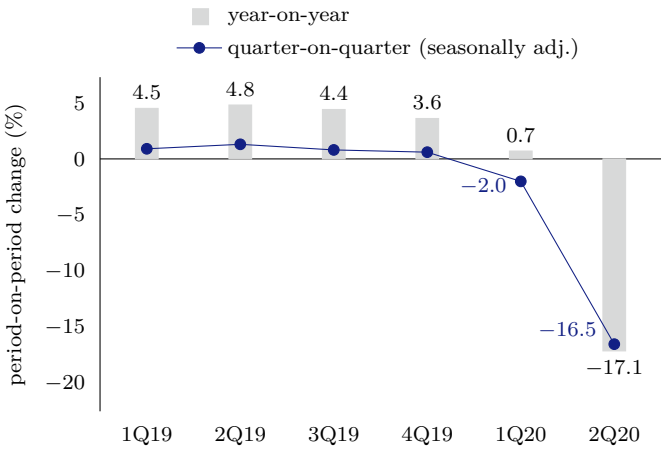
Developments in the Malaysian Economy

Highlights

- **The Malaysian economy contracted by 17.1%.**
- **Headline inflation was negative while core inflation moderated slightly.**
- **The current account surplus amounted to RM7.6 billion or 2.5% of GDP.**

Growth declined in 2Q 2020

Chart 4: Real GDP Growth



Source: Department of Statistics Malaysia

The Malaysian economy was confronted by concurrent supply and demand shocks arising from weak external demand conditions and strict containment measures in 2Q 2020. As a result, the economy registered its first contraction since the Global Financial Crisis (2Q 2020: -17.1%; 3Q 2009: -1.1%). On the supply side, this was reflected in negative growth across most sectors. From the expenditure side, domestic demand declined, while exports of goods and services registered a sharper contraction. On a quarter-on-quarter seasonally-adjusted basis, the economy declined by 16.5% (1Q 2020: -2.0%).

Weak growth across most economic sectors

Chart 5:
Growth by Economic Sectors

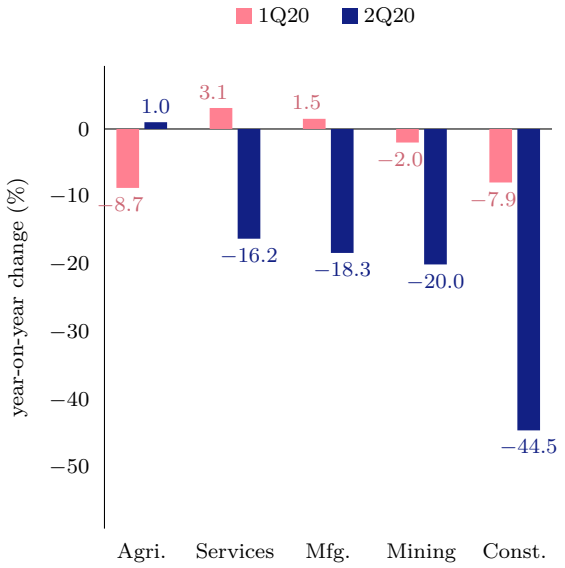
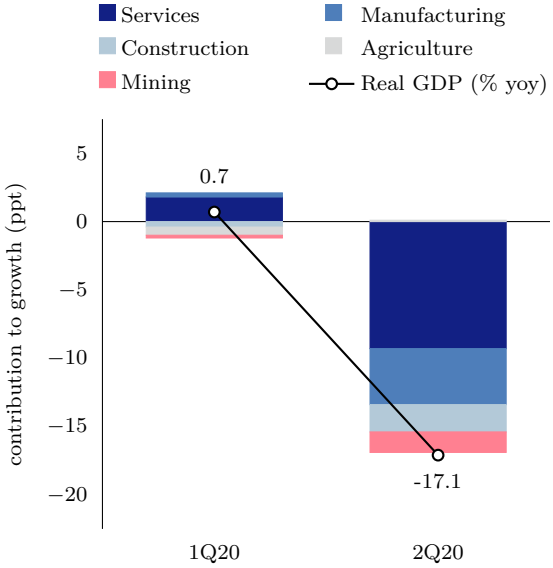


Chart 6:
Contributions to Real GDP by Economic Sector



Source: Department of Statistics Malaysia

Weak growth was recorded across most economic sectors amid the imposition of the Movement Control Order (MCO), followed by the Conditional and Recovery MCO, during 2Q 2020.

The services sector contracted by 16.2% (1Q 2020: 3.1%). The sector was affected by the implementation of a nationwide restrictive MCO, with only essential services such as food-related retail, utilities, banking, transportation as well as information and communication entities allowed to operate with very limited capacity. The subsequent transition to Conditional MCO (CMCO) in May and Recovery MCO (RMCO) in June provided some relief to businesses in the sector. The lockdown had substantially affected consumer spending and tourism activity, as shown by the significant declines in the wholesale and retail trade, as well as food and beverages and accommodation sub-sectors. The transport and storage sub-sector was impacted by a sudden stop in tourist arrivals due to travel restrictions imposed domestically as well as the international border closures. Growth in the finance and insurance sub-sector was weighed down by lower net interest income, and lower fee-based income amid subdued capital market activity. Meanwhile, growth in the information and communication sub-sector was relatively sustained by the continued high demand for data communication services especially during this period of remote working arrangements.

The manufacturing sector contracted by 18.3% (1Q 2020: 1.5%), due largely to the imposition of MCO restrictions as well as weak demand conditions. The extension of the MCO from end-March throughout April curtailed production activity across all industries. Essential sectors and those in the related supply-chain sectors operated at reduced capacity to ensure sufficient social distancing at workplaces, while non-essential sectors such as transport equipment and textile-related industries did not operate. Following the lifting of MCO restrictions in May, manufacturing firms gradually restarted operations, but did so while observing sector-specific health protocols amidst subdued demand conditions externally and domestically. The latter had particularly affected the performance of the primary- and consumer-related clusters. Nevertheless, the impact of weak demand was partially mitigated by a backlog of orders which supported a faster production recovery, observed mainly in the electric and electronics (E&E) industry.

The mining sector recorded a sharper contraction of 20.0% in 2Q 2020 (1Q 2020: -2.0%). Oil and gas output were affected by a sharp decline in demand due to the MCO as well as maintenance works in East Malaysia. Growth was also weighed by lower production in the other mining segment due to restrictions during the MCO period.

Activity in the construction sector declined by 44.5% (1Q 2020: -7.9%), as almost all activities came to a standstill particularly in the month of April. Despite the partial reopening of the economy on 4 May, most construction sites faced challenges restarting due to adjustments required to comply with the strict COVID-19 Standard Operating Procedures (SOPs). Most of the construction sites were reported to remain idle as developers faced challenges to restart, including financial constraints, initial lack of clarity over the SOPs and COVID-19 testing, and disruptions in the supply of construction materials. However, the situation improved significantly towards the end of the quarter after the Government implemented additional measures to facilitate the revival of the economy[1].

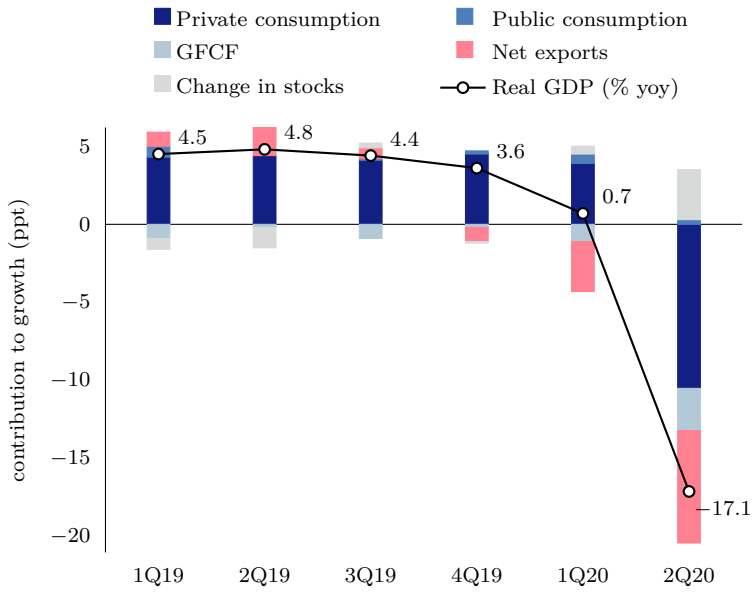
However, the agriculture sector rebounded in the quarter at 1.0% (1Q 2020: -8.7%), mainly due to the recovery in oil palm production as fresh fruit bunch yields normalised from the earlier impact of dry weather and fertiliser cutbacks. The oil palm recovery was also supported by higher harvesting activities, arising from the greater presence of workers in estates during the MCO period[2]. This more than offset the weaker production in the other agriculture subsectors, such as fisheries and livestock, due to weak demand.

[1] These measures included providing details on SOPs by publishing a set of frequently asked questions, and subsidising COVID-19 tests for workers covered by SOCSO. Workers were encouraged to use the MySejahtera mobile application to aid contact tracing if needed.

[2] Greater presence of workers was attributed to the border closures during MCO which prevented foreign workers from returning to their home countries especially during the festive season.

Sharp contraction in domestic demand

Chart 7: Contribution of Expenditure Components to Real GDP Growth



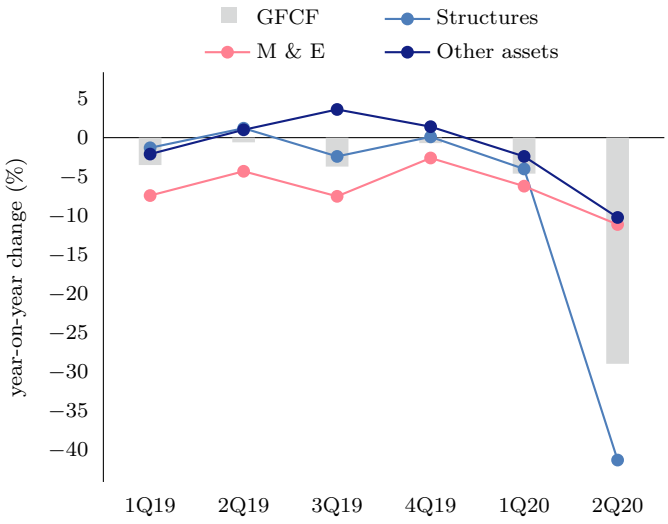
Source: Department of Statistics Malaysia

Domestic demand declined by 18.7% in 2Q 2020 (1Q 2020: 3.7%), due mainly to weaker private sector expenditure. Spending by the private sector was impacted by lower income, movement restrictions and subdued consumer and business sentiments. While net exports continued to decline, the contribution of the external sector to the economy improved due mainly to the larger contraction in imports vis-a-vis the previous quarter.

Private consumption growth declined by 18.5% in 2Q 2020 (1Q 2020: 6.7%). Household spending was particularly impacted by the strict movement restrictions in the early part of the quarter and income losses amid weak economic conditions. As movement restrictions were gradually relaxed towards the end of the quarter, retail and financing data indicated some improvement in spending, albeit remaining subdued. During this challenging period, stimulus measures such as the disbursement of Bantuan Prihatin Nasional cash transfers, EPF i-Lestari withdrawals and the implementation of the loan moratorium helped to cushion consumption spending.

Public consumption continued to expand, albeit at a more moderate pace of 2.3% (1Q 2020: 5.0%). Growth was supported by continued increase in emoluments amid lower spending on supplies and services.

Chart 8: GFCF Growth by Type of Assets



Source: Department of Statistics Malaysia

Gross fixed capital formation (GFCF) registered a sharper contraction of 28.9% (1Q 2020: -4.6%), weighed by significantly lower capital spending by both public and private sectors. By type of asset, both investment in structures and machinery & equipment (M&E) declined by 41.2% (1Q 2020: -4.0%) and 11.1% (1Q 2020: -6.2%), respectively.

Private investment declined by 26.4% (1Q 2020: -2.3%), due mainly to the COVID-19 containment measures and heightened uncertainty which affected business sentiments and investment intentions. During the quarter, investment was affected by mobility restrictions, which temporarily halted the implementation of projects. Despite the gradual relaxation of the MCO, firms maintained a cautious approach to capital expenditure amid slower production and disruptions to global value chains. Furthermore, businesses also faced challenges in the delivery and installation of M&E amid border closures.

Public investment also recorded a larger decline of 38.7% (1Q2020: -11.3%). This was due to a contraction in capital spending by both general government and public corporations due mainly to the movement restrictions.

Negative headline inflation due to decline in fuel prices; risk of deflation is minimal

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), declined to -2.6% during the quarter (1Q 2020: 0.9%). The lower headline inflation was primarily due to the substantial decline in retail fuel prices (average RON95 petrol price per litre in 2Q 2020: RM 1.37; 1Q 2020: RM 1.96) and the implementation of the tiered electricity tariff rebate beginning the month of April.

Notwithstanding the negative headline inflation, the decline in prices was not broad-based. In April, a relatively larger share of CPI items recorded unchanged prices (61%; March: 50%) amid the MCO which resulted in a significant reduction in economic activity. As economic activity gradually resumed under the CMCO and RMCO beginning from early May, there were some signs of normalisation in prices with a gradual increase in the share of CPI items recording price increases (May: 36%; June: 44%).

Core inflation moderated slightly to 1.2% (1Q 2020: 1.3%). Despite the moderation in overall demand pressure and weaker labour market conditions, some essential goods and services such as food away from home and small household appliances experienced price increases during the quarter. This suggests the continued presence of underlying demand especially for necessities.

Chart 9: Contribution to Headline Inflation by Components

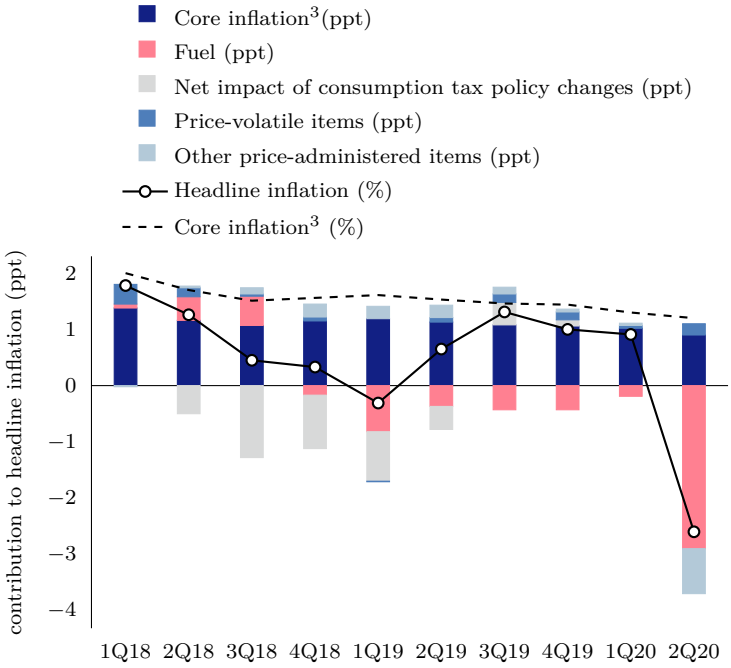
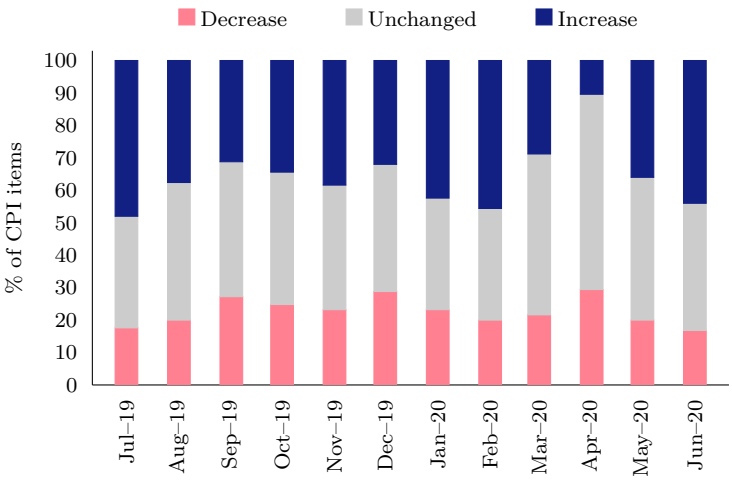


Chart 10: Month-on-Month Price Changes of CPI Items[4]



Source: Department of Statistics Malaysia and Bank Negara Malaysia estimates

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

[4] Based on the month-on-month inflation for 125 CPI items at the 4-digit level.

Box Article

COVID-19: Impact on Inflation

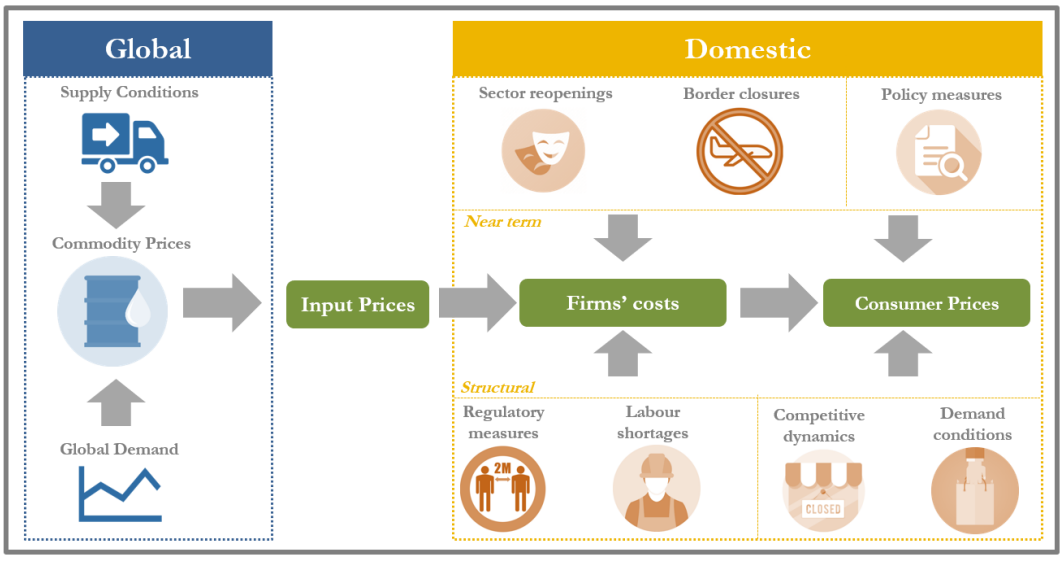
by **Peter Aun Maojun *and* Nur Aimi Abdul Ghani**

Introduction

The COVID-19 pandemic and the ensuing "Great Lockdown" (International Monetary Fund (IMF), 2020) involves a unique combination of shocks to both demand and supply (Baqaee and Farhi, 2020). As such, there has been debate surrounding whether this will lead to deflationary pressures or higher inflation.

Generally, a decline in aggregate demand amid heightened uncertainty and income fragilities may act to dampen inflationary pressures. However, higher production costs, due to supply chain disruptions and the impact of physical distancing and cross-border movement restrictions on labour supply, could lead to upward cost-push inflationary pressures. The initial lockdown at the onset of the pandemic has led to a shift in demand patterns that if permanent, could translate into changes in the degree of market power firms can exercise, ultimately affecting equilibrium inflation. This article aims to evaluate some of the channels that have affected inflation in the near-term, and provide an interim assessment of the structural changes in inflation dynamics that could materialise, yet remain highly uncertain.

Figure 1: Illustration of several global and domestic factors and their potential impact on prices



Source: Bank of England (2020) and Portes (2020)

Observed impact on inflation: What we have seen so far

Figure 1 illustrates the various factors at play. The crisis has brought about a significant decline in the demand for many key commodities. Global oil prices experienced a steep decline in March and April, as worldwide lockdowns led to a significant reduction in demand for energy products.[1] This translated into low domestic retail fuel prices, which had a large negative contribution on domestic headline inflation since March. However, prices of food commodities rose due to export restrictions amid preservation of supplies in producer nations, coupled with disruption in export logistics. For example, Vietnam and Cambodia initially elected to place temporary export restrictions on rice to ensure adequate domestic rice supply, which led to costlier imported rice.[2]

On the domestic front, significant supply disruptions were observed at the onset of the crisis due to strict movement restrictions, which led to some upward price pressures for certain perishable food items. Meanwhile, with the reopening of the economy, there is some evidence that sectors previously required to temporarily cease operations[3] continue to experience tepid demand given health concerns, leading to promotional pricing to entice customers.

The legal enforcement of health-related regulatory measures has also affected inflation. Alongside the strict stay-at-home order instituted during the Movement Control Order (MCO) period, the Government had also implemented sector-specific Standard Operating Procedures in efforts to contain the spread of the virus.[4] There has been mixed evidence showing that businesses with more inelastic demand (e.g. hair salons) were able to pass on costs to consumers, while others, such as hotels and entertainment outlets, largely absorbed cost increases to spur demand amid precautionary behaviour. The Government has also implemented measures aimed at easing cost burdens[5] which have helped to dampen inflationary pressures.

Altogether, Malaysia has experienced muted inflationary pressures since the onset of the pandemic, largely due to low global oil prices – an experience similar to other countries. The IMF has since revised inflation projections downwards for 2020, attributing a combination of lower commodity prices and weaker economic activity as key factors (see Table 1).

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[1] The decline was exacerbated by the failure of the Organization of the Petroleum Exporting Countries and its allies (collectively known as OPEC+) to agree on production cuts (Woodmac, 2020).

[2] Rice constitutes 1.1% of the Consumer Price Index (CPI) basket, of which imported rice makes up 20%.

[3] For example, entertainment and well-being outlets (e.g. reflexology services).

[4] Some of these measures include social distancing, usage of hygiene-related material (e.g. sanitisers, disinfectants, masks, gloves) within premises and other precautionary measures (e.g. digital menus, testing for employees, digital thermometers).

[5] These include tiered electricity tariff rebates and price controls on some essential goods.

Table 1: IMF Inflation Projections

	2020 projections		**2021 projections**	
	Jan-20	Jun-20	Jan-20	Jun-20
Advanced Economies	1.7	0.3 ↓	1.9	1.1 ↓
Emerging Markets & Developing Economies	4.6	4.4 ↓	4.5	4.5 ∼

Source: IMF World Economic Outlook Update Reports (January & June 2020)

Moving forward, while initial concerns are beginning to dissipate, the outlook would still depend on evolving COVID-19 developments and the pace of economic recovery. At this juncture, there are limited risks of a broad-based and persistent decline in prices, with price pressures showing signs of normalisation[6] since the gradual reopening of the economy. In addition, while underlying inflation is expected to be subdued, it is expected to average within earlier expectations for the year as a whole, reflecting the gradual resumption of economic activity and improvement in demand conditions.

Structural factors and the longer-term impact on inflation: What remains uncertain

While the impact from the various shocks outlined above were assessed based on existing frameworks (as illustrated in Figure 1), it is imperative to note that inflation channels may evolve. This section discusses where these structural changes could occur going forward.

1) **Shift in consumption patterns during the pandemic**

Households' consumption patterns shifted significantly during the implementation of the MCO as evident from the study on the Impact of MCO on Household Expenditure conducted by the Department of Statistics Malaysia (DOSM).[7]

The survey showed a shift towards higher consumption of food products, as households stock-piled during the initial MCO period and generally consumed more food at home. There was also a drop in expenditure for categories such as transport, restaurants and hotels, as well as recreation and clothing, amid movement restrictions and mandatory closures of selected sectors.

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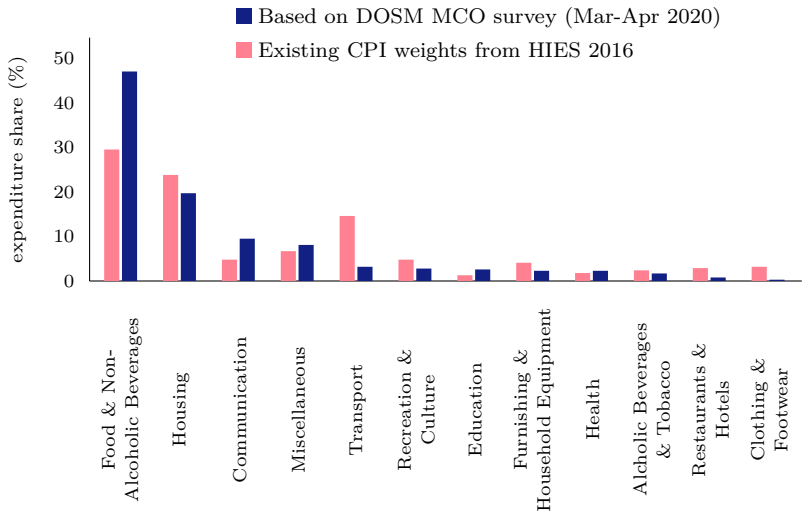
[6] The share of items displaying price increases has steadily recovered:
(June: 44% of CPI items; May: 36%; April: 10%; 2010-18 Average: 46%).

[7] Current CPI weights are based on DOSM's 2016 Household Income and Expenditure Survey (HIES).

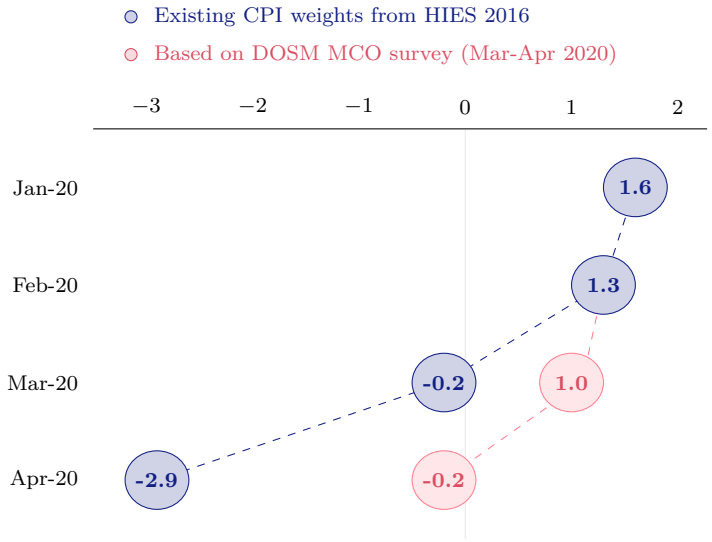
Figure 2: Shift in Expenditure Shares during the MCO period



Source: Department of Statistics Malaysia and Bank Negara Malaysia estimates

To provide a COVID-19 perspective and evaluate the impact on the measurement of inflation in Malaysia, we computed the inflation numbers by updating the Consumer Price Index (CPI) basket weights using findings from the previously mentioned study on the impact of the MCO conducted by DOSM.

Figure 3: Headline Inflation based on Various Expenditure Patterns



Source: Department of Statistics Malaysia and Bank Negara Malaysia estimates

As seen in Figure 3, headline inflation would have been higher for March and April once the shift in consumption patterns are accounted for. These findings are similar to those observed in other countries, such as the United States, France, the United Kingdom and Japan, among others[8], where researchers found that the official inflation rate would have been higher when taking into account changes in expenditure patterns (Cavallo, 2020).

Due to this distinct shift in consumption patterns, there were initial concerns surrounding the accuracy of inflation assessments. While these concerns are valid, it is important to note that according to international standards, CPI basket weights should not be adjusted in response to short-term changes in expenditure patterns.

Based on current assessments, these expenditure patterns are expected to gradually normalise as the economy recovers, health concerns dissipate and restrictions are removed. As such, no further adjustments to the CPI weights are necessary at this juncture. However, if these shifts in consumption continue as a result of other forms of structural changes in the economy, this could warrant the need to incorporate such shifts in ensuring an accurate assessment of inflationary pressures.

2) **Change in competitive dynamics**

Aside from the shift in consumption patterns, the crisis could also alter competitive dynamics (Pastor, 2020). As firms exit as a result of the pandemic, the resulting composition of surviving firms could potentially impact inflation dynamics in Malaysia. The impact could depend on whether large international chains or small businesses make up the majority of firms that survive. In the case of the former, prices of domestic goods could potentially become more sensitive to global price movements.

The responsiveness of inflation to slack in the economy may also change due to a shift in market structure (Guilloux-Nefussi, 2020). It has been shown that firms, primarily large ones with high market power, act strategically by adjusting their mark-ups in response to perceived competition, also known as strategic complementarity. It has been found that these firms mostly adjust prices in response to changes in the prices set by competitors, rather than their own costs (Amiti et al., 2019). Thus, the degree of pass-through of cost shocks to domestic prices would highly depend on whether local industries mainly constitute a few large firms, as they are more likely to employ strategic mark-up adjustments. At this juncture, such structural changes and their subsequent impact on inflation remain uncertain given the evolving developments. Going forward, more data and deeper surveillance are required to ascertain any shifts in industry composition.

[8] Cavallo (2020) also found similar results for Brazil, Uruguay, Korea, Chile, Colombia, Turkey, Spain, Argentina and Canada.

3) **Impact from economic scarring and shifts in labour market**

Economists have also raised concerns on the potential longer-term damage to the economy, or "economic scarring" (IMF, 2020), particularly on the labour market, which could have implications on inflation dynamics. Should economic recovery be more sluggish than expected, there may be a rise in unemployed individuals, particularly in sectors heavily affected by the pandemic. Some may exit the labour force altogether. In addition, prolonged unemployment for these individuals may lead to skills atrophy over time, which could lead to both a decline in the productivity of the working population (Neuman, 1995) and the labour force participation of individuals with obsolete skills (Van Loo et al., 2001). In fact, past epidemics were associated with a decline in labour productivity of 6 percent five years later in affected countries (World Bank, 2020). Nonetheless, the impact on prices remains uncertain. While the increased slack, coupled with the increase in technological adoption by firms as seen during this pandemic may lead to downward wage pressures, the decline in labour force participation and productivity growth rates may lead to higher cost pressures.

This pandemic may have also accelerated the shift to more flexible forms of employment, such as gig workers in selected sectors (Moulds, 2020). Such forms of employment could affect inflation dynamics mainly through its downward pressure on wage inflation due to the decline of employees' bargaining power and lower costs for firms as a result of reduction in firms' turnover costs in labour markets (Duca, 2018). In the long run, some may not be offered permanent employment, which would lead to smaller pressures on wage inflation when the economy eventually recovers (Cœuré, 2017).

If the pandemic and containment measures persist, disruptions to the labour market would delay the recovery of output to pre-COVID-19 levels. The extent of the permanence of these output losses would certainly depend on how deep and persistent the pandemic would be. While a complete and definitive assessment on these structural changes would not be possible at this current stage given the uncertainty surrounding the ongoing crisis, it is prudent to closely monitor the developments and their impact, if any, on inflation.

Conclusion

The COVID-19 pandemic and the ensuing unprecedented containment measures have brought about significant changes to the way the economy operates. Beyond the near-term impact, there are also channels that would lead to structural implications on inflation dynamics in the longer term. As we transition into a new normal, however, there remains a significant amount of uncertainty surrounding the future assessment of inflation and growth trajectories – a common sentiment across countries.

While the situation has begun to stabilise, it is certain that we are not in the clear yet and thus greater vigilance is necessary as we continue to assess any changes in inflation dynamics. To this end, the Bank will continue to closely monitor price developments and inflation expectations, complemented by real-time and high frequency indicators, as well as engage industry players to gain deeper insights. In addition, the Bank will continue to communicate clearly to the public on inflation developments and outlook as they unfold to ensure that price expectations remain anchored.

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Weak labour market conditions

Chart 11: Employment and Private Sector Wage Growth[5]

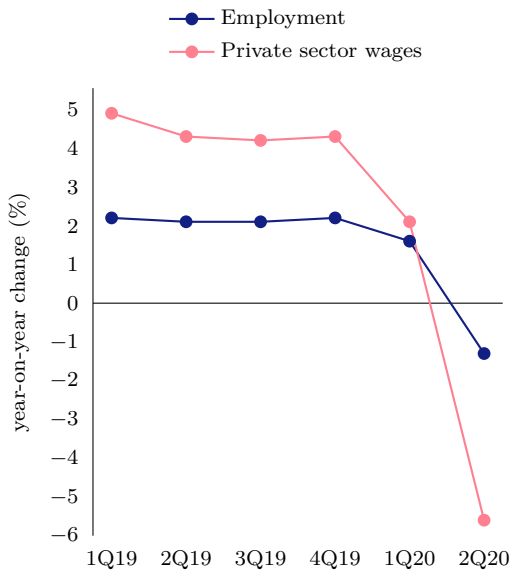
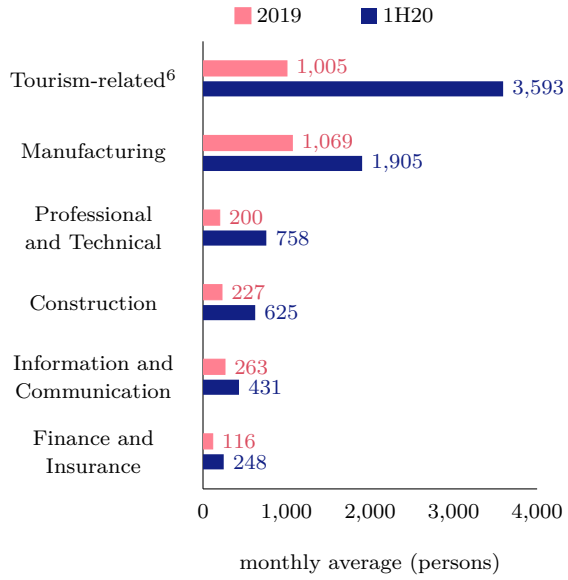


Chart 12: Average Monthly Jobless Claims for Key Industries



Source: Department of Statistics Malaysia and Employment Insurance System, Social Security Organisation

Labour market conditions weakened as containment measures and weak demand led firms to undertake cost-cutting actions. Measures such as retrenchments, pay-cuts and unpaid leave weighed on employment and income conditions. Employment declined by 1.3% (1Q 2020: +1.6%). Job losses were concentrated in the tourism-related industries as demand weakened considerably amid border closures. As a result, the unemployment rate rose to 5.1 % (1Q 2020: 3.5%).

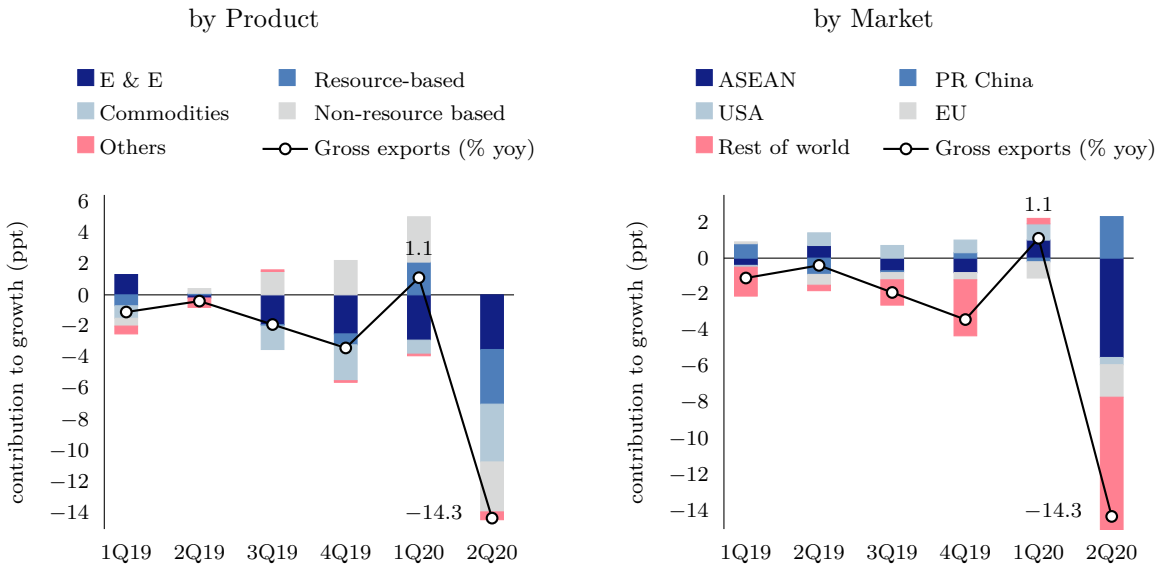
In addition to the job losses, shorter working hours and pay-cuts among those who remained in employment resulted in negative private sector wage growth in 2Q 2020 (-5.6%, 1Q 2020: 2.1%). The negative private services wage growth in 2Q 2020 (-6.4%, 1Q 2020: 1.4%) was driven mainly by tourism-related services, such as wholesale and retail trade, food and beverage, and accommodation (-3.5%; 1Q 2020: 1.9%) as well as transportation and storage (-29.7%; 1Q 2020: -3.5%) sub-sectors. In the manufacturing sector, wages contracted by 4.0% (1Q 2020: +3.4%). This was mainly due to lower wage growth in the transport equipment and other manufactures sub-sector (-13.3%; 1Q 2020: 1.3%) and the textiles, wearing apparel, leather and footwear sub-sector (-15.3%; 1Q 2020: 2.4%) that were unable to operate during the MCO period.

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

[6] Refers to wholesale retail trade, food and beverage, accommodation, transport and storage, entertainment and recreation, and administrative and support services.

Trade activity declined due to contraction in manufacturing & commodities exports, and weaker demand from main trade partners

Chart 13: Gross Exports by Product and Market



Source: Department of Statistics Malaysia

In 2Q 2020, gross exports declined by 14.3% (1Q 2020: 1.1%) weighed by weaker growth in both manufactured and commodities exports. Gross imports contracted by 15.1% (1Q 2020: 1.3%) due to lower intermediate and consumption imports. The trade surplus[7] narrowed to RM27.6 billion (1Q 2020: RM37.0 billion).

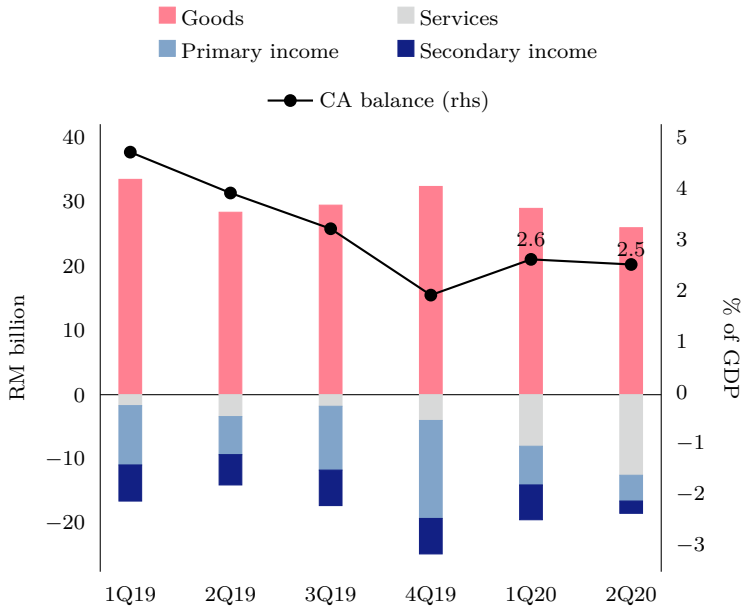
Malaysia's export performance in 2Q 2020 was affected by COVID-19 lockdowns globally, which resulted in disruptions to the global supply chains, lower demand from key trade partners and weaker commodity prices. Domestically, while the MCO restrictions had affected production in the early part of the quarter, manufactured exports registered a positive turnaround in June once the restrictions were eased. This was partly due to firms meeting a backlog of orders, particularly in the E&E sector. For the second quarter as a whole, manufactured exports contracted by 12.1% (1Q 2020: 2.5%) due mainly to lower non-E&E exports, which registered double-digit decline at -14.1% (1Q 2020: 11.2%). This was attributed to lower exports of petroleum products, metal manufactures and chemical & chemical products. E&E exports contracted further (-9.5%; 1Q 2020: -7.6%) amid lower exports to key trade partners, including the EU, US and Japan. Commodities exports worsened (-24.7%; 1Q 2020: -5.6%) due mainly to a sharp contraction in mineral exports following weaker prices and export volumes.

Intermediate imports contracted by 23.4% (1Q 2020: 8.1%) during the quarter due to lower imports of industrial supplies and fuel & lubricants amid weaker manufacturing activity. Consumption imports also declined (-9.3%; 1Q 2020: 4.8%), driven primarily by a sharp contraction in consumer durable goods. Meanwhile, capital imports increased by 14.8% (1Q 2020: -27%), due mainly to the import of a large floating structure.

[7] The goods and trade surpluses differ because goods for processing, storage and distribution (with no change in ownership) are excluded from the goods account. This is as per the 6th Edition of the Balance of Payments and International Investment Position Manual by the IMF.

Current account balance registered a surplus of RM7.6 billion

Chart 14: Current Account Balance



Source: Department of Statistics Malaysia

The current account of the balance of payments registered a surplus of RM7.6 billion or 2.5% of GDP in 2Q 2020 (1Q 2020: RM9.5 billion or 2.6% of GDP). The goods surplus decreased to RM25.9 billion (1Q 2020: RM28.9 billion), as the decline in the level of exports outpaced that of imports. In the services account, the deficit widened to RM12.5 billion (1Q 2020: -RM8.0 billion), the largest ever recorded. This was due primarily to a travel deficit (-RM3.1 billion; 1Q 2020: +RM2.1 billion) amid international travel restrictions.

The primary income account registered a lower deficit of RM4.0 billion (1Q 2020: -RM6.0 billion). This mainly reflected higher direct investment income from Malaysian investments abroad.

The deficit in the secondary income account narrowed to RM1.9 billion (1Q 2020: -RM5.4 billion). Outward remittances by foreign workers were lower due to the broad-based weakness in economic activity during the quarter.

Financial account registered a net outflow

Chart 15: Net Direct Investment Flows by Sector

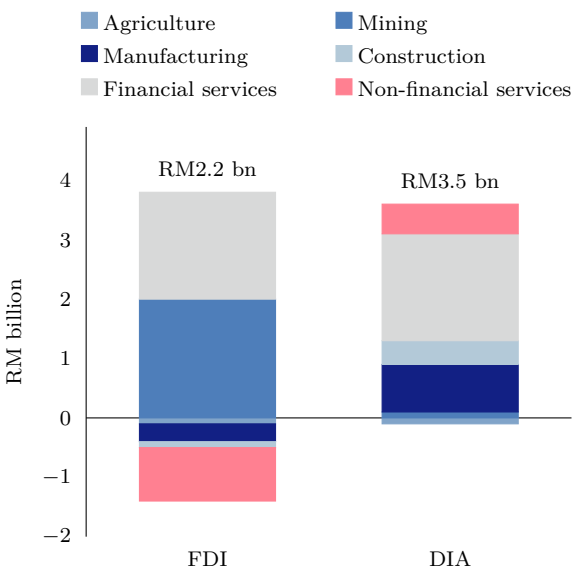
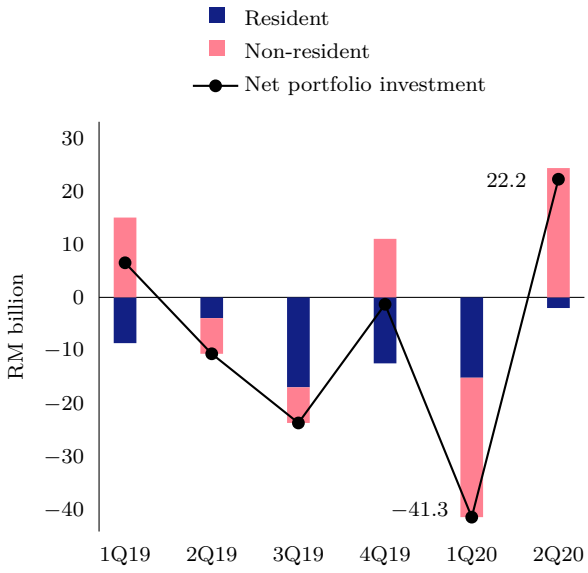


Chart 16: Portfolio Investments



Note: For DIA, positive (negative) values refer to net outflows (inflows). Figures may not sum due to rounding.

Source: Department of Statistics Malaysia and Bank Negara Malaysia

The financial account registered a net outflow of RM19.8 billion (1Q 2020: -RM13.3 billion), due mainly to outflows from the other investment account. This was partly offset by a turnaround in the portfolio investment account.

The direct investment account turned around to register a small net outflow of RM1.2 billion (1Q 2020: +RM3.4 billion), as direct investment abroad (DIA) recorded higher outflows amid smaller foreign direct investment (FDI) inflows. DIA recorded outflows of RM3.5 billion in the second quarter (1Q 2020: -RM3 billion). These investments were mainly channelled into the services sector, particularly the financial services and information and communication services sub-sectors. FDI recorded smaller inflows amounting to RM2.2 billion (1Q 2020: +RM6.4 billion), amid the contraction in global growth. Inflows were mainly channelled into the mining sector, followed by the services sector, particularly financial services.

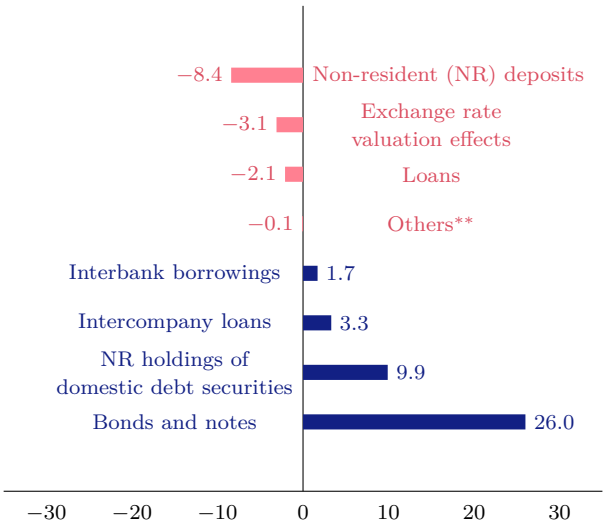
The portfolio investment account registered a sizeable net inflow of RM22.2 billion (1Q 2020: -RM41.3 billion), following inflows from non-residents (NR) amid a moderation in residents' portfolio investments abroad. NR investments recorded a net inflow of RM24.3 billion (1Q 2020: -RM26.2 billion). These inflows were channelled into debt securities (RM33.1 billion), and were partly offset by continued outflows from the equity market (RM8.9 billion). This follows the issuance of long-term bonds by the national oil and gas firm, and NR inflows into Malaysian Government Securities (MGS). Portfolio investment by residents recorded a small net outflow of RM2 billion (1Q 2020: -RM15.1 billion).

The other investment account recorded a significant net outflow of RM41.3 billion (1Q 2020: +RM22.1 billion). This mainly reflected net interbank lending abroad by the domestic financial sector. Net errors and omissions amounted to +RM5.9 billion during the quarter, or +1.5% of total trade.

External debt increased but remains manageable

Chart 17: Changes in External Debt

Net change*: + RM27 billion



*Changes in individual debt instruments exclude exhange rate valuation effects.

**Comprises trade credits, IMF allocation of SDRs, and other debt liabilities.

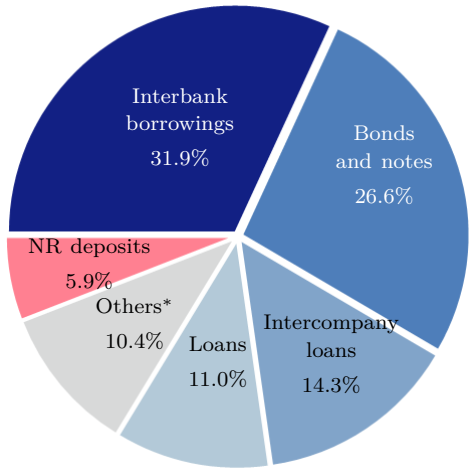
Source: Ministry of Finance Malaysia and Bank Negara Malaysia

Malaysia's external debt amounted to RM1,003 billion, or 69.3% of GDP as at end-June 2020 (end-March 2020: RM975.9 billion or 64.4% of GDP). The higher external debt mainly reflects a net issuance of international bonds and notes, and an increase in NR holdings of MGS. This was partly offset by lower NR deposits in the banking system and valuation effects following the stronger ringgit against selected major and regional currencies in the second quarter of 2020.

Malaysia's external debt remained manageable, given its currency and maturity profiles, and the availability of large external assets. Ringgit-denominated external debt amounted to RM305.2 billion, or 30.4% of total external debt (end-March 2020: 30.4%), mainly in the form of NR holdings of domestic debt securities (64.4% share of ringgit-denominated external debt) and NR ringgit deposits (19% share) in domestic banking institutions. As such, these liabilities were not subject to valuation changes that arise from fluctuations in the ringgit exchange rate.

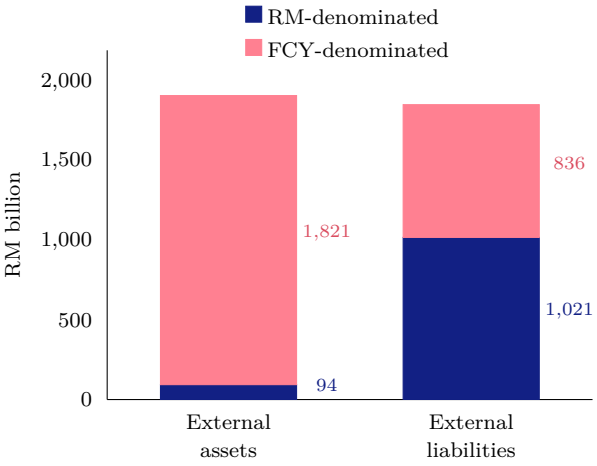
The remaining external debt of RM697.8 billion, or 69.6% of total external debt were denominated in foreign currency (FCY). The corporate sector accounted for 49% of FCY-denominated external debt and are largely subject to prudential and hedging requirements. Long-term bonds and notes issued offshore, accounting for 26.6% of total FCY-denominated external debt, stood at RM185.3 billion as at end-June 2020. These were mainly by non-financial corporations and channelled primarily to finance asset acquisitions abroad. Intercompany loans, amounting to RM100 billion or 14.3% of FCY-denominated external debt, were typically on flexible and concessionary terms.

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



*Comprises trade credits, IMF allocation of SDRs, and other debt liabilities.

Chart 19: International Investment Position



Source: Ministry of Finance Malaysia, Department of Statistics Malaysia, and Bank Negara Malaysia

Interbank borrowings and FCY deposits in the domestic banking system accounted for 37.7% (or RM263.2 billion) of FCY-denominated external debt. Around 82.1% of interbank borrowings were in the form of intragroup borrowings, which were generally more stable, thereby limiting rollover risks faced by banks. Meanwhile, foreign-currency risk, measured in terms of the net open position of FCY-denominated exposures[8], remained low at 4.9% of banks' total capital.

During the quarter, banks' FCY-denominated short-term external debt declined by RM9.8 billion driven by lower liquidity needs of onshore banks as bank funding of ringgit operations remained predominantly domestically sourced. The stable domestic funding and liquidity conditions which saw banks benefitting from lower funding costs following successive OPR cuts, an expansion of the deposit base and ample liquidity have further reduced attractiveness of external borrowings. However, the decline in borrowings by onshore banks was partly offset by higher borrowings by foreign bank branches in Labuan International Business and Financial Centre (LIBFC). Funds received by foreign LIBFC banks were mostly sourced from their parent banks and subsequently on-lent to non-resident clients, a reflection of their 'out-out' business activities.

From a maturity perspective, 58.7% of the total external debt was skewed towards medium- to long-term tenure (end-March 2020: 56.8%), suggesting low rollover risk. Short-term external debt accounted for the remaining 41.3% of external debt. Of which, 47.9% were intragroup borrowings among banks and corporations, which were generally stable and on concessionary terms. About another 12.1% were accounted by trade credits, largely backed by export earnings and are self-liquidating.

As at 30 July 2020, international reserves stood at USD104.2 billion, sufficient to finance 8.4 months of retained imports, and is 1.1 times the short-term external debt. In addition, Malaysia maintained a sizable net foreign currency asset position. About 95.1% of external assets were denominated in foreign currency compared to 45% of total external liabilities. This demonstrates Malaysia's ability in responding to external shocks. In particular, a depreciation in the ringgit exchange rate will result in a larger increase in external assets compared to external liabilities, thus enhancing Malaysia's external position.

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