Executive Summary

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In 2016, the world economy recorded the lowest growth rate since the Global Financial Crisis. Global trade continued to moderate reflecting the weakness in economic activity. With the exception of some Asian economies, growth was slower in most advanced and emerging economies. The advanced economies expanded more modestly. This was partly due to subdued investment activity amid weak business sentiments and heightened political and policy uncertainties. Emerging economies also experienced a slower growth momentum given the subdued external demand, weak commodity prices and volatile financial markets arising from the heightened global uncertainties. In Asia, while PR China's economy expanded at a more gradual pace due to ongoing reforms and rebalancing towards a consumption-led growth model, many other Asian economies recorded stronger growth. The expansion was driven by higher infrastructure investments and implementation of monetary, fiscal and structural policy measures to support growth. Global inflationary pressures remained low reflecting mainly the weak demand and weak commodity prices, especially crude oil.

Confronted with increasing growth concerns and low inflationary pressures, the stance of macroeconomic policies turned more accommodative in most countries. In the advanced economies, monetary policy continued to be the key policy instrument. The Federal Reserve adopted a more gradual path towards monetary policy normalisation than previously expected, whereas central banks in Australia, New Zealand, Norway and Sweden reduced key policy rates. Along with monetary easing, some advanced economies such as the euro area and Japan also implemented some structural reforms. In Asia, many economies employed a combination of fiscal and monetary measures to bolster domestic economic activity, and continued to pursue structural reforms to enhance economic resilience and support sustainable growth.

As the conventional and unconventional policy space has narrowed, vulnerabilities in many economies have also increased. Global leverage has risen amid unprecedented quantitative easing, productivity growth has remained low and the benefits from ongoing structural reforms have yet to fully materialise. These were compounded by the heightened political and policy uncertainties in major economies that raised concerns about the future of the global economy going into 2017 and beyond. In this environment, policy makers faced an increasingly daunting task to deliver short-term growth while maintaining steadfastness in undertaking necessary and difficult reforms to achieve sustainable growth over the longer term.

Despite the challenging economic environment, the Malaysian economy registered a commendable growth of 4.2% in 2016. The Annual Report provides an analysis of the developments in the Malaysian economy and outlines the challenges ahead. The report also highlights the Bank's efforts to enhance its governance, organisational development and communications.

The Malaysian Economy in 2016

In 2016, the Malaysian economy recorded a growth of 4.2% (2015: 5.0%) despite considerable external and domestic headwinds. The global economic landscape was challenging given the subdued global demand and low commodity prices. International financial markets were also subjected to heightened uncertainty with significant reversal of capital flows from emerging economies. This was driven by the unexpected political developments in the advanced economies, such as the UK and the US, and the macroeconomic policies adopted by these economies. Domestically, the economy continued to face headwinds from the higher cost of living amid soft employment 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 significant underperformance of the ringgit.

Against these external and domestic challenges, all sectors of the economy recorded a modest expansion during the year. Domestic demand continued to anchor growth, supported mainly by private sector spending. Private consumption growth, in particular, was sustained at 6.1% (2015: 6.0%), supported by continued employment and wage growth following the increase in minimum wage and civil servant salaries. Government measures to boost disposable income such as the temporary reduction in employees' contribution to the Employees Provident Fund (EPF), higher Bantuan Rakyat 1Malaysia (BR1M) payouts and tax relief to lower-income tax payers also supported household spending. Public consumption growth moderated to 1.0% (2015: 4.4%) following the expenditure rationalisation adopted by the Government in early 2016 given the lower petroleum-related revenue because of low crude oil prices. Gross fixed capital formation (GFCF) expanded moderately by 2.7% in 2016 (2015: 3.7%) driven mainly by lower private investment growth due to weak profitability and business sentiments. Public investment recorded a smaller rate of decline in 2016 (-0.5%; 2015: -1.0%) due to the smaller contraction in spending on fixed assets by public corporations given the higher investment in the downstream oil and gas industry, and the transportation and utilities sub-sectors.

On the supply side, all economic sectors continued to expand in 2016, with the exception of the agriculture sector. Agriculture production declined by 5.1% (2015: 1.2%), as crude palm oil (CPO) output was affected by the El Niño weather phenomenon. While growth in the services sector was higher at 5.6% (2015: 5.1%) following sustained demand in the consumer-related sectors, other sectors expanded more moderately.

Labour market conditions remained broadly stable as employment and wages continued to expand during the year. Net employment gains during the year amounted to 112,300 jobs, concentrated in the high-skilled segments such as professional and managerial jobs, while aggregate nominal wages in the private and public sectors grew by 4.2% and 6.7%, respectively in 2016 (2015: 4.9% and 4.7%, respectively). While total employment continued to expand, the pace however, was not able to fully absorb new labour market entrants as employers adopted a cautious stance and refrained from expanding their workforce too quickly. Consequently, the unemployment rate rose to 3.5% in 2016 (2015: 3.1%).

Inflationary pressures in the economy remained low with headline inflation averaging 2.1% in 2016 (2015: 2.1%). Despite the weaker ringgit exchange rate during the year, low global energy and commodity prices resulted in lower domestic fuel prices and input costs, which mitigated the impact of adjustments to administered prices and higher food prices caused by the El Niño phenomenon. Core inflation was also relatively stable during the year, averaging 2.1% in 2016 (2015: 2.3%) as demand driven inflationary pressures in the economy remained largely contained. This was underpinned by continued modest growth in private consumption and an absence of significant wage pressures.

Malaysia's external position remained resilient in 2016. The current account of the balance of payments remained in surplus, but by a smaller amount. The narrowing of the current account surplus reflected the lower trade surplus and the persistent structural deficits in the services and income accounts. Growth in gross exports moderated to 1.1% in 2016 (2015: 1.6%), reflecting the subdued global growth and low commodity prices. Gross imports recorded a higher growth of 1.9% (2015: 0.4%) driven by higher imports of capital goods amid the ongoing implementation of infrastructure projects and continued expansion in investment activity.

During the year, the financial account of the balance of payments improved against the environment of significant volatile cross-border capital flows. The financial account recorded a smaller net outflow of RM4.2 billion (2015: net outflow of RM50.9 billion) following a higher net inflow in the direct investment account amid lower net outflows in the portfolio and other investment accounts. During the year, the direct investment account recorded a higher net inflow of RM17.9 billion (2015: net inflow of RM4.8 billion) reflecting the lower direct investment abroad by Malaysian companies. The portfolio investment account recorded net outflows of RM19.7 billion (2015: net outflow of RM28.2 billion).

The international reserves of Bank Negara Malaysia amounted to USD94.5 billion (equivalent to RM423.9 billion) as at end-2016. As at 28 February 2017, the reserves level amounted to USD95.0 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, exchange rate flexibility has enabled the economy to reduce its reliance on the Bank's international reserves.

Malaysia's external debt remains manageable. The external debt stood at RM908.7 billion, equivalent to USD200.6 billion or 73.9% of GDP as at end-2016 (2015: RM833.8 billion). The increase in external debt 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 increased by 6.2%, mainly on account of higher intercompany and interbank borrowings. The profile of Malaysia's external debt remained healthy with more than one-third of total external debt being denominated in ringgit, thus limiting the risks arising from foreign exchange fluctuations. The remaining portion of the external debt, which is denominated in foreign currency, is mostly hedged either naturally using export earnings or through the use of financial instruments. The rollover risks are also contained as more than half of the total external debt is of medium- to long-term maturity. In addition, not all short-term external debts pose a claim on reserves due to the availability of export earnings and external assets which enable borrowers to meet external obligations without necessarily creating a claim on international reserves.

Overall, the strong fundamentals of the Malaysian economy have accorded Malaysia the ability to weather these external and domestic challenges. The diversified sources of growth in the economy have helped to contain the spillover effects of sector-specific shocks. Stable labour market conditions amid continued wage growth continued to support 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, an appropriate and timely monetary policy response and targeted pro-growth measures played a key role in supporting growth during the year. The reduction of the Overnight Policy Rate (OPR) by the Bank was complemented by measures to increase household disposable income and support business activities. These included policies to create a conducive ecosystem for a sharing economy to thrive, temporary reduction in employees' EPF contributions, higher BR1M payouts and tax incentives to spur business activities, particularly among the small and medium enterprises (SMEs).

In recognising the impending challenges posed by global and domestic trends such as ageing populations, the influx of new technologies and slower growth in productivity, critical reforms and structural adjustments remained a priority to ensure the future growth of the Malaysian economy is sustained. These include efforts to enhance export competitiveness, ongoing investments to modernise physical and virtual infrastructure and policies to develop a high quality workforce by improving the quality of the education system.

Economic and Monetary Management in 2016

Monetary policy in 2016 was focused on ensuring monetary conditions remained supportive of the sustainable growth of the domestic economy with price stability. This was against a challenging policy environment characterised by material shifts in the balance of risks to the domestic economic outlook and significant volatility in the financial markets. In particular, the risks to domestic growth increasingly shifted to the downside by mid-year, originating from a confluence of external developments including the weaker-than-expected global growth momentum and policy uncertainties in the US and PR China. The challenging external environment was further exacerbated by the uncertainties surrounding the outcome of the UK's European Union (EU) referendum and the increase in global geopolitical risks. Against this downside shift in the risks to growth, the Monetary Policy Committee (MPC) adjusted the degree of monetary accommodativeness by reducing the OPR by 25 basis points to 3.00% on 13 July 2016. The adjustment was a pre-emptive measure aimed at ensuring the Malaysian economy continued on a steady growth path. At the level of 3.00%, the OPR was considered to be consistent with the intended policy stance given the growth and inflation outlook.

Since the adjustment in July, the MPC assessed that the monetary policy stance has remained consistent with the macroeconomic outlook and kept the policy rate unchanged at 3.00% for the rest of the year. The domestic economy remained on track to expand as projected for 2016 and 2017. During the course of the year, the MPC was also vigilant to the heightened degree of volatility in the domestic financial markets and the ringgit exchange rate given shifts in global liquidity and investor sentiments. The MPC emphasised through the Monetary Policy

Statement (MPS) that the Bank would continue to provide sufficient liquidity to ensure the orderly functioning of the domestic financial markets, such that overall domestic liquidity remains sufficient for efficient financial intermediation.

In 2016, the ringgit, along with most major and regional currencies, continued to be influenced by shifts in portfolio flows. For the year as a whole, the ringgit depreciated by 4.3% and ended the year at RM4.486 against the US dollar. In the first four months of the year, the ringgit was broadly on a strengthening trend against the US dollar due to sustained inflows driven mainly by expectations of a delay in the US interest rate normalisation and further monetary easing in advanced economies. Subsequently, sentiments started to shift, and the ringgit, together with several regional currencies, depreciated against the US dollar. Sentiments among investors were affected by persistent expectations of an interest rate increase in the US before year-end, continued volatility in global crude oil prices during this period and geopolitical uncertainty following the UK's referendum to exit the EU. These developments led to a reversal of portfolio flows from emerging market economies, which affected the performance of most of these currencies, including the ringgit. The strength of the US dollar was further reinforced by the anticipation of a faster pace of US interest rate normalisation in 2017 amid expectations of an expansionary fiscal policy in the US following the outcome of the US presidential election. For Malaysia, these developments had contributed to further capital outflows in November and early December, which reversed the earlier gains in the ringgit.

During the year, the volatility of the ringgit exchange rate was exacerbated by speculative activities in the opaque offshore non-deliverable forward (NDF) market, particularly in November. Speculation in the NDF market led to the sharp disconnect between the exchange rate and underlying domestic economic fundamentals. Consequently, the non-transparent pricing mechanism in the NDF market spilled over to the onshore foreign exchange market which then disrupted the domestic price discovery process during the period.

Volatility in the ringgit was also due to the rising supply and demand imbalances in the domestic foreign exchange market. Despite the sustained current account surplus, insufficient export proceeds were converted into ringgit which had the effect of weakening the structural demand for the ringgit. Conversely, the undertaking of investments by Malaysian companies abroad had increased the demand for foreign currencies. These underlying imbalances left the ringgit vulnerable to the sharp movements of portfolio investment flows by non-resident investors, which resulted in frequent ringgit overshooting in response to global developments. To rectify these imbalances, the Financial Markets Committee (FMC), in collaboration with Bank Negara Malaysia, introduced several measures to deepen and broaden the domestic foreign exchange market. The measures included promoting foreign exchange hedging within the domestic foreign exchange market and requiring the conversion of foreign currency export proceeds into ringgit. The renewed flow of foreign currency export proceeds into the domestic market would subsequently improve foreign currency liquidity in the onshore market.

Monetary operations in 2016 focused on ensuring the domestic money market continued to effectively intermediate short-term funds in an environment of heightened global financial market uncertainties. As part of a comprehensive effort to ensure sufficient liquidity in the domestic financial system, the Bank reduced the Statutory Reserve Requirement (SRR) ratio from 4.00% to 3.50%, which took effect from February 2016 onwards. The broad-based release of liquidity into the banking system led to increased liquidity in the interbank market and eased the pressure on interbank borrowing costs. As the volatility of capital flows increased towards the later part of the year, the composition of monetary instruments used to absorb surplus liquidity was also adjusted in favour of shorter tenures to provide banks with greater flexibility in managing their liquidity positions. This enabled banks to readily meet any sudden withdrawals of funds due to capital outflows. As such, notwithstanding the volatility in domestic financial and foreign exchange markets, aggregate banking system liquidity remained ample throughout the year.

Domestic financial intermediation was uninterrupted during the year, with net financing to the private sector growing by 5.5% in 2016 (2015: 8.2%). The more moderate pace of growth in net financing during the year was in line with economic activity, reflecting mainly the lower growth of outstanding loans to both households and businesses. The moderation in the growth of household debt was also attributable to moderate domestic demand

and in part due to the pre-emptive macro- and microprudential measures implemented by the Bank to ensure prudent levels of household debt. The slower outstanding business loan growth was confined to certain sectors, with limited evidence of broad-based tightening in access to financing. Capital market funding to businesses also remained healthy with the bond market remaining as a key source of financing for the private sector.

Outlook for the Malaysian Economy in 2017

Global economic activity is projected to improve in 2017, underpinned by an expansion in domestic demand in the advanced and emerging market economies, boosted in part by expansionary fiscal policies in selected major economies. These pro-growth policies would spur global demand and provide impetus to global trade. The outlook would also be supported by a recovery in commodity prices amid the move to reduce oversupply conditions. Nonetheless, the global economy will continue to be subjected to several downside risks. These include a potential retreat from globalisation and free trade in the advanced economies, and uncertainty over the UK and EU negotiations and geopolitical developments. Anticipation of monetary policy divergence between the US and the other major economies could also result in overadjustment in the foreign exchange markets amidst destabilising capital flows.

With the gradual improvement in global growth, recovery in global commodity prices and the continued growth of domestic demand are expected to collectively support Malaysia's growth performance. The Malaysian economy is projected to register a sustained growth of 4.3% - 4.8% in 2017.

Domestic demand will continue to be the principal driver of growth, underpinned by private sector activity. Notwithstanding the higher inflation, private consumption growth is expected to be sustained by continued wage growth and the increase in disposable income due to selected Government measures and higher global commodity prices. In an environment of cautious business sentiment and continued uncertainty in the economy, investment growth is projected to remain modest. Nonetheless, private investment activity will be supported by higher capital expenditure in export-oriented industries and implementation of ongoing and new projects, particularly in the manufacturing and services sectors. While public expenditure would be lower as a result of the Government's continued commitment to fiscal consolidation, the public sector is projected to support growth, driven mainly by higher public investment arising from the ongoing implementation of key infrastructure projects in selected sectors.

Malaysia's external sector is expected to remain resilient despite continued uncertainties in the global environment. Both exports and imports are expected to strengthen in 2017, underpinned by the projected improvements in global growth, higher commodity prices and sustained domestic demand. Nonetheless, import growth is expected to continue to outpace export growth, resulting in a lower trade surplus. The services account is projected to register a larger deficit, in line with higher trade and improvement in investment activity. Overall, the current account is expected to register a surplus of 1.0% - 2.0% of GNI in 2017.

On the supply side, all economic sectors are projected to register positive growth in 2017. The services and manufacturing sectors would be the key contributors to overall growth. The agriculture sector is expected to rebound as yields recover from the El Niño weather phenomenon. Growth in the mining sector is expected to remain steady, as a stronger expansion in natural gas output offsets a moderation in the crude oil sub-sector.

Headline inflation is projected to average higher in the range of 3.0% - 4.0% in 2017, given the prospect of higher global commodity and energy prices, and the impact of the depreciation of the ringgit exchange rate. These cost-push factors, however, are not expected to cause significant spillovers to broader price trends, given the stable domestic demand conditions. Core inflation is, therefore, expected to increase modestly.

Economic and Monetary Management in 2017

As the global landscape is set to experience concurrent shifts in policy stance, there could be varying implications for the Malaysian economy. In particular, the prospect of increased protectionism among the major economies would have a dampening effect on global trade. The prospect of increasing monetary policy divergence between the US and other major economies could lead to tighter financial market conditions, with higher volatility in capital flows and exchange rates. The materialisation of these external risks would be a source of heightened uncertainty for the Malaysian economy and financial system, with implications for sentiments and labour market conditions. In addition, the persistence of earlier domestic headwinds, such as higher cost of living and weak sentiments, could also moderate the growth of domestic demand.

Nonetheless, the Malaysian economy's strengths derived from its highly diversified economic structure, resilient external position and policy flexibility would provide it with the ability to weather these challenges going forward. Financial intermediation will remain supportive of growth, supported by strong bank balance sheets and a well-developed financial market. Looking ahead, the challenging global environment necessitates continued emphasis on enhancing the nation's economic resilience and broadening the sources of growth. Efforts are being intensified to rebuild policy space, proactively address potential vulnerabilities and unlock new growth areas.

Monetary policy in 2017 will continue to ensure that its stance is consistent with sustaining a steady growth path amid price stability. The policy environment is expected to remain challenging. Although growth is expected to improve due to better performance of the external sector, the economy will be challenged by higher inflation, volatile capital flows and lingering uncertainties in the global economic and financial environment. While the risk of destabilising financial imbalances has remained largely contained, it will continue to be closely monitored. Given the expectation of continued volatility in capital flows, the Bank's monetary operations will ensure that domestic liquidity in the financial system remains sufficient in order to support the orderly functioning of the domestic financial markets.

Fiscal policy in 2017 will focus on further strengthening of the Government's fiscal position, while ensuring continued support for domestic growth and promoting economic inclusiveness. The Federal Government's fiscal deficit is expected to narrow further, underpinned by sustained growth in revenue and a modest expansion in operating expenditure. In the 2017 Budget, fiscal resources have been strategically prioritised towards high impact infrastructure projects and programmes for capacity building. The budget was also consistent with efforts to ensure inclusive and sustainable growth. In particular, welfare enhancement programmes and socio-economic support are expected to sustain the capacity of lower- and middle-income segments to cope with the rising cost of living and provide support to private consumption.

Governance, Organisational Development and Communications

Individuals who work in the Bank are committed to the mandates of maintaining monetary and financial stability that are critical towards achieving sustainable economic growth. The Bank's staff are held accountable by strong governance and oversight exercised by the Board of Directors (the Board). In 2016, there were several changes to the composition of the Board. Dr. Zeti Akhtar Aziz completed her term of service as the Governor on 30 April 2016 and Muhammad bin Ibrahim was appointed as Governor on 1 May 2016. Shaik Abdul Rasheed bin Abdul Ghaffour was appointed as the Deputy Governor on 16 July 2016 and Nor Shamsiah binti Mohd Yunus completed her tenure as Deputy Governor on 15 November 2016. Consequently, the size of the Board decreased from 12 to 11 members. The Board currently comprises the Governor as Chairman, the two Deputy Governors and the Secretary-General to the Treasury and seven independent non-executive members.

In 2016, the Bank's risk appetite and tolerance statements were reviewed to strengthen the Bank's risk management capabilities. These statements indicate the amount and type of risks that the Bank is willing to take in meeting its mandates. In strengthening audit processes, the Internal Audit Department (IAD) engaged an independent external party to conduct a quality assurance review of its auditing practices. The IAD's auditing practices is in general conformance with the highest rating of the International Standards for the Professional Practice of Internal Auditing. As part of the Bank's business plan for 2016, new initiatives were introduced to address emerging priorities, such as fostering an enabling environment for financial technology (FinTech) solutions, accelerating the development of the insurance industry and building new capabilities in data analytics.

During the year, the Bank further improved succession planning, talent management and talent development. In particular, the Bank streamlined the succession and corporate talent pools. This integration allowed for more targeted development interventions for staff, aimed at preparing them to assume more critical roles. An independent review of the Bank's physical security management was also conducted aimed at enhancing the Bank's response to emerging threats. The review covered all aspects of security management, people, processes and technology. Several security initiatives were implemented to enhance security at the Bank. An independent review of the Bank's IT infrastructure was also completed and the Bank has embarked on a four-year transformation of the IT services, which will result in more specialised IT skill sets, new technology platforms and architectures.

Communication channels and practices were strengthened to relay important announcements and developments to the public. In line with shifting global media trends, digital platforms were utilised for better outreach to different groups of stakeholders. Embargo times on press releases were reduced to earlier in the day to allow ample time for markets to assess and understand the implications of various communications.

In 2016, the Bank established the FMC to serve as a more inclusive forum to recommend strategies aimed at fostering the development of Malaysia's financial market. This committee comprises of representatives from the Bank, financial institutions, corporations and other key stakeholders in the financial market. The Financial Technology Enabler Group (FTEG) was also established during the year to formulate and enhance regulatory policies on technological innovations in the Malaysian financial services industry. The setting up of FTEG is part of the Bank's commitment to support innovations which will improve the quality, efficiency and accessibility of financial services in Malaysia.

The Bank's revamped website is now more user-friendly with an improved browsing experience on mobile devices. The new enhanced live streaming infrastructure introduced during the Bank's hosting of international events allowed for live telecasts on multiple platforms, with broadcasts accessible to event participants.

As collaboration among central banks is critical for knowledge sharing in the various areas of central banking, the Bank's Sasana Kijang has become a focal centre for such activities. Notable events during the year included the launch of the World Bank Group Global Knowledge and Research Hub, the Wharton Global Forum, the SEACEN Conference in honour of a past governor who was instrumental in deepening regional central banking cooperation, the Responsible Finance Summit and meetings in collaboration with the Bank for International Settlements (BIS). Apart from being the permanent headquarters of the Alliance for Financial Inclusion (AFI) and the World Bank Group Global Knowledge and Research Hub, Sasana Kijang also functions as an interim campus for the Asia School of Business (ASB).

Bank Negara Malaysia's Audited Financial Statements for 2016

The financial position of Bank Negara Malaysia, as audited and certified by the Auditor General, remained strong in 2016. The total assets of Bank Negara Malaysia amounted to RM451.0 billion, with a net profit of RM6.5 billion for the financial year ending 31 December 2016. Bank Negara Malaysia declared a dividend of RM2.5 billion to the Government for the year 2016.