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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.

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.

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

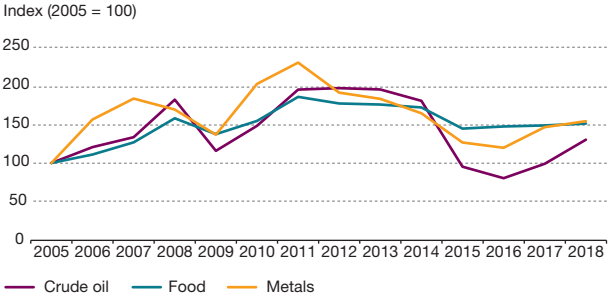
The extension of OPEC output cuts, re-imposition of US sanctions on Iran and lower-than-expected Iranian oil exports lifted the oil price index for most of 2018. Towards the end of the year, however, Brent crude oil prices declined from a peak of USD76 per barrel to USD67 per barrel due mainly to a rebound 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.

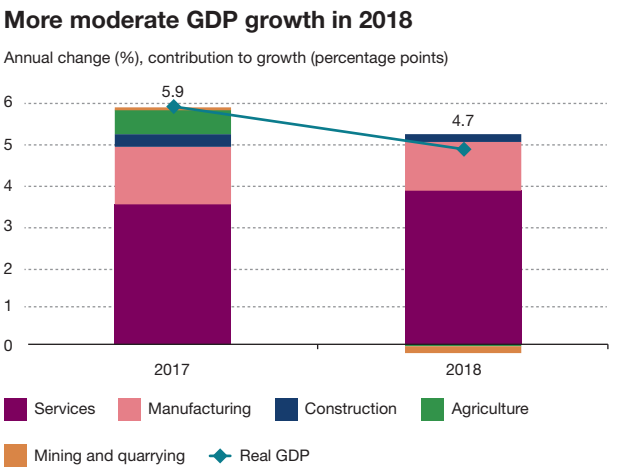
THE MALAYSIAN ECONOMY

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



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.

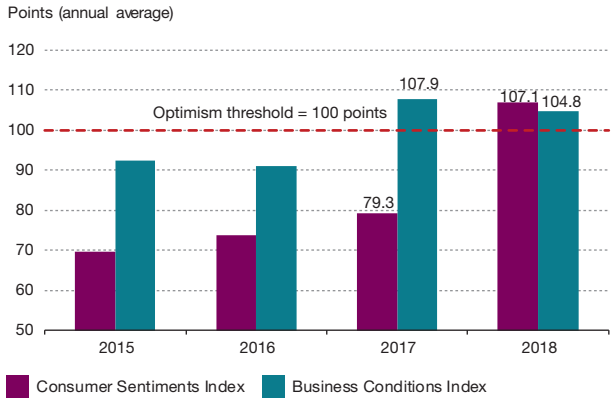
On the domestic front, supply disruptions adversely impacted activity in the mining and agriculture sectors, as well as commodity exports. In particular, unplanned maintenance shutdown and pipeline repairs resulted in declining natural gas output, while production constraints and adverse weather conditions 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

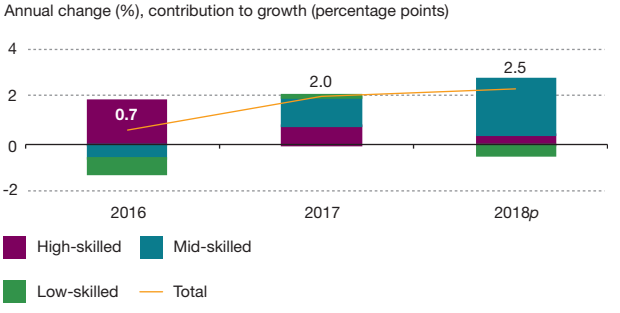
Source: Department of Statistics, Malaysia and Ministry of Human Resources, Malaysia

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...



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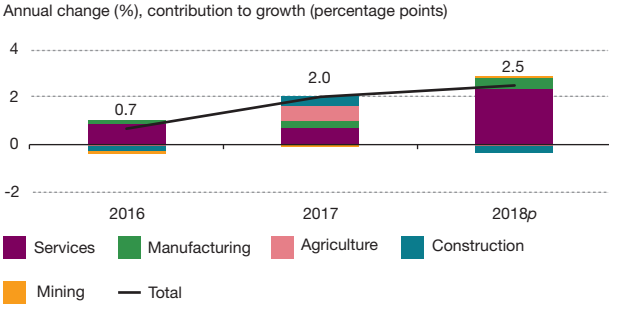
Source: Bank Negara Malaysia estimates using data published by the Department of Statistics, Malaysia

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

...as well as the services and manufacturing sectors



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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.

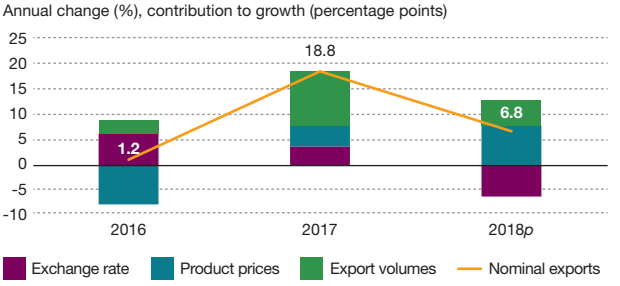
Following exceptionally robust exports performance in 2017 (18.8%, highest since 2004), gross exports registered a more moderate growth of 6.8% in 2018 (1980 - 2017: 10.4%). Exports performance was driven by manufactured exports (9.1%; 2017: 18.6%), with continued demand from major trade partners, including 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



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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.

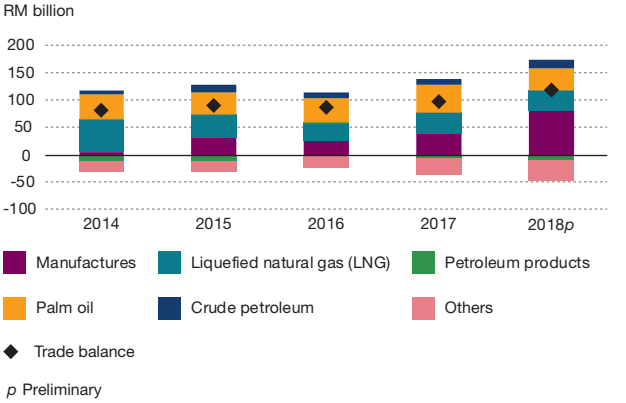
Consequently, Malaysia's trade surplus widened to RM120.5 billion (2017: RM98.5 billion), supported by higher surplus from manufactured exports, particularly for E&E and optical and scientific equipment (Chart 1.5). These products offset the deficits in other non-E&E manufactured goods such as machinery,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



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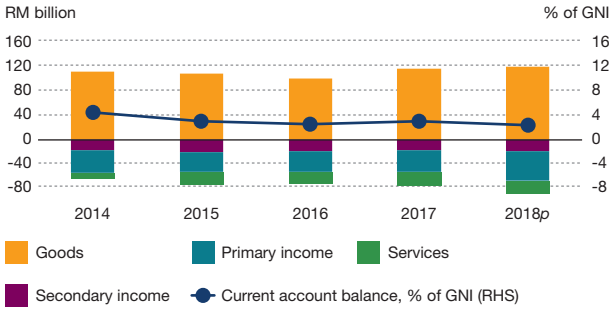
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.6: Current Account Balance

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



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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).

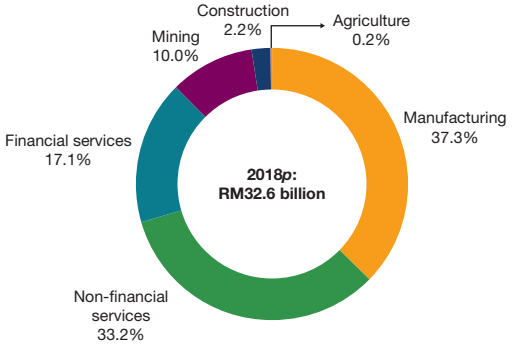
In the income account, the primary income deficit widened to RM49.4 billion (2017: -RM36.4 billion), due to the larger net payments in portfolio and direct investment income, as well as a lower net receipts from other investments. In particular, the widening deficit in the direct investment income account 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

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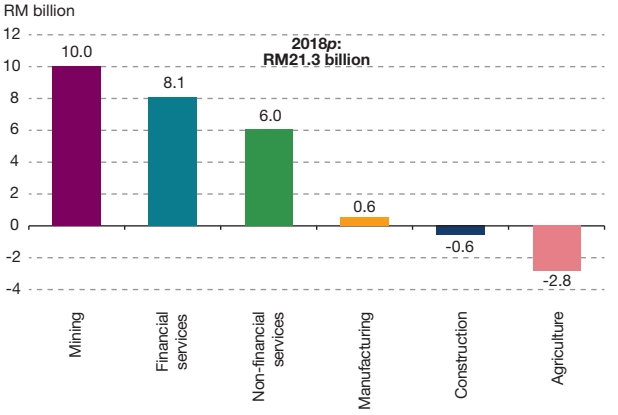
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

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.

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Source: Department of Statistics, Malaysia and Bank Negara Malaysia

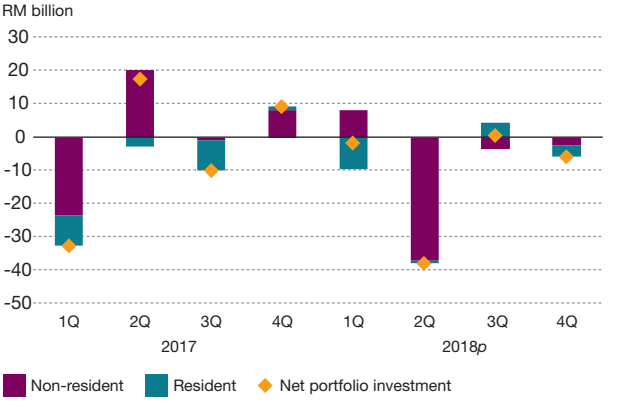
retail and property sectors abroad. By sector, DIA was mainly channelled into the mining sectors, followed by the financial services sub-sector (Chart 1.8). Asian countries like Singapore (30.2% of total DIA flows for the year) and Indonesia (12.8%) remained major beneficiaries of DIA.

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



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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

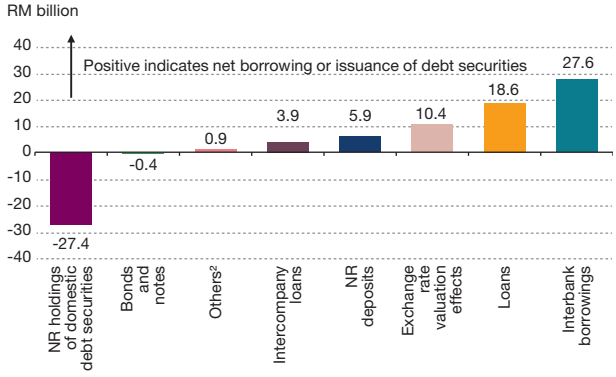
The international reserves of Bank Negara Malaysia amounted to USD101.4 billion as at end-2018 compared to USD102.4 billion as at end-2017. The lower international reserves level was largely attributable to foreign exchange revaluation changes. Despite the diversified foreign currency reserves, the US 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



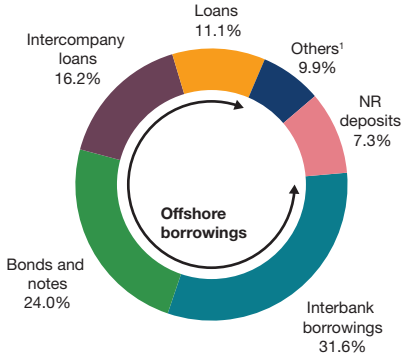
[1] Changes in individual debt instruments exclude exchange rate valuation effects
[2] Comprises trade credits, IMF allocation of SDRs and other debt liabilities

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

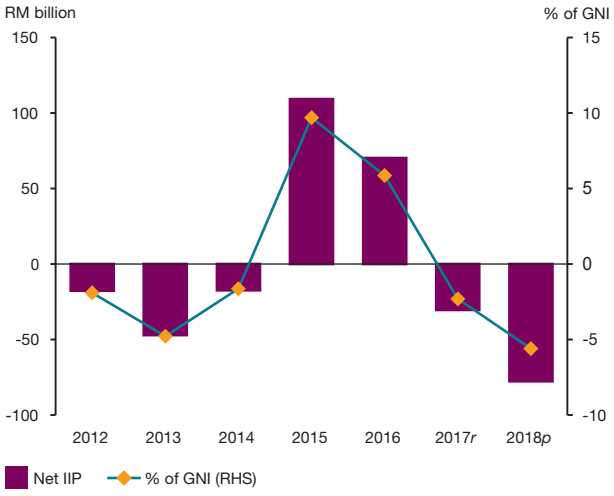
Note: Figures may not necessarily add up due to rounding

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



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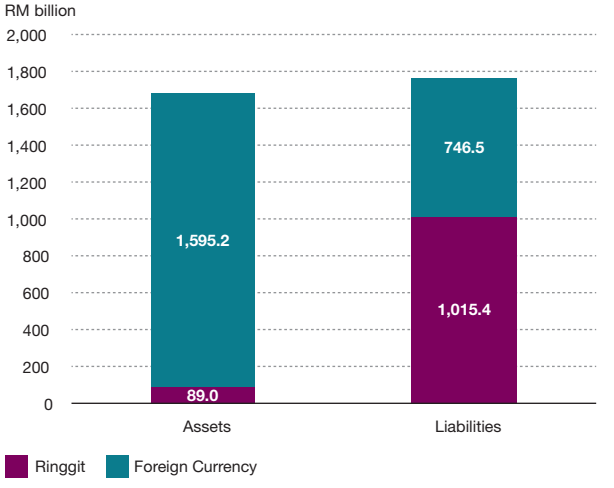
Source: Department of Statistics, Malaysia

Chart 1.14: International Investment Position (IIP) by Currency

Foreign currency external assets exceeded foreign currency external liabilities



Source: Bank Negara Malaysia

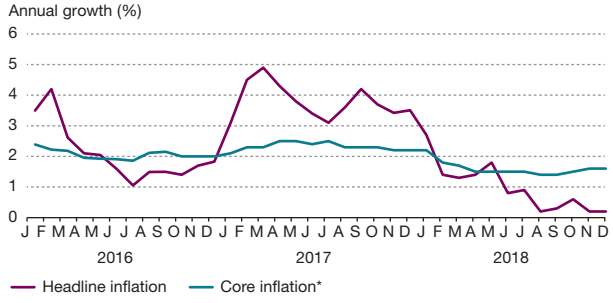
INFLATION DEVELOPMENTS

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.

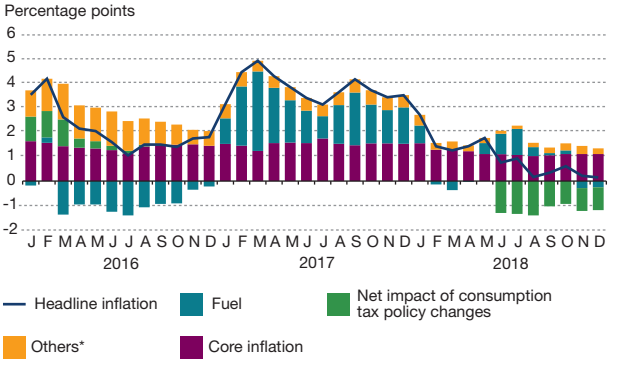
[2] Core inflation excludes price-volatile and price-administered items, whose price movements are not likely to be related to changes in demand conditions. Core inflation also excludes the estimated direct impact of consumption tax policy changes.

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



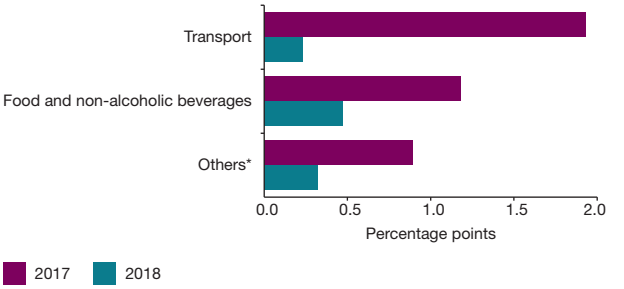
* Others include price-volatile items and other price-administered items

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.

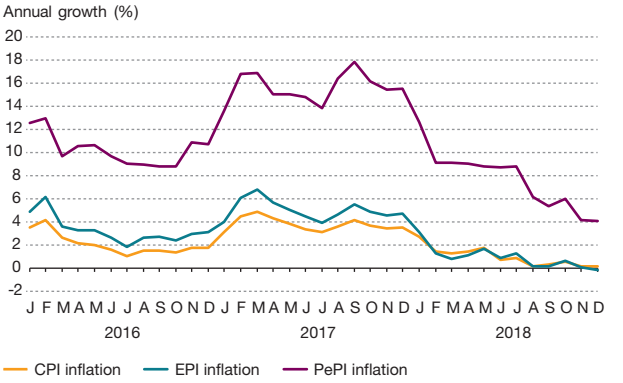
The **inflation rate**, as measured by the change in the Consumer Price Index (CPI), measures the price increase for a basket of items that represents the average pattern of purchases among households in Malaysia. The CPI assumes homogenous spending patterns across households and holds the quantity and 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).

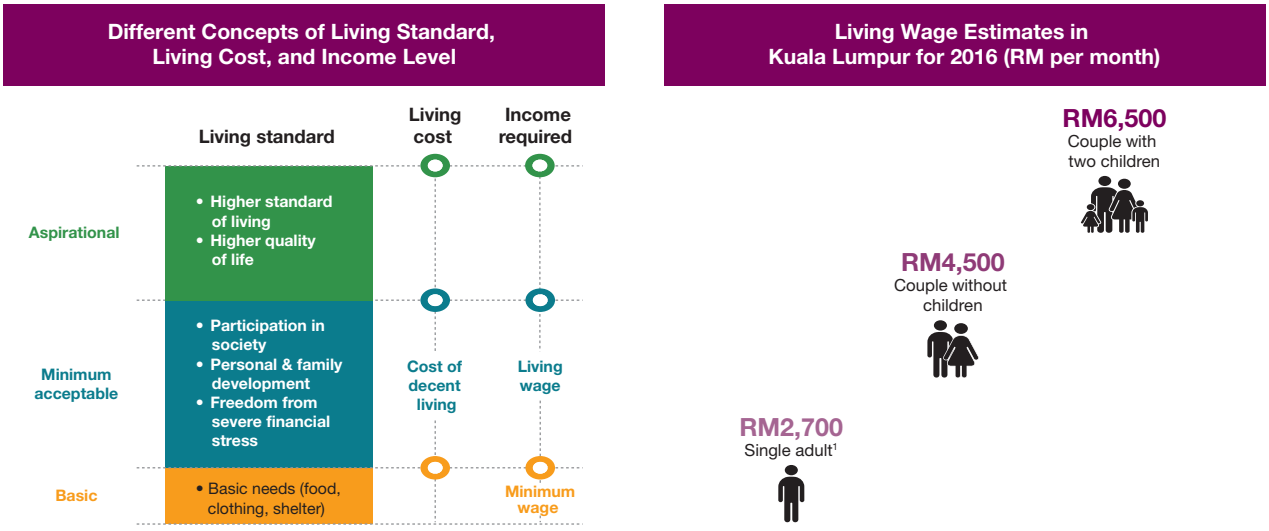
Over the medium term, the cost of living in Malaysia will continue to be a factor in impacting households' well-being and sentiments, especially since wages remain low. Approximately half of Malaysian workers, or 4.4 million people, earn RM2,160 or less a month.[7] A moderate pace of aggregate price 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



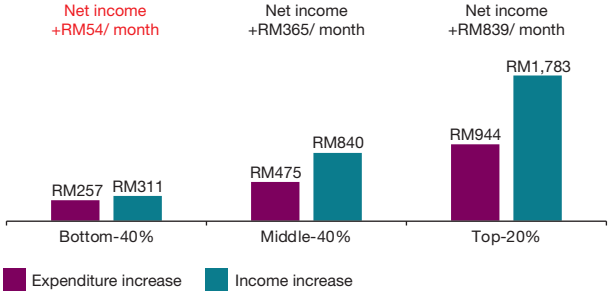
Note: Bank Negara Malaysia uses the term 'living wage' to mean income from all sources besides wages, such as non-wage work benefits and social assistance

[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.

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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.

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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

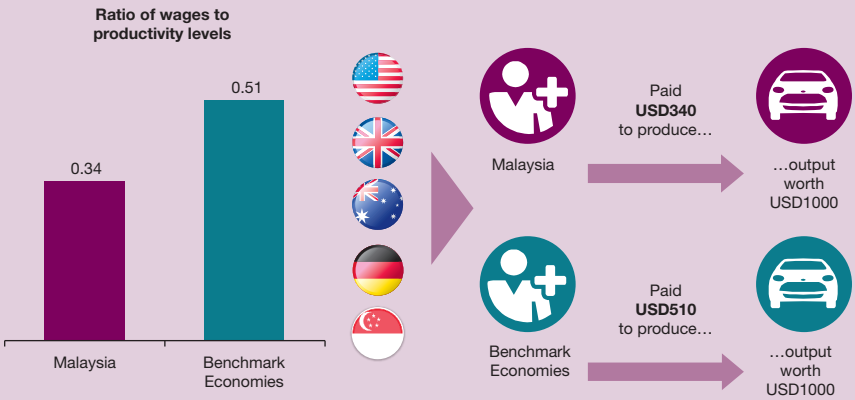
Note: Productivity is computed by taking a ratio of nominal GDP to the total number of employed persons in the economy

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)

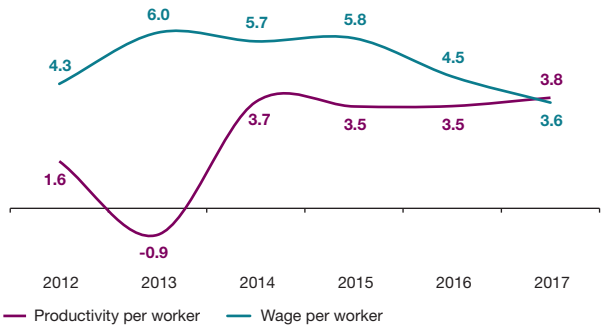
Agents	Perspective of Wages	Wage Deflator	Rationale
Employer	Cost of producing goods and services	Output Deflator	Change in the market value of goods and services sold by the firms
Employee	Means to purchase goods and services	Consumer Price Index	Change in prices of purchasing a "basket of goods and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

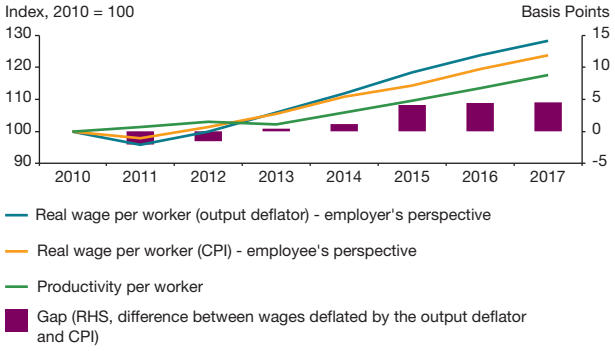


Source: Bank Negara Malaysia estimates using data from Labour Productivity Statistics and Salaries and Wages Survey Report published by Department of Statistics, Malaysia

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.

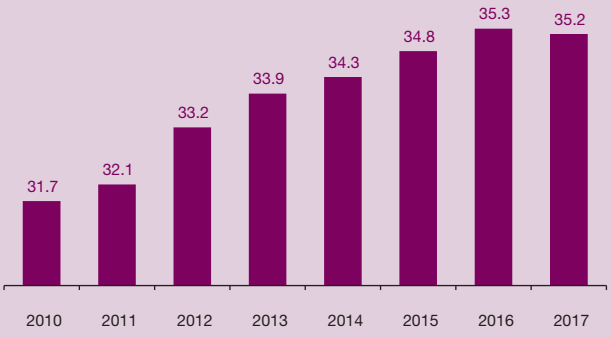
C. Benchmarking Incomes against Equity: Workers vs. Capital Owners

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

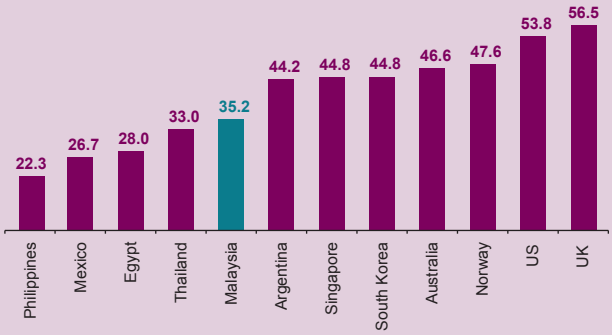
Malaysian labour share of income has risen over the years



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

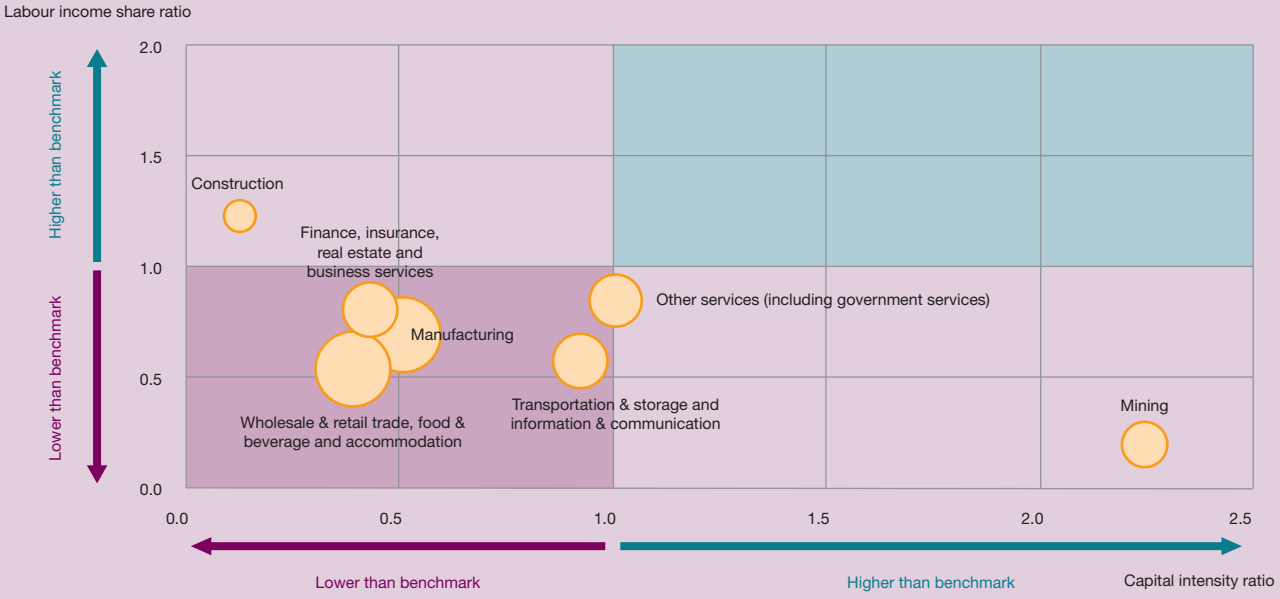
Despite being less capital intensive (more labour intensive), Malaysian labour share of income is lower

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?

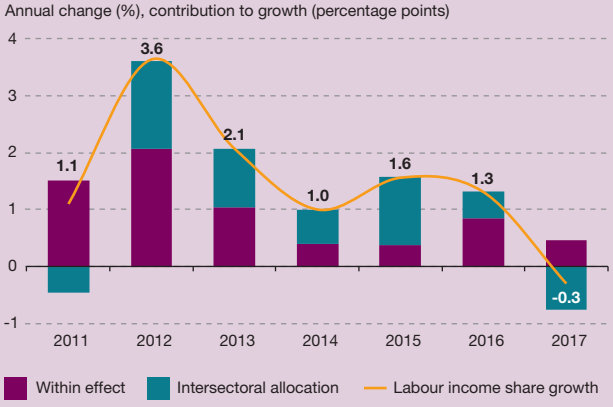
Overall, Malaysia's labour income share has been on an upward trend. While this is a positive step in ensuring better income distribution, it masks some unsettling developments. A shift-share analysis[14] reveals that 36% of the improvements in Malaysia's labour income share between 2010 and 2017 was 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)

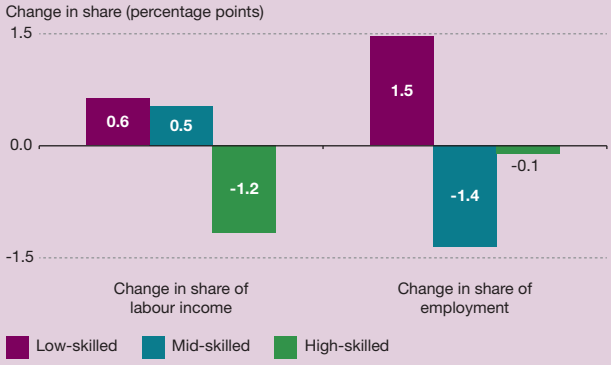
Movement of workers into more labour-intensive industries drove growth in labour income share



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

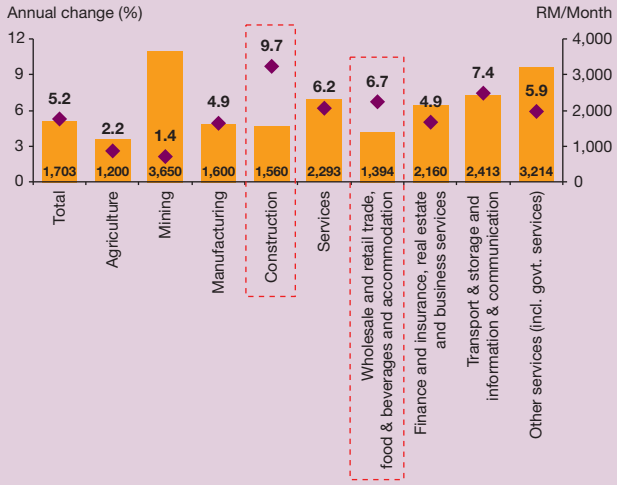


Source: Bank Negara Malaysia estimates using data from Gross Domestic Product Income Approach, Labour Force Survey Report and Salaries and Wages Survey Report published by Department of Statistics, Malaysia

[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).

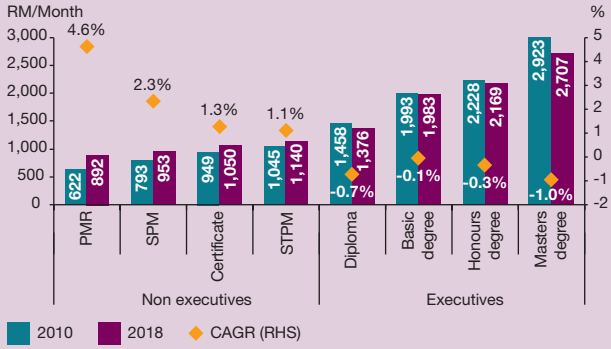
Chart 13: Labour Force with Tertiary Education (2010 – 2017)

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

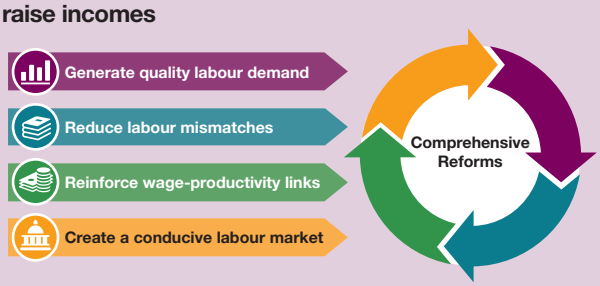
Malaysia has made significant progress in transforming the economy from that of a low-income agrarian country to an upper-middle-income country. Significant reduction in poverty was achieved while big strides were made in improving living standards across the population.

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



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].

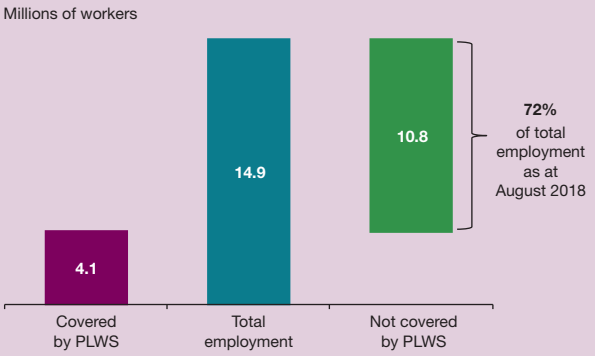
Beyond PLWS, the link between productivity and wages could be enhanced through closer collaboration between the National Productivity Council (NPC)[26] and the National Wage Consultative Council, with the mandate to strengthen the link between productivity and wages in Malaysia, in both level and growth 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.

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[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.

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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.

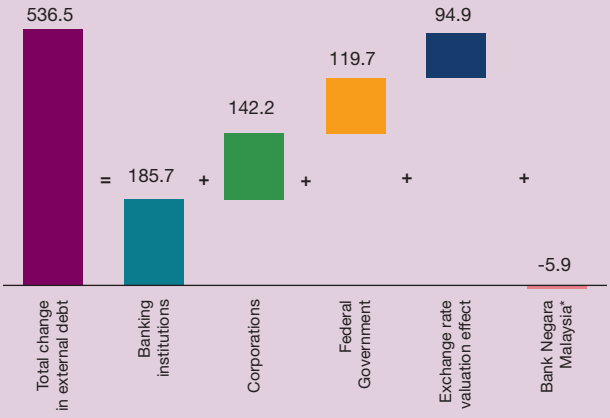
Malaysia has also experienced an increase in external debt. Malaysia's external debt is higher relative to the EMEs[1] median peer countries. This article examines the underlying drivers of Malaysia's external debt and mitigating factors that contain the risks emanating from external shocks. A medium-term 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

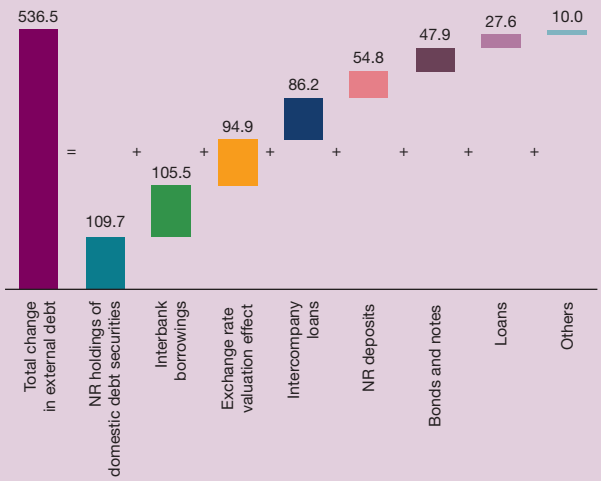


* The decline reflects largely liquidation of NR holdings of Bank Negara Monetary Notes

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

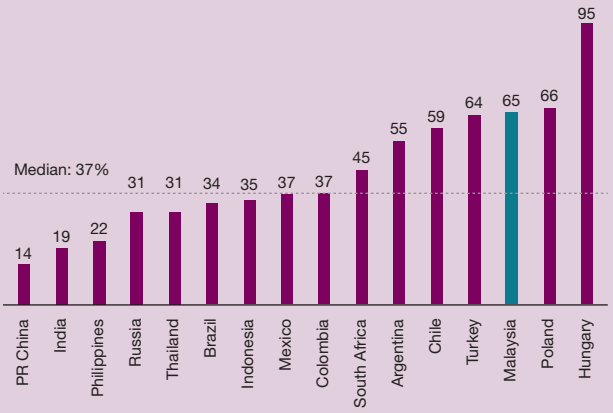
[1] Median of peer countries of Malaysia, i.e. Argentina, Brazil, Chile, Colombia, Hungary, India, Indonesia, Mexico, Philippines, Poland, PR China, Russia, South Africa, Thailand and Turkey. This composition of countries applies throughout this article.

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)

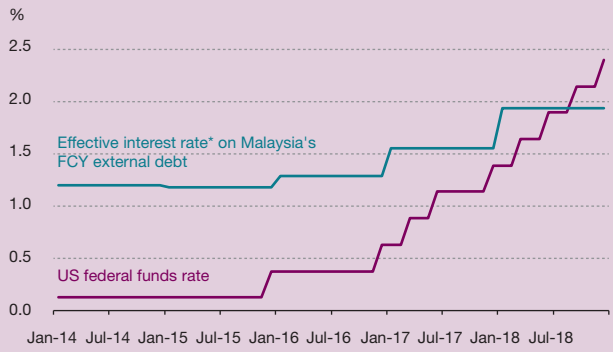
Malaysia's external debt relative to the size of the economy is higher than the EMEs median



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

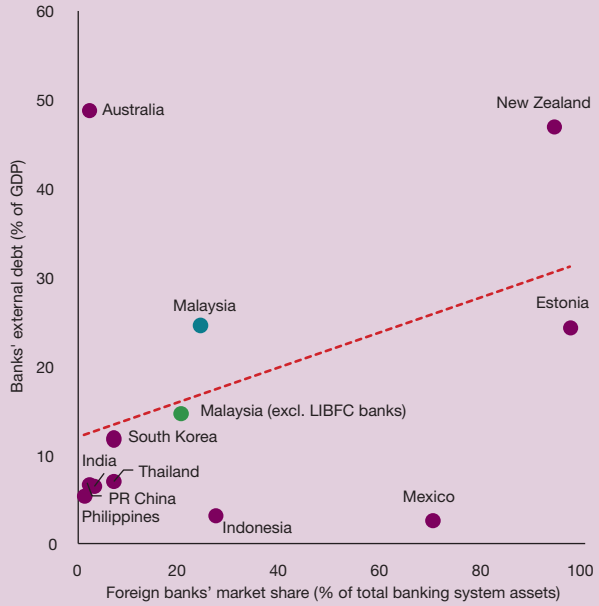
About 41% of banks' external debt is attributable to banks operating in LIBFC, predominantly in the form of intragroup placements from foreign[4] parent banks and regional offices (83% of total LIBFC banks' external debt) (Chart 9). Given LIBFC's position as an international financial centre, banks in 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

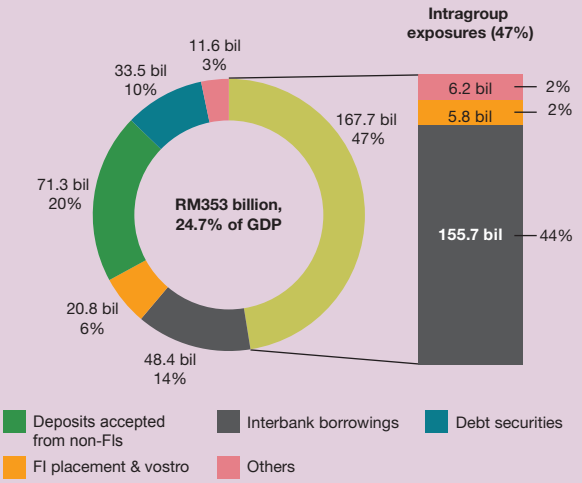
The remaining 39% of banks' external debt is attributable to domestic banking groups (DBGs) (Chart 9), particularly those with extensive regional operations. These DBGs typically adopt centralised liquidity management[5] (CLM) in order to optimise funding cost advantages across various overseas operations 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

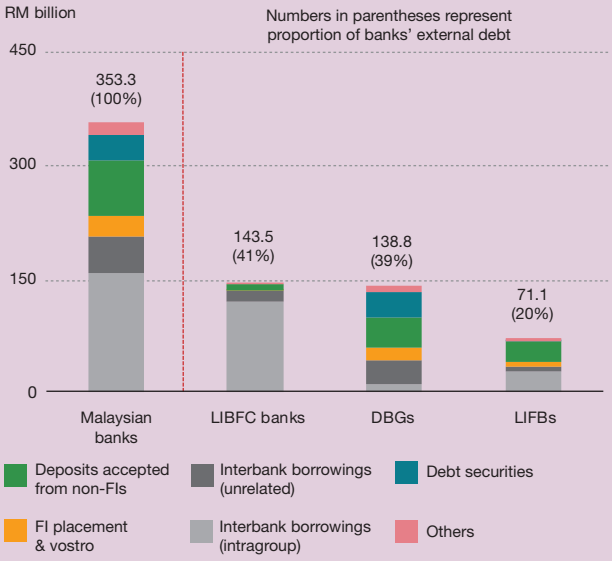


Note: Figures may not necessarily add up due to rounding

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.

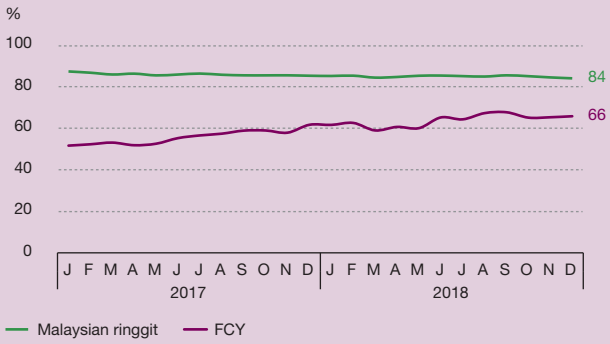
Sound risk management practices mitigate risks associated with external debt

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

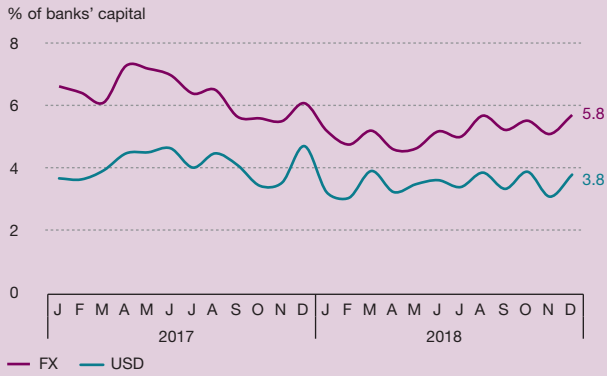


Note: Funds comprise deposits accepted from non-banks and all debt instruments

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.

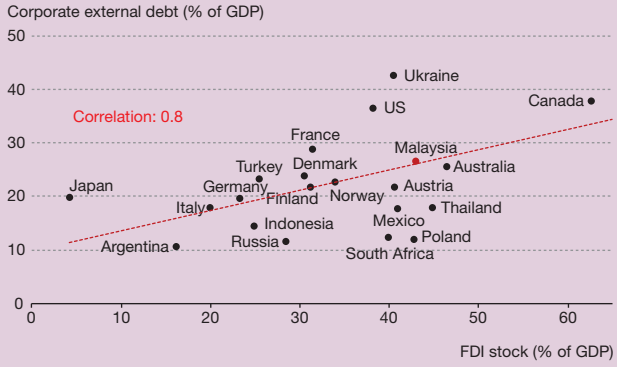
Public corporations account for about one third of the corporate external debt (Chart 13). A significant share of this is held by the national petroleum company which has a solid financial position as affirmed by major international credit rating agencies. A few other public corporations with external 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

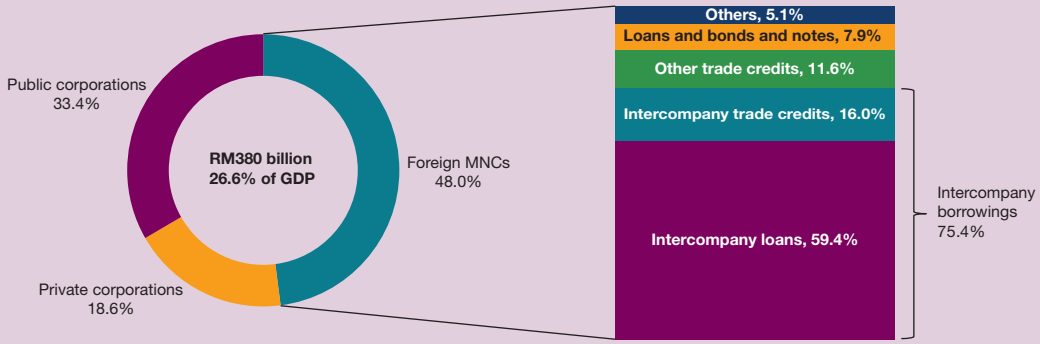
Positive correlation between FDI stock and corporate external debt



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)

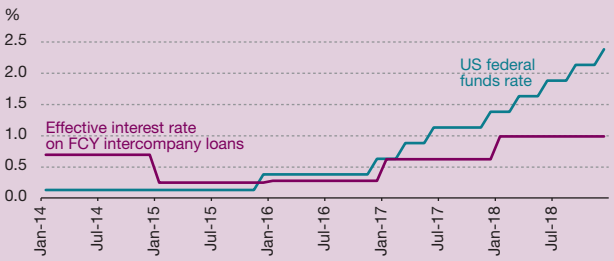
MNCs account for the bulk of Malaysia's corporate external debt



Source: Bank Negara Malaysia

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

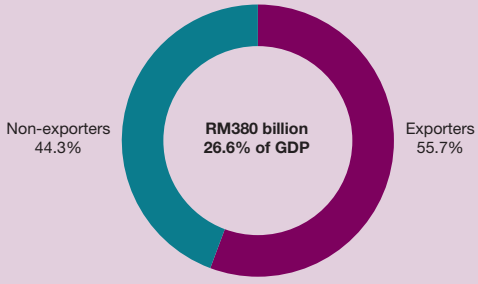
Interest rate on Malaysia's FCY intercompany loans remains very low and stable despite higher US federal funds rate



Source: Bank Negara Malaysia and US Federal Reserve Board

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

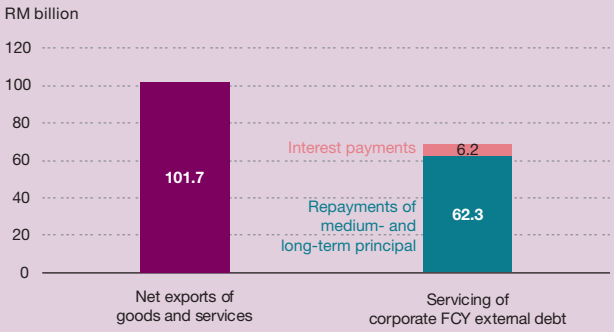
Exporters account for more than half of Malaysia's corporate external debt exposure



Source: Bank Negara Malaysia

Chart 16: Corporate FCY External Debt Servicing and Net Exports

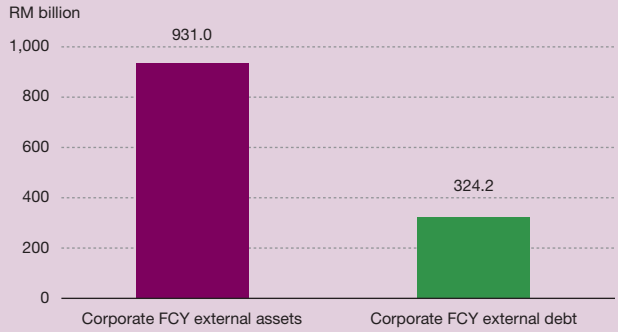
Net exports are sufficient to cover the servicing of corporate FCY external debt



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.

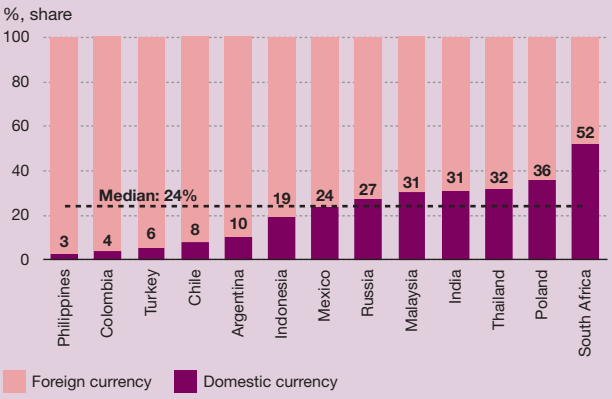
Large and sophisticated domestic institutional investor base attenuates rollover risk

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

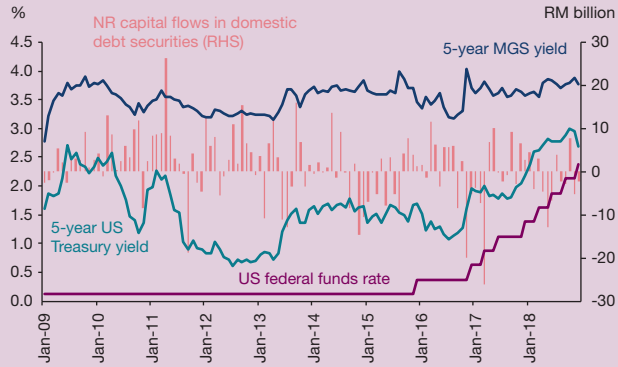
Malaysia has a higher proportion of domestic currency external debt than the EMEs median



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.

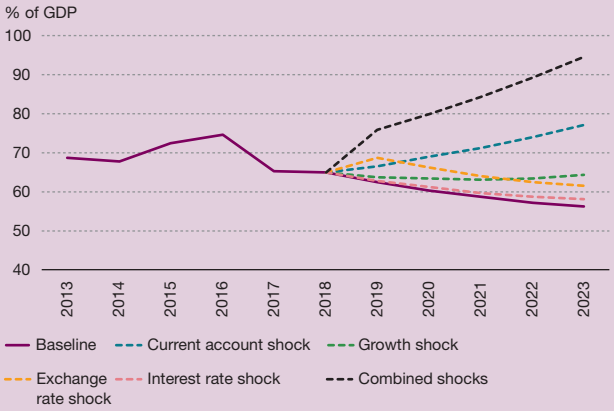
[12] 10-year standard deviation, utilising annual data from 2009 to 2018.
[13] Derived from the actual interest payments on external debt divided by the average external debt outstanding during the year.

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.

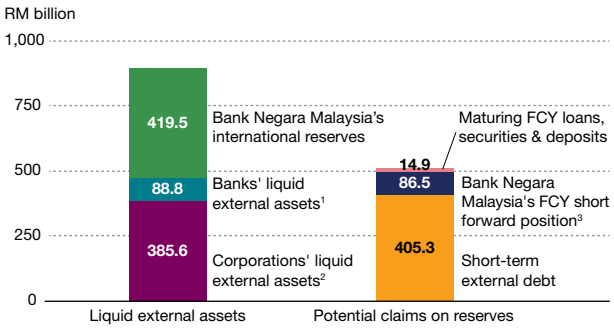
The international reserves are not the primary means in meeting external obligations. The long-standing policy of decentralisation of international reserves has enabled resident banks and corporations to accumulate sizeable external assets which stood at RM1.3 trillion as at end-2018. This is equivalent 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.

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