BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

The BNM Quarterly Bulletin presents a quarterly review of Malaysia's economic, monetary and financial developments. It includes the Bank's latest assessments on the direction of the economy going forward. The Bulletin also provides insights on current economic and financial issues, including highlights of policy initiatives undertaken by Bank Negara Malaysia in pursuit of its mandates.

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Key Highlights on
Economic and Financial Developments in 2Q 2019

Higher GDP growth of 4.9% (1Q: 4.5%)

Continued expansion in domestic demand and across all economic sectors

Higher private sector expenditure

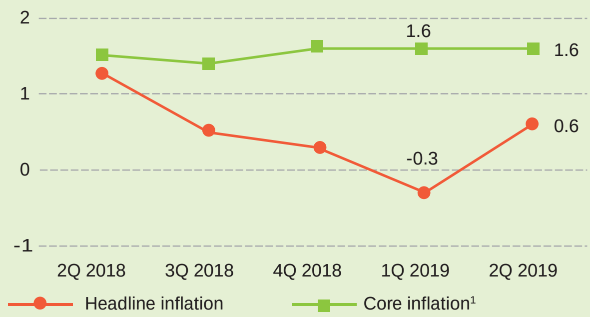
Services and manufacturing sectors remained the key drivers of growth

Rebound in mining sector driven by recovery in natural gas production

Headline inflation increased

Higher headline inflation due to the lapse in the impact of the GST zerorisation

Headline and Core Inflation[1]

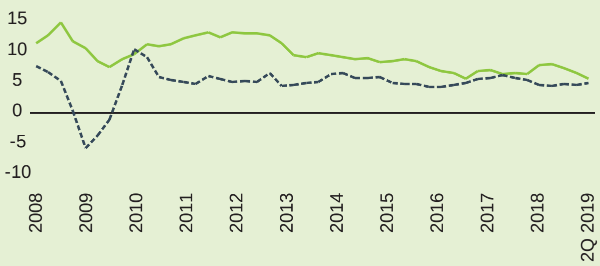


[1] Core inflation is computed by excluding price-volatile and price-administered items. It also excludes the estimated direct impact of consumption tax policy changes.

Overall financing in line with economic activity

Credit expansion commensurate with growth in recent periods

Credit and GDP Growth[2]

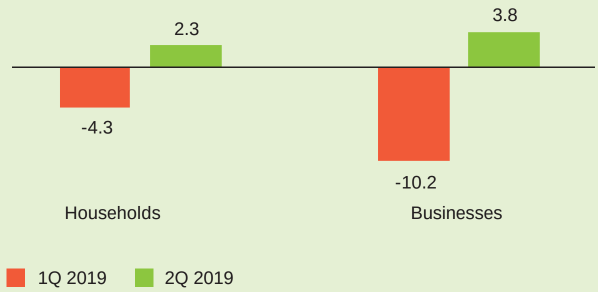


[2] Credit refers to outstanding loans from the banking system and development financial institutions (DFIs), and outstanding corporate bonds

Note: Real GDP in constant 2015 prices

Demand for financing showed some signs of improvement

Loan Application[3]

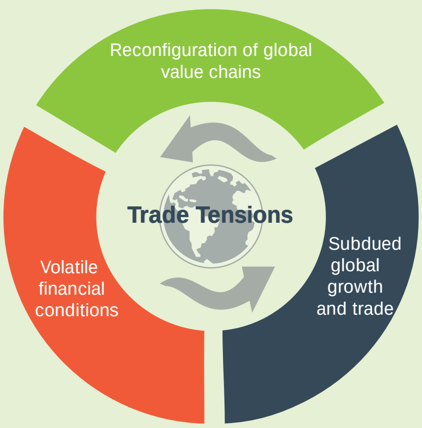


[3] Loan application refers to banking system data only

Box Articles

Unresolved trade disputes one year on

Emerging Global Trends



Enhancing market efficiency to preserve financial market stability

Development initiatives to enhance:

- Market liquidity
- Risk management capabilities
- Access to the onshore market

Two key developments:

Appointed Overseas Office as a gateway for investment

Dynamic hedging programme

Source: Department of Statistics Malaysia, Bank Negara Malaysia unless stated otherwise
For more information, visit www.bnm.gov.my

International Economic Environment

HIGHLIGHTS

- The global economy grew at a more moderate pace in the second quarter of 2019.
- Lower external demand led to weaker export performance in regional economies.
- Financial market volatility increased as trade tensions escalated in May.

Global growth moderated

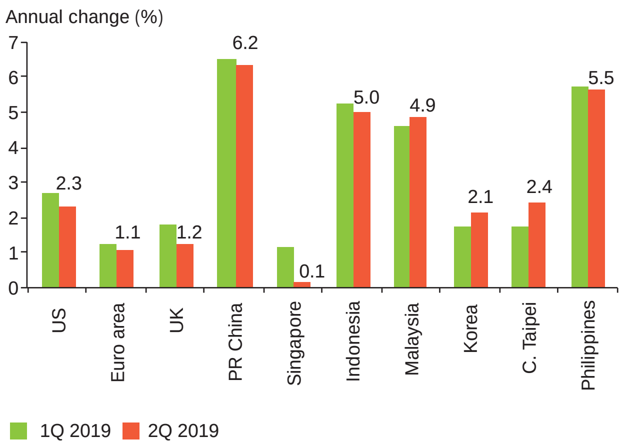
The global economy grew at a more moderate pace in the second quarter of 2019.

In the US, GDP growth moderated in the second quarter of 2019. The latest data release was accompanied by a revision to the back series to indicate stronger growth from 2017 to the third quarter of 2018, but slower growth in the fourth quarter of 2018 and first quarter of 2019. This suggests that growth peaked in the first half of 2018, and has slowed more than previously anticipated, due mainly to weaker investment activity. Meanwhile, growth in the euro area moderated to its weakest level since the fourth quarter of 2013. Besides softer consumption demand, industrial production remained in contraction, weighed by sluggish global trade activity and supply constraints in the automotive sector. Growth in the UK moderated due mainly to a drawdown of inventories amid sustained private consumption.

In Asia, growth in PR China continued to moderate, as weaker private consumption was only partially offset by an improvement in policy driven investments. Growth in the rest of the Asian region also slowed, mainly affected by weaker external demand amid the ongoing trade dispute between the US and PR China.

Most economies moderated in 2Q 2019

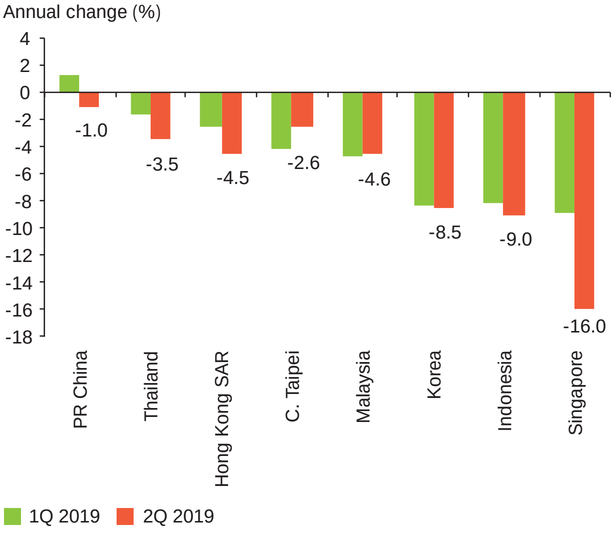
Chart 1: GDP Growth of Selected Economies



Source: National authorities

Lower export growth in 2Q 2019

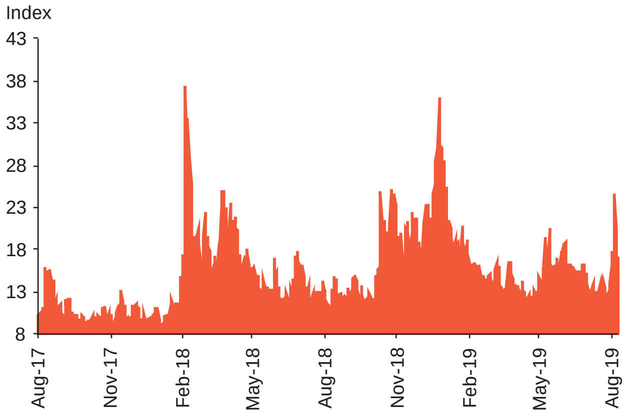
Chart 2: Export Growth of Selected Economies (in USD terms)



Source: National authorities

Financial market volatility increased

Chart 3: Chicago Board Options Exchange (CBOE) Volatility Index (VIX)



Source: Bloomberg

Contraction in exports

Exports in all Asian economies contracted in the second quarter, indicating weaknesses in external demand and effects from the ongoing trade tensions between the US and PR China.

PR China's exports declined by 1.0% in the second quarter as shipments to the US, particularly for electrical parts and equipment, continued to contract. Similarly, across Asian economies, the contraction in exports was contributed mainly by a slowdown in exports of electronic equipment and parts.

Higher financial market volatility

Market volatility rose during the quarter. This was triggered by an escalation in trade tensions when the US raised tariffs on USD200 billion of imports from PR China from 10% to 25% in May 2019, and placed sanctions on Huawei, a Chinese telecommunications company.

Nevertheless, market volatility gradually receded as the increased downside risks from trade tensions and a subdued inflation outlook prompted the US Federal Reserve to signal a higher probability of a cut in interest rates. This shift to a dovish policy stance helped ease overall market anxiety[1]. Market volatility also continued to trend lower towards the end of the quarter after the US and PR China agreed to restart trade negotiations at the G20 Summit in end-June.

Brent crude oil price averaged higher at USD68 per barrel in the second quarter of 2019 (1Q 2019: USD64), driven mainly by worsening supply disruptions in Venezuela and Iran as well as ongoing voluntary output cuts by OPEC+.

[1] The Federal Open Market Committee of the Federal Reserve subsequently reduced the federal funds rate by 25 bps on 31 July 2019.

Developments in the Malaysian Economy

HIGHLIGHTS

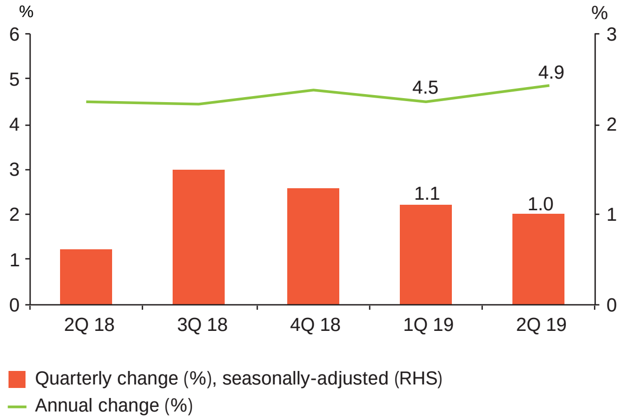
- The Malaysian economy expanded by 4.9% in the second quarter of 2019.
- Headline inflation increased mainly reflecting the lapse in the impact of the Goods and Services Tax (GST) zerorisation, while core inflation remained stable.
- Current account surplus was sizeable at RM14.3 billion.

The Malaysian economy grew at a stronger pace of 4.9% in the second quarter of 2019

GDP registered a higher growth of 4.9% in the second quarter of 2019 (1Q 2019: 4.5%), supported by continued expansion in domestic demand. On a quarter-on-quarter seasonally-adjusted basis, the economy grew by 1.0% (1Q 2019: 1.1%).

Higher growth in 2Q 2019

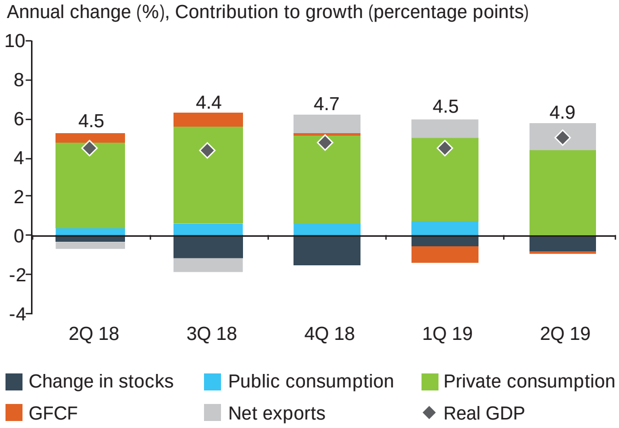
Chart 4: Real GDP Growth



Source: Department of Statistics, Malaysia

Private sector activity remained the key driver of growth

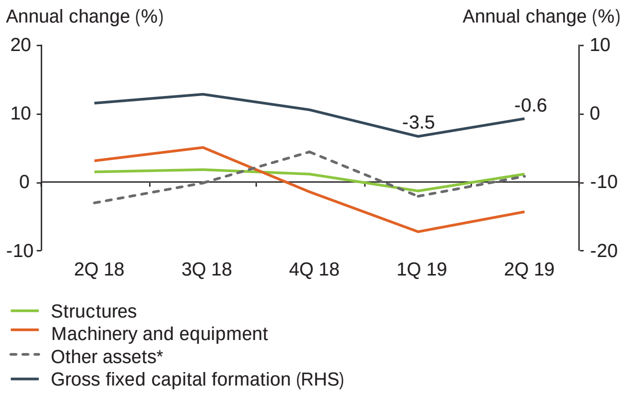
Chart 5: Contribution of Expenditure Components to Real GDP Growth



Source: Department of Statistics, Malaysia

Gross fixed capital formation registered a smaller contraction

Chart 6: GFCF Growth by Type of Assets



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

Source: Department of Statistics, Malaysia

Private sector activity remained the key driver of growth

Domestic demand expanded by 4.6% in the second quarter (1Q 2019: 4.4%), supported by firm household spending and slightly higher private investment.

Private consumption expanded by 7.8% (1Q 2019: 7.6%), supported by continued income growth and festive spending during the quarter. Selected Government measures, such as the special Aidilfitri assistance and Bantuan Sara Hidup, also provided some lift to overall household spending.

After a strong growth in the first quarter of 2019 (6.3%), public consumption expanded marginally by 0.3%, due to lower spending on supplies and services.

Growth in gross fixed capital formation (GFCF) registered a smaller contraction of 0.6% (1Q 2019: -3.5%), driven by a slightly higher private investment growth amid a continued decline in public investment. By type of assets, investments in structures turned around to register a positive growth of 1.2% (1Q 2019: -1.3%), reflecting some improvement in the residential property segment. Capital expenditure on machinery and equipment recorded a smaller decline of 4.2% (1Q 2019: -7.4%), following higher spending on information and communications technology (ICT).

Private investment expanded at a faster pace of 1.8% (1Q 2019: 0.4%), supported by increased capital spending in the services and manufacturing sectors. Nonetheless, uncertainty surrounding global trade tensions and prevailing weaknesses in the broad property segment continued to weigh on the investment growth performance.

Public investment registered a smaller contraction of 9.0% (1Q 2019: -13.2%), mainly reflecting higher fixed asset spending by the Federal Government which partially offset the continued weak investment by public corporations.

Expansion across all economic sectors

The services sector expanded by 6.1% in the second quarter of 2019 (1Q 2019: 6.4%). Growth in the wholesale and retail trade subsector was relatively sustained across the wholesale, retail and motor vehicle segments amid firm household spending. The finance and insurance subsector was supported by the fee-based income segment following a major initial public offering in the capital market. Growth in the transport and storage subsector was driven by higher air passenger traffic and port activity in both transhipment and gateway segments. However, growth in the information and communication subsector moderated following slower demand for data communication services.

Growth in the manufacturing sector registered a marginal improvement at 4.3% (1Q 2019: 4.2%) amid better performance in the domestic-oriented industries. Higher production of motor vehicles mainly reflected strong sales during the festive season. Demand for metal-related materials for existing transport and infrastructure projects supported the higher production within the construction-related cluster. Meanwhile, within the export-oriented industries, the production of electronic components continued to be weighed by weaker global demand, with negative spillovers across the global semiconductor value chain.

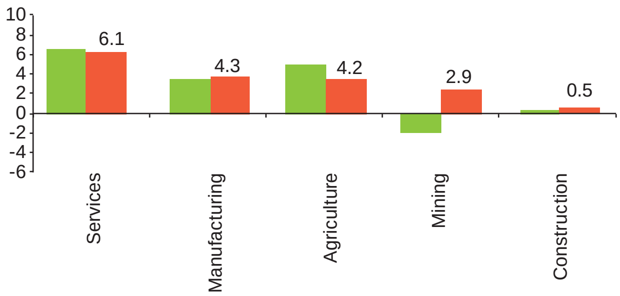
Growth in the mining sector rebounded to 2.9% (1Q 2019: -2.1%), the first positive growth since the third quarter of 2017. The turnaround was supported mainly by the recovery in natural gas output following the pipeline disruptions in 2018. This had more than offset the continued drag to growth posed by lower oil production amid the planned facility shutdowns in East Malaysia.

The construction sector registered marginally higher growth at 0.5% (1Q 2019: 0.3%), on account of growth improvements in the residential and special trade subsectors. While the residential subsector registered a smaller contraction, activity remained weak amid the high unsold properties. The higher growth in the special trade subsector was due to end-works activity amid completion of some mixed development projects. The near-completion of a large petrochemical project continued to affect growth in the civil engineering subsector, while the non-residential subsector remained weak amid the oversupply of commercial properties.

In the agriculture sector, growth moderated to 4.2% (1Q 2019: 5.6%) following the decline in fishing and forestry activities as well as the moderation in natural rubber output growth due to the wintering season[2]. This had partially offset the continued recovery in oil palm yields from the adverse weather in 2018.

Growth supported by the recovery from commodity supply disruptions and improvements in the manufacturing and construction sectors

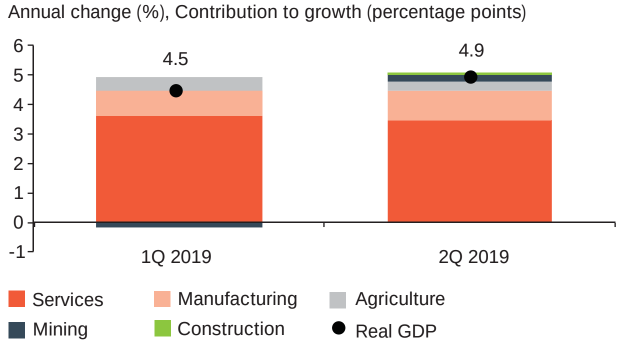
Chart 7: Growth by Sector



Source: Department of Statistics, Malaysia

Services and manufacturing sectors remained the key drivers of growth

Chart 8: Contributions to Real GDP by Economic Sector



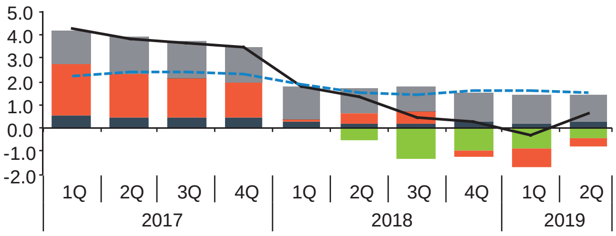
Source: Department of Statistics, Malaysia

[2] The wintering season typically occurs between February and May during which the rubber trees shed their leaves and new leaves are formed, affecting both the metabolism of the trees and latex production.

The increase in headline inflation reflected the lapse in the impact of the GST zerorisation

Chart 9: Contribution to Headline Inflation by Components

Annual change (%), Contribution to headline inflation (percentage points)



- Headline inflation (%)
- Core inflation[1] (%)
- Core inflation[1] (ppt)
- Fuel (ppt)
- Net impact of consumption tax policy changes (ppt)
- Others[2] (ppt)

[1] Core inflation is computed by excluding price-volatile and price-administered items. It also excludes the estimated direct impact of consumption tax policy changes
[2] Others include price-volatile items and other price-administered items

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

Headline inflation increased mainly reflecting the lapse in the impact of the GST zerorisation

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), averaged higher at 0.6% in 2Q 2019 (1Q 2019: -0.3%).

The increase mainly reflected the lapse in the impact of the GST zerorisation that was implemented in June 2018. This contributed to the rise in headline inflation in June 2019 to 1.5% (May 2019: 0.2%; April 2019: 0.2%).

Fuel inflation recorded a smaller negative largely due to domestic fuel prices averaging higher during the quarter in addition to the base effect (Average RON95 petrol price per litre in 2Q 2019: RM2.08; 1Q 2019: RM2.02).

Core inflation, excluding the impact of consumption tax policy changes, was unchanged at 1.6%. Demand-driven inflationary pressures remained broadly stable and contained, amid the absence of excessive wage pressure and some degree of spare capacity in the capital stock.

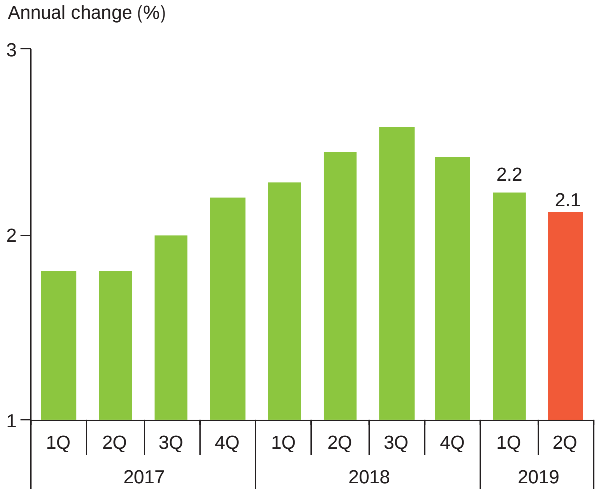
Stable labour market conditions

During the second quarter, labour market conditions were stable. Employment growth was sustained at 2.1% (1Q 2019: 2.2%) while the unemployment rate remained unchanged at 3.3% (1Q 2019: 3.3%) as employment gains kept pace with labour force expansion during the quarter.

Private sector wages grew by 4.2% (1Q 2019: 4.9%), driven by the services sector (4.4%; 1Q 2019: 3.8%) as the wholesale and retail trade subsector saw a pick-up in wage growth (4.1%; 1Q 2019: 3.3%). However, growth in manufacturing wages were lower (3.9%, 1Q 2019: 7.0%), especially in the export-oriented industries, such as the E&E (5.1%; 1Q 2019: 9.7%) and petrochemical clusters (3.1%; 1Q 2019: 6.7%).

Sustained employment growth

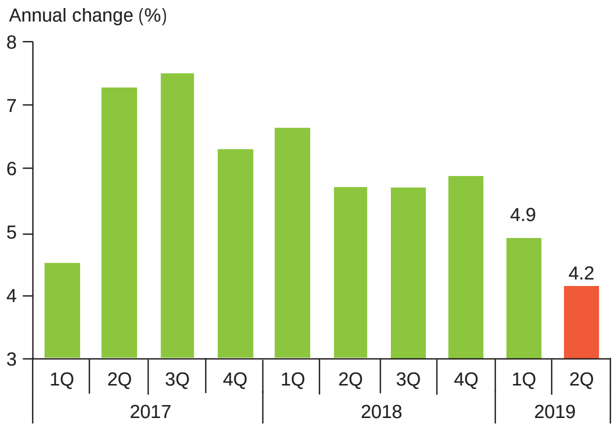
Chart 10: Employment Growth



Source: Department of Statistics, Malaysia

Private sector wages continued to expand, albeit more modestly

Chart 11: Private Sector Wages*



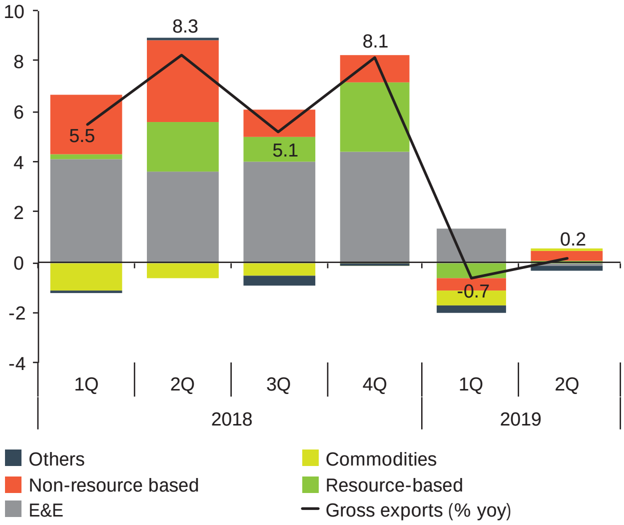
* Private sector wages are derived from the salaries and wages data published in the Monthly Manufacturing Statistics and Quarterly Services Statistics by the Department of Statistics, Malaysia. They cover 62.9% of total employment.

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

Non-E&E and commodities exports contributed to the recovery in exports

Chart 12: Gross Exports by Products

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

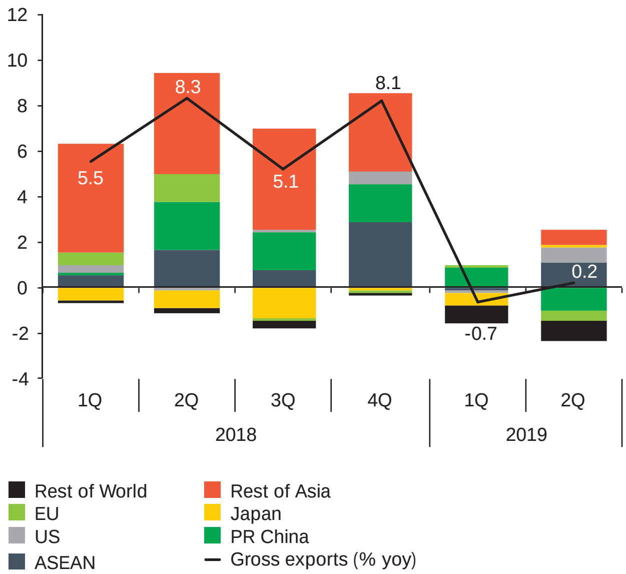


Source: Department of Statistics, Malaysia

Diversified export markets supported export growth

Chart 13: Gross Exports by Markets

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



Source: Department of Statistics, Malaysia

Slight recovery in exports and smaller decline in imports

In the second quarter of 2019, gross exports turned around to register a positive growth of 0.2% (1Q 2019: -0.7%). This was supported by the rebound in commodities exports amid sustained manufactured exports. The trade surplus[3] remained sizeable, albeit narrower at RM30.1 billion (1Q 2019: RM37.0 billion).

Manufactured export growth was sustained at 0.3% (1Q 2019: 0.3%) as higher non-E&E exports helped offset the contraction in E&E exports. The improvement in non-E&E exports (0.9%; 1Q 2019: -2.5%) was attributed to higher demand for both resource-based and non-resource based exports including iron & steel and chemicals & chemicals products. In contrast, E&E exports declined by 0.4% (1Q 2019: 3.7%) on account of lower demand from PR China due in part to the ongoing trade tensions. Commodities exports rebounded to 0.8% (1Q 2019: -3.7%), supported by LNG and palm oil exports.

Imports recorded a smaller decline of -1.2% (1Q 2019: -2.5%) on account of higher intermediate and consumption imports. Intermediate imports (7.5%; 1Q 2019: 0.0%) were driven by higher crude petroleum imports to cater for refinery activities. Capital imports recorded a smaller contraction due to a lower drag from machinery and equipment investments.

[3] The difference between the goods surplus and trade surplus arises from the exclusion of goods for processing, storage and distribution in the goods accounts as per the 6th Edition of the Balance of Payments and International Investment Position Manual (BPM6) by the IMF.

Current account surplus remained sizeable

The current account surplus of the balance of payment remained sizeable at RM14.3 billion or 3.9% of GNI in the second quarter of 2019 (1Q 2019: RM16.4 billion or 4.7% of GNI). This was due to higher investment income earned by Malaysian firms abroad which partly offset the lower goods surplus.

As the improvement in import growth outpaced export growth, the goods surplus narrowed to RM28.1 billion (1Q 2019: RM33.8 billion).

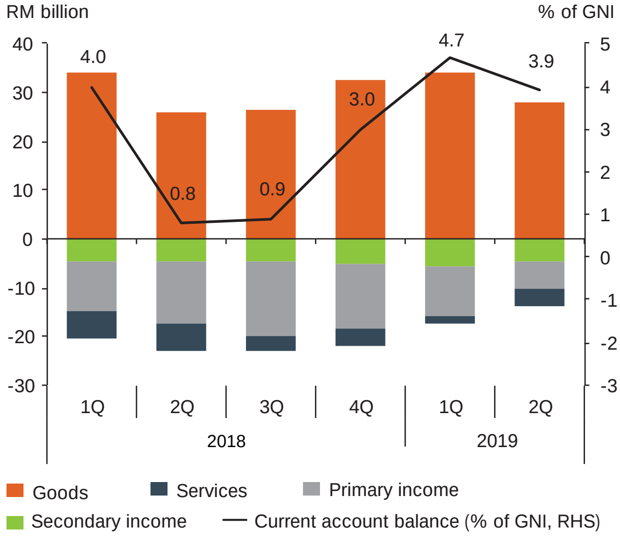
The primary income account registered a smaller deficit of RM5.5 billion (1Q 2019:-RM10.1 billion) due to the increase in investment income earned by Malaysian firms abroad, particularly from direct and portfolio investments. These investments were mainly in the finance and insurance, mining, information and technology sectors. This development more than offset the increase in investment income accrued to foreign direct investors and foreign portfolio investors in publicly-listed firms.

In the services account, the deficit widened to RM3.4 billion (1Q 2019: -RM1.8 billion). This was attributable to higher net payments to foreign providers for transport and insurance services, in line with higher trade activity during the quarter. The travel account surplus narrowed to RM7.1 billion (1Q 2019: RM7.9 billion) on account of lower tourist per capita spending.

The secondary income account deficit amounted to RM4.9 billion (1Q 2019: -RM5.5 billion), reflecting mainly outward remittances by foreign workers.

Sizeable current account surplus

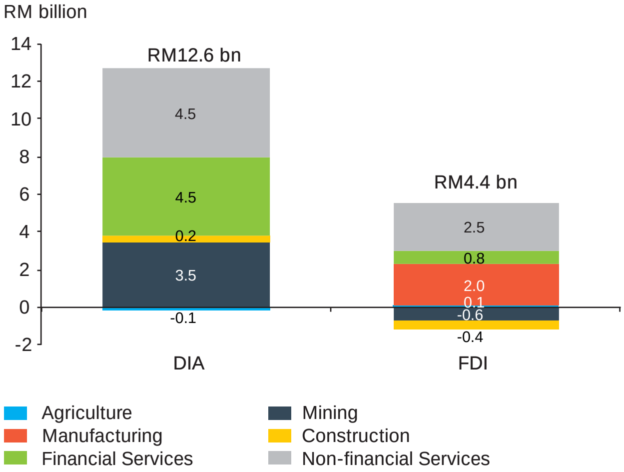
Chart 14: Current Account Balance



Source: Department of Statistics, Malaysia

Higher DIA and more moderate FDI

Chart 15: Net Direct Investment Flows by Sector

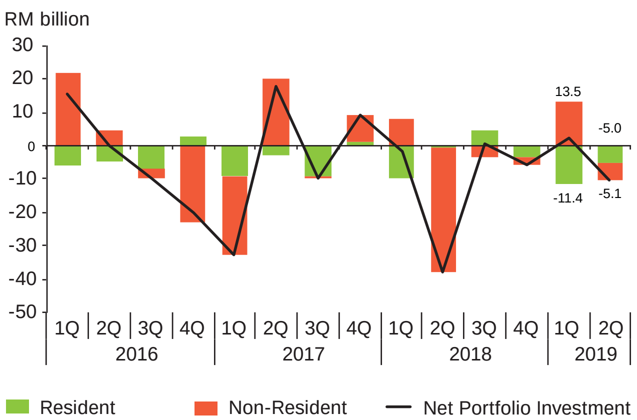


Note: For DIA, positive values refer to net outflows while negative values refer to net inflows

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Net outflows of both resident and non-resident portfolio investments

Chart 16: Portfolio Investments



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Financial account registered a net outflow

The financial account registered a net outflow of RM18.6 billion (1Q 2019: -RM13.8 billion), following outflows in the direct investment and portfolio investment accounts. These outflows have more than offset the marginal net inflow in the other investment account during the quarter.

The direct investment account registered a net outflow of RM8.2 billion (1Q 2019: net inflow of RM16.3 billion). Foreign direct investments (FDI) registered a smaller net inflow of RM4.4 billion (1Q 2019: net inflow of RM21.7 billion). Inflows were channelled mainly into the services and manufacturing sectors. Direct investments abroad (DIA) by Malaysian companies registered a larger net outflow of RM12.6 billion (1Q 2019: net outflow of RM5.5 billion). DIA was channelled mainly into the services sector, particularly the financial services subsector and the accommodation and food services subsector, followed by the mining sector.

The portfolio investment account registered a net outflow of RM10.2 billion (1Q 2019: net inflow of RM2.1 billion), following a reversal of non-resident portfolio investments. Non-resident portfolio investments recorded a net outflow of RM5.1 billion during the quarter (1Q 2019: +RM13.5 billion). Following increased risk aversion and more cautious sentiments, non-resident investors pared down holdings in both the domestic equity and debt markets. At the same time, residents' portfolio investments abroad also recorded a smaller net outflow of RM5.0 billion (1Q 2019: -RM11.4 billion).

The other investment account recorded a marginal net inflow of RM0.3 billion (1Q 2019: -RM31.9 billion). This reflected inter-bank borrowings by the domestic banking system, which were almost entirely offset by interbank placements abroad and a net repayment of loans and trade credits by the private sector. Net errors and omissions amounted to RM2.9 billion, or 0.6% of total trade.

Manageable external debt

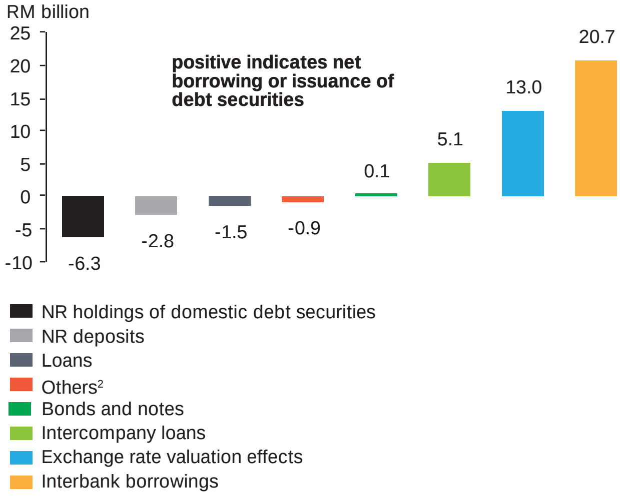
Malaysia's external debt amounted to RM931.1 billion, or 61.3% of GDP as at end-June 2019 (end-March 2019: RM903.7 billion or 59.5% of GDP). The increase reflects mainly the net drawdown of interbank borrowings and intercompany loans. There was also revaluation adjustment from the weaker ringgit against regional and major currencies during the period. These were partially offset by some liquidation of domestic debt securities and withdrawal of deposits by non-residents.

The country's external debt remains manageable, given its currency and maturity profiles, and the presence of large external assets. Close to one-third of external debt is denominated in ringgit (31.7%; end-March 2019: 32.7%), mainly in the form of non-resident holdings of domestic debt securities (61.7% share of ringgit-denominated external debt) and in ringgit deposits (18.0% share) in domestic banking institutions. As such, these liabilities are not subject to valuation changes from the fluctuations in the ringgit exchange rate.

The remaining external debt of RM636.1 billion or 68.3% of total external debt is denominated in foreign currency (FC). As at end-June 2019, offshore borrowings increased to RM580.5 billion or 38.2% of GDP (end-March: RM546.9 billion or 36.0% of GDP). The corporate sector accounted for slightly more than half of FC-denominated external debt and are largely subject to prudential and hedging requirements.

Higher external debt in 2Q 2019

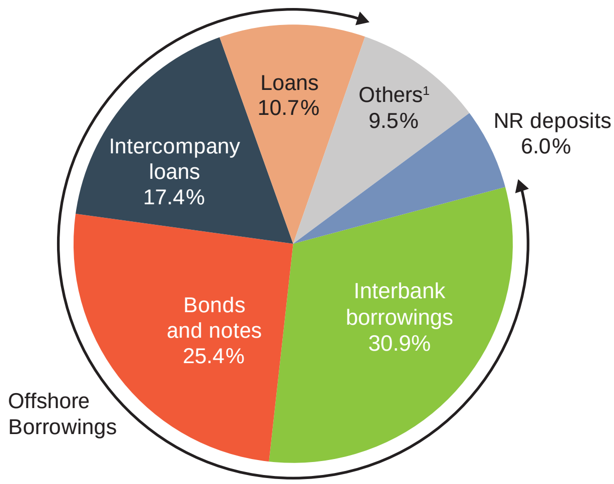
Chart 17: Changes in External Debt
Net change[1]: +RM27.4 billion



[1] Changes in individual debt instruments exclude exchange rate valuation effects
[2] Comprises trade credits, IMF allocation of SDRs and other debt liabilities
Note: NR refers to non-residents
Figures may not add up due to rounding
Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

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

Chart 18: Breakdown of Foreign Currency-Denominated External Debt (% share)



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

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

By instrument, 36.9% (or RM234.9 billion) of FC-denominated external debt are accounted by interbank borrowings and FC deposits in the domestic banking system. 78.3% of the interbank borrowings are in the form of largely stable intragroup borrowings from related offices abroad, including parent banks, regional offices and subsidiaries. This reflects banks' centralised liquidity and funding management practices.

During the quarter, banks' FC-denominated short-term external debt increased by RM20.6 billion driven by higher interbank borrowings. This was largely attributable to parent bank placements with foreign banks' in Malaysia (including banks in Labuan International Banking and Financial Centre (LIBFC)) to facilitate lending and investment activities. Funds received by foreign LIBFC banks were largely invested abroad with non-resident clients, a reflection of LIBFC banks' 'out-out' business activities. For locally-incorporated foreign banks, intragroup funds continue to be primarily used for short-term investments and lending in the domestic interbank market. Domestic banking groups accounted for the remaining increase in interbank borrowings reflecting their central role in managing liquidity and funding needs on a group-wide basis. In line with these developments, banks' total external assets also increased during the quarter by RM22.8 billion.

Overall, banks' funding and liquidity risks continue to be proactively managed via robust internal controls and policies, including internal limits on (i) interbank borrowings; (ii) foreign currency funding and liquidity positions; and (iii) foreign exchange market risk exposures. Foreign-currency risk, measured in terms of the net open position of FC-denominated exposures[4] remained low at 4.9% of banks' total capital.

Long-term bonds and notes issued offshore stood at RM161.7 billion as at end-June 2019, accounting for 25.4% of total FC-denominated external debt. These were mainly by non-financial corporations and channelled primarily to finance asset acquisitions abroad. Intercompany loans, which amount to RM110.5 billion and account for 17.4% of FC-denominated external debt, are typically on flexible and concessionary terms. About 80% of these intercompany loans were obtained by multinational corporations (MNCs) from parent or affiliate companies abroad.

From a maturity perspective, 58.3% of the total external debt is skewed towards medium- to long-term tenure (end-March: 59.2%), suggesting limited rollover risks. Short-term external debt accounted for the remaining 41.7% of external debt. While rollover risks may be inherent, this is well contained. Close to half of the short-term external debt are intragroup borrowings among banks and corporations which are generally stable, while another 11% are accounted by trade credits, largely backed by export earnings. As at 31 July 2019, international reserves stood at USD103.9 billion, sufficient to finance 7.6 months of retained imports, and is 1.1 time the short-term external debt.

Of significance, reserves are not the only means for banks and corporations to meet their external obligations. The progressive liberalisation of foreign exchange administration rules has resulted in significant increase in non-reserves external assets. In particular, banks and corporations held roughly three-quarters of Malaysia's RM1.8 trillion external assets, which can be drawn down to meet their RM728.3 billion external debt obligations. While the flexible exchange rate remains the first line of defence, adequate international reserves and availability of substantial foreign currency external assets by banks and corporations continue to serve as important buffers against potential external shocks.

[4] Refers to the aggregated sum of the net short or long foreign currency positions for all currencies across banks.

1
Box Article

Unresolved Trade Disputes One Year On

Authors: Muhamad Aizuddin, Daryl Yong, Ooi Kiesha, Catharine Kho, Chang Wen Huei

HIGHLIGHTS

- Trade tensions in the past year have broadened in terms of products and countries.
- In addition to impacting global trade and growth, trade tensions have also spurred the reconfiguration of global value chains.
- Latest assessment finds the impact of trade tensions to reduce Malaysia's 2019 export growth by -0.5 to -0.8 ppt.

Over a year since it started, the trade disputes between the US and PR China, as well as with some other economies, remain unresolved and continue to cast its shadow over the global economy. What began as the imposition of tariffs on selected imports, namely steel, aluminium and solar products, have widened to encompass a broader range of goods, with increasingly large spillover effects on global trade and growth. As the disputes escalated, the adverse impact on growth morphed from just the transmission of higher trade costs, to amplification through the Global Value Chain (GVC), increased policy uncertainty for firms in the tradable sector and heightened volatility in financial markets.

This box article is the third in a series of articles[1] on the ongoing global trade dispute, reflecting on the past year of shifting trade tensions, with a focus on: (i) recent trade developments; (ii) emerging trends; and (iii) implications for Malaysia.

Recent developments reignited trade tensions

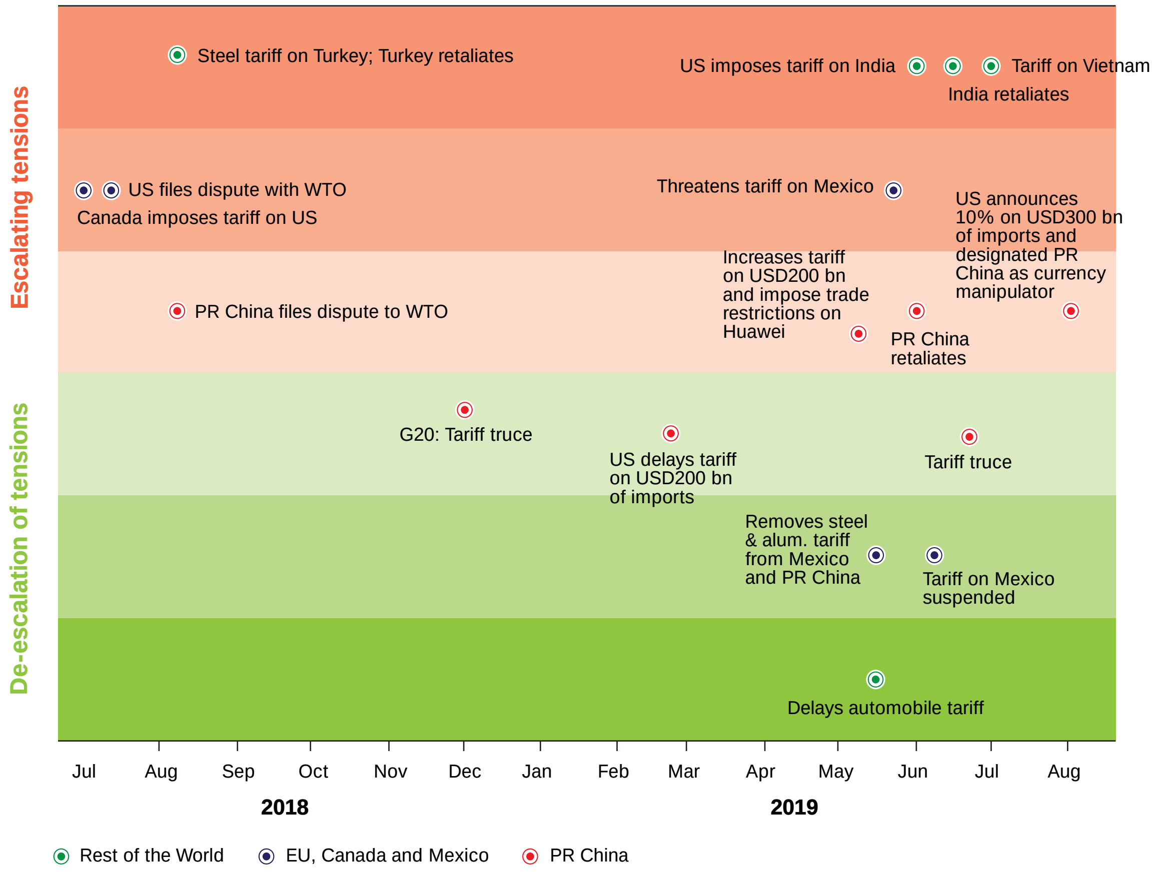
The second quarter of 2019 solidified fears of many since March 2018 that trade tensions were going to persist and propagate to other countries. After the US implemented tariffs of 10% on USD200 bn of imports from PR China in September 2018, tensions eased towards end-2018 as both countries agreed on a truce. This respite was short-lived when the US further raised tariffs from 10% to 25% on USD200 bn of Chinese imports in May 2019, and banned the Chinese telecommunications company, Huawei from purchasing from US companies without government approval. What followed thereafter was a series of developments that vacillated between an intensification and de-escalation of trade tensions, sometimes within the span of a few days. First, the US delayed its decision to implement blanket tariffs on automobile imports. Subsequently, the US threatened and suspended its threat to impose tariffs on Mexico within a week. Thereafter, the US removed India and Turkey as beneficiaries under the Generalised System of Preferences (GSP) programme. The US then agreed on a temporary truce with PR China in June 2019 which also eased restrictions on Huawei. However, this truce was not extended to other countries as the US imposed higher tariffs and circumvention rulings on steel imports from Vietnam in July 2019. Most recently, the US announced tariffs of 10% on all remaining imports from PR China worth USD300 bn to be implemented on 1 September 2019[2].

[1] 1Q 2018 Quarterly Bulletin box article on "Trade Disputes: Implications for Trade and Investments", and 3Q 2018 Quarterly Bulletin box article on "Escalating Trade Tensions and Potential Spillovers to Malaysia".

[2] Since the time of writing, a portion of this tariff on USD300 bn has been postponed to mid-December 2019.

With the lingering risk of potentially sudden US trade actions against other countries, and early signs of a trade conflict between Japan and Korea, the whipsawing developments in the past three months suggest trade policies are likely to remain uncertain (Chart 1).

Chart 1: Summary of Key Developments in the Past Year



Source: National authorities, Newsflows

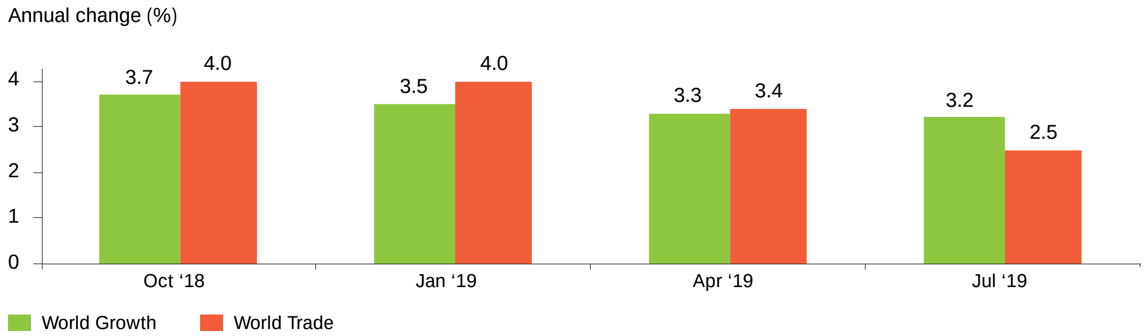
Trade tensions have contributed to a new global landscape

The developments in the past year have shown that the retreat from free trade has evolved from a transient to a potentially longer term threat. The failure of trade negotiations to ease tensions and yield lasting results has triggered a rethink among firms globally about their production strategies and consequently, potential reconfiguration of GVCs. We observe three emerging trends from the prolonged trade disputes:

Trend 1: Protracted trade disputes are weighing on growth and trade prospects

The global economy was already showing signs of moderation amid a cyclical slowdown in trade activity since early 2018 and the trade disputes have only served to exacerbate this downturn (Chart 2). The longer trade disputes remain unresolved, the poorer the outlook for businesses, as firms continue to face uncertainties that materially affect future investment decisions. This is evidenced in monthly Purchasing Managers' Index (PMI) surveys, where companies across the world have cited the ongoing trade disputes as a key concern in making investment decisions, particularly since the escalation of tensions in May 2019.

Chart 2: Evolution of IMF World GDP Growth and Trade Forecasts for 2019



Source: IMF World Economic Outlook

While global growth is expected to improve going forward, this is heavily premised on a resolution of existing trade disputes. In the worst-case scenario of an all-out trade dispute in which blanket tariffs are imposed on automobiles and electronics, global growth could potentially fall to its lowest level since the Global Financial Crisis (Chart 3).

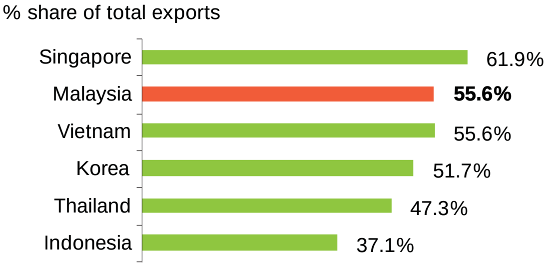
Chart 3: Long-Term Global GDP and Trade Growth

Source: IMF World Economic Outlook, authors' estimation

The inertia against global growth recovery is expected to be prolonged as trade tensions persist. This is more so as trade actions between the US and PR China expanded to encompass technology products and the protection of intellectual property (IP) rights, which would take time to resolve. The continued widening of trade disputes affecting more countries, a larger variety of products and a broader range of strategic sectors, will ultimately be detrimental to global growth and global trade prospects.

For Malaysia, the prolonged trade disputes and the resulting impact on lower global trade has mainly affected Malaysia's trade activity. Not only are Malaysia's exports to affected countries lower (direct channel), exports to countries within the GVC (indirect channel) have also been affected. The latter channel is not negligible, given Malaysia's position as one of the most integrated economies in the GVC, even among regional peers (Chart 4).

Chart 4: GVC Participation Index[3]



Note: Index measures the share of an economy's exports that contain imported inputs and/or are used as inputs for other countries' exports

Source: TiVA OECD, Department of Statistics, Malaysia, Bank Negara Malaysia, authors' estimation

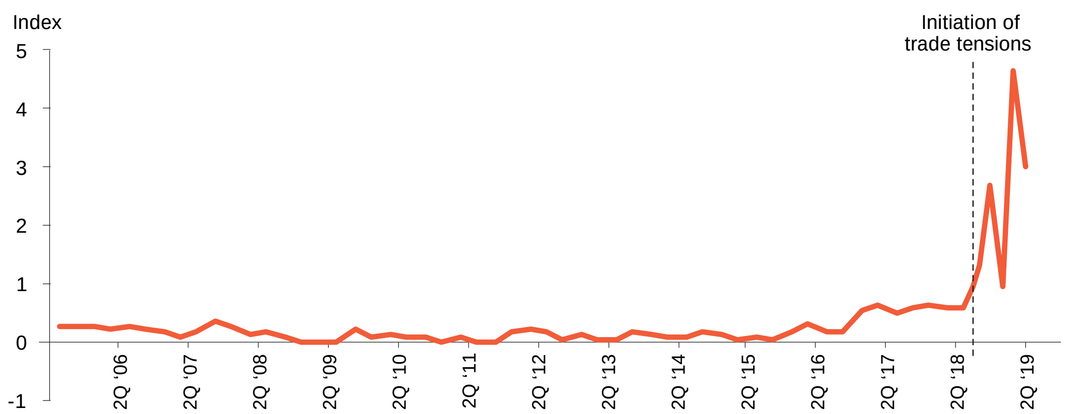
While the direct channel captures demand for Malaysia's exports that are consumed in the final destination country, the indirect channel refers to demand by countries within the GVC for Malaysia's exports which are used as intermediate inputs. Accounting for both direct and indirect channels, the ongoing trade disputes is projected to weigh on Malaysia's 2019 baseline gross export growth by -0.5 to -0.8 ppt, with the GVC channel contributing to about 20 per cent of the decline.

The impact of lower trade activity on growth is also compounded by increased business uncertainty. Should the downside risks[4] from the ongoing trade dispute materialise, this could potentially reduce Malaysia's export growth by up to an additional -0.2 ppt and GDP growth by approximately -0.1 ppt in 2019[5].

Trend 2: Volatile financial markets and high investor uncertainty

The rapidly changing trade developments have also induced significant uncertainties, manifesting in deteriorating sentiments and financial market volatility. The extent of the trade-related uncertainty is illustrated by the sentiment-based World Trade Uncertainty Index, which has increased to its highest level in more than two decades (Chart 5). Trade tensions have also heightened financial market volatility, amid the shifting directions of monetary policy among major economies and stretched equity valuations amid slowing economic growth (Chart 6).

Chart 5: World Trade Uncertainty Index



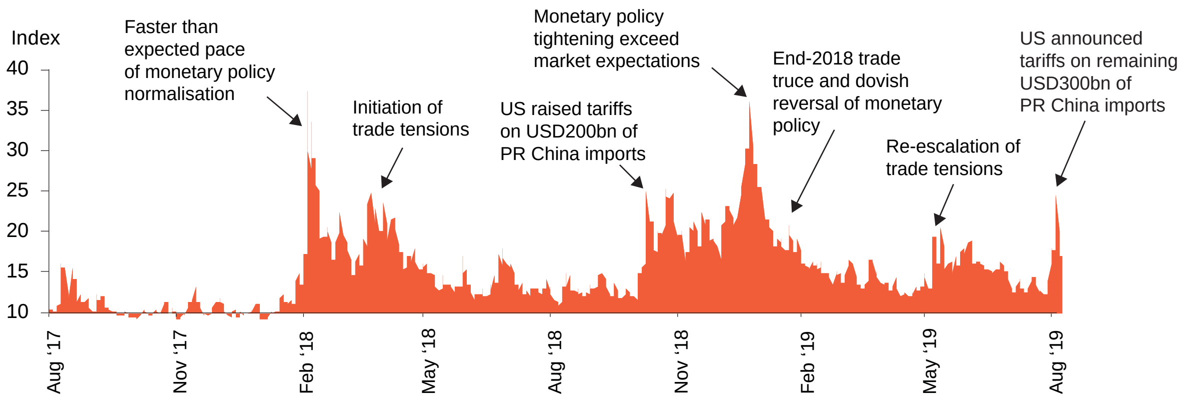
Source: Ahir, Bloom and Furceri, (2018) "The World Uncertainty Index"

[3] GVC participation is estimated as the sum of backward linkage (measures use of imported inputs to produce goods for exports) and forward linkage (measures exports of intermediate goods that are used as inputs for the production of another country's exports) relative to total exports of an economy. The higher the GVC participation index, the more integrated an economy is in the GVC.

[4] The downside risks for 2019 are higher tariffs on all remaining imports from PR China. For 2020, downside risks also include blanket tariffs on automobile and technology imports.

[5] This is an updated estimate since the 3Q 2018 Quarterly Bulletin box article. The lower downside risks in the current assessment for 2019 is due mainly to the shift in the expected implementation of blanket tariffs on automobiles and technology imports from 2019 to 2020. In addition, the impact of the materialisation of downside risks in 2019 is expected to be smaller as the end-year approaches. Nonetheless, the expected prolonged trade tensions could lead to larger downside risks to growth in 2020.

Chart 6: Chicago Board Options Exchange (CBOE) Volatility Index (VIX)



Source: Bloomberg

In early August 2019, following the announcement of 10% tariffs on the remaining imports from PR China, the Chinese renminbi depreciated to its lowest level in more than a decade against the US dollar. Soon after, the US Treasury Department designated PR China as a currency manipulator[6]. In the immediate term, this has generated greater volatility, and could affect the real economy going forward.

The increased financial market volatility following inconclusive trade negotiations and unpredictable global trade policies have dampened domestic business and investor sentiments. In the face of unpredictable coverage and timing of the trade disputes, firms, including in Malaysia, have generally taken a "wait-and-see" approach in capacity expansion. This in part contributed to the recent moderation in private investment.

Trend 3: Reconfiguration of trade and investment networks in the GVCs

The past intensification of GVCs by manufacturers was driven by a race to produce goods at the lowest possible cost. GVCs proliferated significantly with the ascension of PR China into the global market due mainly to its large workforce. Today, any reconfiguration of an established GVC involves the consideration of many factors including but not limited to geographical proximity to consumers and suppliers, financing conditions, profit margins after relocation, investment policies and political stability in the host country. As such, the US-PR China trade disputes will have both short- and long-term implications on trade and investment networks of economies which are integrated in the GVCs.

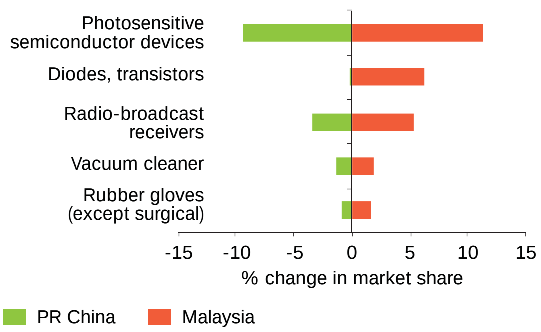
In the short-term, the trade disputes have led to trade diversion, in which firms source for inputs from countries unaffected by the higher tariffs. Since the implementation of tariffs on Chinese imports in the first quarter of 2018, several regional economies, including Vietnam, Chinese Taipei and Korea, have benefitted from trade diversion[7]. In the case of Malaysia, there are preliminary signs of trade diversion arising from higher imports from the US and PR China for certain products[8] (Chart 7 and Chart 8).

[6] The US Treasury Department has three criteria for identifying countries that possibly conduct unfair currency practices. These are (i) significant bilateral trade surplus with the US; (ii) material current account surplus, and (iii) persistent, one-sided intervention in currency markets.

[7] "Exploring US and China trade diversion", Nomura Global Markets Research (2019).

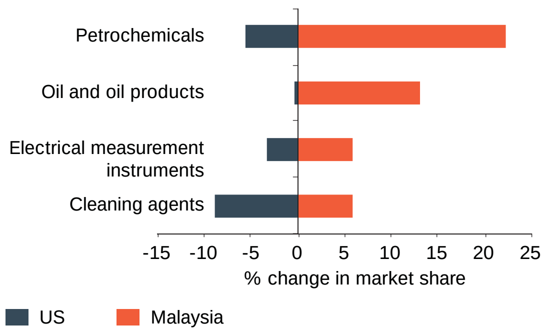
[8] Selected products are tariffed products in which Malaysia has a meaningful presence (Malaysia's exports account for at least 5% of US' import) and experienced an increase in share in the US at the expense of PR China between July 2018 and April 2019. The same method applies to PR China's imports from Malaysia.

Chart 7: Change in share of US imports for selected products (%) (Malaysia and PR China)



Source: Global Trade Atlas

Chart 8: Change in share of PR China imports for selected products (%) (Malaysia and US)

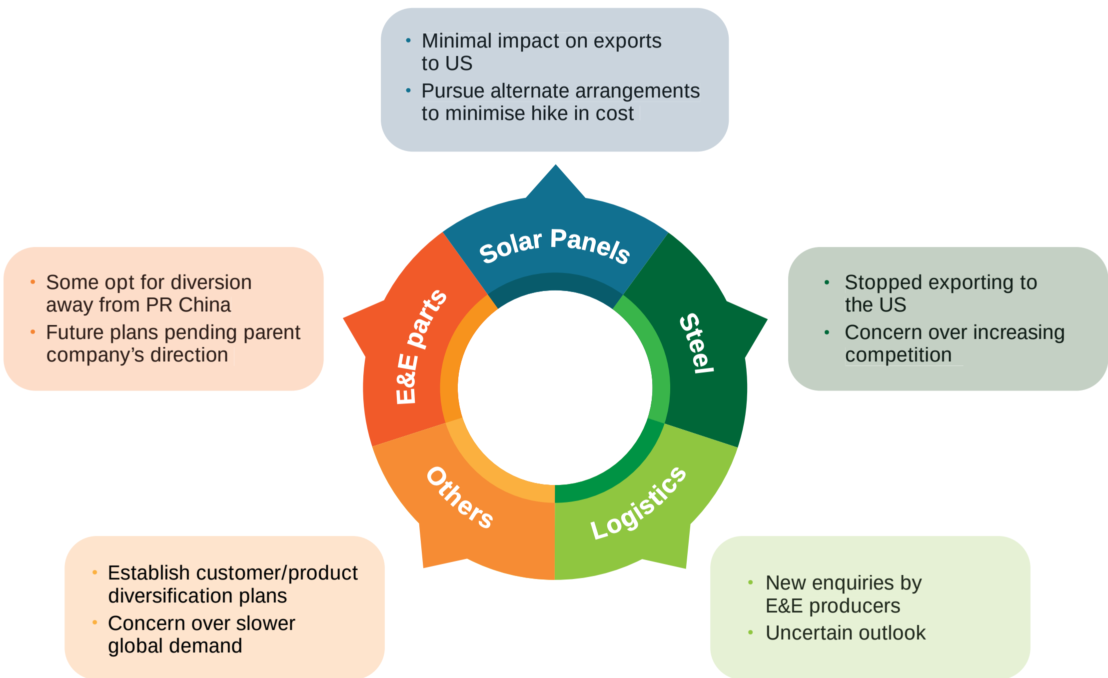


Source: Global Trade Atlas

In other cases, firms that have presence in PR China and across the region have leveraged on their network to set up dual supply chains, namely one to cater for PR China demand and one for other markets. The decoupling of the supply chain involves tasking Chinese factories to produce goods for the domestic market or destinations other than the US, while instructing other regional production plants to meet the orders from the US.

Apart from sourcing inputs from other countries, firms have also signaled more willingness to diversify their supply chain by investing in production facilities in other countries given the persistence of the ongoing trade tensions. However, such investment re-direction will most likely only be realised in the longer term. A recent survey by the American Chamber of Commerce China noted that 30.2% of its

Chart 9: Summary of Feedback from Industry Players



Source: BNM Regional Economic Surveillance member companies are now seeking to source their components from outside of PR China[9], while 18.3% are considering relocating some or all of their operations to other countries, predominantly to Southeast Asian countries. Among the more notable announcements, Apple has signaled for its suppliers to shift approximately 15% to 30% of its production capacity from PR China to Southeast Asian countries[10]. Similarly, Li & Fung, a major global supply chain player in the consumer product industry, has also announced that it will source less than half of its goods from PR China for the first time in 15 years[11].

Such developments point towards a reordering of global manufacturing supply chains as new trade flows of intermediate and final products among countries break existing linkages while creating new ones. It is likely that even if trade tensions subside, the current structure of GVCs are likely to be structurally altered as firms seek to diversify their exposure to any particular country to insure against trade policy shocks. This brings about new opportunities for economies to the extent that these countries are able to capitalise on them.

Opportunities arising from GVC reconfiguration

High tariff costs and the uncertainty over the future of US and PR China relations have compelled global manufacturers to reroute production facilities from PR China to new markets in Asia. While there are early signs of several global E&E manufacturers indicating intentions to relocate operations to Malaysia[12], this is unlikely to offset the adverse impact from unresolved trade conflicts in the immediate term given the long lead time required to reorient supply chains.

Conclusion

An eventful year of trade developments has passed. There were episodes of intense action followed by swift retaliation, punctuated by negotiations and tenuous ceasefires. Throughout this period, trade tensions have induced heightened volatility in financial markets and generated substantial uncertainties for firms planning to invest and policymakers striving to promote growth. A reflection of the recent past suggests that trade tensions will continue, possibly into the medium- to long-term. Smaller countries that are well-integrated in the GVC must tread carefully to avoid circumventing established trade restrictions of the major economies, and thus risk being caught in the crossfire. As such, any further escalation could amplify current trade tensions into a global trade war, in which there will be no winners.

In this environment of heightened uncertainty, swift, nimble and adroit policy measures are critical to ensure that Malaysia remains resilient and well-positioned to weather any downside risk of a trade war. First, structural reforms such as promoting high value-added industries, diversifying our export products and markets, enhancing labour market flexibility, and attracting quality investments that would create high-value jobs, should continue to be pursued. Second, Malaysia's position in the GVC should be consistently reassessed in order to leverage on opportunities to fortify our role in the ecosystem. Third, Malaysia must proactively pursue multilateral and bilateral trade pacts with other economies. Crucially, these policy thrusts will contribute towards enhancing the resilience of the Malaysian economy.

9 "Impact of US and Chinese Tariffs on American Companies in China", AmCham China & AmCham Shanghai (2018).

10 "Apple weighs 15%-30% capacity shifts out of China amid trade war", Nikkei Asian Review (2019).

11 "Li & Fung cuts China's role in supply chain as it shifts sourcing to cheaper markets in Southeast Asia", SCMP (2019).

12 "More foreign investors turning to Malaysia due to trade war", The Edge Markets (2018).

Monetary and Financial Developments

HIGHLIGHTS

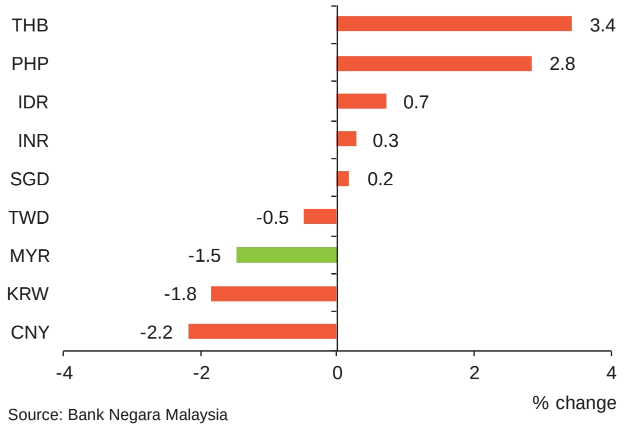
- **The ringgit depreciated in the second quarter amid global and domestic uncertainties.**
- **The performance of domestic bond and equity markets were supported by sustained demand from domestic institutional investors.**

The performance of domestic financial markets were mixed during the second quarter

During the first two months of the quarter, domestic financial markets were affected by cautious investor sentiments amid the moderating global growth outlook and escalations in global trade tensions. Domestically, potential reviews on Malaysia's inclusion in the FTSE Russell World Government Bond Index (WGBI) also weighed down sentiments in the domestic bond market. As a result, non-resident portfolio outflows of RM5.1 billion led the ringgit to depreciate by 1.5% against the US dollar during the quarter. Despite the weak sentiments, domestic bond and equity markets remained supported by sustained demand from domestic institutional investors throughout the quarter.

Ringgit depreciated against the US dollar, driven by non-resident portfolio outflows

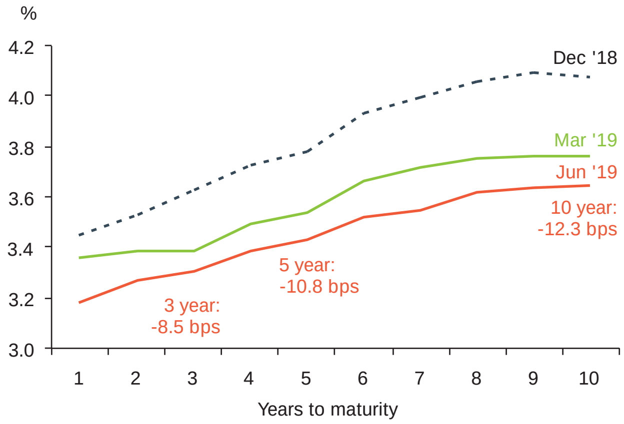
Chart 19: Performance of Regional Currencies Against the US Dollar (1 April - 28 June 2019)



Source: Bank Negara Malaysia

MGS yield curve shifted downwards during the second quarter

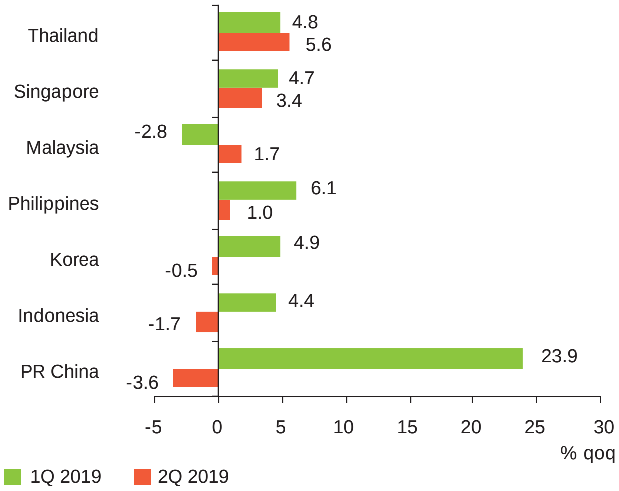
Chart 20: Trend in MGS Yields



Source: Bank Negara Malaysia

Domestic equity market performance improved during the quarter

Chart 21: Performance of Regional Equity Markets



Source: Bloomberg

Towards the end of the quarter, the performance of domestic bond and equity markets were lifted by a recovery in investor sentiments. In June, expectations of monetary policy easing by major central banks led to an improvement in global investor risk appetite, which spurred a recovery in non-resident portfolio inflows. As a result, the FBM KLCI increased by 1.7% in the second quarter to close at 1,672.1 points as at end-June (end-March 2019: 1,643.6 points) and the 3-year, 5-year and 10-year MGS yields declined by 8.5, 10.8 and 12.3 basis points, respectively.

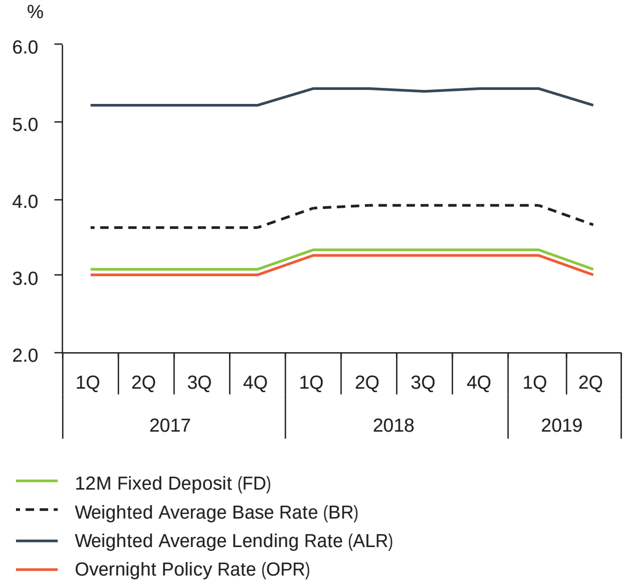
Interest rates decreased during the quarter given the reduction in the Overnight Policy Rate (OPR)

Following the reduction in the OPR on 7 May 2019, interest rates in the wholesale and retail markets trended lower. In the interbank market, strong and immediate pass-through was observed, with the 3-month KLIBOR decreasing by 23 basis points to 3.46% (1Q 2019: 3.69%). Similarly, nominal fixed deposit (FD) rates also decreased following the OPR adjustment. The decline ranged from 24 to 25 basis points across tenures of 1 to 12 months. Correspondingly, real FD rates decreased given the decline in nominal rates and higher inflation during the quarter.

For the retail segment, the transmission of OPR to base rate (BR) was also strong, with all banks revising their BRs downwards by 25 basis points to the current weighted average of 3.68% (1Q 2019: 3.92%). By end-quarter, the weighted average lending rate (ALR) on outstanding loans was also lower by 20 basis points at 5.23% (1Q 2019: 5.43%).

Interest rates decreased following the reduction in the OPR

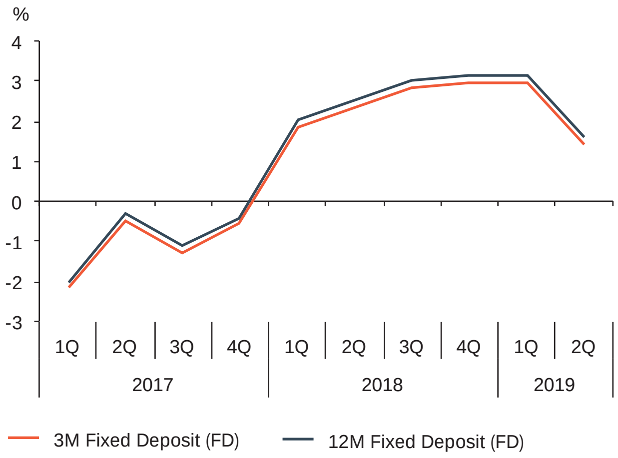
Chart 22: Fixed Deposit Rate, Base Rate and Average Lending Rate (at end-period)



Source: Bank Negara Malaysia

Real deposit rates declined

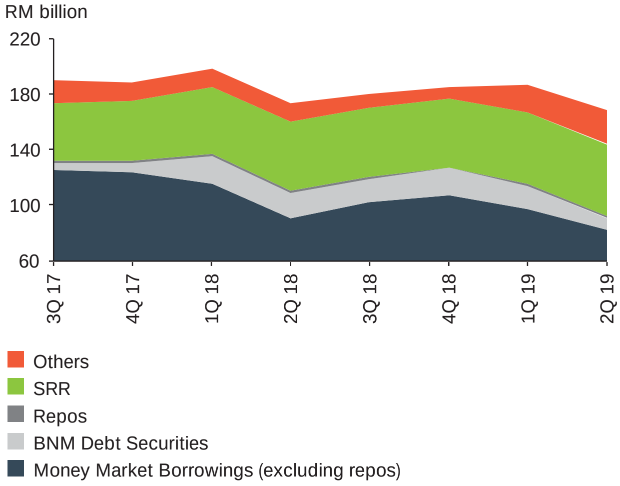
Chart 23: Real Fixed Deposit Rates by Maturity (at end-period)



Source: Bank Negara Malaysia

Outstanding surplus ringgit liquidity placed with the Bank declined

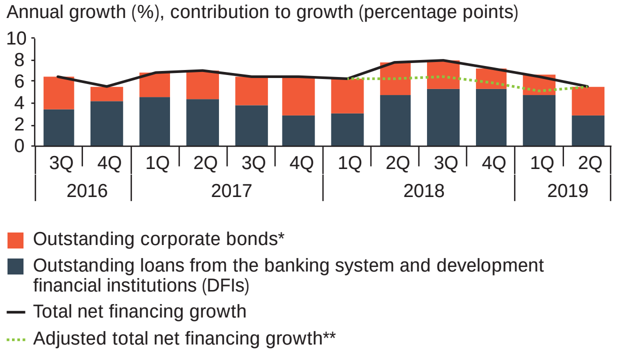
Chart 24: Outstanding Ringgit Liquidity Placed with Bank Negara Malaysia as at end-period



Source: Bank Negara Malaysia

Net financing continued to grow as outstanding loans and corporate bonds continued to expand

Chart 25: Contribution to Net Financing Growth



* Excludes issuances by Cagamas and non-residents
** Removing transitory impact for the period of 2Q 2018 to 1Q 2019, due to the inclusion of data for a newly licensed commercial bank (MBSB Bank Berhad) from April 2018

Source: Bank Negara Malaysia

Liquidity conditions remained sufficient to facilitate financial intermediation

The level of surplus liquidity placed with the Bank decreased, reflecting the net outflows during the quarter. Notwithstanding this, liquidity conditions remained sufficient in the banking system at both the system-wide and institutional levels, with most banks continuing to maintain surplus liquidity positions with the Bank.

Net financing continued to expand during the quarter

In the second quarter, net financing expanded by 5.6% on an annual basis (1Q 2019: 6.5%), driven by the continued expansion of outstanding corporate bonds[5] and loans[6]. Growth of outstanding corporate bonds increased to 10.6% during the quarter (1Q 2019: 7.1%), largely driven by a one-off issuance in the finance, insurance, real estate and business services sector. Outstanding total loans recorded a 3.9% growth on an annual basis (1Q 2019: 6.4%), with outstanding business loans expanding by 2.7% (1Q 2019: 4.4%), while outstanding household loans grew by 4.8% (1Q 2019: 7.5%). Apart from a low base effect for the first quarter of 2019 due to the inclusion of data for a newly licensed commercial bank from April 2018 onwards[7], the moderation in growth of outstanding total loans in the second quarter of 2019 reflected the high loan repayments, which outpaced disbursements.

For the business segment, a steady level of loans were disbursed to both SMEs and non-SMEs (total loans disbursed to businesses: RM197.2 billion, 1Q 2019: RM193.8 billion). Loans were mainly disbursed to the manufacturing; wholesale and retail trade, restaurants and hotels; and construction sectors, in line with the continued economic expansion in these sectors. Demand for financing among businesses showed some signs of improvement during the quarter as loan applications[8] increased (RM95.5 billion, 1Q 2019: RM77.4 billion). For the household segment, loans for residential property continued to be the primary driver of household loan expansion (contribution to growth: 3.8 percentage points), supported by sustained approval rates for housing loans.

5 Corporate bonds exclude issuances by Cagamas and non-residents.
6 Loans from the banking system and development financial institutions (DFIs).
7 Effective June 2019, data for April 2018 onwards were revised to include data from a newly licensed commercial bank (MBSB Bank Berhad). It was previously classified as a non-bank financial institution. The inclusion of the outstanding loan figures resulted in higher financing annual growth rates for a transitory period from 2Q 2018 to 1Q 2019 due to the lower base in preceding years.
8 Loan applications to the banking system only.

The Bank's Policy Considerations

HIGHLIGHTS

- The MPC reduced the OPR by 25 basis points to 3.00% at the May 2019 MPC meeting. The adjustment was intended to preserve the degree of monetary accommodativeness.
- Subsequently, the MPC kept the OPR unchanged at the July 2019 MPC meeting. At this prevailing level, the stance of monetary policy is accommodative and supportive of growth and inflation.

The MPC reduced the OPR by 25 basis points to 3.00% at the May MPC meeting and kept the OPR unchanged at the July MPC meeting

In May 2019, the Monetary Policy Committee (MPC) reduced the Overnight Policy Rate (OPR) by 25 basis points to 3.00%. Against the backdrop of a challenging global environment, the Malaysian economy was expected by the MPC to grow within the projected range of 4.3% — 4.8% in 2019. However, there were downside risks to domestic growth from heightened uncertainties in the global and domestic environment, trade tensions and extended weakness in commodity-related sectors. While domestic monetary and financial conditions have remained supportive of economic growth, there were some signs of tightening of financial conditions. The adjustment to the OPR was therefore intended to preserve the degree of monetary accommodativeness.

At the subsequent meeting in early July 2019, the MPC kept the OPR unchanged at 3.00%. At this prevailing level, the stance of monetary policy is accommodative and supportive of growth and inflation.

Average headline inflation is expected to be broadly stable in 2019 compared to 2018. The trajectory of headline inflation will, however, continue to be dependent on global oil prices and policy measures such as the timing of the lifting of the price ceiling on domestic retail fuel prices. Underlying inflation is expected to remain stable, supported by the continued expansion in economic activity and in the absence of strong demand pressures.

The MPC will continue to assess the balance of risks to domestic growth and inflation, to ensure that the monetary policy stance remains conducive to sustainable growth amid price stability.

Other policy highlights in the second quarter of 2019

Policy highlights	Salient requirements
Trade Credit Insurance/Trade Credit Takaful (TCIT) – Policy Document (PD)	• The PD came into force on 3 May 2019, setting out regulatory expectations on the offering of TCIT, including requirements surrounding the approval process and information submission. • The enhanced regulatory clarity is intended to increase the availability of trade facilitation products, including Shariah compliant products, that will facilitate the growth of Malaysian halal business. • The offering of TCIT will also contribute towards portfolio diversification for licensed insurers and takaful operators.
Framework for Electronic Trading Platforms (ETP) – Exposure Draft (ED)	• The ED was issued on 14 June 2019, setting out the Bank's requirements and expectations on market participants that offer ETP services in the Malaysian money and foreign exchange markets. • The ED aims to ensure that ETP services offered to Malaysian participants are secure, efficient and robust, to maintain orderly market conditions and to safeguard the integrity of the financial market. • In particular, platform operators must– o obtain the Bank's prior approval; and o have in place adequate operational and governance capacities to ensure clear segregation of responsibilities and accountabilities across its Management and Board of Directors.
Insurance and Takaful Aggregation Business Registration – ED	• The ED was issued for public consultation on 18 June 2019, setting out proposed expectations for the registration of insurance and takaful aggregators as a new category of business under the Financial Services Act 2013. • The ED aims to provide clarity on the regulatory treatment of such non-advisory services, including registration procedures and business conduct obligations to be observed by a registered insurance and takaful aggregator at all times.
Takaful Operational Framework – PD	• The PD sets out strengthened parameters governing the management of takaful funds and shareholders fund by licensed takaful operators and retakaful operators. • The revised policy aims to enhance the operational efficiency of takaful business and sustainability of takaful funds by– o allowing flexibility in the adoption of new Shariah contracts subject to adherence to certain safeguards; and o strengthening the Bank's expectations on the robustness of internal policies to manage additional takaful funds, internal controls on inter-fund cross trading activities and requirements for the separate management of savings and investment funds. • The policy will come into force on 1 July 2020.

Macroeconomic Outlook

HIGHLIGHTS

- In 2019, global growth is expected to remain moderate.
- For Malaysia, economic growth to remain within the range of 4.3% — 4.8%.
- Headline inflation is expected to average higher in 2H 2019.

Moderate global growth in 2019

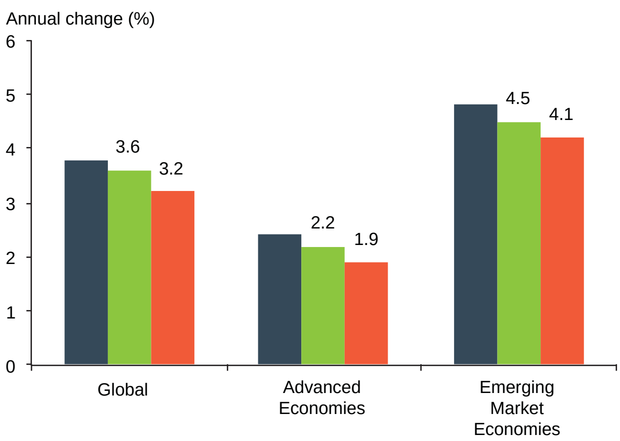
The global economy is expected to grow at a moderate pace in 2019 compared to 2018. The IMF revised downward its 2019 global growth forecast, by 0.1 ppt to 3.2%.

Despite continued labour market strength, US GDP growth is expected to slow as investment activity moderates from waning fiscal support and uncertainties from the trade conflict with PR China. Euro area growth is projected to be adversely affected by moderating domestic and external demand. Economic activity in the Asian region is also expected to be slower, given weaker external demand. Active policy stimulus will help to support growth in PR China.

Risks to the outlook remain tilted to the downside, emanating from a potential escalation of trade disputes, continued uncertainties in Brexit negotiations, and excessive financial market volatility.

Moderating global growth in 2019

Chart 26: GDP Growth



f Forecast

Source: IMF World Economic Outlook (July 2019)

Growth in the Malaysian economy to remain within 4.3% — 4.8% in 2019

Growth of the Malaysian economy continued to improve, mainly supported by the recovery from commodity-related shocks experienced last year.

While the recovery from supply shocks is expected to continue into the second half of the year, the slower global growth amid ongoing trade tensions would continue to weigh on growth. In this environment, economic growth is projected to remain supported mainly by private sector activity. Household spending will continue to be driven by stable labour market conditions, while investment activity will be supported by capacity expansion in key sectors such as manufacturing and services.

The baseline projection, therefore, remains within the range of 4.3% - 4.8%. Nonetheless, the outlook is subject to downside risks from lingering uncertainties in the global and domestic environment, worsening trade tensions and extended weakness in commodity-related sectors. Positive conclusion to ongoing trade negotiations would pose as an upside risk.

Headline inflation is expected to average higher in the second half of 2019

Headline inflation in the second half of 2019 is expected to average higher compared to the first half of 2019 following the lapse in the impact of consumption tax policy changes.

For the rest of the year, the trajectory of headline inflation will be dependent on global oil prices and policy measures including the timing of the lifting of the price ceiling on domestic retail fuel prices. Price control policies such as the enhancement of the festive season price control scheme may result in a relatively subdued food inflation.

Underlying inflation is expected to remain stable, supported by the continued expansion in economic activity and in the absence of strong demand pressures.

2
Box Article

Steering Through Volatility: Enhancing Market Efficiency to Preserve Financial Market Stability

Author: Ei-Jean Kong, CFA and Reza Baharin, CFP

HIGHLIGHTS

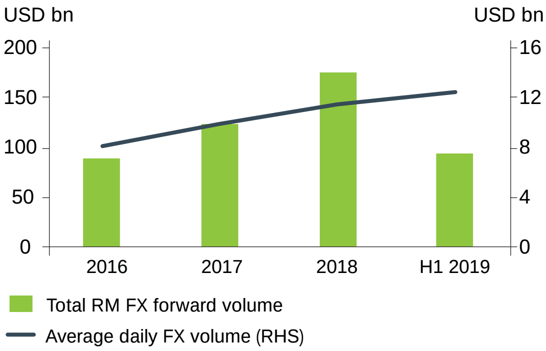
- A deep and liquid financial market is fundamental to preserve market stability.
- The Bank is committed to enhance market liquidity, risk management capabilities and transparency in order to strengthen the role of financial markets in supporting economic activity.
- Financial market development to enhance access to the onshore market reflect current priorities based on the nation's state of development.

Malaysia's deep financial markets continue to facilitate efficient allocation of resources in order to support economic growth

The deepening of Malaysia's financial markets has played an important role in the nation's economic development, helping businesses fund investments and manage risks with improved access and efficiency. This in turn has supported the continuous restructuring of the economy, from trade-oriented industrialisation in the past, to the diversification into services and innovation-based industries, and digitalisation of the economy moving forward.

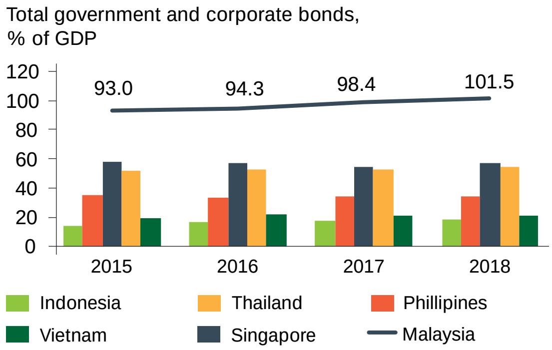
Today, Malaysia has one of the largest bond markets in the region along with an active foreign exchange market. Daily foreign exchange (FX) volumes have increased to more than USD12 billion from an average of USD8 billion daily in 2016, with the annual forward market volume doubling to a peak of USD175 billion since 2016. The capitalisation of the equity markets has grown twofold since 2009, with new markets such as ACE and LEAP[1] for young and growing firms gaining greater traction. Importantly, risks associated with greater access by Malaysian businesses to global sources of funding continue to be mitigated through prudential measures, strengthened surveillance of capital flows and strong domestic institutional investors.

Malaysia's onshore FX market continues to grow in support of economic growth



Source: Bank Negara Malaysia

Malaysia's bond market is the largest in Southeast Asia



Source: Asian Bonds Online

[1] LEAP, or Leading Entrepreneur Accelerator Platform was established by Bursa Malaysia in 2017 as a complementary marketplace for small and medium enterprises.

Market development initiatives aim to further enhance market access and liquidity, while containing risks to stability

Recognising the importance of well-developed financial markets to economic growth and performance, measures continue to be taken to further enhance access, liquidity and efficiency of Malaysia's financial markets. A well-defined legal framework, robust market infrastructure and sound macroeconomic fundamentals remain key to Malaysia's attractiveness to investors. Current priorities of the Bank to further enhance market accessibility and liquidity include:

Increase repo market liquidity and flexibility	• Bank Negara Malaysia will further increase the availability of off-the-run bonds to be borrowed via repo for market-making activities. • The repo guidelines will be reviewed accordingly to extend the repo tenor beyond one year, among other enhancements.
Enhancement to the MGS futures market	• To further develop an effective hedging platform for investors, Bank Negara Malaysia, in collaboration with Securities Commission Malaysia, Bursa Malaysia and key market players will further enhance the delivery mechanism for MGS futures settlements.
Expand participation in dynamic hedging programme	• Trust banks and global custodians can now apply under the dynamic hedging programme (introduced in December 2016) to undertake dynamic hedging on behalf of their clients.
Greater dynamic hedging flexibility to manage FX risks	• Registered institutional investors can enter into forward contracts to buy ringgit beyond 25% of underlying assets upon approval by Bank Negara Malaysia. • Applications can be submitted to *investorregister@bnm.gov.my*
Simplified FX trade and documentation process	• Standard documentation guides for FX transactions have been developed by the industry to ease investor's accessibility to the onshore FX market.
Improve ringgit liquidity beyond local trading hours	• Bank Negara Malaysia will continue to facilitate the market-making capacity of AOOs to ensure sufficient access to two-way ringgit prices.

As an open economy with an internationally integrated financial system, Malaysia is exposed to contagion risks that can arise from external developments, including those associated with rising geopolitical tensions and unexpected economic uncertainty. The heightened and prolonged financial market volatility can undermine the effectiveness of monetary policy and amplify risks in the economy. Against this backdrop, the Bank remains committed to improving the breadth and depth of onshore financial markets while preserving orderly market conditions. Two key developments have supported the ability of the market to meet the diverse needs of firms and investors for access to financial products with differing risk, return and maturity profiles:

(i) Appointed Overseas Office as a gateway to invest in Malaysia

While ringgit exchange rates are market determined, the spillover impact from speculative and unregulated offshore FX markets can severely destabilise the real economy. Recognising the need to maintain accessibility while mitigating these risks, Malaysia introduced the Appointed Overseas Office[2]

[2] A licensed onshore bank is allowed to appoint its overseas branches to facilitate the settlement of ringgit assets for non-resident investors with firm underlying investment commitment. The AOO framework is intended to provide additional flexibilities on ringgit transactions where a non-resident financial institution appointed by a licensed onshore bank can undertake back-to-back transactions to facilitate settlement of trade and ringgit assets between non-resident with a resident.

(AOO) framework in 2007 to maintain connectivity with the global network of investors and bridge geographical and timezone differences.

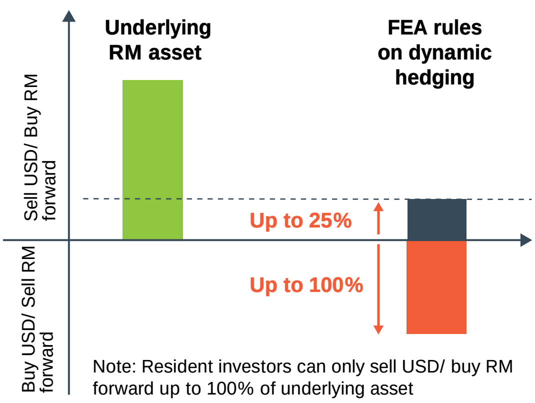
The AOOs function as a gateway for international entities such as corporates, financial institutions and investors to conduct trade and investment activities, thereby maintaining efficient access by foreign investors to Malaysia. The AOO framework works to harness greater synergies between onshore and offshore banking institutions to respond to the needs and preferences of investors and businesses. To meet demand from market participants, the AOO framework was expanded in 2016 to include additional transaction capabilities such as the facilitation of foreign exchange hedging for own account and on behalf of clients for current and financial accounts, opening of ringgit accounts and extension of ringgit trade financing facilities.

The AOO network has continued to gain prominence, with more than 150 AOOs from 21 banking groups operating in 36 countries to-date. The Bank is currently looking to further enhance and facilitate AOOs' ringgit market-making capacity beyond local trading hours through increased flexibilities for transactions among trading parties.

(ii) Dynamic hedging programme aids risk management

In times of market stress, one-sided capital flows arising from herd behaviour by investors homogeneously managing risks can be highly disruptive. To facilitate two-way liquidity for currency hedging in the onshore market, the dynamic hedging programme introduced in 2016 provides market access for institutional investors to actively manage FX exposures of their invested assets in a transparent and orderly manner. Under the programme, flexibilities are provided for investors to undertake forward hedging upon registration[3] with the Bank without the need for documentation.

Illustration of dynamic hedging programme



Source: Bank Negara Malaysia

The dynamic hedging programme is supported by onshore banks and the AOO network, thus enabling access by both domestic and foreign investors to a broader suite of risk management products and avenues. As at end of the second quarter of 2019, 89 investors (72 non-residents; 17 residents) were registered under the programme with RM128 billion of assets under management. In May 2019, the programme was further expanded to include trust banks and global custodians that undertake dynamic hedging on behalf of their clients.

Continuous expansion in market data further supports informed investment decisions

Since 2018, resident and non-resident investors conduct transactions and settlements through segregated securities accounts in the Real-time Electronic Transfer of Funds and Securities System (RENTAS). The segregation of securities accounts enables all securities transactions to be settled in RENTAS in a transparent manner, allowing for better information flows on the composition of investors in Malaysia. Information such as investor categories aligned with international standards and flows in

[3] A non-resident institutional investor registered with the Bank is allowed to: (i) Enter into forward contracts to sell ringgit up to 100% of invested underlying ringgit asset; (ii) Enter into forward contracts to buy additional ringgit up to 25% of invested underlying ringgit asset, or higher with the approval of BNM; or (iii) Unwind the forward contracts described in (i) and (ii) above.

the government bond market for both non-resident and resident investors have been made available on the Bond Info Hub website[4] and the Quarterly Bulletin. The operationalisation of the segregated securities account leverages on the use of the global legal entity identifier (LEI) system, thereby also facilitating Malaysia's compliance with global standards to improve the identification and management of financial risks within and across counterparties and jurisdictions.

Financial market development initiatives are part of the broader economic strategy to ensure the sustainability of Malaysia's economic development

Amid a global landscape characterised by elevated volatility and heightened uncertainties, Malaysia's flexible exchange rate policy combined with the increasing sophistication of its financial market serve to buffer the impact of external shocks and mitigate risks from excessive volatility to the real economy. The Bank continues to take a forward-looking approach in strengthening the resilience of the onshore financial market, while continuing to improve market access and efficiency for both domestic and foreign investors. A flexible exchange rate will continue to be the key source of strength for Malaysia in managing capital flow volatility, with sound market infrastructure and accommodative policy initiatives serving as pillars to secure an attractive financial marketplace for trade and investments in Malaysia.

[4] http://bondinfo.bnm.gov.my/portal/server.pt

Annex

Table 1

GDP by Expenditure Components (at constant 2015 prices)

	Share 2018 (%)	2018		2019		
		2Q	1H	1Q	2Q	1H
		Annual growth (%)				
Aggregate Domestic Demand (excluding stocks)	94.1	5.5	4.8	4.4	4.6	4.5
Private sector	74.2	7.3	6.3	5.9	6.2	6.1
Consumption	*57.0*	*7.9*	*7.2*	*7.6*	*7.8*	*7.7*
Investment	*17.3*	*5.5*	*3.4*	*0.4*	*1.8*	*1.2*
Public sector	19.8	-1.6	-0.9	-1.4	-2.8	-2.1
Consumption	*12.5*	*3.1*	*1.8*	*6.3*	*0.3*	*3.2*
Investment	*7.4*	*-9.9*	*-5.4*	*-13.2*	*-9.0*	*-11.3*
Net Exports	7.0	-6.0	22.7	10.9	22.9	16.0
Exports of Goods and Services	*67.6*	*2.6*	*2.5*	*0.1*	*0.1*	*0.1*
Imports of Goods and Services	*60.6*	*3.6*	*0.6*	*-1.4*	*-2.1*	*-1.8*
GDP	**100.0**	**4.5**	**4.9**	**4.5**	**4.9**	**4.7**
GDP (q-o-q growth, seasonally adjusted)	**-**	**0.6**	**-**	**1.1**	**1.0**	**-**

Source: Department of Statistics, Malaysia

Table 2

GDP by Economic Activity (at constant 2015 prices)

Annual growth (%)	Share 2018 (%)	2018		2019		
		2Q	1H	1Q	2Q	1H
Services	56.7	6.5	6.5	6.4	6.1	6.3
Manufacturing	22.4	4.9	5.0	4.2	4.3	4.2
Mining	7.6	-3.4	-2.0	-2.1	2.9	0.3
Agriculture	7.3	-1.7	0.7	5.6	4.2	4.9
Construction	4.9	4.8	4.9	0.3	0.5	0.4
Real GDP	**100.0[1]**	**4.5**	**4.9**	**4.5**	**4.9**	**4.7**

[1] Numbers do not add up due to rounding and exclusion of import duties component

Source: Department of Statistics, Malaysia

Table 3

Balance of Payments[1]

	2018		2019		
	2Q	1H	1Q	2Q	1H
	RM billion				
Current Account	2.8	16.4	16.4	14.3	30.6
(% of GNI)	0.8	2.4	4.7	3.9	4.3
Goods	25.9	60.1	33.8	28.1	62.0
Services	-5.6	-11.1	-1.8	-3.4	-5.3
Primary income	-12.8	-23.1	-10.1	-5.5	-15.7
Secondary income	-4.8	-9.4	-5.5	-4.9	-10.4
Financial Account	**10.5**	**22.4**	**-13.8**	**-18.6**	**-32.4**
Direct investment	-0.5	8.7	16.3	-8.2	8.0
Assets	*-4.5*	*-7.7*	*-6.9*	*-11.5*	*-18.4*
Liabilities	*4.0*	*16.4*	*23.1*	*3.2*	*26.4*
Portfolio investment	-37.9	-39.4	2.1	-10.2	-8.1
Assets	*-0.7*	*-10.3*	*-11.4*	*-5.0*	*-16.5*
Liabilities	*-37.2*	*-29.1*	*13.5*	*-5.1*	*8.4*
Financial derivatives	0.8	1.6	-0.2	-0.5	-0.7
Other investment	48.2	51.5	-31.9	0.3	-31.6
Net errors & omissions[2]	-14.2	-21.5	2.9	2.9	5.9
Overall Balance	**-0.9**	**17.3**	**5.5**	**-1.4**	**4.1**

Assets: (-) denotes outflows due to the acquisition of assets abroad by residents
Liabilities: (+) denotes inflows due to the incurrence of foreign liabilities
[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] As at 1Q 2018, quarterly net E&O excludes reserves revaluation changes. This practice is backdated up to 1Q 2010.

Note: Numbers may not add up due to rounding
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 4

Outstanding External Debt

	2018	2019	
	end-June	end-Mar	end-June
	RM billion		
Total External Debt	**927.3**	**903.7**	**931.1**
USD billion equivalent	*226.9*	*219.3*	*222.6*
By instrument			
Bonds and notes[1]	149.5	158.1	162.2
Interbank borrowings[1]	223.3	175.7	199.1
Intercompany loans[1]	132.0	140.9	147.7
Loans[1]	71.9	72.1	71.5
NR holdings of domestic debt securities	185.1	186.9	181.9
NR deposits	85.6	93.6	91.3
Others[2]	79.9	76.3	77.4
Maturity profile			
Medium- and long-term	523.1	535.2	542.7
Short-term	404.2	368.5	388.4
Currency denomination			
Ringgit	293.1	295.7	295.0
Foreign	634.2	607.9	636.1
Total debt/GDP (%)	64.1	59.5	61.3
Short-term debt/Total debt (%)	43.6	40.8	41.7
Reserves/Short-term debt (times)	1.0	1.1	1.1[3]

[1] These debt instruments constitute the offshore borrowings.
[2] Comprise trade credits, IMF allocation of SDRs and miscellaneous.
[3] Based on international reserves as at 31 July 2019.
Note: NR refers to non-residents
Figures may not add up due to rounding.

Source: Ministry of Finance and Bank Negara Malaysia

Table 5

Financing of the Private Sector through the Banking System, DFIs and Capital Market

	2018		2019			2018		2019		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
	Change during the period (RM billion)					Annual growth (%)				
Net total financing	**64.6**	**101.3**	**23.0**	**45.3**	**68.3**	**7.8**	**7.8**	**6.5**	**5.6**	**5.6**
Outstanding loans[1,2]	53.4	71.7	8.8	12.4	21.1	6.4	6.4	6.4	3.9	3.9
Of which:										
Business enterprises	13.0	21.6	1.3	2.2	3.6	3.2	3.2	4.4	2.7	2.7
SMEs[3]	*3.8*	*5.9*	*-1.6*	*-0.9*	*-2.5*	*5.3*	*5.3*	*0.2*	*-1.2*	*-1.2*
Non-SMEs	*9.2*	*15.7*	*2.9*	*3.1*	*6.0*	*1.2*	*1.2*	*8.7*	*6.5*	*6.5*
Households	37.1	48.7	10.3	11.2	21.5	7.9	7.9	7.5	4.8	4.8
Outstanding corporate bonds[4]	11.3	29.6	14.2	32.9	47.1	12.4	12.4	7.1	10.6	10.6

[1] Loans from the banking system and development financial institutions (DFIs). Effective June 2019, data for April 2018 onwards were revised to include data from a newly licensed commercial bank (MBSB Bank Berhad). It was previously classified as a non-bank financial institution. The inclusion of the outstanding loan figures resulted in higher financing annual growth rates for a transitory period from 2Q 2018 to 1Q 2019 due to the lower base in preceding years
[2] Includes loans sold to Cagamas
[3] Partly reflects an ongoing reclassification exercise of SMEs to Non-SMEs by financial institutions
[4] Excludes issuances by Cagamas and non-residents
Note: Numbers may not add up due to rounding

Source: Bank Negara Malaysia

Table 6

Loan Indicators

	2018		2019			2018		2019		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
	During the period (RM billion)					Annual growth (%)				
Total										
Loan applications[1]	223.1	432.2	194.4	228.1	422.5	8.9	7.4	-7.1	2.2	-2.3
Loan approvals[1]	100.8	191.1	90.8	109.6	200.4	9.9	6.7	0.5	8.7	4.9
Loan disbursements[2]	302.5	603.0	313.9	311.3	625.1	9.1	5.3	4.4	2.9	3.7
Loan repayments[2]	301.3	597.6	319.3	313.8	633.1	8.7	4.9	7.8	4.1	5.9
Of which:										
Business enterprises[3]										
Loan applications	101.8	196.0	84.4	104.1	188.4	17.5	13.3	-10.4	2.2	-3.9
Loan approvals	47.9	87.6	41.1	52.2	93.3	17.1	7.0	3.4	9.2	6.6
Loan disbursements	216.7	426.9	221.4	219.8	441.2	10.1	4.0	5.4	1.4	3.3
Loan repayments	216.9	422.9	226.6	222.8	449.4	9.1	3.3	10.0	2.7	6.3
SMEs[4]										
Loan applications	49.0	93.0	43.9	48.6	92.5	16.3	11.7	-0.2	-0.6	-0.4
Loan approvals	16.6	31.7	15.4	16.5	32.0	9.5	9.0	2.2	-0.6	0.7
Loan disbursements	73.6	149.5	75.7	76.3	152.1	6.3	6.0	-0.2	3.7	1.7
Loan repayments	74.2	148.9	76.8	76.5	153.3	8.3	7.6	2.8	3.1	3.0
Non-SMEs[3]										
Loan applications	52.9	103.1	40.5	55.4	95.9	18.7	14.7	-19.4	4.8	-7.0
Loan approvals	31.2	55.8	25.6	35.7	61.3	21.5	5.9	4.2	14.3	9.9
Loan disbursements	143.1	277.4	145.7	143.4	289.1	12.2	2.9	8.5	0.2	4.2
Loan repayments	142.8	274.0	149.7	146.4	296.1	9.5	1.1	14.1	2.5	8.1
Households										
Loan applications	121.3	236.2	110.0	124.0	234.0	2.6	3.0	-4.3	2.3	-0.9
Loan approvals	53.0	103.6	49.8	57.4	107.1	4.1	6.4	-1.7	8.3	3.4
Loan disbursements	85.8	176.1	92.4	91.5	183.9	6.7	8.7	2.3	6.7	4.4
Loan repayments	84.4	174.7	92.7	90.9	183.7	7.8	9.0	2.8	7.7	5.2

[1] Loan applications and approvals for all segments include only banking system loans
[2] Loan disbursements and repayments for all segments include the banking system and development financial institutions (DFIs)
[3] Includes domestic non-bank financial institutions, domestic financial institutions, government, domestic other entities and foreign entities
[4] Partly reflects an ongoing reclassification exercise of SMEs to Non-SMEs by financial institutions
Note: Numbers may not add up due to rounding
Effective June 2019, data for April 2018 onwards were revised to include data from a newly licensed commercial bank (MBSB Bank Berhad). It was previously classified as a non-bank financial institution

Source: Bank Negara Malaysia

Table 7

Banking System Profitability Indicators

	2018				2019	
	1Q	2Q	3Q	4Q	1Q	2Q*p*
Return on equity (%)	12.4	13.3	12.8	12.7	11.5	13.0
Return on assets (%)	1.4	1.5	1.4	1.4	1.3	1.5
	RM million					
Net interest income	12,045	12,287	12,483	12,782	12,438	12,009
Add: Fee-based income	2,606	2,517	2,476	2,499	2,548	2,619
Less: Operating cost[1]	8,101	7,919	7,820	8,326	8,385	8,421
Gross operating profit	6,550	6,885	7,138	6,955	6,601	6,206
Less: Impairment[2] and other provisions	682	466	692	737	159	274
Gross operating profit after provision	5,868	6,418	6,446	6,218	6,442	5,933
Add: Other income	3,048	4,071	2,240	3,368	2,548	5,532
Pre-tax profit	**8,916**	**10,489**	**8,686**	**9,586**	**8,990**	**11,465**
	Annual growth (%)					
Return on equity *(percentage points)*	0.6	0.6	-0.1	-0.4	-0.8	-0.3
Return on assets *(percentage points)*	0.1	0.1	0.0	0.0	-0.1	0.0
Net interest income	6.7	5.7	6.3	9.6	3.3	-2.3
Add: Fee-based income	4.3	-0.4	-3.1	-17.7	-2.2	4.0
Less: Operating cost[1]	7.1	3.2	1.8	1.8	3.5	6.3
Gross operating profit	5.2	6.3	7.9	6.7	0.8	-9.9
Less: Impairment[2] and other provisions	126.9	-43.3	31.1	77.7	-76.7	-41.3
Gross operating profit after provision	-0.9	13.5	5.9	1.9	9.8	-7.6
Add: Other income	52.0	13.8	-26.3	-12.3	-16.4	35.9
Pre-tax profit	**12.4**	**13.6**	**-4.9**	**-3.6**	**0.8**	**9.3**

[1] Refers to staff cost and overheads
[2] Refers to 12 Months Expected Credit Losses (ECL), Lifetime ECL Not Credit Impaired and Lifetime ECL Credit Impaired based on the Malaysian Financial Reporting Standard 9 (MFRS 9)
p Preliminary

Source: Bank Negara Malaysia

Table 8

Insurance and Takaful Sector Profitability Indicators

	2018				2019	
	1Q	2Q	3Q	4Q	1Q	2Q*p*
	RM million					
Life Insurance & Family Takaful						
Excess income over outgo	4,095	-1,222	7,610	-1,011	8,561	7,949
General Insurance & General Takaful						
Operating profit	561	759	1,207	476	716	678
Claims ratio (%)	57	59	53	57	57	62
	Annual growth (%)					
Life Insurance & Family Takaful						
Excess income over outgo	-33.1	-127.7	116.3	-120.5	109.0	750.6
General Insurance & General Takaful						
Operating profit	13.4	-0.4	84.7	-39.2	27.5	-10.7
Claims ratio (percentage points)	-6.0	3.7	-7.9	2.3	-0.1	3.0

p Preliminary
Source: Bank Negara Malaysia

Table 9

Federal Government Finance[p]

	2018		2019		
	2Q	1H	1Q	2Q	1H
	RM billion				
Revenue	52.5	106.8	63.7	62.1	125.8
% annual growth	*4.0*	*10.0*	*17.2*	*18.3*	*17.8*
Operating expenditure	62.9	117.8	59.5	65.3	124.8
% annual growth	*17.5*	*6.0*	*8.3*	*3.8*	*5.9*
Current account	**-10.4**	**-11.0**	**4.2**	**-3.2**	**1.0**
% of GDP	***-3.0***	***-1.6***	***1.2***	***-0.9***	***0.1***
Net development expenditure	9.1	19.8	11.3	12.1	23.4
% annual growth	*-14.8*	*-0.7*	*5.5*	*33.2*	*18.2*
Overall balance	**-19.5**	**-30.8**	**-7.1**	**-15.3**	**-22.4**
% of GDP	***-5.5***	***-4.4***	***-2.0***	***-4.1***	***-3.1***
Memo:					
Total net expenditure	72.0	137.6	70.8	77.4	148.2
% annual growth	*12.1*	*5.0*	*7.8*	*7.5*	*7.7*
Total Federal Government debt (as at end-period)	725.2	725.5	776.8	799.1	799.1
% of GDP	*50.1*	*50.1*	*51.2*	*52.7*	*52.7*
Domestic Debt	541.3	541.3	581.6	609.1	609.1
% of GDP	*37.4*	*37.4*	*38.3*	*40.1*	*40.1*
External Debt	184.0	184.0	195.2	190.0	190.0
% of GDP	*12.7*	*12.7*	*12.9*	*12.5*	*12.5*
Non-resident holdings of RM-denominated Federal Government debt	*167.5*	*167.5*	*171.5*	*165.6*	*165.6*
% of GDP	*11.6*	*11.6*	*11.3*	*10.9*	*10.9*
Offshore borrowing	*16.5*	*16.5*	*23.7*	*24.4*	*24.4*
% of GDP	*1.1*	*1.1*	*1.6*	*1.6*	*1.6*

[p] Preliminary
Note: Numbers may not add up due to rounding

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia