

Malaysia

Summary

Growth has slowed from a robust 7.1% seen in 2004 and is now expected to be 5.1% for 2005. This downward revision from the 5.7% projected in *ADO 2005* stems from extended weakness in the global semiconductor industry, softer external trade, and slack construction activity. Higher oil prices, too, may be negatively affecting the non-oil sector of the economy. Growth is forecast to pick up slightly in 2006, lifted by an expected upturn in the electronics cycle and new spending allocations under the Ninth Malaysia Plan (2006–2010).

Inflation rose to a 6-year high of 3.2% in June as the Government reduced fuel subsidies and raised some nonfuel charges. For all of 2005, inflation is forecast at 3.3%, revised up by nearly 1 percentage point from the *ADO 2005* estimate, but is expected to ease thereafter. The trade surplus has soared, mainly the result of a sharp slowdown in imports of intermediate goods. The ratio of the current account surplus to GDP is revised up for this year and next. The decision in July to adopt a managed float of the ringgit against a basket of foreign currencies had induced a slight appreciation of the currency against the US dollar by late-August.

As a net oil exporter, the country benefits directly from higher global oil prices, but the budget still bears the weight of fuel subsidies, while the non-oil sector is hurt by the negative impact of higher oil prices on costs, domestic demand, and exports.

Updated assessment

Growth decelerated to 4.1% in the second quarter of 2005, the slowest in 3 years, from 5.8% in the

first. In the first half, the economy expanded by 4.9% year on year. Growth in private consumption in that period was robust at 8.7%, slightly lower than the year-earlier rate, while investment grew by 4.5%, 1 percentage point faster than in the same period of the previous year. But public consumption contracted as the Government reined in expenditure. Net exports grew rapidly, in contrast with the year-earlier period (Figure 2.5).

The services sector led the expansion on the supply side, growing by 5.8% in the first half, year on year. Agriculture and manufacturing both rose by about 4.5%, while mining output barely changed and construction, which bore the brunt of cuts in public spending, continued to contract. Growth is expected to pick up a bit in the second half as a result of the investment rebound and a forecast increase in exports, putting full-year growth at 5.1%.

Consumer price inflation rose to a 6-year high of 3.2% in June, from an average of 1.4% in 2004. Aside from price rises for some food items, much of the increase was a consequence of fiscal revenue initiatives: reductions in fuel subsidies, the imposition of higher duties on cigarettes and liquor, and an increase in road toll charges. Factors helping constrain inflation included the moderating growth, intense competition in the retail sector, and excess capacity. Inflation is expected to average about 3.3% in 2005, revised up from an *ADO 2005* estimate of 2.4%.

Export growth slowed to 12% over the first 6 months of 2005 from 20% in the year-earlier period as a result of the slowdown in global demand, especially for electronic goods. Import growth decelerated even more abruptly over the same period, to 9% from 28% in the previous year. The main drag on imports was weaker

Table 2.5 Selected economic indicators, Malaysia, 2005–2006, %

| Item | 2005 | | 2006 | |
|---------------------|----------|--------|----------|--------|
| | ADO 2005 | Update | ADO 2005 | Update |
| GDP growth | 5.7 | 5.1 | 5.3 | 5.3 |
| Inflation (CPI) | 2.4 | 3.3 | 2.5 | 2.5 |
| Current account/GDP | 10.2 | 12.7 | 8.3 | 11.1 |

Source: Staff estimates.

growth in imports of intermediate goods, which account for 71% of total imports. This decelerating demand for imports of intermediate goods, plus weak growth in manufacturing, suggest that demand for exports was met by a drawdown on inventories. The trade surplus rose by 28.3% to RM47.9 billion at end-June and is expected to climb to RM88.6 billion by the end of the year, compared with the estimate of RM75.0 billion in *ADO 2005*. Buttressed by the higher trade surplus, the ratio of the current account surplus to GDP for 2005 is now expected to be 12.7%, up from 10.2% forecast in *ADO 2005*.

Inflows of net portfolio investment remained substantial in the first 6 months of 2005. To some degree, these inflows may have been encouraged by an expected revaluation of the ringgit. Both current and capital account surpluses will sustain a large balance-of-payments surplus this year.

On 21 July, Malaysia shifted its policy of pegging the ringgit to the US dollar to a managed float against a basket of currencies. The change should promote a more efficient allocation of resources. To the extent that the ringgit appreciates, pressures on underlying credit expansion and on inflation should abate somewhat, and the authorities will have greater latitude over monetary policy. By late-August, the ringgit had appreciated by 0.8% against the US dollar.

In fiscal developments, the Government missed expenditure targets in early 2005, recording a first-quarter fiscal surplus before returning to a deficit, equivalent to 2.3% of GDP, in the second quarter. Faster disbursements for the rest of 2005 are expected to compensate for the shortfall in the first half, and a deficit of RM17.7 billion (3.8% of GDP) is expected. Also, RM2.4 billion of projects under the Ninth Malaysia Plan have been brought forward to 2005.

Malaysia, as a net oil exporter, gains directly from higher global oil prices (net oil export revenues jumped by RM1.1 billion to RM7.4 billion in the first half of 2005). However, as a major exporter of manufactured products and commodities, the country is also vulnerable to secondary effects from softer global economic growth induced by higher oil prices.

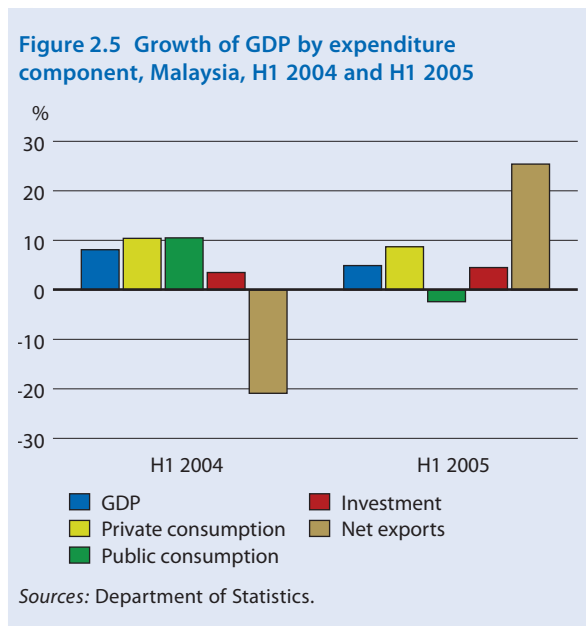
Direct fuel subsidies, though reduced, still drain budgetary resources, and are expected to cost the Government RM6.6 billion this year, up from RM4.8 billion in 2004. Tax exemptions on gasoline and diesel will cost the Government an additional RM7.9 billion in forgone revenues. Malaysians now pay RM1.62, or 43 US cents, for a liter of premium gasoline, whereas they would pay RM2.45 or 51% more, if the subsidy was ended and the tax reimposed. Similarly, diesel is sold at RM1.28 a liter, compared with RM2.07 or 62% more.

Despite continuing low interest rates, the stock market gained just 0.9% in the first 8 months of the year and prices of new residential property posted only modest gains in this period. The banking system's nonperforming loans continued to decline.

So far, slowing economic growth has not added to unemployment. The total jobless rate stayed near 3.5% in the first quarter, but graduate unemployment remains a problem. To address the issue, the Government reintroduced programs that teach work-related skills and that help match potential employees to jobs through an electronic labor exchange. Conversely, some industries faced serious labor shortages when an estimated 450,000 undocumented foreign workers left the country under an amnesty in early 2005. Malaysia has tapped new labor sources, especially Pakistan, to fill the gap.

Prospects

Supported by a likely upturn in the global electronics cycle, growth in the economy in 2006 is expected to be a touch stronger than in 2005 at 5.3%. New budgetary allocations under the Ninth Malaysia Plan should breathe life into construction after 2 weak years. Inflation is forecast to ease to 2.5% in 2006, kept in check by government price controls on selected essential goods and an expected tightening of liquidity.



Trade surpluses are set to remain high, but not as large as in 2005. The current account is expected to register a slightly smaller surplus of 11.1% of GDP in 2006, revised up from 8.3% in *ADO 2005*. This will likely lead to a further buildup in foreign reserves, albeit at a slower pace. The central bank has signaled that ringgit appreciation will be gradual, so as to avoid disrupting trade and capital flows.

In 2006, public investment is likely to expand as more projects under the Ninth Malaysia Plan get under way. The Government aims to balance the budget in the medium term, without cutting spending so much that it derails economic growth.

Policies will also focus on improving the business and investment climate by reforming government-linked companies and by cracking down further on corruption. Government-linked companies play a major role in the economy and account for a large proportion of stock market

capitalization. Targets and deadlines have been set for reforming the companies, and these should be met in four phases over 10 years. Policies to be implemented over the next 18 months aim primarily at improving company management and transparency. In the intensified fight against corruption, heavy sentences have been imposed on those found guilty. The Government has taken steps to reduce the opportunities for corruption by improving systems and procedures within the public administration.

Private investment is forecast to pick up in the next 2 years, underpinned by the expected recoveries in electronics and construction, new oil-field development, and a push by the Government to promote services.

Two potential issues for the financial sector are high household debt levels and excess supply in the residential property market. On the first concern, household debt has risen to about 59% of GDP, and although the possibility of a Korean-style consumer credit dislocation is currently small, such borrowing levels could cause difficulties if interest rates rise.

On the second, a glut of residential property has developed in most states. For example, in the Klang Valley near Kuala Lumpur, an estimated 79,500 housing units are expected to be built over the next 2 years, adding significantly to the area's existing stock of 391,000. Take-up rates of new housing have weakened, but the supply pipeline is still flowing as projects are completed. Banks have been taking on some additional risk, competing for market share by offering low initial interest rates and up to 100% financing and, while the banks in general are adequately capitalized and nonperforming loans have declined overall, the nonperforming ratio for residential property stood at 9% in June. The default rate on housing would rise if economic conditions turned out less favorable than forecast.