Malaysia

Consumption spending, bolstered by rising incomes, led economic expansion in the first half of 2007, with fixed investment making a robust contribution. Public investment under the Ninth Malaysia Plan is supporting growth, but weaker global demand for electrical and electronic products hurt exports. The projection for GDP growth this year is revised up slightly to 5.6% and kept at near this level for 2008. Inflation has slowed and is projected to stay low.

Updated assessment

Led by domestic demand, the economy expanded by 5.6% in the first half of 2007. Private consumption accelerated at its fastest pace (10.8%) for several years (Figure 3.5.1), accounting for nearly all the expansion in GDP (Figure 3.5.2). Supporting consumption were increases in incomes, stronger prices received for agricultural commodities, a healthy labor market, and stable interest rates. Government consumption also stepped up in the first half.

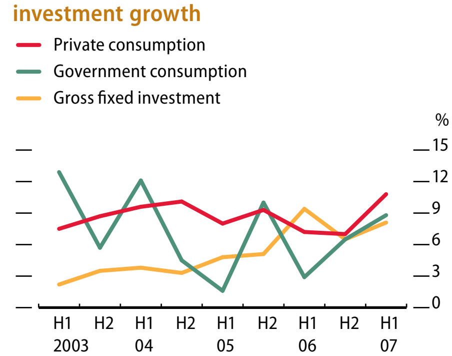
Fixed investment expansion was a robust 8.1%, close to the increased rate posted in 2006, the first year of the Ninth Malaysia Plan (2006–2010), which boosts investment on public infrastructure. Private sector fixed investment showed signs of picking up, with strong sales growth in construction-related materials and in loans to business. Net foreign direct investment (FDI) rose by 54.1% to $1.6 billion in the first 3 months of the year. Total fixed investment added 1.9 percentage points to GDP growth (though this was more than offset by a decline in inventories).

Real exports and imports grew by about 2.5% in the first half, much slower than in recent years, partly a reflection of weaker global demand for electrical goods (including electronic products), one of Malaysia's biggest export industries. Net exports added just 0.4 percentage points to GDP growth.

On the supply side, expansion in the services sector accelerated to nearly 10%, and contributed 4.5 percentage points to total growth in the first half of 2007 (Figure 3.5.3) This sector has grown much faster than industry over recent years as the economic structure has evolved toward a greater emphasis on services. Double-digit growth rates were recorded in three major subsectors: real estate and business services, finance and insurance, and wholesale and retail trade. Services benefited from strong consumption spending and an increase in tourism.

Industrial production, in contrast, grew at a slower rate in the first half (2.4%) than the year-earlier period, and contributed only 1.1 percentage points to GDP growth. Manufacturing slumped and barely stayed in positive territory, at 0.5%, reflecting weaker global demand for electrical products, where output contracted by 5.6% in the first half. Construction, in particular civil engineering, benefited from infrastructure spending under the Ninth Plan and development of oil and

3.5.1 Consumption and gross fixed investment growth



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007.

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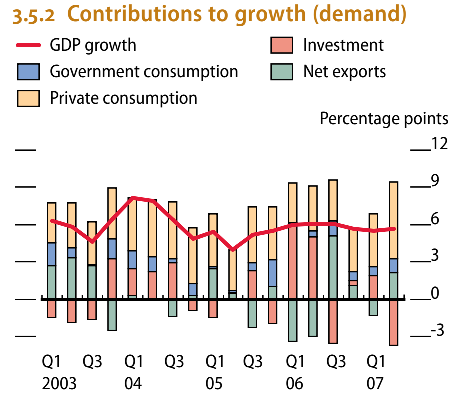
3.5.2 Contributions to growth (demand)



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my; CEIC Data Company Ltd.; both downloaded 30 August 2007.

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natural gas projects. It grew by 4.4%, after shrinking for 3 years in a row. Mining production also switched to a positive outturn, and was up by 3.5%, as oil and gas output picked up. Agriculture grew by just 0.6% in the first half as unfavorable weather reduced palm oil yields.

In the second half of 2007, private consumption will get further support from significant pay increases for about 1 million public sector employees. These came into effect in July, at an annual cost to the Government of more than $2 billion. Investment for the full year will remain underpinned by public infrastructure development. However, net exports will be a drag on aggregate growth. Taking these factors into account, the projection for full-year GDP growth in 2007 is revised up to 5.6% from 5.4% in *ADO 2007*.

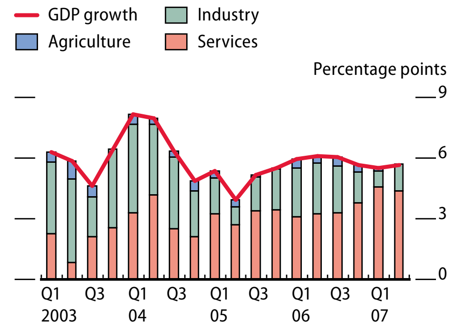
Total government expenditure increased by 25.4% in the first half of 2007 (year on year; Figure 3.5.4), with development spending up by more than double this rate as spending picked up under the Ninth Plan. Public spending is projected to accelerate in the second half of the year, when government outlays usually accelerate. The Government is aiming for a full-year fiscal deficit of 3.2% of GDP, narrower marginally from 3.3% in 2006. Based on an expected rise in petroleum-related revenue, the fiscal target could well be met. Over the longer term, though, reliance on such revenue (oil and gas receipts, including dividends from the national oil company, account for about 35% of total revenues) makes the fiscal position more susceptible to a decline in energy production or prices.

Inflation, at 2.0% on average in the first 7 months of 2007, decelerated from 3.8% in the year-earlier period (Figure 3.5.5). The impact of an 18–24% increase in retail fuel prices in March 2006 subsided, an appreciation of the ringgit helped curb imported price pressures, and the Government maintained price controls on food staples. Although inflation trended down, Bank Negara Malaysia, the central bank, kept its overnight policy interest rate at 3.5%, given buoyant domestic demand and a robust labor market.

Based on lower than expected inflation and the steady stance of monetary policy, the inflation projection for the full year is revised down to 2.5% from 2.7% in *ADO 2007*. Money supply (M2) expanded by 13.3% in January–July year on year, reflecting increases in net foreign assets held by the banking sector and a steady rise in international reserves. The ringgit, after appreciating by 7.0% against the US dollar in 2006, firmed by a further 2.2% by end-July, although it subsequently gave back much of 2007's appreciation, to be 0.8% firmer by end-August, after the global reassessment of risk caused a softening in many currencies. Foreign exchange administration policies were liberalized from April in a move aimed at facilitating development of the financial market and investment in ringgit assets. The changes included greater flexibility in ringgit overdraft facilities for nonresidents and higher limits for residents to invest in foreign currency assets.

The weakness in global demand for electrical goods, which make up about half Malaysia's total merchandise exports, induced a sharp pullback in growth of total merchandise exports to 7.7% in the first half (on a US dollar customs basis) from 13.8% in the year-earlier period. The value of electrical products shipped from Malaysia was virtually flat in US dollar terms in this period. In contrast, exports of agricultural products surged,

3.5.3 Contributions to growth (supply)



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my; CEIC Data Company Ltd.; both downloaded 30 August 2007.

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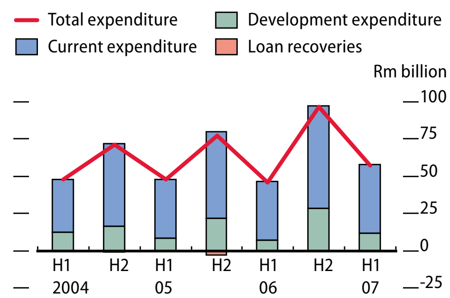
3.5.4 Government finance



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007.

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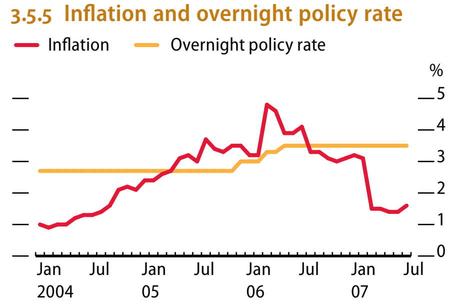
3.5.5 Inflation and overnight policy rate



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007.

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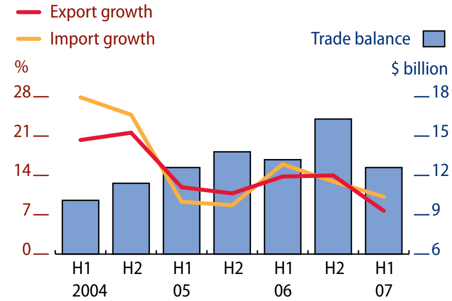
led by palm oil. Prices of this commodity climbed on strong global demand, reinforced by a rise in soybean oil prices as some US producers switched to planting corn for biofuel, and by the fact that India, a major buyer of edible oils, reduced its tariff on palm oil imports.

Merchandise imports rose by 10.2% in the first half in US dollar terms, also slowing from the first half of 2006. Imports of some consumption goods such as food, consumer durables, and medicines rose at a rapid rate, as did imports of intermediate goods. But imports of capital goods rose by just 3.4%. Faster growth in total imports than exports in the first 6 months lowered the trade surplus slightly to $12.6 billion (Figure 3.5.6). Data available for the first quarter show the current account surplus at $5.8 billion, down $2.0 billion from end-2006. For the full year, the current account surplus is projected to decline to a still-substantial 11.9% of GDP (changed from 10.7% in *ADO 2007* because of revisions to 2006 data). International reserves in the first 7 months of 2007 rose to $98.5 billion, equivalent to 8.9 months of retained imports and 8.7 times short-term external debt.

Employment rose by 305,000 in the first quarter from a year earlier, with services generating many of the jobs. This increase was well above that of the labor force (270,000). Consequently, the unemployment rate fell to 3.4% from 3.8% a year earlier, and is expected to decline further by year-end.

3.5.6 Trade indicators



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007.

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Prospects

Robust domestic demand and a projected improvement in exports of electrical goods are expected to sustain the economy's momentum into 2008. Consumer spending will again be the main driver of growth, supported by increases in incomes. Public investment will remain strong as projects are rolled out under the Ninth Plan. These include the Iskandar Development Region, a large logistics and tourism project in southern peninsular Malaysia, and the Northern Corridor Economic Region, involving four states in the north of the peninsula.

Private sector investment is likely to be encouraged by planned cuts in the company income tax rate to 26% in 2008 and 25% in 2009 (the rate was lowered this year to 27% from 28%), by plans to exempt dividend income from tax, and by solid consumer demand expected next year. Regional development projects, such as Iskandar, will involve substantial private sector participation, too. To stimulate real estate development, the Government recently announced tax breaks for property owners and liberalized foreign ownership guidelines, which should have some impact next year.

Net exports are again likely to be a drag on performance, though GDP growth in 2008 is projected at 5.7%, about the average rate recorded over the previous 5 years (Figure 3.5.7) and unchanged from *ADO 2007*.

The Government budget announced in September 2007 puts economic expansion at 6.0–6.5% in 2008, compared with its projection of 6.0% in 2007. The budget projects that growth will accelerate from 2007 levels in agriculture, construction, manufacturing, and oil and gas; and slow only slightly in services from this year's fast pace.

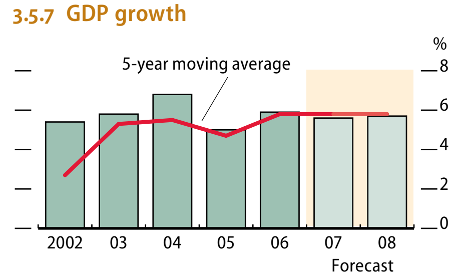
From the production side, manufacturing will gain from the projected

3.5.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	5.4	5.6	5.7	5.7
Inflation	2.7	2.5	2.7	2.5
Current acct. bal. (share of GDP)	10.7	11.9	10.2	11.6

Source: Staff estimates.

3.5.7 GDP growth



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007; staff estimates.

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increase in external demand for electrical products. Construction will continue to benefit from public sector development spending and the incentives for private-sector property development. In agriculture, production is projected to rise for food, natural rubber, and palm oil, encouraged by high prices. Oil and gas will be boosted by completion of maintenance work on oil fields and expansion of capacity.

To maintain development of services, the Government is targeting the financial subsector and tourism for growth. It is providing incentives for further expansion of Islamic financial services, including tax exemptions. Tourism also has strengthened rapidly and is receiving government investment and incentives. Tourist arrivals rose by nearly 25% to 10.7 million in the first half of 2007, spurred by promotion of events celebrating Malaysia's 50th anniversary of independence. Gross earnings from tourism will account for about 7% of GDP this year. The official goal is for 20.1 million tourist arrivals in 2007, rising to 21.5 million next year.

Exports should perform better in 2008 than this year, especially for electrical products, but the US economy, Malaysia's biggest export market, could still be hurt more than anticipated by the housing and financial market problems there. Palm oil and liquefied natural gas exports are seen expanding. Although growth in imports is likely again to outpace that of exports, the higher base of exports is projected to result in a larger merchandise trade surplus. Increased tourism earnings will be offset in the services account by higher payments for transportation and business services.

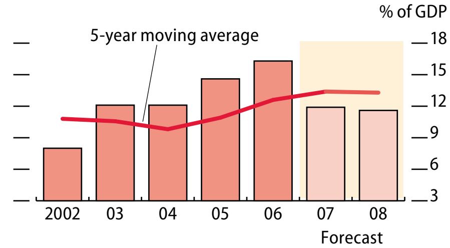
Taking these projections into account, plus likely net outflows in the income and transfers accounts, the current account surplus is forecast to decline as a share of GDP to 11.6% (Figure 3.5.8), revised from 10.2% in *ADO 2007*.

On the fiscal side, the Government is expected to maintain a generally expansionary policy, while gradually reining in the deficit (which has narrowed from 5.5% of GDP in 2000). Despite the impact on revenue of tax breaks announced this year, the authorities aim to limit the budget deficit to 3.1% in 2008.

Inflation next year is forecast to stay at around 2.5% (Figure 3.5.9), trimmed from the *ADO 2007*. This prediction would need to be raised if the Government further phased down fuel subsidies or implemented a goods and services tax (scheduled to start in January this year to replace the sales and services tax, but postponed).

The main risk to the above outlook is a significant slowdown of the US economy, which would hurt exports. The external account surplus would be smaller and GDP growth would be weaker in this scenario. Given that consumption is expected to be a driver, an acceleration in inflation could erode consumer spending and therefore GDP growth. The Ninth Plan targets 6% average annual GDP growth for 2006–2010, to be achieved in part by moving the economy up the value-added chain in manufacturing and services. The outcome could fall short of target if further gains are not made in building workforce skills and in enhancing the investment climate.

3.5.8 Current account balance



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007; staff estimates.

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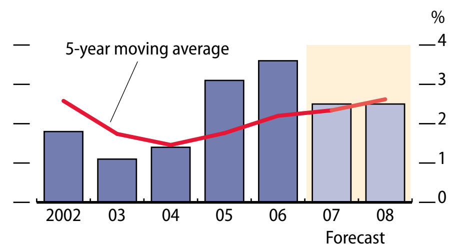
3.5.9 Inflation



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007; staff estimates.

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