	-0.4	2.8
Mining and quarrying	3.3	5.3	2.1	1.0	-1.5	0.8
Manufacturing	6.1	4.8	4.4	6.0	5.0	4.8
Construction	11.7	8.4	7.4	6.7	4.2	3.0
Services	6.6	5.3	5.7	6.2	6.8	5.7
Plus: Import duties	10.0	18.6	8.8	13.0	-11.5	4.1
GDP at purchasers' prices	**6.0**	**5.1**	**4.2**	**5.9**	**4.7**	**4.3 ~ 4.8**

[1] Numbers may not necessarily add up due to rounding
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table A.2

Growth in Manufacturing Production (2015=100)

	2015	2016	2017	2018	2016	2017	2018
	Index				Annual change (%)		
Export-oriented industries	**100.0**	**105.0**	**111.9**	**116.9**	**5.0**	**6.7**	**4.4**
Electronics and electrical products cluster	**100.0**	**107.4**	**115.7**	**122.4**	**7.4**	**7.8**	**5.8**
Electronics	100.0	109.4	120.5	128.5	9.4	10.2	6.6
Electrical products	100.0	105.0	110.2	115.4	5.0	4.9	4.7
Primary-related cluster	**100.0**	**103.5**	**109.7**	**113.5**	**3.5**	**5.9**	**3.5**
Chemicals and chemical products	100.0	105.3	109.5	114.4	5.3	4.0	4.4
Petroleum products	100.0	103.1	106.7	110.2	3.1	3.5	3.4
Textiles, wearing apparel and footwear	100.0	106.8	115.3	120.2	6.8	8.0	4.3
Wood and wood products	100.0	105.6	110.7	115.7	5.6	4.8	4.6
Rubber products	100.0	104.1	110.5	115.8	4.1	6.1	4.8
Off-estate processing	100.0	96.9	114.1	114.1	-3.1	17.7	0.0
Paper products	100.0	104.9	110.3	114.7	4.9	5.1	4.1
Domestic-oriented industries	**100.0**	**102.9**	**108.0**	**114.1**	**2.9**	**4.9**	**5.6**
Construction-related cluster	**100.0**	**104.2**	**109.3**	**114.7**	**4.2**	**5.0**	**4.9**
Non-metallic mineral products	100.0	104.4	109.1	115.1	4.4	4.5	5.5
Basic iron & steel and non-ferrous metal	100.0	102.1	107.6	112.1	2.1	5.4	4.2
Fabricated metal products	100.0	105.2	110.5	116.0	5.2	5.0	4.9
Consumer-related cluster	**100.0**	**102.0**	**107.0**	**113.6**	**2.0**	**4.9**	**6.1**
Food products	100.0	105.8	111.7	119.1	5.8	5.7	6.6
Transport equipment	100.0	96.3	101.0	107.7	-3.7	4.8	6.7
Beverages	100.0	109.7	119.8	123.7	9.7	9.2	3.3
Tobacco products	100.0	103.2	105.4	107.3	3.2	2.1	1.8
Others	100.0	104.8	107.7	114.4	4.8	2.7	6.3
Total	**100.0**	**104.3**	**110.7**	**116.0**	**4.3**	**6.1**	**4.8**

Source: Department of Statistics, Malaysia, Bank Negara Malaysia

Table A.3

Services Sector Performance at Constant 2010 Prices

	2014	2015	2016	2017	2018*p*	2014	2015	2016	2017	2018*p*
	Annual change (%)					Share to GDP (%)				
Services	**6.6**	**5.3**	**5.7**	**6.2**	**6.8**	**53.5**	**53.6**	**54.3**	**54.5**	**55.5**
Intermediate services	6.0	4.7	5.6	6.6	7.0	20.5	20.4	20.7	20.8	21.3
Finance and insurance	*2.3*	*-0.5*	*2.6*	*4.6*	*5.8*	*7.3*	*6.9*	*6.8*	*6.7*	*6.8*
Real estate and business services	*8.0*	*6.5*	*6.9*	*7.4*	*7.6*	*4.2*	*4.3*	*4.4*	*4.5*	*4.6*
Transport and storage	*5.4*	*5.8*	*5.7*	*6.2*	*6.4*	*3.5*	*3.5*	*3.6*	*3.6*	*3.6*
Information and communication	*10.0*	*9.5*	*8.1*	*8.4*	*8.4*	*5.5*	*5.7*	*5.9*	*6.1*	*6.3*
Final services	7.0	5.6	5.8	6.0	6.7	33.0	33.1	33.6	33.6	34.2
Wholesale and retail trade	*8.9*	*7.0*	*6.3*	*7.1*	*8.1*	*14.4*	*14.6*	*14.9*	*15.1*	*15.6*
Food & beverages and accommodation	*6.5*	*6.4*	*7.1*	*7.4*	*8.9*	*2.7*	*2.8*	*2.8*	*2.9*	*3.0*
Utilities	*3.8*	*3.7*	*5.4*	*2.9*	*4.9*	*2.6*	*2.6*	*2.6*	*2.5*	*2.5*
Government services	*6.3*	*4.2*	*4.9*	*4.9*	*4.5*	*8.8*	*8.8*	*8.8*	*8.7*	*8.7*
Other services	*4.8*	*4.8*	*4.9*	*5.1*	*5.6*	*4.4*	*4.4*	*4.4*	*4.4*	*4.4*

p Preliminary
Note: Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

Table A.4

GNI by Demand Aggregates

	2014	2015	2016	2017	2018*p*	2019*f*
	at Current Prices (RM million)					
Consumption	727,460	778,710	829,869	913,528	990,365	1,055,309
Private consumption	*579,985*	*626,372*	*674,964*	*748,857*	*819,880*	*882,344*
Public consumption	*147,475*	*152,338*	*154,905*	*164,671*	*170,485*	*172,965*
Investment	287,393	302,708	316,832	342,219	348,866	357,225
Private investment	*183,885*	*198,648*	*211,297*	*234,824*	*246,410*	*261,092*
Public investment	*103,508*	*104,060*	*105,535*	*107,395*	*102,456*	*96,133*
Change in stocks[1]	-11,030	-11,497	1,191	3,683	-11,050	-9,064
Exports of goods and services	816,483	817,370	834,491	966,174	996,352	1,006,314
Imports of goods and services	713,863	728,778	751,363	872,223	894,691	909,972
GDP at purchasers' value	1,106,443	1,158,513	1,231,020	1,353,380	1,429,842	1,499,811
Balance of primary income	-36,624	-32,112	-34,592	-36,354	-49,377	-50,186
GNI	1,069,819	1,126,401	1,196,428	1,317,027	1,380,465	1,449,625
	at Constant 2010 Prices (RM million)					
Consumption	662,389	700,209	734,651	783,757	840,041	886,906
Private consumption	*525,038*	*556,632*	*589,774*	*630,988*	*682,250*	*727,212*
Public consumption	*137,351*	*143,577*	*144,877*	*152,769*	*157,791*	*159,694*
Investment	264,242	273,788	281,069	298,472	302,790	306,780
Private investment	*168,550*	*179,140*	*186,914*	*204,268*	*213,453*	*223,816*
Public investment	*95,692*	*94,649*	*94,154*	*94,203*	*89,338*	*82,964*
Change in stocks[1]	-8,872	-1,211	459	1,141	-16,213	-9,020
Exports of goods and services	769,794	771,739	781,939	855,196	868,171	868,612
Imports of goods and services	675,105	680,527	689,182	764,238	764,990	765,343
GDP at purchasers' value	1,012,449	1,063,998	1,108,935	1,174,329	1,229,800	1,287,936
Balance of primary income	-39,913	-24,362	-23,285	-23,041	-38,293	-38,469
GNI	972,535	1,039,636	1,085,650	1,151,288	1,191,507	1,249,467

[1] Includes statistical discrepancy
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table A.5

Savings-Investment Gap

	2014	2015	2016	2017	2018*p*
	RM million				
Gross national savings	324,916	326,366	347,930	386,177	371,320
(as % of GNI)	30.4	29.0	29.1	29.3	26.9
Gross domestic capital formation	276,363	291,211	318,023	345,902	337,816
(as % of GNI)	25.8	25.9	26.6	26.3	24.5
Balance on current account	48,554	35,155	29,907	40,275	33,505
(as % of GNI)	4.5	3.1	2.5	3.1	2.4

p Preliminary

Source: Department of Statistics, Malaysia

Table A.6

Balance of Payments[1]

Item (Net)	2014	2015	2016	2017	2018*p*	2019*f*
	RM million					
Goods[2]	**113,327**	**109,224**	**102,046**	**116,766**	**121,362**	**116,167**
Services	**-10,706**	**-20,632**	**-18,917**	**-22,815**	**-19,700**	**-19,825**
Transportation	-26,050	-24,565	-23,459	-29,561	-27,757	-29,347
Travel	33,233	26,941	31,515	32,882	28,853	28,928
Other services	-17,541	-22,405	-26,309	-24,738	-19,921	-18,510
Government transactions n.i.e.	-349	-603	-665	-1,399	-875	-896
Balance on goods and services	**102,620**	**88,592**	**83,128**	**93,951**	**101,662**	**96,342**
Primary income	**-36,624**	**-32,112**	**-34,592**	**-36,354**	**-49,377**	**-50,186**
Compensation of employees	-4,902	-5,595	-5,606	-4,773	-7,793	-7,918
Investment income	-31,722	-26,517	-28,986	-31,581	-41,584	-42,268
Secondary income	**-17,443**	**-21,325**	**-18,629**	**-17,322**	**-18,780**	**-18,150**
Balance on current account	**48,554**	**35,155**	**29,907**	**40,275**	**33,505**	**28,005**
% of GNI	*4.5*	*3.1*	*2.5*	*3.1*	*2.4*	*1.5 - 2.5*
Capital account	**344**	**-1,136**	**102**	**-27**	**-106**	
Financial account	**-79,954**	**-55,350**	**-249**	**-4,730**	**18,609**	
Direct investment	-17,974	-1,810	13,792	16,171	11,341	
Assets	*-52,623*	*-39,698*	*-42,246*	*-24,234*	*-23,290*	
Liabilities	*34,649*	*37,888*	*56,038*	*40,405*	*34,632*	
Portfolio investment	-39,354	-26,122	-14,203	-15,358	-44,402	
Assets	*-28,112*	*-9,098*	*-15,009*	*-19,442*	*-9,112*	
Liabilities	*-11,242*	*-17,024*	*806*	*4,084*	*-35,290*	
Financial derivatives	-975	-663	-802	-197	971	
Other investment	-21,652	-26,755	964	-5,346	50,699	
Official sector	*1,083*	*-1,878*	*-3,033*	*-3,129*	*-5,627*	
Private sector	*-22,735*	*-24,877*	*3,997*	*-2,217*	*56,326*	
Balance on capital and financial accounts	**-79,610**	**-56,486**	**-148**	**-4,757**	**18,503**	
Errors and omissions[3]	**-13,023**	**-32,222**	**-23,899**	**-19,109**	**-44,287**	
Overall balance	**-44,080**	**-53,553**	**5,860**	**16,409**	**7,721**	
Bank Negara Malaysia international reserves, net[4]						
USD million	115,930	95,283	94,488	102,431	101,429	
RM million	405,345	409,096	423,874	414,591	419,511	
Foreign exchange revaluation gain (+) / loss (-)	7,573	57,303	8,918	-25,691	-2,838	
Reserves as months of retained imports	8.3	8.4	8.7	7.2	7.4	

1 In accordance with the Sixth Edition of the Balance of Payments and International Investment Position Manual (BPM6) by the International Monetary Fund (IMF)
2 Adjusted for valuation and coverage of goods for processing, storage and distribution
3 As at 1Q 2018, the net E&O excludes reserves revaluation changes. This practice is backdated to 1Q 2010
4 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 Bank Negara Malaysia's audited accounts
p Preliminary
f Forecast
n.i.e. Not included elsewhere
Note: Numbers may not add up due to rounding
Assets: (-) denotes outflows due to the acquisition of assets abroad by residents
Liabilities: (+) denotes inflows due to the incurrence of foreign liabilities

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table A.7

Gross Exports

	2016	2017	2018*p*	2017	2018*p*	2018*p*
	RM million			Annual change (%)		% share
Manufactures	**645,768**	**765,858**	**835,615**	**18.6**	**9.1**	**83.7**
of which:						
Electrical and electronic products	287,810	343,070	380,816	19.2	11.0	38.1
Semiconductors	*144,655*	*178,142*	*220,278*	*23.1*	*23.7*	*22.1*
Office machines and automatic data processing equipment	*53,534*	*62,702*	*62,358*	*17.1*	*-0.5*	*6.2*
Electrical machinery, apparatus and appliances, and parts	*49,236*	*58,279*	*57,512*	*18.4*	*-1.3*	*5.8*
Telecommunications and sound-recording and reproducing equipment	*40,385*	*43,947*	*40,668*	*8.8*	*-7.5*	*4.1*
Petroleum products	54,662	71,813	76,529	31.4	6.6	7.7
Chemicals and chemical products	41,396	47,138	57,721	13.9	22.5	5.8
Manufactures of metal	33,352	37,937	44,671	13.7	17.8	4.5
Machinery, equipment and parts	37,498	40,133	40,622	7.0	1.2	4.1
Optical and scientific equipment	28,747	32,395	36,329	12.7	12.1	3.6
Rubber products	20,253	26,308	26,410	29.9	0.4	2.6
Palm oil-based manufactured products	19,552	23,785	22,791	21.6	-4.2	2.3
Processed food	18,958	19,713	19,386	4.0	-1.7	1.9
Transport equipment	13,476	15,605	18,029	15.8	15.5	1.8
Agriculture	**70,424**	**78,072**	**67,005**	**10.9**	**-14.2**	**6.7**
of which:						
Palm oil and palm oil-based agricultural products	48,370	54,023	44,703	11.7	-17.3	4.5
Sawn timber and moulding	4,212	4,738	4,530	12.5	-4.4	0.5
Natural rubber	3,614	4,726	3,774	30.8	-20.1	0.4
Minerals	**65,056**	**81,836**	**87,744**	**25.8**	**7.2**	**8.8**
of which:						
Liquefied natural gas (LNG)	32,709	41,417	40,136	26.6	-3.1	4.0
Crude petroleum	22,319	28,255	36,674	26.6	29.8	3.7
Others	**5,717**	**9,161**	**7,914**	**60.2**	**-13.6**	**0.8**
Total	**786,964**	**934,927**	**998,278**	**18.8**	**6.8**	**100.0**

p Preliminary

Source: Department of Statistics, Malaysia

Annex

Table A.8

Gross Imports

	2016	2017	2018*p*	2017	2018*p*	2018*p*
	RM million			Annual change (%)		% share
Capital goods	**100,245**	**115,567**	**111,802**	**15.3**	**-3.3**	**12.7**
Capital goods (except transport equipment)	88,432	102,507	95,825	15.9	-6.5	10.9
Transport equipment industrial	11,813	13,060	15,977	10.6	22.3	1.8
Intermediate goods	**399,033**	**478,931**	**460,192**	**20.0**	**-3.9**	**52.4**
Food and beverages, mainly for industry	17,506	19,141	17,776	9.3	-7.1	2.0
Industrial supplies	172,305	199,910	213,747	16.0	6.9	24.4
Fuel and lubricants	31,093	47,921	55,942	54.1	16.7	6.4
Parts and accessories of capital goods (except transport equipment)	151,461	183,230	142,695	21.0	-22.1	16.3
Parts and accessories of transport equipment	26,666	28,729	30,033	7.7	4.5	3.4
Consumption goods	**66,977**	**71,036**	**72,782**	**6.1**	**2.5**	**8.3**
Food and beverages, mainly for household consumption	26,681	28,873	29,336	8.2	1.6	3.3
Transport equipment non-industrial	904	942	803	4.2	-14.8	0.1
Consumer goods, n.e.s	39,392	41,221	42,644	4.6	3.5	4.9
Others	**132,564**	**170,889**	**232,984**	**28.9**	**36.3**	**26.5**
of which:						
Dual use goods	15,754	25,054	30,242	59.0	20.7	3.4
Re-exports	113,968	142,801	199,927	25.3	40.0	22.8
Total	**698,819**	**836,422**	**877,761**	**19.7**	**4.9**	**100.0**

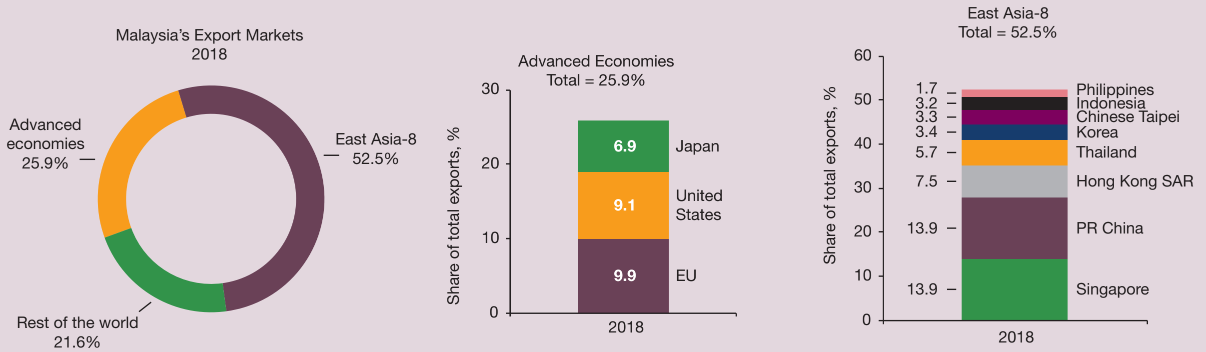
p Preliminary
n.e.s. Not elsewhere specified
Note: Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

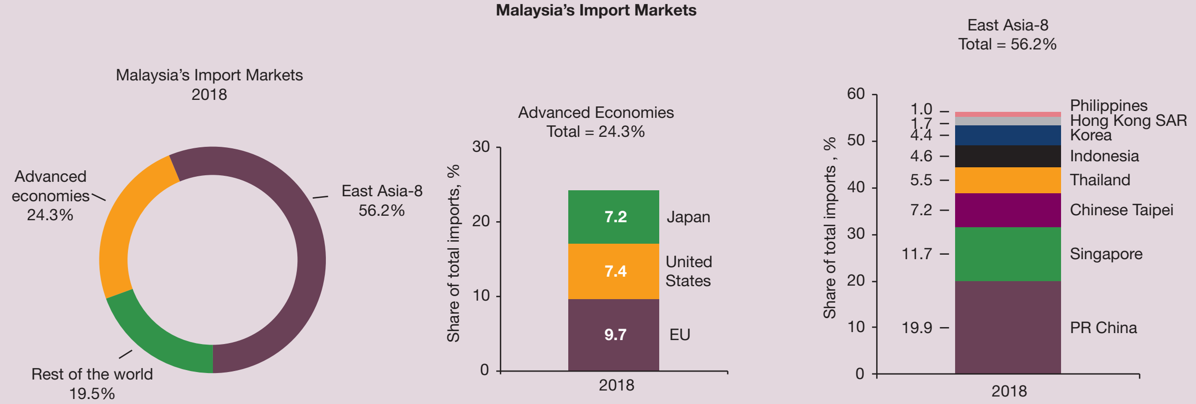
Chart A.9

Malaysia's Trading Partners

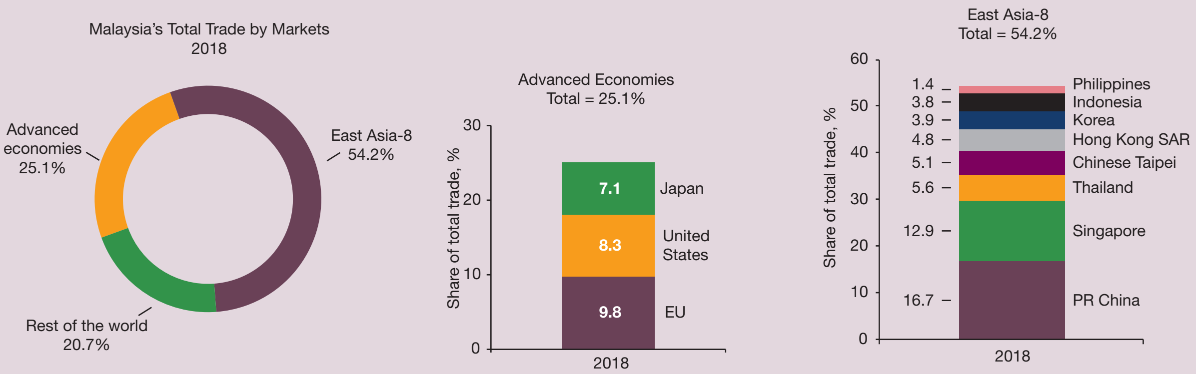
Malaysia's Export Markets



Malaysia's Import Markets



Malaysia's Total Trade by Markets



Source: Department of Statistics, Malaysia

Table A.10

Outstanding External Debt and Debt Servicing

	2014	2015	2016	2017	2018*p*
	RM million (unless stated otherwise)				
Total external debt	**747,757**	**836,985**	**914,464**	**885,218**	**924,887**
USD million equivalent	*211,895*	*192,991*	*201,900*	*215,902*	*220,951*
% GNI	*69.9*	*74.3*	*76.4*	*67.2*	*67.0*
Annual change (%)	*7.3*	*11.9*	*9.3*	*-3.2*	*4.5*
By instrument					
Bonds and notes	117,146	159,771	165,709	151,364	153,170
Interbank borrowings	149,272	161,345	170,977	172,199	204,102
Intercompany loans	70,072	93,062	139,234	131,341	136,477
Loans	43,189	52,597	55,010	53,680	73,194
NR holdings of domestic debt securities	223,289	211,347	212,767	207,389	180,228
NR deposits	78,050	81,615	86,274	92,025	98,238
Others[1]	66,739	77,249	84,492	77,221	79,478
Maturity profile					
Medium- and long-term	383,697	485,108	536,418	533,402	519,552
Short-term	364,061	351,876	378,046	351,816	405,336
Currency composition (% share)	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Ringgit	*41.0*	*36.0*	*34.0*	*34.7*	*31.1*
US dollar	*47.5*	*51.5*	*53.9*	*50.6*	*55.4*
Japanese yen	*2.4*	*2.6*	*2.4*	*2.2*	*2.2*
Others	*9.1*	*9.8*	*9.7*	*12.5*	*11.3*
Total servicing (including short-term interest payment)	**155,685**	**185,772**	**206,719**	**142,121**	**111,231**
of which:					
Medium- and long-term debt	**154,311**	**184,272**	**204,659**	**139,571**	**106,173**
Repayment[2]	**143,190**	**172,391**	**191,142**	**125,989**	**90,227**
of which:					
Redemption of matured domestic debt securities held by NR	23,698	27,695	24,403	27,105	22,012
Interest payment	**11,121**	**11,881**	**13,517**	**13,582**	**15,946**
of which interest payment on:					
NR holdings of domestic debt securities	6,941	6,575	7,409	6,089	8,170
Debt service ratio (% of exports of goods and services)					
Total debt	**19.1**	**22.7**	**24.8**	**14.7**	**11.2**
Medium- and long-term debt of which:	18.9	22.5	24.5	14.4	10.7
NR holdings of domestic debt securities	3.8	4.2	3.8	3.4	3.0

[1] Comprises trade credits, IMF allocation of SDRs and other debt liabilities
[2] Includes prepayment
p Preliminary
Note: Numbers may not necessarily add up due to rounding
NR refers to non-residents

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Table A.11

Consumer Price Index

	Weights (%) (2010=100)	2015	2016	2017	2018
		Annual change (%)			
Total	**100.0**	**2.1**	**2.1**	**3.7**	**1.0**
Food and non-alcoholic beverages	29.5	3.6	3.9	4.0	1.6
Alcoholic beverages and tobacco	2.4	13.5	17.2	0.2	-0.1
Clothing and footwear	3.2	0.5	-0.4	-0.3	-2.0
Housing, water, electricity, gas and other fuels	23.8	2.5	2.4	2.2	2.0
Furnishings, household equipment and routine household maintenance	4.1	2.7	2.4	2.1	0.3
Health	1.9	4.5	2.7	2.5	0.8
Transport	14.6	-4.5	-4.6	13.2	1.6
Communication	4.8	1.9	-1.5	-0.4	-1.7
Recreation services and culture	4.8	1.7	2.5	1.9	-0.4
Education	1.3	2.4	2.1	1.7	1.1
Restaurants and hotels	2.9	4.1	2.8	2.5	1.6
Miscellaneous goods and services	6.7	4.1	2.9	1.2	-1.4

Source: Department of Statistics, Malaysia

Table A.12

Producer Price Index[1]

	Weights (%) (2010=100)[2]	2015	2016	2017	2018
		Annual Change (%)			
Total	**100.0**	**-7.4**	**-1.1**	**6.7**	**-1.1**
Crude materials for further processing	16.4	-20.5	3.4	14.8	2.6
Foodstuffs and feedstuffs	*3.2*	*1.2*	*1.8*	*6.2*	*-2.0*
Non-food materials	*13.2*	*-26.5*	*4.0*	*17.9*	*3.7*
Intermediate materials, supplies and components	56.1	-6.2	-3.2	6.7	-1.9
Materials & components for manufacturing	*29.6*	*-2.7*	*2.2*	*5.6*	*-5.2*
Materials & components for construction	*2.9*	*0.8*	*0.3*	*2.0*	*-1.4*
Processed fuel & lubricants	*11.9*	*-18.7*	*-16.6*	*15.3*	*8.7*
Containers	*0.6*	*0.3*	*1.5*	*5.5*	*2.3*
Supplies	*11.2*	*5.3*	*0.5*	*0.3*	*-3.8*
Finished goods	27.5	1.2	0.4	0.9	-2.4
Finished consumer goods	*11.5*	*1.2*	*0.9*	*1.7*	*-2.2*
Capital equipment	*16.0*	*0.9*	*0.3*	*0.5*	*-2.5*

[1] The Producer Price Index (PPI) series is for local production. Starting from January 2016, the PPI for the domestic economy, imports and exports have been discontinued

[2] Effective from 2015, the PPI has been revised to the new base year 2010=100, from 2005=100 previously

Source: Department of Statistics, Malaysia

Table A.13

Broad Money (M3)

	Annual change					As at end
	2014	2015	2016	2017	2018	2018
	RM million					
Broad money (M3)[1]	105,295	46,326	51,287	81,220	139,183	1,875,628
Currency in circulation[2]	5,319	8,658	8,792	6,908	1,920	94,307
Demand deposits	13,431	5,058	11,430	34,791	2,068	331,232
Broad quasi-money	86,545	32,609	31,065	39,520	135,196	1,450,089
Fixed deposits	*42,109*	*24,075*	*26,149*	*49,944*	*78,867*	*902,032*
Savings deposits	*3,166*	*659*	*9,538*	*5,376*	*6,805*	*157,310*
NIDs	*4,005*	*-8,922*	*-928*	*-172*	*3,393*	*11,547*
Repos	*-2,090*	*0*	*0*	*0*	*0*	*0*
Foreign currency deposits	*15,397*	*49,310*	*-7,231*	*-4,325*	*18,228*	*151,496*
Other deposits	*23,958*	*-32,513*	*3,537*	*-11,303*	*27,904*	*227,704*
Factors Affecting M3						
Net claims on Government	34,317	-7,645	16,508	16,631	60,602	190,425
Claims on Government	*31,336*	*-353*	*11,428*	*20,246*	*59,339*	*246,011*
Less: Government deposits	*-2,981*	*7,292*	*-5,080*	*3,616*	*-1,262*	*55,586*
Claims on private sector	118,034	118,975	90,399	96,371	111,289	1,856,380
Loans	*111,388*	*106,122*	*83,927*	*56,656*	*76,548*	*1,613,549*
Securities	*6,646*	*12,853*	*6,471*	*39,715*	*34,741*	*242,831*
Net foreign assets[3]	-9,358	16,207	-3,425	-551	4,676	521,945
Bank Negara Malaysia	*-35,003*	*1,027*	*14,669*	*-8,924*	*4,936*	*411,768*
Banking system	*25,645*	*15,179*	*-18,095*	*8,373*	*-260*	*110,177*
Other influences	-37,698	-81,211	-52,194	-31,231	-37,383	-693,122

[1] Excludes interplacements among banking institutions
[2] Excludes holdings by the banking system
[3] Includes exchange rate revaluation losses/gains
Note: Numbers may not add up due to rounding

Annex

Table A.14

Money Supply: Annual Change and Growth Rates

	2014		2015		2016		2017		2018	
	RM million	%	RM million	%	RM million	%	RM million	%	RM million	%
M3[1]	105,295	7.3	46,326	3.0	51,287	3.2	81,220	4.9	139,183	8.0
M1[2]	18,820	5.7	14,087	4.1	20,358	5.6	41,959	11.0	4,718	1.1
Currency in circulation	5,189	8.2	8,744	12.8	8,769	11.4	6,925	8.1	1,936	2.1
Demand deposits with commercial and Islamic banks	13,630	5.2	5,343	1.9	11,589	4.1	35,034	11.9	2,782	0.8
Other deposits with commercial and Islamic banks[3]	88,888	8.0	37,607	3.1	31,058	2.5	41,237	3.3	131,021	10.0
Deposits with other banking institutions[4]	-2,413	-15.2	-5,368	-39.9	-129	-1.6	-1,977	-24.8	3,444	57.6

[1] Comprising M1 plus other deposits of the private sector placed with commercial and Islamic banks and deposits of the private sector placed with other banking institutions, namely the investment banks
[2] Comprising currency in circulation and demand deposits of the private sector
[3] Comprising savings and fixed deposits, negotiable instruments of deposits (NIDs), repos and foreign currency deposits of the private sector placed with commercial and Islamic banks
[4] Comprising call deposits, fixed deposits, negotiable instruments of deposits (NIDs), repos and foreign currency deposits of the private sector placed with investment banks. Excludes interplacements among the banking institutions
Note: Numbers may not add up due to rounding

Table A.15

Interest Rates (%)

	As at end-year						
	2012	2013	2014	2015	2016	2017	2018
Overnight interbank	3.00	2.99	3.23	3.05	3.00	2.91	3.19
1-week interbank	3.01	3.02	3.30	3.13	3.02	3.03	3.28
1-month interbank	3.06	3.20	3.38	3.45	3.10	3.08	3.45
Commercial banks							
Fixed deposit							
3-month	2.97	2.97	3.13	3.13	2.92	2.94	3.15
12-month	3.15	3.15	3.31	3.31	3.06	3.10	3.33
Savings deposit	1.03	0.99	1.07	1.04	0.99	0.97	1.07
Base lending rate (BLR)	6.53	6.53	6.79	6.79	6.65	6.68	6.91
Weighted average base rate (BR)				3.77	3.62	3.64	3.91
Treasury bills (91 days)[1]	3.04	3.00	3.42	2.74	3.06	2.86	3.29
Malaysian Government Securities[1]							
1-year	3.01	3.03	3.48	2.59	3.26	2.89	3.45
5-year	3.24	3.66	3.84	3.47	3.70	3.56	3.78
Corporate bond[1]							
AAA							
3-year	3.53	3.71	4.00	4.13	4.25	4.13	4.21
5-year	3.80	3.96	4.27	4.37	4.40	4.33	4.39
AA							
3-year	4.04	4.16	4.33	4.49	4.61	4.46	4.50
5-year	4.30	4.41	4.60	4.73	4.78	4.64	4.69
A							
3-year	6.34	6.32	6.25	6.34	6.13	5.73	5.85
5-year	6.98	7.02	6.87	6.97	6.66	6.36	6.37
BBB							
3-year	10.06	10.02	10.16	9.90	9.17	8.59	8.45
5-year	11.14	11.17	11.17	11.13	10.12	9.62	9.66
BB & below							
3-year	12.53	12.52	13.03	12.55	11.31	10.80	10.74
5-year	13.76	13.70	14.60	13.89	12.69	12.08	11.80

[1] Source: FAST, Bank Negara Malaysia

Table A.16

Movements of the Ringgit

	RM to one unit of foreign currency[1]			Annual change (%)		Change (%)
	2005	2017	2018	2017	2018	21 Jul. '05 -
	21 Jul.[2]	End-Dec.				Dec. '18
SDR	5.5049	5.7428	5.7565	5.2	-0.2	-4.4
US dollar	3.8000	4.0620	4.1385	10.4	-1.8	-8.2
Singapore dollar	2.2570	3.0392	3.0322	2.1	0.2	-25.6
100 Japanese yen	3.3745	3.6020	3.7475	6.7	-3.9	-10.0
Pound sterling	6.6270	5.4660	5.2532	0.8	4.1	26.2
Australian dollar	2.8823	3.1659	2.9228	2.5	8.3	-1.4
Euro	4.6212	4.8510	4.7340	-2.6	2.5	-2.4
100 Thai baht	9.0681	12.433	12.701	0.7	-2.1	-28.6
100 Indonesian rupiah	0.0386	0.0300	0.0286	11.4	4.8	35.1
100 Korean won	0.3665	0.3801	0.3721	-2.1	2.1	-1.5
100 Philippine peso	6.8131	8.1232	7.8739	11.4	3.2	-13.5
100 New Taiwan dollar	11.890	13.682	13.541	1.7	1.0	-12.2
Chinese renminbi	0.4591	0.6230	0.6017	3.6	3.5	-23.7

[1] US dollar rates are the average of buying and selling rates at noon in the Kuala Lumpur Interbank Foreign Exchange Market. Rates for foreign currencies other than US dollar are cross rates derived from rates of these currencies against the US dollar and the RM/US dollar rate

[2] Ringgit was unpegged against the US dollar

Annex

Table A.17

Financing of the Economy

By borrower / By financing type/institution	Businesses[1] Total	Businesses[1] *of which: SMEs*	Households	Government	Total financing
	RM million				
Net Change in Financing (2017)					
Financial intermediaries					
Banking system	12,192	*17,192*	44,319	6,401	62,912
Development financial institutions (DFIs)[2]	-2,063	*-1,264*	2,279	-	216
Other domestic intermediaries[3]	-381	*-255*	6,620	-	6,239
Capital markets					
Bond market[4]	75,102	-	-	40,750	115,852
Equity market[5]	12,232	-	-	-	12,232
External financing					
Foreign direct investment	40,419	-	-	-	40,419
Offshore borrowing[6]	-21,672	-	-	-1,897	-23,569
Total	**115,828**	***15,673***	**53,218**	**45,254**	**214,301**
Net Change in Financing (2018*p*)					
Financial intermediaries					
Banking system	35,633	*352*	50,763	2,747	89,143
Development financial institutions (DFIs)[2]	-1,974	*1,666*	1,492	-	-482
Other domestic intermediaries[3]	-2,248	*335*	8,639	-	6,391
Capital markets					
Bond market[4]	45,189	-	-	51,973	97,162
Equity market[5]	2,365	-	-	-	2,365
External financing					
Foreign direct investment	32,648	-	-	-	32,648
Offshore borrowing[6]	26,316	-	-	140	26,457
Total	**137,929**	***2,353***	**60,894**	**54,861**	**253,683**

1 Businesses include domestic banking institutions, domestic non-bank financial institutions, domestic other entities and foreign entities
2 Refers to DFIs regulated under the Development Financial Institutions Act 2002 (DFIA 2002)
3 Other domestic intermediaries include Employees Provident Fund (EPF), leasing and factoring companies, insurance companies, housing credit institutions, and *Lembaga Pembiayaan Perumahan Sektor Awam* (previously Treasury Housing Loans Division)
4 Refers to the change in outstanding corporate bonds and Government securities (Malaysian Government Securities and Government Investment Issues), held by both residents and non-residents. Data excludes issuances by Cagamas and non-residents; and short-term papers
5 Refers to equity issuances during the year, excluding issuances by non-residents
6 Refers to all offshore borrowings under the redefined external debt effective first quarter 2014, excluding short-term offshore borrowings by the banking sector
p Preliminary
Note: Numbers may not add up due to rounding

Table A.18

Consolidated Public Sector Finance

	2015	2016	2017	2018*p*	2019*f*
	RM billion				
Revenue[1]	216.0	222.4	224.3	227.5	230.8
% growth	*6.9*	*3.0*	*0.9*	*1.4*	*1.5*
Operating expenditure	243.3	236.4	245.1	260.9	289.4
% growth	*0.8*	*-2.8*	*3.7*	*6.4*	*10.9*
Current balance of NFPCs[2]	78.2	90.7	117.2	96.2	114.0
Total public sector current balance	**50.9**	**76.7**	**96.4**	**62.8**	**55.4**
% of GDP	***4.4***	***6.2***	***7.1***	***4.4***	***3.7***
Development expenditure[3]	140.4	139.1	139.5	143.3	141.2
% growth	*-14.6*	*-1.0*	*0.3*	*2.7*	*-1.4*
General Government[4]	47.5	46.8	50.6	62.6	61.0
NFPCs	92.9	92.3	88.9	80.7	80.2
Overall balance	**-89.5**	**-62.4**	**-43.1**	**-80.5**	**-85.8**
% of GDP	***-7.7***	***-5.1***	***-3.2***	***-5.6***	***-5.7***

[1] Excludes transfers within General Government
[2] Refers to 28 NFPCs from 2017 onwards
[3] Adjusted for transfers and net lending within public sector
[4] Comprises Federal Government, state and local governments, and statutory bodies
p Preliminary
f Forecast
Note: Numbers may not add up due to rounding

Source: Ministry of Finance, Malaysia and Non-Financial Public Corporations (NFPCs)

Glossary, Acronyms and Abbreviations

Glossary

Accrual accounting
An accounting method that recognises revenues and expenses based on the occurrence of economic events, rather than that of cash transactions.

Aggregate outstanding ringgit liquidity placed with the Bank
Surplus liquidity absorbed by Bank Negara Malaysia, through its monetary operations and Statutory Reserve Requirement (SRR). The main borrowing instruments used for this purpose include direct money market borrowing, repurchase agreements (repo), Qard acceptance, Commodity Murabahah Programme (CMP), sell-buy swaps, Bank Negara Monetary Notes (BNMN) and Bank Negara Interbank Bills (BNIB).

Asset purchase programme
A form of expansionary monetary policy undertaken by central banks through the purchase of predetermined amounts of government bonds or other specified securities in order to lower long-term interest rates and stimulate the economy.

Balance of payments
A statistical summary of economic transactions between residents and non-residents of a country during a specific time period.

Bank Negara Interbank Bills (BNIB)
A short-term discounted note with maturity of up to one year and qualifies as Level 1 high-quality liquid assets (HQLA). BNIB can only be purchased by and traded among licensed banks and investment banks.

Banker's acceptance (BA)
A bill of exchange drawn on and accepted by a bank in Malaysia to finance the drawer's business-related purchases from or sales of goods to another person, evidenced by proper and adequate documentation.

Bilateral currency swap arrangements
Agreements with other countries enabling for the exchange of Malaysian ringgit for foreign currencies.

Booking centres
Banks' offices which serve as a registry for transactions arranged and managed in another location.

Brexit
The United Kingdom's decision to leave the European Union.

Commodity Murabahah Programme (CMP)
A cash deposit product based on a globally accepted Islamic concept. It utilises crude palm oil contracts and other Shariah-compliant commodities as the underlying assets to facilitate liquidity management.

Contagion risk
Risk that the impact of a financial shock or crisis in a particular economy or region will spread to other economies with similar vulnerabilities or significant interlinkages.

Core inflation
A measure of underlying inflation. One common method of calculation is by excluding items whose price fluctuations are deemed transitory from the Consumer Price Index (CPI) basket. These items include price-volatile and price-administered goods and services. Core inflation that is estimated by Bank Negara Malaysia also excludes the estimated direct impact of consumption tax policy changes.

Counter-cyclical policy
Monetary or fiscal policies aimed at reducing fluctuations in the business cycle of the economy.

Demonetisation
The act of withdrawal of a currency unit from its status as legal tender. For example, the Indian government announced the withdrawal of INR500 and INR1,000 bank notes as legal tender on November 2016, in exchange for new INR500 and INR2,000 bank notes.

Direct investment abroad (DIA)
A category of cross-border investment by a Malaysian resident investor associated with the objective of establishing a lasting interest in an enterprise abroad. A 'lasting interest' is when there is a long-term relationship in which the direct investor has a significant degree of influence on the management of the enterprise (e.g. an ownership of at least 10% of the voting power).

Domestic institutional investors
Resident financial institutions with large holdings of financial assets in domestic financial markets. These include banks, pension funds and insurance companies.

Exchange rate valuation effect
The changes in ringgit equivalent value of Malaysia's foreign-currency denominated external assets and liabilities, and export and import values due to changes in the ringgit exchange rate.

Export conversion measure
Financial market measure introduced by Bank Negara Malaysia and the Financial Markets Committee (FMC) which requires exporters to convert 75% of their foreign currency export proceeds into ringgit, with sufficient flexibilities granted.

Financial Markets Committee (FMC)
The FMC was established in May 2016 with the objective to broaden industry engagement with a focus in reviewing and formulating comprehensive strategies for the wholesale financial markets to meet the diverse and complex demands of a more developed and internationally integrated economy. It comprises participants/representatives from Bank Negara Malaysia, financial institutions, corporations, financial service providers and other institutions or stakeholders which have prominent roles or participation in the financial markets.

Flight-to-safety
A broad-based shift of investors' funds from riskier assets to relatively safer assets such as sovereign bonds, safe-haven currencies and selected commodities, such as gold. This typically occurs during an increase in investor risk aversion. Safe-haven currencies refers to currencies expected to appreciate or remain stable during periods of volatility, such as the US dollar, Japanese yen and Swiss franc.

Foreign currency forward position
The aggregated sum of future transactions to exchange foreign currency for domestic currency. A long foreign currency forward position indicates a net future obligation to purchase foreign currency for domestic currency, resulting in potential inflow of foreign currency. Conversely, a short foreign currency forward position indicates a net future obligation to sell foreign currency for domestic currency, resulting in potential outflow of foreign currency.

Foreign direct investment (FDI)
A category of cross-border investment by a non-resident investor associated with the objective of establishing a lasting interest in an enterprise in Malaysia. A 'lasting interest' is when there is a long-term relationship in which the non-resident direct investor has a significant degree of influence on the management of the enterprise (e.g. an ownership of at least 10% of the voting power).

Foreign exchange net open position (NOP)
The aggregated sum of the net short or long positions across any particular foreign currency or all foreign currencies for banks. A long position indicates a net foreign currency asset position while a short position indicates a net foreign currency liability position.

General Government
Refers to the Federal and State Governments as well as the statutory bodies and local authorities.

Goods and Services Tax (GST)
A consumption tax based on the value-added concept, imposed at every stage of production and distribution process. The GST incurred on business inputs is claimable. In Malaysia, the GST was imposed on taxable goods and services between April 2015 and May 2018 before the rate was zerorised.

Headline inflation
The annual price increase for a basket of items that are commonly consumed by an average household. For Malaysia, headline inflation is computed based on the Consumer Price Index (CPI) basket.

Hedging
An investment strategy to reduce investment risk using financial derivatives such as options, swaps and futures contracts.

International investment position (IIP)
The external balance sheet, detailing the country's outstanding financial assets and liabilities position relative to the rest of the world. A positive net IIP denotes Malaysia's position as a net creditor nation, while a negative net IIP denotes Malaysia as a net debtor nation.

Internet of Things (IoT)
The network of physical objects that contain embedded technology to communicate and sense or interact with itself or the external environment.

Liquidity injection operations
The use of monetary operations to provide liquidity to the banking system through instruments such as reverse repurchase agreements (reverse repos) and foreign exchange swap facilities.

Monetary Policy Committee (MPC)
The body responsible for formulating monetary policy and the policies for the conduct of monetary policy operations, as stipulated in the Central Bank of Malaysia Act 2009.

Monetary policy normalisation
Actions by central banks to return the stance of monetary policy back to more normal levels, which is consistent with the medium-term objective of achieving macroeconomic stability.

Negotiable instrument of deposits (NID)
Interest-bearing deposit certificates issued by banks that can be traded in the wholesale secondary money market. NIDs issued in the Malaysian financial market can be based on either fixed, zero coupon or floating rates or a combination of either of the three.

Net domestic borrowing of the Federal Government
The Federal Government's gross domestic borrowings, in the form of Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (MGII), less repayments.

Net errors and omission
Balancing or residual item which occurs when the current, capital and financial accounts do not mirror the change in international reserves due to imperfections in data source and compilation (e.g. incomplete data sources, difference in timing of recording, valuation factors).

Net external borrowing of the Federal Government
The Federal Government's gross external borrowings, in the form of project and market loans, less repayments.

Non-deliverable forward (NDF)
A cash-settled outright forward contract. In the case of a currency NDF, the difference between the contracted NDF rate and the prevailing spot rate determines the profit or loss on the notional amount, and this difference is typically settled in US dollar (without exchanging the notional amount itself, hence non-deliverable).

Non-resident entity
An institutional unit which engages in economic activities and transactions for a period of one year or longer from a location outside of Malaysia.

Outstanding corporate bonds
Current stock of corporate bonds plus net issuances of corporate bonds during the period. Net issuances of corporate bonds is the difference between corporate bonds issued and corporate bonds redeemed.

Outstanding loans
Current stock of loans plus net loans disbursed during the period. Net loans disbursed is the difference between loans disbursed and loans repaid.

Overnight Policy Rate (OPR)
The indicator of the monetary policy stance for Malaysia. The level of the OPR is decided by the MPC. It also serves as the target rate for the day-to-day liquidity operations of the Bank, which will influence other interest rates in the economy.

Portfolio investment
A category of cross-border transactions and positions involving debt or equity securities in the capital markets, other than those categorised as foreign direct investments, direct investments abroad, or reserve asset transactions.

Portfolio rebalancing
A process whereby investors or fund managers reallocate the weightings of financial assets in their investment portfolios. This is achieved by buying and selling assets to align the investor's holdings with a target portfolio allocation.

Price ceiling
A Government-imposed maximum price for a good or service.

Primary income
Income earned from the contribution to production processes, provision of financial assets and renting of natural resources. These include compensation of employees (e.g. wages, salaries), investment income (e.g. dividends), interest income and rent transactions between residents and non-residents.

Producer price inflation
The annual change in Producer Price Index for local production, which is an output-based index that measures the price of goods sold to the domestic market charged by producers at the ex-factory price.

Protectionist policies
Economic policies which restrict international trade through tariffs, subsidies, quotas and/or other regulations aimed at reducing the competitiveness of foreign imports relative to domestically produced goods and services.

Public corporation
A corporation that is controlled by the Government. Control can be determined by: the ownership of the majority of the voting interest; control of the board or other governing body; control of the appointment and removal of key personnel; control of key committees of the entity; golden share and options; regulation and control; control by a dominant customer; and control attached to borrowing from the Government.

***Qard* acceptance**
A contract of lending money by a lender to a borrower where the latter is bound to return an equivalent replacement amount to the lender.

Resident entity

An institutional unit which engages in economic activities and transactions for a period of one year or longer from a location in Malaysia.

Risk-off

Periods of perceived high financial risk which encourage investors to take on less risk or unwind their exposure to riskier investments.

Secondary income

Current transfers (provision of goods, services, or financial assets) between residents and non-residents with no corresponding economic returns. These include transfers by the general government, personal transfers (e.g. remittance by foreign workers) and other transfers in cash or kind.

Sales and Services Tax (SST)

Refers to the consumption tax policy that was implemented in Malaysia since September 2018. Sales tax is a single-stage tax levied on taxable goods imported into Malaysia and those locally manufactured in Malaysia by a taxable person, subject to the Sales Tax Act 2018. Service tax is a tax charged on taxable services provided by any taxable person in Malaysia in the course and furtherance of business, subject to the Service Tax Act 2018.

Technical correction

A sharp decline in the price of a financial asset following a prolonged upward trend in valuations.

Terms of trade

The ratio of a country's export prices to its import prices. It can also be interpreted as the amount of imported goods a country can purchase per unit of exported goods. Improving terms of trade indicates that for every unit of exports sold, more units of imported goods can be purchased, and vice-versa.

Trade openness

A country's sum of gross exports and imports as a share of its GDP, representing a country's total exposure to international trade.

Turnover ratio

An indicator of financial market liquidity which measures the trading volume of a financial asset during a specified period relative to the total amount outstanding.

Twin deficit

A situation in which a country simultaneously records both a fiscal and current account deficit.

Underlying inflation

The persistent trend component of inflation. It is typically constructed by removing the transitory and seasonal components from headline inflation.

Weighted average base rate

Effective 2 January 2015, the base rate (BR) is the main reference rate for new retail floating rate loans. The BR is determined by financial service providers' (FSPs) benchmark cost of funds and the Statutory Reserve Requirement (SRR). Other components of loan pricing such as borrower credit risk, liquidity risk premium, operating costs and profit margin would be reflected in a spread above the BR. The average BR of FSPs is weighted by the amount of outstanding floating rate loans.

Yield curve

A yield curve draws out the yields of a bond with respect to its different maturities. For example, the yield curve for Malaysian Government Securities (MGS) plots the yields from the 1-year to 30-year bond maturities.

Zero-based budgeting

A budgeting method in which annual allocations are decided based on needs, independent of the previous year's budget.

Acronyms and Abbreviations

AOIR	average overnight interbank rate
AE	advanced economies
ALR	average lending rate
ASA	ASEAN Swap Arrangement
ASEAN	Association of Southeast Asian Nations
B40	Bottom 40% income group
BA	banker's acceptance
BCBS	Basel Committee on Banking Supervision
BCM	business continuity management
BCSA	Bilateral Currency Swap Arrangement
BIS	Bank of International Settlements
BNIB	Bank Negara Interbank Bills
BNIBI	Bank Negara Interbank Bills Islamic
BNM CSS	Bank Negara Malaysia Consumer Sentiment Survey
BNMN	Bank Negara Monetary Notes
BOE	Bank of England
BOJ	Bank of Japan
BR	base rate
BSH	Bantuan Sara Hidup
CBA 2009	Central Bank of Malaysia Act 2009
CLM	centralised liquidity management
CMIM	Chiang Mai Initiative Multilateralisations
CMP	Commodity Murabahah Programme
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CPI	Consumer Price Index
CPO	crude palm oil
CREST	Collaborative Research in Engineering, Science and Technology
DBGs	domestic banking groups
DFIs	development financial institutions
DIA	direct investment abroad

DRO	Departmental Risk Officer
E&E	electronics and electrical
E&O	errors and omissions
ECB	European Central Bank
EME	emerging market economies
EMEAP	Executives' Meeting of East Asia-Pacific Central Banks
EPI	Everyday Price Index
EU	European Union
FAO	Food and Agriculture Organization of the United Nations
FBM KLCI	FTSE Bursa Malaysia Kuala Lumpur Composite Index
FCY	foreign currency
FD	fixed deposit
FDI	foreign direct investment
FEA	foreign exchange administration
Fed	Federal Reserve
FMC	Financial Markets Committee
FPC	Fiscal Policy Committee
FSC	Financial Stability Committee
FTP	Financial Transaction Plan
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GFCF	gross fixed capital formation
GLC	government-linked companies
GNI	gross national income
GNS	gross national savings
GST	Goods and Services Tax
HCI	Human Capital Index
HRDF	Human Resources Development Fund
IAIS	Insurance Association of Insurance Supervisors

ICLIF	International Centre for Leadership in Finance
IFSB	Islamic Financial Services Board
IILM	International Islamic Liquidity Management Corporation
IIP	International Investment Position
IMF	International Monetary Fund
INCEIF	International Centre for Education in Islamic Finance
IORWG	International Operational Risk Working Group
IoT	Internet of Things
KLIBOR	Kuala Lumpur Interbank Offered Rate
KLSE	Kuala Lumpur Stock Exchange
LIA	Liquidity Investment Arrangement
LIBFC	Labuan International Business and Financial Centre
LNG	liquefied natural gas
LFS	Labour Force Survey
M&E	machinery and equipment
MEF	Malaysian Employers Federation
MFRS	Malaysian Financial Reporting Standards
MGII	Malaysian Government Investment Issues
MGS	Malaysian Government Securities
MIER	Malaysian Institute of Economic Research
MNC	multinational corporation
MPC	Monetary Policy Committee
MPS	Monetary Policy Statement
MSCI EM	Morgan Stanley Capital International Emerging Market
NAB	New Arrangements to Borrow
NDF	non-deliverable forward
NEER	nominal effective exchange rate
NID	negotiable instrument of deposits
NPC	National Productivity Council
NR	non-resident
O&G	oil and gas
OPEC	Organization of Petroleum Exporting Countries
OPR	Overnight Policy Rate
PBOC	The People's Bank of China
PEKA	Skim Perlindungan Kesihatan
PePI	Perceived Price Index
PFC	Public Finance Committee
PLWS	Productivity Linked Wage System
PPI	Producer Price Index
PR China	The People's Republic of China
PRIMA	Perumahan Rakyat 1Malaysia
QES	Quarterly Employment Statistics
RAPID	Refinery and Petrochemical Integrated Development
RENTAS	Real-Time Electronic Transfer of Funds and Securities
RMA	Range Maturity Auction
RPGT	Real Property Gains Tax
RTC	Rural Transformation Centres
SAC	Shariah Advisory Council
SDR	Special Drawing Rights
SMEs	small and medium enterprises
SST	Sales and Services Tax
SWA	Staff Welfare Account
SWIFT	Society for Worldwide Interbank Financial Transaction
TRC	Tax Reform Committee
TVET	Technical and Vocational Education and Training
UK	United Kingdom
US	United States
UTC	Urban Transformation Centres
WTI	West Texas Intermediate