Economic Developments in 2016

Economic Developments in 2016

THE INTERNATIONAL ECONOMIC ENVIRONMENT

The year 2016 recorded the lowest world GDP growth since the Global Financial Crisis. International trade growth underperformed world GDP growth for the second consecutive year. The moderation in GDP growth was driven by subdued investment activities in most economies and weak commodity prices amid heightened political and policy uncertainties in major economies. Sustainable recoveries remained an elusive goal for many economies while inflation continued to be below target for many major central banks. As conventional and unconventional policy space narrowed further, vulnerabilities in many economies also increased. Global leverage rose amid unprecedented quantitative easing, while productivity growth remained low. Benefits from ongoing structural reforms have yet to fully materialise. The growing scepticism over the benefits of globalisation, manifested in the UK's EU referendum and the result from the US Presidential election, raised concerns about the future of the global economy going into 2017 and beyond. In this environment, policymakers faced an increasingly daunting task to deliver short-term growth while maintaining the momentum to follow through the necessary and difficult reforms to achieve sustainable growth over the longer run.

World economy recorded the lowest growth rate since the Global Financial Crisis

More moderate world growth

Global economic growth moderated for the second consecutive year since 2014, defying initial expectations of an improvement from the growth rate recorded in 2015. As a result, the IMF revised the global growth projection downwards, from 3.4% in January 2016 to 3.1% in October 2016. Global trade growth moderated further in 2016 due to subdued investment growth across major economies and economic rebalancing in PR China. World trade volume for goods and services registered its slowest pace of expansion since the crisis, leaving global trade elasticity[1] to fall to 0.6.

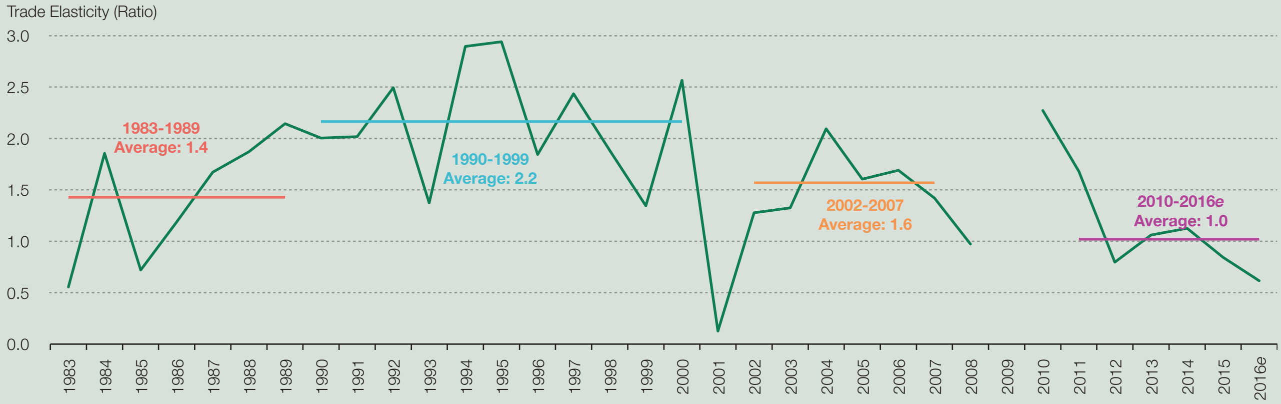
Advanced economies experienced modest economic growth, which was partly attributable to subdued investments. In the US, private consumption also moderated leading to lower GDP growth in 2016. Despite favourable labour market conditions, earnings growth slowed. In the euro area, business lending continued to decline and business sentiments remained weak amid the heightened policy and political uncertainty in member states. Despite experiencing a major political event, namely the unexpected referendum outcome to leave the EU, the UK economy sustained a growth rate of 1.8%, underpinned by favourable household spending. Higher wealth effects arising from improving house prices and strengthening labour market conditions continued to support consumer spending. However, investment activity remained weak, particularly in non-residential properties and construction, transportation equipment and intangible fixed assets.

In the emerging markets, growth was slower than expected. Commodity prices recorded a larger contraction relative to earlier projections, weighing on the pace of recovery in some regions such as Latin America and Commonwealth of Independent States. Headwinds to growth, particularly private consumption activity, remained, reflecting the adverse impact from the implementation of structural reforms, including those relating to energy, tax and prices. The currencies of most emerging market economies were also affected by the volatility in capital flows

[1] Global trade elasticity is calculated as the ratio of world trade growth to GDP growth.

Chart 1.1

Global Trade Elasticity



e Estimate

Source: International Monetary Fund (IMF)

arising from heightened global risk aversion. Subdued external demand, as indicated by the moderation in global trade activity, continued to affect the more open emerging economies.

PR China's growth expanded at a more gradual pace due to ongoing rebalancing from an investment-driven growth model towards a consumption-led one. This led to reforms to curb excess capacity in the heavy industries, such as steel, coal and cement. Many economies in the rest of Asia registered stronger expansion, allowing the region to grow at a faster pace relative to other emerging market economies. An increased focus on expanding infrastructure investments by both the public and private sector provided support to capital spending, with expectations of reduced structural constraints to future growth. The implementation and introduction of additional fiscal, monetary and structural measures to support economic activity by policymakers lifted the region's growth trajectory. On the demand front, weak export performance was offset by improvements in domestic demand conditions.

Global inflation remained low

Inflationary pressures remained low in many economies as inflation rates continued to be below target for most inflation-targeting economies and lower than historical levels for many others, reflecting mainly weak domestic demand. Nevertheless, in many countries, headline inflation was on a slight upward growth trajectory during the year. The increase was a reflection of the diminishing

Table 1.1

World Economy: Key Economic Indicators

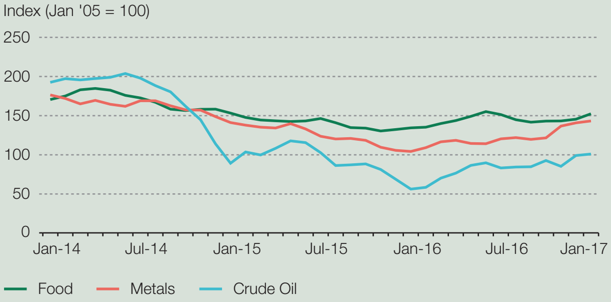
	Real GDP Growth (Annual change, %)		Inflation (Annual change, %)	
	2015	2016*e*	2015	2016*e*
World Growth	**3.2**	**3.1**	**-**	**-**
World Trade	**2.7**	**1.9**	**-**	**-**
Advanced Economies				
United States	2.6	1.6	0.1	1.3
Japan	1.2	1.0	0.8	-0.1
Euro area	1.9	1.7	0.0	0.3
United Kingdom	2.2	1.8	0.0	0.7
Emerging Asia[1]	**5.8**	**5.7**	**1.7**	**1.9**
Other Advanced Asian Economies	**2.0**	**2.2**	**0.4**	**1.0**
Korea	2.6	2.7	0.7	1.0
Chinese Taipei	0.7	1.5	-0.6	1.0
Singapore	1.9	2.0	-0.5	-0.5
Hong Kong SAR	2.4	2.0	3.0	2.4
The People's Republic of China	**6.9**	**6.7**	**1.4**	**2.0**
ASEAN-4	**4.6**	**4.8**	**3.6**	**2.4**
Malaysia	5.0	4.2	2.1	2.1
Thailand	2.9	3.2	-0.9	0.2
Indonesia	4.9	5.0	6.4	3.5
Philippines	5.9	6.8	1.4	1.8
India[2]	**7.5**	**7.5**	**4.9**	**4.9**

[1] Emerging Asia refers to Chinese Taipei, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, PR China, Singapore and Thailand
[2] For India, GDP data is presented on a fiscal year basis
e Estimate

Source: International Monetary Fund, National Authorities and Bank Negara Malaysia estimates

Chart 1.2

Indices of Primary Commodity Prices



Source: International Monetary Fund (IMF)

impact of the sharp decline in commodity prices in 2014-15 following a modest recovery in prices. Other factors that affected inflationary pressures included changes to administered prices and exchange rate movements.

The IMF commodity price indices showed a return to an upward trajectory for food, metals and crude oil during the year. In the crude oil markets, Brent prices reached a 12-year record low of USD28[2] per barrel in mid-January, following the lifting of international sanctions on Iran. The lower crude oil prices were reinforced by concerns over worsening global oversupply amid subdued aggregate demand growth and strong supply by OPEC members. However, as the year progressed, unplanned disruptions to output combined with expectations of future production cuts led to rising crude oil prices. On 30 November 2016, OPEC and Russia agreed to their first production cuts in eight years.

Similarly, metal prices improved, supported by production cuts in the tin, lead and zinc markets. Iron ore prices were driven by greater demand for steel in PR China, as public infrastructure spending rose. The cost of food increased as well, as prices of agricultural products such as rice, soybeans, palm oil and sugar were driven higher by weak production amid adverse weather conditions.

The recovery in commodity prices led headline inflation rates to edge higher across major advanced and emerging economies. Among the advanced economies, headline inflation rose in the US and the UK due to a smaller contraction in transport costs, while headline inflation was modest in the euro area, averaging 0.3% in 2016 (2015: 0%). Comparable trends were observed in some Asian economies, including Thailand and Korea. Inflation in PR China and India was further supported by rising food prices. Nonetheless, subdued demand in many economies had kept underlying price increases modest, as reflected by the low growth in core inflation. The only major exception was the US, where core inflation was supported by a continued expansion of private consumption, particularly of services such as medical care.

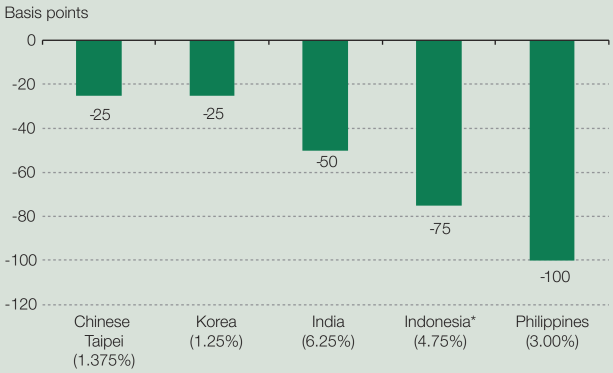
[2] Based on global Brent crude oil 1-month futures price.

Further policy support globally

Confronted with increasing growth concerns and low inflationary pressures, the policy stance turned more accommodative in most regions. In the advanced economies, monetary policy remained as the key policy option as some governments continued to rebuild their fiscal positions. The Federal Reserve adopted a more gradual path on monetary policy normalisation than previously expected, increasing the federal funds rate target by 25 basis points to a range of 0.50% - 0.75% on 14 December 2016, while in other major advanced economies, central banks undertook further monetary easing. Following the UK's EU referendum results, the Bank of England launched a package of measures designed to provide support to growth. Across other advanced economies, central banks in Australia, New Zealand, Norway and Sweden also reduced key policy rates following higher downside risks to inflation and growth. Along with monetary

Chart 1.3

Cumulative Movements of Policy Rates (January 2016 - January 2017)



Note: Current policy rates as at end January 2017 in parentheses
*Indonesia official policy interest rate changed to the 7-day reverse repo rate in April 2016

Source: National Authorities

easing, several advanced economies implemented structural reforms during the year to enhance macroeconomic fundamentals and medium-term growth sustainability. The Japanese government launched two committees to spearhead structural changes in agriculture, medicine and undertake labour market reforms to boost productivity. In the euro area, structural reforms continued to take place, particularly in enhancing the labour market and improving the business environment.

In Asia, many economies employed a combination of monetary and fiscal policies to spur domestic economic activities. Additionally, policymakers in Asia continued to pursue structural reforms to strengthen macroeconomic fundamentals and enhance medium-term growth sustainability. PR China, Chinese Taipei and Thailand implemented fiscal measures to bolster domestic economic activity. These measures were in the areas of providing financing support for state-owned enterprises and small businesses, and higher public investment. Asian policymakers also introduced measures to accelerate infrastructure investment, prioritising both hard and soft infrastructures, through upgrading transportation networks, enhancing existing public-private partnership (PPP) frameworks as well as increasing broadband penetration. Additionally, efforts were focused on improving governance, liberalising industrial sectors and enhancing the ease of doing business (see also the Box Article on 'Structural Reforms in ASEAN-5 Economies: Past Successes and Future Challenges').

Challenges from the continuing legacies of the financial crisis, growing domestic vulnerabilities and increasing strains in the global financial and foreign exchange markets complicated policy considerations throughout the year. This was compounded by narrowing policy space in many economies and rising public discontentment against existing trade and political arrangements. The operating environment will become even more challenging in 2017 as the international economic policy and political landscape will be reshaped by the potential change in the relationship between the UK and the European Union and new policy stances from the US. Policymakers will have to be proactive and move strategically, utilising all available policy options, to achieve the objectives of supporting short-term growth and enhancing long-term economic prospects.

THE MALAYSIAN ECONOMY

In 2016, the Malaysian economy continued to face considerable external and domestic headwinds. While some of the impact of earlier domestic shocks gradually dissipated during the year, growth performance was affected by the materialisation of new risks and ongoing adjustments to external shocks that have impacted the economy since end-2014[3]. Despite these challenges, however, the economy recorded a commendable performance and grew by 4.2% in 2016.

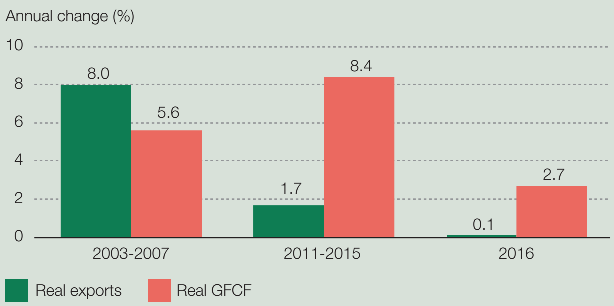
Despite the challenging economic environment, the Malaysian economy registered a commendable growth of 4.2% in 2016

The challenging global landscape necessitated continued spending adjustments by households, businesses and the Government, amid the dissipating impact of previous domestic shocks. Export performance and investment activity were relatively subdued throughout the year following lacklustre global demand and low commodity prices (Chart 1.4). In addition, the unexpected outturn of political developments in the advanced economies, especially the UK and the US, and the macroeconomic policies adopted by these economies, have led to heightened uncertainty in financial markets and a significant reversal of capital flows from emerging economies.

On the domestic front, the economy continued to face headwinds from higher cost of living and weak sentiments. Ongoing adjustments by households, especially the low

Chart 1.4

Real Exports and Gross Fixed Capital Formation (GFCF) (2010=100)



Source: Department of Statistics, Malaysia

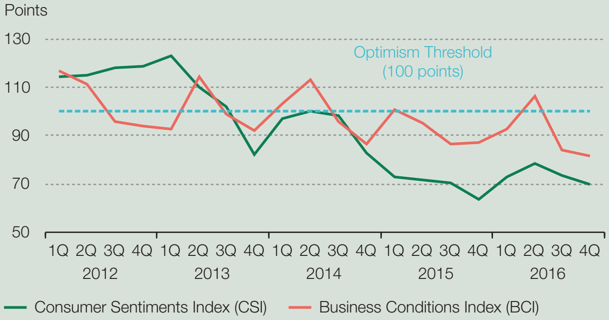
[3] External shocks include weak commodity prices, lower growth in both advanced and regional economies, and geopolitical developments.

Economic Developments in 2016

and middle-income groups, to the increased cost of living was further exacerbated by soft labour market conditions (See Information Box on 'Soft Labour Market Conditions'). Concurrently, business and consumer sentiments were affected by a confluence of global and domestic factors, including the heightened volatility in financial markets and the prolonged underperformance of the ringgit (Chart 1.5).

Chart 1.5

Quarterly MIER Consumer Sentiments and Business Conditions Indices



Source: Malaysian Institute of Economic Research (MIER)

These external and domestic challenges resulted in a slower expansion across all sectors of the economy during the year. The environment of higher prices and increased uncertainties led to moderate growth of household spending. While tentative signs of a recovery in the spending momentum emerged towards the second half of the year, overall growth of household spending remained below its long-term average of 6.6% (1990 - 2015). Investment growth moderated amid the multiple shocks to the economy and the uncertain business environment. In early 2016, the projection of lower petroleum-related revenue arising from low crude oil prices resulted in the recalibration of the Government's Budget and re-prioritisation of Government expenditure. The reduction in Government spending further weighed down on real activity.

In the external sector, the current account of the balance of payments remained in surplus, but by a smaller amount. This stemmed from a lower trade surplus as export growth moderated in line with the subdued global demand. The persistent structural deficits in the services and income accounts also contributed further to the narrowing of the current account surplus. The financial account continued to record net outflows. While direct investment registered net inflows, portfolio investment inflows in the first half of the year were offset by larger net outflows in the second half of the year.

The strong fundamentals of the Malaysian economy have accorded Malaysia the ability to weather these challenges. The diversified sources of growth in the economy have allowed the adverse impact of sector-specific shocks to remain manageable. Despite some softening, labour market conditions remained stable with continued income growth providing continued support to household spending. Healthy financial institutions and ample domestic liquidity also ensured orderly financial intermediation. Notwithstanding the weak global demand, Malaysia's external position remained strong, supported by ample international reserves and manageable levels of external debt.

In addition, appropriate and timely policy responses played a key role in supporting growth during the year. These included a combination of an accommodative monetary policy and targeted pro-growth measures. Bank Negara Malaysia adjusted the Overnight Policy Rate (OPR) downwards to maintain the degree of monetary accommodativeness. The reduction in the OPR was complemented by efforts to increase household disposable income and support business activity. For example, the Government embarked on policies to create a conducive ecosystem for a sharing economy that would unlock new sources of income for households. Other measures, such as the reduction of employees' EPF contributions and higher payments from Bantuan Rakyat 1Malaysia (BR1M), were also introduced during the year to support low and middle-income households, while incentives were provided to spur business activity, particularly among the small and medium enterprises (SMEs). These included funds and incentives to increase adoption of technology, promote entrepreneurship and increase research and development (R&D) activity.

In recognising the challenges posed by global and domestic trends such as ageing population, the influx of new technologies and lower productivity gains, critical reforms and structural adjustments remained a priority. Efforts to enhance export competitiveness were accelerated in line with the role of the external sector as an important engine of growth for the economy. Ongoing investments to modernise the physical and virtual infrastructure remain on track to meet the rising demand for greater interconnectedness. In developing a high quality workforce, the quality of the education system remained a policy priority, with increased emphasis on skills improvement and life-long learning. Notwithstanding the limited impact on economic growth in the short-term, these structural reforms are key to the sustained future growth of the Malaysian economy.

Table 1.2

Malaysia - Key Economic Indicators

	2014	2015	2016*p*	2017*f*
Population (million persons)	30.7	31.2	31.7	32.1
Labour force (million persons)	14.3	14.5	14.7	14.9
Employment (million persons)	13.9	14.1	14.2	14.3
Unemployment (as % of labour force)	2.9	3.1	3.5	3.6 ~ 3.8
Per Capita Income (RM)	34,839	36,078	37,738	39,656
(USD)	10,645	9,238	9,096	8,906[3]
NATIONAL PRODUCT (% change)				
Real GDP at 2010 prices	6.0	5.0	4.2	4.3 ~ 4.8
(RM billion)	1,012.5	1,062.8	1,107.9	1,158.5
Agriculture, forestry and fishery	2.1	1.2	-5.1	4.0
Mining and quarrying	3.5	4.7	2.7	2.7
Manufacturing	6.2	4.9	4.4	4.3
Construction	11.7	8.2	7.4	8.0
Services	6.6	5.1	5.6	4.9
Nominal GNI	8.7	5.2	6.2	6.7
(RM billion)	1,069.8	1,125.1	1,194.6	1,274.7
Real GNI	6.1	6.8	4.4	4.7
(RM billion)	972.6	1,038.5	1,084.4	1,135.5
Real aggregate domestic demand[1]	5.9	5.1	4.4	4.4
Private expenditure	7.9	6.1	5.7	5.6
Consumption	7.0	6.0	6.1	6.0
Investment	11.1	6.4	4.4	4.1
Public expenditure	0.4	2.1	0.4	0.5
Consumption	4.3	4.4	1.0	-0.2
Investment	-4.7	-1.0	-0.5	1.5
Gross national savings (as % of GNI)	30.4	28.9	28.9	27.9
BALANCE OF PAYMENTS (RM billion)				
Goods balance	113.3	109.6	101.2	98.4
Exports	678.9	685.4	686.0	723.4
Imports	565.5	575.8	584.8	625.1
Services balance	-10.7	-21.0	-22.6	-24.0
Primary income, net	-36.6	-32.0	-34.7	-36.3
Secondary income, net	-17.4	-21.9	-18.7	-20.7
Current account balance	48.6	34.7	25.2	17.4
(as % of GNI)	4.5	3.1	2.1	1.0 ~ 2.0
Bank Negara Malaysia international reserves, net[2]	405.3	409.1	423.9	-
(in months of retained imports)	8.3	8.4	8.7	-
PRICES (% change)				
CPI (2010=100)	3.2	2.1	2.1	3.0 ~ 4.0
PPI (2010=100)	1.5	-7.4	-1.1	-
Real wage per employee in the manufacturing sector	1.5	3.7	4.1	-

[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's account
[3] Based on average USD exchange rate for the period of January-February 2017
p Preliminary
f Forecast
Note: Numbers 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)	2014		2015		2016*p*	
Revenue	220.6		219.1		212.4	
Operating expenditure	219.6		217.0		210.2	
Net development expenditure	38.5		39.3		40.6	
Overall balance	-37.4		-37.2		-38.4	
Overall balance (% of GDP)	-3.4		-3.2		-3.1	
Public sector net development expenditure	164.5		138.6		158.1	
Public sector overall balance (% of GDP)	-7.4		-7.8		-7.3	
EXTERNAL DEBT						
Total debt (RM billion)	747.8		833.8		908.7	
Medium-and long-term debt	383.7		481.9		532.1	
Short-term debt	364.1		351.9		376.6	
Debt service ratio[1] (% of exports of goods and services)						
Total debt	19.1		22.6		25.0	
Medium-and long-term debt	18.9		22.5		24.8	
MONEY AND BANKING	**Change in 2014**		**Change in 2015**		**Change in 2016**	
	RM billion	**%**	**RM billion**	**%**	**RM billion**	**%**
Money supply M1	18.8	5.7	14.0	4.1	20.4	5.7
M3	101.5	7.0	40.8	2.6	47.9	3.0
Banking system deposits	116.4	7.6	28.8	1.8	25.0	1.5
Banking system loans[2]	114.1	9.3	105.4	7.9	76.4	5.3
Loan to deposit ratio (%, end of year)[3]	86.8		88.7		89.8	
Loan to fund ratio (%, end of year)[3&4]	82.1		83.0		84.3	
Loan to fund and equity ratio (%, end of year)[3,4&5]	74.2		74.6		75.3	
INTEREST RATES (%, AS AT END-YEAR)	**2014**		**2015**		**2016**	
Overnight Policy Rate (OPR)	3.25		3.25		3.00	
Interbank rates (1-month)	3.38		3.45		3.10	
Commercial banks						
Fixed deposit 3-month	3.13		3.13		2.92	
12-month	3.31		3.31		3.06	
Savings deposit	1.07		1.04		0.99	
Weighted average base rate (BR)	-		3.77		3.61	
Base lending rate (BLR)	6.79		6.79		6.65	
Treasury bill (3-month)	3.42		2.74		3.06	
Malaysian Government Securities (1-year)	3.48		2.59		3.26	
Malaysian Government Securities (5-year)	3.84		3.47		3.70	
EXCHANGE RATES (AS AT END-YEAR)	**2014**		**2015**		**2016**	
Movement of Ringgit (%)						
Change against SDR	-0.7		-15.1		-0.8	
Change against USD	-6.1		-18.6		-4.3	

1 Includes prepayment of medium- and long-term debt
2 Includes loans sold to Cagamas
3 Deposits exclude deposits accepted from banking institutions. 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 and all debt instruments (including subordinated debt, debt certificates/sukuk issued, commercial paper and structured notes)
5 Equity comprises ordinary and preferred shares, share premium and retained earnings
p Preliminary

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Domestic Demand Anchored Growth in 2016

The Malaysian economy registered a growth of 4.2% in 2016 (2015: 5%). Domestic demand continued to anchor growth during the year, supported mainly by private sector spending. Public sector spending, however, moderated following the expenditure rationalisation adopted by the Government. On the external front, export growth was weaker against a backdrop of more moderate global expansion, particularly in key trading partners.

Private consumption growth was sustained at 6.1% in 2016 (2015: 6%), mainly supported by continued wage and employment growth, with additional impetus coming from Government measures. Nominal wages in the private sector grew by 4.2%, partly supported by the increase in the minimum wage in July 2016. Public sector wages recorded a higher growth with the increase in civil servants salary in the second half of the year. Government measures to increase household disposable income have also supported household spending. These included the reduction in employees' EPF contributions by 3 percentage points (11% to 8%) from March 2016 to December 2017, higher Bantuan Rakyat 1Malaysia (BR1M) payouts and the special tax relief of RM2,000 to individual taxpayers with a monthly income of RM8,000 or below for the 2015 assessment year.

Table 1

Real GDP by Expenditure (2010=100)

	2016*p*	2015	2016*p*	2015	2016*p*
	% of GDP	Annual change (%)		Contribution to growth (ppt)	
Domestic Demand[1]	**91.8**	**5.1**	**4.4**	**4.7**	**4.0**
Private sector expenditure	70.2	6.1	5.7	4.2	3.9
Consumption	*53.3*	*6.0*	*6.1*	*3.1*	*3.2*
Investment	*16.9*	*6.4*	*4.4*	*1.1*	*0.7*
Public sector expenditure	21.6	2.1	0.4	0.5	0.1
Consumption	*13.1*	*4.4*	*1.0*	*0.6*	*0.1*
Investment	*8.5*	*-1.0*	*-0.5*	*-0.1*	*0.0*
Gross Fixed Capital Formation	*25.4*	*3.7*	*2.7*	*1.0*	*0.7*
Change in stocks	**0.2**			**0.6**	**0.4**
Net Exports of Goods and Services	**8.1**	**-3.8**	**-1.8**	**-0.4**	**-0.2**
Exports	70.0	0.6	0.1	0.5	0.1
Imports	61.9	1.2	0.4	0.8	0.2
Real Gross Domestic Product (GDP)	**100.0**	**5.0**	**4.2**	**5.0**	**4.2**

[1] Excluding stocks
p Preliminary

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

Public consumption growth moderated to 1% (2015: 4.4%) due to lower spending on supplies and services, in line with the Government's efforts to rationalise expenditure. Spending on emoluments, however, was higher during the year, mainly reflecting the salary increment in July 2016.

Gross fixed capital formation (GFCF) expanded moderately by 2.7% in 2016 (2015: 3.7%). Public investment growth improved, but remained in contraction, while private investment growth continued to moderate.

Public investment recorded a smaller rate of decline in 2016 (-0.5%; 2015: -1%) due to the smaller contraction in spending on fixed assets by public corporations. This reflected mainly the improvement in investment in the downstream oil and gas industry as well as the *transportation* and *utilities* sub-sectors. Capital spending by the Federal Government continued to increase in 2016, albeit at a moderate rate, and was focused mainly on developing the transportation infrastructure, enhancing industrial development, improving public utilities and accelerating agriculture and rural development.

As firms adjusted to the shocks emanating from the external and domestic environment, growth of private investment moderated further to 4.4% in 2016 (2015: 6.4%). While financing conditions remained supportive of private investment, profitability and business sentiments remained weak during the year. In terms of sector, overall investment performance continued to be supported by the implementation of new and ongoing projects in the manufacturing and services sectors. Investment in the mining sector continued to be constrained by the low oil price environment.

For GFCF by type of assets, spending on machinery and equipment increased (1.1%; 2015: -0.2%) following the faster pace of expansion in civil engineering investment, particularly in the petrochemical, transportation and utilities sub-sectors. However, growth of investment in structures, which accounted for 56% of total GFCF, moderated to 4.9% (2015: 6.8%) due mainly to lower non-residential investment, particularly in the commercial property sub-sector due to the oversupply of office and retail space. Growth of investment in other assets declined during the year (-4.2%; 2015: 1.6%), due to lower capital expenditure in the development of intellectual property products (e.g. in mineral exploration and evaluation) and cultivated biological products (e.g. livestock and crops).

During the year, gross national savings (GNS) grew by 6.3% (2015: 0%) to remain at 28.9% of gross national income (2015: 28.9% of GNI) on account of higher growth in public savings (36.1%; 2015: -40.4%). Gross capital formation expanded at a faster pace of 10.4%, attributable mainly to stronger growth in private capital formation (15.3%; 2015: 7.7%). As a result, savings-investment gap narrowed further to 2.1% of GNI in 2016 compared to 3.1% of GNI in 2015.

Soft Labour Market Conditions

The unemployment rate rose to 3.5% in 2016 (2015: 3.1%, average 2011-2015: 3%), due mainly to slower job creation amid more moderate economic growth. While total employment continued to expand, the pace remained insufficient to absorb new labour market entrants. The labour force expanded by 168,000 people, while net employment gains amounted to 112,300 jobs. Industrial engagements throughout the year reaffirmed the view that employers adopted a cautious stance and refrained from expanding their workforce too quickly. The younger labour force was the most affected, as the moderate growth environment made it more challenging for youth to secure employment. The labour force participation rate slipped marginally to 67.6% of working-age population (2015: 67.9%).

Table 1

Selected Labour Market Indicators

	2012*r*	**2013*r***	**2014*r***	**2015*r***	**2016*p***
Employment ('000 persons)	12,821	13,545	13,853	14,068	14,180
Labour force ('000 persons)	13,222	13,981	14,264	14,518	14,686
Unemployment rate (% of labour force)	3.0	3.1	2.9	3.1	3.5
Layoffs[1] (persons)	33,989	33,086	25,917	44,343	37,699
Foreign workers ('000 persons)	1,572	2,250	2,073	2,135	1,866

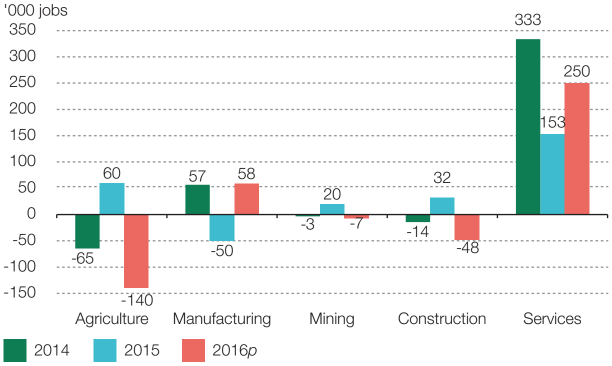
p Preliminary
r Figures for 2012-2015 have been revised to reflect new population estimates
[1] Constitutes workers affected by retrenchments and voluntary separation scheme (VSS) offerings

Source: Department of Statistics, Malaysia; Ministry of Human Resources; Ministry of Home Affairs; and Bank Negara Malaysia estimates

Nonetheless, overall labour market conditions generally remained stable, as employment and wages continued to expand during the year. Employment gains were driven mainly by the services sector, particularly by the *wholesale and retail trade, accommodation and food and beverage,* and *education* sub-sectors, while gains in the manufacturing sector were moderate (Chart 1). In terms of skills, net job gains were mostly concentrated in the high-skilled segments such as professional and managerial jobs, a continuation of the trend since 2014 (Chart 2). However, job gains in these segments remained insufficient to address the high rates of youth unemployment, particularly among tertiary-educated youth[1] (2016: 10.5%; 2015: 10.7%, See Box Article on 'Youth Unemployment in Malaysia: Developments and Policy Considerations').

Chart 1

Net Employment Gains[1] by Sectors, 2014-2016



p Preliminary
[1] Net employment gains are the difference between employment level in a given year compared to the previous year

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

Chart 2

Employment Growth by Skill Levels, 2012-2016

p Preliminary

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

Layoffs reported to the Ministry of Human Resources remained elevated (37,699 persons; 2015: 44,343 persons) but were concentrated within selected industries, reflecting industry-specific trends. These include restructuring of operations due to shifting consumer preferences and technological advancement in the banking sector, mergers and acquisitions in the electronics and electrical (E&E) sector, and streamlining of operations in the mining industry in response to lower global oil prices. In the agriculture sector, employment contracted, due to the impact of adverse weather conditions on the plantation sector. Of note, the number of registered low-skilled foreign workers in Malaysia declined to 1.87 million in 2016 (2015: 2.14 million). These workers remain concentrated in the construction, manufacturing and agriculture sectors.

Aggregate nominal wages in the private[2] and public sectors grew by 4.2% and 6.7%, respectively in 2016 (2015: 4.9% and 4.7%, respectively). Wage growth was partly supported by the new minimum wage[3] and salary increments for civil servants, which took effect on July 2016. In the private sector, higher wage growth was seen in the manufacturing sector (6.2%; 2015: 5.8%), while wages in major services sub-sectors[4] grew at a more moderate rate (3.3%; 2015: 4.6%). Labour productivity, as measured by real value-added per worker, grew by 3.2% (2015: 3.4%), driven mainly by productivity increases in the manufacturing and construction sectors (3.7% and 7.9%, respectively; 2015: 7.2% and 5.5%, respectively). Labour productivity growth in the services sector was modest at 2.1% (2015: 3.3%).

[1] Among the labour force between the ages of 15 - 24.
[2] Private sector wages refers to wages in the manufacturing and selected services sectors published by the Department of Statistics, Malaysia.
[3] The upward revision of the minimum wage sets the level at RM1,000 per month in Peninsular Malaysia and RM920 per month in Sabah and Sarawak (Previous: RM900 and RM800, respectively).
[4] Major services sector consists of wholesale and retail trade and food and beverages, accommodation; information and communications, transportation and storage; health, education and arts, entertainment and recreation; and professional and real estate services sub-sectors.

Continued Expansion in Most Economic Sectors

On the supply side, all economic sectors continued to expand in 2016, with the exception of the agriculture sector. Agriculture production declined, as crude palm oil (CPO) output was affected by the El Niño weather phenomenon.

Table 1

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

	2016*p*	2015	2016*p*	2015	2016*p*
	% of GDP	Annual change (%)		Contribution to growth (ppt)[1]	
Services	54.2	5.1	5.6	2.7	3.0
Manufacturing	23.0	4.9	4.4	1.1	1.0
Mining and quarrying	8.8	4.7	2.7	0.4	0.2
Agriculture	8.1	1.2	-5.1	0.1	-0.5
Construction	4.5	8.2	7.4	0.3	0.3
Real Gross Domestic Product (GDP)	**100.0[1]**	**5.0**	**4.2**	**5.0**	**4.2**

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 recorded a higher growth of 5.6% in 2016 (2015: 5.1%). Growth was supported by expansion across all sub-sectors. The *finance and insurance* sub-sector turned around to register positive growth, driven by higher net interest income and better performance of the life insurance segment. The *retail* and *food and beverage and accommodation* sub-sectors recorded higher growth, supported by continued wage and employment growth and a recovery in tourist arrivals. The *utilities* sub-sector benefited from the hot weather conditions, particularly in the first half of the year, which increased the demand for electricity. The sustained trade-related activity and higher air passenger traffic during the year contributed to the growth in the *transportation and storage* sub-sector.

The manufacturing sector grew by 4.4% in 2016 (2015: 4.9%), supported by continued expansion in both export- and domestic-oriented industries. The performance of the export-oriented industries was mainly driven by firm growth of the *electronics and electrical* (E&E) segment, with semiconductors exports growing strongly in response to the recovery in global demand for semiconductors in the second half of 2016. Growth was further supported by higher production of petrochemical products to meet sustained regional demand. The domestic-oriented industries were weighed down by the weak output of motor vehicles, but strong demand for food-related products and construction-related materials provided support to growth.

The construction sector recorded moderate growth in 2016 (7.4%; 2015: 8.2%). The faster pace of expansion in the *civil engineering* and *residential* sub-sectors was partially offset by a decline in *non-residential* activity. Growth in the *civil engineering* sub-sector was driven by higher activity in existing multi-year projects, particularly in the petrochemical, transportation and utilities segments. Activity in the *residential* sub-sector was supported by large property launches in the previous years while growth in the *special trade* sub-sector continued to be supported by early and end-works activity. Growth in the *non-residential* sub-sector, however, was weighed down by slower activity in the commercial property segment amid the oversupply of office and retail space.

In the agriculture sector, growth contracted by 5.1% (2015: 1.2%), attributable mainly to the decline in CPO production as yields were affected by the El Niño weather phenomenon. In particular, fresh fruit bunch yields declined by 13.9% compared to the previous year.

Growth in the mining sector moderated (2.7%; 2015: 4.7%), due partly to the high base effect from 2015 which saw an intensification of production from the Gumusut-Kakap oil field. Nonetheless, higher natural gas production provided support to the sector, following the resumption of operations at the Sabah-Sarawak gas pipeline in mid-2016 and the commissioning of new facilities (LNG Train 9 and PETRONAS' FLNG Satu) in the second half of 2016.

EXTERNAL SECTOR

Modest global demand in 2016 and weak commodity prices

Amid subdued growth of Malaysia's major trading partners and a further decline in commodity prices, gross exports registered a growth of 1.1% in 2016 (2015: 1.6%), the lowest since 2012. In terms of markets, exports to key trading partners such as PR China and Japan fell by 2.9% and 12.9%, respectively. Cumulatively, exports to these economies accounted for 20.6% of gross exports. Exports to PR China were lower due mainly to lower exports of commodities and non-resource based products, while exports to Japan were affected by weak LNG demand, attributable to the restart of nuclear power plants that were shut down following the Fukushima disaster in 2011. Conversely, exports to the US (10.2% share) grew by 8.9% driven by continued demand for semiconductors, while exports to the ASEAN region (29.4% share) grew by 5.4%, mostly on account of E&E and petroleum products. In sum, Malaysia's diversified trade structure helped to partially mitigate the impact of negative developments in some major export partners on the overall trade performance.

Table 1.4

Balance of Payments[1]

Item (Net)	2014	2015	2016*p*
	RM billion		
Goods	113.3	109.6	101.2
Services	-10.7	-21.0	-22.6
Primary Income	-36.6	-32.0	-34.7
Secondary Income	-17.4	-21.9	-18.7
Current account balance	**48.6**	**34.7**	**25.2**
% of GNI	*4.5*	*3.1*	*2.1*
Capital account	**0.3**	**-1.1**	**0.1**
Financial account	**-80.0**	**-50.9**	**-4.2**
Direct investment	-18.0	4.8	17.9
Portfolio investment	-39.4	-28.2	-19.7
Financial derivatives	-1.0	-0.7	-0.8
Other investment	-21.7	-26.8	-1.7
Errors and omissions (E&O)[2]	*-5.5*	*21.1*	*-6.3*
% of total trade	*-0.4*	*1.4*	*-0.4*
of which:			
Foreign exchange revaluation gain (+) or loss (-)	*7.6*	*57.3*	8.9
Overall balance	**-36.5**	**3.8**	**14.8**
Bank Negara Malaysia international reserves, net	**405.3**	**409.1**	**423.9**
USD billion equivalent	**115.9**	**95.3**	**94.5**

[1] The data are compiled in accordance with the Sixth Edition of the International Monetary Fund's (IMF) Balance of Payments and International Investment Position Manual (BPM6)
[2] Includes unrealised foreign exchange revaluation gains/losses on international reserves
p Preliminary
Note: Figures may not necessarily add up due to rounding
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Malaysia's external trade remained subdued, reflecting modest global growth and low commodity prices

Gross imports recorded a higher growth of 1.9% (2015: 0.4%), driven largely by higher imports of capital goods in line with the on-going implementation of infrastructure projects and continued expansion in investment activity. In addition, intermediate imports registered a smaller contraction, due mainly to lower imports of fuel-related inputs following persistent weakness in commodity prices.

Some tentative signs of recovery in external trade performance began to emerge towards the end of the year. This was observed in the upticks in export and import growth in the last two months of 2016 (average November - December 2016 growth: 9.2% and 11.4%, respectively). This reflected

Table 1.5

External Trade

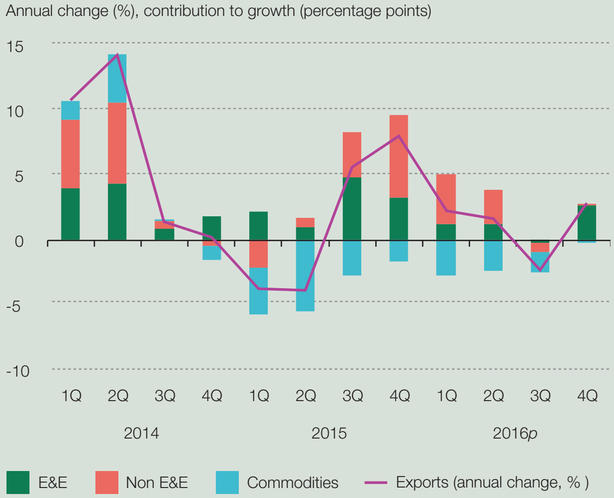
	Share 2016 (%)	2014	2015	2016*p*
		Annual change (%)		
Gross exports	**100.0**	**6.3**	**1.6**	**1.1**
of which:				
Manufactures	82.2	7.1	6.5	3.2
Electronics and electrical (E&E)	*36.6*	*8.1*	*8.5*	*3.5*
Non-E&E	*45.5*	*6.4*	*5.0*	*3.0*
Commodities	17.1	3.9	-14.9	-8.6
Agriculture	*9.0*	*0.5*	*-2.8*	*4.7*
Minerals	*8.2*	*6.2*	*-22.9*	*-19.8*
Gross imports	**100.0**	**5.3**	**0.4**	**1.9**
of which:				
Intermediate goods	57.1	7.6	-2.1	-0.1
Capital goods	14.3	-2.4	-0.3	4.9
Consumption goods	9.6	5.7	24.1	7.3
Trade balance (RM billion)	**-**	**82.5**	**91.6**	**87.3**

p Preliminary
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

both the stronger demand momentum from regional economies and positive price movements. Of importance, E&E exports grew by 11.1% in the last two months of the year. There were also positive valuation effects from the depreciation of the ringgit and gradual improvement in commodity prices towards the end of the year.

Chart 1.6

Export Performance



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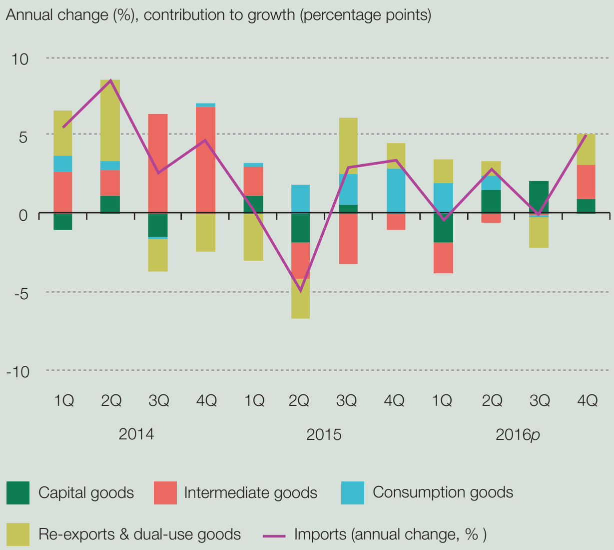
Source: Department of Statistics, Malaysia

Chart 1.7

Import Performance



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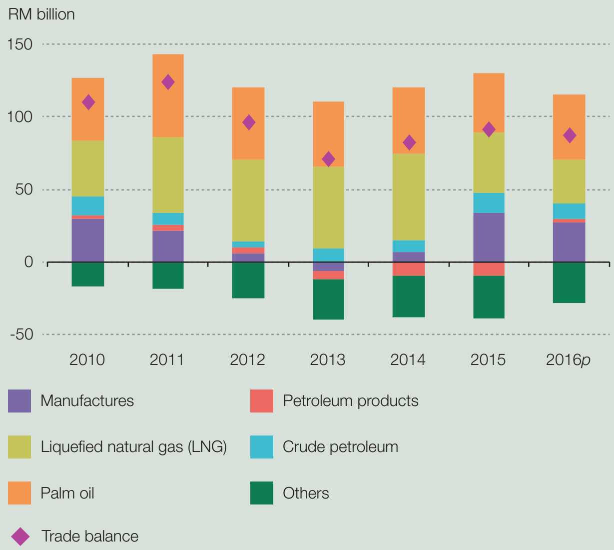
Source: Department of Statistics, Malaysia

Chart 1.8

Trade Balance by Commodities



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Source: Department of Statistics, Malaysia

As export growth moderated and imports improved, for the year as a whole, the trade surplus narrowed to RM87.3 billion (2015: RM91.6 billion).

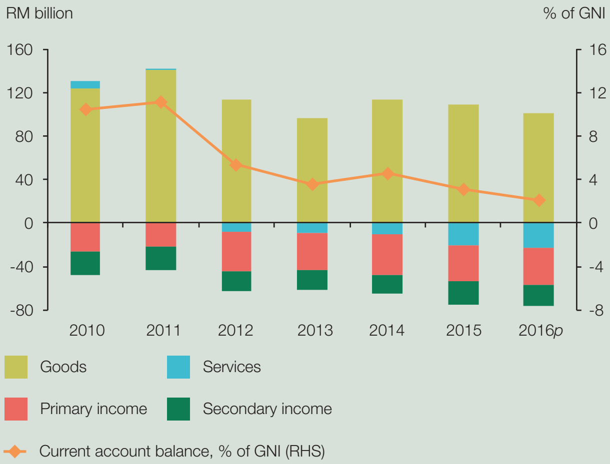
The services account registered a larger deficit, due mainly to higher employment of foreign professional, technical and engineering services (21% growth; 2015: 7.9%), particularly in the aviation, oil and gas, and utilities sectors. This, however, was partially offset by lower net payments in the transport account, in tandem with the modest trade activity. The travel account also recorded a higher surplus following the recovery in tourist arrivals.

In the income account, the primary income deficit widened due to lower net receipts from other investments, but was partially offset by a smaller deficit in direct investment income. In contrast, the secondary income account recorded a smaller deficit due to higher inward remittances amid the continued increase in outward remittances by foreign workers.

Overall, the current account balance remained in surplus as the trade surplus exceeded the deficits in the services and income accounts. The current account position stood at RM25.2 billion or 2.1% of GNI, a smaller amount compared to the previous year (2015: RM34.7 billion, 3.1% of GNI).

Chart 1.9

Current Account Balance



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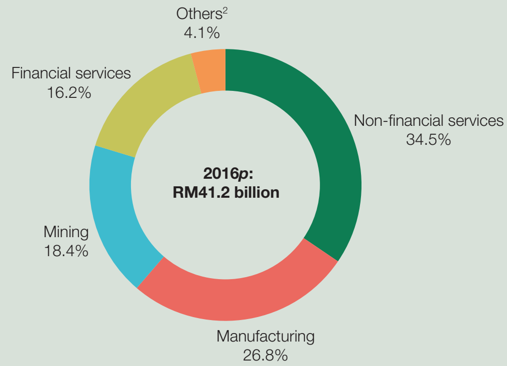
Source: Department of Statistics, Malaysia

Chart 1.10

Net Foreign Direct Investment by Sectors[1]



[1] Foreign direct investment as defined according to the 5th Edition of the Balance of Payments Manual (BPM5) by the International Monetary Fund (IMF)
[2] Refers to agriculture and construction sectors

p Preliminary

Source: Department of Statistics, Malaysia

Significant two-way movement of capital flows

The external financial sector of the balance of payments continued to be confronted with significant volatility in the cross border movements of capital flows. However, the financial account recorded a smaller net outflow of RM4.2 billion in 2016 (2015: net outflow of RM50.9 billion), due mainly to higher net inflows in the direct investment account and lower net outflows in both the portfolio and other investment accounts.

Supported by ample reserves, a floating exchange rate and manageable external debt levels, the external financial position remained resilient despite considerable volatility in capital flows

The direct investment account recorded a higher net inflow of RM17.9 billion (2015: net inflow of RM4.8 billion), on account of higher net inflows arising from the incurrence of direct investment liabilities and the moderation in net outflows due to a lower level of acquisitions of direct investment assets[4].

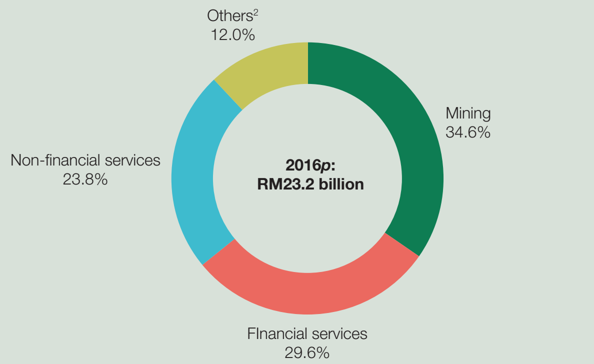
During the year, foreign direct investment (FDI) in Malaysia moderated to RM41.2 billion, equivalent to 3.4% of GNI (2015: RM43.4 billion or 3.9% of GNI), arising mainly from lower investments in the manufacturing and mining sectors. The challenging global environment had resulted in several large multinational corporations (MNCs), particularly in the E&E industry, to undergo restructuring and consolidation of their operations in the region, including those in Malaysia. The environment of low oil prices also led to a considerable decline in foreign investments, particularly in upstream oil and gas activities. However, FDI in the services and construction sectors increased, reflecting mainly the large acquisition of domestic power generation assets by a foreign entity, continued expansion in the *finance and insurance*, and *wholesale and retail trade services* sub-sectors and the implementation of ongoing residential and infrastructure projects, particularly in the Klang Valley and Iskandar Malaysia.

Direct investment abroad (DIA) by Malaysian companies declined to RM23.2 billion or 1.9% of GNI (2015: RM38.7 billion or 3.4% of GNI). This was attributed mainly to investment in the mining sector declining by 67% to RM8 billion (2015: RM24.4 billion). This reflected the downscaling and deferment of capital expenditure for international upstream oil and gas activities amid cost optimisation measures, mainly by the national oil company. Nevertheless, DIA into the services sector improved, particularly in the *finance and insurance* sub-sector.

[4] The main difference between 'direct investment assets/liabilities' and 'DIA/FDI' is the treatment of intercompany loans that has been changed from a directional basis to an asset-liability basis, in accordance with the 6th edition of the Balance of Payments and International Investment Position Manual (BPM6) by the International Monetary Fund (IMF). For further details, please refer to the White Box on 'Classification of Direct Investment in BPM6' in Bank Negara Malaysia's Annual Report 2013.

Chart 1.11

Net Direct Investment Abroad by Sectors[1]

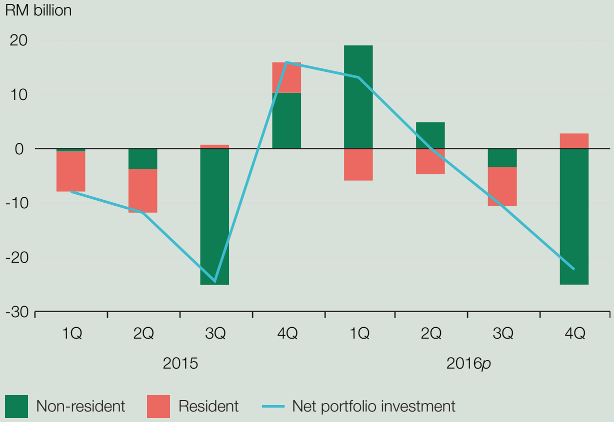


[1] Direct investment abroad as defined according to the 5th Edition of the Balance of Payments Manual (BPM5) by the International Monetary Fund (IMF)
[2] Refers to manufacturing, agriculture and construction sectors
p Preliminary

Source: Department of Statistics, Malaysia

Chart 1.12

Portfolio Investments



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Source: Department of Statistics, Malaysia

Portfolio investment registered a lower net outflow of RM19.7 billion in 2016 (2015: net outflow of RM28.2 billion). In particular, portfolio investment by non-residents were largely characterised by two distinct periods. In the first half of the year, there were net inflows amounting to RM23.8 billion. The inflows were driven mainly by the purchase of debt securities, as the continued search for yield by non-resident fixed income investors led to strong demand for Malaysian Government Securities (MGS) and Government Investment Issues (GII). As a result, non-resident holdings of total outstanding public debt securities rose to 23% as at end-June 2016 (end-December 2015: 22.1%). In the second half of the year, non-resident portfolio flows recorded a net reversal amounting to RM28.5 billion. These outflows were mainly a reaction on the part of international investors to expectations of a faster pace of monetary policy normalisation by the Federal Reserve and expectations of growth-positive policies under the new US administration. The outflows during the period reflected mainly the maturity of foreign currency-denominated Wakala Global Sukuk issued by the Federal Government and the lower holdings of MGS and Bank Negara Monetary Notes (BNMN). Consequently, non-resident holdings of total outstanding public debt instruments declined to 20.8%. Notwithstanding some liquidation of equity securities during the year, foreign participation was sustained at 22.3% of stock market capitalisation as at end-December 2016 (end-December 2015: 22.3%).

Portfolio investment by residents recorded a higher net outflow of RM15 billion during the year (2015: net outflow of RM9.1 billion). These investments reflected mainly the continued purchases of foreign financial assets by domestic institutional investors, fund managers and financial institutions in line with their diversification strategies.

Despite the significant volatility in short-term capital flows, the impact on the overall financing conditions remained manageable. Malaysia's deep and diversified financial markets, coupled with a resilient financial sector, which continues to operate with strong capital and liquidity buffers, has enabled the domestic financial system to smoothly intermediate the large volumes of capital flows. The presence of large domestic institutional investors also played an instrumental role in stabilising the financial markets by providing sustained demand for domestic financial assets as foreign investors rebalanced their exposures.

The other investment account recorded a lower net outflow of RM1.7 billion (2015: net outflow of RM26.8 billion). The private sector recorded a net inflow of RM1.3 billion (2015: net outflow of RM24.9 billion). This turnaround was mainly attributable to loan repayments by non-resident financial institutions to Malaysian banks and the maturity of overseas deposits held by Malaysian banks. There was also a lower net extension of trade credits by Malaysian exporters to their trading partners, reflecting the subdued growth in exports. The public sector, however, registered a higher net outflow of

RM2.9 billion (2015: net outflow of RM1.9 billion), following a moderation in drawdown of new external borrowings amid continued repayment of external loans.

On the whole, the overall balance of payments registered a higher surplus of RM14.8 billion (2015: surplus of RM3.8 billion). Errors and Omissions (E&O) amounted to -RM6.3 billion or -0.4% of total trade, reflecting mostly foreign exchange revaluation gains on international reserves. Excluding revaluation gains, the E&O stood at -RM15.2 billion or -1% of total trade.

The international reserves of Bank Negara Malaysia amounted to USD94.5 billion (equivalent to RM423.9 billion as at end-2016 compared to USD95.3 billion (equivalent to RM409.1 billion) as at end-2015. Besides developments in the current and financial accounts, the reserves level was also affected by foreign exchange revaluation changes. The reserves level in USD terms declined during the year as the USD strengthened against most of the currencies that make up the diversified foreign currency reserve assets. In ringgit terms, the reserves level has correspondingly increased as the ringgit weakened against most currencies during the same period.

As at 28 February 2017, the reserves level amounted to USD95 billion (equivalent to RM426.3 billion). The international reserves remain ample to facilitate international transactions and sufficient to finance 8.5 months of retained imports and are 1.1 times the short-term external debt. Furthermore, the wide range of monetary policy instruments and the exchange rate flexibility have enabled the economy to reduce its reliance on the Bank's international reserves in managing external pressures.

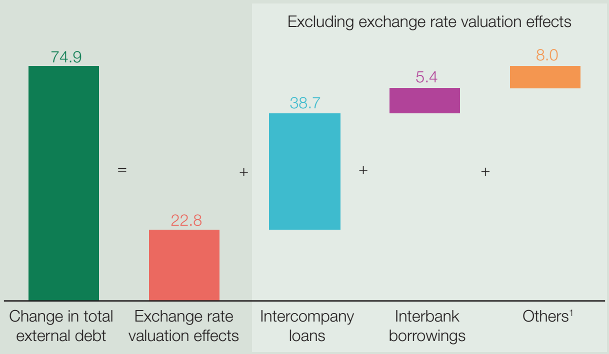
Manageable external debt

Malaysia's external debt amounted to RM908.7 billion, equivalent to USD200.6 billion or 73.9% of GDP as at end-2016. The increase of RM74.9 billion or 9% from RM833.8 billion at end-2015 was partly attributed to valuation effects following the weakening of the ringgit against most currencies during the year. Excluding valuation effects, Malaysia's external debt position increased by 6.2%, mainly on account of higher intercompany and interbank borrowings (Chart 1.13).

Malaysia's external debt remains manageable given its currency, maturity and balance sheet profiles. More than one-third of total external debt is denominated

Chart 1.13

Changes in Total External Debt in 2016 (RM billion)



[1] Include other instruments such as bonds and notes, loans, non-resident (NR) holdings of domestic debt securities, NR deposits, trade credits, IMF allocation of SDRs and miscellaneous, such as insurance claims yet to be disbursed and interest payables on bonds and notes

Source: Bank Negara Malaysia

in ringgit (34.4%), mainly in the form of non-resident holdings of domestic ringgit debt securities and ringgit deposits in domestic banking institutions. As such, these liabilities are not subjected to valuation changes arising from fluctuations in the ringgit exchange rate. In the course of the year, the total non-resident holdings of domestic debt securities increased by 1.4% to RM214.2 billion (end-2015: RM211.3 billion). Non-resident acquisition of GII and MGS during most parts of the year had offset the liquidation of BNMN. This liquidation by non-resident portfolio investors, particularly towards the end of the year, was driven by the increase in the US Federal Reserve's policy rate in December 2016, the anticipation of a faster pace of US interest rate normalisation in 2017, and speculative activity in the non-deliverable forward (NDF) market. On the other hand, the level of non-resident ringgit-denominated deposits in the domestic banking institutions increased by RM6.2 billion or 14.3%.

While the remaining portion of total external debt of RM597.3 billion (65.6%) is denominated in foreign currency, most of it is hedged, either naturally using foreign currency earnings or through the use of financial instruments. Most of these obligations are offshore borrowings[5], raised mainly to further expand productive capacity and to better manage financial resources within corporate groups. As at

[5] Equivalent to the external debt as previously defined, comprised mainly foreign currency loans raised, and bond and notes issued offshore.

Chart 1.14

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

[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

Source: Bank Negara Malaysia

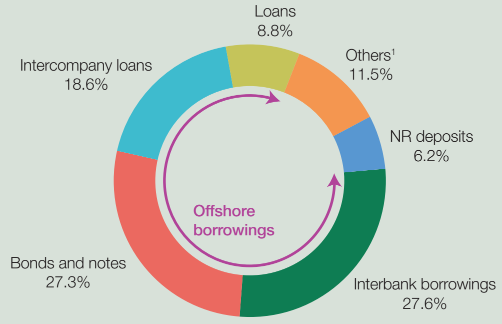
end-2016, the offshore borrowing had declined to 42.7% of GDP compared to 60% of GDP during the Asian Financial Crisis.

Of the total foreign currency-denominated external debt (inclusive of exchange rate valuation effects), around one-third is accounted by interbank borrowing and foreign currency deposits in the domestic banking system (Chart 1.15), which had increased by RM10.4 billion from end-2015. This reflects the banks' intragroup liquidity management and placements of deposits from foreign parent entities, which are subjected to prudent liquidity management practices. Among these are internal limits on funding and maturity mismatches. This is then followed by long-term bonds and notes issued offshore (RM163.4 billion), primarily to finance asset acquisitions abroad that will generate future income. The net increase of RM40.3 billion in foreign currency-denominated intercompany loans was mainly accrued by private corporations in the oil and gas sector and finance and insurance sub-sector. These obligations are normally subjected to flexible and concessionary terms, such as having no fixed repayment schedules or bearing low interest rates.

From a maturity perspective, more than half of the total external debt is skewed towards medium- to long-term tenures (58.6% of total external debt), suggesting limited rollover risks. Also, not all short-term external debt pose a claim on reserves, given the export earnings of borrowers and external assets. As at end-2016, Malaysia recorded a current account surplus and remains a net creditor nation (Chart 1.16), with international reserves accounting for only a quarter of total external assets. The majority of total external assets are held by banks and corporations. The availability of these external assets better enable these entities to meet their external obligations without necessarily creating a claim on international reserves. As at end-2016, Malaysia still recorded a net short-term external surplus position of RM327.3 billion (Chart 1.17), an increase of RM45.2 billion from end-2015 (net short-term asset surplus of RM282.1 billion).

Chart 1.15

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



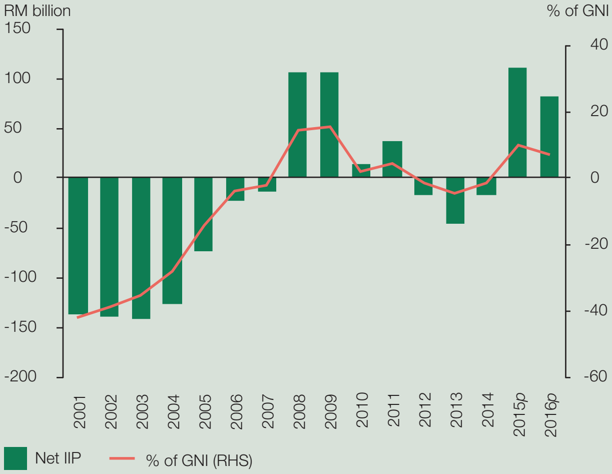
[1] Includes trade credits and miscellaneous, such as insurance claims yet to be disbursed and interest payables on bonds and notes

Source: Bank Negara Malaysia

Economic Developments in 2016

Chart 1.16

Net International Investment Position (IIP)



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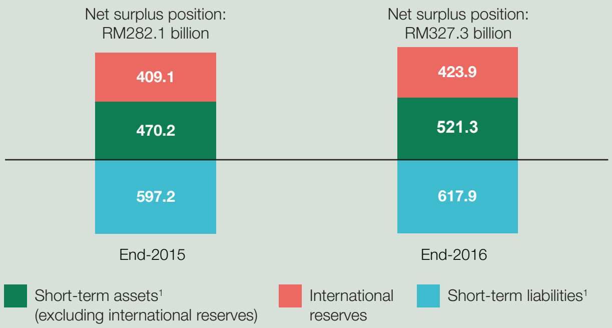
Source: Department of Statistics, Malaysia

Chart 1.17

Short-term External Assets and Liabilities (RM billion)

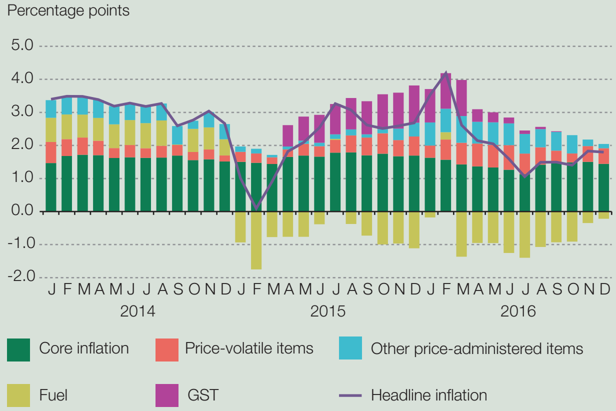


[1] Short-term debt instruments and portfolio equity

Source: Bank Negara Malaysia

Chart 1.18

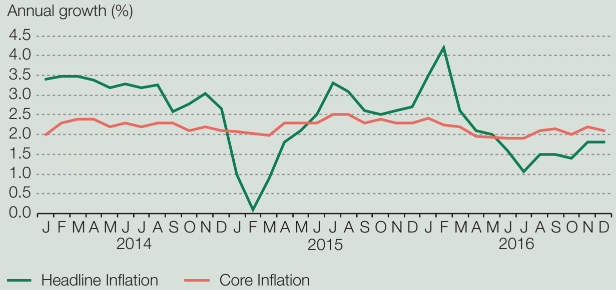
Contribution to Headline Inflation by Components



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.19

Consumer Price Inflation



Source: Department of Statistics,Malaysia and Bank Negara Malaysia

INFLATION DEVELOPMENTS

Headline inflation remained low in 2016

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), was unchanged at 2.1% in 2016 (2015: 2.1%), which is at the lower end of the Bank's forecast range of 2% - 3%. Inflation during the year was driven mainly by adjustments to administered prices undertaken since the fourth quarter of 2015[6] and higher prices of fresh food items due to the El Niño weather phenomenon. The inflationary pressures were, however, offset by the lapse in the impact of GST and lower domestic fuel prices. Moderate domestic demand conditions and a subdued external price environment also helped to contain domestic inflationary pressures. Correspondingly, core inflation[7] was broadly stable during the year, averaging 2.1% in 2016 (2015: 2.3%).

While the average headline inflation for the year was unchanged compared to 2015, the monthly headline inflation continued to be volatile due to global factors. Headline inflation started the year at an elevated level, peaking at 4.2% in February 2016. The higher inflation was driven mainly by the base effect from the low domestic fuel prices in the corresponding

[6] The administered price items are toll charges (October 2015), cigarette prices (November 2015), railway fares (December 2015), reduction in electricity rebates (January 2016) and cooking oil (November 2016).

[7] Core inflation is computed by excluding price-volatile and price administered items. It also excludes the estimated direct impact of GST.

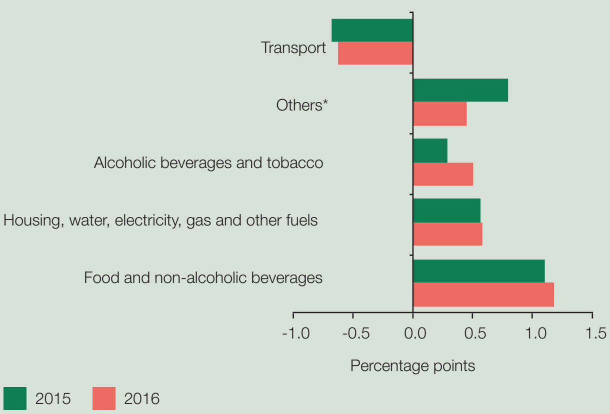
period in 2015 and the relatively high prices of fresh food following the occurrence of El Niño at the beginning of the year. It, however, moderated quickly to 2.6% in March 2016 as a result of the decline in domestic fuel prices. The price of RON95 petrol was revised downwards to a low of RM1.60 per litre in March 2016 following the decline in global oil prices. The impact of El Niño was also temporary as weather conditions began to normalise in the second half of 2016. Headline inflation continued to moderate further, averaging 1.6% for the remaining nine months of the year amid the lapse in the GST impact and lower domestic fuel prices. In addition, the moderate demand pressures, low global energy and non-food commodity prices and subdued global inflation also helped to keep inflation low. The benign domestic inflationary environment led to the downward revision of the Bank's official forecast range from 2.5% - 3.5% to 2% - 3% in July 2016.

Inflation during the year was driven mainly by domestic cost factors arising from upward price adjustments for several price-administered items undertaken since the fourth quarter of 2015. Electricity tariffs and cooking oil prices were revised upwards in January and November 2016, respectively. In addition, the dry weather conditions caused by El Niño affected the production of fresh food such as vegetables, fruits and fish at the beginning of the year. For the year as a whole, fresh food inflation was higher at 5.6% (2015: 4.2%). However, domestic inflation was dampened by the lapse in the impact of GST and by lower domestic fuel prices during the year. Prices of RON97 petrol, RON95 petrol and diesel averaged lower at RM2.11, RM1.76 and RM1.62 per litre, respectively, in 2016 (2015: RM2.33, RM1.98 and RM1.92 per litre, respectively).

Externally, the continued low global commodity prices also played a key role in mitigating domestic inflation despite the weaker ringgit exchange rate[8]. The IMF Primary Commodity Index declined by 10% in 2016 (2015: -35.3%), driven mainly by lower energy prices amid continued excess supplies. As a result, the lower global commodity prices led to an overall decline in the input costs of firms as reflected in the decline

Chart 1.20

Contribution to Inflation by Categories

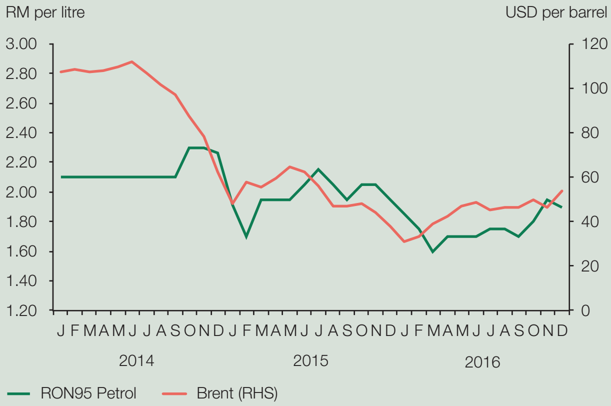


*Others include clothing and footwear, health, education, communication, recreation services and culture, furnishings, household equipment and routine household maintenance, restaurants and hotels, and miscellaneous goods and services categories.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.21

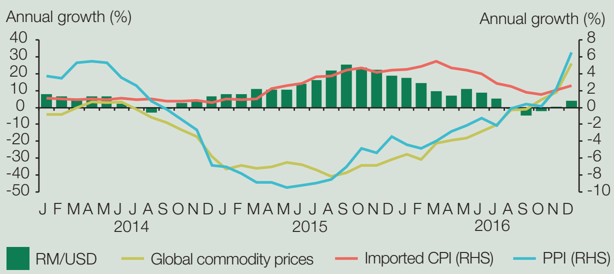
Domestic Fuel and Global Oil Prices



Source: Ministry of Domestic Trade, Co-operatives and Consumerism, and Bloomberg

Chart 1.22

Exchange Rate, Global Commodity Prices, Imported CPI and PPI



Note: For RM/USD, annual growth refers to the annual change in the monthly average. A positive figure indicates a depreciation in ringgit against the US dollar.

Source: Department of Statistic, Malaysia, Bloomberg, International Monetary Fund (IMF) and Bank Negara Malaysia

[8] On the impact of ringgit depreciation on domestic inflation, see Box Article on 'The Impact of Exchange Rate Depreciation on Inflation in Malaysia' in Bank Negara Malaysia's Annual Report 2015.

of the Producer Price Index (PPI) by 1.1% in 2016 (2015: -7.4%). The lower costs of production for firms helped in containing prices of domestically produced goods. The weaker ringgit did lead to higher imported inflation during the year. Excluding fuel, the prices of the imported components of the CPI increased by 3.5% (2015: 3%)[9]. The increase was driven by higher prices of imported finished food items as the inflationary impact of the weaker ringgit was exacerbated by the higher global food prices. Global food prices were higher for the year amid adverse weather conditions following the occurrence of El Niño, as reflected in the 2% increase in the IMF Food Price Index (2015: -17.1%).

Core inflation was relatively stable during the year averaging 2.1% in 2016 (2015: 2.3%). Demand driven inflationary pressures in the economy remained largely stable during the year, underpinned by continued modest growth in private consumption and an absence of significant wage pressures. This was also reflected in the small positive output gap and the relatively stable capacity utilisation rate of 77.5% (2015: 76.5%).

[9] Excluding fuel, imported items only account for a small share of 6.7% of the CPI basket. Hence, its impact on overall inflation is small.

Understanding the Changing Dynamics of the Current Account of the Balance of Payments in Malaysia

By Cheah Wenn Jinn, Low Ai Loon and Nooraihan Mohd Radzuan

Introduction

Over the past two decades, Malaysia's current account performance can be broadly characterised by two distinct periods. The current account surplus rose following the Asian Financial Crisis (AFC) and peaked at 17.6% of GNI in 2008 (Chart 1). This was supported by the widening trade surplus amid sustained deficits in the services and income accounts. During this period, Malaysia's exports registered robust growth, supported by strong global demand and rising commodity prices. Conversely, import growth was more moderate, on account of subdued investment activity after the AFC. Following the Global Financial Crisis in 2008, the current account surplus began to narrow. Export growth slowed following the prolonged weakness in global demand and the steep decline in commodity prices. Demand for imported goods improved, underpinned by stronger domestic demand, that was partly driven by stimulative macroeconomic policy. Coupled with the widening deficits in the services and income accounts, the current account surplus settled at 2.1% of GNI in 2016.

Chart 1

Narrowing Current Account Balance Since 2008

Source: Department of Statistics, Malaysia

The current account balance is commonly assessed from the international trade perspective, focusing on factors determining exports and imports of goods and services, and payments and receipts of external incomes. Another perspective of the current account is the saving-investment gap (the excess of savings over investment), reflecting the intertemporal saving and investment decisions of the public and private sectors in the domestic economy. In a closed economy, domestic savings are essentially the only source of capital for investment activity. However, in an open economy, when investment in the economy exceeds the available domestic savings, there is a need to rely on foreign savings, and this causes the current account to go into deficit. In the case of Malaysia, the economy has in fact been saving more than it has been investing, thus resulting in a current account surplus. These excess savings have either been accumulated in the form of foreign assets held as part of Malaysia's international reserves, or they have been channelled abroad to finance economic activity in foreign countries.

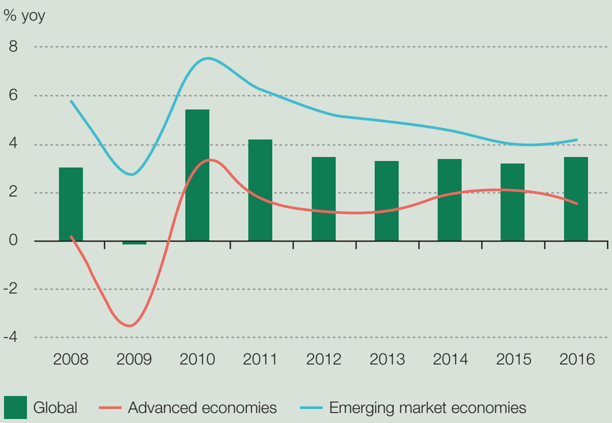
Given the narrowing current account surplus, it would be insightful to understand the factors which contribute to the changing dynamics of the current account over time. Building on a previous article on the current account position in 2012[1], this article provides a closer and more up-to-date examination of the drivers of the current account balance. We continue to evaluate the trends from the perspectives of international trade and the saving-investment gap, before concluding with a brief assessment on the outlook for the current account balance going forward.

Drivers of Malaysia's Current Account Balance

In recent years, Malaysia's current account movement has been influenced by three major global and domestic developments. First, the global economy has experienced a prolonged period of slow growth amid weak and uneven growth momentum across the advanced and emerging market economies (Chart 2). More recently, while advanced economies have begun to gradually recover, growth in the emerging market economies has moderated. Second, global commodity prices have declined sharply, with a low prospect for prices to return to their previous levels (Chart 3). Third, investment in the Malaysian economy, particularly by the private sector, has continued to expand.

Chart 2

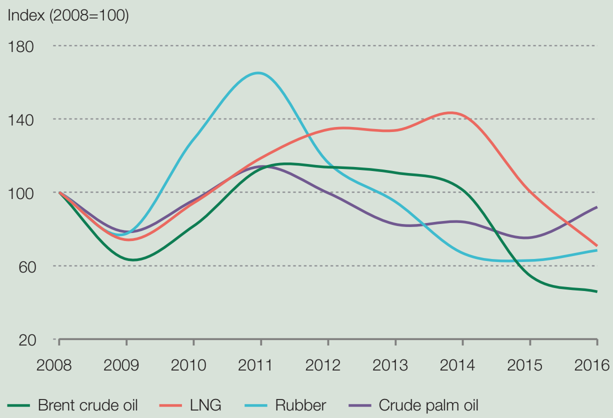
Slower Global Growth (Real GDP)



Source: International Monetary Fund

Chart 3

Sharp Decline in Commodity Prices



Source: Department of Statistics, Malaysia, Malaysian Palm Oil Board (MPOB), Malaysian Rubber Board, Bloomberg

From the international trade perspective, these factors have manifested in a lower goods surplus and higher services and income deficits (Chart 4). The goods surplus has declined as the subdued external environment weighed on Malaysia's export performance. At the same time, a period of strong domestic investment (2012 - 2016 average: 7.7%, 2003 - 2007 average: 5.6%) had contributed to the rise in imports[2]. Amid rapid capacity expansion and the implementation of large infrastructure projects, capital imports increased to an average of RM97 billion between 2012 and 2016 (2003 - 2007 average: RM57 billion).

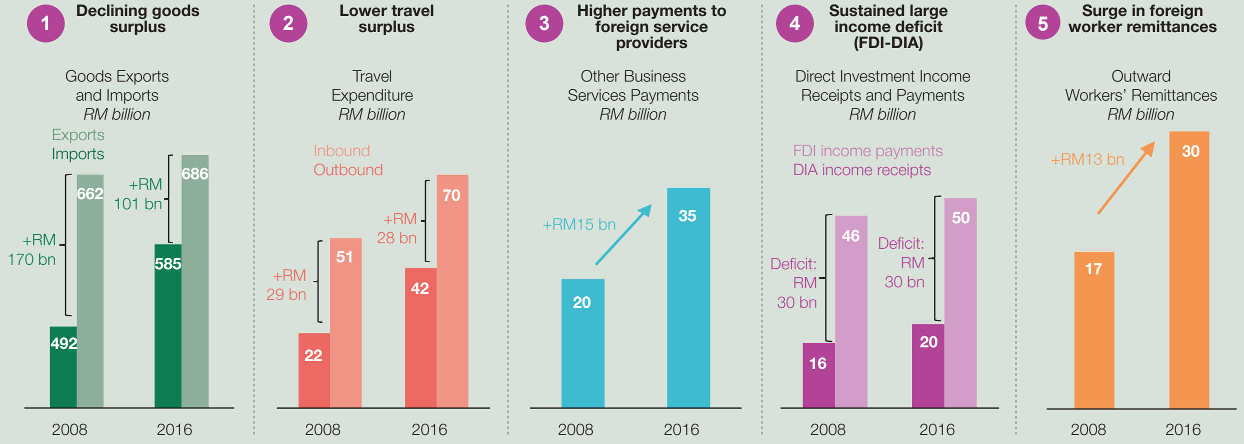
The travel surplus in the current account, while still high, has been gradually declining. Since 2010, the increase in outbound travel expenditure (i.e. Malaysian tourists travelling and spending abroad) has outpaced that of inbound travel expenditure. This has been supported by a growing middle income group and the increased affordability of overseas travel, following the rapid expansion of low-cost carriers in Malaysia. Modest income growth in foreign countries and rising tourism competition in the region contributed to a slower increase in inbound travellers in recent years.

Payments to foreign service providers, particularly for technical and engineering services, have also increased. Domestic technical expertise and consultancy management services have steadily been complemented by foreign

[1] Refer to the Box Article on 'Current Account Balance in Malaysia: Recent Developments and Outlook', Bank Negara Malaysia's Annual Report 2012.
[2] Refer to the Box Article on 'Private Investment in Malaysia: Drivers and Sustainability', Bank Negara Malaysia's Annual Report 2012.

Chart 4

Five Key Developments in Malaysia's Current Account Balance



Source: Department of Statistics, Malaysia

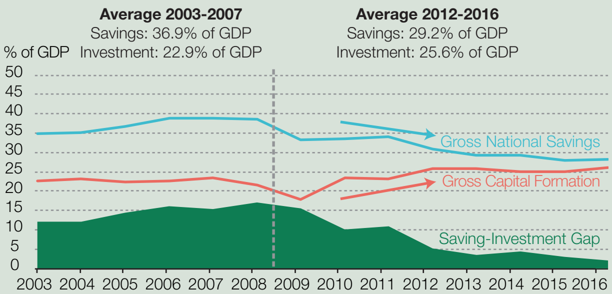
expertise and advisors, particularly for projects that use more complex technologies. Foreign services that require skilled and specialised knowledge have been used, mainly by the oil and gas, transportation and the utilities sectors.

The deficit in the investment income account has remained sizeable[3], as incomes accrued to Malaysian companies investing abroad, particularly in the mining and services sectors, were affected by the weaker global demand conditions. At the same time, foreign investors in Malaysia, particularly those in the manufacturing sector continue to earn sizeable profits from their investments in Malaysia. Foreign worker remittances also continued to grow, reflecting the increased reliance on foreign workers in the labour-intensive sectors of the economy.

From the saving-investment (S-I) perspective, the recent narrowing of the current account surplus has been driven by the rise in investment activity amid a moderation in gross national savings (Chart 5). Following a period of low investment after the AFC, the implementation of the Economic Transformation Programme (ETP) since 2010 has played a catalytic role in reviving investment activity in Malaysia. During this period, foreign firms continued to invest in Malaysia as reflected in the higher inflows of foreign direct investments (2012 - 2016 average: RM37.4 billion; 2003 - 2007 average: RM18.8 billion), particularly in the services and manufacturing sectors.

Chart 5

Narrowing Surplus Reflects Higher Investments Amid Moderating Savings in Malaysia



Source: Department of Statistics, Malaysia

[3] Refer to the Box Article on 'Payoffs from Going Global: Assessing the Returns from Malaysia's Direct Investment Abroad'.

The private sector continued to be the key driver of investments in Malaysia (Chart 6). On average, private investments advanced by 11.2% between 2012 and 2016 (2002 - 2007 average: 9%), underpinned by the implementation of large infrastructure projects and capacity expansion in high value-added services, manufacturing and mining sectors, which accounted for 92% of total private investment in 2015. Public investment remained broadly stable owing to sustained capital spending by public corporations, mainly in the oil and gas, transportation and utilities sub-sectors. These investments have also had a discernible impact on Malaysia's productive capacity, particularly in the oil and gas sector. Of note, the development of the new oil field in Gumusut-Kakap contributed to the increase in Malaysia's oil production capacity from 570,000 barrels per day (bpd) in 2013 to 661,000 bpd in 2016. Development expenditure by the Federal Government also supported public investment, focusing mainly on education, healthcare, housing, transport system and industrial infrastructure spending[4].

On the whole, investments by both the private and public sectors are necessary to boost Malaysia's productive capacity, enhance efficiency and connectivity, and to drive the growth of high value-added exports in the future (Table 1). Nonetheless, some risks of overinvestment in less productive sectors, as manifested by the oversupply of commercial properties, should be closely monitored and managed.

Chart 6

Higher Investments Driven by the Private Sector

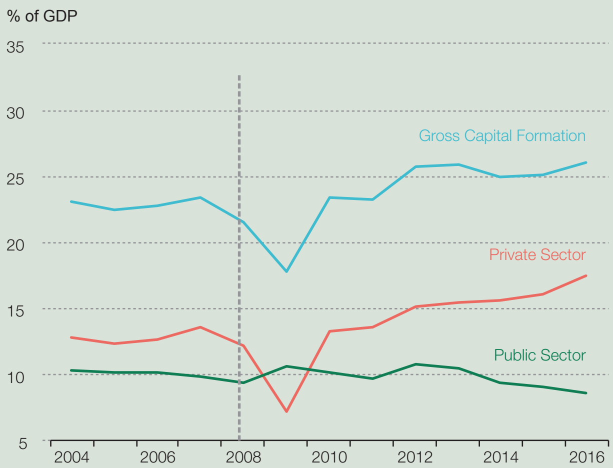
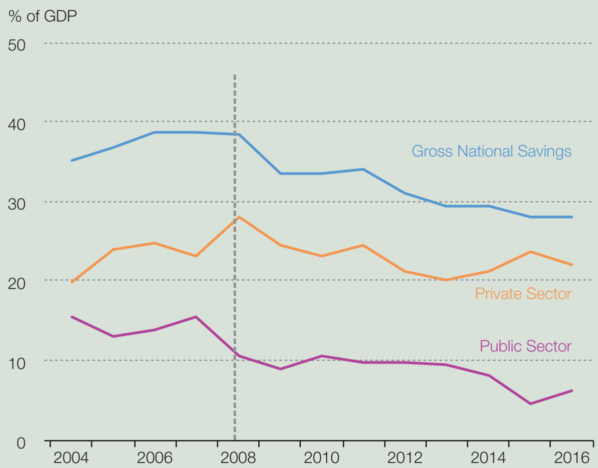


Chart 7

Moderating Savings Amid Lower Private Sector Savings



Source: Department of Statistics, Malaysia

Table 1

Productive Investments to Enhance Domestic Productive Capacity and Export Competitiveness

Sectors	Selected examples of major investments since 2008
Transportation & Storage	Mass Rapid Transit (MRT), Light Rail Transit (LRT) extensions
Manufacturing	New production lines by Hewlett-Packard, Intel and OSRAM (E&E)
Oil and gas & Utility	Pengerang Integrated Petroleum Complex (PIPC), Refinery and Petrochemical Integrated Complex (RAPID), Gumusut-Kakap and Malikai deepwater oil and gas projects (upstream and downstream), Sabah Oil and Gas Terminal, Tanjung Bin Power Plant, Janamanjung Power Plant
Aviation	Aircraft purchases by major airliners
Tourism & Retail	Genting 20th Century Fox Themepark, Meru Animation Studio, LEGOLAND, Johor and Mitsui Premium Outlets

Source: News flows

[4] Refer to the White Box on 'Debunking Malaysia's Investment Myths', in Bank Negara Malaysia's Annual Report 2014.

The moderation in gross national savings had also contributed to the narrowing S-I gap in Malaysia (Chart 7). The moderating trend was attributable mainly to lower private sector savings amid sustained savings by the public sector. Private savings were lower, stemming from the modest growth in the operating surplus of firms and continued strength in household consumption. As an indication, firms in the agriculture sector experienced a contraction in operating surplus (2012 - 2015 average: -2.4%; 2011: 28.2%), following the sharp decline in agriculture prices. Over this period, crude palm oil (CPO) and rubber prices had declined by 34% and 62% from their peak of RM3,279 per tonne and RM13.70 per kg in 2011, respectively. Significantly slower growth in the operating surplus of manufacturing firms (2012-2015 average: 3.3%; 2011: 16.0%) also weighed on private sector savings. Nevertheless, firms in the construction sector, wholesale and retail, as well as the finance and business services sub-sectors recorded sustained increases in profits (2012 - 2015 average: 7.3%; 2011: 7.4%), as domestic demand remained resilient. Household spending was underpinned by the continued growth in compensation of employees (2012 - 2015 average: 8.3%; 2011: 12.2%) and stable labour market conditions. The concurrent increase in costs of living also contributed to the lower household savings.

For the public sector, savings were broadly stable. Firms in the mining sector, which include public corporations, reported marginal growth in operating surpluses (2012 - 2015 average: 1.8%; 2011: 7.0%). Nevertheless, public corporations in the transportation, storage and communication services sub-sectors recorded relatively higher growth in profits, thus providing support to public savings (2012 - 2015 average: 5.9%; 2011: 12.3%). The smaller General Government[5] current deficit also alleviated pressure on public savings as efforts were taken to broaden the tax base and rationalise subsidies. Notable measures include the introduction of the Goods and Services Tax (GST) and the removal or reduction of subsidies on vehicle fuel, sugar and cooking gas. Despite these trends, Malaysia's gross national savings remained high at 28.1% of GDP in 2016 (2015: 28.1% of GDP), compared to the average savings rate of 22.9% of GDP in emerging market economies, excluding PR China[6]. This high rate of savings has enabled Malaysia to finance economic growth mainly from domestic sources.

Prospects for the Current Account

Going forward, Malaysia's current account balance is expected to remain in surplus, but will be narrower. In the near-term, global and domestic developments will continue to influence the performance of the current account. Malaysia's export performance is projected to improve, in line with higher global demand and commodity prices. This should also support higher incomes for export-oriented firms and Malaysia's outward FDI, particularly those in the commodity-related sectors. Investments are expected to continue to be channelled towards productive sectors. While large-scale and more complex investment activities will contribute to raising demand for foreign goods and services, these investments are expected to raise productive capacity and lift efficiency. These short-term trade-offs may be necessary to place Malaysia on a solid footing to tap on the opportunities in a fast-changing global environment.

Malaysia's external sector resilience was demonstrated during the recent sharp decline in commodity prices. Although it has narrowed, Malaysia's trade balance remained in surplus, underpinned by a diversified export structure – both in terms of products and markets. This underscores the importance of advancing structural reform measures to promote trade and investment diversification and competitiveness, and more importantly to move up the value chain. Under the broad strategies of the ETP, 11th Malaysia Plan, Services Sector Blueprint, Logistics and Trade Facilitation Masterplan, and the National Export Council, several measures have been introduced over the years. These include labour and product market reforms, the gradual removal of subsidies, allowing greater foreign participation in the services sector, enhancing efficiency of administrative processes, facilitating private investment in infrastructure, easing tourist visa regulations and deepening market access. The continued implementation of these reforms will be critical in strengthening Malaysia's external sector and shaping the path of Malaysia's current account balance moving forward.

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[5] General Government comprise the Federal, State and Local Governments, as well as statutory bodies.
[6] Gross national savings rate of emerging economies including PR China is 32.5% of GDP in 2015.

Payoffs from Going Global: Assessing the Returns from Malaysia's Direct Investment Abroad

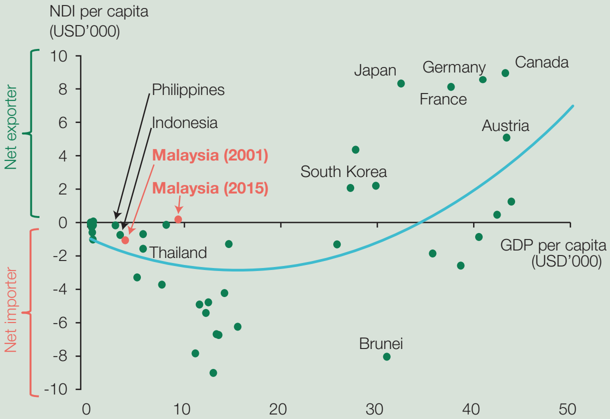
By Mohd Shazwan Shuhaimen and Lim Ming Han

Introduction

As a highly open economy, Malaysia has been a longstanding recipient of foreign direct investment (FDI), which has been a vital source of capital formation for economic growth. However, compared to its peers, Malaysia has transitioned from being a net importer of long-term capital to being a net exporter within the recent decade on account of the rapid expansion of direct investment abroad (DIA)[1] by Malaysian corporations (Chart 1). This evolution underscores the growing maturity and capability of domestic firms to compete on a global and regional scale and the changing structure of the economy as it progresses towards a high-income nation. Of significance, Malaysia's DIA stands out as among the largest in the region as a proportion to the size of the economy, second only to Singapore (Chart 2). Since such capital outflows reflect, in part, a recycling of domestic savings abroad, this study assesses the returns of Malaysia's DIA from the profitability perspective[2].

Chart 1

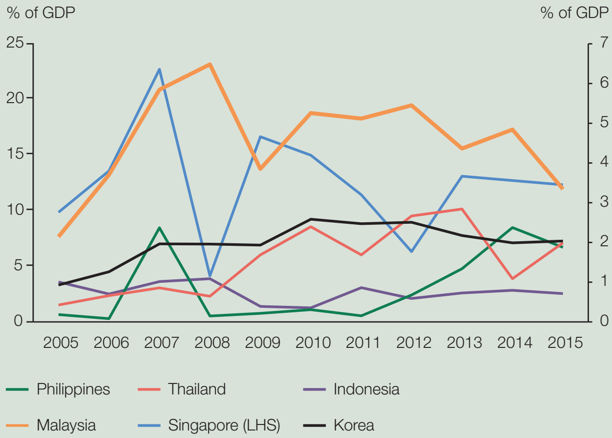
Net Direct Investment (NDI) and GDP per capita, 2015



Source: United Nations Conference on Trade and Development (UNCTAD), International Monetary Fund (IMF) and Department of Statistics, Malaysia

Chart 2

DIA Flows: Selected Regional Economies, 2005 – 2015



Source: UNCTAD, IMF and Department of Statistics, Malaysia

Overview of Malaysia's Direct Investment Abroad

The rapid expansion of DIA has been facilitated by key regulatory and policy developments. Foreign exchange administration rules have been progressively deregulated with the aim of enhancing the competitiveness of resident companies by providing greater flexibilities to invest abroad, obtain external financing, manage cross-border movement of funds and hedge their foreign currency exposures. Equally important is the deepening economic co-operation and integration among regional economies through initiatives such as bilateral and regional trade agreements. These initiatives have reduced regulatory barriers, lowered the costs of doing business and opened up new markets for trade and investment. Finally, the domestic financial system has become more diversified, competitive and resilient. This has supported the internationalisation of Malaysian firms through more effective intermediation of cross-border financial flows and greater access to financing.

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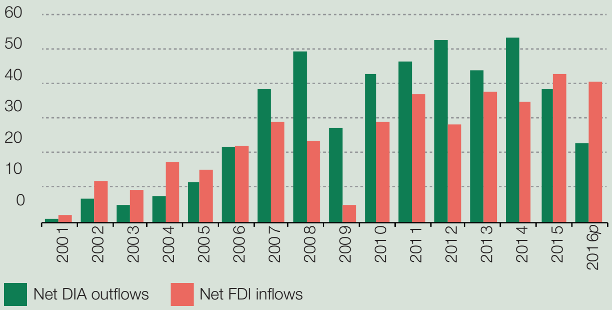
1 Direct investment abroad, as defined according to the 5th edition of the Balance of Payments Manual (BPM5) by the International Monetary fund (IMF), refers to the cross-border investment by a resident in Malaysia having control or a significant degree of influence on the management of an enterprise that is resident in another country. This control or influence is achieved when the direct investor owns at least 10 percent of the voting power in the direct investment enterprise.

2 DIA investment performance may also be assessed from other dimensions, for example, in terms of cost of financing, dividend policy, asset turnover or operational efficiency perspectives.

Chart 3

DIA and FDI Flows

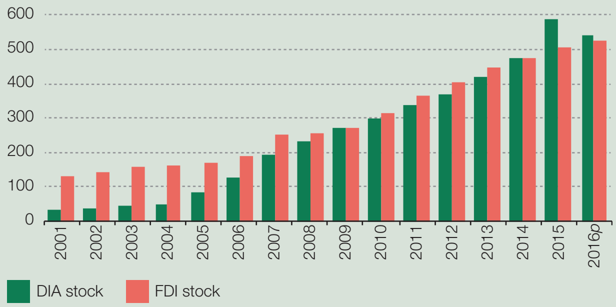


p Preliminary

Source: Department of Statistics, Malaysia

Chart 4

DIA and FDI Stock (end-position)



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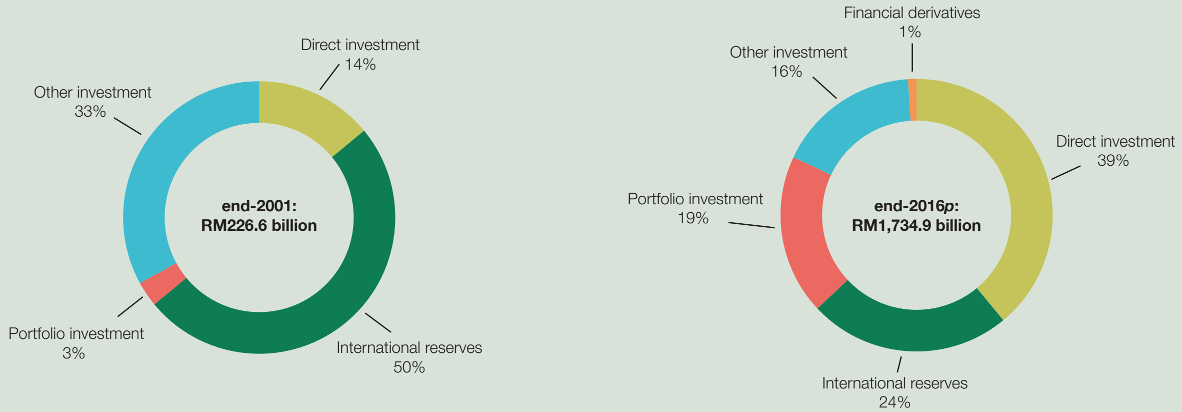
Source: Department of Statistics, Malaysia

Chart 5

Composition of Malaysia's External Assets



p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

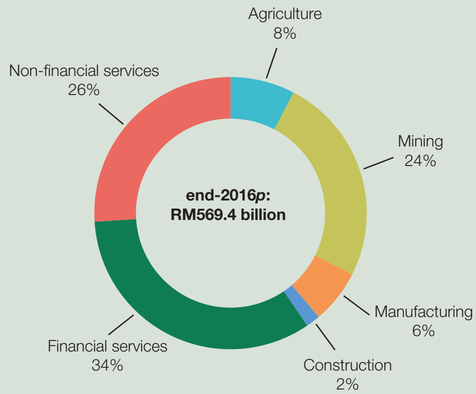
These developments have complemented the aspirations of Malaysian firms to expand their global footprint. Thus, DIA outflows have increased significantly in recent years and have consistently surpassed FDI inflows since 2007. Since 2015, however, DIA has moderated amid subdued global growth environment and prolonged weakness in commodity prices (Chart 3). Nevertheless, from an international investment position (IIP) perspective, Malaysia has become a net creditor of direct investment since 2015. The stock of DIA has exceeded the stock of FDI, in part reflecting capital gains arising from exchange rate revaluation (Chart 4). As at end-2016, DIA accounted for a 39% share of Malaysia's overall external assets. This is even larger than the level of international reserves (24% share) (Chart 5).

It is important to consider the underlying structure of Malaysia's DIA in relation to its FDI, in order to understand the relative characteristics of the returns and income generated by both types of long-term capital. In terms of sectorial composition, DIA is concentrated in the services sector, underscoring the growing regionalisation of Malaysian corporations in the finance, insurance, real estate and business services; information and communication; and utilities sub-sectors. This is followed by sizeable investments in the mining and agriculture sectors (Chart 6). Conversely, the bulk of FDI in Malaysia is channelled into the manufacturing and services sectors (Chart 7).

In terms of its geographical distribution, the bulk of DIA was channelled into the regional economies namely Singapore, Indonesia, India and Thailand, as well as the advanced economies such as Canada and Australia. A sizable share

Chart 6

Direct Investment Abroad Position by Sector



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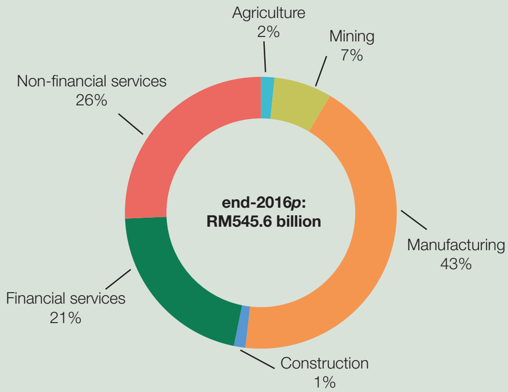
Source: Department of Statistics, Malaysia

Chart 7

Foreign Direct Investment Position by Sector



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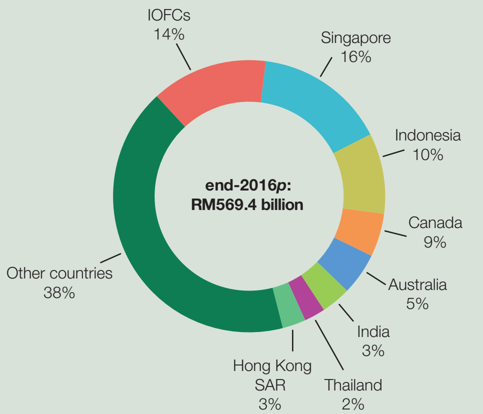
Source: Department of Statistics, Malaysia

Chart 8

Direct Investment Abroad Position by Country



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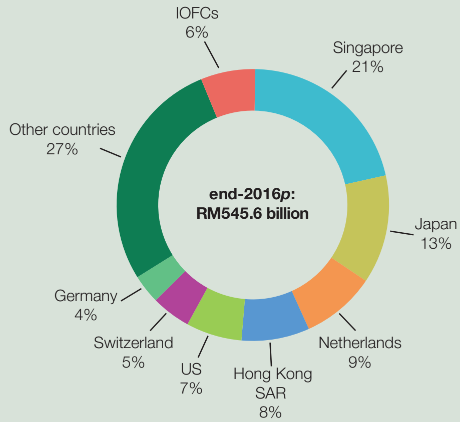
Note: IOFCs refer to International Offshore Financial Centres

Source: Department of Statistics, Malaysia

Chart 9

Foreign Direct Investment Position by Country



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Note: IOFCs refer to International Offshore Financial Centres

Source: Department of Statistics, Malaysia

went to the International Offshore Financial Centres (IOFCs), where investible funds were pooled before being redirected to economic sectors in various other locations (Chart 8). On the other hand, a larger share of FDI is sourced from the advanced economies directly, namely Japan, Netherlands, United States and Switzerland, followed by the regional economies such as Singapore and Hong Kong SAR (Chart 9).

Assessing the Returns from Malaysia's Direct Investment Abroad

In evaluating the returns of DIA on the economy, both the direct and indirect benefits must be considered. Typically, countries that have a large number of home-grown multinational corporations (MNCs) enjoy positive spillover benefits in the form of greater productivity growth from enhanced firm competitiveness; higher wages and inward remittances from employment opportunities abroad; and the formation of backward linkages in terms of input sourcing from its domestic operations and other local firms. However, recent studies for Malaysia[3] suggest that evidence of these benefits was

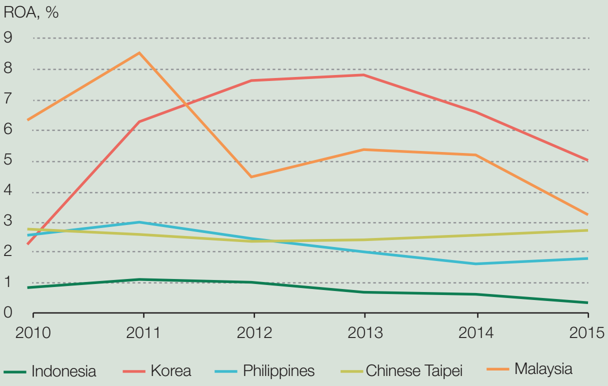
[3] Empirical studies on the impact of DIA on economy by Goh and Wong (2014), Goh et al (2013), Wong (2013) and Chen et al (2012).

inconclusive and would only potentially materialise over a longer timeframe. These studies allude to the fact that Malaysia's DIA has limited scope for backward linkages as it is largely in the services rather than manufacturing sectors. The inability of local suppliers and small and medium enterprises (SMEs) to meet the varied procurement needs of outward bound Malaysian firms was possibly another constraint hindering deeper backward linkages. The studies also demonstrated that the channelling of domestic savings for investment abroad occurred because of relatively low growth in domestic capital formation, particularly from 2005 to 2009. Nevertheless, the sustained inflows of FDI and the revival of domestic capital spending since 2010, particularly by the private sector[4], were more than sufficient to offset the upward trend in DIA.

The direct benefits of DIA can be measured in a more straightforward manner. From a profitability perspective, a firm's DIA performance can be assessed from the amount of income generated or the return on assets (ROA) arising from its investments abroad. As a percentage of outstanding DIA stock, the direct investment income[5] of Malaysian corporations has fared better compared to some regional peers (Chart 10), underscoring their relative competitiveness. In 2016, the ROA of Malaysia's DIA was 3.5%. This means that an income of RM3.50 is generated for every RM100 invested abroad. Nevertheless, in recent years, the returns have trended downwards in tandem with its regional peers, reflecting the more challenging global economic environment.

Chart 10

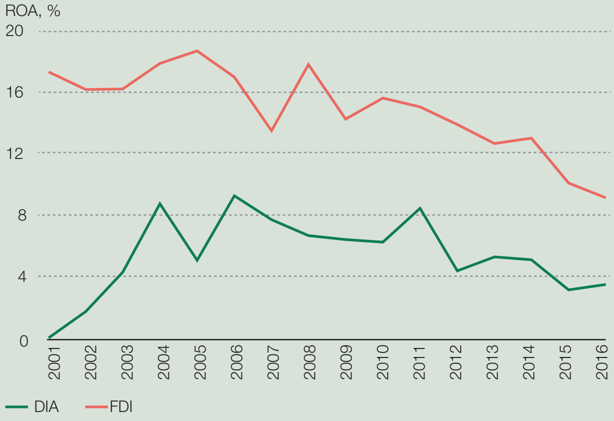
Returns on DIA of Selected Asian Economies, 2010-2015



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

Chart 11

Returns on Malaysia's DIA and FDI, 2001- 2016



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

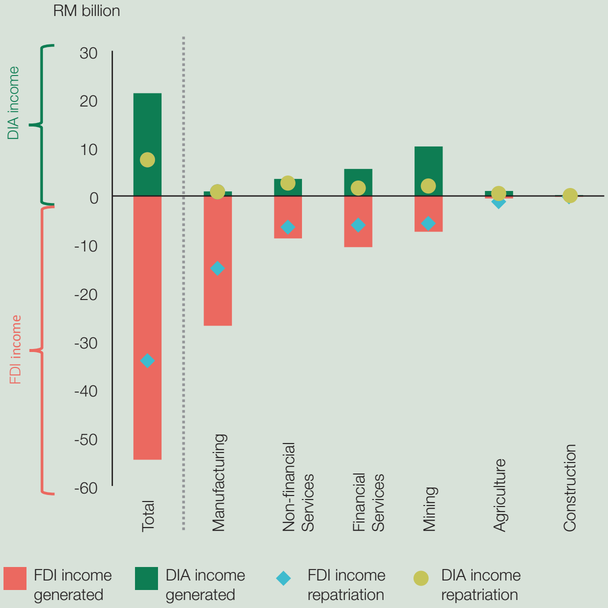
An alternative approach in assessing DIA returns is to benchmark against the performance of FDI in Malaysia. Chart 11 shows that DIA generated much lower returns compared to its FDI counterpart, though the latter also has been trending downwards. In level terms, the amount of income generated by DIA is also lower than FDI, with the divergence most apparent in the manufacturing, financial and non-financial services subsectors. DIA companies have also repatriated a smaller share of their income to their parent companies, compared to their FDI counterparts (Chart 12). This deficit in the direct investment income account, along with the structural deficits in the services and secondary income accounts has led to a narrowing of Malaysia's current account surplus. It should be noted that Malaysia is not unique in experiencing investment income deficits as several other regional countries with large FDI presence also share a similar characteristic (Chart 13). This is attributable, in part, to the rise of global value chains over the past several decades, whereby multinational corporations (MNCs) had diversified their presence by investing and operating in various stages of production across countries in the region, thus reaping the benefits of improved cost optimisation and profitability through specialisation and greater economies of scale.

[4] For a more detailed account, please refer to Box Article on 'Debunking Malaysia's Investment Myths' in Bank Negara Malaysia's Annual Report 2014 and 'Private Investment in Malaysia: Drivers and Sustainability' in Bank Negara Malaysia's Annual Report 2012.

[5] The receipts of direct investment income measures the returns accrued to Malaysian corporations from their investment abroad. It consists of earnings from the firm's productive activities in the current period that may be distributed in the form of dividends or reinvested into the firm's operations, plus interest on intercompany debt.

Chart 12

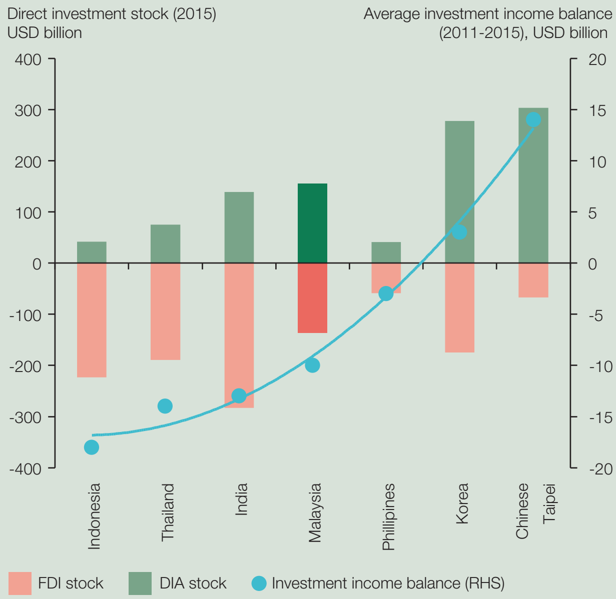
Average FDI and DIA Investment Income Generated and Repatriated by Sector, 2010-2016



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

Chart 13

Direct Investment Stock and Average Investment Income Balance of Selected Regional Peers, 2011-2015



Source: UNCTAD, Haver

The differences in the rate of returns between DIA and FDI can be attributable to several factors[6]. The first is the timing and level of maturity between domestic and foreign firms in the global arena[7]. Although Malaysian corporations are market leaders domestically, most are at a relatively nascent stage of venturing abroad in terms of organisational capacity and managerial experience. DIA, which only began in earnest during the 1980s and 1990s[8], were undertaken mainly by public corporations in the mining and agriculture sector. Since the mid-2000s, private sector participation has increased significantly, expanding mostly in the services sector. By contrast, FDI is led by large MNCs which have established a longer presence in Malaysia. It is worth noting that several reputable foreign financial institutions have been in existence in Malaysia as early as the 1880s, while rapid industrialisation in the 1970s witnessed the influx of Japanese and US investments in the manufacturing sector. As these MNCs possess more recognisable brands, intellectual property assets, better supply chain management and a wider customer base, they are able to obtain a steadier and higher income stream.

The second factor is the divergence in underlying investment motivations. There are a host of reasons that can influence a firm's decision to expand beyond its shores. Based on research[9], firms most often are seeking natural resources, markets, production efficiency, strategic assets, or some combination of these. In this respect, Malaysia's DIA is driven mainly by market-seeking and resource-seeking motives, whereas FDI is primarily influenced by efficiency-seeking purposes. Being new entrants into the host country, Malaysian firms in the finance and insurance, information and communication and utility sub-sectors (comprising 47% share of DIA) tend to incur high start-up costs,

[6] Adapted from 'On Returns differentials' (Curcuru et al, 2013).
[7] Firms' years of experience in foreign markets are considered a key measure of international competitiveness, in addition to geographical and product variety, and share of foreign operations (Clarke et al, 2013).
[8] For a more detailed account, refer to Box Article on 'Malaysia: Trends in Direct Investment Abroad' in Third Quarter 2006 Bank Negara Malaysia's Quarterly Economic Bulletin.
[9] Research has identified four key motivations for direct investment (USAID, 2005 and Dunning, 1980). They are: 1) *Natural resource-seeking* – to access to a natural resource not available in the company's home market; 2) *Market-seeking* – to gain access to new customers and export markets; 3) *Efficiency-seeking* — to reduce production costs by gaining access to competitively priced input and labour; and 4) *Strategic asset-seeking* – to gain strategic assets in another economy, such as brands or new technologies.

prioritising brand-building strategies over better margins in order to attract customers and gain market share. They also undertake strategic acquisition of established players in the host country to accelerate their footprint expansion process. Similarly, DIA in the mining and agriculture sector (24% and 8% share of DIA, respectively) often involves large expenditure to acquire oil fields and plantations, obtain exploration and land rights and develop the necessary infrastructure. Compounded by fluctuations in global commodity prices, a longer gestation period is therefore needed to recoup these initial capital outlays before it yields steady returns. On the other hand, FDI in the manufacturing sector (43% share of FDI) tends to have a shorter time to maturity. The outperformance of MNCs in export-oriented industries are supported, in part, by their cost-effective supply chain network optimisation strategies, better utilisation of technology and the adaptation into the faster-growing and higher value-added segments.

Third, the macroeconomic and business conditions of the host country also affect the degree of returns. As DIA is channelled into diverse countries, particularly the developing and emerging economies, they are also subjected to the various risks associated with doing business in those markets. These include the growth outlook, level of economic and financial sector development, business regulations, government policies concerning protectionism and liberalisation of industries as well as geopolitical developments. On the other hand, Malaysia has long been favoured as a competitive destination and profit centre for foreign investment, underpinned by pro-business policies, strong rules of protection for foreign investors, educated workforce, sizeable upper middle-income class, well-developed infrastructure and attractive incentives. This can be attested by Malaysia's favourable rankings in international competitiveness surveys such as the World Bank Doing Business Survey (2017: 23rd position), World Economic Forum Competiveness Index (2016 - 2017: 25th position) and the AT Kearney Global Services Location Index (2016: 3rd most attractive location for offshore operations). Thus, MNCs are able to execute their investment plans with a high degree of certainty and predictability, resulting in a shorter time frame between the initial capital injection and when income is eventually realised.

Strategies to Unlock Greater Payoffs from DIA

While underlying structural factors explain the divergence in the rate of returns between DIA and FDI, it is important to note that this gap should narrow over time as the investments abroad by Malaysian corporations eventually mature. Moreover, there is scope to generate greater returns at the firm-level and optimise the intended spillover benefits to the wider domestic economy. To accomplish this, outward bound Malaysian firms should enhance their synergies with domestic operations and local suppliers, thus strengthening the development of backward linkages. For example, the growing presence of Malaysian firms involved in infrastructure and real estate projects overseas should not only be a conduit for greater procurement of locally produced materials and inputs, but also for ancillary service providers such as architecture and design, project management and consultation, legal and financial services. Domestic SMEs should also bolster their competitiveness by continuously moving up the value chain and exploring opportunities abroad. For example, industries that are heavily reliant on foreign labour such as garments, wood and plastic products could shift their production base to other countries with lower labour costs, while retaining their operational headquarters in Malaysia. In this regard, the success of countries such as Korea in promoting their SMEs to invest abroad can be emulated through facilitation and advisory, dissemination of information and a recalibration of incentives. Lastly, subsidiaries of Malaysian corporations abroad should make concerted efforts to raise their operational efficiencies, identify niche markets and innovate continuously.

Conclusion

The increasing DIA trend is expected to continue in line with Malaysia's broader economic development and the deepening integration with the global economy and financial system. Despite the greater number of Malaysian corporations going abroad, the commensurate returns have yet to be fully realised. While Malaysia's DIA has generated better returns compared to some regional peers, there remains a structural underperformance against its FDI counterpart. Hence, the ability to generate greater payoffs from their investments abroad going forward is critical both from a macroeconomic standpoint as well as to achieve a more sustainable rate of return over the longer term. In this regard, there is a need for outbound Malaysian firms to continuously move up the value chain and secure their foothold in the ever shifting global business landscape. This would help in equipping Malaysian corporations to compete and even thrive in international markets, and produce the desired spillover benefits for the Malaysian economy.

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