



Malaysia

The Malaysian economy continued to grow rapidly in 1995. The effectiveness of the macroeconomic management of the economy is reflected in the high growth rate, with price stability, achieved since the economic boom began in 1988. The medium-term outlook for the economy remains positive; strong domestic demand and continued outstanding export performance should sustain the rate of growth. The high rate of economic growth and existing low level of unemployment will exert upward pressure on the price level; however, tight monetary policy and reductions in import duties should help contain inflation. The current account deficit, while increasing in absolute terms, is likely to decline as a proportion of GDP over the next two years, and it can be financed easily with continued strong inflows of FDI.

Recent Trends and Prospects

Growth, Investment, and Employment. In 1995, GDP grew by 9.3 percent. As in the past, the manufacturing sector and export expansion continued to be the driving forces, aided in 1995 by a turnaround in agriculture and mining.

Growth in the agriculture sector recovered to over 4 percent in 1995. The high commodity prices prevailing in 1994 and 1995 induced a large increase in the production of palm oil and rubber, the two commodities which together account for over 70 percent of the cropped area in Malaysia. The increase in palm oil production was also aided by recovery from tree stress which affected output in 1994, and the coming into maturity of additional areas. However, owing to continuing

labor shortages in agriculture, growth in production of most other crops, livestock, and fishing slowed further. Also, sawlog output continued to decline in line with the Government's policy of promoting sustainable forest resource management. The increase in production in Sarawak and Sabah was more than offset by the reduction in output in Peninsular Malaysia.

Industrial production increased by over 13 percent in 1995. Output in the mining sector, where oil and gas production account for about 80 percent of the total, expanded sharply. The production of crude oil increased by 5.2 percent, largely because of the coming-on-stream of a new oil field off Sarawak in early 1995; and gas output increased by 24 percent in response to continued strong growth in demand and expansion in the natural gas processing and distribution system. However, tin-in-concentrate production declined for the sixth consecutive year and is now less than 20 percent of what it was in 1989.

Manufacturing growth was still high at 13 percent in 1995. Production in the electrical and electronics sector, which is by far the largest industry in Malaysia, grew by 24 percent, driven largely by strong external demand. Other important industries with improved growth performance in 1995 were transport equipment, iron and steel, fabricated metal products, and petroleum products. The higher growth in these industries reflected increased capacity and strong domestic demand, particularly for passenger cars and construction materials. However, the performance of the textile and apparel industry was disappointing. Growth in the production

Table 2.10 Major Economic Indicators: Malaysia

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	8.3	9.2	9.3	8.5	8.0
Agriculture	% change	4.3	-1.0	4.1	2.8	2.6
Industry	% change	10.1	12.4	13.1	11.5	10.8
Services	% change	8.1	9.9	7.0	6.9	6.3
Gross Domestic Investment	% of GDP	35.1	38.7	40.6	41.0	41.5
Gross Domestic Saving	% of GDP	35.4	37.6	37.2	37.5	38.0
Inflation Rate	% change in CPI	3.6	3.7	3.4	3.7	4.0
Money Supply Growth	% change	22.1	14.7	22.8	16.0	17.0
Merchandise Exports	\$ billion	46.2	56.9	72.1	85.4	99.5
	% change	16.1	23.1	26.6	18.5	16.5
Merchandise Imports	\$ billion	43.2	55.3	72.3	85.3	99.0
	% change	17.8	28.1	30.6	18.0	16.0
Current Account Balance	\$ billion	-2.8	-4.1	-7.6	-7.7	-7.5
	% of GDP	-4.5	-5.9	-8.9	-8.0	-7.0
External Debt Outstanding	\$ billion	23.3	24.8	27.0	29.0	31.0
Debt-Service Ratio	% of exports	7.8	7.7	6.0	6.0	6.0

Sources: Government of Malaysia, Ministry of Finance, *Economic Report 1995/1996* (Kuala Lumpur, 1995); International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

of textiles moderated in 1995, while output of the apparel industry declined in the face of increasing competition from labor-abundant countries.

Growth in the construction sector accelerated to 15.2 percent in 1995. Rapid urbanization and rising disposable incomes continued to generate a growing demand for housing, as well as for retail space. At the same time, high rates of investment in the manufacturing sector generated demand for factory premises and industrial buildings, while rapid growth in tourism promoted the construction of new hotels, theme parks, and other tourism-related facilities. Growth in the construction sector was also boosted by the large number of major infrastructure projects being implemented.

The services sector expanded by 7 percent in 1995, substantially below the 1994 growth rate of about 10 percent. The slowdown was largely the result of a fall in the growth rate of government services, which is an indicator of the success of the official policy of downsizing the public sector. The financial services and transport and communications sectors maintained double-digit growth rates.

While Malaysia is considered to be a model of export-oriented growth, in an accounting sense, its recent growth has been driven primarily by domestic demand, as the net contribution of the external sector to aggregate demand has been negative in seven of the past eight years. The reason for the seeming contradiction between the popular perception about Malaysia's recent economic growth, on the one hand, and that shown by analysis of components of demand, on the other, is that a large proportion of the investment component in domestic demand is FDI financed by foreign investors themselves. This investment increases imports of machinery and equipment and thus adds to the current account deficit; however, at the same time, it provides the financing both for their imports and for the deficit. This factor must be kept in mind in any analysis of aggregate demand, the savings-investment gap, and the balance-of-payments deficit of Malaysia.

In 1995, growth in domestic demand of about 15 percent again substantially exceeded growth in GDP. Rising levels of per capita income, cuts in personal income taxes, and

easy availability of consumer credit stimulated private consumption, the growth rate of which almost doubled to 13.7 percent in 1995. Both public and private investment continued to expand rapidly, buoyed by increases in infrastructure spending, housing starts, and FDI.

The expansion in fixed capital formation resulted in an increase in the investment rate to 40.6 percent of GDP, the highest level ever achieved by Malaysia. However, the gross domestic savings rate declined slightly to 37.2 percent of GDP because of a sharp fall in public sector saving resulting from stagnation in federal government revenues. Consequently, the savings-investment gap widened further and was met through increased FDI inflows and external borrowing by some public enterprises.

Rapid economic growth continued to generate new jobs in significant numbers and the unemployment rate declined further to 2.8 percent of the labor force in 1995. Most of the new jobs were in construction, manufacturing, and the trade, hotels, and restaurants sectors. The employment share of agriculture and government services declined further to about 19 percent and 11 percent of total employment, respectively. Labor shortages are now widespread in both skilled and unskilled occupations; this is reflected in the high incidence of worker turnover in all sectors of the economy. To alleviate the shortage of skilled labor, the coverage of the Human Resource Development Fund was extended to more employers and industries in the services sector. In addition, existing private technical training institutions were given tax incentives to upgrade their facilities, and legislation aimed at promoting technical and higher education was enacted.

The growth rate of the Malaysian economy is expected to slow down to 8.5 percent in 1996 and to 8 percent in 1997. Agriculture sector growth is likely to be lower because of perennial labor shortages and a decline in commodity prices from the unusually high levels reached in 1995. Sawlog production will be reduced further in line with government policy. Growth of industrial output will continue to be strong although somewhat slower than in 1995, as recent measures to tighten consumer credit begin to affect sales of consumer durables. Expansion in the services sector is also expected to moderate.

Strong domestic demand – both consumption and investment – and sustained exports

will provide the impetus for growth. The ongoing massive infrastructure investment program is likely to boost the gross domestic investment rate further to 41 percent of GDP in 1996. Some recovery in public saving should raise the overall savings rate to 37.5 percent of GDP, and thus maintain the savings-investment gap at about the same level as in 1995. As a consequence of strong growth, pressure in the labor market is unlikely to ease and, with the unemployment rate declining to 2.7 percent by 1997, labor shortages will continue to be felt in most sectors.

Budget, Money, and Prices. There was some loosening of fiscal policy in 1995. The Federal Government's operating and development expenditures rose by 9 percent and 15 percent, respectively. Government revenue, however, increased by only 2 percent because of cuts in income and corporate taxes and excise and import duties. As a result, the budget surplus declined to 0.3 percent of GDP from 2.4 percent in 1994. The fiscal impact of the overall public sector (i.e., including public enterprises) was, however, expansionary in 1995. This was largely because of a 32 percent increase in capital expenditure by public enterprises, primarily in the telecommunications, power, and oil and gas sectors. As a result, while total public revenue remained virtually constant, operating expenditure increased by 10 percent and development expenditure by 28 percent. Thus, an overall public sector surplus of 1.8 percent of GDP in 1994 was followed by a deficit of 3.5 percent in 1995.

The Central Bank followed a policy of monetary restraint in 1995. Bank Negara used open market operations, including direct money market borrowing and the issue of Bank Negara Bills complemented by generally higher interest rates, to reduce excess liquidity. At the end of 1995, interbank and deposit rates in Malaysia were about 150 basis points higher than a year earlier, while the base lending rate (BLR) was about 100 basis points higher. In November 1995, Bank Negara introduced a new framework for calculating the BLR by commercial banks to make the lending rates more responsive to the Central Bank's interventions in the money market. Despite the tight monetary policy, growth of narrow money (M1) was virtually unchanged, while that of the broader monetary aggregates increased sharply. In 1995, M2 and M3

both grew by over 20 percent. This was almost entirely because of the 23 percent expansion in credit to the private sector, as private investment and expenditure on consumer durables accelerated.

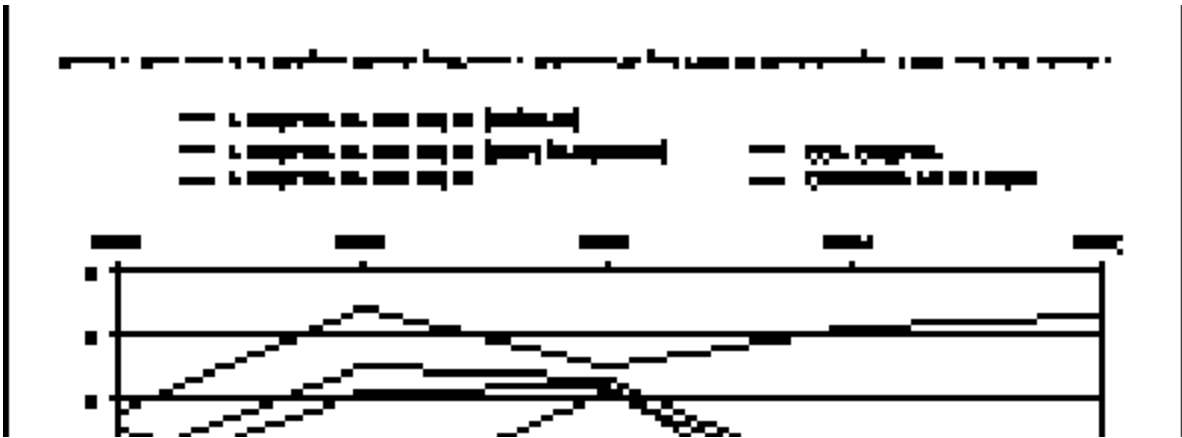
Malaysia continued to enjoy relative price stability in 1995 despite the expansionary public sector position, high GDP growth rate, and tight labor market. Inflation (as measured by the consumer price index) at 3.4 percent was down slightly from the 3.7 percent recorded in 1994. Important factors contributing to the price stability were the Government's monetary restraint and import liberalization policies. In recent years, Malaysia has followed a policy of reducing inflationary pressure by cutting tariffs and thereby reducing import prices. The success of this policy can be seen from the fact that, while the producer price index (PPI) for local production increased by 9 percent in 1995, the PPI for imports declined by 1 percent (Figure 2.12). The Figure also indicates that there may be some basis for the widely held view that the CPI is not a good measure of inflation in Malaysia, as a substantial proportion of the items included in it are at government-controlled prices. From the Figure it can be seen that, while other price indexes show considerable fluctuations in inflation from year to year, the CPI is virtually a straight line with a slight downward slope. Moreover, the other price indexes show increasing inflationary pressure in the economy since 1993, kept only partially in check by declining domestic prices of imported goods. This is what would be expected in a period of high GDP growth with full employment, acceleration in the growth of money supply, and an expansionary public sector position.

The 1996 federal budget proposes an increase of 7.6 percent (two thirds of it because of salary revision) in operating expenditure and an 8.7 percent increase in development expenditure. A buoyant economy should ensure a healthy increase in revenues, which were projected to grow by 8 percent. However, actual revenue growth is likely to be smaller than this because of a reduction in personal income tax rates, tariffs, and excise duties proposed in the budget, and only a small surplus is expected in 1996. The Government announced a number of specifically targeted fiscal and other measures in the budget. To promote saving, the contribution by employees to the Employees Provident Fund (EPF)

and the maximum deduction allowed (for income tax purposes) for contributions by employers to EPF and other approved savings schemes were increased. Both the minimum monthly payment on credit cards and the road tax for luxury cars were increased as a means of curbing consumption. Import duties and/or sales tax on more than 1,500 items - including 800 items of raw materials, intermediate goods, and equipment - were abolished or reduced, the aim being to reduce business costs, increase competition, and curb inflationary pressure. To control the growing deficit on the services account of the balance of payments, the coverage of fiscal incentives was expanded to include investment in service industries such as communications, public utilities, and transportation.

It is expected that the Central Bank will continue with its tight monetary policy for the foreseeable future. Bank Negara made its intentions clear in this regard by raising the financial institution's statutory reserve requirements by 1 percentage point to 12.5 percent in early 1996. However, Bank Negara will have to be careful not to repeat the mistakes of 1993, when tight monetary policies and the accompanying higher interest rates resulted in massive short-term capital inflows. These in turn led to problems of monetary control and accumulation of huge losses by the Central Bank on its sterilization operations and in the management of excess foreign exchange reserves. This is a real danger because in 1996, as in 1993, Malaysian interest rates are rising, while international interest rates are declining. The strong domestic demand and the high rate of growth with full employment will ensure continuing inflationary pressure. However, budgetary restraint, tight monetary policy, and import duty reductions should help contain the rate of inflation, which (as measured by the CPI) is expected to increase only slightly over the next two years.

External Trade and Payments. Capacity expansion in the manufacturing sector and higher prices of Malaysia's major agriculture exports resulted in further improvement on the strong export performance of 1994. In value terms, exports grew by about 27 percent in 1995, with manufactured exports increasing by 28 percent. Agriculture and mineral export earnings also recovered because of higher export unit values as well as increased volumes



of palm oil, natural rubber, crude oil, and liquefied natural gas.

The growth in manufactured exports was led by electrical and electronic products, which accounted for about 65 percent of Malaysia's manufactured exports. All sub-sectors had strong growth, with exports of electronic components (semiconductors) increasing by 31 percent, consumer electronics (audio and video recorders, radios, and televisions) by 36 percent, and cables and wires by 35 percent. The second largest foreign exchange earner was the chemicals industry, exports of which increased by over 50 percent in 1995 as new capacity continued to come on stream. However, the export performance of the textiles, apparel, and footwear industries continued to be mixed, with new capacity resulting in an increase of over 35 percent in exports of textile yarns and fabrics, while exports of apparel and footwear either stagnated or declined. Because of rising wages, Malaysia is rapidly losing its competitiveness in labor-intensive industries such as garments and footwear.

Import liberalization and strong domestic demand resulted in acceleration of import growth to 31 percent in 1995. With imports

expanding faster than exports, the merchandise trade account moved into a deficit for the first time since 1982. On the services account, large deficits have been incurred on a regular basis, mainly because of substantial outflows of FDI earnings and freight and insurance payments. In 1995, gross outflows in these two categories were \$6 billion and \$4.5 billion, respectively; the services account deficit increased significantly in value terms, although as a proportion of GDP it remained at about 8.5 percent. However, deterioration in the trade account resulted in a widening of the current account deficit to 8.9 percent of GDP in 1995 from 5.9 percent in 1994.

A significant proportion of the profits and dividends shown as outflows on the services account are actually reinvested in Malaysia and thus appear as investment on the capital account. Net corporate investment increased to \$5.9 billion in 1995 which, together with a net inflow of \$1.5 billion of official long-term capital (mainly borrowing by public enterprises), was sufficient to cover the deficit on the current account. Thus, the basic balance, as in the past, remained in surplus; foreign exchange reserves at \$27 billion exceeded external debt, and the debt-service

ratio, at about 6 percent of export earnings, continued to be very manageable.

Exports of electrical and electronic products, Malaysia's largest export earner, should continue to grow strongly, given buoyant world demand; and this should help sustain growth in manufactured exports at recent high levels. However, possible softening of prices of major agricultural commodities, such as rubber, palm oil, and sawlogs, as well as prices of crude oil and natural gas, could result in a deceleration in the rate of growth of merchandise exports. In line with the slower output growth in the manufacturing sector and because of a sharp decline in imports of large items such as commercial aircraft by Malaysian Airlines and ships by the Malaysian Shipping Corporation, total merchandise imports are also expected to increase at a slower rate. Moreover, the growth in exports should exceed that for imports, resulting in the reemergence of a small trade surplus. The deficit on the services account is likely to increase only marginally and, therefore, the deficit on the current account of the balance of payments as a proportion of GDP is expected to decline somewhat. The deficit will be financed primarily by FDI. External borrowing by public enterprises is expected to be less than in 1995. Malaysia will maintain its current comfortable international reserves position, although large short-term capital inflows, because of favorable interest rate differentials, could boost these considerably.

Policy and Development Issues

During the past eight years, the Malaysian economy has outperformed many other economies in Asia. Growth has been outward oriented with Malaysia having one of the most open trade regimes in the region. The Government has also pursued an ambitious privatization program and Malaysia has probably gone further than any other country in Asia toward the private provision of infrastructure services. Downsizing of the government sector and a prudent fiscal policy have resulted in federal budget surpluses for the last three years. Political and macroeconomic stability, good infrastructure, and private sector-oriented government policies have attracted large amounts of FDI and short-term capital, resulting in accumulation of substantial international reserves.

While the economy is being managed effectively and doing extremely well, shortages of skilled and technical human resources could adversely affect Malaysia's export-oriented growth over the medium term. Malaysia has been successful in delivering general education at the primary and the secondary level. However, the country's tertiary school enrollment rates lag behind those of its neighbors. Also, while the rate of labor force participation by women has increased, it is still significantly below the participation rate for men. With Malaysia having achieved virtual full employment, it is likely that opportunities for the participation of women in the labor force will increase. The extent to which women are able to take advantage of these opportunities, however, will depend on how well their education and skill levels match the emerging employment opportunities. Thus, the expansion of the tertiary education system in Malaysia, particularly for women in technical and scientific education, is necessary. The Government is well aware of this, and legislation has been enacted to encourage the private sector to enter the field of tertiary education to upgrade Malaysia's human resources. Expanding the domestic supply of high-level skills will also help to deal with the problem of the growing deficit on the services account of the balance of payments.

An emerging economic issue in Malaysia is growing regional imbalance. Malaysia has made rapid progress in reducing poverty over the last two decades, with the incidence of poverty declining from about 60 percent in 1970 to about 9 percent in 1995. This is an impressive record by any standard, and more so because the official poverty line in Malaysia is liberal by international comparison. However, poverty reduction has been uneven geographically; most of the country's industrial development has been concentrated in the western corridor from Penang in the north to Johor in the south. The Government is encouraging development of the lagging regions of the country by providing fiscal incentives, improving road links along the east coast of the Peninsula, and promoting subregional cooperation arrangements, such as the Indonesia-Malaysia-Thailand growth triangle in the north and the Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA) for Sabah and Sarawak in East Malaysia.