Malaysia

Consumption spending produced a pickup in growth in 2006. Private and public investment also strengthened with support from the Ninth Malaysia Plan. Growth is projected to slow by about a half percentage point in 2007 as export markets soften and both household spending and private investment decelerate. Higher government investment is expected over the Ninth Plan period as the Government encourages firms to climb the value chain, but constraints such as gaps in skills will need to be overcome for private investment to follow.

Economic performance

The economy grew by 5.9% in 2006, largely because of robust consumer spending (Figure 2.24.1). Private consumption continued to be a driver, rising by 7.0% and accounting for 3.5 percentage points of total growth. Last year was the fourth in a row that private consumption rose faster than GDP. Low, though rising, interest rates and favorable terms of trade for agricultural exports such as natural rubber (raising rural incomes), supported household spending.

Strong consumer spending encouraged business investment, which helped push growth in private fixed capital investment to 11.1% in 2006. Higher business confidence also stemmed from several years of robust exports and expectations of higher government spending following publication of the Ninth Malaysia Plan (2006–2010), which commits the Government to large development programs over the 5 years (Box 2.24.1 below). In the first year, public investment rose by 5.4% after much weaker spending in previous years. Total investment (including changes in inventories) contributed 1.7 percentage points of GDP growth.

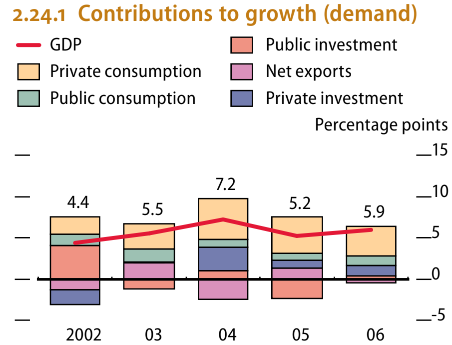
On the production side, agriculture represents less than 10% of GDP, but is important for rural incomes and for exports, and as a basis for large and growing agroindustry subsectors. Growth in 2006 of 6.4% (Figure 2.24.2) represented a longer-term supply response to high international prices for crops, such as rubber and palm oil, and better weather than seen in 2005.

Industrial output rose by 5.3% in 2006, but this masks a combination of strong manufacturing growth (up 7.0%) with continued weaknesses in mining (down 0.2%) and construction (down 0.5%). Mining, at 6–7% of GDP, consists mainly of oil and natural gas production. Output of hydrocarbons in 2006 was hindered by shutdowns of production facilities for scheduled maintenance.

Construction contracted for a third year in a row, although it appeared to be stabilizing during 2006, perhaps in response to the startup of Ninth Plan projects. Manufacturing makes up a third of the economy and has been growing rapidly, supported by export-oriented sectors including electrical and electronic products.

Services account for more than half the economy and grew by 6.6% in

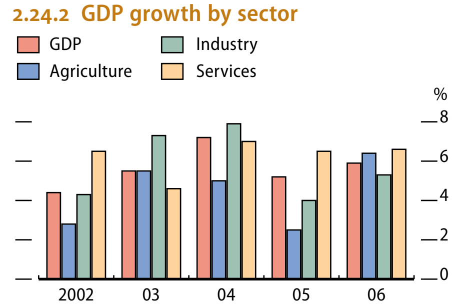
2.24.1 Contributions to growth (demand)



Sources: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007; staff estimates.

Click here for figure data

2.24.2 GDP growth by sector



Source: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007.

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2006, paced by finance- and trade-related businesses. Total employment rose by 2.5% in 2006 and the unemployment rate steadied at 3.4%.

Pushed by higher international energy prices, consumer prices rose by 3.6% in 2006 after 3.0% in 2005. Inflation peaked in the first half of the year after hikes of 18–24% in administered retail fuel prices in February 2006. (Malaysia is a net exporter of oil and gas and the Government subsidizes retail energy.) Before the sharp price rises in February, retail diesel and gasoline prices were little different from the equivalent costs of crude oil, with production and distribution costs subsidized. After the price rises, the remaining subsidies were estimated to be equivalent to 28% of average retail prices and totaled roughly RM19 billion, or about 14% of federal government spending. Cost pressures, while slower in the second half of 2006, were still apparent later in the year, as, for instance, electricity prices were hoisted in June by an average of 12%, depending on the category of user.

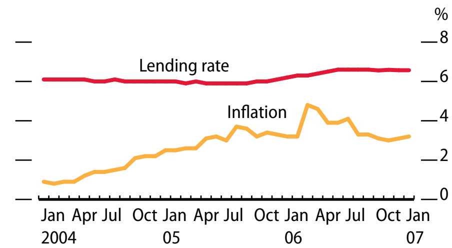
The inflationary pressures prompted increases in interest rates, although monetary policy remains broadly accommodating to growth. Bank Negara Malaysia, the central bank, raised its overnight policy rate from 2.7% to 3.5% in three separate actions between November 2005 and April 2006, and has kept it unchanged since. Lending interest rates have been above comparable inflation rates (Figure 2.24.3). The rise in the overnight policy rate lifted most short-term deposit rates so they were narrowly positive in real terms as inflation moderated. In 2006, broad money (M2) rose by 16.6%, little different from 2005 (Figure 2.24.4).

Malaysia's decision in mid-2005 to move off the fixed peg for the ringgit allowed some flexibility in monetary policy in 2006. The ringgit appreciated by 7.0% from the start of 2006 to year-end against the US dollar. This was somewhat more than the movement of the yuan, but it was less than for other Southeast Asian currencies. The smooth shift to a managed float from a US dollar peg and the steady appreciation relative to the US dollar have enhanced the credibility of the monetary authorities and reduced market concerns of sudden currency revaluations.

Fiscal policy has balanced meeting a longer-term goal of cutting government borrowing with a more immediate concern of encouraging growth. The fiscal deficit has been lowered from above 5% of GDP in the early part of this decade to 2.6% in 2006. As a net hydrocarbons exporter, high international energy prices provide a cushion for government spending. In 2006, a $1 per barrel rise in the price of crude oil corresponded to RM228 million ($62 million) higher oil-related revenues. Such revenues represented 37% of central government income; however, remaining retail fuel subsidies could absorb up to one quarter of these receipts.

The external sector lowered GDP growth by 0.4 percentage points in 2006 because growth of imports (in dollar terms) at 24.5% outpaced that of exports of 16.9% (Figure 2.24.5). Total exports still exceeded imports, supported by strong growth in electronic and electrical goods (constituting about half of merchandise exports) and rising prices for oil, gas, and some agriculture products. Imports are linked closely to exports, with intermediate imports making up about 70% of the total. These imports grew apace with exports, while imports for consumer goods grew faster, responding to strong household demand.

2.24.3 Lending rate and inflation



Note: Lending rate is the average for commercial banks.
Source: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007.
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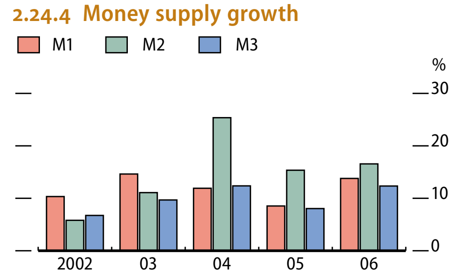
2.24.4 Money supply growth



Source: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007.
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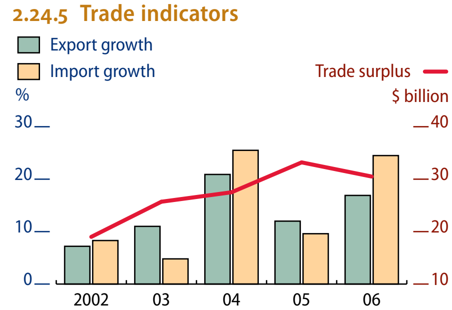
2.24.5 Trade indicators



Sources: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007; staff estimates.
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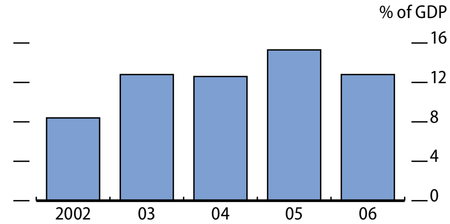
Owing to the smaller merchandise trade surplus, the current account surplus fell slightly to $19.6 billion or 12.8% of GDP (Figure 2.24.6). The deficit on net services exports widened a little. International reserves climbed to $82.2 billion, equivalent to seven times external debt falling due within 12 months.

2.24.6 Current account balance



Sources: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007; staff estimates.

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Economic prospects

The economy is projected to grow by 5.4% in 2007, a half percentage point slower than in 2006, based on the assumption that the external environment will be less supportive. Likely continued moderate appreciation of the ringgit (similar to the appreciation against the US dollar in 2006) will also diminish gains from exports in dollar-denominated markets. The deceleration in export growth will, however, also lower import demand (for intermediate products), mitigating the larger impact on the domestic economy.

Although prices for export commodities might soften, they will likely still be stronger than expected a few years ago, and current expectations are for commodity prices to stay high enough to merit new investment in oil and gas projects as well as rubber and palm oil (Figure 2.24.7). Overall, real private investment is expected to expand at a more moderate 7.7% pace in 2007 compared with 2006. Investment by the public sector, though, is forecast to pick up, encouraged by the Ninth Plan.

Surveys late in 2006 suggested rising consumer confidence, in line with growing incomes and receding inflation. Consequently, private consumption spending will continue to support growth, but not as strongly as in recent years as trends in expenditure move back in line with the larger pattern of national income growth. This slowing in household spending, an assumed moderate appreciation of the ringgit against the US dollar, and lower global oil prices than in 2006, point to inflation decelerating to about 2.7% in 2007.

2.24.1 Selected economic indicators

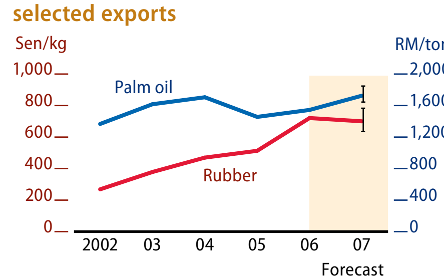
	2007	2008
GDP growth	5.4	5.7
Inflation	2.7	2.7
Current account balance (% of GDP)	10.7	10.2

Source: Staff estimates.

The growth of monetary aggregates stepped up in the second half of 2006, so for the monetary authorities it will be important to carefully balance accommodating growth with discouraging any buildup of inflationary expectations. Pressure on the ringgit to appreciate, manifested especially in the buildup of foreign reserves, complicate this balancing act.

By industry, construction is expected to expand as a result of increased investment, especially by the public sector. House construction may soften though, because approvals for housing trended down last year. Mining (largely oil and gas) is set to expand as projects started earlier come on stream. Manufacturing and services will show some slowdown in output growth, especially in segments that rely on overseas trade. Agriculture will benefit from continuing opportunities to supply products such as rubber and palm oil to export markets, but also from structural changes, such as the growing role of supermarket supply chains that can better link higher value-added urban markets to farms.

2.24.7 Price movements of selected exports



Note: Vertical bars indicate the range of price forecasts for 2007.

Sources: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007; staff estimates.

Click here for figure data

The policy of gradual fiscal consolidation is likely to be maintained, but will be balanced against the interest of ensuring that the Ninth Plan's investment programs are undertaken. Financing the Government's broader development agenda is helped by large surpluses run by

government-linked companies such as the oil firm Petronas. However, the projects that make up the plan will test the capacity of government administrators both to initiate and implement them expeditiously.

The importance of government investment spending to the forecast highlights the domestic risks to the projections: meeting the Ninth Plan's investment agenda is crucial to ensuring that growing business and household confidence is warranted. Maintaining momentum in economic activity will also be important to reduce the impact of possible negative economic shocks such as could come from avian flu or weather-related problems, as seen in floods that swept the state of Johor in late 2006 and early 2007.

Development challenges

Malaysia is a middle-income country attempting to ensure more rapid, sustained growth and job creation. The Ninth Plan sets an ambitious tone. One focus of the plan—moving up the value-added ladder of manufacturing industries and services—is well articulated, and firms will get encouragement from the Government to enter the fields of biotechnology and of information and communications technology. Some firms have experience in world markets for electronic and electrical goods that should help them expand into these new fields.

It will be a challenge for Malaysia to build the workforce skills that enable it to forge world-class firms in these new areas. The Ninth Plan proposes to revamp the education system. An important role is seen for the private sector, in providing educational services and in linking education curricula with the needs of employers. This will be a long-term endeavor; in the medium term the success of the move into new industries is likely to depend on how well domestic firms partner with foreign firms.

In many respects, the country is well placed to attract business partnerships and investment. It scores better than many others in Southeast Asia in international rankings on the availability of infrastructure services and on the issue of corruption.

But the performance on generating investment has been patchy. During 2000–2006, in real terms private investment accounted for 12.0% of GDP (9.4% in nominal terms), much lower than the 35–36% prior to the 1997/98 Asian financial crisis. One key to encouraging a sustainable increase in investment levels will be improving the performance of government-linked companies, which span a wide range of sectors in the economy, dominating some fields and accounting for more than one third of the domestic stock market capitalization. Efforts have been made to improve management and governance at such companies, but much of the essential market structure of sectors they dominate is unchanged.

More broadly, surveys show that firms say they face a restrictive regulatory environment, especially in the services sectors. Liberalization of the services sector, which is on the agenda of the Association of Southeast Asian Nations (ASEAN), would help ensure that Malaysia meets its target of encouraging growth in high technology industries.

2.24.1 Ninth Malaysia Plan

The Ninth Malaysia Plan, issued in 2006, reiterates an official target to lift the economy to "developed nation" status by 2020. It lists specific poverty targets, such as halving the overall rate and eliminating severe poverty by 2010. It also sets ambitious, but not unrealistic, economic targets. Its 6% average annual GDP growth target for 2006–2010 would mean bettering the record of the past half-decade, but by less than 0.5 percentage points a year.

The plan sets the tone for government policies, including:

- An emphasis on government investment to provide infrastructure, support domestic demand, and encourage private investment. The projects providing for the Iskandar Development Region next to Singapore, for instance, encourage private firms to exploit synergies between the two countries, already one of the most successful examples in ASEAN of production sharing and trade.
- Actions to assist firms compete internationally. Thus the Government is encouraging a consolidation of palm-oil plantations into the world's largest listed palm-oil plantation enterprise controlling 600,000 hectares. This should enhance potential for internal productivity gains.
- Continuing financial sector strengthening. In early 2006, a restructuring of the large banking groups was nearly complete, allowing banks to meet more stringent capital requirements. The banking system's net nonperforming loans fell to 4.8% of all loans, from 5.8% in 2005.
- Support to sectors that might have a comparative advantage. Recent liberalization in finance, for instance, was aimed especially at encouraging issuance of Sharia-consistent instruments to strengthen Islamic finance. Assets of Islamic banking institutions made up 11.8% of all assets in mid-2006, and 47% of all outstanding bonds in September 2006 were Sharia compliant.