In 2013, the global economy expanded at a modest pace amid an uneven growth environment across economies. In the advanced economies, growth continued to improve gradually. The pace of recovery, however, was modest as policy uncertainties and structural constraints continued to weigh on overall demand. Growth in emerging economies moderated as domestic demand was affected by the prolonged weakness in external demand. In a number of emerging economies, growth was also affected by policy measures introduced to manage domestic vulnerabilities. In addition, the shift in market expectations for reduction in monetary accommodation in the US towards the second half of the year led to large capital flow reversals from the emerging economies. Against this backdrop, global inflation slowed, reflecting the moderate demand conditions in many economies and lower non-energy commodity prices.

Despite the weaker external environment, the Malaysian economy continued to expand in 2013, driven by the continued strong growth in domestic demand. 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 of the Malaysian economy amid the ongoing global economic and financial developments and the key challenges going forward. The report also highlights the organisational changes in the Bank to further strengthen its governance and capacity through enhancements in strategic management, risk management and talent development.

The Malaysian Economy in 2013

The Malaysian economy expanded by 4.7% in 2013 (2012: 5.6%), driven by the continued strong growth in domestic demand. Despite the weaker external environment in the first half of the year, domestic demand remained resilient throughout the year, led by robust private sector activity. Private consumption was supported mainly by favourable employment conditions and wage growth. Private investment was underpinned by capital spending in the mining, services and manufacturing sectors. The more moderate growth performance in 2013 was, to a large extent, attributable to developments in the external sector. Slower demand from the advanced and regional economies in the first half of the year contributed to the overall decline in real exports during the year. This was compounded by the continued expansion in real imports throughout 2013 arising from the sustained growth in domestic investment and consumption, which contributed to the contraction in net exports.

Private consumption growth remained strong at 7.6% in 2013, underpinned mainly by the favourable employment conditions and wage growth. Private consumption was also supported by Government transfers to low- and middle-income households and continued access to financing for creditworthy borrowers. Public consumption recorded a higher growth of 6.3% in 2013 due mainly to higher expenditure on supplies and services.

Although the pace of investment activity moderated from the exceptionally strong growth in 2012, it continued to be supported by private sector capital expenditure. Private investment continued to register double-digit growth of 13.6%, driven by capital spending by both the domestic and foreign investors in the mining, services and manufacturing sectors. Public investment recorded a small positive growth of 0.7%, following the decline in the Federal Government development expenditure. Nevertheless, this was offset by higher capital spending by the public enterprises, which was channelled mainly into the oil and gas, transportation and energy sectors.

From the supply perspective, the continued firm growth in domestic demand contributed to the expansion in the domestic-related activity in the services and manufacturing sectors during the year. The export-oriented industries in the manufacturing sector benefited from the improvement in external conditions in the second half of the year. The robust activity in the residential and civil engineering sub-sectors contributed to the continued strong growth of the construction sector.

Labour market conditions remained favourable in 2013, as the continued expansion in economic activity across all sectors supported the demand for labour. Employment recorded a strong growth of 4.8% while total retrenchments decreased, suggesting that most firms were able to adapt to the minimum wage policy. During the year, the unemployment rate remained low at 3.1%.

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), remained modest at 2.1% in 2013 (2012: 1.6%). The average inflation was low at 1.7% in the first eight months of the year before increasing to 2.9% in the remaining four months of 2013. The higher inflation in the latter part of the year was driven by domestic cost and supply factors, arising from upward adjustments to administered prices and weather-related domestic supply shortages. Despite the strong growth in private consumption and sustained wage growth during the year, adequate productive capacity in the economy helped contain demand pressures. Hence, core inflation, an indicator of demand-driven pressures, moderated to 1.8% in 2013.

Malaysia's external sector remained resilient in 2013 amid a challenging global economic and financial environment. The overall balance of payments remained strong, as the current account surplus more than offset the net outflows in the financial account. In the first half of the year, the current account recorded a smaller surplus of RM11.2 billion, on account of a smaller trade surplus amid lower services and income deficits. The continued economic weakness in the advanced countries, slower-than-expected growth in regional economies and the lower prices of Malaysia's key commodities resulted in a marked decline in Malaysia's exports. The services and income deficits narrowed due mainly to higher net travel receipts following stronger intra-regional tourism, and lower net primary income payments, reflecting higher profits of Malaysian companies investing abroad. In the second half of the year, the current account surplus widened to RM26.1 billion as export growth returned to positive territory, driven by higher demand across both manufactured products and commodities. This was further reinforced by the more favourable prices of CPO and LNG relative to the first half of 2013. Growth in imports remained strong throughout the year, given the robust domestic demand. For the year as a whole, the current account registered a surplus of RM37.3 billion (2012: RM57.3 billion).

The financial account continued to experience sustained two-way flows involving cross-border financial transactions by both residents and non-residents. The economy's performance and growth prospects continued to support international investors' confidence, leading to significantly higher inward direct investment flows. Foreign direct investment (FDI) inflows were fairly broad-based across sectors, with significant inflows into the manufacturing and mining sectors. Outward direct investment, however, moderated in tandem with the moderation in the growth outlook for regional economies. Malaysia's deep capital markets and relatively favourable growth prospects remained attractive to foreign portfolio investors. These portfolio flows, however, exhibited considerable volatility during the year. Net inflows of non-resident portfolio investment was strong in the early part of 2013, but following the indication by the Federal Reserve (Fed) of a possible scale-back of its asset purchase programme in May, there were strong portfolio outflows between May and August. For the year, non-resident portfolio investment recorded a smaller net inflow. Overall, the financial account registered a net outflow of RM15 billion in 2013.

Malaysia's external debt amounted to RM318.1 billion (USD95.8 billion) as at end-2013 (2012: RM252.8 billion), equivalent to 33.5% of GNI (2012: 27.9% of GNI). Higher medium- and long-term external debt during the year mainly reflected the net drawdown of external borrowing by the public enterprises and the non-bank private sector. The Federal Government continued to register net repayment of external debt. The higher short-term external debt in 2013 was largely the outcome of the net drawdown of interbank borrowing, mainly for the management of foreign exchange liquidity positions. The appreciation of some major and regional currencies against the ringgit during the year also contributed to the higher external debt in ringgit terms. Overall, Malaysia's external debt remained manageable. The debt profile continued to be skewed towards a longer maturity structure, with medium- and long-term debt accounting for 59.7% of total external debt.

The international reserves of Bank Negara Malaysia increased by RM14.6 billion to RM441.9 billion at end-2013 (end-2012: RM427.2 billion). As at 28 February 2014, the reserves level amounted to RM427.6 billion (equivalent to USD130.6 billion), which is sufficient to finance 9 months of retained imports and is 3.3 times the short-term external debt. The international reserves held by the Bank remain usable and unencumbered.

Economic and Monetary Management in 2013

Monetary policy in 2013 was focused on balancing the risks surrounding the outlook for domestic growth and inflation. Against a backdrop of increased uncertainties on the balance of risks to the growth and inflation outlook, the Monetary Policy Committee (MPC) maintained the Overnight Policy Rate (OPR) at 3.00% during the year. Although the risks to domestic growth and inflation was assessed to be broadly in balance in the earlier part of the year, the uncertainties surrounding the balance of risks increased towards the second half. While the growth momentum was expected to improve in the second half of the year and into 2014, uncertainties on the strength of the global recovery and the extent to which the fiscal consolidation and subsidy rationalisation would affect domestic demand, remained as the key downside risks to growth. Following the upward adjustments to administered prices in the later part of the year, the inflation dynamics shifted and inflation was expected to increase for the remainder of year and into 2014. Based on its assessment of the possible downside risks to growth and upside risks to inflation, the MPC viewed that holding the OPR steady would provide the best outcome for its monetary policy objectives. Also, given that the risks of financial imbalances were confined to certain segments of the economy, the MPC decided that other tools would be better suited to address these risks. Consequently, macroprudential measures were introduced in July to manage such financial risks in a more targeted manner.

A key development in the second half of the year was the capital flow reversals from the emerging market economies following the Fed's indication of a possible scale-back of its asset purchase programme. Despite the increase in the size and volatility of capital outflows since May 2013, adjustments in the domestic currency and financial markets were orderly. The managed float exchange rate system accorded flexibility for the ringgit exchange rate to facilitate adjustments. The depth of the financial system also ensured that these volatile flows were intermediated without causing disruptions to economic activity. The growing demand from the domestic institutional investors provided the underlying support to the bond market and contained the increase in borrowing costs that were benchmarked against the bond yields. There were consequently minimal spillovers to the real economy.

The performance of the ringgit during the year was influenced mainly by two-way portfolio and trade flows, reflecting both international and domestic developments. In the first four months of the year, the ringgit was relatively stable. Subsequently, the indication of a possible scale-back in the Fed's asset purchase programme shifted market expectations and prompted a reversal of portfolio flows from most regional markets, resulting in the depreciation of most regional currencies, including the ringgit. For the year as a whole, the ringgit depreciated by 6.8% to end the year at RM3.2815 against the US dollar.

During the year, yields on Malaysian Government Securities (MGS) were driven primarily by external factors. While the Fed's indication of a possible scale-back of its asset purchase programme led to significant portfolio reversals in the bond market, the increases in MGS yields were generally smaller compared to markets across the region, due to the support of domestic institutions in the MGS market. In the private debt securities (PDS) market, the cost of private debt financing increased but remained supportive of fund raising activity. The FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) increased by 10.5% (2012: 10.3%) to close at 1867.0 points. The underlying performance of the market was supported by investors' confidence in the positive economic outlook for the Malaysian economy.

Liquidity conditions remained stable throughout 2013, despite heightened volatility in the global financial markets and capital flow reversals. Notwithstanding the net withdrawal of liquidity due to net foreign outflows during the year, surplus liquidity placed with Bank Negara Malaysia remained high. Private sector liquidity, as measured by broad money or M3, continued to expand, albeit at a more moderate pace of 8.1% during the year (2012: 9.0%).

Financing continued to support domestic economy activity. While growth in net financing moderated, the level of loans disbursed and funds raised in the capital market remained favourable. The overall demand for gross financing by businesses was sustained following continued strength in private consumption and investment activity. Demand for loans by households was also sustained, supported by favourable employment conditions and wage growth. Of significance, the growth rate of outstanding loans for *personal use* moderated to 4.6% in 2013 (2012: 9.1%), partly as a result of the pre-emptive measures introduced by the Bank in July 2013 to reinforce responsible lending practices. For the year, net financing to the private sector through the banking system and the PDS market expanded at an annual rate of 9.8% (2012: 12.4%).

Outlook for the Malaysian Economy in 2014

The Malaysian economy is expected to remain on a steady growth path in 2014, expanding by 4.5%-5.5%. Domestic demand will remain the key driver of growth, albeit at a more moderate pace. Private investment is forecast to register robust growth for the fifth consecutive year, driven by the ongoing implementation of multi-year projects and the improvement in external demand. Public investment is projected to register a higher growth, supported by both Government and public enterprise capital spending. Private consumption will be underpinned by healthy labour market conditions and sustained income growth. Public consumption is anticipated to record a lower growth due to the ongoing fiscal consolidation.

In line with the improvement in external demand, Malaysia's export performance across most product categories is expected to pick up in 2014. Exports is expected to be further supported by a small positive growth in commodity exports and the stronger services exports, supported by Visit Malaysia Year 2014. At the same time, gross imports is projected to increase at a faster pace, driven mainly by higher intermediate imports. With import growth remaining robust, the current account surplus is projected to narrow in 2014.

On the supply side, all economic sectors are expected to register positive growth in 2014. The services and manufacturing sectors will be the key drivers to the overall growth, benefiting from the improvement in the global economic environment. The construction sector is expected to continue recording high growth, albeit at a more moderate pace, as the completion of several large civil engineering projects will more than offset the progress in existing projects in the transport, utility, and oil and gas sectors. The growth in the agriculture sector is expected to improve on account of higher production of palm oil as both yields and the number of matured palm trees increase. In the mining sector, better performance is projected due to higher crude oil and natural gas production from deepwater and marginal fields; and enhanced oil recovery.

Headline inflation is projected to average 3%-4% in 2014, due mainly to domestic cost factors. These include the recent price adjustments arising from the subsidy rationalisation and the spillover effects of these adjustments on the prices of other goods and services. The higher cost pressures, however, will be partly contained by subdued external price pressures, continued expansion in domestic capacity and a moderation in domestic demand.

Notwithstanding the moderation in domestic demand, the underlying fundamentals of the Malaysian economy remain strong. Growth will be driven by the private sector across a diversified range of economic activities. Of importance, employment remains strong and incomes are rising. The financial system is resilient with financial intermediation expected to provide continued support to investment and consumption. The strength of Malaysia's external position also remains intact, with international reserves at healthy levels and external debt within prudent limits.

Downside risks to global growth, however, could affect the performance of the domestic economy in 2014. The advanced economies will continue to experience excess capacity in the labour and product markets, while fiscal uncertainties may affect the pace of recovery. In several of the emerging economies, there could be slower-than-expected domestic demand amid policy measures to address risks arising from high growth in credit and asset prices. In addition, volatility in global financial markets could contribute to large and volatile capital flows. While the environment will continue to be challenging, the economy could also register stronger growth performance if the pace of global recovery exceeds expectations.

Economic and Monetary Management in 2014

The focus of policies by the Government and the Bank will be on supporting the Malaysian economy to grow at a sustainable level, while mitigating the risks arising from the global environment, inflation and the buildup of financial imbalances.

Monetary policy in 2014 will aim to support the sustainable growth of the Malaysian economy while mitigating any potential vulnerabilities arising from inflation and the buildup of financial imbalances. While price pressures are expected to be stronger, the source of inflation is primarily due to cost-push factors. Monetary surveillance, however, will remain focused on identifying signs of inflation becoming more pervasive and persistent, whereby a monetary policy response would become appropriate. Of significance, the prolonged period of relatively low international and domestic interest rates could encourage excessive risk-taking behaviour. To the extent that this occurs within specific segments of the economy, other targeted policy instruments such as macroprudential measures would be deployed to address these risks. Such measures are, however, complementary in nature and not a substitute for interest rate policy. Given the expected large shifts in global liquidity and capital flows, it is important to ensure that the monetary and financing conditions do not become destabilising and continue to be supportive of the economy.

Fiscal policy in 2014 is aimed at strengthening and consolidating the fiscal position, while ensuring continued support for domestic growth and the protection of the well-being of the society. Fiscal reforms are being pursued gradually to avoid undermining growth. Concurrently, fiscal resources will be directed towards key economic sectors to accelerate the shift towards a high value-added, high-income economy. In June 2013, the Fiscal Policy Committee (FPC) was established to serve as the central policy-making committee for the formulation and implementation of fiscal strategies and giving due consideration to their impact on overall macroeconomy.

Organisational Development and Governance
In 2013, the Bank completed most of the targeted initiatives for the year and sustained the progress of its three-year Business Plan. During the year, the Board of Directors met monthly to consider key economic and financial conditions and the Bank's policy responses, as well as to deliberate on the Bank's financial condition, reserves and currency management, and talent management issues. The official opening of the Bank's Beijing Representative Office witnessed the first occasion where a Board meeting was conducted abroad, in conjunction with other activities to further strengthen bilateral ties with PR China. The Board is supported by three non-executive Board Committees, namely the Board Governance Committee (BGC), the Board Audit Committee (BAC) and the Board Risk Committee (BRC).

The Bank's organisational development strategies were aimed at sustainability and preparedness as it continues to deliver the core mandates amid the challenging global economic and financial environment. This was achieved through organisation-wide clarity and focus on key outcomes and deliverables anchored to the Business Plan. During the year, steps were taken to further integrate elements of business strategy, risk, human capital and financial resources for a more holistic view of organisation performance management and more informed decision-making.

The Bank's communications role was intensified in 2013 in view of heightened challenges and uncertainties, especially in the global environment. More intensive engagements were carried out with various stakeholders, explaining the international and domestic economic and financial developments and their implications on the Malaysian economy and the financial system. Communication efforts were also focused in driving the Bank's strategic initiatives, including explaining the new Financial Services Act 2013 and the Islamic Financial Services Act 2013, and a nationwide campaign on `Experience IBG´, or Interbank GIRO, to encourage the switch from cheques to IBG services.

The Bank continues to engage with the global central banking community including in the area of capacity building. To enhance the knowledge and skills of policymakers and regulators globally in their pursuit of greater financial inclusion, the Bank and the Alliance for Financial Inclusion (AFI) signed a Letter of Cooperation for capacity building in August 2013. The Bank also intensified its capacity building efforts to support the Association of South East Asian Nations (ASEAN) financial integration agenda through the conduct of technical cooperation programmes. Capacity building programmes in the development of an effective and well-regulated Islamic financial system also continued to be a major focus area in 2013.

Bank Negara Malaysia's Audited Financial Statements for 2013
The financial position of Bank Negara Malaysia, as audited and certified by the Auditor General, remained strong in 2013. The total assets of Bank Negara Malaysia amounted to RM474.2 billion, with a net profit of RM5.5 billion for the financial year ending 31 December 2013. Bank Negara Malaysia declared a dividend of RM1.5 billion to the Government for the year 2013.