Malaysia

Rebounding from contraction in 2009, GDP rose at a faster rate than anticipated in the first half of 2010. Exports recovered strongly, sparking a broad-based increase in domestic demand that powered the growth in GDP. The pace will slow in the second half, but the 2010 full-year forecast is raised from that presented in April. In 2011, the economy is expected to return to growth at a touch above trend level. Inflation has been milder than expected, and is forecast to remain low. Substantial current account surpluses will likely continue to underpin a firming ringgit.

Updated assessment

Recovery in global trade and a broad-based increase in domestic demand drove a stronger than expected economic rebound in the first half of 2010. GDP rose by 10.1% year on year in January–March (Figure 3.6.1), easing a shade to 8.9% in April–June. That put the expansion for the first 6 months at 9.5%, a turnaround from the year-earlier period when the economy contracted by 5.1%.

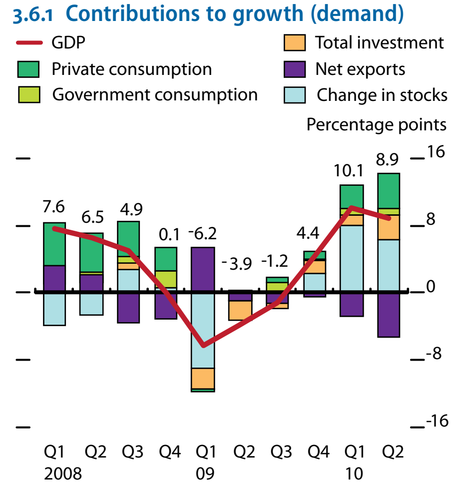
On the demand side, growth was underpinned by a robust 6.5% increase in private consumption in the first 6 months, reflecting renewed consumer confidence and rising incomes, which resulted from a lift in manufacturing output and wages coupled with higher agricultural commodity prices. Private consumption contributed 3.5 percentage points of total GDP growth in the first half. Government consumption spending increased by 6.6%, as disbursements of fiscal stimulus measures implemented in 2009 quickened.

Fixed capital investment rebounded by 9.4% owing to the recovery in world trade, while inventories posted their first increase in over 3 years. Total investment accounted for 2.0 percentage points of GDP growth. The large contribution of domestic demand to GDP growth was partially offset by net exports (in volume terms), which contracted from year-earlier levels as robust growth in exports of goods and services was offset by an even faster rise in imports, due to Malaysia's dependence on imported inputs for its manufactured exports.

In terms of supply, growth was spearheaded by a buoyant performance in manufacturing and services (Figure 3.6.2). Manufacturing, which accounts for around 25% of GDP, expanded by 16.4% in the first half, on account of the rebound in world trade. Production of electronic and electrical goods, which account for around one-third of total manufacturing, shot up by 32.8% owing to greater industrial-country demand to replenish depleted inventories.

Construction picked up by 6.3%, reflecting the impact of the fiscal stimulus on nonresidential and civil engineering activity. The services sector, which accounts for close to 60% of GDP, expanded by 7.9% in

3.6.1 Contributions to growth (demand)



Source: Department of Statistics, Malaysia. http://www.statistics.gov.my (accessed 8 September 2010).

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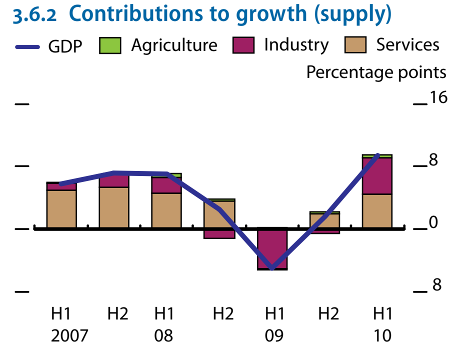
3.6.2 Contributions to growth (supply)



Source: Department of Statistics, Malaysia. http://www.statistics.gov.my (accessed 8 September 2010).

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This chapter was written by Purnima Rajapakse of the Southeast Asia Department, ADB, Manila.

the first half, underpinned by growth in wholesale and retail trade and financial services.

Agricultural output also gained in the first half, by 4.5%. Production of natural rubber climbed steeply early in the year, then moderated owing to seasonal factors and bad weather. The weather problems, and replanting, meant that palm oil production rose only slightly.

Mirroring the economic recovery, the number of job vacancies in the first 6 months went up from prior-year levels, with the highest increases in manufacturing and services, and the number of layoffs fell. The unemployment rate was little changed at 3.7% of the labor force at end-June compared with the start of 2010.

Year-on-year inflation edged up to 1.9% in July 2010 from 1.1% in December 2009 (Figure 3.6.3), in tandem with rising global commodity and food prices. Prices of food and beverages rose by 2.9%, reflecting the stronger domestic demand and supply constraints due to the bad weather.

The current account surplus for the first half declined to a still substantial \$14.1 billion (12.6% of GDP), from \$16.5 billion a year earlier. Wider deficits in the income and transfer accounts, and a reversal in services from a surplus to a deficit, more than offset a trade surplus. The rebound in global trade pushed up merchandise exports (Figure 3.6.4), by 38.1% in US dollar terms in the January–June period.

Electronic and electrical products (about 40% of total exports) led the recovery as industrial countries restocked after running down inventories for much of 2009. Exports of palm oil and liquefied natural gas also rose strongly, owing to gains in both volume and prices. Strong demand from the People's Republic of China (PRC), now Malaysia's biggest trading partner, supported the export rebound. Higher exports were accompanied by a 44% leap in imports, mainly intermediate goods used in the manufacture of electronic and electrical goods for export. However, given the considerably higher export base, the surplus in the trade balance increased.

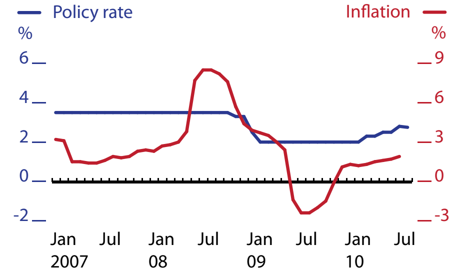
Deterioration in the services account stemmed mainly from higher payments on transportation as the volume of external trade picked up, and on other services such as insurance and finance, reflecting the bounce in economic activity. The wider deficit on the income account reflected higher outflows of dividends and interest from foreign companies operating in Malaysia than the equivalent inflows from Malaysian firms' investments abroad. The transfer account moved further into deficit due to higher remittances by foreign workers in Malaysia.

The lower current account surplus was accompanied by a significantly reduced deficit in the financial account due mainly to a reversal in portfolio flows from an outflow to an inflow. In part, that switch illustrated increased risk appetite for emerging market debt securities. Net foreign direct investment (FDI) recorded an inflow in the first half, compared with an outflow in the last 3 quarters of 2009.

Other investments, however, continued to register a large outflow. International reserves at mid-August 2010 amounted to \$95.1 billion, sufficient to cover 7.8 months of retained imports and 4.3 times short-term external debt (Figure 3.6.5).

Having run a budget deficit of 7.0% of GDP in 2009 (widened by spending on two fiscal stimulus packages), the government aims to rein

3.6.3 Inflation and policy interest rate



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. July. http://www.bnm.gov.my; CEIC Data Company (both accessed 8 September 2010).

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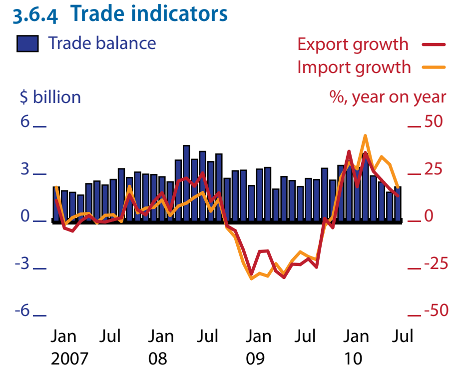
3.6.4 Trade indicators



Source: CEIC Data Company (accessed 8 September 2010).

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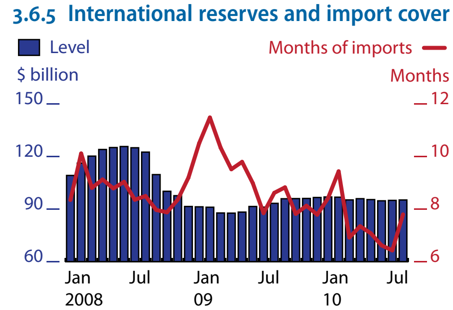
3.6.5 International reserves and import cover



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. July. http://www.bnm.gov.my; CEIC Data Company (both accessed 10 September 2010).

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in the deficit to 5.4% of GDP in 2010, mainly from the expenditure side. During the first half of 2010, revenue collection came in at 43.7% of budgeted receipts, while operational and development expenditures were 46.7% and 36.2%, respectively, of budgeted amounts. The fiscal outturn in the second quarter showed increases in indirect taxes, export duties, and nontax revenue owing to higher levels of economic activity and higher prices for petroleum, which is produced domestically. Development spending also picked up in the second quarter. At midyear, the 2010 fiscal deficit target appeared to be within reach (Figure 3.6.6).

Federal government debt at end-July 2010 was the equivalent of 53.2% of GDP, up from 41.4% at end-2008. Although this increase is of some concern, it is manageable in the context of a government commitment to fiscal consolidation over the medium term. Moreover, most public sector debt is domestic and the share of short-term debt is low.

Monetary stimulus, too, is being unwound this year. Bank Negara Malaysia, the central bank, increased its policy interest rate three times between March and end-August 2010, by a cumulative 75 basis points to 2.75% (Figure 3.6.3, above). (The policy rate had been cut to record lows during the recession.) The reserve ratio for banks was left at just 1.0%.

In response to the increase in the policy rate, the average overnight interbank rate has firmed, while the average lending rate of commercial banks edged up to 5.05% in the 2 months to end-June 2010, from 4.93%. Reflecting the rebound in economic activity, growth in bank lending picked up over the same period to 12.5% from 10.0%. Bank soundness indicators remain healthy: At mid-2010 the risk-weighted capital-adequacy ratio was 14.8% and net nonperforming loans were 2.2% of totals loans.

Yields on 10-year sovereign bonds had declined to 3.7% at end-August from 4.3% at the beginning of 2010, reflecting the upbeat outlook for the economy, a strengthening of the ringgit (it appreciated by 8.8% against the US dollar in the first 8 months of 2010—Figure 3.6.7), and moderate inflation. The Kuala Lumpur Composite Index of share prices rose by 12.5% in the same period on the back of the domestic and regional economic recoveries.

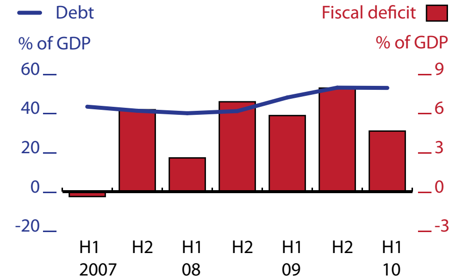
Prospects

With recovery now appearing to be firmly on track, the authorities are likely to complete the gradual unwinding of policy stimulus during the forecast period, though the economy will continue to benefit from fiscal stimulus this year. As of mid-August, 38% of the second stimulus package, which is to be fully disbursed by end-2010, had yet to be spent.

The government has signaled its intention to rein in the fiscal deficit over the medium term through subsidy reforms, streamlining the social safety net system, reviewing tax incentives to foreign and domestic companies, and rolling out a long-delayed goods and services tax. The fiscal deficit for 2011 is projected by the government's Economic Planning Unit at 3.8% of GDP, and according to the 10th Malaysia Plan (2011–2015) unveiled at midyear, the deficit is to be further narrowed to 2.8% by 2015.

Monetary policy is also likely to be tightened further. The central bank has flexibility as regards the timing and extent of interest rate rises,

3.6.6 Federal government fiscal indicators



Note: Federal government debt is based on rolling annual GDP.

Source: Bank Negara Malaysia. http://www.bnm.gov.my (accessed 16 September 2010).

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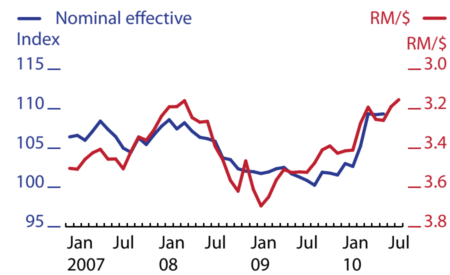
3.6.7 Exchange rates



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. July. http://www.bnm.gov.my; CEIC Data Company (both accessed 8 September 2010.)

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3.6.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth	5.3	6.8	5.0	5.0
Inflation	2.4	1.8	3.0	2.4
Current acct. bal. (share of GDP)	14.0	13.2	13.8	12.0

Source: ADB estimates.

given a relatively large output gap and the strength of the ringgit, which is largely based on balance-of-payments surpluses. It can also raise its reserve ratio for banks as a way to tighten policy.

Even with the strong recovery this year, Malaysia's economic growth has slowed notably in the decade since the Asian financial crisis, with private investment declining to 9.5% of GDP in 2009 from an average of about 30% in the mid-1990s, and outward direct investment currently exceeding inward FDI. The economy lags behind some others in Southeast Asia in terms of growth, productivity, and investment rates.

The global competitive landscape, too, has become much more challenging with the country facing greater competition for FDI and exports in the context of likely slower growth in demand from industrial economies. It is widely accepted that the country can no longer rely on past strategies that drove growth, but needs a revamp to put greater emphasis on innovation, creativity, and high-valued-added industries.

The 10th Malaysia Plan suggests a new approach to structural reforms. It lays out the structural transformation needed if the country is to become a high-income nation by 2020 and focuses on, among other goals, improving the environment for private sector–led growth; moving toward inclusive socioeconomic development; developing and retaining a skills base as key to promoting productivity and innovation-led growth; and transforming the role of the government to become an effective facilitator in the transformation of the economy and to provide quality services.

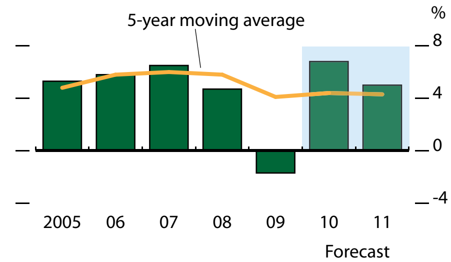
The new approach can be best illustrated by a comparison with some elements of the old: Growth through productivity (rather than growth through capital accumulation); private sector–led growth (dominant state participation in the economy); localized decision making (centralized strategic planning); cluster- and corridor-based economic development (balanced regional growth); favoring technologically capable industries and firms (specific industries and firms); a greater focus on Asian and Middle Eastern markets (an emphasis on being part of production chains to supply consumer goods and components to industrial markets); and policies to attract and retain foreign skilled professionals (restrictions on foreign skilled workers).

After consultation with the private sector, the government in September 2010 unveiled an Economic Transformation Program that further refines its plan to propel Malaysia toward developed-country status by 2020. The program is aimed at expanding higher-valued-added industries, such as energy, financial services, and public transportation to generate a greater number of well-paid jobs. It identifies 133 projects that would require investment totaling $444 billion over 10 years, mostly from the private sector (60%) and government-linked companies (32%), with the government to provide 8% of the funding.

The challenge is daunting and is likely to require difficult trade-offs, particularly in the context of tighter fiscal resources. Consensus will need to be forged, which suggests a measured pace of implementation over the 10th Plan period, with little impact this year or next on GDP growth.

In the light of the stronger than expected GDP rebound in the first half of this year, the full-year growth forecast is raised to 6.8% (Figure 3.6.8). Higher growth will narrow, but not close, the output gap. Private consumption is expected to remain robust due a firming labor

3.6.8 Annual GDP growth



Source: Asian Development Outlook database.

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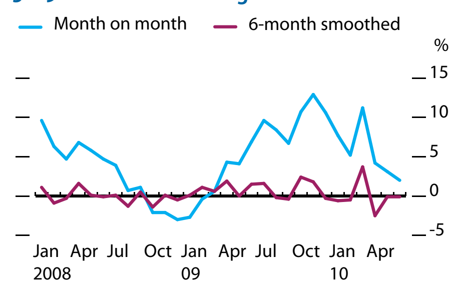
3.6.9 Growth of leading index



Note: The 6-month smoothed growth rate is computed as the ratio of the current month's index to the average index of the preceding 12 months.

Source: Department of Statistics, Malaysia. http://www.statistics.gov.my (accessed 10 September 2010).

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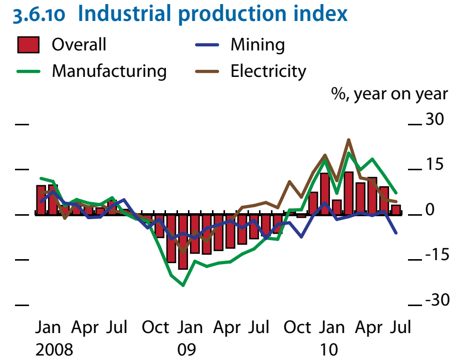
3.6.10 Industrial production index



Sources: CEIC Data Company; Department of Statistics, Malaysia. http://www.statistics.gov.my (both accessed 8 September 2010).

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market and higher incomes coupled with a pickup in business earnings and asset prices. Private investment in fixed capital and inventories will continue to get support from the recovery in export-oriented manufacturing industries, though investment growth still is moderated by excess capacity in some parts of the economy. Efforts to reduce the fiscal deficit are likely to damp public consumption and investment during the rest of 2010.

GDP growth is expected to moderate to a shade over 4% in the second half of this year, mainly owing to a base effect (the economy picked up in the second half of 2009). The government's index of leading indicators has contracted month on month since March 2010, while the 6-month smoothed growth rate of the index decelerated from 11.2% in March to 2.0% in June 2010 (Figure 3.6.9), indicating a slowing pace of economic growth for the rest of this year. Growth in the industrial production index slowed in June and July (Figure 3.6.10).

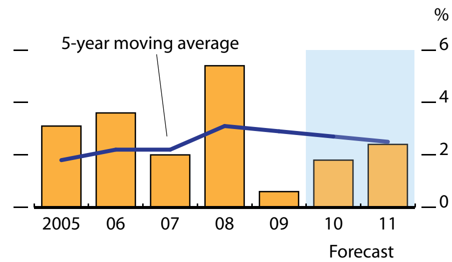
For 2011, GDP growth is forecast at about 5.0%, moderating from this year owing to less favorable base effects, unwinding of policy stimulus, and more subdued growth in several major export markets. Private consumption and fixed investment are projected to remain robust next year, as the labor market strengthens further and the output gap is closed. Public consumption, though, will probably be subdued because of the move to fiscal consolidation.

Upward pressure on prices has been milder than anticipated, so that the 2010 inflation forecast is lowered to 1.8%. The continuing output gap, exchange rate appreciation, and maintenance of price controls on basic goods will keep inflation at low levels. In 2011, higher domestic demand, combined with planned reductions in subsidies, will add to inflation, while the firming exchange rate and subdued global commodity prices will counteract some of that influence. Taking these factors into account, inflation now is forecast at 2.4% in 2011 (Figure 3.6.11).

On the trade front, export growth is projected to moderate over the rest of 2010 and into next year, due to a less supportive external environment, the completion of inventory buildups in industrial economies, and lower prices for some commodities. Import growth is expected to remain robust owing to buoyant domestic demand. A narrowing of the trade surplus is likely to be reinforced by a further deterioration in the income balance because of increased outflows of profits and dividend payments.

This narrowing should be partly offset by an improvement in the services account as inbound tourism picks up. Forecasts for the current account surplus are edged down to the equivalent of 13.2% of GDP this year and about 12.0% in 2011, putting the balances a little below those of recent years (Figure 3.6.12).

3.6.11 Inflation



Source: Asian Development Outlook database.

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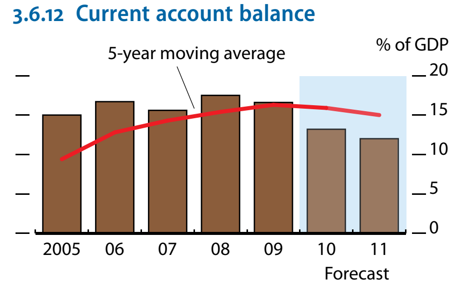
3.6.12 Current account balance



Source: Asian Development Outlook database.

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