Malaysia

Growth moderated in 2005 as external demand weakened for electronic products, though the industry recovered later in the year and is expected to improve further in 2006, helping lift overall economic activity. Inflationary pressures are likely to persist, prompting further increases in interest rates. On the policy front, fiscal consolidation will continue while monetary policy, despite rate rises, will remain accommodative. Over the medium term, among the constraints to stronger growth is a falling investment rate.

Economic performance

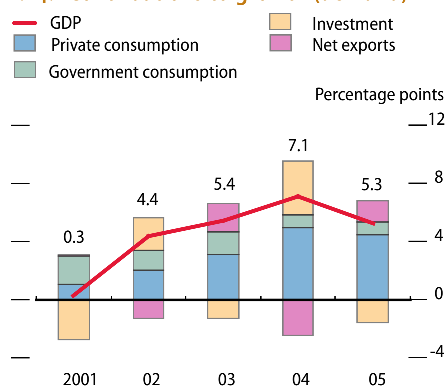
The economy expanded by 5.3% in 2005, in line with the 5-year average, but down by nearly 2 percentage points from 2004 mainly because of weaker external demand for the country's electronic products. For the third year running, private consumption was the main contributor, at 4.5 percentage points, to growth in gross domestic product (GDP) (Figure 2.24.1). It was helped by low interest rates and easy access to credit, and by firm commodity prices that lifted rural incomes. Net exports contributed 1.5 percentage points to GDP growth. Investment, in contrast, detracted from growth. Public investment fell as the Government narrowed its fiscal deficit, while slower growth in exports damped private investment.

On the supply side, the services sector continued to grow briskly, boosted by spending of households and foreign tourists, and by new areas of growth such as outsourcing of business services. Services contributed 3.3 percentage points to growth, a second consecutive year of strong input (Figure 2.24.2). The industry sector, dragged down by weaker export demand for electronic goods (which make up about half of all export earnings), contributed 1.8 percentage points to growth, the lowest level since the global technology bust in 2001. The contribution of agriculture was 0.2 percentage point, with growth mainly in palm oil production.

Consumer inflation accelerated to a 6-year high of 3.0% last year, after 5 years when inflation averaged just 1.5%. Much of the rise was the result of fiscal policy decisions—reductions in fuel subsidies, higher duties on cigarettes and liquor, and increased highway toll charges. The administered retail price of gasoline was raised by 14% and of diesel by 42% over the year. These increases filtered through the supply chain, as indicated by a rise in core inflation. In the labor market, the rate of increase in employment roughly matched that of the workforce, and the unemployment rate remained at 3.5% (Figure 2.24.3).

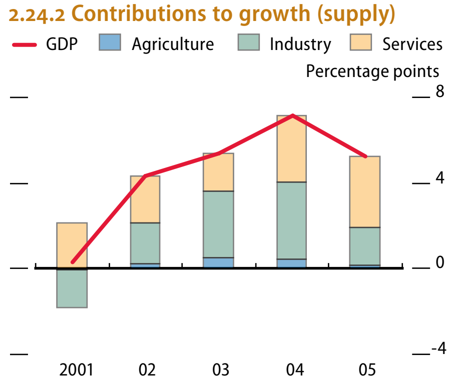
Two key changes in monetary policy were made in 2005: adoption of a managed currency float against a basket of currencies in July, ending the peg of the ringgit (RM) against the United States (US) dollar; and the

2.24.1 Contributions to growth (demand)



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my/index.php?ch=109&pg=294&mth=12&yr=2005, downloaded 2 February 2006.

2.24.2 Contributions to growth (supply)



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my/index.php?ch=109&pg=294&mth=12&yr=2005, downloaded 2 February 2006.

raising of interest rates for the first time in 7 years. In the context of the stronger inflationary pressures, Bank Negara Malaysia, the central bank, sent a signal in November that the interest-rate cycle had turned when it raised the benchmark overnight policy rate by 30 basis points to 3.0%, which is still low by international comparisons. The rate increase also started to close a widening differential between Malaysian and US interest rates. Negative real rates, along with a lethargic Malaysian stock market and only a slow appreciation of the ringgit, prompted capital outflows that led to a near $10 billion decline in foreign reserves in the fourth quarter of 2005 (Figure 2.24.4). Reserves for the full year continued their upward trend, though.

The Government, adhering to fiscal consolidation, reined in the fiscal deficit to 3.8% of GDP in 2005, a third consecutive year of narrowing deficits (Figure 2.24.5). Total outstanding federal government debt also came down, to 46.2% of GDP at end-2005, reversing an uptrend since 2001.

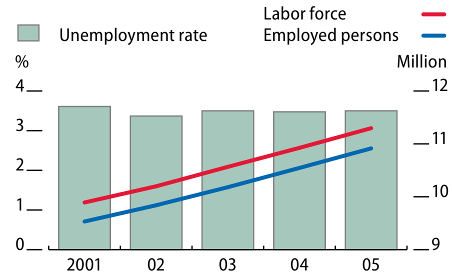
Malaysia, a net oil exporter, benefits from higher global oil prices, though the trade-dependent economy is also vulnerable to secondary effects if those higher oil prices erode global economic growth. The Government provides large subsidies for fuel consumption: direct subsidies cost RM7.4 billion last year (up from RM4.8 billion in 2004), and tax exemptions on fuel cost an additional RM7.9 billion in forgone revenues. This was offset by higher petroleum income tax receipts and royalty payments. As subsidies are phased down, the fiscal position will be strengthened.

A goods and services tax (GST) scheduled to start in January 2007 to replace the current sales and service tax has been postponed to a date that has not yet been set. More time is needed to refine the GST model and for businesses to prepare for it. The introduction of the GST should help improve tax compliance and provide room for personal and corporate taxes to be lowered without reducing government revenue.

Export growth slowed in 2005, but imports decelerated even more abruptly, generating a bigger trade surplus (Figure 2.24.6). This led to a surge in the current account surplus to $20.5 billion, or 15.7% of GDP. The large surplus was also reflected in an excess of savings over investment. A lack of enthusiasm among companies to increase investment remains a concern for policy makers. The investment rate has been declining for 5 years, reaching 20.7% of gross national product in 2005. Malaysia's investment potential has been dented both by its displacement as a low-cost manufacturing center and by the slow progress that domestic firms have made in climbing the value-added ladder. Still, gross foreign direct investment inflows rose by 6.4% in 2005.

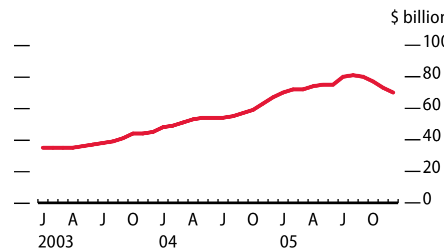
Domestically, a lack of business opportunities caused in part by the dominance of state enterprises in several sectors, and—for some firms—limited access to capital because of tough collateral requirements and frail balance sheets, were other restraining factors on investment. The overall balance of payments remained in surplus and external debt as a share of GDP continued to nudge lower. The ringgit appreciated very slightly after the move to the managed float, indicating limited impact of the basket mechanism, notwithstanding the substantial current account surplus.

2.24.3 Labor indicators



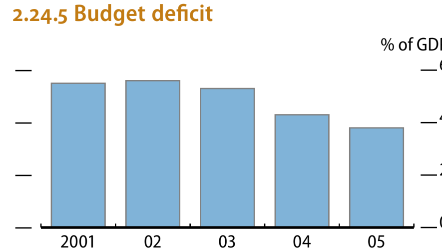
Sources: Department of Statistics, available: http://www.statistics.gov.my/english/frameset_keystats.php; *Asian Development Outlook* database.

2.24.4 Gross international reserves



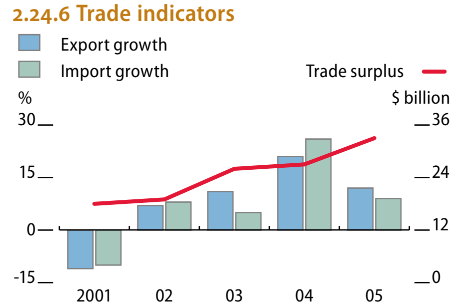
Source: Bank Negara Malaysia, available: http://www.bnm.gov.my/index.php?ch=109&pg=294&mth=1&yr=2006, downloaded 28 February 2006.

2.24.5 Budget deficit



Source: Treasury Malaysia, available: http://www.treasury.gov.my/index.php?ch=22&pg=165&ac=1402&lang=eng, downloaded 2 February 2006.

2.24.6 Trade indicators



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my/index.php?ch=109&pg=294&mth=12&yr=2005, downloaded 24 March 2006.

Economic outlook

Prospects for 2006 and 2007

Assuming that fiscal policy continues to consolidate and that monetary policy is accommodative, the economy is likely to sustain its growth momentum, expanding by 5.5% this year and 5.8% next year (Figure 2.24.7). Forward-looking indicators, such as the leading composite index and the US new orders index, which generally lead Malaysia's business activity by some 6 months, suggest stronger growth. Robust growth in the People's Republic of China and the US, plus a strengthening in global electronics demand, is assisting manufacturing. Domestically, robust consumer spending, an expected pickup in private investment, and higher government expenditure related to the start of the Ninth Malaysia Plan (2006–2010) will all provide further support. Private investment should be spurred by improving electronics exports (Figure 2.24.8) and higher government development spending. This forecast is supported by an 8% rise in planned manufacturing investment approved in 2005 by the Ministry of International Trade and Industry.

Some moderation is likely in consumption expenditure after 2 years of rapid growth, given that interest rates could edge up at a time that household debt has increased, to 61.5% of GDP. Moreover, consumers are sensitive to inflation, which is forecast to average around 3.5% in 2006, the highest rate in 7 years (Figure 2.24.9). The Government raised the price of gasoline, diesel, and liquefied petroleum gas by about 20% in February. This move, and an expected lift in electricity charges, will maintain upward pressure on inflation. (The price of unleaded gasoline is now RM1.92 a liter, still subsidized by about RM0.54 a liter.)

On the supply side, manufacturing and services will remain the engines of growth. Manufacturing output is projected to scale up by 5.5% in 2006, buttressed by the recovery in external demand for electronics. The services sector, which accounts for about half of the economy, is forecast to grow by 6.6%, underpinned by continued buoyant consumption and an increase in business activity. Agricultural growth is likely to decelerate because of expected lower production of palm oil after a bumper harvest in 2005. Mining, though, will be bolstered by new oil and gas fields coming on stream. Construction is expected to post a mild recovery in 2006, with new infrastructure projects under the Ninth Malaysia Plan outweighing a moderate slowdown in residential construction.

A higher allocation for development outlays in the 2006 budget, announced in September 2005, and implementation of new projects under the Ninth Malaysia Plan will lead to modestly higher growth in public investment. This is not expected to affect fiscal consolidation because aggressive tax collection, higher revenue from oil production, and reduced fuel subsidies provide room for the extra spending. Hence the target of reducing the fiscal deficit to 3.5% of GDP in 2006 and to 3.0% in 2007 looks achievable. The challenge for fiscal policy is to gradually shrink the deficit without derailing economic growth.

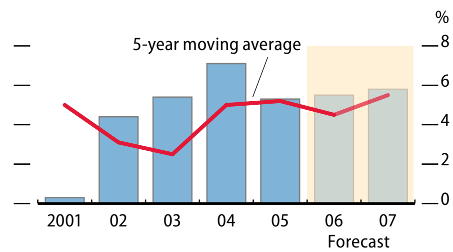
Stronger investment and still-robust growth in consumer spending will result in a higher growth rate of imports than exports (despite the increase in electronics shipments), although the trade surplus in dollar

2.24.1 Selected economic indicators

	2006	2007
GDP growth	5.5	5.8
Inflation	3.5	3.3
Current account balance (% of GDP)	13.0	11.2

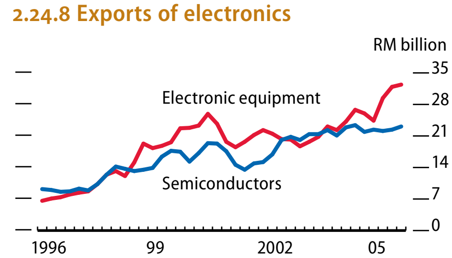
Source: Staff estimates.

2.24.7 GDP growth



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my/index.php?ch=109&pg=294&mth=12&yr=2005, downloaded 1 March 2006; staff estimates.

2.24.8 Exports of electronics



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my/index.php?ch=109&pg=294&mth=1&yr=2006, downloaded 11 March 2006.

terms will be little changed. The current account surplus will decline, but remain substantial at $19.4 billion (Figure 2.24.10) or about 13% of GDP. The ringgit exchange rate, which strengthened by 2.6% in the 8 months after the managed float was adopted in July, is expected to appreciate (Figure 2.24.11) further, supported by rising interest rates. Bank Negara Malaysia, which raised the overnight policy rate by a further 25 basis points to 3.25% early this year, has room to raise interest rates still further to combat inflation and to maintain positive rates.

Medium-term outlook

Over the period 2006–2010, annual economic growth is expected to average 5.5%, given the low investment rate. The Government has a strategy to diversify sources of growth, which involves a transition toward a more services-oriented economy (Box 2.24.1). Health, tourism, retailing, information and communications technology, transport, and education are all targeted as important sources of future growth, as the industry sector becomes relatively less important. The official Vision 2020 plan, which aims to raise Malaysia to developed-nation status by the end of the next decade, has a more optimistic 7.0% growth rate target.

Growth in the past has been driven primarily by the accumulation of physical capital. However, since there is now more competition

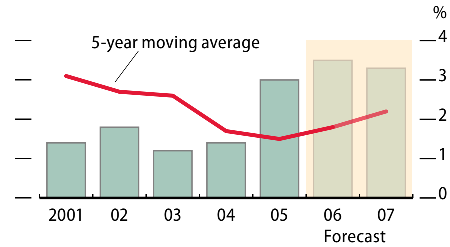
2.24.1 Foreign participation in services

Malaysia is opening parts of its services sector to greater foreign participation, though significant barriers are still in place, limiting the growth of services. Foreign participation in many services is already allowed, but the level of market access is subject to conditions. Most services firms involving foreigners are joint ventures where foreign ownership is capped at 30%. Professional services have restrictions on foreign participants and foreign certification is seldom recognized. For example, lawyers are required to be Malaysian citizens or permanent residents (as are accountants wanting a license to practice) and to pass a Malay-language exam (unless exempted). Foreign law firms are barred from operating in Malaysia (except in the special enclave of Labuan). Foreign accounting firms can provide accounting and tax services only through affiliates.

While foreign banks outnumber local banks, their market share is much smaller. This is partly because foreign institutions are restricted in the number of branches and automated teller machines they can operate, but plans are afoot to liberalize the banking sector by 2007. In preparation, the Government is encouraging mergers among domestic banks, and Bank Negara Malaysia has raised the minimum capital requirements to strengthen local banks. Already, the 71 domestic banks operating before the Asian crisis have merged into 10 groups.

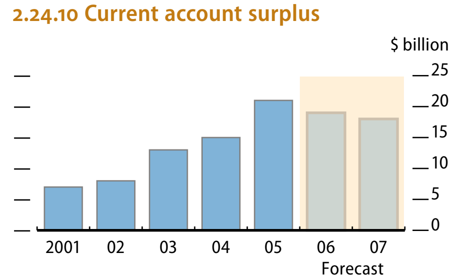
In telecommunications, several foreign companies have been licensed, but Telekom Malaysia remains the dominant provider of fixed-line services. The number of licenses for mobile phone services is restricted and the foreign equity stake generally is limited to 30%. In insurance, where foreign companies play a major role, and especially in life assurance, branches of foreign firms are required to incorporate in Malaysia. A cap on foreign ownership is also in force.

2.24.9 Inflation



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my/index.php?ch=109&pg=294&mth=12&yr=2005, downloaded 2 February 2006; staff estimates.

2.24.10 Current account surplus



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my/index.php?ch=109&pg=294&mth=12&yr=2005, downloaded 2 February 2006; staff estimates.

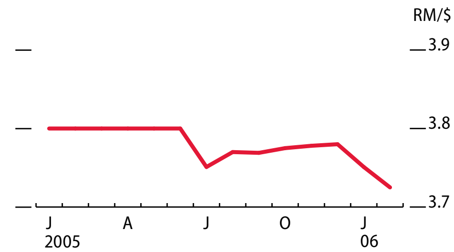
internationally to attract manufacturing on the basis of low cost, sustaining a high level of growth will require a shift to growth led by enhancing productivity. This will entail both moving up the value-added chain into new areas of competitive advantage and developing new products and services. Labor skills must therefore be improved and much greater support for technical innovation and entrepreneurship offered, though the Government has already invested heavily in information technology infrastructure, such as digital fiber-optic networks, industrial parks, and computer laboratories in schools. However, policies, regulations, institutions, and skills are likely to determine the degree to which new industries take root. Grants and tax breaks are provided to encourage research and development activity and skills training.

There are concerns, though, about how effectively the education and training systems can produce the skills and knowledge needed to assure the transition to a more technology-oriented and innovative economy. Malaysia's enrollment performance in tertiary education does not match that of some newly industrialized economies. Schools, as in many other countries, are characterized by rote learning, excessive pressure to pass exams, and an emphasis on uniformity, while the transition to new industries and services will require creativity, risk taking, entrepreneurship, and adaptability. Such attributes would more likely stem from an education system that promotes problem-solving skills, communication, and teamwork.

The planned transition will also require language skills. Malaysia had an advantage in this area with a relatively high standard of English in the past, though recent years have seen some slippage. The Government, among others, has recognized the need to improve the standard of English as a national priority, and has decided that all primary schools should teach mathematics and science in the English language. Other developments that would facilitate the development of technology and services industries include a further opening of the economy to foreign competition—which should encourage innovation, investment in new technology, and entrepreneurial capacity—as well as enhanced protection of intellectual property rights.

Domestic risks to the economic forecasts in the near term include the possibility of higher inflation and of avian flu. The unexpectedly sharp February hike in fuel prices and an anticipated increase in electricity charges could keep inflationary expectations high, triggering a sharper rise in interest rates than these forecasts assume and undermining consumer confidence and spending. With regard to avian flu, Malaysia may be particularly vulnerable if an international human epidemic were to occur because its economy depends heavily on external demand, despite the growing role of domestic consumption, and has a substantial tourism industry.

2.24.11 Nominal exchange rate



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my/index.php?ch=12, downloaded 8 March 2006.