Malaysia

Brisk domestic demand, particularly private consumption, lifted economic growth to 6.3% in 2007. Fixed capital investment expanded at its fastest rate since 2000. Export growth slowed sharply, though, as electrical and electronic products suffered from weakening global demand. Both consumption and investment are likely to decelerate in 2008 and the export outlook has deteriorated, slowing GDP growth by about 1 percentage point. Government subsidies have helped to keep inflation low but, with price pressures rising, are putting greater strain on the budget.

Economic performance

Powered by domestic demand, the economy expanded by 6.3% in 2007, above the 5.8% average recorded in 2002–2006. Growth in private consumption, which has been the main driver of GDP in the last few years, accelerated to 11.7% from 7.1% in 2006. It contributed 5.7 percentage points of total GDP growth (Figure 3.25.1).

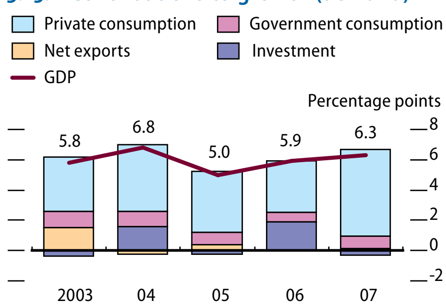
Household spending was buoyed by a strong labor market, a hefty (7.5–42%) increase in public sector salaries from July 2007, low interest rates, and the wealth effect felt by individuals from stock market gains. Rural incomes benefited from high global prices for agricultural commodities. Public consumption also grew, by 6.4%.

Gross fixed capital formation increased robustly by 10.2% last year, the highest rate since 2000, supported by both stronger public and private investment. The former was bolstered by development projects implemented under the Ninth Malaysian Plan 2006–2010, and the latter by the solid economic growth, low interest rates, and improvements to the investment climate. Among policy changes in 2007 that helped private investment, the Government cut the corporate tax rate by 2 percentage points over 2 years to 26%; approved a 10-year tax exemption for venture capital; and eased foreign exchange restrictions somewhat. In addition, investment incentives were introduced for domestic and foreign investors in the Iskander Development Region, one of three economic development regions being developed under the Ninth Plan (Box 3.25.1).

Foreign direct investment (FDI) net inflows rose by 54.4% to \$9.4 billion in 2007, with manufacturing, particularly the electrical and electronics subsector, attracting more than half the total. Gross fixed capital formation added 2.3 percentage points to GDP growth (although this was more than offset by a decline in inventories). On the external front, real exports and imports each grew by about 4%, the weakest performance for several years, largely reflecting soft global demand for electrical products, and net exports did not make a significant contribution to GDP growth.

This chapter was written by Hiroki Kasahara of the Southeast Asia Department, ADB, Manila.

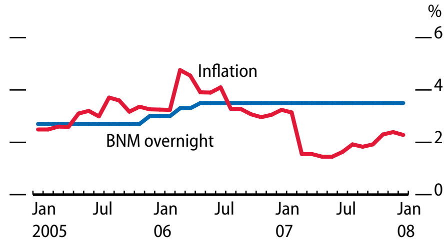
3.25.1 Contributions to growth (demand)



Source: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 17 March 2008.

Click here for figure data

3.25.2 Policy rates and inflation



Source: CEIC Data Company Ltd., downloaded 17 March 2008.

Click here for figure data

On the supply side, the services sector expanded strongly by 10.0% and contributed 4.7 percentage points to GDP growth. Its growth was led by finance, insurance, real estate, and business services. Wholesale and retail trade, as well as accommodation and restaurants, also registered healthy growth owing to strong household spending and inward tourism programs to commemorate the 50th anniversary of independence. Tourist arrivals rose by 19.5% to 21 million in 2007, with significant increases in visitor numbers from People's Republic of China, India, and Indonesia.

Growth in industry rose modestly by 3.3%, the lowest rate in 5 years. Manufacturing, which accounts for two thirds of industrial output, grew by 3.1%, damped by the softer external demand for electrical products (40% of total manufacturing). Indeed, production of semiconductors and other electrical parts contracted slightly in the first half of 2007, while production of household appliances, office machinery, and audiovisual appliances fell sharply from the same period a year earlier. Mining and construction performed well, reflecting increased crude oil and natural gas production, and projects initiated under the Ninth Plan. Agriculture expanded slightly, by 2.2%. Production of crude palm oil (almost a third of total agricultural output) fell by 0.4% because of bad weather and floods.

Despite the robust domestic demand, inflation eased to average 2.0% in 2007 from 3.6% in 2006. This was largely attributed to subsiding effects of a 18–24% hike in administered retail fuel prices in 2006, and was helped by an appreciation of the ringgit. Inflation bottomed out in the second quarter (1.5%) and rose to 2.4% in December, reflecting high global commodity prices and a 3.0% rise in prices of food and beverages (nearly a third of the consumer price index basket). Bank Negara Malaysia, the central bank, has maintained its overnight policy interest rate at 3.5% since April 2006 (Figure 3.25.2). Money supply (M2) growth decelerated to 9.5% from 17.1% in 2006, owing to outflows of foreign portfolio funds (bank lending increased) (Figure 3.25.3).

The ringgit continued to appreciate against the US dollar, although it weakened for a while, along with other currencies, when US subprime credit problems intensified (Figure 3.25.4). For all of 2007, it appreciated by 5.8% against the US dollar (and by 13.8% since Malaysia ended the peg against the US dollar in mid-2005). The real effective exchange rate appreciated by 2.7% in 2007.

The federal Government continued to run a budget deficit of about 3% of GDP in 2007. Increased spending reflected the salary hike for civil servants and accelerated disbursement for the Ninth Plan's development projects. Revenues benefited from higher corporate tax receipts and increased income from Petronas, the national oil and gas company. Its dividends, income tax, export duties, and royalties accounted for 38% of total revenues. However, Malaysia also subsidizes retail fuels at great cost—equivalent to an estimated 7% of total operating expenditures in 2007.

Growth in merchandise exports decelerated to an estimated 9.6% in 2007 in nominal US dollar terms in 2007. Electrical products, accounting for 44% of total exports, increased by just 1.2% due to weak global demand. In contrast, palm oil and palm oil product exports, the second largest export item, jumped by 51.3% on high global prices. Exports of liquefied natural gas increased by 19.9% thanks to buoyant demand from Japan; Republic of Korea; and Taipei,China. Merchandise imports also

3.25.1 Regional development

The Government is investing heavily in three regions in peninsular Malaysia with the aim of spurring growth and reducing regional income disparities. Under the Ninth Plan, $16.4 billion is allocated for the regions and an additional $2.7 billion is to be sourced from the private sector. Significant public funding is planned until 2025 and tax concessions are offered to investors.

The Iskander Development Region in the south was launched in November 2006. Taking advantage of proximity to Singapore, the idea is to establish a logistics and services center for trade, develop electrical product manufacturing, and build tourist facilities. The region has introduced incentives including tax breaks and liberalized rules on use of foreign labor and capital. It received investment commitments totaling $2.3 billion in the first 10 months of 2007.

The North Corridor Economic Region was launched in July 2007. Its focus is on development of commercial-scale farming and food processing. It also aims to take advantage of proximity to Thailand and Indonesia to become a processing, logistics, and trade center.

The East Coast Economic Region, the least developed of the three, was launched in October 2007. It involves development of a deep-sea fishing port, aquaculture, palm-oil processing (tapping the region's palm oil plantations), and petrochemicals.

One challenge is to execute these large projects simultaneously. Another is to secure the cooperation of the private sector, government-linked companies, local communities, and the state governments. In the areas that intend to develop commercial farming, deep-sea fishing, and acquaculture, the cooperation of local communities which follow traditional farming and fishing will be crucial if the required skills are to be taught.

decelerated, to an estimated 11.9% in 2007, largely reflecting soft demand for inputs for the electrical products industry. The trade balance was still in substantial surplus. Increased earnings from tourism helped swing the services account into surplus, from a long-standing deficit, and the current account surplus grew to $29.7 billion, or 15.9% of GDP. International reserves rose to $101.3 billion by end-2007, equivalent to 8.5 months of retained imports and 6 times short-term external debt.

A generally robust labor market saw employment rise by an estimated 2.1% in 2007, with services generating most jobs. The unemployment rate declined to 3.1%. Malaysia imports labor—it had more than 1.9 million registered foreign workers as of May 2007, or 16.8% of total employment, mainly unskilled workers in manufacturing and agriculture. Another estimated 3 million unregistered foreign workers are in the country.

Economic prospects

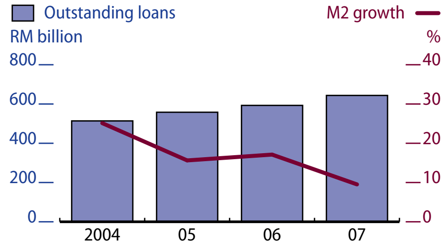
Domestic demand is again likely to be the mainstay of economic growth in the forecast period, given the expected weaker export markets in industrial countries and slowdown in most of Asia. Private consumption will remain the main driver, although it is likely to decelerate somewhat relative to 2007. The consumer sentiment index dipped a little from high levels in late 2007. Heightened inflation pressure, uncertainty about the world economic outlook, and a retreating impact of last year's big salary increase for civil servants will likely weigh on consumer spending.

The expansion of fixed investment in 2007, supported by public investment related to the Ninth Plan and the pickup in private investment, is expected to moderate in 2008 because of the weaker global prospects. Real exports of energy and commodities might hold up relatively well, but electrical products and other manufactured exports face weaker markets. On the balance of these factors, GDP growth is projected to slow to 5.4% in 2008 before speeding up to 5.9% in 2009 (Figure 3.25.5)—if global export markets improve as expected.

From the production side, the services sector is forecast to slow as household incomes and business activity decelerate. Tourist arrivals are unlikely to increase at such a high pace after the close of 50th anniversary events in August 2008. Manufacturing growth will be hurt by the weaker outlook for electrical products. Production of oil and natural gas is forecast to rise because the capacity of some oil fields and gas facilities has been increased. As a net exporter of oil and gas, Malaysia has some protection against the impacts of rising world energy prices. Construction will be underpinned by Ninth Plan infrastructure projects. Agriculture is expected to do better (depending on the weather) as high prices for commodities and food stimulate production.

The government budget for 2008 projects higher development expenditures under the Ninth Plan and a fiscal deficit still of around 3% of GDP. Subsidies for diesel and gasoline, as well as food staples, cost about $3.5 billion last year, or about 10% of total operating expenditures, and are rising. Even after administered fuel prices were raised in 2006, the cost of fuel subsidies rose by 20% in 2007 as global oil prices climbed. To reduce fiscal strains that might arise because of the tax concessions granted last year and the rising cost of subsidies on fuel and some food,

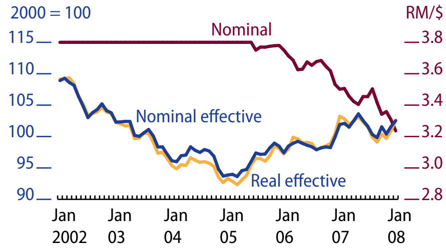
3.25.3 Monetary indicators



Source: CEIC Data Company Ltd., downloaded 17 March 2008.

Click here for figure data

3.25.4 Exchange rates



Sources: Bank for International Settlements, available: http://www.bis.org; CEIC Data Company Ltd.; both downloaded 17 March 2008.

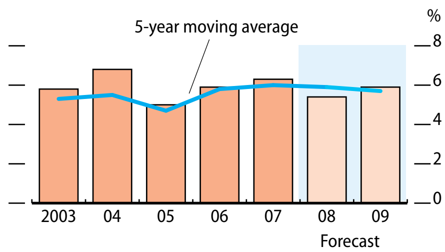
Click here for figure data

3.25.1 Selected economic indicators

	2008	2009
GDP growth	5.4	5.9
Inflation	2.7	2.5
Current account balance (% of GDP)	11.6	11.7

Source: Staff estimates.

3.25.5 GDP growth



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

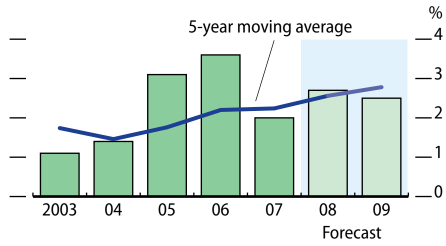
the Government could raise fuel prices or introduce the proposed goods and services tax, or both. However, elections held in March this year returned the Government to office with a reduced majority and loss of control of some states, complicating both passage of economic legislation and implementation of projects in the development regions.

Inflation pressure is likely to remain elevated in 2008 and will be further affected if retail fuel prices are raised or the goods and services tax is introduced. With inflation quickening to 2.4% in late 2007 (and further to 2.7% in February 2008), the Government established a National Price Council early this year to stockpile cooking oil, rice, and other staples in an effort to keep prices of these goods stable. In 2008, inflation is forecast to average 2.7% (Figure 3.25.6).

Given the weak outlook for manufactured exports and high prices for some imports, the trade surplus is expected to narrow this year. The services balance is seen reverting to a deficit because of a deceleration in tourism earnings. Together, these outcomes will lower the current account surplus to about 11.6% of GDP (Figure 3.25.7).

Domestic risks to the outlook include delays in implementation of projects under the Ninth Plan. As of October 2007, only about 30% of the total allocation for development projects over the 5-year period of the plan had been disbursed from the federal budget, against a scheduled 37%. Capacity constraints in agencies involved were part of the cause. Delay in implementation affects not only public investment but also private investment in projects.

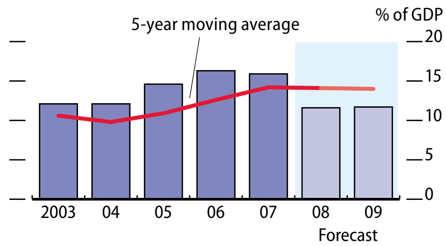
3.25.6 Inflation



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

3.25.7 Current account balance



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data