Malaysia

A plunge in exports wounded this trade-sensitive economy in 2009. The impact of weak exports spread to private investment, which fell sharply, and to private consumption, which was nearly flat. Fiscal stimulation packages provided some buffer for aggregate demand. Economic growth will rebound during the forecast period, underpinned by a recovery in exports and rising incomes. Annual inflation is set to pick up from low levels. The government plans renewed efforts to encourage private investment.

Economic performance

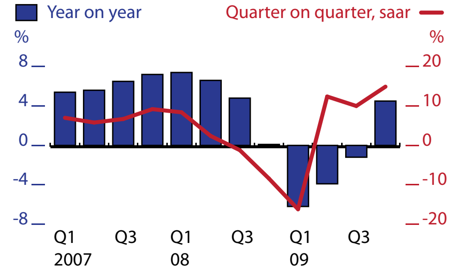
Heavily reliant on external trade, the economy was slammed by the global recession in 2009. GDP dropped by 6.2% in the first quarter on a year-on-year basis, after which the pace of contraction eased before the economy expanded in the fourth quarter. On a quarter-on-quarter basis, GDP started to grow after the first quarter (Figure 3.26.1). For the full year, GDP contracted by 1.7%, compared with average growth of 5.8% over the previous 5 years.

The downturn was widespread, and declines in exports and investment were accompanied by considerably slower growth in government and private consumption. Exports in volume terms fell by 10.1%, reflecting depressed demand in most major markets. This was offset by a 12.5% contraction in import volumes, as net exports registered growth for the year. Fixed investment fell sharply by 5.5%, with many firms canceling or deferring investment decisions. Investment acted as the major drag on GDP in 2009 (Figure 3.26.2). Growth in private consumption, which accounts for around one-half of GDP, slowed to just 0.8% owing to job losses and reduced rural incomes on the back of depressed agriculture commodity prices.

In terms of supply, agriculture grew by a slight 0.4% as depressed export prices for palm oil and natural rubber damped production. Output from industry fell and caused GDP to decline (Figure 3.26.3). Mining and quarrying output declined by 3.8% in response to lower condensate and crude oil prices. Manufacturing, which is dominated by the export-oriented electrical and electronic subsector, contracted by 9.3% due to the downturn in export markets. Construction, however, increased by 5.7% for the year, supported by government stimulus measures. Growth of services eased to 2.6%, in line with subdued domestic economic activity.

Underpinning the upturn in the fourth quarter was a turnaround in exports and investment as industrial economies replenished depleted inventories and business sentiment improved on the back of a pickup in external demand and a gradual recovery in private consumption.

3.26.1 Quarterly GDP growth



saar = seasonally adjusted annualized rate.

Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. January. http://www.bnm.gov.my; CEIC Data Company (accessed 23 March 2010).

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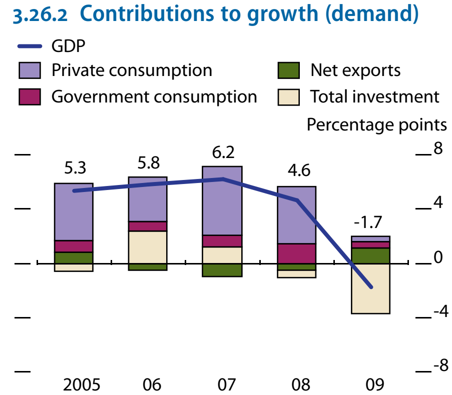
3.26.2 Contributions to growth (demand)



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. January. http://www.bnm.gov.my; CEIC Data Company (accessed 23 March 2010).

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

The labor market bottomed in the first quarter, when the unemployment rate peaked at 4.0%. The rate then fell to 3.5% by the fourth quarter. Most layoffs were in manufacturing.

Inflation decelerated to 0.6% in 2009 from 5.4% in 2008. This stemmed from falling global commodity prices, slower domestic demand, and the base effect of an increase in administered fuel prices in June 2008. Consumer prices fell for 6 months of last year (Figure 3.26.4). However, month-on-month inflation was pushed up steadily from August 2009 by the effect of fiscal stimulus measures on domestic demand, a gradual rise in commodity prices, and the low-base effect of the fall in global food and fuel prices late in 2008. After falling sharply, producer prices also picked up later in the year, to 1.8% in December 2009. In the first 2 months of 2010, consumer prices rose by an average of 1.3%, while producer prices increased by 4.2% in January.

Malaysia's current account surplus declined to $32.0 billion in 2009 (16.7% of GDP) from $38.9 billion in 2008. This was mainly attributable to a reduced trade surplus, which offset higher net receipts on services and lower net income payments. Merchandise exports fell by about 21%. All major categories of exports declined in value relative to 2008, with electrical and electronic exports, which account for 41% of export earnings, recording a decrease of about 11%.

The export decline was only partly offset by a 21% fall in merchandise imports, since the value of exports outweighs those of imports. The decline in imports was mainly due to a sharp contraction in imports of intermediate goods, most of which are used in making electrical and electronic products for exports. Exports and imports picked up during the second half of 2009 (Figure 3.26.5).

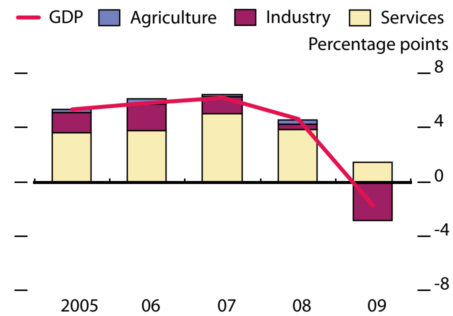
The improvement in the services account was largely attributable to higher receipts from tourism offsetting marginally higher payments on transportation. The narrower deficit in the income account was mainly due to lower outflows of profits and dividend payments. The lower current account surplus was accompanied by a smaller deficit in the financial account as a turnaround in portfolio investments, from a large outflow to a modest inflow, and a modest decline in direct investment outflows offset significantly higher outflows on account of other investments.

As a result of these developments, the overall balance of payments recorded a surplus of $3.9 billion in 2009 compared with a deficit of $5.5 billion in 2008. External reserves at the end of 2009 amounted to $96.8 billion, or 8 months of retained imports and 4.4 times short-term external debt.

The ringgit, having depreciated by 5.0% against the dollar during the first 3 months of 2009—when increased risk aversion and deleveraging activities by international investors increased the demand for dollars—has since appreciated (Figure 3.26.6). At the end of 2009, the ringgit had appreciated by 1.2% against the dollar on an easing of risk aversion. For the first 2 months of 2010, the ringgit further appreciated by around 1% against the dollar.

While the recovery in the second half of 2009 was largely attributable to external developments, the economy also benefited from expansionary fiscal and monetary stances. An RM7 billion fiscal stimulus package (1% of GDP) in November 2008, focusing mainly

3.26.3 Contributions to growth (supply)



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. January. http://www.bnm.gov.my; CEIC Data Company (accessed 23 March 2010).

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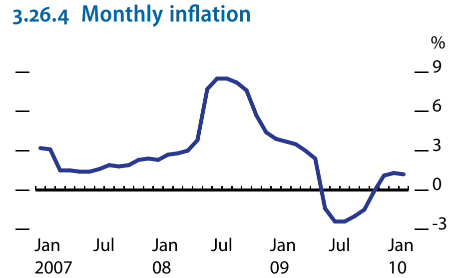
3.26.4 Monthly inflation



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. January. http://www.bnm.gov.my; CEIC Data Company (accessed 23 March 2010).

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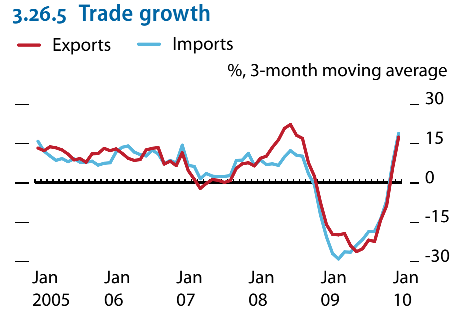
3.26.5 Trade growth



Source: CEIC Data Company (accessed 17 March 2010).

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on infrastructure-related projects, was followed in March 2009 by a RM60 billion (9% of GDP) set of measures to be implemented over 2 years. The second package includes additional spending measures (RM15 billion), loan guarantee funds (RM25 billion), equity investments (RM10 billion), public–private partnerships and other off-budget projects (RM7 billion), and tax incentives (RM3 billion). As of January 2010, over 95% of stimulus expenditure under the first package had been spent, and 42% under the second.

The central government fiscal deficit in 2009 widened to an estimated 7.0% of GDP (Figure 3.26.7), the deepest gap since the 1997–98 Asian financial crisis (although the actual deficit in 2009 was smaller than the target of 7.4%). Capital expenditure increased by 15.5% relative to 2008 as the government accelerated project implementation under the stimulus packages and the Ninth Malaysia Plan 2006–2010. Operating outlays also rose, due in part to increased domestic debt service payments, while revenue declined slightly.

As a result of the deeper fiscal deficit, the ratio of central government debt to GDP increased from 41.5% at end-2008 to about 54% a year later. Concerns over the size of the fiscal deficit and an apparent lack of a fiscal consolidation plan led in June 2009 to the first local currency debt downgrade since the 1997–98 crisis. Most of the public debt is domestic—only 3.8% was external debt at end-2009.

Bank Negara Malaysia, the central bank, maintained an accommodative monetary policy stance in the context of low inflation and weak economic activity. It reduced the overnight policy interest rate to 2.0% in February 2009 (Figure 3.26.8) and the bank reserve ratio to 1.0% in March 2009. These actions brought down the average lending rate from 5.9% in December 2008 to 4.8% in December 2009. Notwithstanding lower lending rates, loan growth of the banking system slowed to 7.8% by end-2009, from 12.8% the previous year. Loan indicators rebounded late in 2009 reflecting improved consumer and business sentiment.

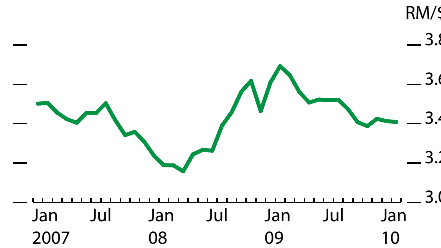
Most of Malaysia's banking sector assets are domestic, and banks had limited exposure to troubled foreign financial institutions or toxic assets. As a result, banking soundness indicators remained healthy and net nonperforming loans fell slightly to 1.8% of total loans in December 2009 from 2.2% a year earlier.

Long-term bond yields (10-year maturity) climbed from 3.1% to 4.3% during 2009, marking investor concerns over the increased supply related to the larger fiscal deficit. The stock market rebounded, along with other markets in Southeast Asia, to end the year up 45%.

Economic prospects

A considerable amount of the fiscal stimulus funding from 2009 remains to be spent in 2010. Still, fiscal policy will be less stimulatory this year than last as the government begins a much-needed fiscal consolidation process. Subsidies will be reduced, discretionary spending cut, and efforts put into making public services more efficient. The 2010 budget implies a 14% across-the-board cut in operating expenditure and a 4.5% cut in development expenditure, aiming to narrow the fiscal deficit to 5.6% of GDP in 2010.

3.26.6 Nominal exchange rate



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. January. http://www.bnm.gov.my; CEIC Data Company (accessed 22 March 2010).

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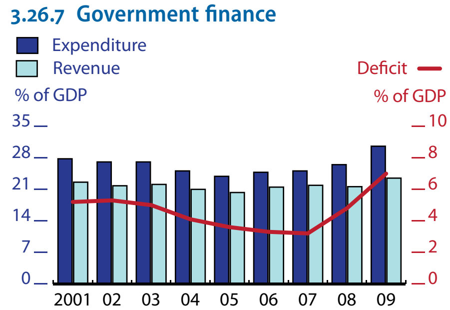
3.26.7 Government finance



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. January. http://www.bnm.gov.my; ADB estimates.

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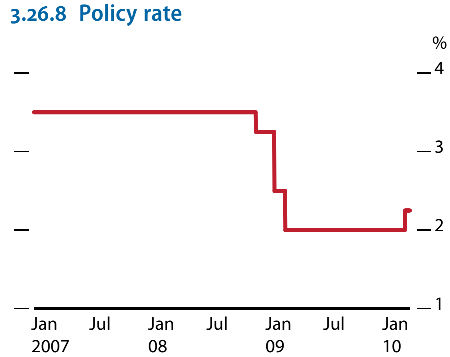
3.26.8 Policy rate



Source: Bloomberg (accessed 25 March 2010).

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3.26.1 Selected economic indicators (%)

	2010	2011
GDP growth	5.3	5.0
Inflation	2.4	3.0
Current account balance (share of GDP)	14.0	13.8

Source: ADB estimates.

On the monetary front, the authorities in March 2010 raised the policy interest rate to 2.25% in light of the improved domestic economic outlook. The increase was aimed at normalizing monetary conditions and preventing risks of financial imbalances from undermining economic recovery. Monetary policy remains accommodative given considerable excess capacity in the economy.

A likely appreciation of the ringgit in the forecast period due to a balance-of-payments surplus should offer the central bank some flexibility to wait until a firmer recovery in credit demand emerges before further raising interest rates. Additionally, the central bank could raise its reserve ratio for banks if it feels a need for policy tightening.

The positive sequential momentum in GDP growth during 2009 sets a solid basis for recovery to continue in 2010 and 2011. GDP growth is forecast to rebound to 5.3% in 2010 before easing to 5.0% in 2011 (Figure 3.26.9). In 2010 the recovery will be underpinned by growth in exports, driven by strong regional demand, particularly from the People's Republic of China, and inventory restocking by industrial countries, as well as the lagged effects of the stimulus packages. Growth will also benefit from the base effect of a sharp contraction in GDP during the first half of 2009. The government's index of leading indicators showed solid gains headed into 2010 (Figure 3.26.10).

The more moderate growth expected in 2011 stems from the factoring out of the base effect of lower growth in the first half of 2009, which will boost growth in 2010, and more moderate growth forecast for next year in some Asian trading partners. The impact of inventory restocking in industrial countries will likely dissipate in 2011, but exports will get support from the forecast stronger global trade recovery.

Higher export growth will, in turn, spur employment and incomes and feed into private consumption. Public consumption and investment are, however, likely to be damped by the reining back of the fiscal deficit, while private investment is expected to rise only gradually due to excess capacity in the economy.

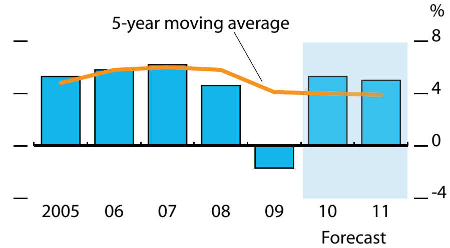
This excess capacity, coupled with the likely appreciation of the ringgit, suggests that inflation pressures will be fairly subdued. Inflation is expected to move up to 2.4% in 2010 and to quicken to 3.0% in 2011 (Figure 3.26.11), on the back of higher domestic demand, a rise in global commodity prices, a rise in some administered prices, and the disappearance from the year-on-year comparison of the high price base in 2008.

The current account surplus is forecast to narrow to about 14% of GDP in 2010 and a touch below that in 2011 (Figure 3.26.12). Exports will benefit from higher global commodity prices—particularly for crude oil, palm oil, and rubber—and a recovering global economy. Imports are likely to outpace exports in the context of Malaysia's dependence on imported inputs for its manufacturing export industries and a pickup in domestic demand.

A lower trade surplus during the forecast period is likely to be reinforced by a further deterioration in the income balance because of increased outflows of profit and dividend payments, while the services account is likely to show a small surplus from a steady increase in tourist arrivals.

Malaysia's reliance on external markets (both exports and imports of goods and services are equivalent to more than 100% of GDP) implies that

3.26.9 Annual GDP growth



Source: Asian Development Outlook database.

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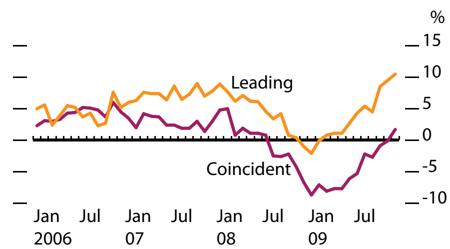
3.26.10 Growth of leading and coincident indexes



Source: CEIC Data Company (accessed 22 February 2010).

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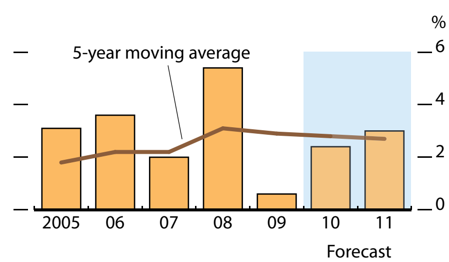
3.26.11 Inflation



Source: Asian Development Outlook database.

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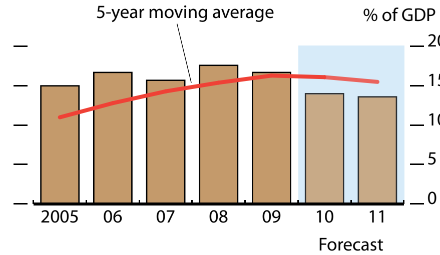
the main downside risk to the forecasts is a slower than expected global recovery. The high level of international reserves and strong banking sector position the economy relatively well to deal with any renewed bout of global instability, provided it is short.

On the domestic front, there is a risk that the planned withdrawal of stimulus measures could prove to be premature if the recovery in either domestic private or external demand is not sustained.

3.26.12 Current account balance



Source: Asian Development Outlook database.

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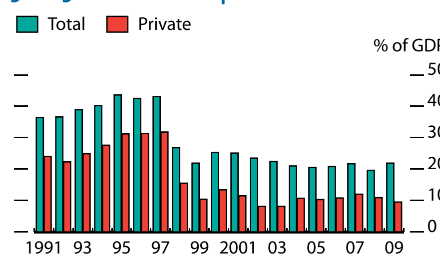
Development challenges

The economic pain caused by the global recession has led to renewed debate on the need to reduce dependence on external markets. However, given the limited size of the domestic market, policy makers seem to accept that Malaysia will need to continue to embrace globalization, alongside perhaps a structural shift in the economy to produce a more diversified range of goods for exports. There is also a growing sense that the economy seems to be caught in a "middle-income trap": unable to remain competitive as a low-cost producer, but also struggling to move up the value chain as a producer of knowledge-intensive products.

Economic growth, while impressive, has slowed and private investment, averaging about 30% of GDP just before the Asian financial crisis, has fallen to around 9.5% of GDP (Figure 3.26.13). These indicators point to the need to address deficiencies in the investment climate and to reappraise the role of public sector companies that compete with the private sector.

3.26.13 Gross fixed capital formation



Sources: Treasury Malaysia. Ministry of Finance. *Economic Report 2009/2010*. http://www.treasury.gov.my; CEIC Data Company (accessed 22 March 2010).

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The government is well aware of the need to modernize the economy. In March this year the Prime Minister announced a New Economic Model, which calls for an overhaul of the country's 4-decades-old affirmative action policies, in order to improve the investment climate and build a more competitive economy. To this end, the Prime Minister outlined plans for privatization of state-owned companies, sales of government land, a reassessment of subsidies, a further review of existing restrictions on foreign investment in services, and education reform. The New Economic Model is to provide the foundation for the formulation of the 10th Malaysia Plan (2011–2015), which is expected to be unveiled in June this year.

In April 2009 the government announced a series of measures that relaxed some rules on foreign investment in Malaysian companies and property, on initial public offerings, and on the financial sector. Most notable among these was the relaxation of a 30% *bumiputra* (ethnic Malay) equity requirement for investment in 27 services subsectors, including health and social services, tourism, transport, and business services.

While these are welcome developments, the unfinished agenda is long. The 27 subsectors are generally the relatively less important ones within the sectors. Liberalization of the entire sector is more likely to bring about a significant increase in private investment. Moreover, the services sector is controlled by a licensing system, and relaxing Foreign Investment Committee requirements do not remove the need for obtaining licenses from the relevant ministries, which may stipulate different *bumiputra* ownership limits to those stipulated by the committee. Investment climate surveys in Malaysia have frequently identified anticompetitive practices and the regulatory burden as major constraints on firms' activities and investments.