Malaysia

High prices for export commodities supported incomes and consumption in the first half of 2008. An expansionary fiscal stance and accommodative monetary policy also underpinned growth. The economy slowed less than foreseen earlier in the year, and the GDP growth forecast is nudged up to 5.6%. With the external environment expected to remain soft next year and commodity prices to moderate, and given limited room for fiscal stimulus, the growth projection for 2009 is revised down to 5.3%. Inflation has accelerated, prompting upward revision to the inflation forecasts. Over the longer term, subsidies on food and fuel could compromise fiscal consolidation and risk blunting incentives for greater efficiency in their use.

Updated assessment

GDP growth slowed more moderately than expected in *Asian Development Outlook 2008* (*ADO 2008*) in April, from a recent peak of 7.3% in the fourth quarter of 2007 to 6.3% in the second quarter of 2008 (Figure 3.6.1). Growth for the first half of 2008 was 6.7%. Agriculture performed well, benefiting from a sharp rise in palm oil production—reflecting improved yields and recovery from the year-earlier period when floods suppressed output—and from the strength of livestock. Industrial output was supported by an expansion of domestic-oriented production, including construction and transport equipment, despite slowing growth in the electronic and electrical subsector. A deceleration in services growth, which accounts for about half of GDP, was broad-based, although the sector continued to comfortably outpace overall growth. Consumer spending buoyed wholesale and retail trade while finance and insurance moderated.

Consumption continued to provide a strong impetus to domestic demand and growth (Figure 3.6.2). The beneficial effects of high commodity prices on rural incomes, a boost to civil servants' salaries in July 2007, a stable labor market, expenditures related to the general elections in March 2008, and low real interest rates all contributed to resilient consumption. Growth in private consumption, which makes up about half of GDP, slowed modestly to 9% in the second quarter from 10.8% in full-year 2007. Public consumption also recorded strong 8.8% growth in the first half. Subsidies on food and fuel, price controls on essential foodstuffs, and government programs to support lower-income groups have temporarily staved off the full impact on consumption of the rise in international prices of food and fuel.

Total investment declined in the first half, reflecting a fall in inventories. Fixed investment growth moderated to 5.6% in the second quarter from a peak of 12.8% in the third quarter of 2007. The deceleration is consistent with a moderation of foreign direct investment to RM3.4 billion in the first quarter from a recent peak of RM11.5 billion in the second quarter of 2007. Businesses are also likely to

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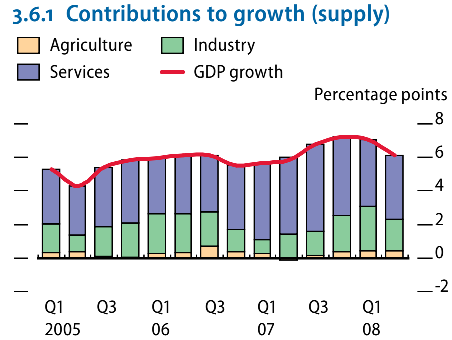
3.6.1 Contributions to growth (supply)



Source: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 1 September 2008.

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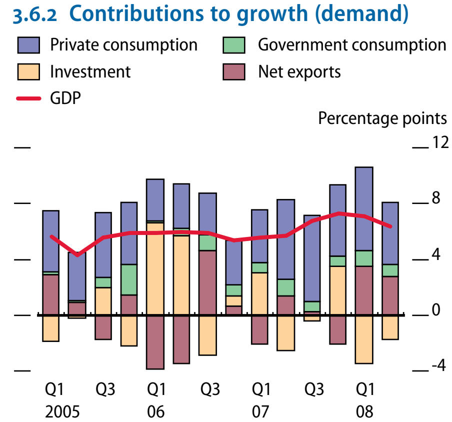
3.6.2 Contributions to growth (demand)



Source: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 1 September 2008.

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have postponed major projects while waiting for the outcome of March's elections and because of the more uncertain economic outlook.

Net exports contributed significantly to growth in the first half. The volume of exports rose faster than in the year-earlier period. Import volumes rose at a slower rate than those of exports, largely reflecting slower growth of the imports required for electronic and electrical exports and a moderate rise in fixed investment.

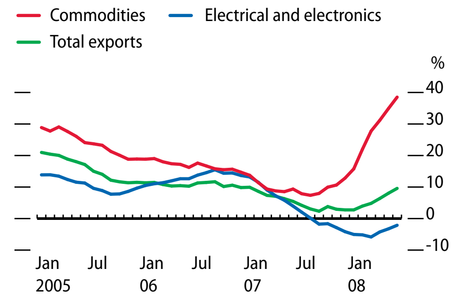
Exports in nominal terms have risen robustly this year, mainly a result of high global commodity prices (Figure 3.6.3) but also by a reorientation of exports: from the United States (US), European Union (EU), and Japan—whose combined share fell from 47% of total exports to 37% between 2000 and 2007—to the People's Republic of China and non-Asian countries. The ringgit value of merchandise exports was up by 15.5% in the first half with a 52% increase in major commodity exports. On the back of the persistent rise in commodity prices in the past few years, the share of major commodity exports in the total has risen to 22% (first-half 2008) from 11% (full-year 2001), with a corresponding decline in the share of electrical, and especially electronic, products to 30% and 12%, respectively. This export group stagnated in the first half relative to a year earlier as the decline in sales of semiconductors and electronic equipment and parts counterbalanced the increase in consumer electrical exports. Imports in nominal terms also rose in the first half, but at a slower 8.3% rate than the rise in exports. The merchandise trade surplus widened by 55% year on year in the first 6 months.

Available data for the first quarter show a 29% increase in the current account surplus, largely reflecting a wider merchandise trade surplus and contributing to a higher surplus in the overall balance of payments. Net inflows from the balance of payments exerted upward pressure on the currency, which the central bank, Bank Negara Malaysia, damped by accumulating foreign exchange reserves. International reserves rose to $124 billion in mid-August from $98 billion at end-2007. In spite of this injection of liquidity, growth in monetary aggregates was moderate: M3 rose by 14.1% in July 2008, just slightly faster than the 13.4% of a year earlier, and below the rise in first-half nominal GDP (Figure 3.6.4).

Inflation pressures have risen significantly and by more than expected in *ADO 2008*, primarily on account of the sharp rises in global food and fuel prices (Box 3.6.1). In the past few years, imported inflation had been tempered somewhat by administered prices of key products, including various foods and fuels, and by the appreciation of the ringgit against the US dollar. But the sharp and persistent rise in world fuel prices prompted the authorities to reduce the subsidies for fuel in June, and raise electricity tariffs from July, in order to contain the fiscal deficit and promote energy efficiency. Consumer price index (CPI) inflation averaged 4.4% in the first 7 months of this year, up from 2.0% a year earlier.

There is little evidence so far of a spillover to other components of the CPI. In the first 7 months of this year, the increase in food and transport prices, which have weights of 31% and 16% in the CPI basket, were the main drivers, accounting for 50% and 25% respectively of CPI inflation (Figure 3.6.5). The producer price index has been rising at a faster pace than the CPI, with a 10.3% increase in the first half, indicating increasing pressure on companies' profit margins.

3.6.3 Merchandise export growth (year-on-year 12-month moving average)



Source: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 1 September 2008.
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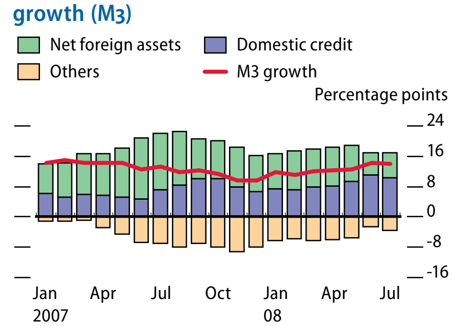
3.6.4 Contributions to money supply growth (M3)



Source: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 1 September 2008.
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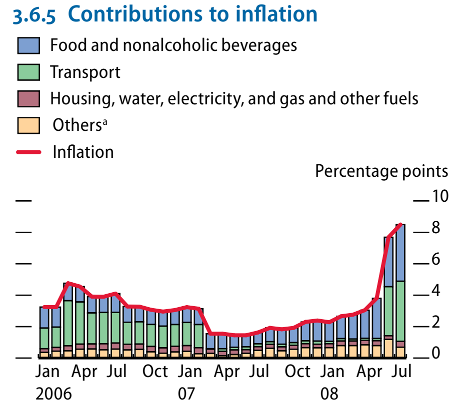
3.6.5 Contributions to inflation



[a] Includes alcoholic beverages, clothing and footwear, furnishings, health, communications, recreation, education, restaurants, and hotels. This category has a 31% weight in consumer price index.

Source: Department of Statistics of Malaysia, available: www.statistics.gov.my, downloaded 29 August 2008.
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3.6.1 Impact of food and fuel price increases

Malaysia is an exporter of palm oil, rubber, timber, and tin, a net exporter of fuel, and a net importer of food. It imports about a third of its domestic milled rice consumption for example, and all its wheat.

The increase in global commodity prices has contributed to higher trade and current account surpluses. Exports of crude oil and liquefied natural gas, in ringgit terms, have risen by more than 20% on average annually in 2003–2007; fuel imports also rose at a similar pace but from a lower base, thus widening the surplus. The impact of food price increases is more modest: imports of primary foods for household consumption rose at an average annual rate of 10% in 2003–2007, to RM4.0 billion.

With the rise in food and fuel prices, the attendant pressures on inflation and the fiscal account have complicated economic management. Domestic consumers have been insulated from the full impact by subsidies, especially on fuel, and by price controls on essential food items. Subsidies accounted for the equivalent of 1.6% of GDP and 8.5% of the federal Government's operating expenditure in 2007. (This excludes subsidies provided by Petronas, the state oil and gas company, to power producers.) The subsidies provided by the Government are estimated to rise to 4.3% of GDP this year.

To contain the increase in subsidies, the domestic price of gasoline was raised by 41%, that of diesel by 63%, and electricity tariffs by 18–26% for commercial and industrial users as well as households that consumed more than 200 kilowatt-hours per month. But even after the increase, domestic prices were still much lower than international prices—and with the subsequent decline in global fuel prices, the domestic price of gasoline was reduced by 5.6% and that of diesel by 3.1% in August. The Government intends to review fuel prices on a monthly basis and maintain a 30 sen per liter subsidy on gasoline and a 50 sen per liter subsidy on diesel.

The rise in domestic prices of fuel contributed to 7.7% year-on-year consumer price inflation in June and 8.5% in July, up from 3.8% in May. Much of the increase until May had been driven by higher food prices.

According to government estimates, the reduction in fuel subsidies amounted to about 2% of GDP, or RM13.7 billion. However, to cushion the impact, about RM5 billion of these savings were given as cash rebates to owners of small vehicles (including private cars with an engine capacity of up to 2,000 cubic centimeters). The scheme also included increased subsidies for approved public transport companies and fishermen. Another RM6 billion was reallocated to support food subsidies and to increase the stock of imported rice. The net effect on the fiscal position was thus broadly neutral.

Measures for lower-income groups have also been announced, including raising the income threshold for eligibility for welfare assistance.

The authorities are attempting to balance fiscal prudence with supporting growth and insulating the more vulnerable segments of the population from inflation. However, over the longer term, if international prices remain high, the relatively lower domestic prices will not provide a strong signal of the relative scarcity of these products, especially fuel, and thus blunt the incentives for greater economy and efficiency in their consumption. Furthermore, the fuel subsidies are likely to benefit the relatively well-off, who are bigger consumers of energy.

Price discrepancy with neighboring countries is also likely to encourage smuggling, leading to a leakage of subsidies. This is less so for food since most of the controlled food items are of lesser quality and thus indirectly target the less well-off. But, for food too, price controls could damp the domestic supply response. A preferred option would be to align domestic prices of fuel and food to international prices in a phased manner and to strengthen the targeted support to lower-income groups.

Demand-side pressures on inflation remain subdued as money supply growth has been moderate in the last few years. The labor market may also be developing some slack as economic growth falls below the economy's potential (estimated by the central bank at 6.4% for 2007). The unemployment rate rose to 3.6% in the first quarter of 2008. In view of the subdued demand-side pressures and an apparent absence of spillover of food and fuel prices into overall prices, Bank Negara Malaysia has left its overnight policy rate unchanged at 3.5% since April 2006.

The rise in international food and fuel prices has complicated the Government's fiscal consolidation program against a backdrop of a more uncertain political environment. (In the March elections, the ruling coalition suffered a loss of its two-thirds majority in Parliament.) In order to contain federal government debt of 42% of GDP, which is higher

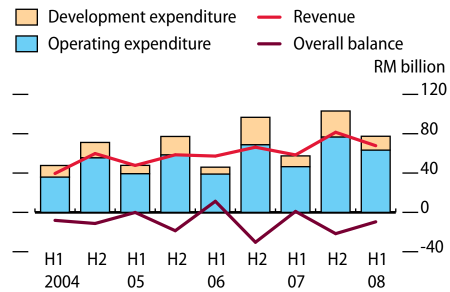
3.6.1 Selected economic indicators (%)

	2008		2009	
	ADO 2008	*Update*	*ADO 2008*	*Update*
GDP growth	5.4	5.6	5.9	5.3
Inflation	2.7	5.6	2.5	4.2
Current acct. bal. (share of GDP)	11.6	16.4	11.7	16.7

Source: Staff estimates.

than that of most other large economies in Southeast Asia, the federal Government trimmed its deficit to 3.2% of GDP in 2007 from a high of 5.5% in 2000. However, this year, a deficit of 2.6% of GDP was posted in the first half compared with a surplus of 0.3% a year earlier (Figure 3.6.6). Much of this reflected a 36% rise in operating expenditures, notably a 30% increase in civil servants' salaries and a 298% jump in subsidies. Revenues rose by a more moderate 16% during the period, supported by a hefty increase in receipts from Petronas, the state oil and gas company, which accounted for close to 40% of total revenues.

3.6.6 Government finance



Source: CEIC Data Company Ltd., downloaded 1 September 2008.

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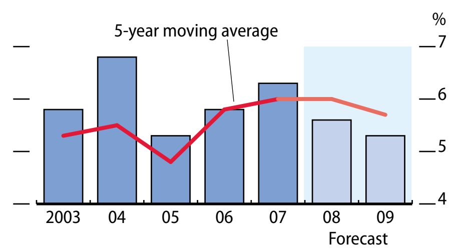
Prospects

The economy is highly open: exports and imports of goods and services accounted for 110% and 89% of GDP, respectively, in 2007. With the global economy weakening and expected to remain lackluster in much of 2009, the country's economic growth is likely to slow both this year and next relative to the trend of the past 5 years. Projections for the period assume that political uncertainties will not have a significant impact on economic policies, that the Government will bring the fiscal consolidation program back on track after slippage this year, and that monetary policy will remain prudent in containing inflation pressures.

The projection for GDP growth this year is increased slightly to 5.6% from that in *ADO 2008*, while growth for next year is marked down to 5.3% on expectation of continued softness in the external environment (Figure 3.6.7). A still-sharper slowdown in economic growth is likely to have been prevented by the temporary fiscal stimulus and an accommodative monetary policy, and by the support from commodity exports.

3.6.7 GDP growth



Sources: Asian Development Outlook database; staff estimates.

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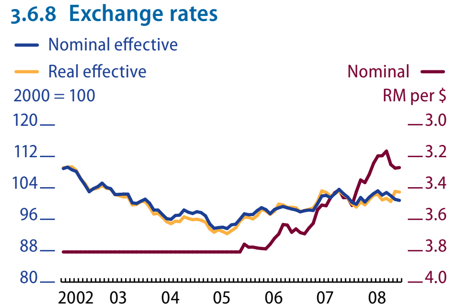
The revision for this year reflects primarily stronger than expected performance in the first half. The impacts of some factors that supported consumption growth, including election-related spending and the increase in civil servants' salaries, have either dissipated, or are likely to do so, over the rest of this year. The labor market is also likely to soften. Furthermore, the rise in inflation will crimp consumers' purchasing power.

Export volumes of goods and services are likely to decelerate in the second half of 2008 and in 2009, in line both with weaker external demand and a moderation in tourism after strong growth last year. The real trade-weighted exchange rate of the ringgit is projected to remain stable. The nominal exchange rate has depreciated against the currencies of some major trading partners this year. Real domestic interest rates are likely to fall further, so the pressure for appreciation of the real exchange rate of the ringgit against major currencies should be subdued (Figure 3.6.8).

3.6.8 Exchange rates



Note: RM per $ is an inverted scale.

Sources: Bank for International Settlements, available: www.bis.org; CEIC Data Company Ltd.; both downloaded 1 September 2008.

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Import volumes are also likely to moderate in the second half of 2008 and in 2009, largely reflecting weaker electronic exports, which tend to be import-intensive, as well as modest growth of fixed investment, due to anxieties about external markets, a dimmer outlook for the domestic economy, and somewhat greater domestic political uncertainties. Net exports are thus likely to contribute to growth this year before subtracting modestly from it next year (as in the past 2 years).

The value of exports is likely to rise faster this year than last on the sharp increase in commodity prices. Next year, as fuel prices are expected to fall and the increase in nonfuel commodity prices to moderate, export

growth should decelerate in tandem. With imports also softening, the trade surplus is likely to rise. The services account will likely retain a small surplus. The income account deficit has declined in recent years, partly reflecting rising dividend incomes from outward direct investment by Malaysian companies. The forecasts for current account surpluses are revised up for both 2008 and 2009 (Figure 3.6.9).

Inflation is forecast to remain high as the June reduction in fuel subsidies and the electricity tariff hike in July filter through the economy, and as food prices remain elevated. The effects of June's and July's measures will probably erode companies' profit margins further, and producers will attempt to pass the higher prices on to consumers. Still, as growth slows and the international price of fuel subsides, inflation should moderate. In fact, marking the fall in global fuel prices, domestic prices of gasoline and diesel were trimmed in August. Average CPI inflation is projected to hit 5.6% this year, the highest rate since 1982, and revised up sharply from *ADO 2008*, before moderating to 4.2% next year (Figure 3.6.10).

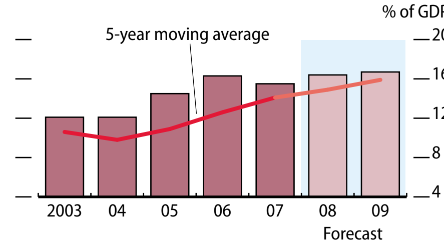
As of August 2008, the central bank had refrained from tightening monetary policy, partly as it expects slower economic growth to temper inflation. The rise in inflation has led to a decline in real deposit and lending rates, and the latter turned negative in June 2008 (the former has been negative for longer). As inflation moderates next year, real interest rates should start to turn positive (Figure 3.6.11).

The Government revised its estimate for the fiscal deficit this year to 4.8% of GDP from an original target of 3.1%. Most of this widening reflects an increase in the allocation for subsidies. Development expenditures are also set to increase. A rise in revenues equivalent to 1.8% of GDP, mainly from oil and gas receipts, is expected to offset some of this increase in total expenditure.

The budget for 2009 envisages a reduction in the deficit to 3.6% of GDP. Revenues are forecast to increase by 9.0% and operating expenditures by a modest 2.0%, as subsidies are expected to remain stable. Development spending growth is projected to increase by 12.0%, only slightly lower than 14.0% this year. The expected increase in revenues may prove ambitious, considering the likely decline in global fuel prices, slower economic growth, and measures to enhance disposable incomes in the 2009 budget (including tax breaks for individuals and elimination of duties on some food items).

The main risks to the baseline projections stem from developments in the external environment and the domestic policy response. If commodity prices, especially of fuel, rise to such an extent that global growth is slower than expected, Malaysia's growth will also suffer. In that event, inflation will likely be higher than the projections because subsidies may need to be further cut. (Fiscal options to support growth are limited.) If subsidies are not reduced, social and development spending will probably need to be curbed or the fiscal consolidation program may slip again, potentially raising the country risk premium and borrowing costs and damping prospects for medium-term growth. Also, if inflation turns out higher than expected, monetary policy, which has remained accommodative so far, may need to be tightened rapidly, generating uncertainty about macroeconomic stability.

3.6.9 Current account balance



Sources: Asian Development Outlook database; staff estimates.

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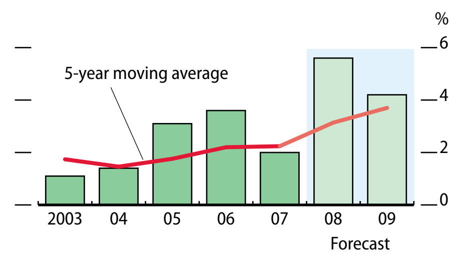
3.6.10 Annual inflation



Sources: Asian Development Outlook database; staff estimates.

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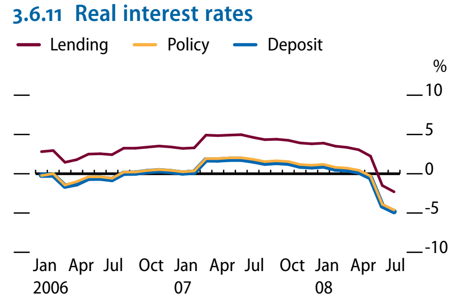
3.6.11 Real interest rates



Notes: Deposit rates are for 6-month fixed deposits in commercial banks. Lending rates are average lending rates for commercial banks.

Source: CEIC Data Company Ltd., downloaded 1 September 2008.

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