the increase in gross borrowings outpaced a higher repayment of loans during the year. The larger drawdown of external loans was mainly by companies in the services, plantation, manufacturing and oil and gas sectors. Despite a higher borrowing, the overall risk profile of the private sector medium- and long-term debt remained low as the bulk of these loans have a natural hedge. Most of these loans were used to finance export-oriented activities and overseas investment with foreign exchange earnings and income. Furthermore, a large share of these loans was sourced from the offshore shareholders and parent or associate companies with more flexible terms and at concessionary interest rates. Meanwhile, the bulk of the repayments was effected by companies in the plantation, services and manufacturing sectors. Thus, the private sector medium- and long-term external debt outstanding increased to RM63.5 billion (USD16.6 billion) as at end-2005 (2004: RM60 billion).

The outstanding **short-term external debt** (maturity of one year or less) rose by RM2.4 billion to RM46.2 billion (USD12.1 billion) in 2005, due entirely to an increase in the short-term external borrowing by the banking sector, mainly for hedging activities on trade-related transactions and treasury activities. Meanwhile, short-term debt by the non-bank private sector, comprising mainly term loans, revolving credits and overdraft facilities, declined further to RM7.3 billion in 2005 (2004: RM8.4 billion).

Compilation of Malaysia's External Debt: Treatment of Offshore Financial Entities in Labuan IOFC as Residents

The Fifth Edition of the Balance of Payments Manual (BPM 5) of the International Monetary Fund classifies offshore entities in an economy as residents for compilation of external data, including external debt data. Similarly, the External Debt Statistics Guide for Compilers and Users[1] (2003), also states that '***The residence of offshore enterprises** — including those engaged in the assembly of components manufactured elsewhere, those engaged in trade and financial operations, and those located in special zones — **is attributed to the economies in which they are located**.*' As such, the debt liabilities of offshore entities that are owed to non-residents are to be included as part of an economy's external debt.

In the current definition of external debt in Malaysia, the offshore entities in Labuan International Offshore Financial Centre (Labuan IOFC) are treated as non-residents for foreign exchange administration purposes. Thus, these entities are not subject to the foreign exchange administration rules applicable to residents, including statistical reporting to Bank Negara Malaysia. As a result, while the external debt data compiled and disseminated by Malaysia include debt transactions and exposure of residents with offshore entities in Labuan IOFC, they exclude debt transactions and exposure of the offshore entities vis-à-vis the rest of the world.

As part of our continuous efforts to improve the compilation of external debt data for better risk assessment as well as in conformity with international best practices, Bank Negara Malaysia, with the assistance of the Labuan Offshore Financial Services Authority (LOFSA) has compiled the new external debt data of Malaysia, starting with position as at end-2004. This data includes borrowings by the offshore financial entities in Labuan IOFC from non-residents, while the borrowings by residents from these offshore financial entities are excluded. A comparison of the existing definition of external debt and the new definition is given in Diagram 1.

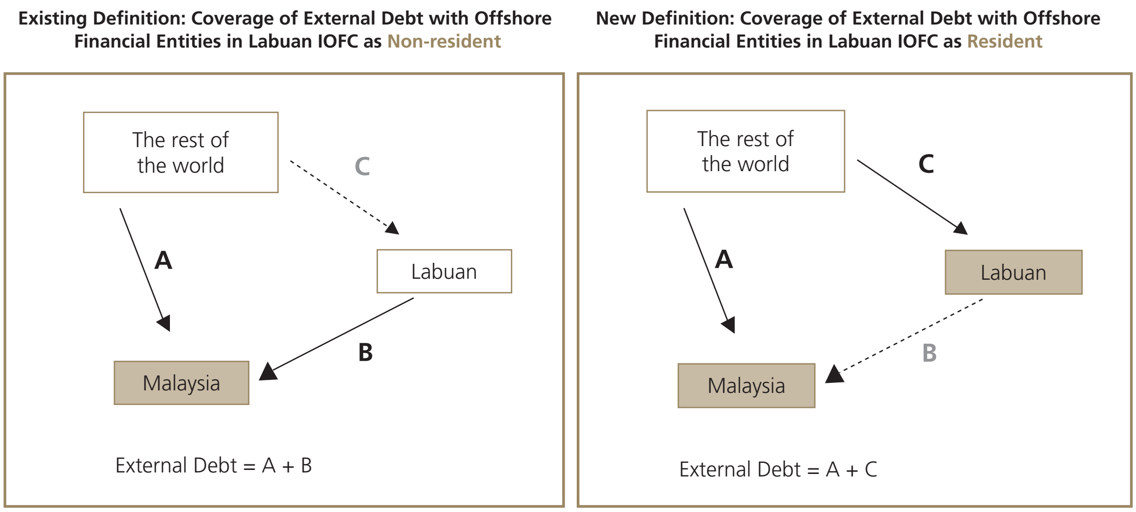
Implication on Malaysia's External Debt

(i) Comparison of newly defined external debt with existing definition for 2004 position

Table 1 provides a comparison of Malaysia's external debt levels with offshore financial entities in Labuan IOFC being treated as non-resident (existing definition) and as resident (new definition)

[1] A guide jointly prepared by the Bank for International Settlements (BIS), Commonwealth Secretariat, Eurostat, International Monetary Fund (IMF), Organisation for Economic Co-operation and Development (OECD), Paris Club Secretariat, United Nations Conference on Trade and Development (UNCTAD) and World Bank.

Diagram 1
Malaysia's External Debt Compilation



respectively. The shift from the existing definition in compilation of external debt to the new definition in accordance with BPM 5 has resulted in some changes in level and profile of external debt as follows:

- Under the new definition, Malaysia's **total external debt** as at end-2004 was higher at RM209.9 billion (USD55.2 billion) or equivalent to 49.4% of GNP compared with the existing level of RM200.6 billion (USD52.8 billion) or 47.2% of GNP.

- **The medium- and long-term external debt** was lower at RM146.4 billion under the new definition (RM156.8 billion under existing definition) due largely to lower external debt of the Federal Government following the reclassification of several market loans sourced from offshore financial entities in Labuan IOFC as part of domestic borrowings. Some of these loans were reflected instead in the medium- and long-term external debt of the banking sector. Consequently, the share of public debt to total external debt was lower at 41.1% compared with 48.3% under existing definition.

- Correspondingly, the share of the private sector debt (medium- and long-term plus short-term debt) to total external debt was larger at 58.9% compared with 51.7% under existing definition. Within this sector, the external debt of the non-bank private sector was lower at RM54.8 billion (RM67.7 billion under existing definition), following the reclassifications of the external loans from the offshore financial entities into domestic borrowings. Some of these loans were reflected in the external debt of the banking sector. As a result, the share of the external debt of the non-bank private sector to total debt declined to 26.1% from 33.7%.

- Meanwhile, the external debt of the banking sector was higher at RM68.7 billion (RM36 billion under existing definition) with its share to total external debt increasing to 32.8% from 18%, reflecting mainly short-term interbank borrowings by offshore financial entities in Labuan IOFC from financial institutions outside Malaysia arising from their investment and treasury operations. As a result, the total **short-term external debt** was higher at RM63.4 billion (RM43.7 billion under existing definition), accounting for a larger share of 30.2% of total external debt (21.8% under existing definition).

Table 1
Outstanding External Debt

	Offshore Financial Entities in Labuan IOFC as		
	Non-Resident	Resident[1]	
	2004	2004	2005
	(RM billion)		
Total external debt (ED)[2]	**200.6**	**209.9**	**220.0**
Medium- and long-term (MLTD)	156.8	146.4	150.6
Federal Government	*34.7*	*23.8*	*22.5*
NFPEs	*62.2*	*62.4*	*60.0*
Private Sector	*60.0*	*60.3*	*68.1*
Bank	*0.7*	*11.0*	*12.4*
Non-Bank	*59.3*	*49.2*	*55.6*
Short-term (STD)	43.7	63.4	69.4
Bank	*35.3*	*57.7*	*64.0*
Non-Bank	*8.4*	*5.7*	*5.4*
Memorandum items:			
Private sector debt (MLTD + STD)	103.7	123.5	136.9
Bank	*36.0*	*68.7*	*76.4*
Non-Bank	*67.7*	*54.8*	*60.5*
	(percent)		
ED/GNP	47.2	49.4	46.5
STD/ED	21.8	30.2	31.6
STD/Reserves	17.3	25.0	26.1
Public debt/ED	48.3	41.1	37.8
Private debt/ED	51.7	58.9	62.2
MLTD	*29.9*	*28.7*	*30.9*
STD	*21.8*	*30.2*	*31.3*
Non-Bank	33.7	26.1	27.5
MLTD	*29.5*	*23.5*	*25.3*
STD	*4.2*	*2.6*	*2.2*
Bank	18.0	32.8	34.7
MLTD	*0.3*	*5.2*	*5.7*
STD	*17.6*	*27.5*	*29.1*

[1] The treatment of offshore financial entities in Labuan IOFC as residents is applicable only to the compilation of the above external debt data by the Bank. Debt transactions and exposure by sector (public, banking and non-bank private sectors) with offshore financial entities in Labuan IOFC will continue to be treated as external debt for other publications until the end of the interim period in mid-2007

[2] Excludes currency and deposits held by non-residents with resident banking institutions

(ii) Developments in 2005 based on new definition

As at the end of 2005, Malaysia's **total external debt** increased by RM10.1 billion to RM220 billion (USD57.6 billion). Nevertheless, the newly defined external debt position accounted for 46.5% of GNP at the end of 2005 compared with 49.4% of GNP at the end of 2004.

The higher external debt level was due to an increase in **short-term debt** to RM69.4 billion (USD18.2 billion), reflecting mainly the higher inter-bank borrowings by offshore banks in Labuan IOFC arising from their investment and treasury operations. Accordingly, the ratio of short-term debt of the banking sector to total debt also increased to 29.1% as at end-2005 compared to 27.5% as at end-2004. Including the short-term debt of the non-bank private sector, the overall ratio of short-term debt to total external debt increased to 31.6%.

Meanwhile, the **medium- and long-term external debt** increased marginally to RM150.6 billion (USD39.4 billion) as at end-2005, reflecting net repayment of loans by the public sector, comprising the Federal Government and NFPEs, being offset by net borrowing by the private sector. Consequently, the share of the public sector debt to total external debt declined to 37.8% while the share of the private sector debt increased to 62.2%.

Risk Assessment of External Debt

Despite a higher total outstanding external debt, Malaysia's external debt position continues to be within the prudent level of 46.5% of GNP in 2005. The higher short-term debt was attributed entirely to borrowings by offshore financial entities in Labuan IOFC, particularly from their head offices and branches abroad, arising from their investment and treasury operations. A large share of these borrowings was on lent to residents in Malaysia. Including the short-term debt of the non-bank private sector, the overall ratio of short-term debt to international reserves and the share of short-term debt to total debt at the end of 2005 remained low at 26.1% and 31.6% respectively.

The increase in medium- and long-term external debt was moderate and reflects the increase in the private sector external debt. The bulk of these loans have a natural hedge as they were used to finance export-oriented activities and overseas investment with foreign exchange earnings and income. Furthermore, a large share of these loans was sourced from the offshore shareholders and parent or associate companies with more flexible terms and at concessionary interest rates.

Conclusion

The compilation of Malaysia's external debt under the new definition, with offshore financial entities in Labuan IOFC being treated as residents, has facilitated a more accurate assessment of the external exposure, including credit, foreign exchange and liquidity risks faced by the Malaysian economy, especially in the light of the increasing trend of residents and non-residents establishing offshore entities in Labuan IOFC to facilitate their financing and investment activities. In addition, the shift towards the new definition underscores Malaysia's commitment to international standard and best practices in external debt compilation and dissemination to facilitate international comparison and assessment.

International Reserves

The **international reserves** held by Bank Negara Malaysia comprises holdings of foreign exchange and gold, the IMF reserve position and holdings of Special Drawing Rights (SDR). For the year 2005 as a whole, net international reserves increased by RM12.8 billion to RM266.3 billion (USD70.5 billion) as at 31 December 2005. The net increase in the reserves in 2005 reflected the fundamentals of the economy with foreign exchange inflows generated mainly from export earnings and foreign direct investment. The reserves level amounted to RM272.7 billion or equivalent to USD72.2 billion as at 28 February 2006. The reserves position is adequate to finance 7.6 months of retained imports and cover 6.7 times the short-term external debt.

In the first half of 2005, the sustained repatriation of export proceeds and foreign direct investment was reinforced by significant inflows of portfolio investment. The large inflows of short-term funds during the period were partly in anticipation of a change in the exchange rate regime. Following the Bank's announcement of the change in the exchange rate regime to a managed float on 21 July 2005, reserves increased further, driven by significant inflows of short-term funds. The flows normalised subsequently amidst an orderly price discovery process. The decline in reserves, from September to November, reflected mainly the unwinding of the speculative short-term positions. Nevertheless, the outflows of short-term funds subsided by December. The outflows during this period also reflected higher import payments associated with stronger domestic demand, larger repayment of external loans by the official sector as well as higher year-end repatriation of profits and dividends by foreign corporations.

During the year, the cumulative foreign exchange revaluation loss amounted to RM15.5 billion (2004: +RM8 billion), following the strengthening of ringgit against the major currencies.