# Monetary and Financial Conditions in 2017

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## INTERNATIONAL MONETARY AND FINANCIAL CONDITIONS

### Global financial conditions improved amid brighter prospects in the global economy

Global financial conditions improved in tandem with brighter prospects in the global economy. The heightened financial market volatility, which stemmed from the uncertainties over the US elections and political events in Europe during 2016, had largely abated. Investors were more sanguine and had a higher risk appetite given the pickup in global economic conditions, expectations of a more gradual monetary policy normalisation path amid subdued underlying inflation in the advanced economies and a recovery in global commodity prices. In particular, signs of improvement in economic activity became increasingly apparent in the US and PR China as the year progressed, pointing towards a further strengthening in global demand, trade and investment. Global equity markets appeared to outperform real economic activity, raising concerns on potential overvaluation in some of the financial assets. Despite monetary policy normalisation in several advanced economies, long-term sovereign bond yields remained subdued as inflationary pressures eased globally.

During the first half of the year, global financial markets were supported by the upward revisions on the global growth outlook, driven by positive economic data from the advanced economies and PR China[1]. Decisions by central banks in the advanced economies to maintain monetary policy accommodativeness provided further assurance to investors that the global growth momentum would be sustained. As the policy rate increase by the US Federal Reserve (Fed) in March was accompanied by a less hawkish policy stance, market expectations were recalibrated towards a more gradual pace of monetary policy normalisation. Consequently, this led to a decline in long-term yields[2] and a 6.4% depreciation of the US dollar index during the period. Investor sentiments were further boosted by the anticipation of the US government's market-friendly policy packages which include large infrastructure expenditure, tax reforms and market deregulation. Subsequently, the search for yield intensified and global financial markets experienced significant upward momentum. Given the relatively higher returns with a positive economic outlook in emerging economies, capital flows returned to these economies, amounting to USD86.3 billion[3] in the first half of the year.

Against this backdrop, financial market volatility declined, with the Chicago Board Options Exchange Volatility (VIX) and Merrill Lynch Option Volatility Estimate (MOVE) indices reaching historical lows during the first half of 2017[4].

Chart 2.1: US Dollar Index

**The US dollar index depreciated during the first half of 2017**


Source: Bloomberg

[1] The IMF upgraded the outlook for global growth, revising it slightly higher from 3.4% to 3.5% for 2017 and maintaining its 3.6% forecast for 2018 (Source: IMF World Economic Outlook, October 2016 and April 2017).

[2] For the period January to June 2017, the 10-year US Treasury yield fell by 14.1 basis points.

[3] For the period January to June 2017 (Source: EPFR Global).

[4] The VIX, a gauge commonly used to measure equity market volatility, fell below 10, the lowest level since 1993 while the MOVE Index, a measure of implied volatility in the US Treasury market fell to 50 in June 2017, the lowest level since August 2014.

Global equity markets reached new highs in tandem with the US equity market. The US S&P 500 Index gained 8.2% during the period and breached the 2,300 level for the first time in February. Similarly, the Morgan Stanley Capital International Emerging Market (MSCI EM) Index recorded a new historical high, gaining by 17.2%. In the sovereign bond markets, the continued monetary accommodation and low volatility environment led to the decline in term premia in the advanced economies. Coupled with subdued inflation, long-term yields in advanced economies remained at low levels[5]. In turn, investors looked to sovereign bonds in emerging economies for better yields, increasing the demand for these assets. As a result, the JP Morgan Emerging Market Bond Index (EMBI) spread was compressed by 37.1 basis points during the period.

Chart 2.2: S&P 500 Index and MSCI Emerging Market Index*

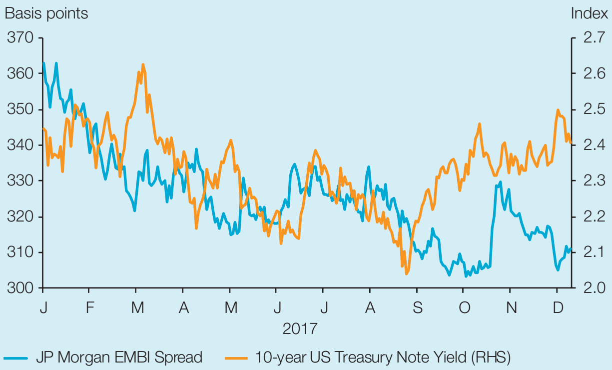
**Global equity markets performed strongly in 2017**


* A benchmark index weighted by market capitalisation which tracks the equity market performance of 24 emerging market economies.

Source: Bloomberg

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

**EMBI spread tightened amid strong demand for emerging market bonds**




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

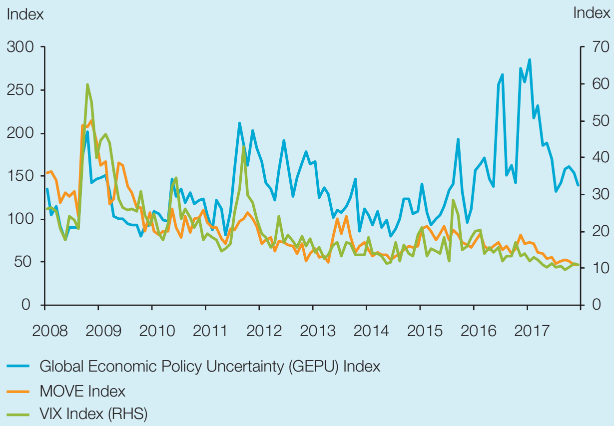
Source: Bloomberg

Despite the market optimism, political developments contributed to intermittent periods of heightened volatility during the first half of 2017. These developments revolved mainly around the US's ability to deliver its proposed fiscal reforms and the US-North Korea geopolitical tensions. These uncertainties, however, did not dampen the overall risk appetite in global financial markets. At one point, especially in early 2017, there appeared to be a widening gap between the increasing uncertainty surrounding policy developments and the persistently low financial market volatility. This was reflected particularly in the persistent divergence between the indicators of policy uncertainty vis-à-vis the VIX[6]. Such a dichotomy raised concerns on whether financial markets were mispricing risks.

Several central banks in the advanced economies proceeded to normalise the degree of monetary accommodation in the second half of 2017, leading to adjustments in market expectations and sovereign bond yields. The Fed, in line with expectations, raised its policy interest rate by 25 basis points twice, in June and December, while indicating another three policy rate increases in 2018. The Bank of England (BOE) also raised its policy interest rate by 25 basis points in November. Apart from

Chart 2.4: Indicators of Policy Uncertainty and Volatility

**Disconnect between policy uncertainty and financial market volatility in early 2017**




Source: Bloomberg, www.policyuncertainty.com

5 Inflation fell broadly in the advanced economies during the first half of 2017. US inflation declined from 2.5% in January 2017 to 1.6% in June 2017 and the euro area inflation declined from 1.8% to 1.3% over the same period.

6 The VIX reached historical lows in 2017, even during periods when the Global Economic Policy Uncertainty (GEPU) Index remained at elevated levels following the US presidential election in the previous year.

the interest rate increases, the Fed also started its balance sheet reduction process in October while the European Central Bank (ECB) announced that it would begin tapering its asset purchase programme from EUR60 billion to EUR30 billion a month starting in January 2018. Despite these actions, market performance remained upbeat amid the continued assurance by these central banks that monetary policy would remain accommodative and the path towards normalisation to be gradual. This was further supported by central banks' commitment to continue with their asset purchase programmes[7]. As a result, while long-term yields adjusted upwards, they remained subdued across the advanced economies[8]. The continued yield differentials led to increased cross-border carry trade activities, with emerging market economies receiving capital inflows amounting to USD66.7 billion during the second half of 2017.

Following another upward revision in the global growth outlook in the second half of 2017, indication of firmer action on tax reform proposals in the US and a recovery in global crude oil prices, global financial markets continued to rally to new highs[9,10,11]. The US S&P 500 Index gained 10.3% and achieved multiple record-highs during this period, closing above 2,600 points for the first time in November. The MSCI EM Index gained a further 14.6% and also recorded a new historic high. The continued demand for emerging market financial assets also led to further compression in sovereign bond yields as the JP Morgan EMBI spread narrowed further by 17.3 basis points.

The exuberance of global financial markets raised concerns on overvaluation of financial assets and underpricing of underlying risks. Global equity markets have consistently recorded new highs while the term premium component in sovereign bond yields, particularly in the advanced economies, was priced in the negative[12]. In the US, for example, price-to-earnings ratios of equity markets have surpassed the long-term median[13]. Technology stocks, in particular, exhibited excessive valuation growth, growing by almost 37% during the year[14]. A market survey of fund managers indicated that almost half believed that the US equity market was overvalued[15]. Such concerns on equity overvaluation also surfaced in emerging markets, albeit to a lesser extent, in view of the high investor risk appetite and large capital inflows. In Asia, most regional equity indices increased by double digits during the year. Price-to-earnings ratios, however, remained close to long-term averages. In the bond markets, signs of overvaluation have been prominent in the advanced economies, suggesting that markets have thus far underpriced risks of monetary policy normalisation. Long-term sovereign bond yields in major advanced economies are still subdued, with term premia remaining negative. In fact, the US Treasury yield curve is now almost as flat as it was prior to the Global Financial Crisis (GFC). Furthermore, the risk-taking activities have spilled over to corporate bonds, where the high-yield segment has also exhibited compressed spreads[16]. In emerging markets, sovereign bond yields experienced some compression due to large capital inflows, but remain close to long-term averages.

Prolonged periods of overvaluation could leave global financial markets susceptible to sharp and sudden corrections that would lead to heightened volatility. There are several risk factors that could

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7 For example, the BOE kept its asset purchase programme unchanged despite raising rates. The ECB, while planning to pare down its asset purchases, also extended its programme at least until September 2018.

8 Between October and December 2017, the 10-year US Treasury yield increased marginally by 7.2 basis points while the 10-year euro area and the 10-year UK bond yields declined by 3.7 basis points and 17.5 basis points, respectively.

9 In October 2017, the IMF revised global growth upwards to 3.6% for 2017 and 3.7% for 2018. Subsequently in January 2018, the global growth estimates were further upgraded to 3.7% for 2017 and 3.9% for 2018 (Source: IMF World Economic Outlook, October 2017 and January 2018).

10 Eventually, the 'Tax Cuts and Jobs Act' was officially signed into law in December 2017.

11 Global crude oil prices recovered after declining in the first six months of the year, reaching USD66.8 per barrel at its peak in December. The recovery was driven by sustained production cuts by Organization of the Petroleum Exporting Countries (OPEC) and Russia, and higher global oil demand.

12 The term premium is the compensation demanded by investors for the risks that are being taken for holding longer-term bonds, more specifically against the risk of higher interest rates in the future. A declining or even negative term premium reflects investors' perception of lower interest rate risk.

13 As at end-2017, the Shiller price-to-earnings ratio, a valuation measure usually applied to the US S&P 500 Index, stood at 32.4 times, higher than the long-term (2000-2017) median level of 25.6 times (Source: Yale University).

14 The S&P Information Technology Index increased by 36.9% and reached an all-time high of 1128.9 points in 2017.

15 According to the November 2017 Global Fund Manager Survey conducted by Bank of America Merrill Lynch, 48% of fund managers responded that the US equity market was overvalued.

16 According to the Bank for International Settlements (BIS), corporate bond spreads are at their narrowest levels since the beginning of 2008. US and European high-yield corporate bond spreads, relative to government bonds, continued to narrow in 2017 amid improved sentiments and strong demand for riskier bonds. (Source: BIS Quarterly Review, December 2017).

trigger such corrections. First, a more rapid pace of monetary policy normalisation in the advanced economies against market expectations of a gradual increase in interest rates could trigger market volatility[17]. Second, uncertainties on political developments in the US could derail some of the market-friendly policy packages which have been priced into the US financial assets. This could be particularly impactful on equity prices, where valuations are based on expectations of increased corporate profits resulting from market deregulation and expansionary fiscal policy. Third, the elevated levels of leverage in emerging economies, which stood at 187% of GDP in 2016[18], remain a source of vulnerability to global financial stability as a debt crisis would cause significant negative spillovers to the global economy and financial markets. Fourth, any escalation of ongoing geopolitical tensions could reignite investor risk-aversion leading to sharp and sudden reversals from financial market assets, especially in emerging economies. Thus far, markets have only been temporarily affected as these geopolitical tensions have not had serious implications on the global economy and financial markets.

## DOMESTIC MONETARY AND FINANCIAL CONDITIONS

### Ringgit strength driven mainly by positive domestic developments

The ringgit strengthened against the US dollar in 2017, in line with most major and regional currencies. After experiencing four consecutive years of depreciation, the ringgit appreciated by 10.4% against the US dollar in 2017, its strongest performance in seven years. The ringgit was also one of the best-performing regional currencies despite intermittent depreciation due to "risk-off" events during the year. The strength of the ringgit was mainly a reflection of the robust domestic economic performance and positive investor sentiments following further liberalisation of the domestic financial markets. The ringgit was also supported by positive global developments during the year. These include the recovery in global growth and trade, slower-than-expected pace of monetary policy normalisation in the advanced economies, and the broad weakness of the US dollar[19].

After reaching a trough of RM4.4995 against the US dollar on 4 January 2017, the ringgit stabilised and recovered marginally against the US dollar in the first quarter. The appreciation of the ringgit was limited initially due to lingering investors' concern over the prospects of the Malaysian financial markets. The uncertainties reflected mainly the misperceptions regarding the liberalisation measures introduced by the Financial Markets Committee (FMC) in December 2016 and the lack of understanding of the onshore hedging facilities among foreign investors.

Sentiments on the ringgit and the Malaysian financial markets, however, improved significantly from the second quarter onwards, during which the ringgit was the best-performing currency in the region, with an appreciation of 9.0% against the US dollar. This period also saw the resumption of portfolio inflows to the domestic government bond market. While external developments continued to affect the movements of regional currencies, the appreciation of the ringgit during this period was also driven by the resilience of the Malaysian economy. This was reflected in the better-than-expected GDP growth in the first three quarters of 2017 and sustained double-digit growth in Malaysia's exports. The announcement of the second series of initiatives to develop the onshore financial market by the FMC in April to promote a fair and effective financial market, improve bond market liquidity, ease hedging activities, and enhance transparency and market information also provided additional impetus for the further strengthening of the ringgit. Finally, the recovery in global demand and positive sentiments on the global and Malaysia's economic outlook following the upward revisions to the growth projections for 2017 and 2018 by the IMF and the World Bank[20], also attracted international investors towards Malaysia's financial assets.

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[17] Following the Federal Open Market Committee (FOMC) meeting in December 2017, the Fed has indicated another three interest rate increases in 2018. A change in this stance may become a source of considerable financial market volatility.

[18] Refers to G20 Emerging Market Economies (EMEs). Excluding PR China, the G20 EMEs recorded debt-to-GDP ratio of 108% at end-2016 (Source: IMF Global Financial Stability Report, October 2017).

[19] The US dollar started the year strong to reach a 14-year high in January 2017 amid growing optimism in the US economy. Nevertheless, as the year progressed, the US dollar was inundated with negative sentiments following uncertainties surrounding US fiscal reforms and the outlook for the path of US monetary policy normalisation. As a result, the US dollar index, which measures the performance of the US dollar against six major currencies, declined by 9.9% in 2017 (Source: Bloomberg).

[20] The World Bank revised upwards Malaysia's GDP growth forecast for 2017 for the third time in December, to 5.8% (previously 5.2%, 4.9% and 4.3%). Malaysia's GDP growth forecast for 2018 was also revised upwards to 5.2% in December.

Apart from being one of the best-performing currencies in the region, the ringgit was also one of the least volatile. The ringgit's 30-day rolling standard deviation averaged at 3.1% in 2017, while other regional currencies, which include the Chinese renminbi, Indonesian rupiah, Korean won, Philippine peso, Singapore dollar, New Taiwan dollar and Thai baht, averaged in the range of 3.2% and 7.8%. The ringgit volatility was low despite intermittent periods of depreciation pressure due to the occasional prevalence of "risk-off" sentiments in the global financial markets, such as the emergence of geopolitical concerns surrounding the tensions between the US and North Korea. The stability of the ringgit was a manifestation of the effectiveness of the measures introduced by the FMC in December 2016 and April 2017 to realign the ringgit market onshore and rebalance the demand and supply of the ringgit and foreign exchange in the domestic market. As a result of these measures, liquidity in the domestic foreign exchange market improved, with the daily volume of foreign exchange turnover registering a significant increase since the end of 2016. The volatility of the ringgit against the US dollar, as indicated by the difference between the highest and lowest intraday rates, also declined following the introduction of the measures. Furthermore, the balance between foreign exchange flows from exports and imports improved after the introduction of the export conversion measure[21], with the demand for ringgit supported by Malaysia's current account surplus.

For the year as a whole, the ringgit appreciated by 10.4% to end the year at RM4.0620 against the US dollar. The ringgit also appreciated against the Japanese yen and pound sterling but depreciated against the euro. Against regional currencies, the ringgit was broadly stronger. As a result, the ringgit's Nominal Effective Exchange Rate (NEER), a measure of ringgit performance against the currencies of Malaysia's major trading partners, appreciated by 4.0%.

While the ringgit's appreciation in 2017 has steered the ringgit towards reflecting the underlying strength of the Malaysian economy, any currency adjustment, irrespective of its direction, should be in an orderly manner. For a highly open economy like Malaysia, a gradual adjustment in the exchange rate provides the foundation for orderly adjustments in the external sector. Given that Malaysia is deeply integrated with the global economic and financial systems, this has proven to be a challenge in the past few years. Against the backdrop of highly volatile global financial markets, cross-border capital flows were driven by sentiments rather than the underlying fundamentals of the domestic economy, resulting in the over-adjustments of the ringgit. While the tide has turned in 2017 as the global economy gains traction, the challenge persists as the subsequent "risk-on" sentiments may result in one-sided speculative capital inflows to the domestic financial markets, which may result in destabilising currency movements. Hence, it is imperative for policymakers to ensure that any exchange rate adjustment is gradual and reflective of the changes in the economic fundamentals.

In the near term, the ringgit will remain susceptible to volatile conditions in the global financial markets given the fluid global environment. With the strengthening global recovery, major central banks other than the Fed will also be transitioning out of ultra-accommodative monetary policy. After years of monetary policy divergence between the Fed and other major central banks, the synchronous movement towards monetary policy normalisation in 2018 will be unchartered territory for financial markets since the GFC. This may accentuate financial market volatility, as financial market participants form differing views on the pace, timing, and magnitude of policy normalisations by these major central banks. At the same time, the proliferation of geopolitical developments in recent years will continue to pose significant risks to the global landscape. In this regard, policymakers have to remain pragmatic and develop a wide range of policy tools to manage these risks. Strong economic fundamentals, a flexible exchange rate, ample international reserves, deeper and more diversified financial markets and a strong banking system have and will continue to be crucial to Malaysia's resilience to swings in capital flows and exchange rate volatility.

In the longer term, the ringgit should reflect Malaysia's robust underlying economic fundamentals. Given the sustained domestic economic growth and improving growth prospects, the appreciation trend of the ringgit should continue. Nevertheless, for the ringgit to continue to better reflect Malaysia's strong economic fundamentals, measures to resolve the structural impediments that have affected the ringgit's performance in recent years will be required. These structural factors include:

- Growth in outbound travel expenditure that has outpaced inbound travel expenditure;
- Continued reliance on foreign service providers in the transport, construction and insurance services due to lack of domestic capabilities; and
- Increasing remittances by foreign workers in Malaysia.

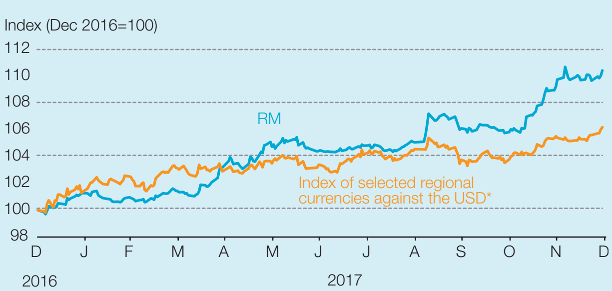
[21] One of the FMC measures introduced in December 2016 was requiring the conversion of foreign currency export proceeds into ringgit to address the imbalances where export proceeds were overwhelmingly placed in foreign currency accounts in offshore markets.

Furthermore, the ringgit's movement has been repeatedly amplified by misperceptions about Malaysia, in particular that it is an oil-dependent economy. While the Bank has taken steps to address the misperception by showing the disassociation between the ringgit and oil price movements, correcting perceptions takes time. The adequacy of Malaysia's international reserves is also a common concern raised by analysts based on unbalanced and simplistic assessments. Concerns on the Government's fiscal position may further add to the excessive movement of the ringgit. These structural factors and negative sentiments, stemming from sometimes unfounded views, could result in persistent imbalances in the foreign exchange market, preventing the ringgit from accurately reflecting Malaysia's real economic activity.

For the Bank, continuous efforts will be focused on ensuring an orderly functioning of the foreign exchange market. For an open economy like Malaysia, a stable exchange rate that adjusts gradually is key to support Malaysian households and businesses in planning their consumption, investment, and hedging needs. Nevertheless, the Bank is cognisant of the fact that while targeted policy measures to address misperceptions and imbalances, along with continuous effort by the Bank to ensure an orderly movement in the ringgit exchange rate may offer temporary solutions in the short term, fixing the root of the issues via long-term structural policies aimed at improving productivity and competitiveness of the Malaysian economy should continue being the focus going forward. This will ensure that the ringgit exchange rate remains competitive in the global environment.

Chart 2.5: Exchange Rate of the Malaysian Ringgit (RM) and Selected Regional Currencies against the US Dollar (USD)

**The ringgit outperformed regional currencies in 2017**



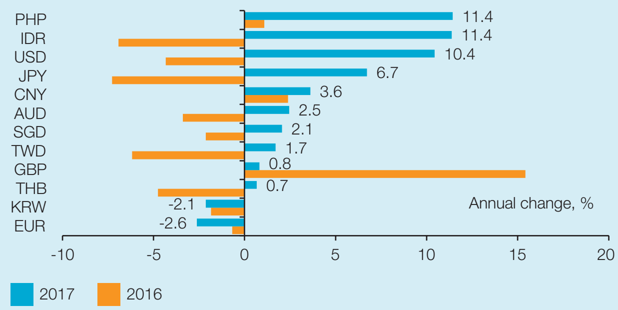

* Regional currencies: Chinese renminbi, Indonesian rupiah, Korean won, Philippine peso, Singapore dollar, New Taiwan dollar and Thai baht. Each currency carries equal weight.

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

Source: Bank Negara Malaysia

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

**The ringgit appreciated against most major and regional currencies in 2017**




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

Source: Bank Negara Malaysia

## Nominal interest rates were steady in 2017, reflecting stable liquidity and financial market conditions

Nominal domestic interest rates were stable in 2017. Funding costs were supported by sufficient aggregate liquidity in both wholesale and retail markets of the banking system. To a certain extent, stable funding conditions were also sustained by the resumption of capital inflows since the second quarter of the year.

Consistent with the unchanged level of Overnight Policy Rate (OPR) in 2017, money market rates were stable throughout the year. The average overnight interbank rate (AOIR) trended within a narrow range of 2.90%-3.00%. Similarly, interbank rates for other short- and medium-term tenures were relatively unvaried. Consequently, the Kuala Lumpur Interbank Offered Rate (KLIBOR) was also stable during the year, reflecting market expectations for the OPR to remain unchanged in 2017.

Table 2.1: Policy, Interbank and Lending Rates

| | Dec-15 | Jul-16 | Dec-16 | Dec-17 |
|---|---|---|---|---|
| | %, as at end period | | | |
| Overnight Policy Rate (OPR) | 3.25 | 3.00 | 3.00 | 3.00 |
| 3-month KLIBOR | 3.84 | 3.40 | 3.41 | 3.44 |
| Weighted average base rate (BR) | 3.77 | 3.62 | 3.62 | 3.64 |
| Weighted average lending rate (ALR) | 5.40 | 5.27 | 5.22 | 5.22 |

Source: Bank Negara Malaysia

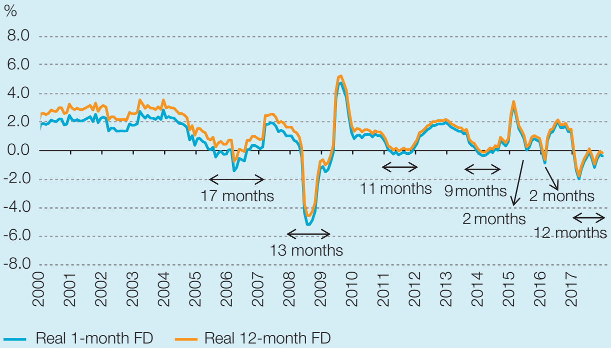
The stability in the interbank market translated into broadly steady trends in retail lending and deposit rates. In the first half of 2017, the weighted average base rate (BR) of commercial banks averaged at 3.61% (end-2016: 3.62%). During the second half of the year, however, the BR increased slightly by 3 basis points to 3.64%. This marginal increase was due to upward revisions by some commercial banks to reflect the shift in their funding composition towards longer-tenured liabilities that carry higher cost. Despite the higher BR, effective lending rates to both households and businesses remained broadly stable. The average quoted fixed deposit (FD) rates of commercial banks were relatively unchanged in 2017, with rates for FD tenures of 1 to 12 months being offered within the range of 2.87%-3.10% throughout the year.

Reflecting the higher headline inflation in 2017, real FD rates turned negative in January and remained so for the rest of the year. This period of negative real deposit rates was not unique to the current operating environment of the banking system. Historically, past episodes of negative real deposit rates have been driven by inflation developments resulting from supply factors which have typically been transitory. In 2018, real deposit rates would likely turn positive, given the increase in nominal interest rates following the higher OPR in January, together with the projected moderation in inflation.

In addition, corporate deposit rates were steady throughout 2017. This contrasted with the trends in the previous years, when corporate deposit rates would have typically increased towards the end of year. The stable development during the year was supported by the absence of competitive pressures for deposits among banks for year-end window dressing purposes and the resumption of capital inflows which helped contain potential funding pressures in the banking system.

Chart 2.7: Real Fixed Deposit Rates

**The period of negative real deposit rates in 2017 was not unprecedented**




Note: The arrows indicate the periods of negative real fixed deposit rates (in months)

Source: Bank Negara Malaysia

Unlike in previous years, corporate deposit rates were stable during year-end, given the absence of competitive pressures for deposits among banks for window dressing purposes and the resumption of capital inflows

## Domestic financial markets performed strongly in 2017

Malaysia's domestic bond and equity markets performed strongly in 2017. Sovereign bond yields continued to decline on sustained demand by non-resident and domestic investors. The domestic equity index ended the year higher after three consecutive years of negative returns. The strong performance of the domestic economy was the underlying factor driving these positive developments. Both markets, however, experienced very distinct developments throughout the year, underpinned by domestic factors that were unique to these markets.

### MGS yields declined amid sustained non-resident inflows and strong support from domestic institutional investors

In 2017, the benchmark Malaysian Government Securities (MGS) yield curve shifted downwards, reflecting lower yields across all maturities. The sustained demand for Malaysian sovereign bonds was underpinned by Malaysia's strong economic performance during the year. The positive domestic development coincided with the lower volatility and improved risk-appetite in global financial markets, driving the demand by non-resident investors. A notable development in the bond market during the year was the investor reaction to the introduction of financial market development measures by the FMC in late 2016 which caused non-resident outflows and upward pressure on MGS yields. The impact, however, was temporary. For the year, the 3-year, 5-year and 10-year MGS yields declined by 16.4, 13.8 and 31.4 basis points, respectively.

During the first quarter of 2017, the bond market experienced large non-resident outflows, particularly from the MGS market, amounting to RM32.6 billion. The outflows were driven mainly by the unwinding of short-term speculative positions held by non-resident financial institutions and short-term asset managers following the introduction of FMC measures and the US presidential election in late 2016. Non-resident holdings of MGS with maturities of less than three years fell by RM31.9 billion, making up 98% of the outflows from MGS during the quarter. While these short-term outflows were the intended effect of the FMC measures, the overall outflows were also exacerbated by misperceptions surrounding the measures. In addition, the period also saw large maturities of MGS, particularly in February and March, of which RM11.5 billion was held by non-resident investors. Nevertheless, the non-resident outflows had limited impact on MGS yields as domestic institutional investors broadly increased their MGS holdings by RM25.5 billion during the same period. As a result, the 3-year and 5-year MGS yields increased by 6.4 and 12.4 basis points, respectively, while the 10-year MGS yield declined by 7.9 basis points[22].

In the subsequent quarters, MGS yields were on a downward trend amid a resumption of non-resident inflows to the domestic bond market and continued support from domestic institutional investors[23]. This was largely driven by improved investor sentiments following Malaysia's strong economic performance, including the better-than-expected GDP growth, continued double-digit growth in exports and stronger ringgit. During this period, the Bank also actively engaged the industry and market participants to reduce misperceptions on the FMC measures. Measures introduced in April that allowed better market accessibility and hedging flexibilities further revitalised investor interest in Malaysian bonds. In addition, these positive domestic developments coincided with market expectations for a more gradual pace of monetary policy normalisation in the advanced economies which led to capital inflows to regional financial markets. As a result, the 3-year, 5-year and 10-year MGS yields declined by 22.8, 26.2 and 23.5 basis points, respectively.

Chart 2.8: MGS Benchmark Yield Curve

**MGS yields declined amid sustained demand by non-resident and domestic investors**


Source: Bank Negara Malaysia

For the year, non-resident holdings of total Government bonds[24] declined to a more sustainable level of 27.7% as at end-2017 (2016: 30.6%). These holdings currently reflect a more stable and well-diversified composition of holders which mainly include longer-term investors such as pension funds, insurance companies, governments and central banks.

The domestic corporate bond market registered strong growth in 2017. Fund-raising activity increased significantly as new corporate bond issuances reached a 5-year high of RM175.7 billion[25] (2016: RM137.3 billion), amid improved sentiments and favourable cost of financing. The decline in corporate bond yields was broad-based in tandem with the decline in MGS yields, with yields on the 5-year AAA, AA and A-rated papers decreasing by 7.6, 14.1 and 30.3 basis points, respectively, for the year. Both liquidity and credit conditions also continued to remain healthy in 2017 with total turnover amounting to RM120.5 billion (2016: RM159.5 billion).

## The domestic equity market improved, anchored by investor confidence on the strong economic outlook

Unlike the bond market, the domestic equity market started the year with a strong upward momentum after experiencing three consecutive years of negative returns. The turnaround in the FTSE Bursa Malaysia

[22] For the period between January and March 2017.
[23] For the period between April and December 2017, non-resident inflows to the MGS market amounted to RM28.5 billion while domestic institutional investors, in particular pension funds, increased their MGS holdings by RM13.5 billion.

[24] Refers to Malaysian Government Securities (MGS), Malaysian Government Investment Issues (MGII) and Sukuk Perumahan Kerajaan (SPK).
[25] Refers to securities issued in Malaysia by both local and foreign companies which can be either short-term, medium-term or long-term papers in Conventional or Islamic principles.

Kuala Lumpur Composite Index (FBM KLCI) was driven mainly by improved investor sentiments following Malaysia's strong economic performance and improved risk appetite in global equity markets which further supported the demand for Malaysian equities. For the year, the FBM KLCI increased by 9.4% (2016: -3.0%).

During the first half of the year, the FBM KLCI recorded an increase of 7.4%. Sentiments in the domestic equity market were supported by Malaysia's strong economic performance and improved corporate earnings, particularly for the *banking*, *plantation* and *export-oriented* sectors. The positive trend was also in line with regional equity indices, tracking the strong performance of the US equity market. During this period, Malaysia experienced net buying by foreign investors amounting to RM10.7 billion.

From July to November, the FBM KLCI experienced a partial retracement due to heightened global uncertainties and factors specific to Malaysia's equity market. The upward trend in global equity markets were interrupted by intensified geopolitical tensions and intermittent periods of uncertainties on the progress of tax reforms in the US, dampening the demand for global equities. When geopolitical risks eased and uncertainties subsided, global equity markets continued on its upward trend. However, the domestic equity index remained subdued during this period. The FBM KLCI was weighed down by cautious sentiments, especially in the *construction* and *manufacturing* sectors amid rising raw material prices. Investors were also cautious towards the *properties* sector amid concerns on the issues of low affordability and oversupply[26]. During this period, the Kuala Lumpur Stock Exchange (KLSE) Construction and Properties indices declined by 8.0% and 6.3%, respectively. These domestic factors resulted in the FBM KLCI's underperformance relative to regional peers. During the period, the index declined by 2.6% while regional indices mostly gained by between 2.1% and 13.2%.

In December, the FBM KLCI recovered firmly, with the index increasing by 4.6%. This occurred amid improved sentiments due to the upward revisions to Malaysia's growth outlook by the IMF and World Bank, and improvements in corporate earnings performance in the third quarter of 2017, especially in the *banking*, *plantation* and *oil and gas* sectors. The strong increase in global oil prices during the month, driven by stronger global demand and sustained production cuts, also provided additional support to the *oil and gas* sector[27]. For the year, the FBM KLCI increased by 9.4% (2016: -3.0%) and closed at 1796.8 points. Amid rising concerns on global equity overvaluation, Malaysian equities remain fairly valued with a price-to-earnings ratio of 16.2 times, which is close to the 10-year average of 16.5 times[28].

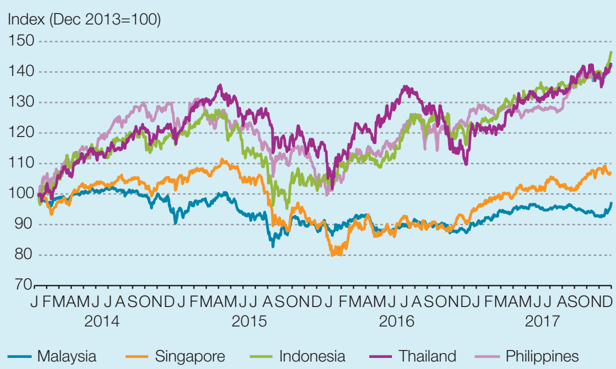
Chart 2.9: FBM KLCI vs MSCI Equity Indices

**The FBM KLCI improved in line with the positive global equity market performance**


Source: Bloomberg

Chart 2.10: Regional Equity Indices

**The FBM KLCI ended higher in 2017 after three consecutive years of negative returns**




Source: Bloomberg

## Overall liquidity conditions remained sufficient

In 2017, overall banking system liquidity remained sufficient to support the financial intermediation

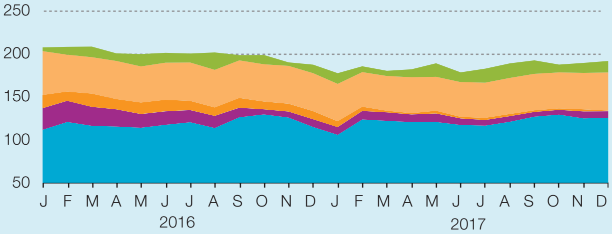
[26] As at 3Q 2017, total unsold residential properties stood at 129,052 units (2016: 120,802 units, Average 2004-2016: 72,239 units).

[27] On 30 November 2017, OPEC and Russia agreed on a nine-month extension of oil production cuts until end-2018, which were previously scheduled to expire in March 2018.

[28] The price-to-earnings (P/E) ratio reflects how much investors value a company's stock based on its earnings. P/E ratios that trend much higher than its long-term average may indicate overvaluation.

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

**Outstanding ringgit liquidity placed with Bank Negara Malaysia remained sufficient**

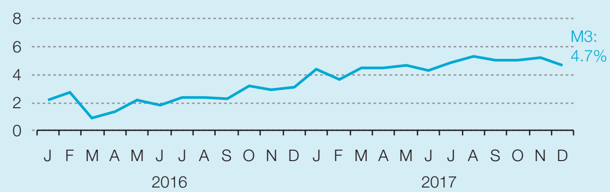



Money market borrowings (excluding repos)
Bank Negara Monetary Notes and Bank Negara Interbank Bills
Repos
Statutory Reserve Requirement (SRR)
Others

Source: Bank Negara Malaysia

Chart 2.12: M3 Growth

**M3 growth increased in 2017**

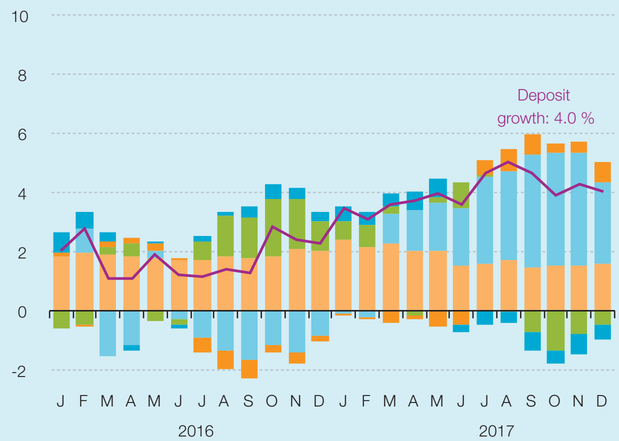



— M3 annual growth

Source: Bank Negara Malaysia

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

**Banking system deposit growth was higher in 2017**




Others[2]
Business enterprises
Federal Government, state governments and statutory authorities
Individuals
Non-bank financial institutions
Total excluding banking institutions

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

Source: Bank Negara Malaysia

process. At the system level, aggregate outstanding liquidity placed with the Bank increased following capital inflows since the second quarter of the year. At the institutional level, most banking institutions continued to maintain surplus liquidity positions.

Throughout the year, the Bank's monetary operations remained focused on maintaining stability in the interbank market. In the first quarter of the year, the slight moderation in domestic liquidity arising from capital outflows were offset by liquidity injection operations through the reverse repo and foreign exchange swap facilities. Following the resumption of capital inflows from the second quarter onwards, the Bank was able to reduce its liquidity injection operations. Subsequently, activity in the domestic money market remained uninterrupted during the year.

Private sector liquidity, as measured by broad money (M3), grew at a much faster pace of 4.7% in 2017 (2016: 3.1%). The expansion in M3 continued to be supported by the extension of credit by banks to the private sector in the form of both loans and the purchase of corporate bonds. Total deposits in the banking system also recorded a higher annual growth rate of 4.0%, mainly due to a turnaround in deposits placed by businesses, which grew by 7.9% in 2017 (2016: -2.3%). Household deposit growth, however, moderated to 3.9% (2016: 5.1%) during the period.

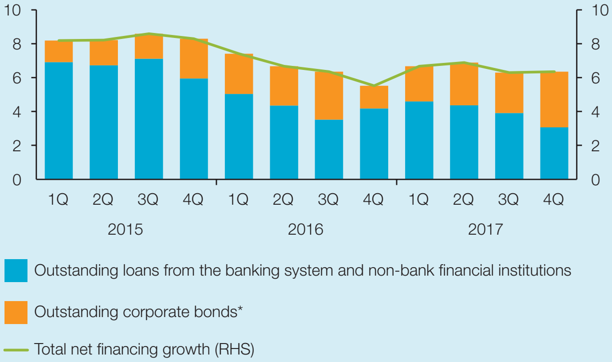
## Financing to the private sector was driven by stronger growth in corporate bond issuances

Net financing through the banking system, non-bank financial institutions[29] and the corporate bond market expanded at an annual rate of 6.4% in 2017 (2016: 5.5%). The faster pace of growth in net financing during the year was driven by financing through the corporate bond market[30], which recorded

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

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

**Increase in total net financing driven by corporate bonds**

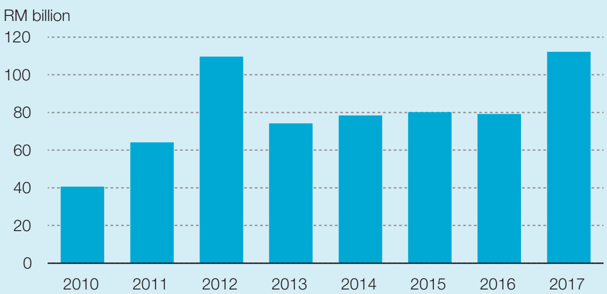



* Excludes issuances by Cagamas and non-residents.

Source: Bank Negara Malaysia

Chart 2.15: Gross Corporate Bond Issuances*

**Issuances increased significantly in 2017**




* Excludes issuances by Cagamas and non-residents.

Source: Bank Negara Malaysia

a strong double-digit annual growth of 15.4% (2016: 6.3%), the highest pace since 2012. In terms of contribution to net financing growth, corporate bonds outpaced loans[31] for the first time despite its relatively smaller weight[32]. The annual growth of outstanding loans moderated to 3.9% (2016: 5.3%) as business loans expanded at a slower pace given growth in repayments outweighed that in disbursements. This also reflected the diversified sources of financing in Malaysia with additional funds raised in the capital markets amid favourable market and economic conditions.

[31] Includes outstanding loans extended by the banking system (both conventional and Islamic banks) and non-bank financial institutions.
[32] The share of corporate bonds and loans in net financing are 25% and 75% respectively.

Business demand for funding from the capital markets increased significantly, with issuances of corporate bonds[33] reaching a 5-year high of RM112.2 billion in 2017 (2016: RM79.2 billion). The bulk of the bond issuances were from the *finance*, *insurance and real estate*; *electricity*, *gas and water supply*; and *construction* sectors, and were used to fund infrastructure projects and for working capital requirements. Financing through the equity market also increased significantly to RM12.2 billion (2016: RM7.0 billion), which reflected issuances of several large initial public offerings (IPOs) in line with improved market sentiments.

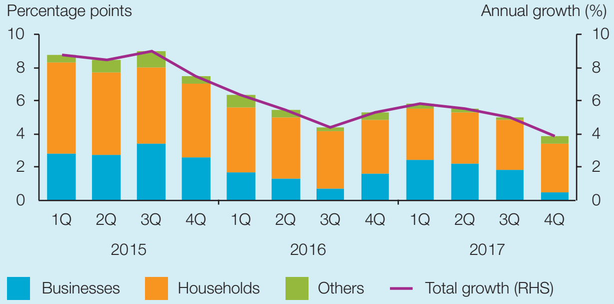
The moderation in the annual growth of outstanding business loans[34] (2017: 1.3%; 2016: 4.7%) was broad-based across most sectors, notably in the *manufacturing*; *wholesale and retail trade*, *restaurants*, *and hotels*; *transport*, *storage and communication*; *finance, insurance and business services*; and *real estate* sectors. The lower growth in business loans reflected higher growth in loan repayments of 7.9% (2016: 2.2%) relative to disbursements of 6.2% (2016: -0.3%). Larger business repayments reflected scheduled repayments and stronger business earnings recorded during the year. The amount of loan disbursements[35], however, increased (2017: RM750.0 billion; 2016: RM706.2 billion), in tandem with the growth in domestic demand of the economy. The increase in loan disbursements was distributed across various sectors, particularly to the *manufacturing*; *construction*; *wholesale and retail trade, restaurants and hotels*; and *primary agriculture* sectors.

The growth in household debt[36] continued to moderate during the year to 4.9% (2016: 5.4%), reflecting the moderation in loans for the *purchase of non-residential properties* and *personal financing*. The growth in *residential property* loans, which accounted for 52.0% of total household debt was sustained at 8.5% during the year (2016: 9.1%). Access to home financing remained intact for borrowers with the capacity to service their debt, supported by sustained approval rates for the purpose of *residential property* loans.

[33] Excludes issuances by Cagamas and non-residents.
[34] Includes outstanding loans of public enterprises (PEs), but excludes outstanding loans of domestic financial institutions, domestic non-bank financial institutions, Government, domestic other entities, and foreign entities with the banking system and DFIs. The change in the level of outstanding loans is total loans disbursed minus total loans repaid.
[35] Includes loan disbursements to Small and Medium Enterprises (SMEs) and businesses other than SMEs.
[36] Loans extended by banks, development financial institutions and major non-bank financial institutions.

## Chart 2.16: Outstanding Loans by Borrowers*

**Moderation in growth of total outstanding loans due mainly to business loans**

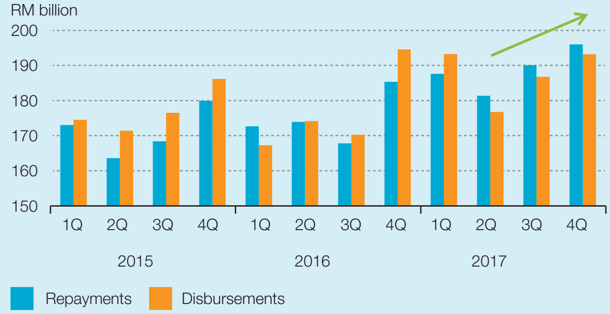



* Comprises outstanding loans from the banking system and non-bank financial institutions.

Source: Bank Negara Malaysia

## Chart 2.17: Business Loan Repayments and Disbursements*

**Business loan repayments outpaced disbursements in 2017**




* Comprises loans from the banking system and development financial institutions (DFIs).

Source: Bank Negara Malaysia

Monetary and Financial Conditions in 2017