

Malaysia

Economic Assessment

At 7.8% in the first half of 2004, the economy expanded faster than forecast in *ADO 2004*. Private consumption rose by 9.9% from a year earlier to contribute 4.7 percentage points to growth, though government consumption added only 1.0 percentage point, the lowest figure since 2000. After years of anemic performance, investment surged as businesses expanded capacity to meet strengthening domestic and foreign demand for their products. Total investment rose by 16.8% from 2003, and gross fixed capital formation increased by 3.5%, as against a 2.0% rise in the first half of 2003. Private investment drove this trend, as, according to preliminary data, government development spending in the first half fell by 28.2% from a year earlier. Imports of capital goods surged by 27.6% in the second quarter, underpinning a concurrent rapid 18.2% expansion in investment, which contributed 4.5 percentage points to GDP growth.

Exports rose by 19.8% in the first half of the year, with the improvement spread evenly across major manufacturing, agricultural, and commodity exports. Exports to the PRC continued to soar, by 32.4% to \$4.0 billion, while those to the US climbed by 13.8% to \$11.1 billion. Imports surged by 27.9%, reducing the trade surplus to \$9.9 billion, for a drop of 9.4%. Net exports fell by 19.6%, taking 2.4 percentage points off GDP growth.

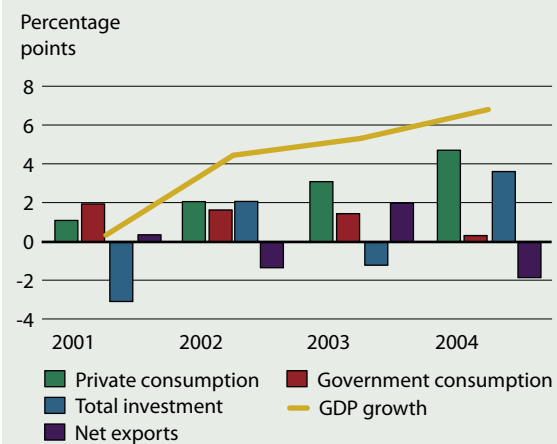
While 2003's 5.2% GDP expansion was primarily due to strong external demand, along with continued pump priming by the Government, this year a healthier and more sustainable balance between external and domestic—primarily private—demand is taking root. This marks a significant structural shift in the growth dynamics of the economy (Figure 2.8).

Growth was bolstered by continued strength in manufacturing output (up 16.2%) and in services (up 7.4%). Tourism rebounded strongly from the 2003 SARS-related slump, with total arrivals in the first half 71.4% higher than in the year-earlier period, and markedly higher than in 2002 and 2001. Agriculture put on a moderate 3.2%, as the improvement in palm oil production slowed.

A rising stock of official external debt, which reached 48.2% of GDP at end-2003, has made fiscal balance one of the Government's priorities. This year's strong economic performance is providing an additional fiscal cushion, as revenues are expected to rise by 4.7%. This will allow for a reduction in the deficit, even though the Government announced in June an RM10 billion boost to development expenditures, targeting small projects. The 2004 fiscal deficit is expected to narrow to 4.5% of GDP from 5.3% in 2003.

Inflation in the first half was subdued, with the CPI up 1.1% in the year to 30 June. The Government continues to subsidize energy prices, insulating consumers from the main impact of

Figure 2.8 Contribution to GDP Growth by Expenditure Account, Malaysia, 2001–2004



Sources: Department of Statistics; staff estimates.

Table 2.8 Selected Economic Indicators, Malaysia, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	5.8	6.8	5.6	6.0
Inflation (CPI)	1.5	1.5	1.7	2.2
Current account/GDP	7.9	7.8	6.5	7.0

Source: Staff estimates.

increases in world oil prices. Higher US interest rates have not led Bank Negara Malaysia (BNM) to change its accommodative stance, despite the ringgit peg to the US dollar. Most analysts consider the local currency to be either undervalued or fairly valued against the US dollar, suggesting limited exchange rate risk in holding ringgit assets. The peg of the PRC yuan against the US dollar has created a de facto ringgit-yuan peg as well, a source of stability in Malaysia's booming trade with that country.

A relatively slow rate of growth in bank lending, of only 6.0% in the year to 30 June, and a reduction in new government borrowing will help maintain current interest rate settings. BNM seems to be under little pressure to remove or adjust the currency peg at this time, and is focusing on strengthening the banking industry to establish conditions for further financial liberalization, including the exchange rate regime, in the future.

Policy Developments

Nearly 1 year after the leadership succession, a clearer picture of the new Government's economic policies is emerging. It has indicated that it intends to review and overhaul some elements of the economic system, so as to reinvigorate the nation's drive to achieve developed country status. The economy starts from a strong position. The 2004 IMD *World Competitiveness Yearbook* shows that Malaysia is now ranked 16th out of the 60 countries surveyed on competitiveness. Within Asia, Malaysia comes behind only Singapore; Hong Kong, China; and Taipei, China and well ahead of Japan, Thailand, and Korea. In the past 3 years, Malaysia has risen from 28 to 16 in these rankings.

However, several policies that were closely identified with the previous administration require reexamination if competitiveness is to be improved further. Three key examples of such policies are: (i) the dominant role of opaquely managed state enterprises in major sectors of the economy; (ii) policies that exclude non-*bumiputra* Malaysians as well as foreigners from key economic positions; and (iii) government reliance on tight controls over interest rates, exchange rates, and capital flows to maintain financial sector stability. Even though any challenge to the interest groups that have coalesced around those policies will be difficult, the early months of 2004 have seen encouraging developments in all three of those areas.

Government-linked companies (GLCs) dominate several sectors of the economy and account for 34% of the market capitalization of the Bursa Malaysia, formerly the Kuala Lumpur Stock Exchange. This has led to politicization and inefficiency in policy making and management, and has virtually frozen out private investment from some infrastructure and related sectors. Recent steps toward reform of these companies by the Government, while gradualist, are encouraging. In May, key performance indicators and performance-based management compensation for GLCs were announced, to be implemented first in Tenaga Nasional Berhad, the national power utility, and Telekom Malaysia, and then rolled out to others by year-end. Chief executives of these and five other GLCs have been replaced. A Corporate Governance Committee has been established, headed by the chairman of the Securities Commission and reporting to the prime minister, and is tasked explicitly with monitoring the enforcement of corporate governance laws in all enterprises.

Similarly, the Government has moved to strengthen and reorient Khazanah Nasional Berhad, its investment holding company. More than 30 GLCs that had previously been supervised directly by the Ministry of Finance were shifted to Khazanah's oversight. A new chief executive with a private sector background was appointed, with a mandate to accelerate the transformation of GLCs into world-class competitors. The new chief executive said Khazanah is looking into making its first-ever investments abroad.

The Government has reiterated its intention to gradually relax policies that are designed to maintain *bumiputra* ownership of assets and control over strategic sectors, and has taken some action. Most notably, non-*bumiputras* are now allowed, for the first time, to serve as chief executives of GLCs. This is an important step to creating a more dynamic corporate culture in the state sector, by emphasizing ability and performance over other criteria for promotion.

The financial sector continued to make efficiency improvements, in keeping with the 10-year Financial Sector Master Plan launched in 2001. The Kuala Lumpur Stock Exchange was demutualized, effective 1 January, and renamed Bursa Malaysia. It has announced plans to establish a cross-trading arrangement with the Singapore Stock Exchange by end-2005. BNM introduced a new interest rate framework in April, establishing its overnight policy rate as the benchmark. BNM also eliminated its base lending rate formula for commercial banks, allowing each bank to determine its own rate, in another small but significant move toward banking liberalization.

However, the small size of the banking industry and the underdeveloped local bond market reflect the limited nature of liberalization to date, particularly in interest rates, which continue to be heavily controlled. Major steps are still to be taken to create a competitive financial sector, including further opening to foreign institutions and relaxation of remaining controls over interest rates and capital flows, in tandem with continued strengthening of the regulatory system.

Outlook for 2004–2005

The vigorous economic recovery has gained enough momentum to continue through 2005, although some deceleration is becoming apparent. For example, the rise in the industrial production index slowed to 9.9% year on year in July. Nevertheless, GDP growth forecasts have been revised up to 6.8% for 2004, from 5.8% in *ADO 2004*, and to 6.0% for 2005, from 5.6%. Inflation is likely to nudge up to 1.5% in 2004 and 2.2% in 2005, as budgetary consolidation may lead the Government to reduce its subsidies on consumer energy. A slowdown in the export expansion, alongside continued strong import growth, is

projected to cut the current account surplus to \$9.4 billion in 2004, with a rise to \$11.0 billion in 2005. Investment growth is put at 15.0% in 2004, easing to 9.5% in 2005 because of further planned cuts in government development spending. Private consumption will remain the main source of strengthening GDP.

The 2005 budget targets a modest reduction in the deficit to 3.8% of GDP. Further out, the Government's plan for a new broad-based goods and services tax in 2007 adds credibility to its commitment to fiscal balance, and may pave the way for a long-anticipated cut in business income taxes.

The unemployment rate is expected to rise to 4.0% by end-2004 from 3.6% at the start of the year, and to remain around 4% in 2005. The announced increase in government development spending, along with positive trends in the labor-intensive tourism sector, should help mitigate the negative impact on employment of the anticipated slowdown in merchandise exports.

As a small net oil exporter—crude oil has a 5% share of exports—Malaysia benefits to a degree from the higher world oil prices. However, an extra \$10 a barrel over all of 2005 could push up inflation by 1.4 percentage points, hurting domestic demand, and leading to a decline in the GDP growth rate of 0.9 percentage points. (Oil scenarios are discussed further in Part 3.)

In the medium term though, burgeoning regional demand for energy offers many economic opportunities. Deepwater exploration is accelerating, driven by the expectation that higher prices are likely to be sustained for some time. Various new exploration agreements have been made public over the last few months. Petronas, the national oil company, plans to raise oil production by 20% over the next 10 years, which will require exploitation of many new oil and gas fields. Consequently, energy production is predicted to be a pillar of the Malaysian economy and a focus of new FDI.

A slowdown in the US economy would have both heavy direct and indirect negative effects on exports, since the US is by far Malaysia's biggest export market. Direct exports to the US made up 18.6% of all exports in the first half of 2004, and recent estimates suggest that half of Malaysia's exports to the PRC are then reexported, and many

of them go to the US. Slower US growth could affect other export markets as well. The signing of a Malaysia-US Trade and Investment Framework Agreement in May 2004 may further strengthen the two countries' economic ties.

To a lesser extent, Malaysia's economic performance will be affected by the PRC's ability to engineer a soft landing, though that country's demand for most Malaysian products—particularly those that are reexported—does not seem to be declining so far.

Looking further ahead, long-term sustainability of growth requires building on this year's promising start in restructuring GLCs.

The Government has said that it intends to seek foreign investment in these companies, and to divest significant blocks of shares in some of them. Strong and commercially oriented Khazanah oversight of these state holdings and greater private, including foreign, share ownership in the GLCs will help accomplish the key purposes of their restructuring. Achieving such an agenda will likely also entail further progress in the two other structural reform areas highlighted above: relaxation of ethnically determined rules on ownership and the holding of management positions, and further liberalization of the financial sector.