2014

EXECUTIVE SUMMARY

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The global economy expanded at a moderate pace in 2014, with uneven growth across and within regions. In the advanced economies, while growth in the US continued to show broader signs of improvement, economic activity in the euro area and Japan remained subdued. In Asia, most economies benefitted from higher external demand. Nevertheless, economic growth was divergent across the region as domestic demand moderated in a number of economies amid country-specific developments. As the year progressed, downside risks to global growth re-emerged following geopolitical developments in Eastern Europe and the Middle East, weaker-than-expected economic activity in a number of major economies, and rising concerns over the growth prospects of commodity-producing emerging economies amid the significant decline in the prices of oil and other commodities in the second half of the year. Inflationary pressures remained benign in most economies, reflecting modest wage growth in the advanced economies and the significant decline in global commodity prices. Global financial markets were characterised by two distinct trends in 2014, with relative low volatility in the first eight months of the year, followed by higher volatility in the subsequent period. The heightened volatility in the later part of the year was driven by uncertainty surrounding monetary policy normalisation in the US, a resurgence of concerns over global growth prospects, and increased uncertainty over the implications of the sharp decline in commodity prices on commodity-producing countries.

The Malaysian economy grew at a stronger pace in 2014 with growth being driven by the continued strength in private domestic demand and positive growth in net exports. The Annual Report provides an analysis of the developments in the Malaysian economy and the policies pursued by the Bank during the year. It also provides an assessment of the prospects for the Malaysian economy given current developments and the challenges ahead. Additionally the report highlights the Bank's efforts to enhance its governance, organisational development and communications.

The Malaysian Economy in 2014

The Malaysian economy recorded a stronger growth of 6.0% in 2014 (2013: 4.7%), driven primarily by the continued strength of domestic demand and supported by an improvement in external trade performance. Net exports turned around to contribute positively to growth after seven years of negative contribution, as Malaysia benefitted from the recovery in the advanced economies and the sustained demand from the regional economies. While the growth in private domestic demand remained strong, public sector expenditure registered slower growth, consistent with the Government's fiscal consolidation efforts.

Private consumption grew by 7.1% in 2014, supported by favourable income growth and stable labour market conditions. Private consumption growth was also supported by the targeted Government transfers to low- and middle-income households. These partially mitigated some of the dampening effects on household spending growth from the higher cost of living following adjustments to administered prices. Public consumption recorded a slower growth rate of 4.4% given the more moderate increase in Government expenditure on supplies and services, which was in line with expenditure rationalisation initiatives announced towards the end of 2013.

Although the growth of overall gross fixed capital formation (GFCF) moderated to 4.7%, private investment grew by 11.0% during the year. Consequently, the share of private investment in GFCF increased to 64% (2013: 60%). Growth in private investment occurred in both export-oriented and domestic-oriented industries and was mainly driven by the services and manufacturing sectors. Public investment contracted by 4.9% following the decline in Federal Government development expenditure and lower capital spending by public enterprises. The latter mainly reflected the completion and near-completion of several major projects.

On the supply side, all economic sectors recorded higher growth rates in 2014, driven by domestic and external factors. In particular, the recovery in the advanced economies and the continued demand from regional economies resulted in the manufacturing sector recording a strong growth of 6.2%. The services sector remained the largest contributor to growth, expanding by 6.3% (2013: 5.9%).

Labour market conditions remained stable as continued expansion across all economic sectors sustained the demand for labour. The labour force participation rate and the total employment increased, while the unemployment rate declined to 2.9%.

Headline inflation averaged at 3.2% in 2014 (2013: 2.1%). After rising in the earlier part of the year, inflation moderated during the last four months due to lower food inflation, the lapse of the impact of the September 2013 fuel price adjustments, and the downward adjustments in fuel prices following the implementation of the managed float fuel pricing mechanism. Inflation during the year was driven mainly by domestic cost factors arising from the adjustments in the prices of several price-administered items since late 2013. The extent of spillovers on the prices of other goods and services was, however, contained given the subdued global prices, stable domestic demand conditions, and the firms' ability to accommodate some of the increase in input costs. As a result, core inflation averaged 2.4% (2013: 1.8%). The contained spillovers and the absence of excessive wage pressures also mitigated the risk of second-round effects.

Malaysia's external sector remained resilient amid continued uncertainty in the global environment. The current account surplus widened compared to the previous year while the level of international reserves remained high and was more than sufficient to meet short-term obligations and to provide ample buffer against external shocks. In the first half of the year, the current account recorded a higher surplus of RM35.8 billion, driven by a stronger trade surplus amid smaller services and income deficits. The growth in gross exports was broad-based amid improvement in demand across markets and products. In the second half of the year, the current account surplus narrowed to RM13.7 billion amid a lower trade surplus and larger deficits in the services and income accounts. Although lower crude oil prices led to lower export proceeds, the net impact on overall trade was somewhat mitigated by the accompanying decline in imports of petroleum products. Furthermore, prices of other major commodities, in particular liquefied natural gas (LNG) and crude palm oil (CPO) remained high, providing support to overall commodity exports. Overall imports growth moderated following the lower growth in imports of consumption goods and the decline in imports of capital goods in line with the moderation in the growth of capital spending in the second half of the year. For the year as a whole, the current account registered a surplus of RM49.5 billion or 4.8% of gross national income (GNI) (2013: RM39.9 billion or 4.2% of GNI).

The financial account continued to experience two-way financial flows, involving cross-border financial transactions by both residents and non-residents. Reflecting confidence in Malaysia's economic resilience and growth prospects, foreign direct investment (FDI) flows were sustained and were mainly channelled into the mining, financial services, and distributive trade services sectors. Outward direct investment flows by Malaysian companies were higher during the year, driven by investments in the mining, information and communications, and financial services sectors. For most of the year, an improving global outlook and the healthy performance of the Malaysian economy contributed to strong interest by non-residents in Malaysia's financial assets. Consequently, Malaysia experienced non-resident portfolio inflows of RM11 billion in the first three quarters of 2014, channelled mainly into the debt securities market. In the fourth quarter, however, investor sentiments turned negative amid concerns over weakening global growth prospects, the possible increase in interest rates in the US, and the rapid decline in oil prices. As a result, there was a net outflow of non-resident portfolio investments of RM20.6 billion in the fourth quarter, mainly from Bank Negara Monetary Notes. For the year as a whole, non-resident portfolio investments recorded a net outflow of RM9.6 billion. Overall, the financial account registered a net outflow of RM76.5 billion in 2014.

Despite the large swings in portfolio flows, the impact on domestic financial markets was cushioned by the deep and diversified financial markets and continued demand from domestic institutional investors. With greater exchange rate flexibility, some of the shocks were absorbed through adjustments in the ringgit exchange rate. At the same time, the high level of international reserves functioned as a buffer to prevent excessive fluctuations in the exchange rate.

The international reserves of Bank Negara Malaysia amounted to RM405.3 billion as at end-2014 (2013: RM441.9 billion). As at 27 February 2015, the reserves level amounted to RM386.0 billion (equivalent to USD110.5 billion), which is sufficient to finance 7.9 months of retained imports and is 1.1 times the short-term external debt. The international reserves held by the Bank remain usable and unencumbered.

Malaysia's external debt amounted to RM744.7 billion, equivalent to 69.6% of GDP, as at end-2014 (2013: RM696.6 billion or 70.6% of GDP). In terms of the maturity profile, slightly more than half of the external debt comprised medium- to long-term maturities. By currency, 41.2% of the external debt was made up of ringgit-denominated debt securities and deposits held by non-residents. During the year, particularly in the fourth quarter, the rise in external debt was partly attributable to the valuation effects from the depreciation of the ringgit. These valuation effects accounted for 42.0% of the RM48.1 billion increase in external debt during the year. Excluding these effects, the increase in offshore borrowing for the year largely reflected the drawdown of short-term borrowing by banks and medium- to long-term borrowing by the banking sector and the non-bank private sector. The increase in non-resident deposits in domestic banks also contributed to the higher external debt.

Interbank offshore borrowing accounted for only a small share of the banking system's total funding. This offshore borrowing mainly reflected domestic banks' increased overseas operations and centralised foreign currency liquidity management operations. In terms of the non-bank private sector's offshore borrowings, 70% of the total was sourced from offshore shareholders, parent companies and associated companies, while most of the debt was either financially or naturally hedged. Furthermore, stress tests conducted on large non-bank corporate borrowers indicated that they were resilient to exchange rate fluctuations.

Economic and Monetary Management in 2014

The Monetary Policy Committee (MPC) adjusted the degree of monetary acommodation by raising the Overnight Policy Rate (OPR) by 25 basis points to 3.25% on 10 July 2014. The economy was assessed to be on a sustained growth path and with the prospects for the domestic economy to remain on this steady growth trajectory in 2014. The MPC also took into account the ongoing concerns about the risks of broader financial imbalances. The key consideration was, therefore, in identifying the appropriate timing for the adjustment, taking into consideration the ongoing assessment of the balance of risks to the outlook for growth and inflation. By May 2014, the expectation was for growth in 2014 to be at the upper end of the initial forecast of 4.5% - 5.5%. There were greater upside risks to inflation, which was expected to trend above its long-run average in 2014 and 2015, driven mainly by domestic cost factors, namely adjustments in administered prices, and the implementation of the Goods and Services Tax (GST). Furthermore, while the implementation of macro- and micro-prudential measures were having the desired effect of moderating the growth of household indebtedness, the MPC assessed that the sustained period of unchanged and low interest rates was creating an environment of understating risks and had the potential of incentivising broader financial imbalances. Thus, the MPC decided to adjust the degree of monetary accommodation at the July 2014 MPC meeting. The adjustment in the policy rate was transmitted efficiently through the financial system and the broader economy. Retail lending rates adjusted quickly to the change in the OPR. Depositors were also compensated with higher rates of return on their savings.

In the later part of the year, the sustainability of external demand became more uncertain following rising concerns over the growth prospects of the global economy. Global growth continued to be uneven, with increasing evidence of a weaker-than-expected growth momentum in a number of major economies. In addition, the marked increased in global financial market volatility and the sharp decline in oil prices towards the end of 2014 further heightened the downside risks emanating from the external environment. As for inflation, despite a number of price adjustments, there was limited evidence of increased pervasiveness of price increases. The absence of external price pressures and the more moderate domestic demand conditions were also expected to mitigate the impact of cost-push inflation. Given the evolving economic and financial environment, and the uncertainty it created around the inflation outlook, and the growth prospects, the MPC was of the view that maintaining monetary conditions at their prevailing level was warranted. The risks of destabilising financial imbalances continued to be monitored.

The performance of the ringgit during the year followed two noticeable patterns. Between February and August 2014, the ringgit was broadly on a strengthening trend due to sustained portfolio inflows. From September, however, the ringgit, along with most regional currencies, faced depreciation pressures as investors unwound their holdings of financial assets in the region amidst nervousness about a possible change in US monetary policy and signs of weakness in the global growth momentum. For the year as a whole, the ringgit depreciated by 6.1% to RM3.4950 against the US dollar.

Malaysian Government Securities (MGS) yields were affected by domestic and external factors during the year. For the first 11 months, while market expectations and the eventual policy rate increase by the Bank led to upward adjustments at the shorter-end of the MGS yield curve, sustained interest from non-resident and local investors contributed to the downward shift at the longer-end of the MGS yield curve. This downward trend, however, was reversed in December as resident investors consolidated their investment positions towards the end of the year.

Aggregate outstanding liquidity placed with the Bank remained high despite the net withdrawal of liquidity due to net outflows from the external sector. Given the net external sector outflows, private sector liquidity, as measured by broad money (M3), grew at a more moderate pace of 7.0% during the year (2013: 7.9%).

Financing to the private sector remained healthy during the year. The growth in net financing through the banking system, development financial institutions (DFIs) and the private debt securities (PDS) market expanded at an annual rate of 8.7% in 2014 (2013: 9.7%). The growth in outstanding loans to businesses increased to 9.0% with continued double-digit growth in SME loans, amid a higher level of loan disbursements. Demand for funding from the capital markets by private sector corporations also remained robust, with gross funds raised through bond and equity issuances remaining relatively stable during the year at RM101.3 billion (2013: RM98.1 billion). Meanwhile, taking into account financing from both banks and non-banks, the growth in outstanding loans to households continued to moderate as intended following measures to curb pockets of excesses.

Outlook for the Malaysian Economy in 2015

Despite a challenging external environment, the Malaysian economy is expected to register steady growth of 4.5% - 5.5% in 2015, supported mainly by sustained expansion in domestic demand amid strong domestic fundamentals and a resilient export sector. Domestic demand will continue to anchor growth in 2015, driven by private sector spending. After registering five consecutive years of above-average growth rates, private consumption is expected to grow by 6.0% in 2015. While the implementation of the GST in April and lower earnings in the commodity-related sectors are expected to affect spending, this will, however, be partially offset by higher household disposable incomes from lower fuel prices, the favourable labour market conditions and the Government measures to assist low- and middle-income households.

After three years of double-digit growth, private investment is expected to expand by 9.0%, amid lower investments in the mining sector. Nevertheless, private investment growth will be supported by on-going projects and new investments in the manufacturing and services sectors with firms benefitting from the continued global recovery and expansion in domestic demand.

Public consumption is projected to grow more moderately, with lower spending on supplies and services following the Government's expenditure rationalisation measures. Public investment is, however, expected to turn around to record positive growth, with higher capital spending by public enterprises and to a lesser extent, by the Federal Government. Investments by public enterprises reflect the continued implementation of key infrastructure projects, particularly in the utilities and transportation sub-sectors.

In the external sector, after a strong performance in 2014, the growth of gross exports is projected to moderate, amid lower commodity prices. Exports of manufactured products, however, are expected to increase at a stronger growth rate. Gross imports growth is expected to be higher in 2015, amid continued growth in intermediate imports given the expansion in export-oriented manufacturing; and higher growth in capital and consumption imports in line with the continued growth of domestic demand. Overall, the trade balance is expected to narrow but remain in surplus. The services account is projected to record a smaller deficit, with the expected recovery in tourist arrivals. Overall, the current account surplus is projected to narrow to 2% - 3% of GNI in 2015.

On the supply side, all economic sectors are expected to expand. The services and manufacturing sectors will remain the key drivers of overall growth. Growth in the mining sector is projected to be sustained amid rising output from a new oil field. Weighed down by lower commodity prices, the agriculture sector is expected to record a marginal positive growth. The construction sector is expected to continue to record high growth, albeit at a more moderate pace. Although activity in the residential sub-sector is expected to increase at a more moderate pace, growth in the non-residential sub-sector is projected to be sustained while new and existing multi-year civil engineering projects will continue to provide additional support to the sector.

Headline inflation is projected to be lower at 2% - 3% in 2015, largely on account of lower global energy and food prices. The decline in global oil prices will lead to lower domestic fuel prices through the managed float fuel pricing mechanism. The more subdued external price pressures would also mitigate increases in the cost of imports stemming from the recent ringgit depreciation, thereby moderating imported inflation. While the implementation of the GST would result in higher prices for some goods and services, the impact on overall headline is expected to be contained. Basic necessities are either zero-rated or exempted from the GST while for some other items, the GST would merely replace the existing Sales and Services Tax (SST). The inflation rate in 2015 would also be affected by the new pricing mechanism for petrol prices in which there would be a more direct transmission of global oil price volatility into domestic prices given the market-based pricing of domestic fuel products. Nevertheless, the expectation is for underlying inflation to still remain relatively stable, amid modest demand pressures.

Economic and Monetary Management in 2015

The external environment in 2015 will be more challenging. While improving, downside risks to the global growth outlook remain given the continued weakness in a number of major economies. In addition, given uneven growth prospects, monetary policies in the major economies could potentially diverge, which may lead to sizable shifts in global liquidity and contribute to greater volatility in global financial markets and capital flows. The sharp decline in the price of oil and the uncertainty over its future price path, coupled with the attendant effects on the prices of other commodities, further compounds the challenging global environment. Amid this challenging landscape, the focus of policies by the Government and the Bank will be on addressing domestic vulnerabilities and supporting the growth of the Malaysian economy.

Monetary policy in 2015 will continue to support a steady growth of the Malaysian economy amid contained risks to inflation. The operating environment for monetary policy will be shaped by key challenges on the external front, which would affect the overall outlook for the domestic economy. These include the considerable downside risks to global growth prospects, the changed outlook for commodity prices, and the potential divergence in the monetary policies of the major economies. Notwithstanding these external risks, domestic demand is expected to expand at a sustained pace while the export sector will remain resilient. In terms of the inflation outlook, the key consideration for monetary policy is the development of underlying inflation, which is expected to remain relatively stable amid modest demand pressures. In addition, monetary policy decisions will also continue to take into account assessments on the potential risk of a further build-up in financial imbalances.

Fiscal policy in 2015 will focus on strengthening fiscal management amid the environment of low global commodity prices. The expected lower oil-related revenue has prompted the Government to introduce pre-emptive fiscal adjustment measures and to revise the fiscal deficit target from 3% to 3.2% of GDP. The net impact of lower oil prices on Malaysia's fiscal position is expected to be manageable. This is on account of the increased diversification of sources of revenue over the years, which will be further supported by the implementation of the GST, and the expenditure rationalisation measures encompassing fuel subsidy reforms and the scaling back of discretionary spending.

As a highly open economy, in the event that some of the external risks materialise, Malaysia would be adversely affected but the strong prevailing underlying fundamentals would act as a buffer to mitigate the impact. The economy is well-diversified, inflation is low, and the balance of payments position is resilient. Labour market conditions remain healthy. The deep financial markets, strong banking system, and ample liquidity conditions will ensure that effective financial intermediation continues and will provide support to Malaysia's resilience during bouts of volatile capital flows. External debt remains manageable with the majority of debt being in medium- to long-term tenures, and with more than 40% being denominated in ringgit. This, together with ample international reserves, accords the economy with the policy flexibility to manage external risks. The combination of these factors will cumulatively enable a more effective policy response to mitigate the impact of any external shocks on domestic demand.

Governance, Organisational Development and Communications

The year 2014 marked the completion of the Bank's three-year strategic Business Plan 2012-2014. During this period, the Bank accomplished several key milestones, including strengthening the legislative framework underpinning the domestic financial sector; establishing the Financial Services Talent Council and Financial Services Professional Board to raise the standards of quality and professionalism in the financial sector; and improving the e-payments ecosystem for more efficient payment transactions.

The Board of Directors' oversight of the Bank's governance included matters relating to financial sector development and financial stability, as well as major initiatives such as the establishment of the Monetary Penalty Review Committee (MPRC), as legislated under the Bank's acts. The Board is supported by three Board Committees, namely the Bank Governance Committee (BGC), the Board Audit Committee (BAC) and the Board Risk Committee (BRC). The Board, with the support of the BRC, provides strategic direction on the Bank's risk management. In 2014, risk dashboards were strengthened and a new principle-based policy was introduced to counter the increased risks associated with the greater use of digital information. The risk management function is complemented by a risk-based internal audit function for all critical operations of the Bank.

Organisational development efforts were focused on enhancing productivity, particularly in facilitating expedited learning given the changing talent demographics in the Bank. Other aspects included improving business processes and strengthening the architecture of the Bank's information systems.

The Bank sustained its proactive communications approach through different channels including the Monetary Policy Statement (MPS) and briefings coinciding with economic press releases, Parliamentary sessions, and meetings with investors and analysts. These engagements have a key role in enhancing the understanding of the Bank's assessments and policy actions as well as sustaining overall confidence. The Bank also continued to engage with the international central banking and financial community at large. Key initiatives included hosting the Alliance for Financial Inclusion (AFI) headquarters in Kuala Lumpur to strengthen global financial inclusion efforts; and establishing a renminbi clearing bank to deepen economic ties between Malaysia and PR China.

Other new initiatives during the year included those in support of the national "Going Green" agenda through the use of recycled fit RM1 and RM5 banknotes during festive celebrations, and Currency Education Programmes to enhance the public's knowledge of banknote security features.

Bank Negara Malaysia's Audited Financial Statements for 2014

The financial position of Bank Negara Malaysia, as audited and certified by the Auditor General, remained strong in 2014. The total assets of Bank Negara Malaysia amounted to RM427.6 billion, with a net profit of RM6.4 billion for the financial year ending 31 December 2014. Bank Negara Malaysia declared a dividend of RM3.0 billion to the Government for the year 2014.