INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/101

MALAYSIA

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE AUTHORITIES OF MALAYSIA

April 2017

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with Malaysia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its March 15, 2017 consultation with Malaysia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 15, 2017, following discussions that ended on December 15, 2016, with the officials of Malaysia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 28, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Authorities** of Malaysia.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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International Monetary Fund
Washington, D.C.

Press Release No. 17/143
FOR IMMEDIATE RELEASE
April 28, 2017

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with Malaysia

On March 15, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Malaysia.

Despite a challenging global economic environment, the Malaysian economy performed well over the past few years. Notwithstanding the impact of the global commodity price and financial markets volatility, the economy remained resilient, owing to a diversified production and export base; strong balance sheet positions; a flexible exchange rate; responsive macroeconomic policies; and deep financial markets. While real GDP growth slowed down, Malaysia is still among the fastest growing economies among peers. The challenging global macroeconomic and financial environment puts premium on continued diligence and requires careful calibration of policies going forward.

Risks to the outlook are tilted to the downside, originating from both external and domestic sources. *External risks* include structurally weak growth in advanced and emerging market economies and retreat from cross-border integration. Although the Malaysian economy has adjusted well to lower global oil prices, sustained low commodity prices would add to the challenge of achieving medium-term fiscal targets. Heightened global financial stress and associated capital flows could affect the economy. *Domestic risks* are primarily related to public sector and household debt, along with pockets of vulnerabilities in the corporate sector. Federal debt and contingent liabilities are relatively high, limiting policy space to respond to shocks. Although the household debt-to-GDP ratio is likely to decline, household debt also remains high, with debt servicing capacity growing only moderately.

Real GDP growth rate is expected to increase moderately to 4.5 percent year-on-year (y/y) in 2017 from 4.2 percent in 2016. Domestic demand, led by private consumption, continue to be the main driver of growth, while a drag from net exports, similar to 2016, will remain. Consumer price

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

inflation is projected to rise and average 2.7 percent y/y in 2017 on the back of higher global oil prices and the rationalization of subsidies on cooking oil. The current account surplus would be largely unchanged as impacts from an improved global outlook and higher commodity prices would be offset by the strength of imports on the back of a resilient domestic demand.

Executive Board Assessment[2]

Executive Directors commended the resilience of the Malaysian economy, which reflects sound macroeconomic policy responses in the face of significant headwinds and risks. While Malaysia's economic growth is expected to continue in 2017, weaker-than-expected growth in key advanced and emerging economies or a global retreat from cross-border integration could weigh on the domestic economy. Against this background, Directors urged vigilance and continued efforts to strengthen policy buffers and boost long-term economic growth.

Directors agreed that the authorities' medium-term fiscal policy is well anchored on achieving a near-balanced federal budget by 2020. The planned consolidation will help alleviate risks from elevated government debt levels and contingent liabilities and build fiscal space for future expansionary policy, as needed. Directors recommended that the pace of consolidation reflect economic conditions and that any counter-cyclical fiscal policy measures be well-targeted and temporary. They noted that improvements to the fiscal framework, such as elaborating medium-term projections and preparing and publishing an annual fiscal risks statement, would help anchor medium-term fiscal adjustment and mitigate risks.

Directors agreed that the current monetary policy stance is appropriate. Going forward, Bank Negara Malaysia (BNM) should continue to carefully calibrate monetary policy to support growth while being mindful of financial conditions. Directors emphasized that global financial market conditions could affect the monetary policy space and should be carefully monitored.

Directors noted that the banking sector is sound overall and that financial sector risks appear contained. Nonetheless, they cautioned that potential pockets of vulnerability should be closely monitored. They noted that household debt remains relatively high, while in the corporate sector, there are emerging vulnerabilities in some sectors. Directors suggested that macroprudential measures be adjusted if needed.

Directors underscored the central role of macroeconomic policy and exchange rate flexibility in helping the economy adjust to external shocks. In this regard, they welcomed the authorities' commitment to keeping the exchange rate as the key shock absorber. They recommended that reserves be accumulated as opportunities arise and deployed in the event of disorderly market conditions. Noting the authorities' aim to improve the functioning of the onshore forward foreign exchange market, Directors urged the BNM to monitor the effects of the recent measures

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

introduced in this regard, recognizing their benefits and costs. They emphasized that close consultation and communication by BNM with market participants will be essential in further developing the foreign exchange market and bolstering resilience.

Directors underscored that steadfast implementation of the authorities' ambitious structural reform agenda is key to boosting long-term economic potential. They supported the emphasis on increasing female labor force participation, improving the quality of education, lowering skills mismatch, boosting productivity growth, encouraging research and innovation, and upholding high standards of governance.

Table 1. Malaysia: Selected Economic and Financial Indicators, 2012–18

Nominal GDP (2016 est.): US$296.4 billion | Population (2016): 31.7 million
GDP per capita (2016, current prices): US$9,360 | Poverty rate (2014, national poverty line): 0.6 percent
Unemployment rate (2016): 3.5 percent | Adult literacy rate (2015): 94.6 percent
Main exports (share in total goods exports): electrical & electronic products (39 percent), and commodities (23 percent)

					Est.	Proj.	
	2012	2013	2014	2015	2016	2017	2018
Real GDP (percent change)	5.5	4.7	6.0	5.0	4.2	4.5	4.7
Total domestic demand	10.6	6.3	5.3	5.9	4.8	5.1	5.1
Private consumption	8.3	7.2	7.0	6.0	6.1	6.2	6.0
Public consumption	5.4	5.8	4.3	4.4	1.0	4.7	2.9
Private investment	21.4	12.8	11.1	6.4	4.4	5.3	5.4
Public gross fixed capital formation	15.9	1.8	-4.7	-1.0	-0.5	1.0	1.9
Net exports (contribution to growth)	-3.6	-1.0	1.2	-0.4	-0.2	-0.2	0.0
Saving and investment (in percent of GDP)							
Gross domestic investment	25.7	25.9	25.0	25.1	26.1	25.5	25.3
Gross national saving	30.9	29.4	29.4	28.1	28.1	27.3	27.1
Fiscal sector (in percent of GDP)							
Federal government overall balance 1/	-5.1	-4.2	-3.4	-3.2	-3.1	-3.0	-2.7
Revenue	20.7	20.4	19.9	18.9	17.3	16.6	16.6
Expenditure and net lending	25.7	24.6	23.3	22.1	20.4	19.6	19.3
Federal government non-oil primary balance	-10.3	-8.7	-7.3	-5.2	-3.4	-3.3	-2.7
Consolidated public sector overall balance 2/	-5.6	-6.0	-7.4	-7.8	-7.2	-6.4	-5.6
General government debt 3/	54.6	56.4	56.2	57.9	56.3	56.0	54.9
Of which: federal government debt	51.6	53.0	52.7	54.5	52.7	52.5	51.4
Inflation and unemployment (period average, in percent)							
CPI inflation	1.7	2.1	3.1	2.1	2.1	2.7	2.9
Unemployment rate	3.0	3.1	2.9	3.1	3.5	3.4	3.2
Macrofinancial variables (end of period)							
Broad money (percentage change) 4/	8.8	7.4	6.3	3.0	2.7	3.3	4.1
Credit to private sector (percentage change) 4/ 5/	12.1	10.2	9.2	8.6	5.2	5.9	6.5
Credit-to-GDP ratio (in percent) 4/ 6/	123.6	129.7	130.1	134.8	134.1	131.9	130.3
Credit-to-GDP gap (in percent) 4/ 6/ 7/	13.5	15.7	12.7	13.5	9.4	…	…
Overnight policy rate (in percent) 4/	3.00	3.00	3.25	3.25	3.00	…	…
Three-month interbank rate (in percent) 4/	3.2	3.2	3.9	3.8	3.4	…	…
Nonfinancial corporate sector debt (in percent of GDP)	98.0	100.2	96.2	102.0	101.5	99.4	97.9
Nonfinancial corporate sector debt issuance (in percent of GDP) 4/	4.7	3.5	3.2	2.6	3.2	…	…
Household debt (in percent of GDP)	80.5	86.1	86.8	89.1	88.9	88.8	88.7
Household financial assets (in percent of GDP)	176.3	187.0	182.4	182.9	181.6	…	…
House prices (percentage change) 4/	11.8	10.9	8.5	7.4	5.4	5.5	6.5
Exchange rates (period average)							
Malaysian ringgit/U.S. dollar	3.09	3.15	3.27	3.91	4.15	…	…
Real effective exchange rate (percentage change)	-0.2	0.5	-0.7	-7.9	-4.3	…	…
Balance of payments (in billions of U.S. dollars) 7/							
Current account balance	16.2	11.3	14.8	8.9	6.1	5.5	6.1
(In percent of GDP)	5.2	3.5	4.4	3.0	2.0	1.8	1.8
Goods balance	36.6	30.6	34.6	28.1	24.4	25.3	26.7
Services and primary income account balance	-14.4	-13.8	-14.5	-13.6	-13.8	-14.6	-14.9
Capital and financial account balance	-7.4	-6.4	-24.3	-13.3	-1.0	2.4	5.2
Of which: Direct investment	-7.9	-2.0	-5.5	1.2	4.3	4.2	3.2
Errors and omissions	-7.6	-0.2	-1.7	5.4	-1.5	0.0	0.0
Overall balance	1.3	4.6	-11.2	1.0	3.6	7.9	11.3
Gross official reserves (US$ billions)	139.7	134.9	115.9	95.3	94.6	102.4	113.8
(In months of following year's imports of goods and nonfactor services)	7.7	7.4	7.4	6.3	5.9	6.1	6.6
(In percent of short-term debt by original maturity) 7/	150.7	130.7	111.6	116.2	112.7	132.6	149.5
(In percent of short-term debt by remaining maturity) 7/	104.1	91.8	78.4	75.1	74.2	79.3	86.5
Total external debt (in billions of U.S. dollars) 7/	196.9	212.3	213.4	194.2	202.6	207.1	214.5
(In percent of GDP) 7/	62.6	65.7	63.1	65.6	68.3	66.8	63.4
Of which: short-term (in percent of total, original maturity) 7/	47.1	48.6	48.7	42.2	41.4	37.3	35.5
short-term (in percent of total, remaining maturity) 7/	68.1	69.3	69.3	65.4	63.0	62.4	61.3
Debt service ratio 7/							
(In percent of exports of goods and services) 8/	17.2	17.3	17.9	21.3	23.7	24.9	25.7
(In percent of exports of goods and nonfactor services)	18.2	18.4	19.1	22.6	25.1	26.3	27.2
Memorandum items:							
Nominal GDP (in billions of ringgit)	971	1,019	1,106	1,157	1,229	1,323	1,426

Sources: Data provided by the authorities; CEIC Data Co. Ltd.; Dealogic; World Bank; UNESCO; and Fund staff estimates.

1/ Based on staff's estimate of the federal government fiscal balance using GFSM 2001, which differs from the authorities' cash-based measure of the fiscal deficit.

2/ Capital expenditure in the budget includes foreign fixed assets and other items, such as purchase of shares and land, which are excluded from public investment in the national accounts

3/ General government includes the federal government, state and local governments, and the statutory bodies.

4/ Latest available data.

5/ Based on the depository corporation survey.

6/ Based on a broader measure of liquidity.

7/ Staff estimates.

8/ Includes receipts under the primary income account.

INTERNATIONAL MONETARY FUND

MALAYSIA

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

February 28, 2017

KEY ISSUES

Resilience to shocks. Despite a challenging global economic environment, the Malaysian economy performed well over the past few years. Real GDP growth has slowed down, but remained among the highest for countries at similar income levels.

Outlook. Real GDP growth is expected to increase moderately to 4½ percent y/y in 2017, while risks to the outlook are tilted to the downside and emanate from both external and domestic sources. Inflation is projected to inch up on the back of higher global oil prices and the rationalization of subsidies on cooking oil.

Fiscal policy. The medium-term fiscal policy is appropriately anchored on achieving a near-balance for the federal budget by 2020. The authorities aim to continue fiscal consolidation in the 2017 Budget, which will help increase space to address downside risks, alleviate risks from elevated debt and contingent liabilities, and maintain the confidence of financial markets. Additional measures would be required in order to meet the medium-term objectives.

Monetary policy. While the current monetary policy stance is appropriate, going forward BNM should continue to carefully calibrate monetary policy to support growth while being mindful of financial conditions. The policy rate has been kept on hold since a reduction (by 25 basis points) in July 2016 on account of stable domestic demand and downside risks to global growth. Current macroprudential policies are appropriate, but pockets of debt-related vulnerabilities, such as those in the household and construction sectors, warrant close monitoring.

Exchange rate flexibility. A flexible exchange rate has helped the economy adjust to external shocks and should remain a key shock absorber in the event of elevated capital flow volatility and outflows. The financial and corporate sectors' balance sheets appear to be resilient to exchange rate fluctuations. Close consultation and communication with market participants will be essential in further developing onshore foreign exchange markets and bolstering resilience.

Structural policies. Malaysia has made important progress in structural reform toward achieving high-income status as envisaged under the 11th Malaysia Plan. The authorities' plans for transforming Malaysia into a productivity-driven and knowledge-based economy would receive a further boost through improved labor market participation, enhanced education quality, and policies to support innovation.

Approved By
Odd Per Brekk and Zeine Zeidane

Mission dates: November 30–December 15, 2016
Mission Team: Daisaku Kihara (Head), Niamh Sheridan, David Grigorian, Juan Manuel Jauregui, Souvik Gupta (all APD), and Geoffrey Heenan (Resident Representative). Harizal Bin Alias (OED) joined the mission. Marzunisham Omar (Executive Director) and Odd Per Brekk (APD Reviewer) participated in policy discussions. Simon Paroutzoglou and Justin Flinner (both APD) assisted in the preparation of this report. Data used in this report for staff analyses are as of February 16, 2017.

CONTENTS

APPENDICES

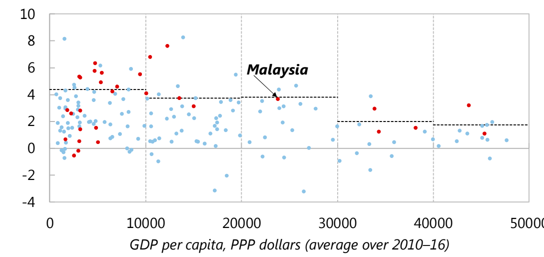
Glossary

11MP	11th Malaysia Plan, the
AFC	Asian financial crisis
AML	Anti-money laundering
BNM	Bank Negara Malaysia
CA	Current account
CFT	Combatting the financing of terrorism
EPF	Employees Provident Fund
FDI	Foreign direct investment
FHC	Finance holding companies
FX	Foreign exchange
GDP	Gross domestic product
GFC	Global financial crisis
GST	Goods and Services Tax
LTV	Loan-to-value ratio
MGS	Malaysian government securities
NDF	Non-deliverable forwards
NFPE	Nonfinancial public enterprise
NFPS	Nonfinancial public sector
NPL	Non-performing loans
PFRAM	PPP Fiscal Risk Management Model
PIMA	Public Investment Management Assessment
PPP	Public-private partnership
R&D	Research and development
TFP	Total factor productivity
US	United States, the
WEO	World Economic Outlook, the
y/y	Year-on-year

ECONOMIC PERFORMANCE, OUTLOOK, AND RISKS

1. **Over the past few years, the Malaysian economy performed well despite significant external headwinds.** Although real GDP growth has slowed down, Malaysia is still among the fastest growing economies at its income level. The economy's resilience, amidst global commodity price and financial market volatility, reflected a diversified production and export base; strong balance sheet positions; a flexible exchange rate; responsive macroeconomic policies; and deep financial markets. However, the authorities continue to face a challenging environment, given continued global uncertainty, which complicates the calibration of near-term macroeconomic policies.

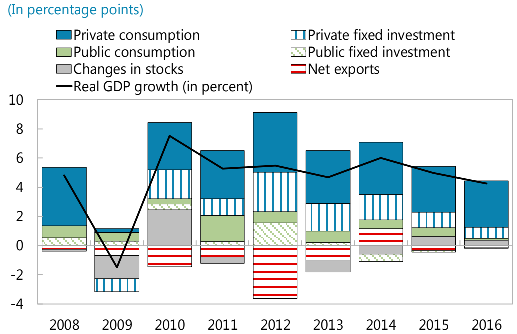
Per Capita Real GDP Growth, 2010-2016 1/
(Percent)



Sources: IMF, *World Economic Outlook* database; and staff calculations.
1/ Darker dots represent the Asia-Pacific economies and the horizontal lines indicate the top 10 percentile of GDP growth rates within each income group. Countries with worse than –4 percent per capita real GDP growth over 2010–16 are not shown here.

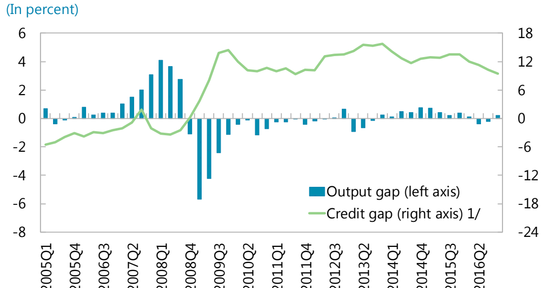
2. **In 2016, the economy saw a moderate expansion, while financial market volatility increased toward the end of year.** Real GDP growth was at 4¼ percent y/y (2015: 5.0 percent y/y), the slowest since the global financial crisis (GFC). Private domestic demand was the main driver of growth, while net exports contributed negatively. On the supply side, a fall in agricultural production of palm oil and weaker activity in other non-service sectors contributed to the slowdown. Inflation remained unchanged from 2015 at 2.1 percent y/y, dampened by lower fuel prices and a small negative output gap. Against this backdrop, credit expansion slowed, ending a period of elevated growth since 2009 and slightly narrowing the credit gap. Malaysia, like other emerging markets, was impacted by global financial market volatility, particularly in the second half of 2016: capital inflows reversed; the currency depreciated; and interest rates on government bonds ended the year higher.

Malaysia: Contributions to Real GDP Growth
(In percentage points)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Malaysia: Output Gap and Credit-to-GDP Gap
(In percent)



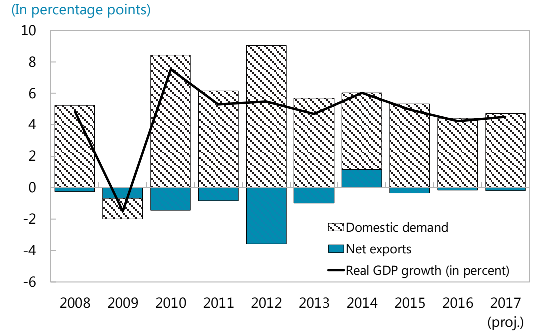
Sources: CEIC Data Co. Ltd.; and IMF staff estimates.
1/ Credit gap is measured using deviation from the one-sided Hodrick-Prescott filter with a large parameter over 2000Q1–2016Q4.

3. **Policies have been largely in line with past Fund advice (Appendix I).** In response to risks to revenues from a tepid outlook for the global oil price, the authorities recalibrated the budget in January 2016 through additional expenditure rationalization to protect the 2016 fiscal targets. Bank Negara Malaysia (BNM) lowered the statutory reserve requirement for banks, effective February 2016, when liquidity conditions tightened, and then, in July, cut the policy rate by 25 basis points, citing weaker global growth, an uncertain global environment, and receding risks from domestic financial imbalances. Moreover, the currency was allowed to adjust in response to external shocks. Macroprudential policies were maintained amidst still-high household indebtedness.

4. **Economic growth is expected to improve in the near term.**

- Staff expects real GDP growth to increase moderately to 4½ percent y/y in 2017. Domestic demand would remain the main driver of growth, while a drag from net exports, similar to 2016, will remain. Private consumption is likely to continue to be supported by improvements in labor market conditions and fiscal measures—including cuts in the Employees Provident Fund (EPF) contribution rates, transfers to lower-income households under the BR1M program, and increases in civil servant salaries—while higher inflation, high household debt, and ongoing impact of macroprudential policy settings could hold consumption back. Lower commodity prices have impacted business sentiment and private investment growth has shifted to a more sustainable pace. Public consumption will provide some support to the economy.

Malaysia: Contributions to Growth
(In percentage points)



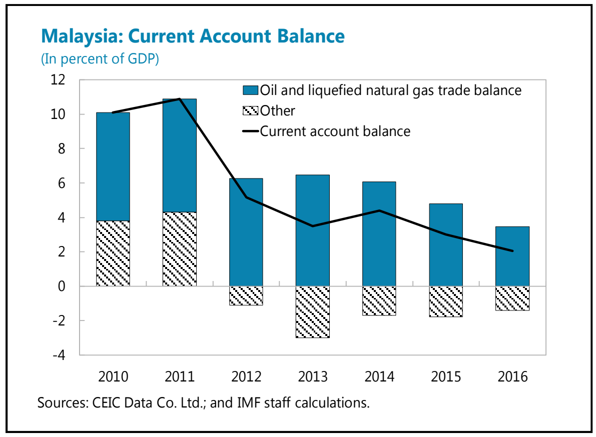
Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

- Consumer price inflation is projected to rise and average 2¾ percent y/y in 2017 on the back of higher global oil prices and the rationalization of subsidies on cooking oil. The exchange rate pass-through is expected to remain weak.[1]

- The current account (CA) surplus, as a ratio to GDP, would see a small decline. In the near term, while an improved global outlook and higher commodity prices would support an increase in goods exports, the strength of imports on the back of a resilient domestic demand, including the ongoing large infrastructure projects, and the deficit on the services accounts would contain the CA surplus.

[1] Staff estimates suggest that the exchange rate pass-through has historically been weak in Malaysia. Imported goods, not including fuel, account directly for 6.7 percent of the CPI basket. Using a common factor model, a near zero loading coefficient on the U.S. nominal effective exchange rate was found for inflation in Malaysia. (IMF (2015) *Regional Economic Outlook: Asia and Pacific*).

5. Malaysia's 2016 external position is assessed to be moderately stronger than warranted by fundamentals and desirable policies. The CA surplus has declined by about 8½ percent of GDP since 2010, the largest drop in emerging Asia. The fall in the CA surplus reflects a drop in saving, primarily by nonfinancial corporations, and an expansion in private domestic investment. The 2016 cyclically-adjusted CA balance is assessed to be about 1 percent of GDP higher than consistent with structural economic fundamentals and desirable macroeconomic policies, and the real exchange rate moderately undervalued by about 3¾ percent (Appendix II).



6. Potential growth is estimated to have fallen below 5 percent. Real GDP is projected to grow at a 4½–5 percent y/y rate over the medium term (Appendix III). Under staff's baseline, this reflects a slow pace of labor force expansion despite an improvement in female labor participation and the impact of weak global trade and low oil prices on private investment. Total factor productivity is expected to gradually revert to its long-term trend growth rate over the medium term; this baseline productivity gain is somewhat lower than envisaged under the 11th Malaysia Plan (11MP, 2016–20).

7. Risks to the outlook are tilted to the downside and emanate from both external and domestic sources (Appendix IV).

- External risks include structurally weak growth in advanced and emerging market economies, and significant slowdown in other emerging market economies. Malaysia's open economy could be affected by retreat from cross-border integration and heightened global policy uncertainty. Although the economy has adjusted well to lower global oil prices, sustained low commodity prices add to the challenge of achieving the medium-term fiscal target. Heightened global financial stress and associated capital outflows could spill over to domestic markets.

- Domestic risks are primarily related to public sector and household debt, along with pockets of vulnerabilities in the corporate sector. Federal debt and contingent liabilities are relatively high, limiting policy space to respond to shocks. Although the household debt-to-GDP ratio is likely to decline, household debt remains high. Risks of a severe downturn in the financial cycle appear to be low, largely due to a resilient banking system, supported by BNM's prudential policies and oversight.

8. Authorities' views. The authorities broadly agreed with staff's assessment. They expected the Malaysian economy to expand at a 4–5 percent y/y rate in 2017 with private domestic demand being the main driver: private consumption to be sustained by expanding employment, higher wages, and fiscal measures, while private investment would provide additional support. Net exports would remain in surplus, supported by greater demand for manufactured goods and higher commodities exports. On the supply side, a turnaround in the agricultural sector is expected, while other sectors would maintain their momentum. Inflation would remain in the 2–3 percent range in 2017 on the back of higher fuel prices and a weaker exchange rate, but will be contained by subdued global inflation. The authorities stressed that risks to the growth outlook are tilted to the downside amidst heightened global uncertainty. Medium-term growth prospects likely have weakened, amid heightened global policy uncertainty. The authorities saw limitations in the applicability of the Fund's external sector assessment framework in the context of the heightened global uncertainty, particularly given the relatively weak power of the regression model in explaining the historical evolution of the CA/GDP ratio in Malaysia.

MACROECONOMIC AND FINANCIAL POLICIES

9. Macroeconomic and financial policies need to balance sustaining growth and preserving the resilience of the economy. While continuing to implement the ambitious structural reforms, focusing in particular on the labor market, education, and research and development, there is a need to build macro policy space to address possible further shocks, especially in light of heightened global policy uncertainty. To this end, the main elements of the staff's recommended policy agenda are:

- Anchor fiscal policy to the medium-term consolidation objective in order to build fiscal policy space and strengthen resilience, supported by improvements in the fiscal framework;
- Carefully calibrate monetary policy to support growth while being mindful of financial conditions;
- Continue to use exchange rate flexibility as a key shock absorber amidst heightened volatility and uncertainty, supplemented by limited intervention to counter short-term volatility;
- Closely monitor financial risks and stand ready to adjust macroprudential measures, as necessary.

A. Fiscal Policy

10. The authorities' medium-term fiscal policy is appropriately anchored on achieving a near-balanced federal budget by 2020. The baseline assumes continued expenditure restraint and a small improvement in revenue collection. Nevertheless, achieving near-balance will require additional measures amounting to about 1 percent of GDP. An illustrative scenario shows a mix of revenue and expenditure policies as a possible way forward, while different combinations of policy measures are also feasible. Consolidation will help alleviate risks from elevated debt and contingent liabilities and maintain the confidence of financial markets, especially in the face of the relatively high foreign ownership of Malaysian government securities (MGS). Looking ahead, the year-to-year pace of fiscal consolidation should reflect evolving economic conditions.

Malaysia: Medium-Term Fiscal Consolidation Scenario, 2017–20 1/

Fiscal measures	Impact (percent of GDP)
Already in the baseline	**1.1**
Higher projected revenue	0.1
(from higher compliance in corporate income tax)	
Expenditure growth restraint	1.0
(as indicated by the authorities)	
Aditional measures	**0.9 - 1.4**
Revenues	
GST	**0.6 - 0.9**
of which, removal of exemptions	0.4 - 0.6
of which, increase in rate	0.2 - 0.3
(0.5 percentage point increase in the rate from 6.0 percent to 6.5 percent)	
Expenditure	
Subsidy rationalization	**0.3 - 0.5**
Total balance improvement	**2.0 - 2.5**

Source: IMF staff estimates.
1/ An illustrative scenario shows a mix of revenue and expenditure policies as a possible way forward, while there could be various different combinations of policy measures.

- **Expenditure policy: Further expenditure rationalization is required to achieve the medium-term objective while meeting priority expenditure needs.**
  - There is scope for further cuts in subsidies following the successful reform of fuel and other subsidies. The authorities should continue to improve the effectiveness and efficiency of government expenditure, which could include better targeting of social transfers, cost recovery in higher education, user fees for health care services, limiting duplication in transport and tourism programs and enhancing the effectiveness of investment tax incentives. These reforms would contribute to generating the additional savings required to reach the medium-term objective, while continuing to protect the poor.
  - The authorities are encouraged to implement continuous expenditure reviews, which could help identify areas for savings while preserving efficiency. Such reviews would be an efficient way to manage immediate and long-term fiscal pressures and would support the 11MP's commitment to a leaner and more productive government sector. It would also tie in well with ongoing reforms on performance budgeting and the medium-term fiscal framework.
- **Tax policy: There is a need to mobilize additional government revenues.**
  - Tax collection and compliance could be improved, including through increased information sharing between agencies. The Goods and Services Tax (GST) provides an incentive for business to register in order to reduce the cost of inputs. Information related to transactions and GST payments are valuable for agencies to increase corporate income tax compliance by reducing informality and misreporting.
  - Upgrading the GST framework would represent a growth-friendly approach to revenue mobilization. The government could start by reducing the number of exempt and zero-rated items, which would also help reduce the scope for evasion and enhance the efficiency of the tax system. The list of items in these categories is broad by international standards, including fuel, tourism and passenger transport.
  - As a second step, the rate of GST, currently at 6 percent or about half the rate among regional peers, could be raised. With the existing coverage of the GST, a rate increase of 0.5 percentage

point would raise revenue by an estimated 0.25 percent of GDP; with a wider base the revenue impact of any increase in the GST rate would be even larger.

- As an open economy, international taxation is an important aspect for Malaysia's fiscal policy (Appendix VI). The authorities have worked to secure its taxing rights as a source country, while also promoting inward foreign direct investment (FDI). Building on past progress, further improvement in the international taxation framework, including strengthening anti-avoidance rules, can raise revenue and Malaysia should continue to pursue international cooperation.

11. The gradual consolidation called for under the 2017 Budget represents continued progress toward the medium-term anchor. In the period 2014–17, oil revenue fell by 3.6 percent of GDP. Several measures, including the introduction of the GST and subsidy rationalization, counteracted the lost revenue and ensured a gradual consolidation of 0.4 percent of GDP in this period. For 2016, the deficit of the Federal budget is estimated at 3.1 percent of GDP, down by 0.1 percentage points from 2015. A revenue decline of 1.6 percent of GDP driven by oil related revenue was compensated by an increase of 0.8 percent of GDP in GST revenues and reductions in expenditure. In 2017, the deficit is targeted at 3.0 percent of GDP, continuing the moderate consolidation path. In its adjustment endeavors the government has protected high multiplier expenditure, such as social spending, while reducing grants and transfers, particularly to self-sustaining statutory bodies with steady income streams and high reserves. Federal government debt is expected to remain within the self-imposed limit of 55 percent of GDP. The consolidated public sector fiscal deficits will fall by about 0.7 percent of GDP both in 2016 and 2017, primarily reflecting the operations of the national oil company (PETRONAS). This improvement largely reflects reductions in overseas capital spending, with limited impact on the domestic economy.

Malaysia: Fiscal Developments, 2014–17
(Percent of GDP, positive sign =improves balance)

A. Oil and gas revenue	-3.6
B. Policy reaction	5.4
B1. Introduction of GST	*1.4*
B2. Expenditure reduction	*4.0*
Subsidies	1.9
Goods and services	1.0
Grants	0.8
Compensation to employees	0.3
C. Other fiscal developments	1.4
Deficit reduction = A+B+C	**0.4**

Source: IMF staff estimates.

12. Fiscal space is limited but could be increased over the medium term through consolidation. The general financing environment, baseline debt, and gross financing dynamics are relatively favorable, while medium-term adjustment needs are manageable. However, Malaysia continues to face large external financing requirements, elevated nonresident holdings of MGS, and a relatively high level of contingent liabilities. Balancing these considerations, Malaysia is judged to have limited fiscal space in the near term but would have increased space in the medium term as the level of government debt falls over the next five years under the baseline (Appendix V). Under the fiscal policy objectives, federal government debt is close to the ceiling at 55 percent of GDP, and reaching a near-balanced budget by 2020 as targeted would require further fiscal measures.

13. Improvements to the fiscal framework would also help anchor medium-term fiscal adjustment and mitigate risks.

- The recently introduced Medium Term Fiscal Framework with a projection of some fiscal aggregates over a multiyear period provides useful fiscal guidance and it should be enriched with more detail.

- Malaysia's relatively high contingent liabilities include such liabilities stemming from public-private partnerships (PPP) and loan guarantees.[2] In this regard, the authorities established the Fiscal Risk and Contingent Liability Technical Committee to evaluate the government's overall fiscal risks and to propose appropriate measures. Continuous monitoring of contingent liabilities along with efforts to reduce the risks from student loans (known in Malaysia as PTPTN)[3] would help contain associated risks.

- The authorities are encouraged to publish an annual fiscal risks statement, which would give a comprehensive view of risks, including those coming from public corporations. The statement should be fully integrated in the budget preparation process and used to develop risk mitigation strategies. The authorities are in the process of conducting a Public Investment Management Assessment, which will help improve effectiveness of spending. Further improvements in the fiscal framework could be implemented with the help of the IMF's Fiscal Affairs Department, including with the help of PPP Fiscal Risks Management Model (PFRAM).

14. Authorities' views. The authorities reiterated their commitment to fiscal sustainability and a broadly balanced budget in the medium term. They emphasized their continuous improvement of fiscal policy, including by diversifying revenue, reviewing expenditure, improving the tax system, and monitoring and mitigating fiscal risks. Although contingent liabilities are sizable, government loan guarantees have a low probability of being called as they are granted strategically to nonfinancial entities with healthy balance sheets.

B. Monetary and Exchange Rate Policy

15. The current monetary policy stance is appropriate in the baseline scenario of moderate growth, low inflation, and external uncertainties. BNM should continue to carefully calibrate monetary policy to support growth while being mindful of financial conditions. At its policy meeting on January 19, 2017 BNM kept the overnight policy rate unchanged at 3 percent, citing stable domestic demand, as well as heightened uncertainty and downside risks to global growth. BNM could provide further easing if growth unexpectedly weakens and liquidity might also be provided to prevent disruption in financial markets, although global financial conditions could affect the policy space.

16. Exchange rate flexibility has played a central role in helping the economy adjust to a sequence of external shocks and should remain a key shock absorber. Malaysia is potentially facing a period of elevated capital flow volatility and outflows. Staff analysis suggests that Malaysia's

[2] Loan guarantees by the government are estimated at 15 percent of GDP.

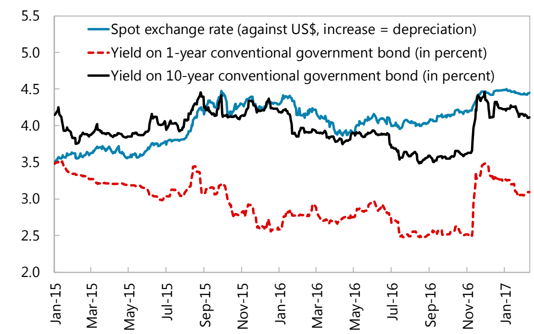
[3] Contingent liabilities related to PTPTN is about 3 percent of GDP.

balance sheet strengths along with exchange rate flexibility help support the resilience of the economy to capital outflows (Appendix VII). Malaysia's external debt-to-GDP ratio is projected to remain on a downward path over the medium term. Moreover, standard stress tests under the Debt Sustainability Analysis indicate that external debt would remain manageable under a variety of shocks (Appendix VIII).

17. Foreign reserves could be deployed in case of disorderly market conditions. During more normal market conditions, reserves could be accumulated as opportunities present while remaining cognizant of underlying conditions affecting the real exchange rate. Foreign exchange reserves largely stabilized during 2016 with a small decline toward the end of the year, and stand at about 80 percent of the IMF's composite reserve adequacy metric, which currently classifies Malaysia's exchange rate regime as "other managed".[4] However, if Malaysia's regime were to be classified as "floating", which is closer to the current practice, the level of FX reserves would be in the adequate range.[5] Similarly, not all short-term external debt constitutes a claim on foreign reserves, and domestic financial institutions could also help mitigate the risks. For these reasons, staff judges current reserve levels to be adequate.

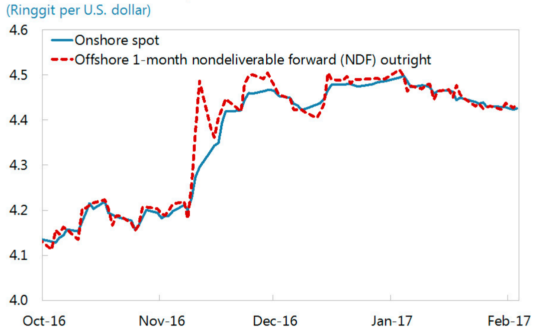
18. In late 2016, BNM announced measures to develop onshore foreign exchange markets and bolster resilience to external shocks. The measures aim at facilitating onshore FX risk management and enhancing the depth and liquidity of onshore financial markets. BNM also reinforced the existing rules on domestic institutions' participation in offshore ringgit transactions (see detailed discussion in Box 1). In

Malaysia: Exchange Rate and Interest Rates



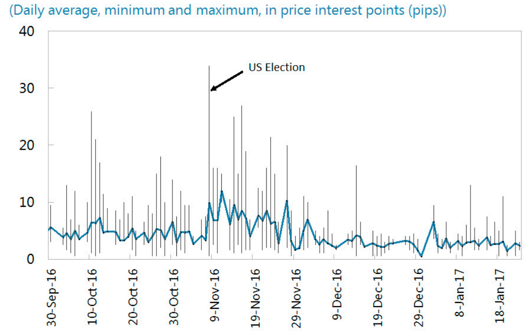
Source: Haver Analytics.

Malaysia: Onshore Spot and Offshore NDF Rates
(Ringgit per U.S. dollar)



Source: Bloomberg LP.

Malaysia: Onshore MYRUSD Bid-Ask Spread
(Daily average, minimum and maximum, in price interest points (pips))



Sources: Bloomberg L.P.; and IMF staff calculations.

[4] For details on the reserve adequacy metric, refer to: International Monetary Fund, *Assessing Reserve Adequacy—Specific Proposals 2015.*

[5] The IMF's reserve adequacy metric is computed under a binary classification of the exchange rate regime: "floating" or "fixed". For the purpose of this metric, Malaysia's current exchange rate regime falls under the "fixed" category. However, if Malaysia's regime were to be classified as "floating", the current level of FX reserves would be at about 115 percent of the metric.

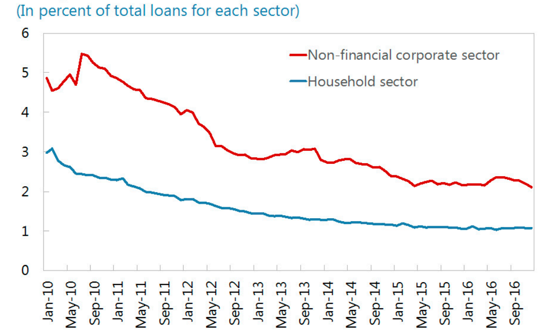
the subsequent period, liquidity in the onshore market has normalized, the spot exchange rate volatility has come down, and the bid-ask spread has declined. Going forward, and in line with the Fund's *Institutional View* on capital flows, exchange rate flexibility and macroeconomic policy adjustments should remain the main line of defense to external shocks. BNM should keep the new FX market measures under review, recognizing their costs and benefits. It should also maintain its close consultation and communication with market participants to sustain investor confidence and support an orderly functioning of the FX market.

19. **Authorities' views.** The authorities emphasized that the exchange rate will continue to play an important role in absorbing external shocks. Monetary policy is well calibrated and remains supportive of growth. Reserves are adequate. The authorities reiterated their reservations about the use of a binary classification of Malaysia's exchange rate regime in the Fund's reserve adequacy calculations, especially since more exchange rate flexibility is being allowed in response to heightened global uncertainty. BNM discussed their recent measures aimed at promoting a deeper, more transparent and well-functioning onshore FX market, so that investors and market participants can effectively manage their market risks through increased flexibility to hedge on the onshore market. The measures also addressed BNM's concern that ringgit prices and volatility had been adversely affected by offshore NDF market activities that were not necessarily reflective of economic fundamentals nor underlying trade and investment activities. BNM stressed that discouraging offshore NDF activity was consistent with its long standing policy of non-internationalization of the ringgit.

C. Financial Sector

20. **Credit growth has slowed to a more moderate and sustainable pace, ending a period of elevated growth since 2009.** Malaysia's banking sector has so far weathered well the turn in the financial cycle, bolstered by strong capital buffers, adequate provisioning and liquidity, and stable funding conditions. Assuming current credit growth rates are maintained, the credit gap should gradually close while at the same time ensuring adequate provision of credit to the economy. As a result, financial sector risks are more balanced; nevertheless, a renewal of rapid credit growth could quickly exacerbate vulnerabilities. Non-performing loan (NPL) ratios remain low, but could increase as the economy moves through the cycle; however, macroprudential measures implemented since 2010 should help reduce the risk of a sharp increase.

Malaysia: Non-Performing Loans
(In percent of total loans for each sector)



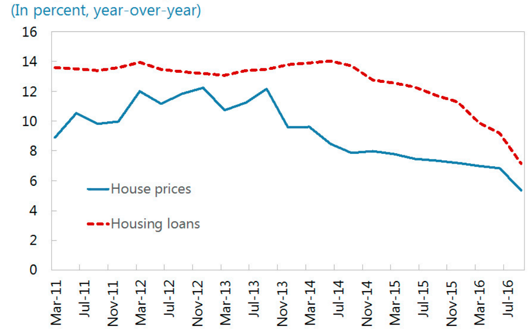
Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

21. **Household debt is relatively high and represents a key vulnerability that requires careful monitoring, although no additional macroprudential measures are recommended at this time (Appendix IX).** Risks are mitigated by macroprudential measures, improvements in

underwriting standards, and high levels of household financial assets (183 percent of GDP at end-2015). Banking system household NPLs remain low at 1.1 percent. The 2017 Budget recalibrated macroprudential policies; stamp duty relief was provided for first-time home buyers (expiring end-2018) and increased housing loan access for public servants. On the other hand, stamp duties on instruments of transfer on real estate above RM 1 million will be increased from January 2018.

22. **Risks associated with the housing market appear to be receding.** House price growth has moderated, following several years of elevated growth, and risks are circumscribed by ongoing supply constraints, increases in public sector wages, and, from a more structural perspective, Malaysia's relatively young labor force and urbanizing population. The risk of a sharp decline in house prices should nevertheless be carefully monitored. If rapid house price growth resumes, LTV caps on second and first mortgages could be considered.

Malaysia: Housing Market Indicators
(In percent, year-over-year)

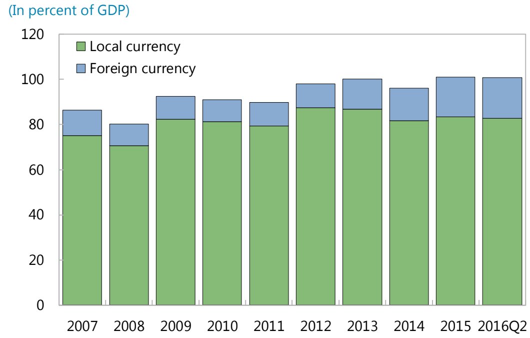


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

23. **Progress toward adopting remaining recommendations of the Financial Sector Assessment Program (FSAP) in the area of financial oversight continued.**[6] Following the change in legislation that extended its legal powers over finance holding companies (FHC), BNM has completed the process of identifying and designating the appropriate holding companies as FHCs for all financial groups. In 2016, it also issued a concept paper on Credit Risk Management, applicable to all financial institutions, including the FHCs.

24. **Malaysia's corporate sector does not appear to present significant macro-financial risks, although there are pockets of vulnerability.** Balance sheet indicators, such as debt-to-equity ratios and interest coverage ratios, do not suggest widespread vulnerabilities. In addition, most foreign exchange debt is either naturally or financially hedged, providing a mitigating factor for the risk associated with corporate sector debt. However, vulnerabilities are emerging in the construction and oil and gas sectors. Risks have increased also in the non-residential property market (which accounts for about 4.5 percent of bank loans).[7] Overall vulnerabilities related to maturity and currency mismatches appear to be

Malaysia: Currency Composition of Corporate Sector Debt
(In percent of GDP)



Sources: CEIC Data Co. Ltd.; Bank Negara Malaysia; and staff calculations.

[6] "International Monetary Fund, *Malaysia: Financial System Stability Assessment 2013.*

[7] There is a large pipeline of supply of new non-residential property over the next 2–3 years and occupancy rates and the value and number of secondary market transactions have declined.

contained (Appendix X). Corporate bond yields are expected to rise as Malaysian government bond yields increase and as domestic institutional investors reallocate toward government bonds. To reduce the potential impact on banks' balance sheets, BNM should continue to increase the loss absorbing capacity of banks with higher exposures to more vulnerable corporates using Pillar II measures.

25. **Malaysia is a world leader and standard-setter in Islamic finance.** In recent years, the government increased the use of Islamic debt instruments for funding purposes. In April 2016, the government issued its fifth dollar-denominated sovereign sukuk for US$1.5 billion using non-physical assets as collateral. The total outstanding stock of government Islamic securities is approaching that of MGS. The main reasons behind increasing issuance of sukuk in recent years have been healthy demand and a desire to develop the market. The inclusion of Islamic debt securities in some global bond indexes provided a boost. The primary auctions for sukuk in Malaysia have consistently generated higher cover ratios than for equivalent conventional instruments, and the spreads between conventional bonds and sukuk have declined steadily over time.

26. **Effective implementation of plans to enhance anti-corruption measures will improve the business environment and enhance public confidence.** The investigative capacity of the Anti-Corruption Commission should continue to be strengthened in conjunction with enhanced use of AML/CFT tools, including by strengthening the asset declaration system. Considering Malaysia's growing importance as a regional financial center, effective international cooperation will boost efforts to mitigate risks arising from money laundering and proceeds-generating crime.

27. **Authorities' views.** The authorities largely agreed with the staff's views. They stressed their commitment to financial stability via continued rigorous oversight of the financial sector. Banks are well-capitalized with adequate liquidity. Credit conditions remain supportive of growth; BNM's macroprudential policies and responsible lending guidelines helped prevent a marked increase in impaired loans as economic activity slowed down. The housing market has softened although demand for affordable housing remains robust and recent budget measures were aimed at encouraging increased supply of affordable housing. No further macroprudential measures are needed at this time. BNM are closely monitoring risks in the corporate sector where there is evidence of weaker debt servicing capacity in some segments, but stress testing results and other analysis do not indicate widespread vulnerabilities.

STRUCTURAL POLICIES TO ACHIEVE HIGH-INCOME STATUS

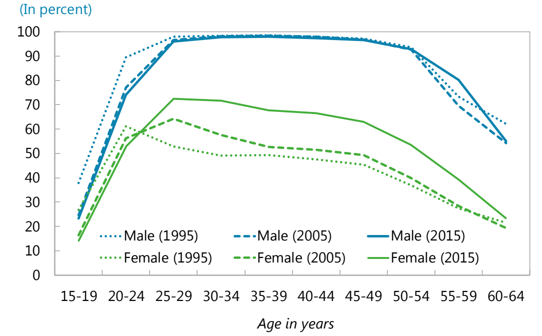
28. **Malaysia has made important progress toward achieving high-income status.** In the last few years, a slew of structural reforms was undertaken, including services sector liberalization and education reforms. Further, private sector investment has increased, female labor force participation has improved, and minimum wages have been raised. But productivity has underperformed, affected in part by global developments. The authorities have laid out a comprehensive reform agenda,

including those under the 11MP, to transform Malaysia into a productivity-driven and knowledge-based economy.

29. The authorities' structural reform agenda is comprehensive and has the potential to significantly boost long-term economic growth. In an environment of sluggish global trade and heightened global uncertainty, steadfast implementation of the domestic reforms agenda will be necessary in realizing the long-term development objectives. Staff's baseline medium-term outlook incorporates some of the gains from the reforms, including improvement in female labor participation, but takes a conservative stance on productivity gains amidst a worsening of global economic prospects since the adoption of the 11MP (Appendix III). In particular:

- *Labor market*. Given a projected slowdown in population growth and high labor force participation rates among male workers, policies should continue to encourage female labor force participation. While female participation rates have increased in recent years, they remain low in light of Malaysia's stage of development. Policies that would help support higher female participation include measures to encourage a return to the labor market after prime child-bearing age, flexible work arrangements, and creating more equal opportunities for women in all fields of education and jobs. Research shows that Malaysia's per capita income would have been as much as 23 percent higher if gender gaps in participation and entrepreneurship were bridged.[8]

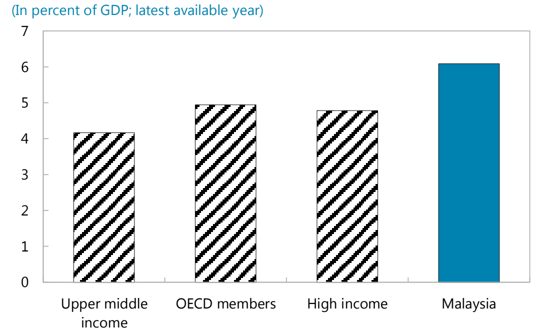
Malaysia: Labor Force Participation Rate by Sex and Age
(In percent)



Source: CEIC Data Co. Ltd.

- *Education*. Important gains have been made in terms of access to, and gender equality in, education, but the quality of education could be further improved. In a global context, while Malaysia's public expenditure on education in percent of GDP is relatively high, student performance needs to catch up. Steady implementation of the measures under the Education Blueprint (2013–25) would be critical in boosting human capital.

Government Expenditure on Education
(In percent of GDP; latest available year)



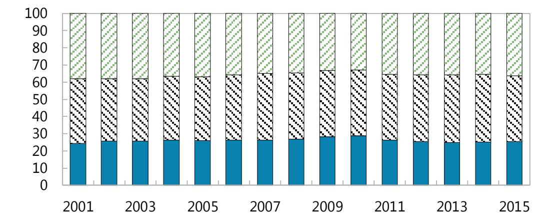
Source: World Bank, *World Development Indicators* database.

- *Skills*. Addressing skill mismatches, including through supporting a higher share of high-skilled jobs, will help improve labor market efficiency and productivity. Studies have found a positive contribution from high-skilled workers to

[8] D. Cuberes and M. Teignier, "Gender Gaps in the Labor Market and Aggregate Productivity", *Sheffield Economic Research Paper*, SERP 2012017 (2012).

Malaysia's economic growth: a 1 percent increase in high-skilled workers could boost GDP per capita by about 0.3 percent.[9] In this context, the authorities' efforts at reforming the technical and vocational education system could help better align skills with the needs of the industry. Improvement in soft skills, including in English language proficiency, will also be important in a more knowledge-driven and connected world.

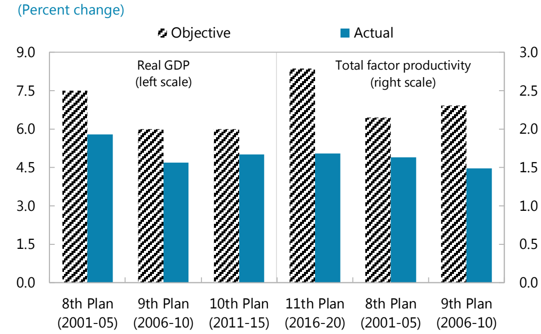
Malaysia: Employment by Occupational Skills
(Share in percent of total employment)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.
1/ High-skilled workers are defined as legislators, senior officers, and managers; professionals; and technicians and associate professionals.
2/ Medium-skilled workers are defined as clerical workers; service, shop, and market sales workers; and skilled agricultural and fishery workers.

- *Productivity*. Despite the progress made, challenges remain as productivity continues to underperform. This calls for a continued focus on investing in public infrastructure and human capital; further improving the business environment, particularly in areas where Malaysia is farther away from the frontier globally and regionally; facilitating trade integration and encouraging foreign investment; and attaining governance standards concomitant with high-income status. Over the medium term, if reforms could boost the capital/labor ratio by an additional 1 percentage point above the baseline, growth would be higher by 0.2 percentage point.

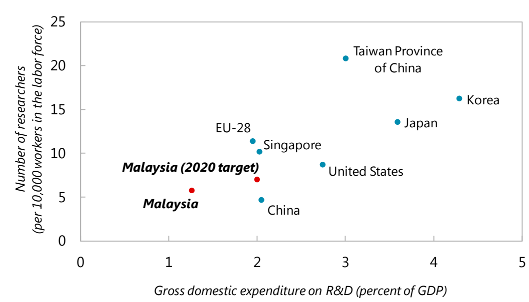
Malaysia: Performance under the Recent Five-Year Plans
(Percent change)



Source: Economic Planning Unit, Malaysia; and IMF staff calculations.

- *Innovation*. To move to a knowledge-based economy, policies should continue to encourage research and development (R&D), including through streamlining the institutional arrangements. A five-year blueprint to boost productivity is being finalized. By 2020, Malaysia aims for a near doubling of the share of R&D expenditure in GDP from its 2012/13 level.

Research and Development (R&D) 1/



Sources: 11th Malaysia Plan document; OECD Statistics; and UNESCO.
1/ Data as of 2014 or latest available.

- *R&D productivity, though difficult to measure* accurately, appears low.[10] In this respect, securing a stable macroeconomic environment and

[9] Mohamed A.G. Hassan and S.A. Sakar, "Foreign Direct Investment, Human Capital and Economic Growth in Malaysia," *Munich Personal RePEc Archive*, MPRA Paper No. 51930 (2013).

[10] Malaysian patent applications, for example, have seen a 30 percent increase over 2010–15, relative to 2001–06, but the ratio of these applications per year to the share of researchers in population is significantly lower than the average for upper middle-income countries.

providing incentives to new firms, rather than small firms, could be helpful in supporting entrepreneurship and innovations.[11]

30. Authorities' views. The authorities appreciated staff's support of the medium-term structural reform agenda, while noting that heightened global policy uncertainties pose a risk to achieving some of the goals under the 11MP. They expressed their commitment to domestic reforms, including on improving the quality of education, lowering skills mismatch, investing in better public infrastructure, promoting research and innovation, expanding trade integration, and pursuing a policy of economic openness.

STAFF APPRAISAL

31. Malaysian economic growth has been resilient despite significant headwinds and risks. Real GDP growth is expected to improve slightly in 2017, while staying below the potential growth rate (estimated to remain between 4½ and 5 percent). Weaker-than-expected growth in key advanced and emerging economies or a global retreat from cross-border integration could weigh on growth. Worsening financial conditions could potentially affect domestic markets. While the current account surplus has declined, Malaysia's 2016 external position is assessed to be moderately stronger than warranted by fundamentals and desired policies. Macroeconomic policies need to balance sustaining growth and preserving the resilience.

32. The authorities' medium-term fiscal policy is well anchored on achieving a near-balanced federal budget by 2020. The planned consolidation will help alleviate risks from elevated government debt levels and contingent liabilities and build fiscal space for expansionary policy. The pace of consolidation should reflect economic conditions and any counter-cyclical fiscal policy measures should be well-targeted and temporary. Further expenditure rationalization is needed to achieve the medium-term objective while meeting priority expenditure needs. There is also a need to mobilize additional government revenues. Finally, improvements to the fiscal framework would help anchor medium-term fiscal adjustment and mitigate risks.

33. The current monetary policy stance is appropriate. Going forward, BNM should continue to carefully calibrate monetary policy to support growth while being mindful of financial conditions. Consumer price inflation is expected to rise slightly due to higher oil prices and subsidies reforms, while remaining within the range of the authorities' projection (2–3 percent). Global financial market conditions could affect the monetary policy space and should be watched carefully.

34. Macroeconomic policy adjustments, including exchange rate flexibility, should continue to play the central role in helping the economy to adjust to external shocks. With the exchange rate being a key shock absorber, reserves could be deployed in the event of disorderly market conditions. During more normal market conditions, reserves could be accumulated as opportunities present while remaining cognizant of underlying developments affecting the real

[11] International Monetary Fund, *Fiscal Monitor: Acting Now, Acting Together 2016, Chapter 2.*

exchange rate. BNM should continue to review its recently announced FX market measures introduced to improve the functioning of the onshore forward FX market, recognizing their costs and benefits. In this regard, close consultation and communication by BNM with market participants will be essential in sustaining investor confidence and orderly functioning of the FX market.

35. Financial sector risks appear contained and pockets of potential stress are being monitored closely. Slower credit growth will help keep the quality of banks' loan portfolio in check while at the same time ensuring adequate provision of credit to the economy. The banking sector remains well-capitalized, liquid, and profitable, with non-performing loan ratios in low single digits. However, household debt remains relatively high, representing a key vulnerability. On the corporate side, while the sector's overall balance sheet does not appear to be stressed, vulnerabilities are emerging in the construction and oil and gas sectors that require close monitoring.

36. Steadfast implementation of the ambitious structural reforms agenda is key to boosting long-term economic potential. In an environment of sluggish global trade and heightened global uncertainty, domestic reforms could play an important role in realizing Malaysia's aim to become a high-income country. In this respect, further raising female labor force participation rate, improving the quality of education, lowering skills mismatch, boosting productivity growth, encouraging research and innovation, and upholding high standards of governance would help support Malaysia's long-term growth potential.

37. The staff recommends that the Article IV consultation with Malaysia be held on the standard 12-month cycle.

Box 1. Malaysia: Measures to Develop Onshore Foreign Exchange Markets

On December 2, 2016, Bank Negara Malaysia (BNM) announced a package of measures designed to aid development of onshore foreign exchange (FX) markets and bolster resilience to external shocks. Key initiatives included:

- To enhance further onshore FX risk management, both resident and nonresident institutional investors may dynamically take onshore forward positions on a portfolio basis up to 25 percent of invested foreign currency or ringgit-denominated assets respectively, without documentary evidence with a licensed onshore bank or an appointed overseas office.[1] A one-time registration with BNM is required.
- Residents are now allowed to hedge foreign currency exposures and cancel hedging positions for US$/MYR and CNH/MYR currency pairs with a licensed onshore bank without documentary evidence up to an aggregate net open position limit of RM 6 million per licensed onshore bank. Participants also have to give a one-time declaration of hedging intent.
- With effect from December 5, 2016, resident exporters can retain up to 25 percent in foreign currency proceeds from their exports of goods and the balance converted into ringgit with a licensed onshore bank. The converted amounts could be deposited in a special facility, earning a higher interest rate of 3.25 percent and available until end-2017. Further, exporters are allowed to reconvert their export proceeds to meet projected loans, imports, and other current account obligations for up to six months ahead. Previously, export proceeds were required to be repatriated within six months, but there was no conversion requirement. This measure aims to enhance onshore FX liquidity, while it could potentially increase the transaction costs for the exporters of goods.
- Prudential limits on foreign currency (FC) investments by residents with domestic ringgit borrowing have been streamlined to include FC investments onshore and apply to all residents (including previously exempted exporters) with ringgit borrowing for prudential reasons. These measures could limit some of these residents' FC investments abroad, while those without domestic ringgit borrowing may continue to invest up to any amount.
- Prior to the December announcement, BNM also enhanced the enforcement of the existing regulations on banks' non-involvement in offshore ringgit transactions. Onshore banks engaging in ringgit foreign exchange transactions in the onshore market are now required to obtain attestation from non-resident banks of non-participation in the NDF market.

Some of the measures in the package would allow more flexibility in onshore trading, and are welcome. However, the conversion requirement and the prudential limits on FC investments limit capital outflows. Based on the Fund's Institutional View, staff recommends to reconsider these measures; macroeconomic policy adjustments should continue to play the central role in response to capital flow volatility. Recognizing that market participants would need some time to adjust to the new measures and address issues such as compliance and risk management; clearing, netting and margin requirements; limited trading hours; and lower onshore liquidity, BNM has published Frequently Asked Questions on the new measures on its website and has been addressing queries from stakeholders.

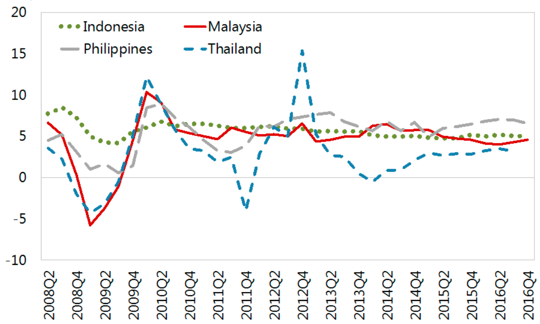
[1] Currently, investors can hedge up to 100 percent of their foreign exposure with underlying documentation.

Figure 1. Malaysia: Growth and Exports

Despite recent slowdown, Malaysia's growth remains comparable to other major emerging ASEAN economies…

Real GDP Growth

(In percent)

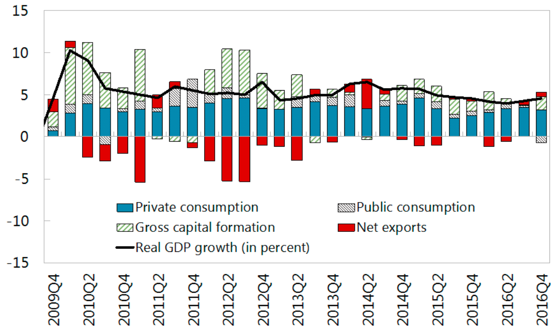


Source: IMF, *World Economic Outlook*.

… supported by robust domestic demand, despite a drag on private consumption from GST implementation and a receding drag from net exports.

Contribution to Real GDP Growth

(Year-on-year percent change)

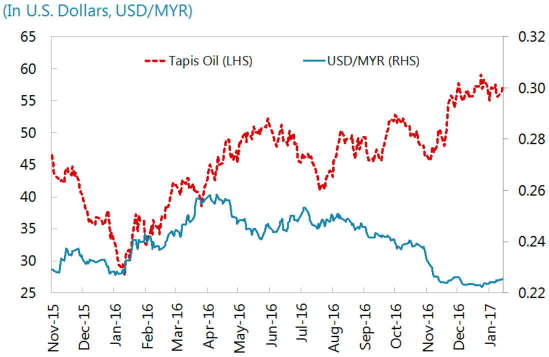


Source: CEIC Data Co. Ltd.; and IMF staff calculations.

The exchange rate has helped absorb external shock…

Tapis Oil Prices & Exchange Rate

(In U.S. Dollars, USD/MYR)

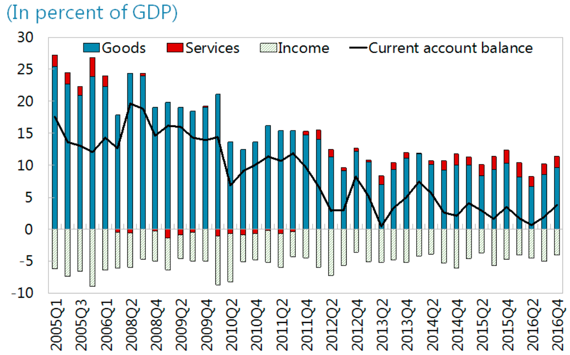


Source: Bloomberg L.P.

… but the current account surplus has declined.

Current Account Balance

(In percent of GDP)

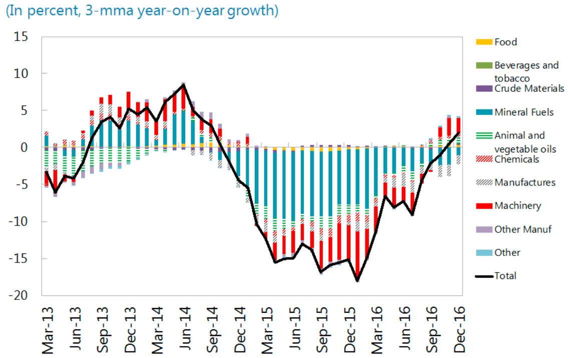


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Export performance has bottomed out…

Export Values Growth Contribution

(In percent, 3-mma year-on-year growth)

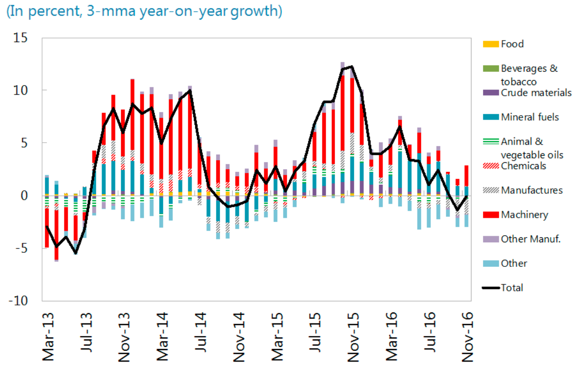


Sources: IMF, *Direction of Trade Statistics*; and IMF staff calculations.

… driven by improvement in prices, as volume growth peaked in late 2015.

Export Volumes Growth Contribution

(In percent, 3-mma year-on-year growth)

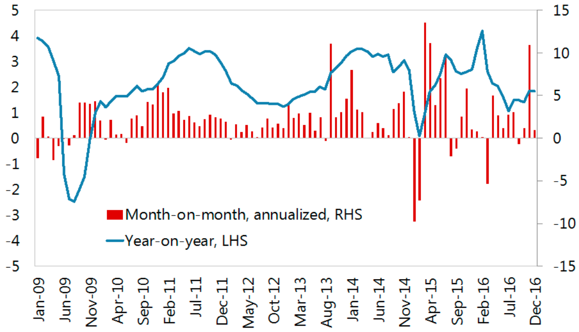


Sources: IMF, *Direction of Trade Statistics*; and IMF Staff calculations.

Figure 2. Malaysia: Inflation and Domestic Resource Constraints

Inflation remains moderate but has been volatile reflecting fuel price adjustments.

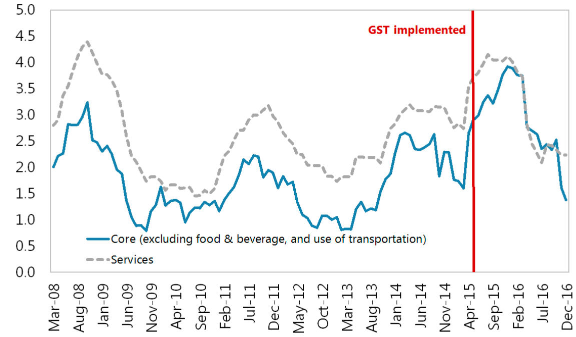
Consumer Price Index
(Percent change)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Core inflation has declined, after rising temporarily following the GST implementation in April 2015.

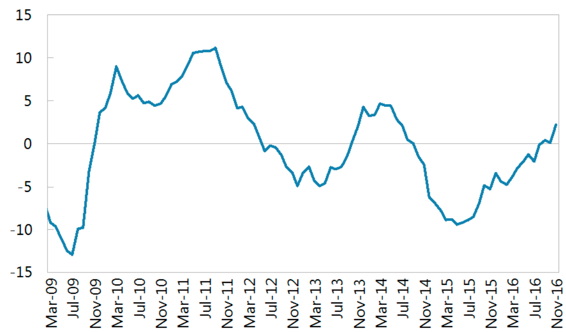
Inflation Developments
(Year-on-year percent change)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Producer prices have been rising since late 2015.

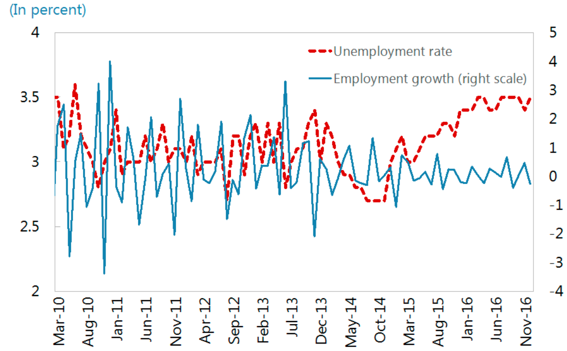
Producer Price Index
(Year-on-year percent change)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

The unemployment rate has been on the rise since 2014 and employment growth has slowed down.

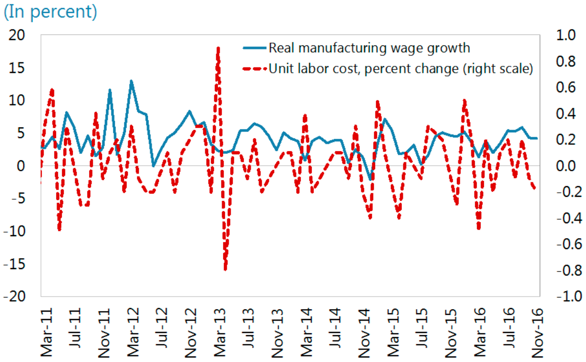
Labor Market Developments
(In percent)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

But wage growth has held up.

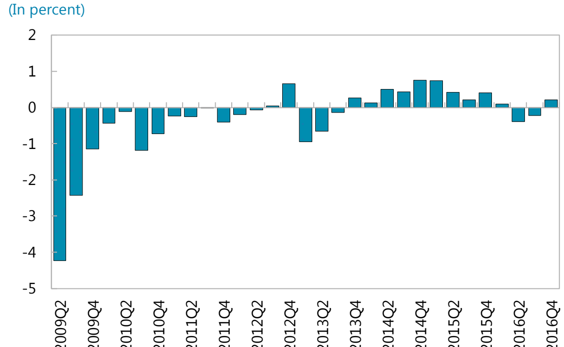
Real Wages and Unit Labor Costs in Manufacturing
(In percent)



Sources: CEIC Data Co. Ltd; and IMF staff calculations.

The output gap remains slightly negative.

Output Gap
(In percent)



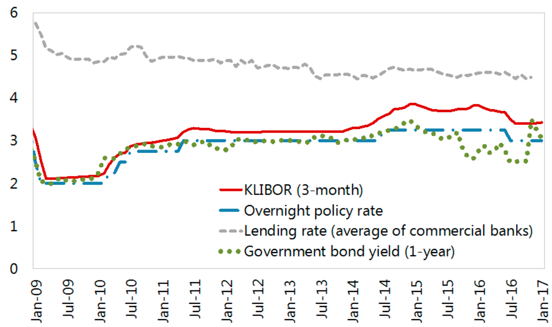
Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

Figure 3. Malaysia: Monetary Developments

Markets have responded to the BNM's reduction in policy rate in July 2016.

Interest Rates

(In percent per annum)

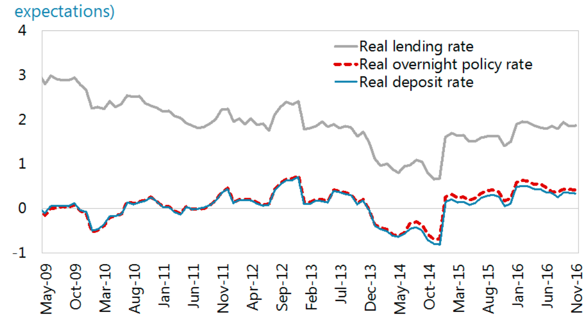


Sources: Bloomberg L.P.; and CEIC Data Co. Ltd.

But real interest rates have increased as the expected inflation rate has declined.

Real Interest Rates

(Percent per annum; nominal rates adjusted for 1–year ahead inflation expectations)

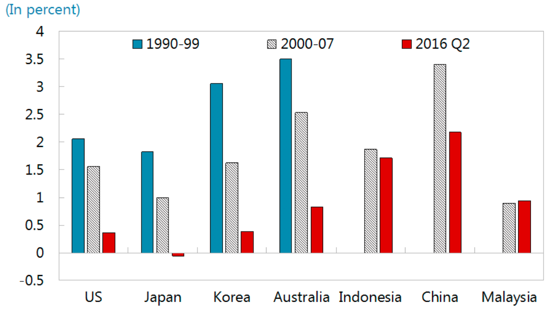


Sources: Bloomberg L.P.; CEIC Data Co. Ltd; Consensus Economics Inc.; and IMF staff calculations.

However, Malaysia's natural real interest rate has not declined like in other countries.

Estimated Natural Real Interest Rates

(In percent)

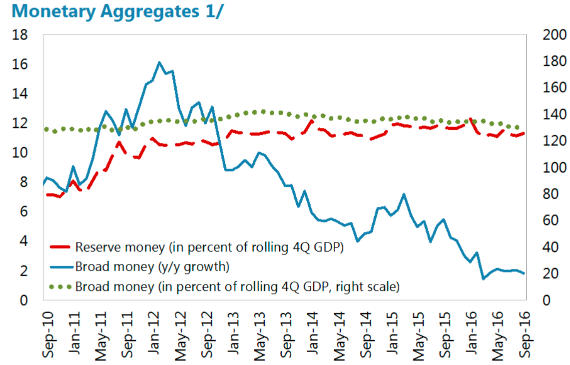


Source: IMF staff estimates based on a TVP-VAR for three variables – real GDP growth, inflation and a measure of real rate.

Note: The conditional long horizon forecast (over 5 years) of the observed real rate is used as a measure of neutral rate.

Broad money growth continued to decline…

Monetary Aggregates 1/



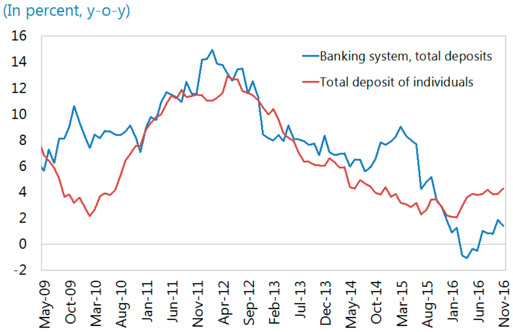
Sources: IMF, *Integrated Monetary database*; and IMF staff calculations.

1/ At depository corporations level.

… along with weaker deposit growth.

Banking System Deposit Growth

(In percent, y-o-y)

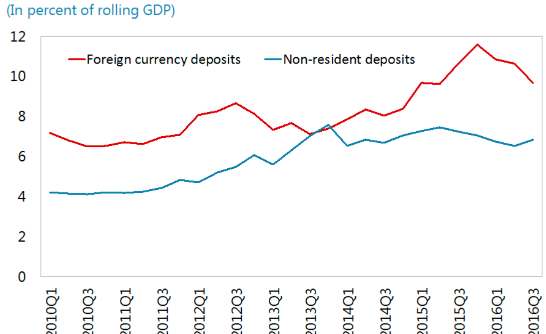


Source: Bank Negara Malaysia

Both foreign currency deposits and non-resident deposits have declined since 2015:Q3.

Foreign currency and non-resident deposits

(In percent of rolling GDP)

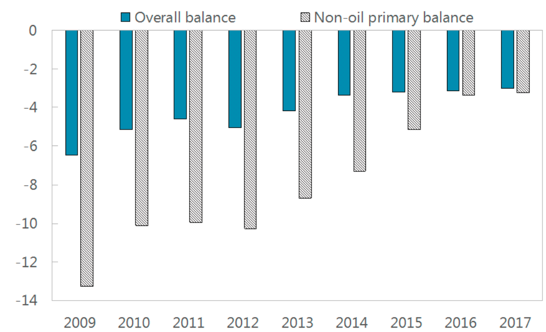


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 4. Malaysia: Fiscal Policy Developments

The authorities have achieved a sustained gradual reduction in the deficit ...

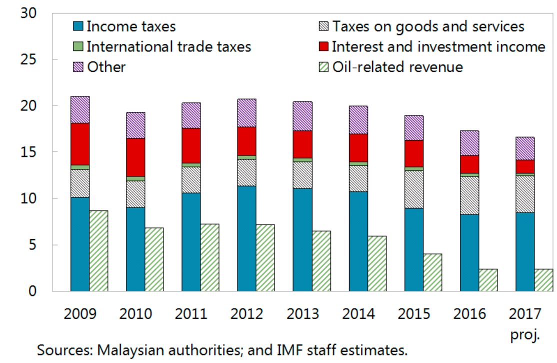
Federal Government: Overall and Non-Oil Balance
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff calculations.

... in an environment of decreasing revenue, especially oil and gas related revenues ...

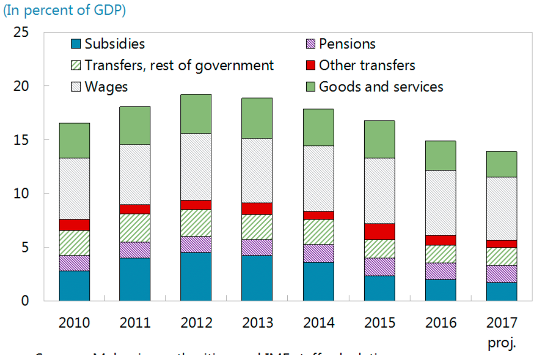
Federal Government Revenue
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

...through reductions in subsidies and transfers and expenditure restraint.

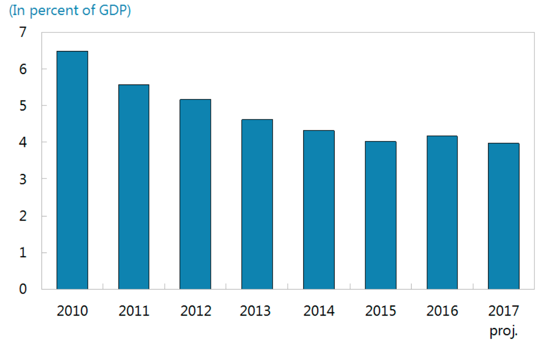
Federal Government Current Expenditures
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff calculations.

Development spending is stable at sustainable levels.

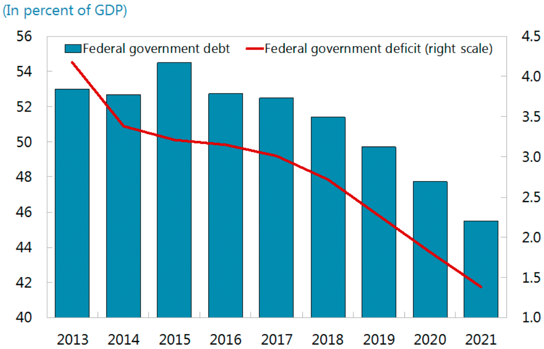
Federal Government Development Spending
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

Debt and deficits are projected to fall over the medium term.

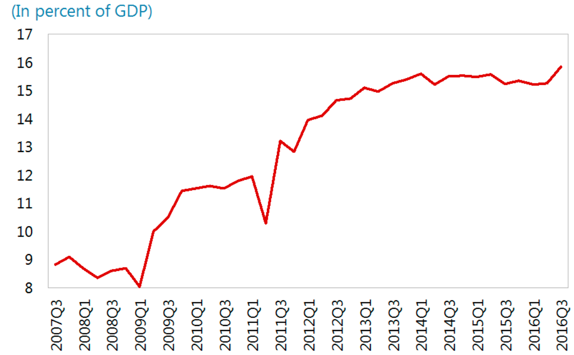
Medium–Term Fiscal Outlook
(In percent of GDP)



Source: IMF staff estimates.

Guarantees have stabilized after a period of growth.

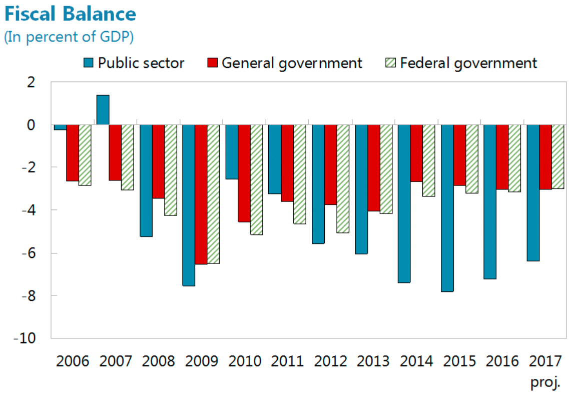
Federal Government Loan Guarantees
(In percent of GDP)



Source: CEIC Data Co. Ltd.

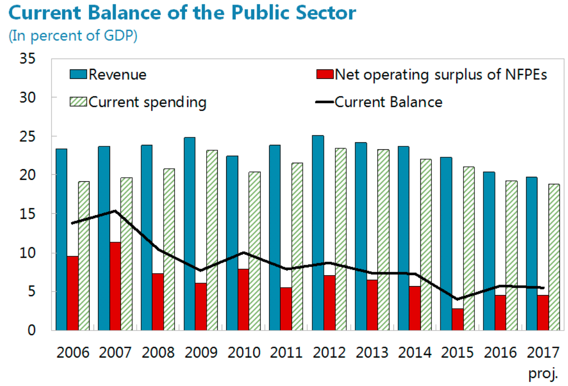
Figure 5. Malaysia: Public Sector Fiscal Stance and Prospects

A lower nonfinancial public sector (NFPS) deficit in 2016 after an increase in 2015…



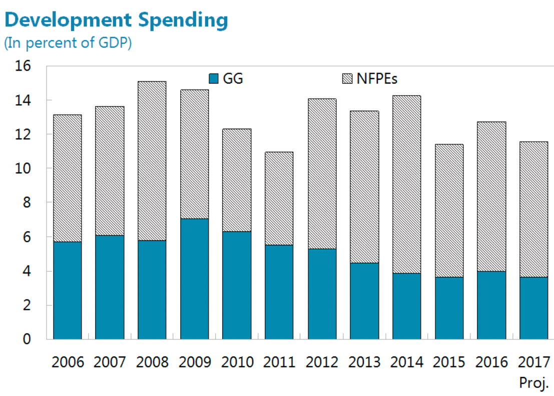
Sources: Malaysian authorities; and IMF staff estimates.

… as the fall in oil price hurt the nonfinancial public enterprise (NFPE) surplus in 2015.



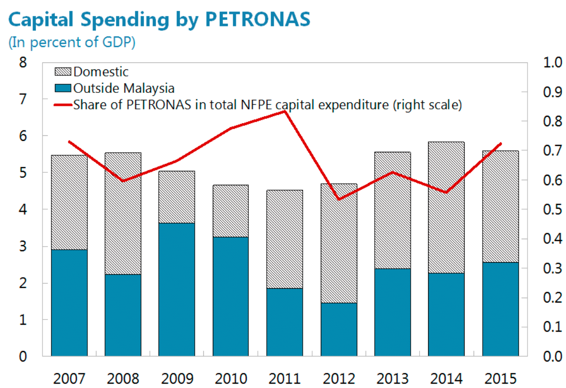
Sources: Malaysian authorities; and IMF staff estimates.

Development spending is kept broadly constant…



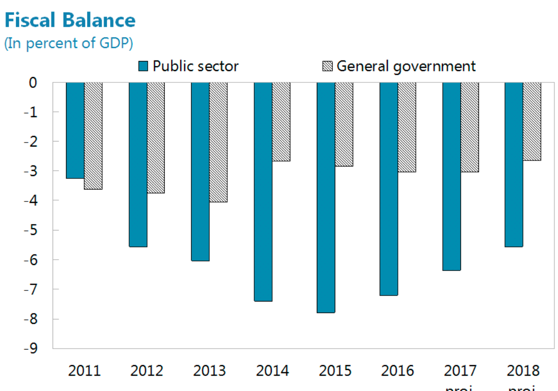
Sources: Malaysian authorities; and IMF staff estimates.

… with PETRONAS driving capex in the NFPS.



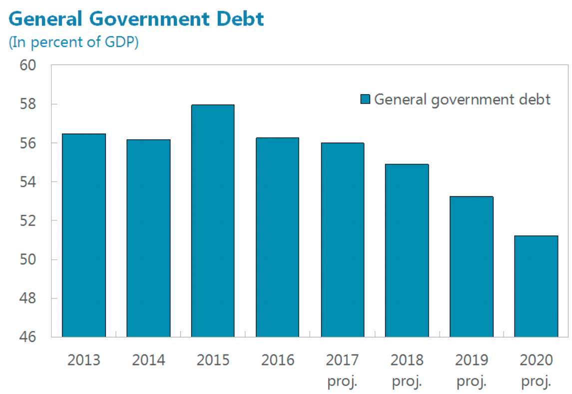
Sources: PETRONAS; Malaysian authorities; and IMF staff calculations.

NFPS deficit is projected to fall in the medium term…



Sources: Malaysian authorities; and IMF staff estimates.

… and general government debt is projected to decline.

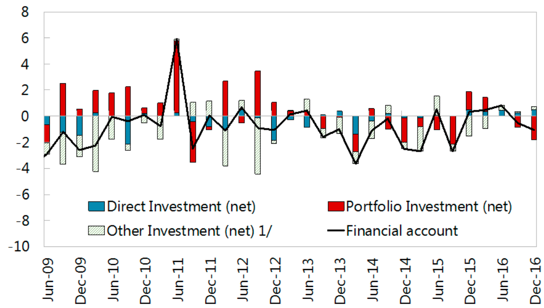


Sources: Malaysian authorities; and IMF staff estimates.

Figure 6. Malaysia: Capital Flows

Portfolio inflows were strong in the first half of 2016, leading to an improvement in the financial account…

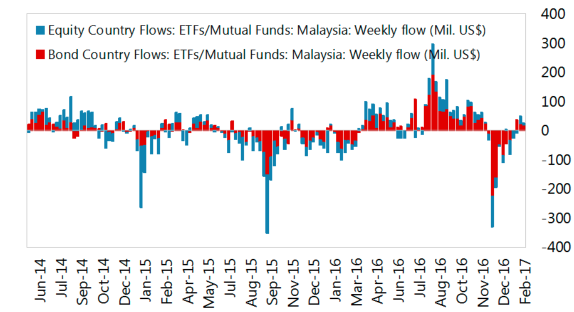
Financial Account
(In percent of 4-quarter rolling GDP)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.
1/ Includes financial derivatives.

… but outflows dominated in late 2016.

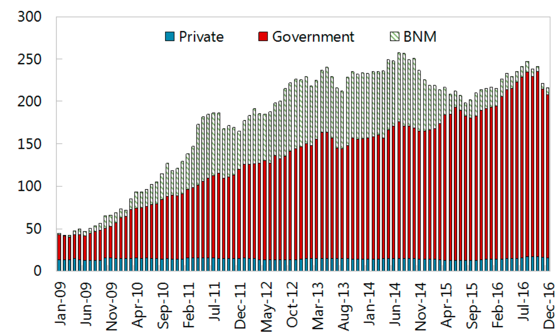
EPFR Global Funds Flows: Equity and Bond Funds 1/
(In millions of U.S. dollars)



Source: Haver Analytics.
1/ Monthly flows. Includes exchange traded funds and mutual funds.

…including a reduction in foreign holdings of Malaysian government securities…

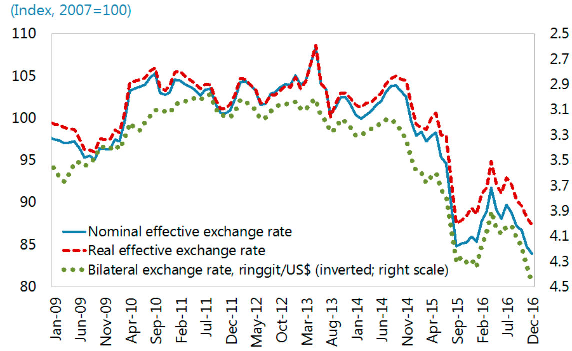
Foreign Holdings of Debt Securities
(In billions of ringgit)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

…and contributed to a depreciation in the exchange rate in the second half of 2016.

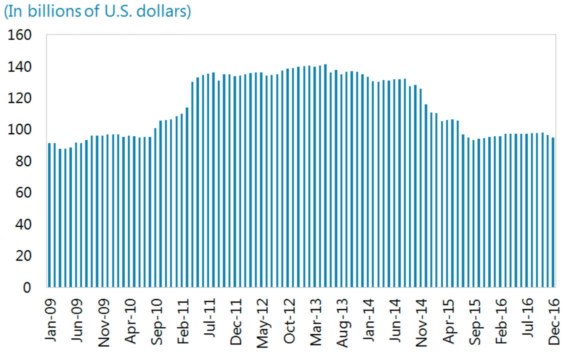
Exchange Rate
(Index, 2007=100)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

BNM's reserves have stabilized.

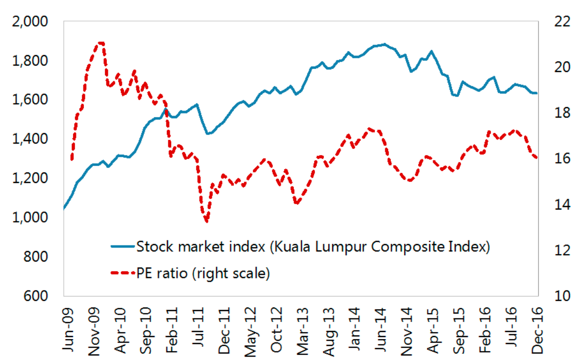
Reserves
(In billions of U.S. dollars)



Source: CEIC Data Co. Ltd.

The stock market has remained range bound since 2015:Q3 and as of end-2016 was nearly 13 percent below its 2014 peak.

Stock Market Performance

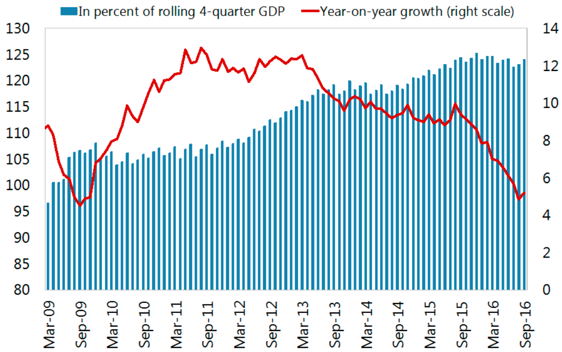


Source: Bloomberg L.P.

Figure 7. Malaysia: Financial Sector Developments

Credit growth has slowed down considerably, stabilizing the credit-to-GDP ratio.

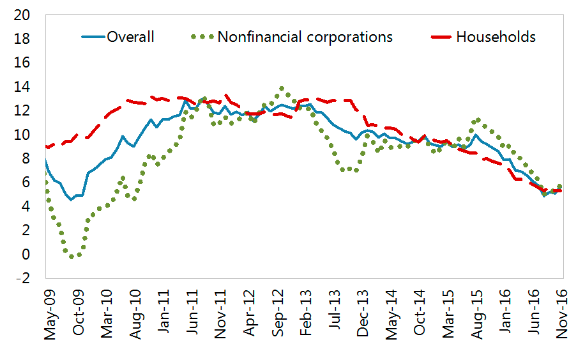
Banks' Claims on Private Sector



Sources: IMF, *Integrated Monetary database*; and IMF staff calculations.

Credit is slowing across the board.

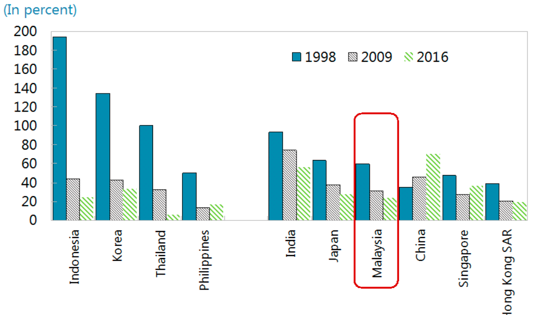
Banks' Claims on Private Sector
(Year-on-year growth)



Sources: IMF, *Integrated Monetary database*; and IMF staff calculations.

Overall corporate sector leverage remains below levels prior to the Asian Financial Crisis.

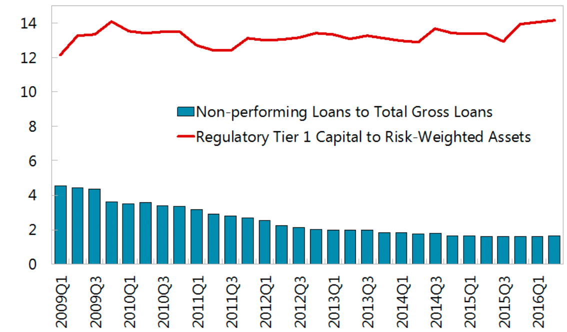
Corporate Debt-to-Equity Ratio 1/
(In percent)



Source: IMF, *Corporate Vulnerability Indicators*.
1/ Median for nonfinancial corporates.

The banking system is well capitalized.

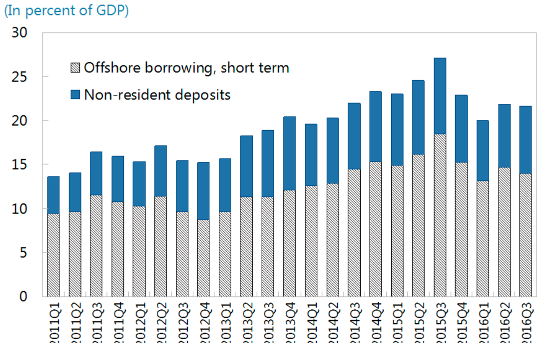
Banks' Financial Soundness Indicators
(In percent)



Source: IMF, *Financial Soundness Indicators* database.

The banking system's reliance on short-term external borrowing has declined and non-resident deposits remained stable…

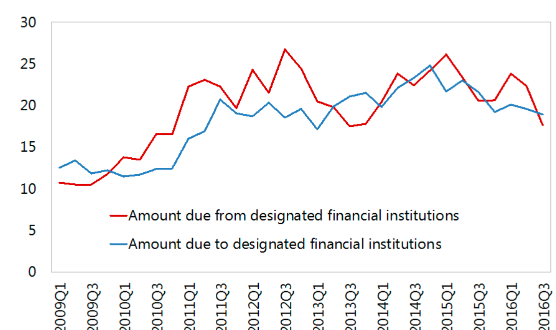
Banks' Short-Term External Debt: 2011:Q1–2015:Q4
(In percent of GDP)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

… while banks' net external assets declined in recent quarters.

Banking System: External Assets and Liabilities, 2009:Q1–2016:Q2
(In billions of U.S. dollars)

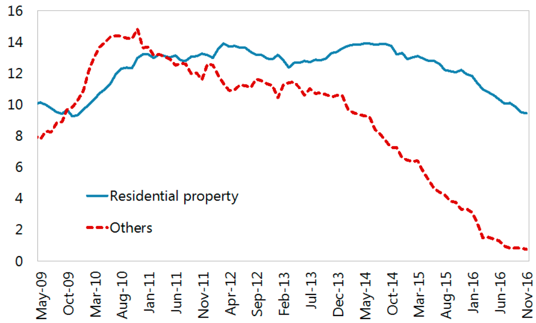


Sources: CEIC Data Co. Ltd; and IMF staff calculations.

Figure 8. Malaysia: Household Debt

Housing and personal loan growth continued to moderate…

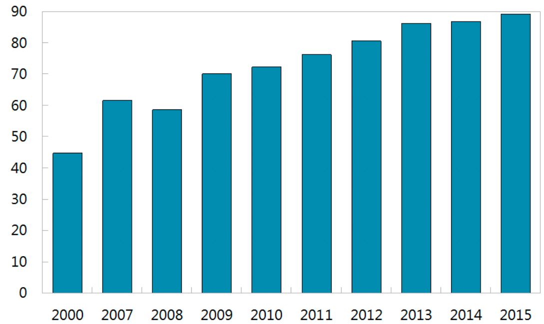
Household Loan Growth
(In percent, year-on-year)



Sources: CEIC Data Co. Ltd; and IMF staff calculations.

… stabilizing the household debt…

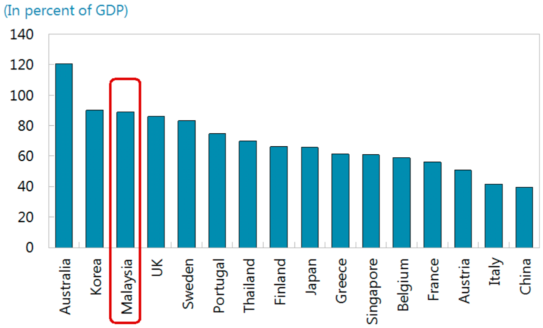
Household Debt
(In percent of GDP)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

… which remains high compared to other countries…

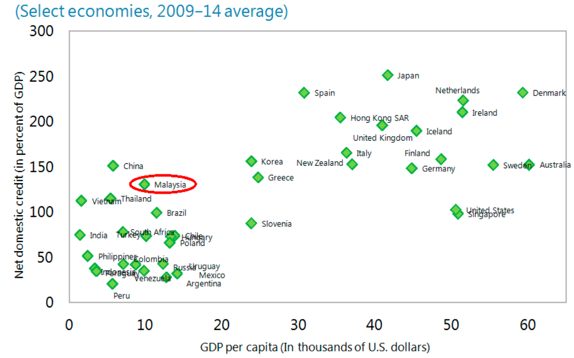
Household Debt, 2016:Q2
(In percent of GDP)



Sources: BIS; CEIC Data Co. Ltd.; IMF, *World Economic Outlook*; and IMF staff calculations.
Note: Data for Malaysia is as of December 2015.

… and is above the ratio in countries with a similar GDP per capita.

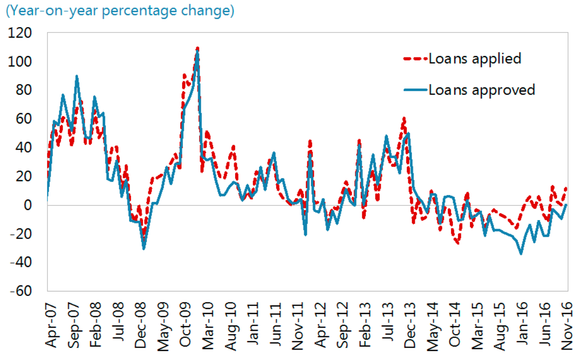
Net Domestic Credit and GDP per Capita
(Select economies, 2009–14 average)



Sources: World Bank, *World Development Indicators*; IMF, *World Economic Outlook*; and IMF staff calculations.

Loan approvals and applications may have turned the corner in recent months.

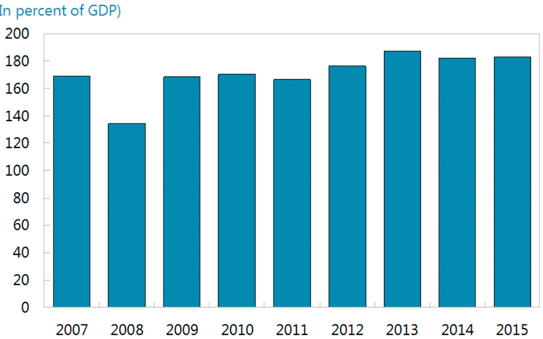
Malaysia: Loan Applications and Approvals
(Year-on-year percentage change)



Source: CEIC Data Co. Ltd.

High household financial assets help mitigate the vulnerability from growing household debt.

Household Financial Assets
(In percent of GDP)

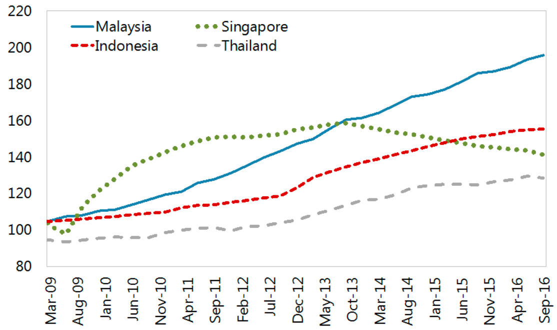


Sources: Malaysian Employee Provident Fund; CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 9. Malaysia: House Prices

House prices continue to rise...

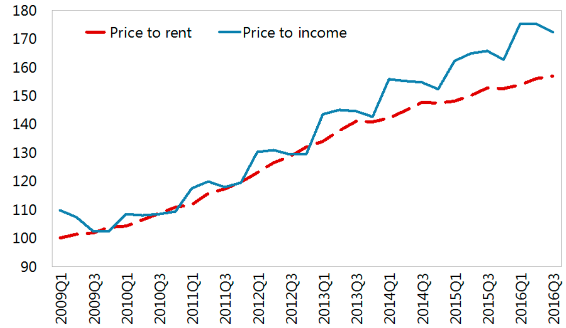
House Price Index
(2007:Q1 = 100)



Sources: CEIC Data Co. Ltd; and IMF staff calculations.

...outpacing incomes and rents.

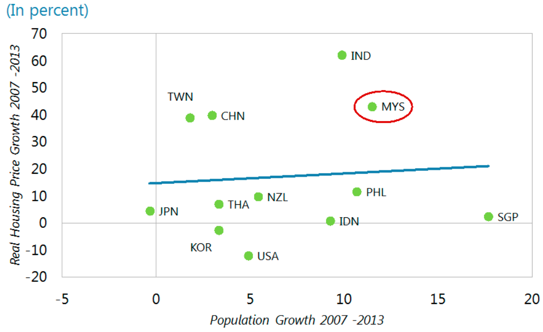
House Prices
(Ratio of indices, 2008:Q4=100)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Although population growth is strong, this cannot fully explain the rise in house prices compared with other countries.

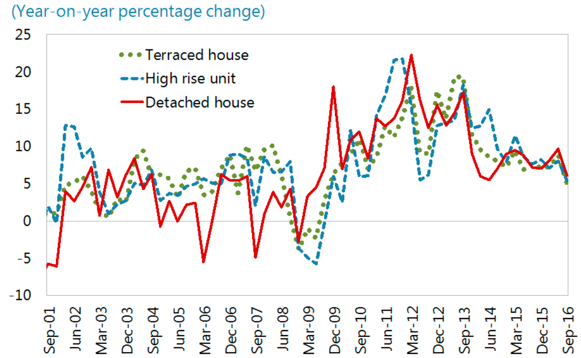
Housing Price and Population Growth
(In percent)



Sources: Global Property Guide; IMF, *World Economic Indicators*; and IMF staff estimates.

The housing market in Kuala Lumpur is moderating.

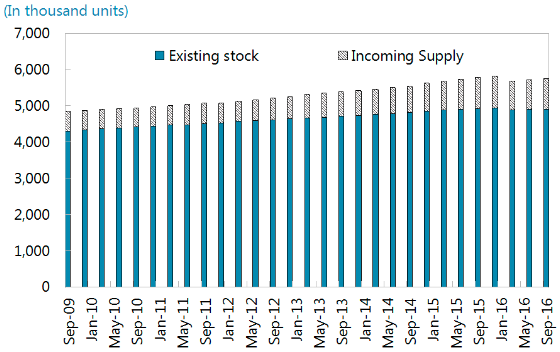
Malaysia: House Prices in Kuala Lumpur
(Year-on-year percentage change)



Source: CEIC Data Co. Ltd.

Residential supply has been increasing...

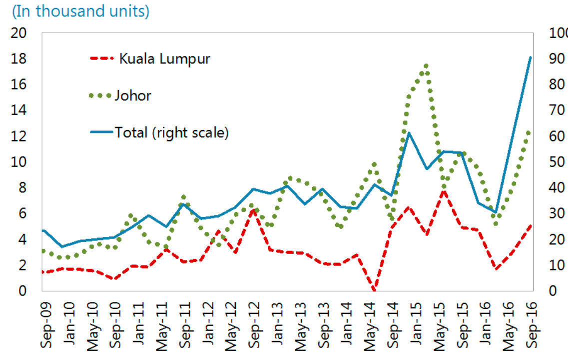
Residential Property Supply
(In thousand units)



Source: CEIC Data Co. Ltd.

... and has picked up in a broad-based manner, helping to ease the pressure on prices.

Residential Property: Construction Started
(In thousand units)

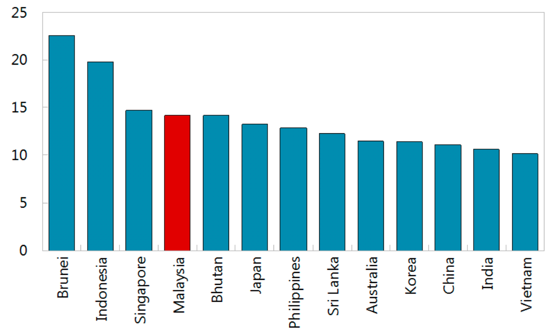


Source: CEIC Data Co. Ltd.

Figure 10. Malaysia: Financial Soundness Indicators, 2016:Q3

Malaysian banks' capital buffers are strong…

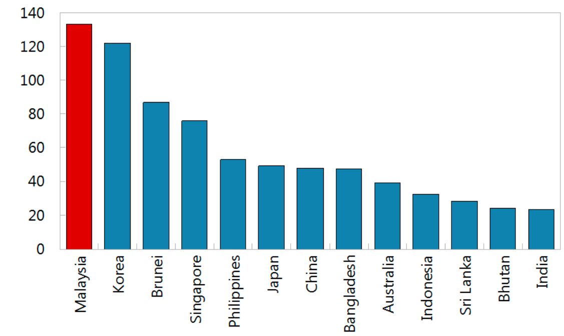
Regulatory Tier 1 Capital to Risk-Weighted Assets
(In percent)



Source: IMF, *Financial Soundness Indicators*.

… while liquidity provides adequate cover for short-term liabilities.

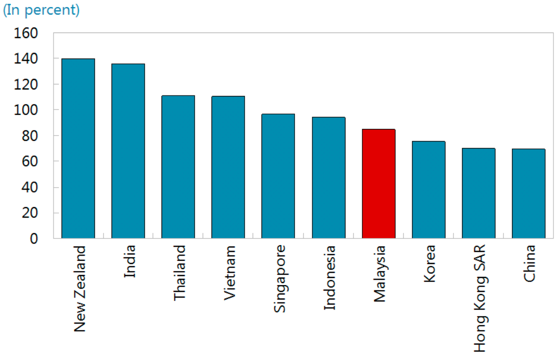
Liquid Assets to Short-Term Liabilities
(In percent)



Source: IMF, *Financial Soundness Indicators*.

Lending in proportion to deposits is reasonable…

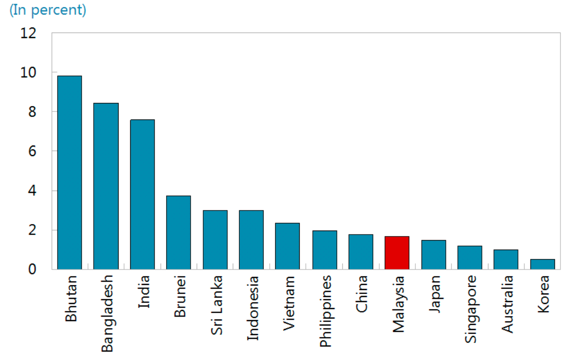
Loan to Deposit Ratio
(In percent)



Sources: CEIC Data Co. Ltd.; Haver Analytics; and IMF staff calculations.

… while asset quality is high.

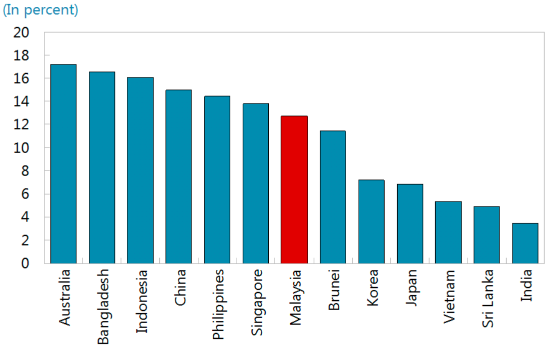
Nonperforming Loans to Total Gross Loans
(In percent)



Source: IMF, *Financial Soundness Indicators*.

Banks are profitable and…

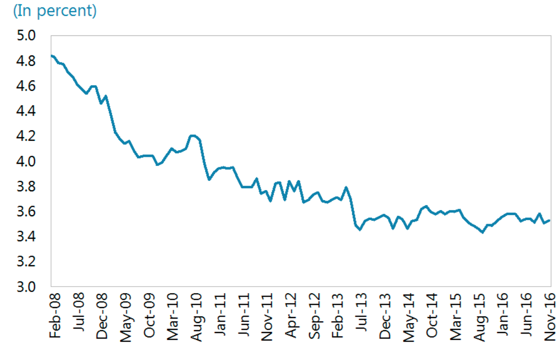
Return on Equity
(In percent)



Source: IMF, *Financial Soundness Indicators*.

… enjoy stable interest rate spreads.

Interest Rate Spreads
(In percent)



Sources: Bank Negara Malaysia; and IMF staff calculations.

Table 1. Malaysia: Selected Economic and Financial Indicators, 2012–18

Nominal GDP (2016 est.): US$296.4 billion
GDP per capita (2016, current prices): US$9,360
Unemployment rate (2016): 3.5 percent

Population (2016): 31.7 million
Poverty rate (2014, national poverty line): 0.6 percent
Adult literacy rate (2015): 94.6 percent

Main exports (share in total goods exports): electrical & electronic products (39 percent), and commodities (23 percent)

	2012	2013	2014	2015	Est. 2016	Proj. 2017	Proj. 2018
Real GDP (percent change)	5.5	4.7	6.0	5.0	4.2	4.5	4.7
Total domestic demand	10.6	6.3	5.3	5.9	4.8	5.1	5.1
Private consumption	8.3	7.2	7.0	6.0	6.1	6.2	6.0
Public consumption	5.4	5.8	4.3	4.4	1.0	4.7	2.9
Private investment	21.4	12.8	11.1	6.4	4.4	5.3	5.4
Public gross fixed capital formation	15.9	1.8	-4.7	-1.0	-0.5	1.0	1.9
Net exports (contribution to growth)	-3.6	-1.0	1.2	-0.4	-0.2	-0.2	0.0
Saving and investment (in percent of GDP)							
Gross domestic investment	25.7	25.9	25.0	25.1	26.1	25.5	25.3
Gross national saving	30.9	29.4	29.4	28.1	28.1	27.3	27.1
Fiscal sector (in percent of GDP)							
Federal government overall balance 1/	-5.1	-4.2	-3.4	-3.2	-3.1	-3.0	-2.7
Revenue	20.7	20.4	19.9	18.9	17.3	16.6	16.6
Expenditure and net lending	25.7	24.6	23.3	22.1	20.4	19.6	19.3
Federal government non-oil primary balance	-10.3	-8.7	-7.3	-5.2	-3.4	-3.3	-2.7
Consolidated public sector overall balance 2/	-5.6	-6.0	-7.4	-7.8	-7.2	-6.4	-5.6
General government debt 3/	54.6	56.4	56.2	57.9	56.3	56.0	54.9
Of which: federal government debt	51.6	53.0	52.7	54.5	52.7	52.5	51.4
Inflation and unemployment (period average, in percent)							
CPI inflation	1.7	2.1	3.1	2.1	2.1	2.7	2.9
Unemployment rate	3.0	3.1	2.9	3.1	3.5	3.4	3.2
Macrofinancial variables (end of period)							
Broad money (percentage change) 4/	8.8	7.4	6.3	3.0	2.7	3.3	4.1
Credit to private sector (percentage change) 4/ 5/	12.1	10.2	9.2	8.6	5.2	5.9	6.5
Credit-to-GDP ratio (in percent) 4/ 6/	123.6	129.7	130.1	134.8	134.1	131.9	130.3
Credit-to-GDP gap (in percent) 4/ 6/ 7/	13.5	15.7	12.7	13.5	9.4	...	...
Overnight policy rate (in percent) 4/	3.00	3.00	3.25	3.25	3.00	...	...
Three-month interbank rate (in percent) 4/	3.2	3.2	3.9	3.8	3.4	...	...
Nonfinancial corporate sector debt (in percent of GDP)	98.0	100.2	96.2	102.0	101.5	99.4	97.9
Nonfinancial corporate sector debt issuance (in percent of GDP) 4/	4.7	3.5	3.2	2.6	3.2	...	...
Household debt (in percent of GDP)	80.5	86.1	86.8	89.1	88.9	88.8	88.7
Household financial assets (in percent of GDP)	176.3	187.0	182.4	182.9	181.6	...	...
House prices (percentage change) 4/	11.8	10.9	8.5	7.4	5.4	5.5	6.5
Exchange rates (period average)							
Malaysian ringgit/U.S. dollar	3.09	3.15	3.27	3.91	4.15	...	...
Real effective exchange rate (percentage change)	-0.2	0.5	-0.7	-7.9	-4.3	...	...
Balance of payments (in billions of U.S. dollars) 7/							
Current account balance	16.2	11.3	14.8	8.9	6.1	5.5	6.1
(In percent of GDP)	5.2	3.5	4.4	3.0	2.0	1.8	1.8
Goods balance	36.6	30.6	34.6	28.1	24.4	25.3	26.7
Services and primary income account balance	-14.4	-13.8	-14.5	-13.6	-13.8	-14.6	-14.9
Capital and financial account balance	-7.4	-6.4	-24.3	-13.3	-1.0	2.4	5.2
Of which: Direct investment	-7.9	-2.0	-5.5	1.2	4.3	4.2	3.2
Errors and omissions	-7.6	-0.2	-1.7	5.4	-1.5	0.0	0.0
Overall balance	1.3	4.6	-11.2	1.0	3.6	7.9	11.3
Gross official reserves (US$ billions)	139.7	134.9	115.9	95.3	94.6	102.4	113.8
(In months of following year's imports of goods and nonfactor services)	7.7	7.4	7.4	6.3	5.9	6.1	6.6
(In percent of short-term debt by original maturity) 7/	150.7	130.7	111.6	116.2	112.7	132.6	149.5
(In percent of short-term debt by remaining maturity) 7/	104.1	91.8	78.4	75.1	74.2	79.3	86.5
Total external debt (in billions of U.S. dollars) 7/	196.9	212.3	213.4	194.2	202.6	207.1	214.5
(In percent of GDP) 7/	62.6	65.7	63.1	65.6	68.3	66.8	63.4
Of which: short-term (in percent of total, original maturity) 7/	47.1	48.6	48.7	42.2	41.4	37.3	35.5
short-term (in percent of total, remaining maturity) 7/	68.1	69.3	69.3	65.4	63.0	62.4	61.3
Debt service ratio 7/							
(In percent of exports of goods and services) 8/	17.2	17.3	17.9	21.3	23.7	24.9	25.7
(In percent of exports of goods and nonfactor services)	18.2	18.4	19.1	22.6	25.1	26.3	27.2
Memorandum items:							
Nominal GDP (in billions of ringgit)	971	1,019	1,106	1,157	1,229	1,323	1,426

Sources: Data provided by the authorities; CEIC Data Co. Ltd.; Dealogic; World Bank; UNESCO; and Fund staff estimates.

1/ Based on staff's estimate of the federal government fiscal balance using GFSM 2001, which differs from the authorities' cash-based measure of the fiscal deficit.
2/ Capital expenditure in the budget includes foreign fixed assets and other items, such as purchase of shares and land, which are excluded from public investment in the national accounts.
3/ General government includes the federal government, state and local governments, and the statutory bodies.
4/ Latest available data.
5/ Based on the depository corporation survey.
6/ Based on a broader measure of liquidity.
7/ Staff estimates.
8/ Includes receipts under the primary income account.

Table 2. Malaysia: Indicators of External Vulnerability, 2012–16

	2012	2013	2014	2015	2016
Financial indicators					
General government debt (in percent of GDP) 1/	54.6	56.4	56.2	57.9	56.3
Broad money (percent change, 12-month basis) 2/ 3/	8.8	7.4	6.3	3.0	2.7
Private sector credit (percent change, 12-month basis) 2/ 3/	12.1	10.2	9.2	8.6	5.2
3-month interest rate (percent, 12-month average) 2/ 4/	3.0	3.0	3.1	3.1	2.8
External indicators 5/					
Goods exports, f.o.b. (percent change, 12-month basis, in U.S. dollars terms) 4/	-3.0	-3.1	2.5	-15.4	-5.8
Goods imports, f.o.b. (percent change, 12-month basis, in U.S. dollars terms) 4/	1.7	-0.3	0.6	-14.7	-4.4
Current account balance (in billions of U.S. dollars)	16.2	11.3	14.8	8.9	6.1
Current account balance (in percent of GDP)	5.2	3.5	4.4	3.0	2.0
Capital and financial account balance (in billions of U.S. dollars)	-7.4	-6.4	-24.3	-13.3	-1.0
Gross official reserves (in billions of U.S. dollars)	139.7	134.9	115.9	95.3	94.6
In months of following year's imports of goods and nonfactor services	7.7	7.4	7.4	6.3	5.9
As percent of broad money 3/	32.2	31.0	26.8	26.2	26.4
As percent of monetary base	420.7	382.2	325.7	297.9	300.4
Total short-term external debt by: 6/					
Original maturity (in billions of U.S. dollars)	92.7	103.3	103.9	82.0	83.9
Remaining maturity (in billions of U.S. dollars)	134.2	147.0	147.9	127.0	127.6
Original maturity to reserves (in percent)	66.4	76.5	89.6	86.0	88.8
Original maturity to total external debt (in percent)	47.1	48.6	48.7	42.2	41.4
Remaining maturity to reserves (in percent)	96.0	109.0	127.6	133.2	134.9
Remaining maturity to total external debt (in percent)	68.1	69.3	69.3	65.4	63.0
Total external debt (in billions of U.S. dollars) 6/	196.9	212.3	213.4	194.2	202.6
Of which: public sector (medium- and long-term (MLT))	71.9	72.9	69.7	70.1	71.5
Total external debt to exports of goods and services (in percent) 7/	74.8	81.8	80.4	87.3	96.3
External amortization of MLT debt to exports of goods and services (in percent) 7/	15.9	16.0	16.5	19.8	21.4
Financial market indicators					
Kuala Lumpur Composite Index (KLCI), end of period 2/	1,689.0	1,867.0	1,761.3	1,692.5	1,641.7
10-year government securities yield (percent per annum, average) 2/	3.5	3.7	4.0	4.0	3.8

Sources: Haver Analytics; data provided by the authorities; and Fund staff estimates.
1/ Gross debt. General government includes the federal government, state and local governments, and the statutory bodies.
2/ Latest available data.
3/ Based on the depository corporation survey.
4/ Discount rate on 3-month treasury bills.
5/ Staff estimates.
6/ Includes offshore borrowing and nonresident holdings of ringgit-denominated securities.
7/ Includes receipts under the primary income account.

Table 3. Malaysia: Balance of Payments, 2012–21

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
						Proj.				
	(In billions of U.S. dollars) 1/									
Current account balance	16.2	11.3	14.8	8.9	6.1	5.5	6.1	6.9	7.5	8.0
Goods balance	36.6	30.6	34.6	28.1	24.4	25.3	26.7	28.5	30.4	32.2
Exports, f.o.b.	208.8	202.4	207.4	175.5	165.4	176.9	184.6	193.3	201.7	209.7
Imports, f.o.b.	172.2	171.7	172.8	147.4	141.0	151.5	157.9	164.8	171.3	177.6
Services and primary income account balance	-14.4	-13.8	-14.5	-13.6	-13.8	-14.6	-14.9	-15.2	-15.9	-16.5
Receipts	54.3	57.2	58.1	47.1	45.1	47.2	49.3	51.1	52.8	54.7
Of which : primary income	13.7	15.1	16.0	12.5	11.2	12.2	13.3	14.1	14.6	15.4
Payments	68.6	71.1	72.5	60.6	58.9	61.8	64.2	66.4	68.6	71.2
Of which : primary income	25.3	25.9	27.2	20.7	19.5	20.9	21.8	22.8	23.8	24.8
Secondary income	-6.0	-5.6	-5.3	-5.6	-4.5	-5.3	-5.8	-6.4	-7.0	-7.7
Capital and financial account balance	-7.4	-6.4	-24.3	-13.3	-1.0	2.4	5.2	6.2	4.5	2.5
Capital account	0.1	0.0	0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-7.5	-6.4	-24.4	-13.0	-1.0	2.4	5.2	6.2	4.5	2.5
Direct investment	-7.9	-2.0	-5.5	1.2	4.3	4.2	3.2	1.7	0.2	-0.2
Portfolio investment	20.7	-1.0	-12.0	-7.2	-4.7	1.5	2.7	4.1	5.7	7.6
Other investment	-20.2	-3.5	-6.9	-7.0	-0.6	-3.3	-0.7	0.4	-1.5	-4.9
Errors and omissions	-7.6	-0.2	-1.7	5.4	-1.5	0.0	0.0	0.0	0.0	0.0
Overall balance	1.3	4.6	-11.2	1.0	3.6	7.9	11.3	13.1	12.0	10.5
Gross official reserves	139.7	134.9	115.9	95.3	94.6	102.5	113.8	126.9	138.9	149.5
In months of following year's imports of goods and nonfactor services	7.7	7.4	7.4	6.3	5.9	6.1	6.6	7.0	7.4	7.7
In percent of short-term debt 2/	104.1	91.8	78.4	75.1	74.2	79.3	86.5	95.7	99.0	101.1
	(In percent of GDP) 1/									
Current account balance	5.2	3.5	4.4	3.0	2.0	1.8	1.8	1.8	1.8	1.8
(Excluding crude oil and liquefied natural gas)	-1.1	-3.0	-1.7	-1.8	-1.4	-2.5	-2.3	-2.1	-1.9	-1.8
Goods balance	11.6	9.5	10.2	9.5	8.2	8.2	7.9	7.6	7.4	7.2
Exports, f.o.b.	66.4	62.6	61.4	59.2	55.8	57.1	54.6	51.5	49.1	46.8
Imports, f.o.b.	54.8	53.1	51.1	49.8	47.6	48.9	46.7	43.9	41.7	39.6
Services and primary income account balance	-4.6	-4.3	-4.3	-4.6	-4.7	-4.7	-4.4	-4.1	-3.9	-3.7
Capital and financial account balance	-2.3	-2.0	-7.2	-4.5	-0.3	0.8	1.6	1.7	1.1	0.6
Direct investment	-2.5	-0.6	-1.6	0.4	1.5	1.4	1.0	0.5	0.1	0.0
	(Annual percentage change)									
Memorandum items:										
Goods trade										
Exports, f.o.b., value growth (in U.S. dollars) 1/	-3.0	-3.1	2.5	-15.4	-5.8	6.9	4.4	4.7	4.4	4.0
Export volume growth	-3.8	1.9	6.6	6.0	3.1	2.0	3.3	3.8	3.4	3.1
Imports, f.o.b., value growth (in U.S. dollars) 1/	1.7	-0.3	0.6	-14.7	-4.4	7.5	4.2	4.3	4.0	3.6
Import volume growth	0.3	5.9	4.1	1.3	0.5	1.8	3.2	3.6	3.1	2.8
Terms of trade	-0.7	-0.4	-1.4	-3.4	-3.3	-0.7	0.1	0.1	0.0	0.0
Net international investment position 1/										
(In billions of U.S. dollars)	-5.8	-14.3	-5.0	25.7	18.1	...	...	...	...	...
(In percent of GDP)	-1.8	-4.4	-1.5	8.7	6.1	...	...	...	...	...

Sources: Data provided by the authorities; and Fund staff estimates.

1/ Staff estimates using the official data in national currency.
2/ Based on staff's estimate by remaining maturity.

Table 4. Malaysia: Illustrative Medium-Term Macroeconomic Framework, 2012–21 1/

						Proj.				
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Real sector (percent change)										
Real GDP growth	5.5	4.7	6.0	5.0	4.2	4.5	4.7	4.9	4.9	4.8
Total domestic demand	10.6	6.3	5.3	5.9	4.8	5.1	5.1	5.3	5.2	5.2
CPI inflation (period average)	1.7	2.1	3.1	2.1	2.1	2.7	2.9	3.0	3.0	3.0
Saving and investment (in percent of GDP)										
Gross domestic investment	25.7	25.9	25.0	25.1	26.1	25.5	25.3	25.1	24.9	24.7
Private, including stocks	15.0	15.4	15.6	16.1	17.5	17.3	17.4	17.4	17.4	17.4
Of which: gross fixed capital formation	14.7	15.9	16.6	17.2	17.2	17.3	17.4	17.4	17.4	17.4
Public	10.7	10.5	9.4	9.0	8.6	8.2	8.0	7.7	7.5	7.3
Gross national saving	30.9	29.4	29.4	28.1	28.1	27.3	27.1	27.0	26.7	26.5
Private	22.2	22.1	21.6	23.7	21.9	21.8	21.6	21.0	20.5	19.9
Public	8.7	7.3	7.8	4.4	6.2	5.5	5.5	6.0	6.2	6.6
Fiscal sector (in percent of GDP)										
Federal government overall balance	-5.1	-4.2	-3.4	-3.2	-3.1	-3.0	-2.7	-2.3	-1.9	-1.4
Revenue	20.7	20.4	19.9	18.9	17.3	16.6	16.6	16.6	16.7	16.8
Tax	15.6	15.3	14.8	14.3	13.6	13.6	13.8	13.8	13.8	13.9
Nontax	5.1	5.1	5.1	4.6	3.7	3.0	2.8	2.9	2.9	2.9
Expenditure	25.7	24.6	23.3	22.1	20.4	19.6	19.3	18.9	18.6	18.2
Current	21.3	21.0	20.0	19.0	17.1	16.1	15.8	15.4	15.1	14.7
Development	4.4	3.6	3.3	3.2	3.3	3.5	3.5	3.5	3.5	3.5
Federal government non-oil primary balance	-10.3	-8.7	-7.3	-5.2	-3.4	-3.3	-2.7	-2.2	-1.8	-1.3
Consolidated public sector overall balance 2/	-5.6	-6.0	-7.4	-7.8	-7.2	-6.4	-5.6	-4.9	-4.5	-4.0
General government debt 3/	54.6	56.4	56.2	57.9	56.3	56.0	54.9	53.2	51.3	49.1
Of which: federal government debt	51.6	53.0	52.7	54.5	52.7	52.5	51.4	49.7	47.8	45.6
Balance of payments (in billions of U.S. dollars) 4/										
Goods balance	36.6	30.6	34.6	28.1	24.4	25.3	26.7	28.5	30.4	32.2
Services and primary income account balance	-14.4	-13.8	-14.5	-13.6	-13.8	-14.6	-14.9	-15.2	-15.9	-16.5
Current account balance	16.2	11.3	14.8	8.9	6.1	5.5	6.1	6.9	7.5	8.0
(In percent of GDP)	5.2	3.5	4.4	3.0	2.0	1.8	1.8	1.8	1.8	1.8
Capital and financial account balance	-7.4	-6.4	-24.3	-13.3	-1.0	2.4	5.2	6.2	4.5	2.5
Of which : Direct investment	-7.9	-2.0	-5.5	1.2	4.3	4.2	3.2	1.7	0.2	-0.2
Errors and omissions	-7.6	-0.2	-1.7	5.4	-1.5	0.0	0.0	0.0	0.0	0.0
Overall balance	1.3	4.6	-11.2	1.0	3.6	7.9	11.3	13.1	12.0	10.5
International trade (annual percent change)										
Goods exports, f.o.b. (in U.S. dollars terms) 4/	-3.0	-3.1	2.5	-15.4	-5.8	6.9	4.4	4.7	4.4	4.0
Goods imports, f.o.b. (in U.S. dollars terms) 4/	1.7	-0.3	0.6	-14.7	-4.4	7.5	4.2	4.3	4.0	3.6
Terms of trade	-0.7	-0.4	-1.4	-3.4	-3.3	-0.7	0.1	0.1	0.0	0.0
Gross official reserves (in billions of U.S. dollars)	139.7	134.9	115.9	95.3	94.6	102.4	113.8	126.9	138.9	149.4
(In months of following year's imports of goods and nonfactor services)	7.7	7.4	7.4	6.3	5.9	6.1	6.6	7.0	7.4	7.7
(In percent of short-term debt by original maturity) 4/	150.7	130.7	111.6	116.2	112.7	132.6	149.5	172.3	178.2	182.1
(In percent of short-term debt by remaining maturity) 4/	104.1	91.8	78.4	75.1	74.2	79.3	86.5	95.6	98.9	101.1
Total external debt (in billions of U.S. dollars) 4/	196.9	212.3	213.4	194.2	202.6	207.1	214.5	221.0	233.8	246.2
(In percent of GDP) 4/	62.6	65.7	63.1	65.6	68.3	66.8	63.4	58.9	56.9	54.9
Short-term external debt (percent of total, original maturity) 4/	47.1	48.6	48.7	42.2	41.4	37.3	35.5	33.3	33.3	33.3
Short-term external debt (percent of total, remaining maturity) 4/	68.1	69.3	69.3	65.4	63.0	62.4	61.3	60.0	60.0	60.0
Debt-service ratio 4/										
(In percent of exports of goods and nonfactor services)	18.2	18.4	19.1	22.6	25.1	26.3	27.2	28.2	28.5	29.1
Net international investment position (in billions of U.S. dollars) 4/	-5.8	-14.3	-5.0	25.7	18.1	...	...	...	...	...
Memorandum items:										
Nominal GDP (in billions of ringgit)	971	1,019	1,106	1,157	1,229	1,323	1,426	1,544	1,671	1,806

Sources: Data provided by the authorities; and Fund staff estimates.

1/ Period ending December 31.

2/ Capital expenditure in the budget includes foreign fixed assets and other items, such as purchases of shares and land, which are excluded from public investment in the national accounts.

3/ General government includes the federal government, state and local governments, and the statutory bodies.

4/ Staff estimates.

Table 5. Malaysia: Summary of Federal Government Operations and Stock Positions, 2012–18

	2012	2013	2014	2015	Est. 2016	Proj. 2017	Proj. 2018
I. Statement of Government Operations			(In billions of ringgit)				
Revenue	200.9	208.0	220.6	219.1	212.6	219.7	236.7
Taxes	151.6	156.0	164.2	165.4	167.1	180.6	196.1
Other revenue	49.3	52.0	56.4	53.6	45.5	39.1	40.6
Expenditure	250.0	250.6	258.0	256.3	251.3	259.6	275.5
Expense	207.4	213.9	221.5	219.4	210.5	213.6	225.9
Compensation of employees	60.0	61.0	66.9	70.1	73.9	76.9	80.0
Use of goods and services	35.6	37.9	38.0	40.5	33.8	32.0	33.3
Interest	19.5	20.8	22.6	24.3	26.6	28.9	32.6
Subsidies	44.1	43.3	39.7	27.3	24.6	22.4	23.1
Grants	32.6	34.8	34.6	37.3	31.5	30.8	32.7
Social benefits and other expense	15.5	16.1	19.7	20.0	20.0	22.6	24.3
Net acquisition of nonfinancial assets	42.7	36.7	36.5	36.9	40.8	46.0	49.5
Gross operating balance	-6.4	-5.9	-0.9	-0.3	2.0	6.1	10.7
Net lending/borrowing	-49.1	-42.6	-37.4	-37.2	-38.7	-39.8	-38.8
Overall fiscal balance (authorities' definition) 1/	-42.0	-38.6	-37.4	-37.2	-38.7	-39.8	-38.8
Net acquisition of financial assets	-5.8	-3.3	-4.2	-1.4	...	...	...
By financial instrument							
Currency and deposits	1.4	0.7	-1.1	-1.4	...	...	...
Loans and equity	-7.2	-4.0	-3.1	0.0	...	...	...
By holder residence							
Domestic	-5.8	-3.3	-4.2	-1.4	...	...	...
Foreign	...	...	...	0	...	...	...
Net incurrence of liabilities	43.3	39.1	36.8	38.2	38.7	39.8	38.8
By financial instrument							
Debt securities	43.3	39.3	37.2	38.6	...	...	...
Loans	0.0	-0.2	-0.4	-0.4	...	...	...
By holder residence							
Domestic	15.2	30.0	28.1	27.1	...	...	...
Foreign	28.1	9.0	8.7	11.1	...	...	...
			(In percent of GDP)				
Revenue	20.7	20.4	19.9	18.9	17.3	16.6	16.6
Taxes	15.6	15.3	14.8	14.3	13.6	13.6	13.8
Other revenue	5.1	5.1	5.1	4.6	3.7	3.0	2.8
Expenditure	25.7	24.6	23.3	22.1	20.4	19.6	19.3
Expense	21.3	21.0	20.0	19.0	17.1	16.1	15.8
Compensation of employees	6.2	6.0	6.1	6.1	6.0	5.8	5.6
Use of goods and services	3.7	3.7	3.4	3.5	2.7	2.4	2.3
Interest	2.0	2.0	2.0	2.1	2.2	2.2	2.3
Subsidies	4.5	4.3	3.6	2.4	2.0	1.7	1.6
Grants	3.4	3.4	3.1	3.2	2.6	2.3	2.3
Social benefits and other expense	1.6	1.6	1.8	1.7	1.6	1.7	1.7
Net acquisition of nonfinancial assets	4.4	3.6	3.3	3.2	3.3	3.5	3.5
Gross operating balance	-0.7	-0.6	-0.1	0.0	0.2	0.5	0.8
Net lending/borrowing	-5.1	-4.2	-3.4	-3.2	-3.1	-3.0	-2.7
Overall fiscal balance (authorities' definition) 1/	-4.3	-3.8	-3.4	-3.2	-3.1	-3.0	-2.7
II. Stock Positions			(In billions of ringgit)				
Liabilities (nominal value)	501.6	539.9	582.8	630.5	648.5	...	...
By financial instrument							
Debt securities	440.0	481.9	530.9	573.9	613.6	...	...
Loans	61.6	58.0	51.9	56.6	34.8	...	...
By holder residence							
Domestic	352.4	381.4	414.6	431.9	452.5	...	...
Foreign	149.3	158.4	168.2	198.6	196.0	...	...
Memorandum items:							
Cyclically adjusted balance (percent of potential GDP)	-5.1	-4.2	-3.6	-2.9	-2.9	-3.0	-2.7
Structural primary balance (percent of potential GDP)	-3.1	-2.1	-1.6	-0.8	-0.8	-0.8	-0.4
Primary balance (percent of GDP)	-3.0	-2.1	-1.3	-1.1	-1.0	-0.8	-0.4
Non-oil and gas primary balance (percent of GDP)	-10.3	-8.7	-7.3	-5.2	-3.4	-3.3	-2.7
Oil and gas revenues (percent of GDP)	7.2	6.5	6.0	4.0	2.4	2.4	2.3
General government balance (percent of GDP) 2/	-3.8	-4.1	-2.7	-2.9	-3.0	-3.0	-2.7
Public sector balance (percent of GDP) 2/	-5.6	-6.0	-7.4	-7.8	-7.2	-6.4	-5.6
Nominal GDP (in billions of ringgit)	971	1,019	1,106	1,157	1,229	1,323	1,426

Sources: Data provided by the Malaysian authorities; and Fund staff estimates.

1/ Authorities' measure of the overall fiscal balance and the IMF's measure of fiscal balance (net lending/borrowing) are different due to differences in methodology/basis of recording (GFSM2001 versus authorities' modified-cash based accounting) and differences in the treatment of certain items.

2/ General government includes federal government, state and local governments, and statutory bodies. Public sector includes general government and nonfinancial public enterprises (NFPEs).

Table 6. Malaysia: Monetary Survey, 2012–16

	2012	2013	2014	2015	2016
	(In billions of ringgit; end of period)				
Net foreign assets	347.4	337.4	326.0	359.7	361.1
Foreign assets	560.1	576.4	579.3	592.8	584.6
Foreign liabilities	212.7	239.0	253.3	233.1	223.5
Net domestic assets	1,012.2	1,100.9	1,200.2	1,213.7	1,254.2
Net domestic credit	1,254.2	1,384.1	1,521.8	1,640.9	1,749.9
Net credit to nonfinancial public sector	69.8	92.9	121.1	121.8	142.2
Net credit to central government	48.5	72.3	101.0	105.0	125.4
Net credit to state & local government	1.6	1.6	1.4	1.2	1.0
Net credit to nonfinancial corporations	19.8	19.0	18.8	15.6	15.9
Credit to private sector	1,108.4	1,221.3	1,334.1	1,448.9	1,524.6
Net credit to other financial corporations	75.9	69.8	66.5	70.2	83.0
Capital accounts	207.5	250.5	293.0	375.2	413.7
Other items (net)	-34.5	-32.7	-28.7	-52.0	-81.9
Broad money 1/	1,328.7	1,427.0	1,517.0	1,563.1	1,604.9
Narrow money	309.0	347.6	374.5	399.0	419.4
Currency in circulation	56.8	62.7	68.0	76.6	85.5
Transferable deposits	252.2	284.9	306.4	322.4	333.9
Other deposits	993.9	1,053.3	1,111.6	1,142.0	1,160.9
Securities other than shares	25.9	26.1	30.9	22.1	24.6
	(Contributions to 12-month growth in broad money, in percentage points)				
Net foreign assets	-0.8	-0.8	-0.8	2.2	0.1
Net domestic assets	8.5	6.7	7.0	0.9	2.6
Memorandum items:					
Broad money (12-month percent change)	8.8	7.4	6.3	3.0	2.7
Currency in circulation (12-month percent change)	6.2	10.4	8.5	12.7	11.5
Money multiplier (broad money/narrow money)	4.3	4.1	4.1	3.9	3.8

Sources: Bank Negara Malaysia; and IMF, *International Financial Statistics*.

1/ Broad money does not equal the sum of net foreign assets and net domestic assets due to non-liquid liabilities, primarily at the other depository corporations.

Table 7. Malaysia: Banks' Financial Soundness Indicators, 2012–2016:Q3

	2012	2013	2014	2015	2016 Q3
			(In percent)		
Capital adequacy					
Regulatory capital to risk-weighted assets	17.6	14.6	15.4	16.3	16.9
Regulatory Tier 1 capital to risk-weighted assets	13.4	13.1	13.4	13.9	14.4
Asset quality					
Nonperforming loans net of provisions to capital 1/	8.3	8.1	7.0	6.8	6.8
Nonperforming loans to total gross loans	2.0	1.8	1.6	1.6	1.7
Total provisions to nonperforming loans	104.6	101.2	100.4	96.3	89.4
Earnings and profitability					
Return on assets	1.6	1.5	1.5	1.2	1.4
Return on equity	17.3	15.8	15.0	12.3	12.8
Interest margin to gross income	54.8	59.6	61.0	61.8	60.4
Non-interest expenses to gross income	45.0	42.6	43.0	46.7	43.6
Liquidity					
Liquid assets to total assets (liquid asset ratio)	13.8	13.2	13.3	22.1	22.1
Liquid assets to short-term liabilities	42.5	41.0	43.2	141.8	134.7
Loan-deposit ratio 2/	82.1	84.7	86.7	88.7	88.7
Liquidity Coverage Ratio 3/	…	…	…	127.4	127.0
Sensitivity to market risk					
Net open position in foreign exchange to capital	8.7	9.1	12.7	13.9	16.8
Sectoral distribution of total loans to nonbanking sector					
Residents	97.7	97.2	96.9	96.9	97.2
Other financial corporations	2.6	2.8	2.8	3.1	3.3
General government	2.6	2.1	1.7	1.4	1.7
Nonfinancial corporations	37.6	36.9	36.8	36.9	36.3
Other domestic sectors	54.9	55.4	55.6	55.5	55.9
Nonresidents	2.3	2.8	3.1	3.1	2.8

Sources: Bank Negara Malaysia; CEIC Data Co. Ltd.; and IMF, *Financial Soundness Indicators* database.

1/ Loans are classified as nonperforming if payments are overdue for three months or more. Total loans include housing loans sold to Cagamas Berhad. Net NPL exclude interest-in-suspense and specific provisions.

2/ Deposits include repos and negotiable instruments of deposit. Loans exclude loans sold to Cagamas Berhad.

3/ Introduced in July 2015.

Table 8. Malaysia: Macroprudential Measures Since 2010
(Based on effective date)

January 2010	Re-introduced 5 percent Real Property Gains Tax (RPGT) for properties disposed in less than 5 years. Properties disposed in the 6th year after the date of acquisition or thereafter are not subject to RPGT. The minimum house price for foreigners was increased to RM 500,000 from RM 250,000.
November 2010	Imposed caps on 70 percent on third and subsequent mortgages.
February 2011	Capital risk-weights were raised to 100 percent for mortgages with LTVs exceeding 90 percent and were also raised for personal loans with a tenure of more than 5 years.
March 2011	The minimum income eligibility for new credit card holders was set at RM 24,000 per annum. Cardholders earning less than RM 36,000 per annum were limited to two credit card issuers and the maximum credit per issuer capped at two times monthly income.
December 2011	Introduced an LTV cap of 60 percent on housing loans for corporates.
January 2012	Issued guidelines on responsible financing and the computation of debt service rations (DSR) based on a borrower's net income. Increased the RPGT rate to 10 percent on properties sold in less than 2 years and 5 percent for properties sold between 3 and 5 years. Properties disposed in the 6th year after the date of acquisition or thereafter are not subject to RPGT.
January 2013	Increased the RPGT rate to 15 percent on properties sold before 2 years and to 10 percent on properties sold between 3 and 5 years. Properties disposed in the 6th year after the date of acquisition or thereafter are not subject to RPGT.
July 2013	Imposed a maximum mortgage term of 35 years and a maximum tenure of 10 years for financing extended for personal use. Prohibited the offering of pre-approved personal financing products.
January 2014	Distinguished between RPGT for Malaysian citizens or permanent resident, non-citizens, and corporates. For non-citizens, the RPGT is 30 percent for properties disposed before 5 years and 5 percent after 5 years. For Malaysians, the RPGT is 30 percent for properties sold up to 3 years; 20 percent between 3 and 4 years; 15 percent between 4 and 5 years; after 5 years 0 percent for individuals and 5 percent for corporates. Increased minimum house price for foreigners to RM 1,000,000. Banned Developers Interest Bearing Scheme (DIBS).
January 2017	Waived 100 percent of stamp duty on instruments of transfer and loan agreements for first-time home buyers, an increase from existing 50 percent rate. The waiver is limited to buyers of houses valued less than RM 300,000 and expires at end-2018. For the purchase of houses amounted to RM 500,000, a waiver of 100 percent stamp duty on the same instrument is also given but up to the first RM 300,000. The remaining balance will be subject to stamp duty at the prevailing rate. Public servants' housing loan eligibility was increased from between RM 120,000 and RM 600,000 to between RM 200,000 and RM 750,000.
January 2018	The rate of stamp duty on instruments of transfer of real estate worth more than RM1 million up from 3 percent to 4 percent.

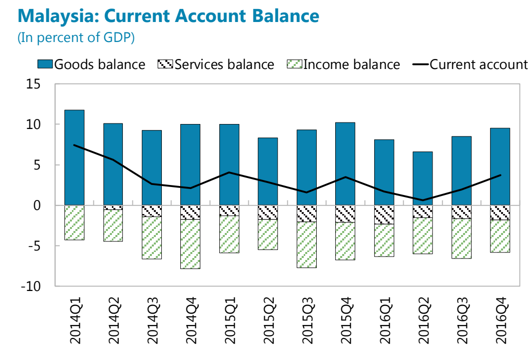
Appendix I. Malaysia—Staff Policy Advice from the 2014 and 2016 Article IV Consultations

Staff Advice	Policy Actions
Fiscal Policy	
Protect the fiscal position in the face of sharply lower oil and gas prices through gradual, growth-friendly multi-year fiscal adjustment (2014). Allow the fiscal stabilizers to work if the economy is weaker than expected (2016).	The authorities promptly revised the 2016 federal budgets (in January 2016) in response to sharp declines in oil and gas prices. These timely actions have maintained the federal budget deficit ceiling close to original targets and were well received by markets and analysts.
Broaden tax bases by implementing a GST and rationalizing tax incentives (2014). Narrow the list of exempt and zero-rated items. Increase GST rate (2016).	The authorities introduced the GST in April 2015. They are undertaking a study on the effectiveness and costs of tax incentives.
Phase out expensive and poorly targeted fuel subsidies and continue gradual adjustment of administered prices for electricity and other services (tolls, utilities). Pass on to consumers' changes in fuel prices with the objective of depoliticizing energy pricing (2014).	Fuel and other subsidies were removed starting in December 2014. The authorities have since maintained their mechanism of monthly adjustment of fuel prices. The issue has thus been depoliticized. Adjustments of toll, electricity, and other utility tariffs are ongoing.
Expand cash transfers to lower income groups as integral component of fiscal reforms eliminating fuel subsidies and introducing GST (2014).	Cash transfers to lower income groups have been expanded starting with the 2015 budget. The 2014 Budget announced the creation of a comprehensive database on welfare recipients, which could facilitate better targeting of transfers.
Gradually bring down federal debt to sustainable levels and near balance the federal budget by 2020. Introduce a medium-term fiscal framework (2014). Publish an annual statement of fiscal risk (2016).	The authorities have announced their intention to gradually balance the federal deficit by 2020, which will result in a substantial decline in the federal debt to GDP ratio. They still need to identify concrete fiscal consolidation actions to achieve this. They have developed and published a medium-term fiscal framework, which has been endorsed by the Fiscal Policy Committee.
Monetary, Exchange Rate, and Financial Policies	
Move from the current accommodative monetary policy stance toward a neutral stance consistent with the need to maintain price stability and curb financial imbalances (2014). Tighten interest rates if signs emerge of second-round inflation pressures (2016).	The authorities raised their policy interest rate in mid-2014 but have stayed put since in view of continued heightened uncertainty surrounding the external and global outlooks in key emerging and advanced economies. In July 2016, BNM cut the policy rate by 25 bps to 3.0 percent, citing weaker global growth, the uncertain global environment, and receding risks from financial imbalances.
Maintain a flexible exchange rate as a shock absorber and a first line of defense against commodity price and capital flow shocks while using reserves and intervention to ensure orderly market conditions and avoid FX rate overshooting (2014). Given low level of reserves, a greater reliance of FX rate flexibility is recommended (2016).	The authorities allowed the exchange rate to depreciate substantially in the face of multiple external shocks while also deploying reserves to help the economy adjust to lower commodity prices and capital outflows. Going forward, they agree with staff that reserves will need to gradually be rebuilt and that they will rely more on greater exchange rate flexibility in response to shocks. In December 2016, the BNM introduced measures to further develop domestic FX markets and thus bolster resilience to external shocks.
Continue to employ macroprudential policies to dampen financial risks and monitor the increase in leverage throughout the economy, including in household and corporate debt (2014). Provide liquidity through open market operations and/or further lower the statutory reserve requirement (2016).	The authorities maintain macroprudential measures to curb household indebtedness and an enhanced framework for risk-based pricing of loans to deal with rising household indebtedness. BNM is collecting granular data on household debt. These efforts have reduced risk from credit growth and also increased the resilience of banks. Corporate borrowing in foreign currency is closely monitored to ensure borrowers are naturally or otherwise hedged.
Structural Policies	
Boost growth and productivity through implementation of structural reforms, including reforms of government-linked companies; liberalization of labor and product markets; and enhanced education and training (2014). Uphold high standards of governance and communication in public financial management (2016).	Many of these recommendations also form part of the authorities' Economic Transformation Program and the Government Transformation Program. Some progress has been made on the strategic reform initiatives and the authorities' further plans to boost growth and improve governance are discussed in this Staff Report.
To achieve high income status, continue to: (i) prioritize infrastructure investment; (ii) further improve public financial management; (iii) boost spending on Research and Development to promote home-grown innovation; and (iv) improve the quality of education with a view to reducing skills mismatches in the labor force and raising productivity (2014, 2016).	In May 2015, the authorities unveiled their 11th Malaysia Plan, spanning 2016–2020. The Plan continues the authorities' efforts to boost public capital through major infrastructure projects and also seeks to promote home grown innovation and a knowledge-based society through increased cooperation between government, education and industry in harnessing research and development and raising the quality of human capital.
Maintain an economic system that is highly open to trade and investment. (2014, 2016).	Malaysia remains a very open economy. The ASEAN Economic Community came into being at the start of 2016 following efforts of Malaysia during its ASEAN chairmanship in 2015. Malaysia is participating in the discussion of a regional trade arrangement with China.

Appendix II. Malaysia—External Sector Assessment

A. External Sector Developments in 2016

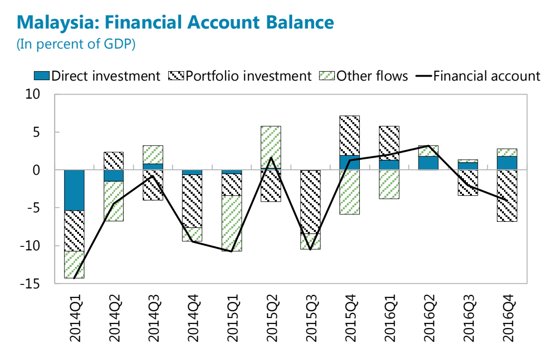
1. **Current account (CA).** Malaysia's CA surplus declined to 2 percent of GDP in 2016 (2015: 3 percent of GDP). This is a significant reduction in the CA surplus from a level of about 11 percent of GDP in 2011. The trend decline has been largely driven by a rise in investment and fall in saving in the nonfinancial corporate sector. The CA balance excluding oil and liquefied natural gas remained in deficit.



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

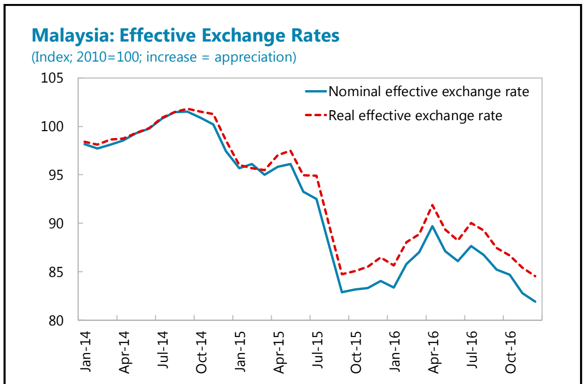
2. In 2016, the decline in the CA balance was driven by a reduction in surplus in the goods balance by nearly 1½ percent of GDP. Although both exports and imports of goods (in U.S. dollar terms) declined at a slower pace than in 2015, exports fell at a faster pace than imports. The weak global trade environment coupled with the terms-of-trade shock from a fall in world oil prices together contributed to a decline in the goods balance. However, export volumes were up and helped cushion some of the impact from the adverse price effects, supported by some weakening of the real exchange rate. A slower pace of decline in goods imports was supported by bottoming out in investment goods and intermediate goods imports. The net services account balance has deteriorated in recent years following increased usage of foreign professional services and a drop in tourist arrivals in 2015, although the latter improved in 2016. Deficit on the primary income account remained unchanged at about 2¾ percent of GDP, while that on the secondary income account improved by close to ½ percent of GDP.

3. **Capital and financial accounts.** Malaysia experienced significant capital outflows since late 2014. Inflows returned in 2015:Q4 and Malaysia recorded a net surplus, though small, in the capital and financial accounts over 2016:Q1–Q2. However, deficits re-emerged in the second half of 2016 as portfolio flows reversed, particularly in the aftermath of the U.S. presidential election. This was offset by direct investment flows, as gross inflows increased and Malaysia's direct investment abroad slowed down. Foreign investments by large nonfinancial public enterprises were cut to make room for supporting the domestic economy. Overall, in 2016, Malaysia recorded a small net outflow in its financial account of about 0.3 percent of GDP, as compared to outflows of 4½ percent GDP in 2015 and 7¼ percent of GDP in 2014.



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

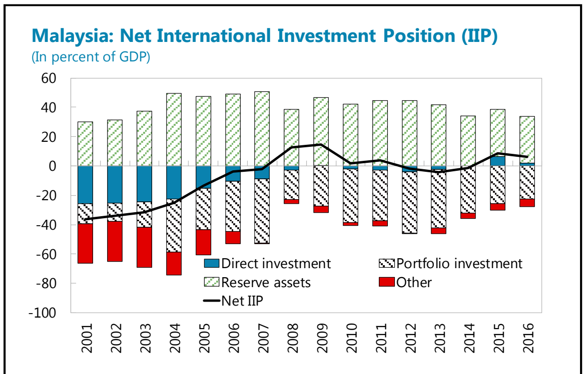
4. **Real exchange rate.** The real effective exchange rate (REER) appreciated in the first half of 2016 from its end-2015 level, but steadily depreciated since July 2016. As a result, in 2016, the average REER depreciated by about 4¼ percent y/y, following a nearly 8 percent y/y depreciation in 2015. Depreciation in the nominal effective exchange rate explains most of the changes in the REER.



Source: IMF, *Information Notice System* database.

5. **Foreign reserves.** Malaysia's foreign reserves in 2016 stood at US$94.6 billion, roughly unchanged relative to 2015 (US$95.3 billion). In the first ten months of 2016, reserves went up, but came down amidst capital outflows during the last two months of 2016. Malaysia faced significant reserve losses in the previous two years. Reserves were largely unchanged in January 2017.

6. **International Investment Position (IIP).** Malaysia's net IIP position, as a percent of GDP, has been in broad balance since the Global Financial Crisis, although it has turned positive more recently supported by valuation effects. Assets are dominated by official FX reserve assets while liabilities are concentrated in the form of foreign portfolio investments. The net IIP position fell to about 6 percent of GDP in 2016 (in U.S. dollar terms), compared to 8¾ percent of GDP as of end-2015, largely on account of valuation effects.[1] Total external debt is estimated at about 68 percent of GDP in 2016, slightly higher than 65½ percent of GDP recorded in 2015.[1] The share of short-term external debt fell.



Sources: Bank Negara Malaysia; CEIC Data Co. Ltd.; and IMF staff calculations.

B. Standard Benchmarks

7. **Current account.** After adjusting for the cycles in relative output gaps and the terms of trade, and also for the multilateral consistency, the 2016 CA balance is estimated at about 3¼ percent of GDP, compared to a CA norm of about ¾ percent of GDP under the External Balance Approach (EBA). This implies a CA gap of about 2½ percent of GDP under the EBA model (Table 1). The identified policy gaps explain about half of the CA gap, with domestic policies accounting for close to one-third of the total policy gap. The domestic policy gaps point to the need for further fiscal consolidation and a higher allocation for public healthcare spending.

8. While the desired direction of change in the CA surplus, as suggested by the EBA CA regression, is appropriate, there are uncertainties around the precise numerical magnitude of this adjustment, reflecting country-specific structural factors that are not well captured, particularly in the post Asian Financial Crisis (AFC) period. Malaysia's historically high saving rate reflects precautionary

[1] The ratios to GDP are based on staff estimates at U.S. dollar values and may vary from the authorities' data mainly due to differences in exchange rates used.

motives to compensate for an insufficient social safety net (not adequately captured by the public healthcare spending variable used in the EBA regression) and the institutional mechanism of large mandatory contributions to retirement saving through organizations like the Employees Provident Fund.[2] The structural break in the investment in Malaysia since the AFC is not well captured in the EBA model.[3] While investment has improved in recent years, the adjustments in the post-AFC period were also impacted by additional external shocks. As existing bottlenecks are reduced, investment should continue to improve gradually over the medium term. Both high saving and low investment have kept the CA in surplus, although the unidentified residual in the EBA regression has declined in recent years suggesting that some of these structural distortions not captured by the EBA model are gradually being addressed. Given uncertainties surrounding the EBA CA model estimates, and the fact that some of Malaysia's unique structural features are not fully captured by the model, staff assesses the CA gap to be somewhat smaller at about 1½ percent of GDP, with a range of plus or minus 1 percent of GDP. This implies that Malaysia's 2016 external position was deemed to be moderately stronger than fundamentals and desired policies.

9. **Real exchange rate.** The EBA REER models (index-based and level-based) show an undervaluation of about 28–36 percent, relative to fundamentals and desired policies, and they are largely accounted for by regression residuals. However, given the absence of high inflation, excessive wage pressures, or reserve build-up—the usual signs of large exchange rate undervaluation—staff assesses, based on its estimated CA gap and the semi-elasticity of the CA balance with respect to the REER, the 2016 REER gap at about –5¼ percent (plus or minus 3.4 percent), implying a moderate undervaluation.[4]

[2] The EPF manages the retirement funds for private and non-pensionable public sector employees, representing about 46 percent of the total employment. The overall contribution rate averages 23–24 percent of wages (lower for employees aged 60 years and above), and EPF's net assets reached about 60 percent of GDP in 2015. In the presence of borrowing constraints, high pension contributions rates could lead to higher saving.

[3] The compound annual growth rate in real gross fixed capital formation nearly halved from about 9 percent during 1982–97 to about 4¾ percent during 2000–15. Guimaraes and Unteroberdoerster (International, Monetary Fund, 2006) report that at the aggregate level sustained overinvestment in the run-up to the AFC was followed by a shift in investor perception following the crisis. At the firm level, low profitability along with financing constraints affecting smaller firms and firms in the services sector explained the structural shift in investment post AFC. (International Monetary Fund, *What's Driving Private Investment in Malaysia? Aggregate Trends and Firm-Level Evidence 2006.*)

[4] The semi-elasticity is estimated at –0.29 and takes into account Malaysia's trade openness and commodity exports.

Table 1. Malaysia: Quantitative External Sector Assessment

	Norm 1/	Est. 1/	Gap
Current account		(In percent of GDP)	
EBA 2.0 current account	0.7	3.3	2.6
Of which: Contribution of identified policy gaps 2/			1.4
Of which: domestic policy gaps			0.4
Unexplained residual			1.2
External sustainability approach 3/			1.0
Staff assessment	1.8	3.3	1.5
Of which: Contribution of identified policy gaps (based on EBA 2.0)			1.4
Of which: domestic policy gaps			0.4
Other			0.1
Exchange rate misalignment		(Percentage)	
EBA Index real exchange rate regression approach 4/	...	...	-36.1
Of which: Contribution of identified policy gaps 2/	...	...	-4.0
Unexplained residual	...	...	-32.1
EBA Level real exchange rate regression approach 4/	...	...	-28.1
Of which: Contribution of identified policy gaps 2/	...	...	-4.5
Unexplained residual	...	...	-23.6
Staff estimate using elasticity approach 5/	...	...	-5.2

1/ Staff's estimate of the multilaterally consistent cyclically-adjusted norm and cyclically-adjusted outturn for 2016, based on EBA February 2017.

2/ Policy gaps refer to policy distortions that can arise from domestic policies and/or as a result of the policies of other countries. See 2015 Pilot External Sector Report.

3/ From EBA February 2017. Based on 2015 NFA/GDP ratio of 9.3 percent of GDP and an adjusted medium-term CAB of 1.6 percent.

4/ Misalignment based on EBA February 2017.

5/ The semielasticity of the current account balance with respect to the REER is $\eta_{CA}= -0.29$, computed according to $\eta_{CA}=\eta_{Xnc}\, s_{Xnc}-(\eta_M-1)\, s_M-s_{Xc}$, where η_{Xnc} is the elasticity of the volume of non-commodity exports with respect to the REER, η_M is the elasticity of the volume of imports with respect to the REER, estimated at $\eta_{Xnc}= -0.82$, $\eta_M= 0.26$, $s_{Xnc}= 58.2$ percent is the share of non-commodity exports in GDP, $s_{Xc}= 16.8$ percent is the share of commodity exports in GDP, and $s_M= 61$ percent is the share of imports in GDP.

10. **Foreign reserves.** Under the IMF's composite reserve adequacy metric, which currently classifies Malaysia's exchange rate regime as "other managed", staff estimates the end-2016 official reserves at about 80 percent of the metric, similar to 2015.[5,6] Under the IMF's reserve adequacy metric for "floating" regimes, end-2016 reserves are estimated to be 115 percent of the metric—that is, within the adequate range. In practice, the exchange rate policy appears to be closer to floating in the past 12 months and the authorities expressed that market forces would determine the direction and level of the exchange rate. Furthermore, while the Fund metric reflects the recent increase in banks' short-term liabilities, it fails to capture the corresponding increase in their short-term assets and, consequently, may overstate reserve adequacy needs. For these reasons, staff assesses foreign exchange reserves to be adequate. Nevertheless, in case of disorderly market conditions, reserves could be deployed to reassure markets. With this in mind, during more normal market conditions,

[5] The IMF's reserve adequacy metric is computed under a binary classification of the exchange rate regime: floating or fixed. For the purpose of this metric, Malaysia's exchange rate regime is classified as fixed. However, if Malaysia's regime were to be classified as floating, current level of FX reserves would be deemed adequate.

[6] International Monetary Fund, *Assessing Reserve Adequacy—Specific Proposals 2015.*

reserves could be accumulated as opportunities present to further improve the reserve adequacy, while remaining cognizant of the needed adjustments in the real exchange rate.

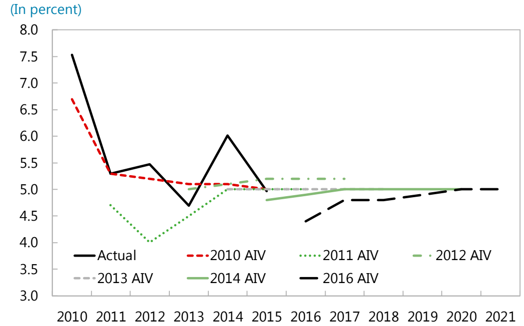
11. **Overall assessment.** Malaysia's CA gap is estimated to have declined in 2016 and the external position is assessed to be moderately stronger than warranted by fundamentals and desirable policies. Macroeconomic policy adjustments, including exchange rate flexibility, and monetary and fiscal adjustments, should remain the central response to external shocks in line with the *Institutional View* on capital flows. Fiscal consolidation should consider the need for further improving social protection—including through the introduction of an unemployment insurance system—higher public healthcare spending, and a reduction in labor market rigidity. Over the medium term, higher public sector saving, driven by fiscal consolidation is expected to be offset by a drop in private saving, as fiscal policies shift toward measures that will help lower the need for precautionary saving by the private sector. At the same time, private investment is expected to rise at a moderate pace as Malaysia addresses structural bottlenecks and unlocks its potential of becoming a high-income country. Together, this will lead to a smaller current surplus over the medium-term, contributing to a gradual rise in the net IIP.

Appendix III. Malaysia—Medium-Term Growth Outlook

Introduction

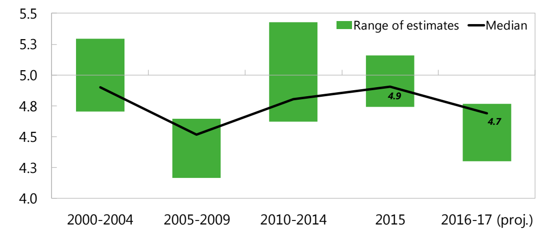
1. In the last several Article IV consultations, staff estimates for Malaysia's medium-term real GDP growth averaged around 5 percent. However, in the current global and regional context of slow growth, weak trade and investment, low global oil prices, feeble productivity gains, and heightened global uncertainty, Malaysia's potential growth may have declined. Indeed, statistical filters indicate a slowdown in trend growth over the next two years.

Malaysia: Real GDP Growth
(In percent)



Sources: Department of Statistics, Malaysia; and IMF staff estimates.

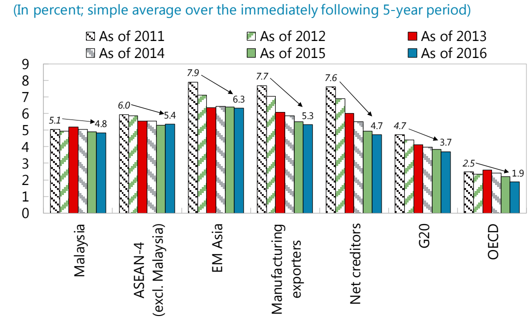
Malaysia: Estimates of the Potential Growth Rate
(In percent; based on univariate and multivariate statistical filters) 1/



Source: IMF staff estimates.
1/ The statistical filters used are the Hodrick-Prescott (HP) filter; the full-sample bandpass filter; finance-neutral HP filters (see Borio and others, 2013, *BIS Working Paper No. 404*); and multivariate Kalman filters (see Blagrave and others, 2015, *IMF Working Paper No. WP/15/79* and Ali, 2015, *IMF Working Paper No. WP/15/144*).

2. In IMF's assessment, several countries, including Malaysia's peers, have already seen a downward revision in their medium-term growth prospects. Between 2011 and 2016, revisions in the five-year ahead growth forecasts ranged between ½ percentage point and 3 percentage points across country groups. However, the magnitude of revision in the case of Malaysia had been lower at about ¼ percentage point.

Medium-Term Growth Forecasts
(In percent; simple average over the immediately following 5-year period)

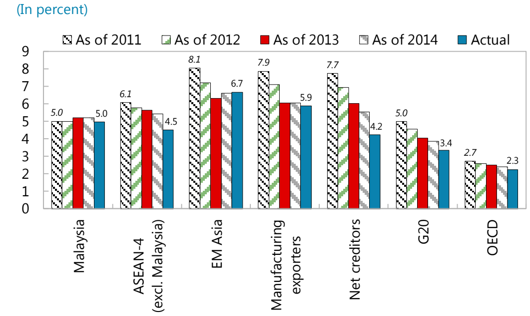


Source: IMF, *World Economic Outlook* database (September/October vintage)

3. In regard to past staff projections, Malaysia's growth performance largely met expectations in recent time periods. In fact, the actual growth outturn over 2011–15 was better than what staff had projected in 2010. Also, the growth projection for the year 2015, made during 2011–12, did materialize.

4. Looking forward, the main uncertainty in Malaysia's growth projection over the medium term relates to the productivity growth.

2015 Growth Forecasts and Actual Outturn
(In percent)



Source: IMF, *World Economic Outlook* database (September/October vintage)

Data Analysis for 2016–20 Growth Projection

5. To analyze growth prospects over 2016–20, staff use the following human-capital augmented production function:

$$Y_t = A_t K_t^{\alpha_t} H_t^{(1-\alpha_t)} L_t^{(1-\alpha_t)}$$

$$H_t = h_t L_t$$

$$h_t = \exp(\varphi S_t)$$

Where, the nonstandard expressions are:

H_t : human capital in year t.

ϕ : return on education (assumed at 7 percent following the economic literature).

S_t : years in schooling, as obtained from the Barro-Lee database.

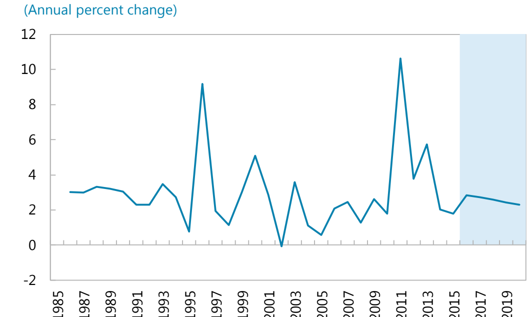
6. Output elasticities with respect to capital and labor are approximated by the shares of operating surplus and compensation of employees in national income, respectively, from the 2006–14 official data. Capital's share averaged at about 70 percent over 2006–14. For our historical growth accounting exercise, we assume that the share of capital in output was same as in 2006. For 2016–20, we follow the goal envisaged under the 11th Malaysia Plan (11MP, 2016–20), which aims to raise the share of labor income in output to 40 percent by 2020 from 34 percent in 2014.

Labor inputs:

7. Malaysia is still a relatively young society and benefits from a demographic dividend. However, population growth is slowing and population aging will accelerate, leading to a deceleration in the growth of labor. To assess the impact of demographic changes, we used gender-specific population growth projections, obtained from the United Nations' population projections, with no change in migration. We also used gender-specific labor force participation rates in forecasting labor supply.

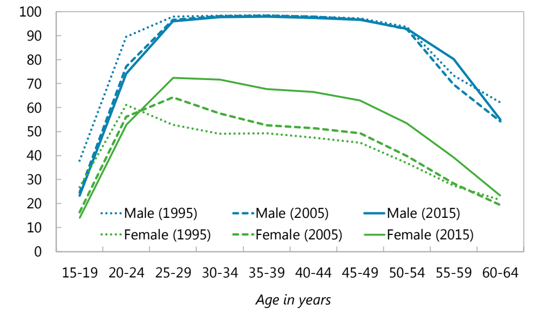
8. The labor force participation rate has increased in recent years, driven by female workers. We assume that labor force participation will increase at the linear trend rate observed between 2009 and 2015. This leads to about 7 percentage points of further increase in the female labor force participation rate by 2020, slightly higher than that envisaged under the 11MP. Male participation rates, which are already high for prime working ages, is assumed to improve by about 1 percentage point. The unemployment rate is assumed to gradually decline to 2.8 percent in 2020 from 3.1 percent in 2015.

Malaysia: Labor Force
(Annual percent change)



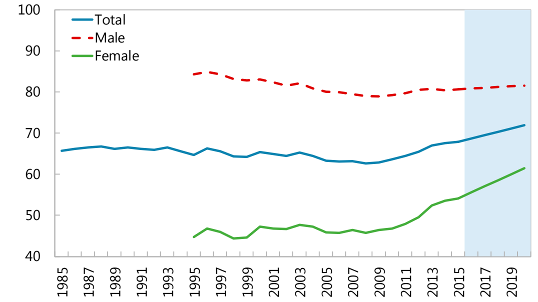
Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

Malaysia: Labor Force Participation Rate by Sex and Age
(In percent)



Source: CEIC Data Co. Ltd.

Malaysia: Labor Force Participation Rate
(In percent)



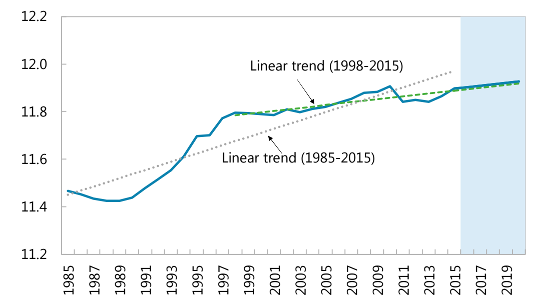
Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

9. Physical labor supply is augmented by human capital formation, using data on years of schooling from the Barro-Lee database on educational attainment. Since the last reported data are as of 2010, we use linear trend extrapolation to project years of schooling in Malaysia over 2011–20. We do not differentiate this data by gender or worker cohorts. For simplicity, a constant return to education of 7 percent is assumed.

Physical capital inputs:

10. We assume that the capital stock will grow at a rate such that the capital/labor ratio continues to grow along its post Asian Financial Crisis (AFC) trend growth rate. We also assume that capacity utilization will improve to its 2001–15 average rate of about 80 percent from 76½ percent in 2015 (based on survey data). However, the implied growth rate of investment is slower than that envisaged under the 11MP, reflecting a worsening of the global outlook since the unveiling of the 11MP in mid-2015.

Malaysia: Capital-to-Labor Ratio
(In logarithmic scale)



Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

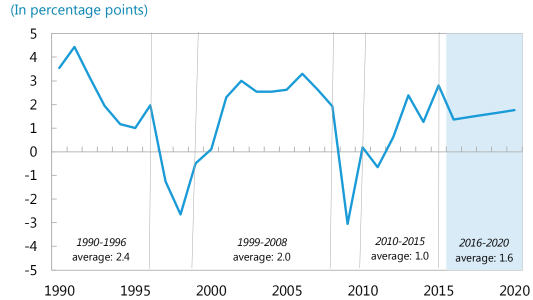
11. Official data on capital stock are used for 2000–15. For the pre-2000 period, we estimate the capital stock using the perpetual inventory method.

Total factor productivity (TFP):

12. Historical decomposition of actual growth reveals that there have been three phases of productivity growth since the early 1990s: pre-AFC; between AFC and the GFC; and post GFC. While in the first two phases average TFP growth was somewhat similar, it slowed down considerably in the last phase.

13. For 2016–20, we, however, project a moderate improvement in average TFP growth from the previous five years, on the back of

Malaysia: Total Factor Productivity – Contributions to Growth
(In percentage points)

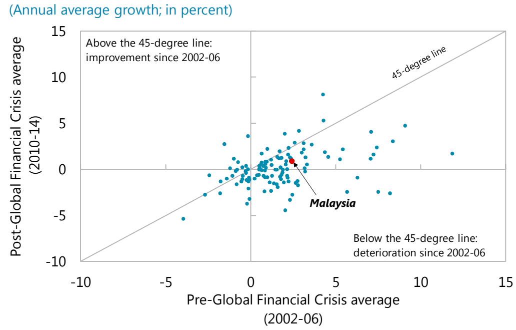


Source: IMF staff estimates.

ongoing policy support to enhance labor skills and productivity, and a pick-up in global growth helping the more productive export-oriented sector.[1] Regression analyses support a wide range of average TFP growth between 1¾ and 2½ percent over the medium term.[2] However, these estimates are likely biased upward by the presence of the lagged dependent variable (TFP growth was stronger in 2015). Staff believes that average TFP growth in excess of 2 percent is unlikely to materialize in the current global and regional context, in which most countries have seen a worsening of productivity growth in the aftermath of the GFC. As a result, relative to the regression outcomes, we conservatively project TFP growth, whereby by it grows at the trend rate observed during 1999–2015, in line with capital/labor ratio maintaining its post AFC trend growth rate.

World: Total Factor Productivity

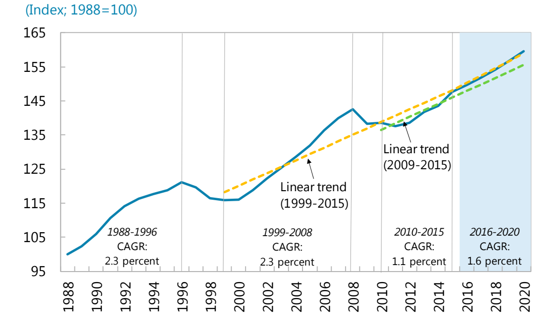
(Annual average growth; in percent)



Source: The Conference Board, *Total Economy Database*, September 2015.

Malaysia: Total Factor Productivity

(Index; 1988=100)



Source: IMF staff estimates.

Note: CAGR stands for compound annual growth rate.

14. Even at conservatively projected TFP growth, its share in real GDP growth over 2016–20 will be higher than both the previous plan period and the average over the past three plan periods. Further, at a similar stage of per capita income, the projected share of TFP growth in real GDP growth, appears higher than that observed in Japan, Korea, Singapore, and the United States. It is to be noted that these countries were no younger than Malaysia during their transition to a per capita income (Atlas method) beyond US$11,000.

15. Based on these estimates, we project an average real GDP growth rate of about 4¾ percent over 2016–20. As in the past, the bulk of the contribution will come from capital formation, followed by TFP, although the former's contribution will drop. Contributions from employment will drop below 1 percentage point.

16. The 11th Malaysia Plan aims for a 5–6 percent growth over 2016–20. However, this plan was formalized in early 2015 and was predicated on more optimistic global scenarios (e.g., global growth at 3.9 percent, compared to the IMF's World Economic Outlook (WEO) projections in October 2016 of 3.4 percent growth; oil price to average around US$71 per barrel, compared to US$51.5 per barrel

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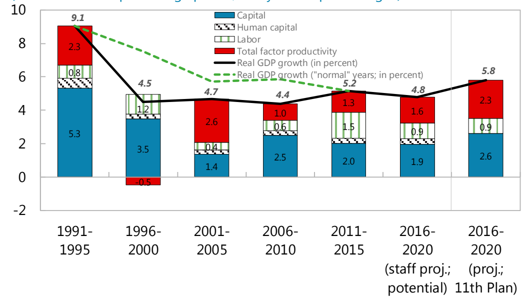
[1] The 11th Malaysia Plan envisages improvement in productivity as one of the main sources of growth. The 2017 Budget identified chemicals industry, electrical and electronics industry, and research and development activities as important areas of productivity-enhancing investments. The current and previous budgets also included tax incentives for and financing support to improve skills and encourage training; upgrade educational facilities; automate and modernize manufacturing processes and facilities; expand activities into higher-value added segments; entrepreneurship development programs etc.

[2] Regression analyses on annual data over 1990–2015 used the following variables in different combinations (only models with all statistically significant parameter estimates are reported here): a crisis dummy for 1997–98 AFC and 2008–09 GFC, one-period lagged TFP growth, current or one-period ahead global growth, two-period lagged capital/labor ratio, labor force growth, and combined share of the manufacturing and mining sectors in GDP.

assumed in the October 2016 WEO projections). It is to be noted that in the last three plan periods, both actual growth and contribution of TFP to growth underperformed the respective Five-Year Plans' aspirations.

Malaysia: Growth Accounting

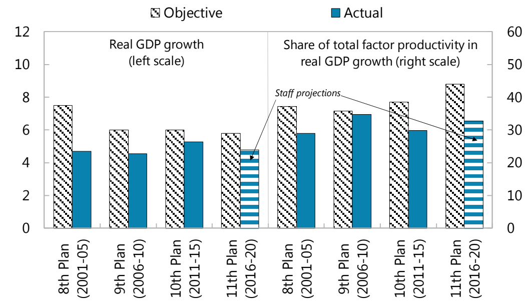
(Contributions in percentage points; five-year simple averages)



Sources: Economic Planning Unit, Government of Malaysia; Department of Statistics Malaysia; and IMF staff estimates.

Malaysia: Performance under the Five-Year Plans

(In percent)



Sources: Economic Planning Unit, Malaysia; and IMF staff estimates.

Conclusion

17. In recent years, Malaysia has experienced a slowdown in real GDP growth, in part due to headwinds from external shocks. While the growth slowdown is not unique to Malaysia in the broader global context, the country faces important challenges, both at home and abroad, in reaching its target growth rate of 5–6 percent over the medium term. In the context of slower population growth and moderate rise in investment, productivity improvement holds the key to realizing Malaysia's medium-term growth objective. Given the uncertainty surrounding productivity growth in the current global context, staff projects that Malaysia's real GDP growth will likely stay between 4¼ percent and 5¼ percent over 2016–20, with the average seen at around 4¾ percent.

Appendix IV. Malaysia—Risk Assessment Matrix 1/

Risks	Likelihood and Transmission	Expected Impact of Risk	Recommended Policy Responses
External			
Significant slowdown in China and other large EMs/frontier economies (Short- to medium term).	**Low/Medium** Liquidity for weak borrowers in the Chinese interbank market may dry up. Investors may withdraw from EM corporate debt in a disorderly fashion, exposing excess household and corporate (FX) leverage.	**Medium** Weaker external demand would likely further suppress commodity prices, dampen domestic demand, lowering growth and increasing unemployment.	The exchange rate should be allowed to act as a key shock absorber, intervening only to smooth excessive volatility. A more accommodative monetary policy stance could be appropriate, if risks of fueling further financial imbalances are low.
Structurally weak growth in key advanced and emerging economies (Medium-term).	**High/Medium** Trade (both volume and price), would be the dominant channel, with adverse second round effects on domestic demand.	**Medium** Prolonged weakness in external demand would likely dampen domestic demand, lowering growth, increasing unemployment, dampening housing and asset prices, weakening bank, corporate, and sovereign balance sheets, in a negative feedback loop.	The ability of macroeconomic policies to provide a long-lived cushion against a protracted slump is limited. Policymakers would need to adjust to slower medium-term growth although carefully selected infrastructure projects and structural reforms could increase productivity.
Significant further strengthening of the US dollar and/or higher rates. (Short-term).	**High** Investors reassess policy fundamentals, term premia decompress, and Fed normalizes more rapidly. Leveraged firms, lower-rated sovereigns and those with unhedged dollar exposures could come under stress.	**Medium** High household and corporate debt along with a high share of foreign holdings of MGS and equities makes Malaysia vulnerability to external shocks. Recent and earlier outflow episodes, however, have had limited impact on credit and the real economy.	The exchange rate should be allowed to continue to act as a key shock absorber, intervening only to smooth excessive volatility. Liquidity support (including in FX) could be provided. If capital outflows threaten domestic activity, reserve requirements could be relaxed (as during the GFC).
European bank distress (Short-term).	**Medium** Strained bank balance sheet amidst a weak profitability outlook could lead to financial distress in one or more major banks with possible knock-on effects on broader financial sector and for sovereign yields.	**Low** This could reduce cross-border borrowing and increase its cost. The resulting credit cycle could reinforce the real cycle itself a result of weaker confidence and slower demand in Europe.	Monetary policy should be more accommodative to compensate for the loss of access to external credit, while macroprodential measures should be deployed to limit systemic risk.
Retreat from cross-border integration. (Short- to medium-term).	**High** A fraying consensus about the benefits of globalization could lead to protectionism and economic isolationism, leading to reduced global and regional policy collaboration with negative consequences for trade, capital and labor flows, and growth.	**Medium** With a highly open economy, Malaysia is vulnerable to measures aimed at curtailing global trade, particularly a change in the policy direction of the TPP. The impact would be felt both directly and indirectly (via trading partner exposures).	The exchange rate should be allowed to continue to act as a key shock absorber. Fiscal policy should only be deployed if the shock is perceived as temporary. New regional trade agreements could help mitigate the impact of TPP not materializing.
Lower energy prices (Short- to medium-term).	**Low** Production cuts by OPEC and other major producers may not materialize as agreed while other suppliers could increase production. Lower commodity prices could affect future investment activities, leading to lower potential growth.	**Medium** Lower growth along with reduced oil revenues could stymie fiscal consolidation efforts. Further declines in commodity prices could also push Malaysia to a twin deficit and trigger an adverse feedback loop of higher interest costs and/or a run by foreign investors.	The exchange rate can provide the first line of defense. Fiscal reforms to reduce the reliance on oil revenues, such as broad-based taxes, are critical. Investment in infrastructure and other productivity-boosting structural reforms could reduce reliance on the energy sector.
Domestic			
Fiscal risks from public debt and contingent liabilities (Short- to medium-term).	**Low** Realization of risks would have adverse consequences for the credibility of fiscal policies, raising the sovereign's financing cost.	**Medium/High** Higher financing costs for the sovereign; a relatively high public debt; and realization of contingent liabilities would exacerbate concerns about public debt sustainability and could lead to an adverse feedback loop of spikes in domestic interest rates and exit of foreign investors.	The authorities' ability to mount countercyclical responses would be boosted by medium-term fiscal consolidation. Continued progress in reforming fiscal institutions can mitigate the impact, including adopting a fiscal risks management framework and publication of an annual fiscal risks statement, along with increased transparency of GLC operations.
Sharp downturn in the financial cycle (Short- to medium-term).	**Low** A sharp decline in credit growth could be accompanied by a sharper than expected decline in property prices. The real economy would be adversely affected through weaker household, corporate, and bank balance sheets, along with negative wealth and confidence effects.	**Low/Medium** Household debt is high at 89 percent of GDP and close to ½ of this is mortgages. Offsetting this are high household financial assets. Macroprudential policies and improvements in underwriting standards should help curb any increase in NPLs and ensure the banking system remains resilient.	Monetary policy easing, continued exchange rate flexibility, along with a temporary fiscal stimulus anchored in a credible medium-term fiscal sustainability framework, could help support growth.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Appendix V. Malaysia—Public Debt Sustainability Analysis

1. **Background**. The debt sustainability analysis (DSA) framework for market access countries is used to assess Malaysia's debt sustainability and other risks related to its funding and debt structure. The framework uses a risk-based approach and includes: (i) an assessment of the realism of baseline assumptions and the projected fiscal adjustment; (ii) an analysis of risks associated with the debt profile; (iii) macro-fiscal risks; (iv) a stochastic debt projection taking into account past macro-fiscal volatility; and (v) a standardized summary of risks in a heat map.

2. **Macro-fiscal assumptions**. Staff's baseline macroeconomic assumptions for the medium-term projections are broadly unchanged since the 2016 Article IV consultation. Growth is projected at 4.2 percent in 2016, recovering to 4.9 percent in 2019, and converging to 4.8 percent in the medium term. In staff's baseline projections, federal government deficit is reduced in the near term from 3.1 percent of GDP in 2016 to 1.4 percent in 2021. The projected fiscal consolidation is consistent with the authorities' targets and is supported by structural reforms announced in recent budgets. The projected consolidation is lower than what is expected under policy commitments.

3. **Data coverage**. Consistent with the data on government debt reported by the authorities, the fiscal assumptions in the DSA are based on the federal government budget. This coverage excludes local and state governments and statutory bodies which typically borrow from the federal government or receive explicit government guarantees. The liabilities of these entities are therefore captured in federal government' gross debt and stock of loan guarantees.[1] Borrowing by state owned enterprises, which are in some cases under federal government guarantees, has increased in recent years and is projected to continue to increase in the medium term.

4. **Choice of framework.** Malaysia's high level of government debt and gross financing requirement calls for using the higher scrutiny framework. Government's gross debt increased sharply in 2009, reflecting sizable discretionary fiscal stimulus, declining real and nominal growth and a large fall in oil prices. Although growth has recovered since then, the primary deficit has remained high, pushing the debt to GDP ratio to about the authorities' debt ceiling of 55 percent. Gross financing needs (GFN) peaked at 10.2 percent of GDP in 2013 and are expected to fall and remain at less than 8 percent in the medium term.

5. **Realism of baseline assumptions**. The median forecast error for real GDP growth during 2007–15 is zero, suggesting that there is no evidence of a systemic projection bias that would undermine the assessment. The median forecast error for GDP deflator is 2.3 percent, suggesting that the staff forecasts have been more conservative. The median forecast error for primary balance suggests that staff projections have been slightly pessimistic (a forecast bias of –0.25 percent of GDP), but the forecast bias has improved in the later years.

6. **Cross-country experience suggests the projected fiscal adjustment is feasible**. The maximum three-year adjustment in the cyclically-adjusted primary balance (CAPB) over the projection period (1.5 percent of GDP) is ambitious but is premised upon concrete measures endorsed by the government. As highlighted earlier, staff does not rule out the existence of implementation risks and therefore considering a no adjustment scenario, as done in this DSA, is

[1] Gross debt of consolidated general government is not published by the authorities.

necessary to take that into account. Finally, the maximum level of the primary balance (0.1 percent of GDP) that is assumed in the projections is reasonable when compared to the experience in other market-access countries.

7. The DSA framework suggests Malaysia's government debt-to-GDP ratio remains below 70 percent, and its gross financing needs remain below 15 percent of GDP under different macroeconomic and fiscal shocks.

- Under the baseline, the debt-to-GDP ratio is projected to decrease to below 46 percent by 2021, but if the projected consolidation does not take place, captured under the constant primary balance simulation, it decreases slightly to 50 percent in the medium term. Under most macro-fiscal stress tests, debt-to-GDP ratio continues to decline, but if there is a one standard deviation shock to real GDP growth, the debt-to-GDP ratio initially increases to almost 56 percent in 2018 and declines thereafter. Something similar happens in a combined macro-fiscal shock that includes higher interest rates and a lower primary balance.
- A permanent oil price shock implies a flat debt-to-GDP profile in the medium term. The oil price shock in analysis is very large. It assumes a 1 percent of GDP permanent reduction in the oil income. Such a shock would be commensurate with a 33 percent decline in oil price, with an amplifying effect that reduces oil companies' profits by 66 percent.
- A contingent liability shock, whereby the government would have to absorb all of the government guaranteed loans, totaling 15 percent of GDP, over two years, would increase risks significantly. This shock also includes a persistent shock to growth and interest rates rise. In it, the debt-to-GDP ratio would grow to an almost 70 percent of GDP. Although this is a low probability scenario, the simulations underscore the growing vulnerability posed by contingent liabilities.
- Gross financing needs under all scenarios remain at below 10 percent, except for the contingent liabilities scenario in which it peaks at 15 percent to fall later below 10 percent by the end of the projection horizon.
- Stochastic simulations based on historical volatilities in Malaysia's macroeconomic variables also show that the 90^{th} percentile of debt-to-GDP ratio simulations is below 65 percent.

8. **Heat map**. Despite its low share of foreign currency and short-term debt, Malaysia faces risks arising from its external financing requirement and relatively large share of public debt held by foreigners. At 47 percent, the external financing requirement is above the upper threshold of early warning benchmarks and the share of debt held by foreigners is relatively high at about 30 percent of total. As discussed earlier, the existence of large domestic institutional investors who tend to make opportunistic investments is a mitigating factor of this risk.

Figure 1. Malaysia: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(In percent of GDP, unless otherwise indicated)

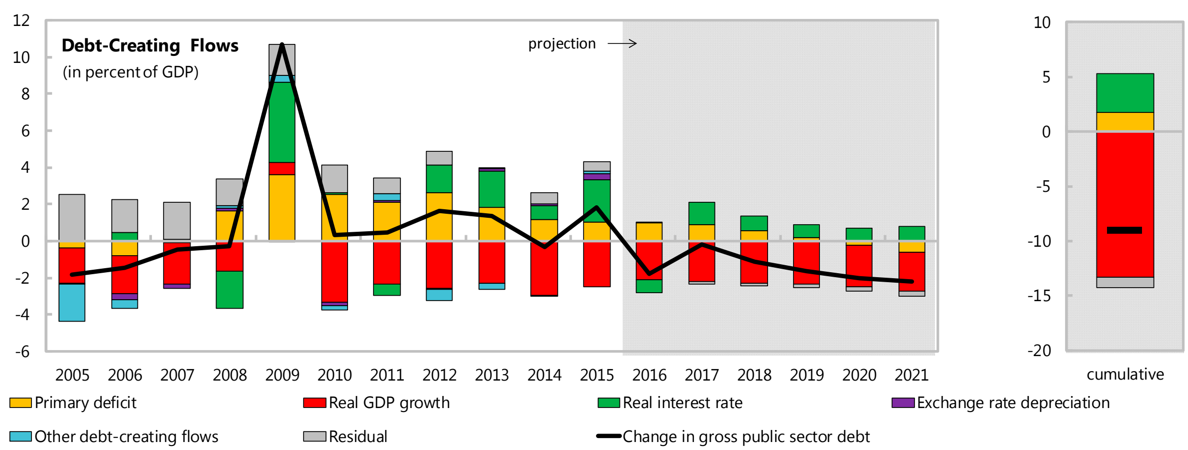
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2005-2013 [2]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	45.6	52.7	54.5	52.7	52.5	51.4	49.7	47.7	45.5
Public gross financing needs	9.1	9.0	9.4	5.1	7.7	6.4	6.6	6.6	6.5
Real GDP growth (in percent)	4.8	6.0	5.0	4.2	4.5	4.7	4.9	4.9	4.8
Inflation (GDP deflator, in percent)	3.2	2.5	-0.4	3.1	2.8	2.9	3.1	3.0	3.1
Nominal GDP growth (in percent)	8.2	8.6	4.6	7.4	7.5	7.7	8.1	8.1	8.1
Effective interest rate (in percent) [4]	4.7	4.2	4.2	1.8	5.5	4.6	4.8	4.7	5.1

As of January 25, 2017		
Sovereign Spreads		
Spread (bp) 3/		161
CDS (bp)		128
Ratings	Foreign	Local
Moody's	A1	A3
S&Ps	A-	A
Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing
Change in gross public sector debt	1.2	-0.32	1.82	-1.8	-0.2	-1.1	-1.6	-2.0	-2.2	-9.0	primary
Identified debt-creating flows	-0.2	-0.92	1.28	-1.9	-0.1	-1.0	-1.4	-1.8	-1.9	-8.0	balance [9]
Primary deficit	1.5	1.2	1.0	1.0	0.9	0.6	0.2	-0.2	-0.6	1.8	-1.3
Primary (noninterest) revenue and grants	21.1	20.1	19.0	17.1	16.4	16.3	16.3	16.3	16.3	98.7	
Primary (noninterest) expenditure	22.6	21.3	20.1	18.1	17.3	16.9	16.5	16.1	15.7	100.5	
Automatic debt dynamics [5]	-1.4	-2.1	0.1	-2.8	-1.0	-1.5	-1.6	-1.5	-1.3	-9.8	
Interest rate/growth differential [6]	-1.3	-2.2	-0.2	-2.8	-1.0	-1.5	-1.6	-1.5	-1.3	-9.8	
Of which: real interest rate	0.7	0.8	2.3	-0.7	1.2	0.8	0.7	0.7	0.8	3.5	
Of which: real GDP growth	-2.0	-2.9	-2.5	-2.1	-2.2	-2.3	-2.3	-2.2	-2.1	-13.3	
Exchange rate depreciation [7]	-0.1	0.1	0.3	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.3	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
General government net privatization proceeds (negativ	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other change in financial assets	-0.3	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8]	1.4	0.6	0.5	0.1	-0.1	-0.2	-0.2	-0.2	-0.3	-1.0	



Source: IMF staff.

1/ Public sector is defined as the Federal government

2/ Based on available data.

3/ Bond Spread over U.S. Bonds.

4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

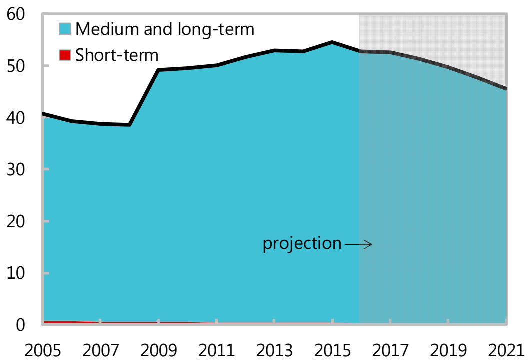
8/ For projections, this line includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

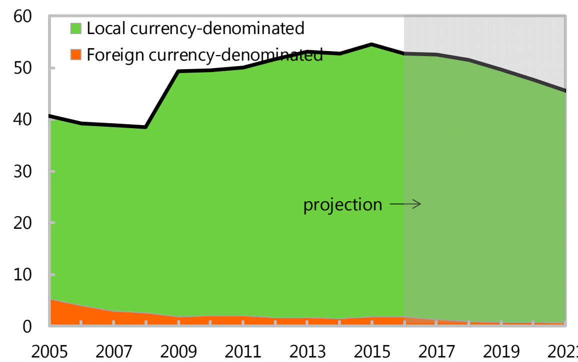
Figure 2. Malaysia: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



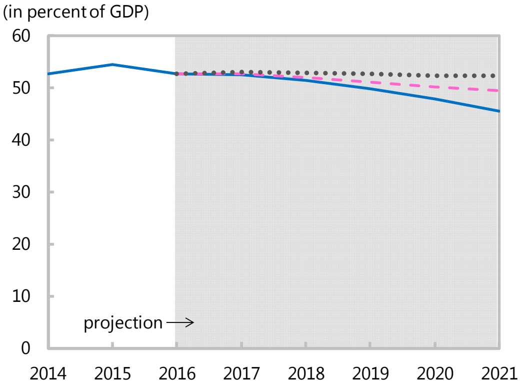
By Currency
(in percent of GDP)



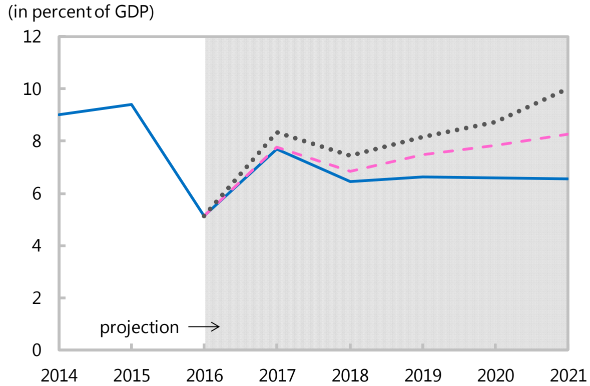
Alternative Scenarios

Baseline
Historical
Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



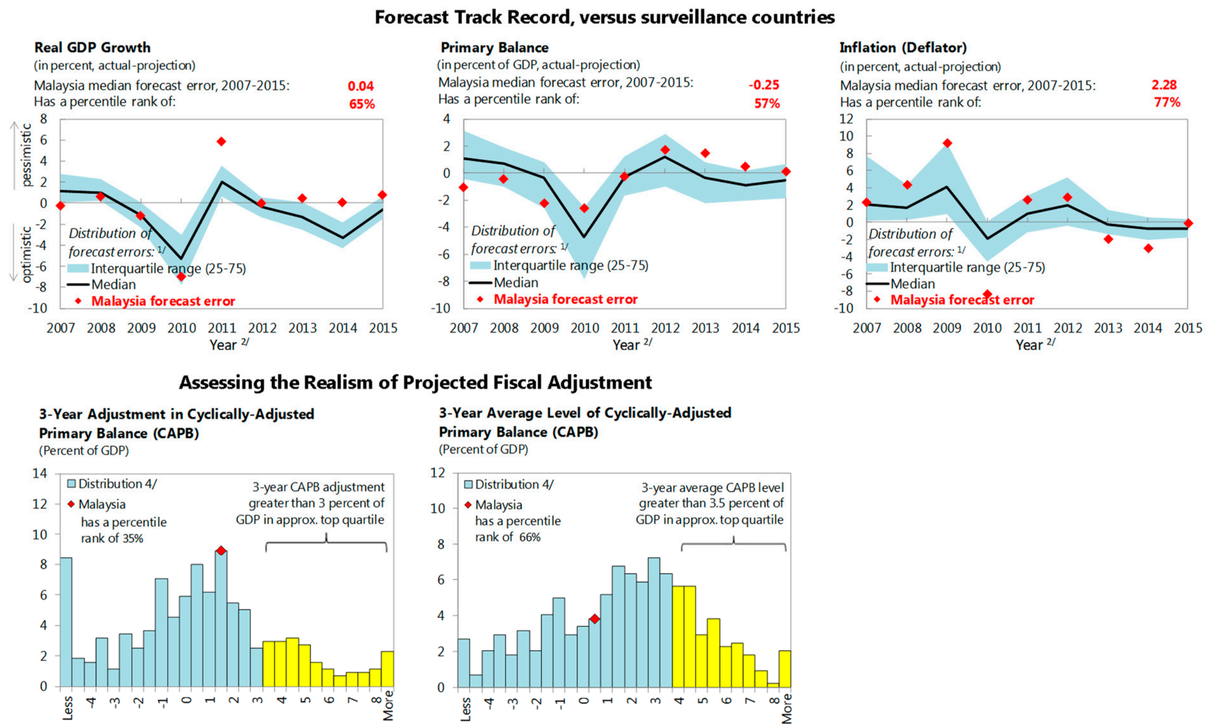
Underlying Assumptions
(in percent)

Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	4.2	4.5	4.7	4.9	4.9	4.8
Inflation	3.1	2.8	2.9	3.1	3.0	3.1
Primary Balance	-1.0	-0.9	-0.6	-0.2	0.2	0.6
Effective interest rate	1.8	5.5	4.6	4.8	4.7	5.1
Constant Primary Balance Scenario						
Real GDP growth	4.2	4.5	4.7	4.9	4.9	4.8
Inflation	3.1	2.8	2.9	3.1	3.0	3.1
Primary Balance	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Effective interest rate	1.8	5.5	4.6	4.8	4.7	5.0

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	4.2	4.9	4.9	4.9	4.9	4.9
Inflation	3.1	2.8	2.9	3.1	3.0	3.1
Primary Balance	-1.0	-1.6	-1.6	-1.6	-1.6	-1.6
Effective interest rate	1.8	5.5	4.6	4.9	5.0	5.3

Source: IMF staff.

Figure 3. Malaysia: Public DSA—Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

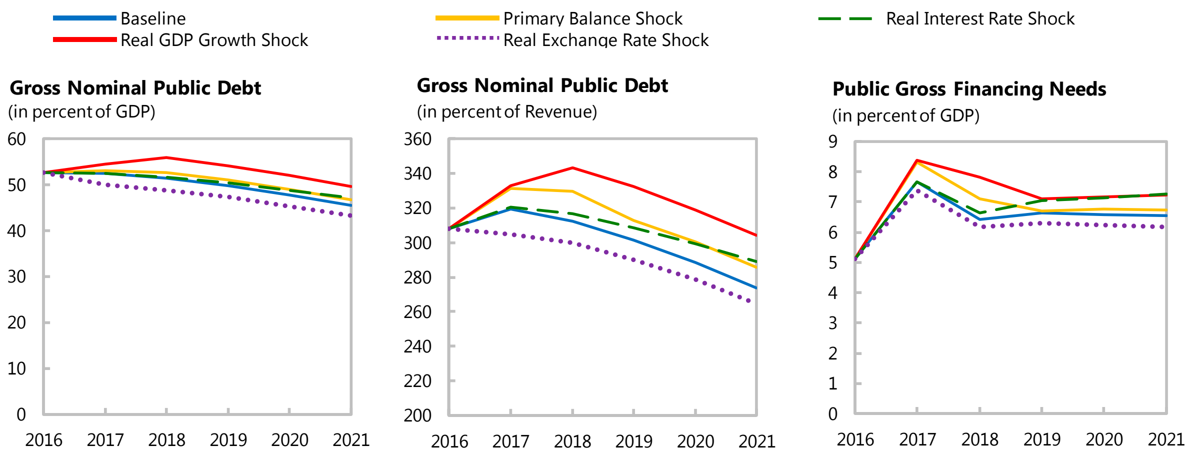
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Malaysia.

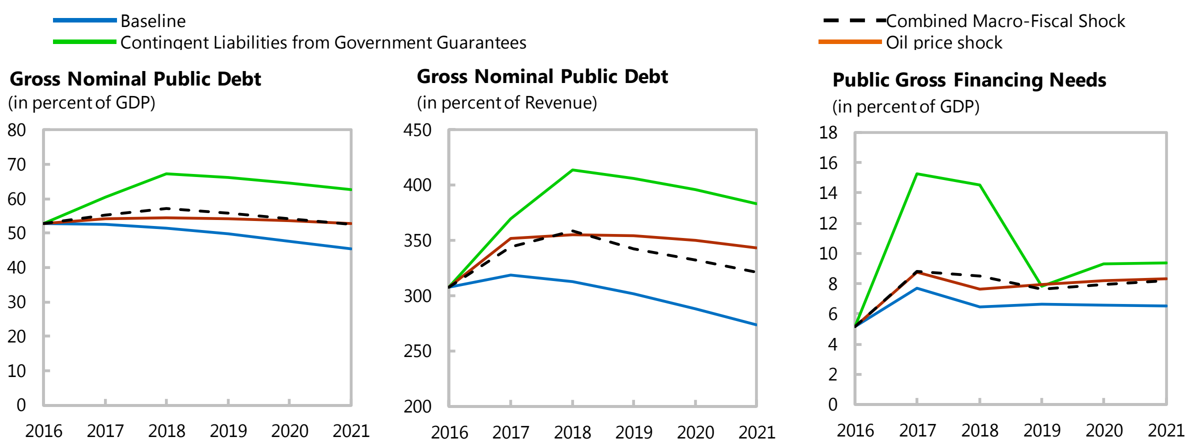
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 4. Malaysia: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2016	2017	2018	2019	2020	2021
Primary Balance Shock						
Real GDP growth	4.2	4.5	4.7	4.9	4.9	4.8
Inflation	3.1	2.8	2.9	3.1	3.0	3.1
Primary balance	-1.0	-1.6	-1.2	-0.2	0.2	0.6
Effective interest rate	1.8	5.5	4.6	4.8	4.8	5.1
Real Interest Rate Shock						
Real GDP growth	4.2	4.5	4.7	4.9	4.9	4.8
Inflation	3.1	2.8	2.9	3.1	3.0	3.1
Primary balance	-1.0	-0.9	-0.6	-0.2	0.2	0.6
Effective interest rate	1.8	5.5	5.0	5.6	5.9	6.5
Combined Shock						
Real GDP growth	4.2	2.1	2.3	4.9	4.9	4.8
Inflation	3.1	2.2	2.3	3.1	3.0	3.1
Primary balance	-1.0	-1.7	-1.9	-0.2	0.2	0.6
Effective interest rate	1.8	5.5	5.0	5.6	5.9	6.5
Contingent Liabilities from Government Guarantees						
Real GDP growth	4.2	3.5	3.7	3.9	3.9	3.8
Inflation	3.1	2.8	2.9	3.1	3.0	3.1
Primary balance	-1.0	-8.4	-8.1	-0.2	0.2	0.6
Effective interest rate	1.8	5.5	4.9	5.3	5.1	5.3

	2016	2017	2018	2019	2020	2021
Real GDP Growth Shock						
Real GDP growth	4.2	2.1	2.3	4.9	4.9	4.8
Inflation	3.1	2.2	2.3	3.1	3.0	3.1
Primary balance	-1.0	-1.4	-1.6	-0.2	0.2	0.6
Effective interest rate	1.8	5.5	4.6	4.8	4.8	5.1
Real Exchange Rate Shock						
Real GDP growth	4.2	4.5	4.7	4.9	4.9	4.8
Inflation	3.1	9.1	2.9	3.1	3.0	3.1
Primary balance	-1.0	-0.9	-0.6	-0.2	0.2	0.6
Effective interest rate	1.8	5.5	4.5	4.7	4.7	5.0
Oil price shock						
Real GDP growth	4.2	3.5	3.7	3.9	3.9	3.8
Inflation	3.1	2.8	2.9	3.1	3.0	3.1
Primary balance	-1.0	-1.9	-1.6	-1.2	-0.8	-0.4
Effective interest rate	1.8	5.5	4.6	4.8	4.8	5.1

Source: IMF staff.

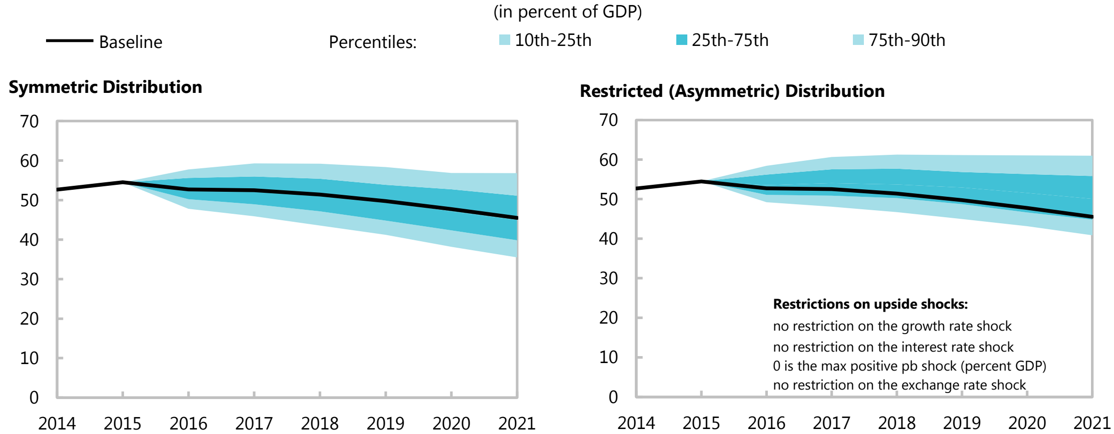
Figure 5. Malaysia: Public DSA Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

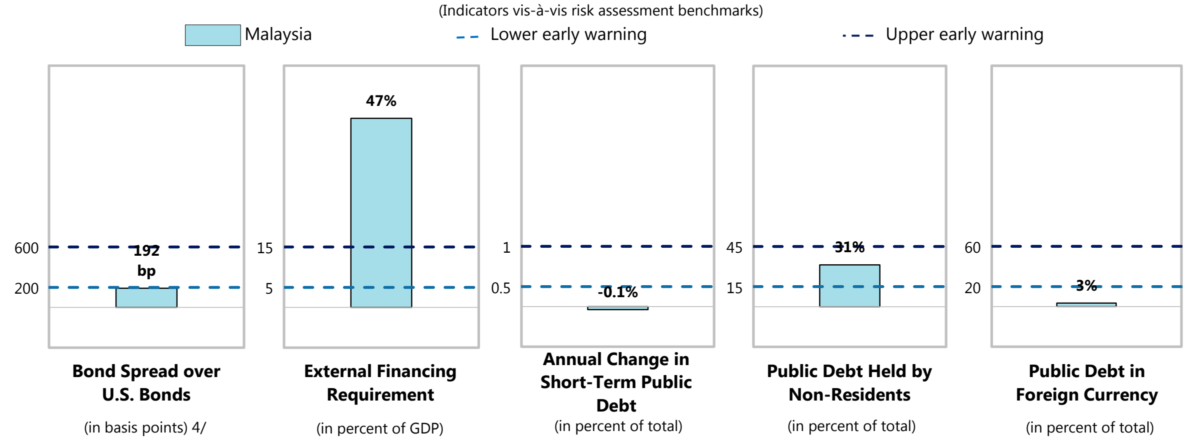
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ An average over the last 3 months, 27-Oct-16 through 25-Jan-17.

Appendix VI. Malaysia—International Taxation

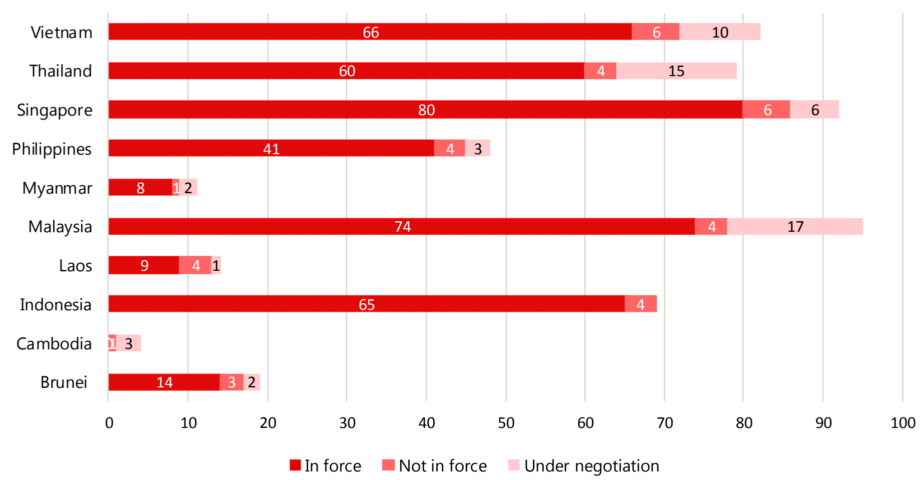
1. As an open economy, international taxation is an important aspect for Malaysia's fiscal policy. Malaysia has worked to secure its taxing rights as a source country while also promoting inward foreign direct investment (FDI). In pursuit of those goals, it has put in place a tax treaty policy, which maintains relatively robust withholding rates, and has had in force, since 2009, a transfer pricing rule. A thin capitalization rule is scheduled to go into force from January 2018.

A. Tax Treaty Policy

General

2. Malaysia has one of the most extensive network of double taxation avoidance agreements (DTAAs) in ASEAN, with 74 countries currently in force (Figure 1).[1] Its DTAA network covers major countries from which it receives FDI[2] including Japan (21.2 percent), Singapore (14.6 percent), the Netherlands (14.5 percent), and Hong Kong SAR (10.5 percent). Most of its DTAAs are based on the OECD model.

Figure 1. Number of DTAAs (ASEAN)



Sources: Malaysian authorities; and IBFD Tax Treaty Database.

Withholding Taxes

3. Under the DTAAs, Malaysia has maintained moderate rates of withholding taxes on important cross-border payments (Figure 2), particularly interest and royalties.[3] Moderate withholding taxes can also secure a certain level of taxation on "hard-to-deal-with" transactions.

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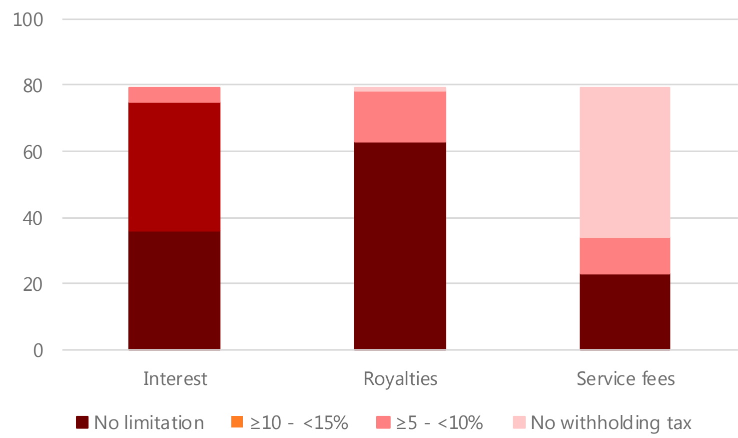
[1] Malaysia concluded one Tax Information Exchange Agreement.

[2] Malaysia's total FDI inward flow amounts to US$11 billion (2015). Country shares are based on data in 2013. Source: Bank Negara Malaysia.

[3] Under the domestic law, dividends paid by Malaysian companies are exempt from taxation, whereas royalties, rental income, and technical service fees are subject to a 10 percent withholding tax and interest is subject to a 15 percent withholding tax. For most of business incomes, the corporate income tax is levied on a territorial basis at a rate of 24 percent.

Figure 2. DTAA Limitation of Domestic Withholding Tax

(Number of DTAAs)



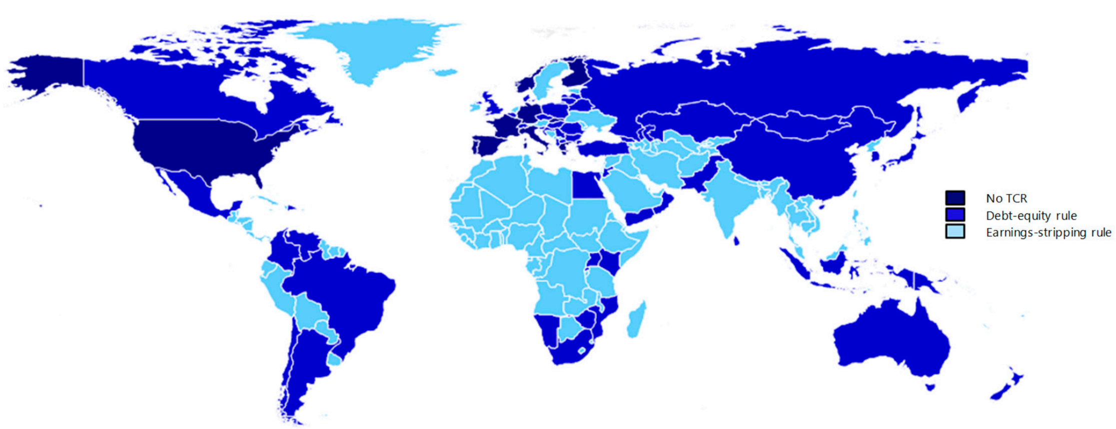
Source: International Bureau of Fiscal Documentation Database.

B. Thin Capitalization Rules

4. Excessive use of related-party borrowing— "thin capitalization"—can erode the domestic tax base by permitting stripping of earnings through inflating deductions for interest payments. A thin capitalization rule (TCR) aims to restrict the deduction of interest expenses of such excessive related-party borrowing. As of 2016, more than 60 countries imposed some form of thin capitalization rules to tackle profit shifting by means of intragroup borrowing (Figure 3).

Figure 3. Thin Capitalization Rules

(As of 2016)



Source: IMF staff estimates.

5. Malaysia introduced a TCR in 2009, but thus far the implementation has been deferred until December 31, 2017 upon consultation with the stakeholders. Most existing TCRs provide a fixed ratio that defines a level of (related-entities or total) debt or interest payment beyond which the deduction of interest expense is denied or restricted. No such ratio has yet been provided in

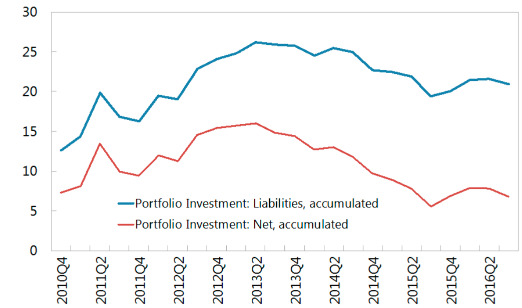
Malaysia. Countries have also adopted other approaches to preventing this tax avoidance, some simply relying on a general arm's length principle; increasingly an earnings-stripping approach, defined as a ratio of permissible net interest payment to earnings before interest, taxes, depreciation and amortization (EBITDA), is being used instead of a debt-to-equity ratio. This can be a more effective approach because it would make taxpayers' room to avoid TCRs narrower than a debt to equity ratio approach and could be considered for Malaysia.

Appendix VII. Malaysia—Capital Flow Volatility

A. Experience with Capital Flow Volatility

1. Malaysia has experienced several episodes of elevated capital flow volatility since the global financial crisis, largely triggered by external events. Beginning in 2009:Q2 inflows surged, peaking at cumulative inflows of 26¼ percent of GDP by the time of the taper tantrum in May 2013. Foreign holdings of domestic debt securities also reach near-peak levels at that same period. The taper tantrum in May 2013 was first of several surges in capital outflows, including outflows as oil prices fell sharply and another bout during Summer 2015 due to domestic political instability and uncertainty related to the outlook for China. Shifts in market sentiment regarding the outlook for US monetary policy also contributed to capital flow reversals at other times. The most recent bout of volatility occurred following the US presidential results.

Malaysia: Portfolio Flows
(In percent of GDP, accumulation since 2009:Q2)

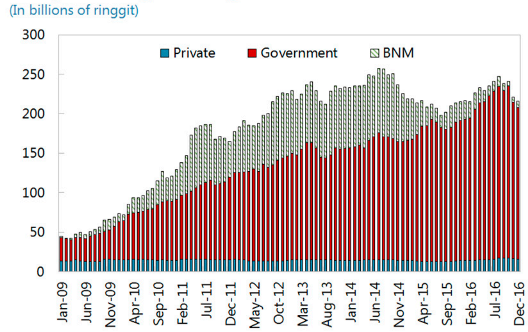


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

2. Capital inflows into the MGS market and, until end-2014 into BNM bills, were significant and coincided with an increase in international reserves. BNM bills are instruments used in monetary policy but were also sold to foreign investors during capital inflow surges and contributed to an increase in reserves. During outflow episodes, foreign holdings wound down. Issuance of BNM bills have declined since end-2014 and as result, foreign investors have increased holding of MGS.

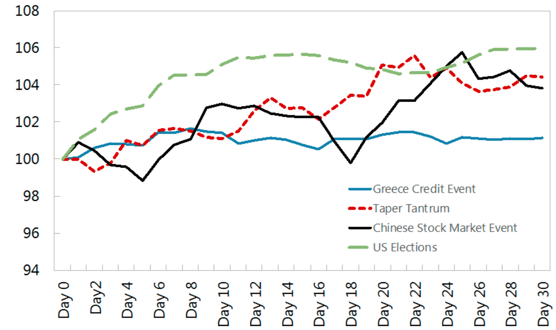
3. **Outflow episodes were characterized by currency depreciation, short-lived increases in MGS yields, and loss of reserves.** Compared with previous outflow episodes, the bout of volatility following the US election results was associated with a stronger depreciation of the exchange rate and a larger increase in yields. Outflows from equity and bond markets were also larger. On the other hand, the impact on reserves was more muted.

Malaysia: Foreign Holdings of Debt Securities
(In billions of ringgit)



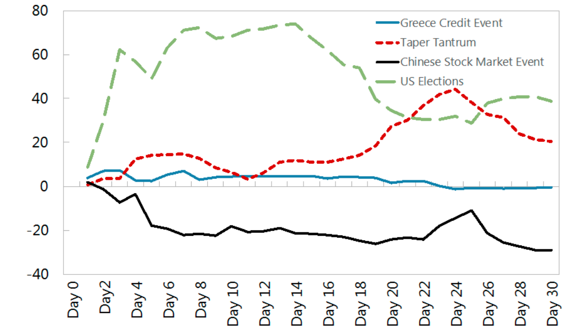
Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Malaysia: Exchange Rate
(In USD; Index, first day of event=100)



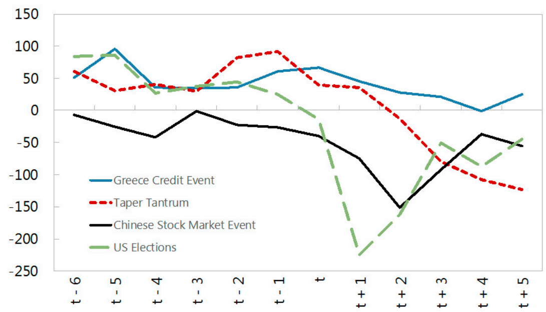
Sources: Bloomberg L.P.; and IMF staff calculations.

Malaysia: 5-Yr Sovereign Bond Yield
(In basis points)



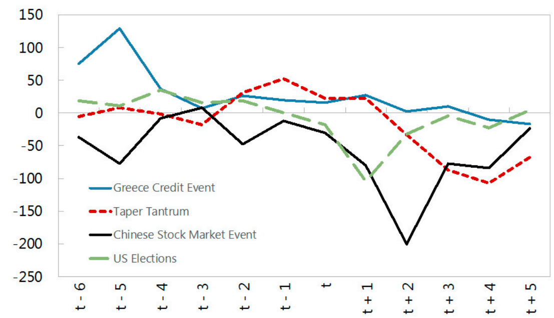
Sources: Bloomberg L.P.; and IMF staff calculations.

Malaysia: Bond Flows
(In USD million)



Sources: Bloomberg L.P.; and IMF staff calculations.
Note: t denotes the time of the event in week intervals.

Malaysia: Equity Flows
(In USD million)



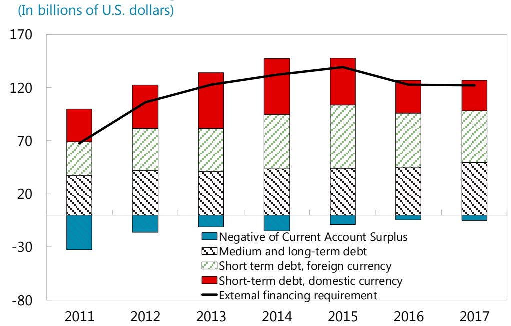
Sources: Bloomberg L.P.; and IMF staff calculations.
Note: t denotes the time of the event in week intervals

B. A Stress Scenario

4. **Malaysia's resilience to capital outflows is tested using an extreme stress scenario,** not unlike the GFC. In this tail-risk scenario, Malaysia faces a sharp slowdown in global growth and a sell-off by foreign investors. The currency depreciates and the current account surplus narrows.

5. In the baseline scenario, Malaysia has significant external financing needs, increasing the vulnerability to shifts in investor sentiment. External financing needs reflect short-term debt and amortization of medium- and long-term debt amounting to 38 percent of GDP. In the baseline scenario, the external financing needs are met by debt and net equity inflows.

External Financing Needs
(In billions of U.S. dollars)



Sources: CEIC Data Co Ltd.; and IMF staff calculations.

6. **Stress scenario assumptions.** The exchange rate is assumed to depreciate by 25 percent, bond yields increase by 200 basis

points, and the stock market decline by 30 percent.[1] The following assumptions are made with regard to capital outflows (Table 1).

- **Foreign holdings of MGS**. These are assumed to fall by half in ringgit terms, calibrated based on outflows during the GFC when holdings declined by 50 percent. However, the stock of MGS held by foreigners is much larger, both relative to GDP and market share, so the magnitude of the shock is now much greater than during the GFC. Therefore, it is assumed that MGS yields increase by 200 basis points[2] which in turn causes domestic institutional investors to opportunistically reallocate their on-shore and off-shore asset holdings into the MGS market. An increase of 200bps in bond yields implies a reduction in bond prices of 8.5 percent (based on the assumption of a 5-year bond currently trading at par). Therefore, foreign investors seeking to reduce holdings of MGS would face losses on two fronts: capital losses from the sale of bonds and valuation loss from the depreciation of the exchange rate. Given initial holdings of US$39.3 billion, a reduction in foreign holdings by 50 percent, taking into account capital and exchange rate losses, would imply an outflow of US$14.7 billion.

- **Rollover rate for short-term debt.** It is assumed that the rollover rate for banks' short-term debt declines to 70 percent, based on the decline in short-term debt between September 2009 and March 2010. This assumption is applied only to that portion of debt estimated to be unrelated to banks' treasury operations; any drawdown of short-term debt related to liquidity management is offset by an equal decline in short-term assets and therefore would not create a call on reserves. Such a reduction in the rollover rate would create an outflow of US$4.9 billion.

- **Non-resident deposits.** An outflow of non-resident deposits of 30 percent is assumed, calibrated based on the reduction in short-term debt. It is assumed that non-resident deposits are primarily denominated in local currency and, as a result, this creates an outflow of US$4.7 billion.

- **Foreign-holdings of equities.** These are assumed to fall by 20 percent in ringgit terms, implying a fall in the foreign participation rate from 22.6 percent to 18.1 percent. This is significantly larger than the decline during the GFC when the foreign participation rate declined from 22 percent in 2008 to 21 percent in 2009. Outflows are mitigated by a decline in the stock prices of 30 percent (assumed to be smaller than the 45 percent during the GFC) and the 25 percent depreciation of the exchange rate but are nevertheless sizeable at US$10.1 billion.

- **Current account balance.** In the baseline, Malaysia's external financing needs are offset by a sizeable current account surplus. It is assumed that the current account balance shrinks to zero

[1] Bond yields are assumed to increase reflecting tighter liquidity in the bond market; however, it is assumed that BNM would not increase policy rates in an attempt to reduce capital outflows.

[2] By contrast during the GFC yields initially increased by up to 100 bps during early 2008 but subsequently declined as central banks around the world loosened their monetary stance. As a result, average yields during 2008 were slightly lower than in 2007. The assumed increase in yields is significantly larger than during the Taper Tantrum episode when yields increased temporarily by about 70 basis points between May and end-July.

but will not fall into deficit. In the stress scenario, the exchange rate depreciation would help offset the impact of the large external demand shock through expenditure switching.

- **Net FDI flows.** In the stress scenario, Malaysian companies are likely to scale back outward FDI investment. However, inward FDI could also be reduced due to the shock, and therefore no change in net FDI flows is assumed in this scenario.

- **Repatriation by domestic investors.** The balance sheet analysis of Malaysia's institutional investors highlighted the sizeable overseas assets of Malaysia's institutional investors. These were conservatively estimated at 3.1 percent of GDP, equivalent to US$8.6 billion, and create a new inflow in the stress scenario (Table 2). In the absence of these inflows, the increase in MGS yields would likely be greater, increasing the capital losses for fleeing foreign investors.

Table 1. Malaysia: Stress Test: Assumptions and Estimated Outflows

Stress Test: Assumptions and Estimated Outflows

	Value at end-2016 US dollars, billions	Stress scenario parameters and assumptions	Impact
Outflows			
Malaysian Government Securities (MGS)	39.3	Foreign holdings of MGS fall by 50 percent (in ringgit) ● Calibrated based on 50 percent decline in foreign holdings during the GFC ● 200 basis point increase in yields is estimated to reduce ringgit value of MGS by 8.5 percent ● Exchange rate depreciation of 25 percent implies additional losses for foreign investors	14.7
Short-term debt of the Banking System 1/	16.4	Rollover ratio declines to 70 percent ● Banking system external debt fell by 70 percent between Sept. 2009 and March 2010. ● Exchange rate depreciation of 25 percent implies losses for foreign investors	4.9
Non-resident deposits	19.2	Non-resident deposits fall by 30 percent ● Calibrated based on short-term debt assumption ● Exchange rate depreciation of 25 percent implies losses for foreign investors	4.7
Foreign holdings of equities (22.6 percent of stock market capitalization at end 2016)	85.3	Assumed to decline by 20 percent in ringgit terms (falling to 18.1 percent share) ● Foreign participation declined by about 5 percent between 2008 and 2009 ● Stock market is assumed to decline by 30 percent (compared with 45 percent during GFC) ● Exchange rate depreciation of 25 percent implies additional losses for foreign investors	10.1
Offsetting inflows			
Current account surplus (projection for 2017)	4.5	Current account balance is assumed to decline to zero ● Current account balance declined by USD8 billion (or 6.5 percentage points of GDP) during the GFC	0
Net FDI flows		Offsetting reductions in gross inflows and outflows are assumed	0
Repatriation of overseas assets by institutional investors		See text table	-8.6
Shortfall compared to the baseline (in US dollars, billions)			25.9
as percent of GDP			8.6
Estimated reserves, at end 2017			68.7

1/ Excludes external liabilities to designated financial institutions which are backed by assets.

7. Malaysia's balance sheet strengths along with exchange rate flexibility would help support the resilience of the economy to capital outflows (Table 1). A flexible exchange rate, forex intervention, and the response of domestic institutional investors all play an important role in mitigating the impact of the capital flow reversal and helping buffer the shock to the Malaysian economy. However, it would also lead to some declines in reserves.

Table 2. Malaysia: Estimated Capacity for Additional Domestic Holdings of Government Debt

(In percent of GDP)

	Total Assets	Overseas Assets	From Domestic Balance Sheet Expansion and Asset Reallocation			Repatriation of Overseas Assets
			Stock	Flow	Total	
Employees Provident Fund (EPF)	55.1	13.8	0.0	0.3	0.3	2.8
Banks	192.6	…	0.4	0.3	0.7	…
Others 1/	47.4	6.5	0.0	0.1	0.1	0.4
Sub- total					**1.1**	**3.1**
Total						**4.2**

Sources: Annual Reports; IMF staff calculations.
1/ KWAP, Khazanah, TLH, PNB.

Appendix VIII. Malaysia—External Debt Sustainability Analysis

1. **Malaysia's external debt is estimated to have risen moderately to about 68 percent of GDP by end-2016.** Data available as of 2016:Q3 showed that external debt stood at 72 percent of GDP, but with the outflow of capital in the last quarter of 2016, particularly from the debt securities, and valuation effects, staff estimates that the stock of external debt would have declined by end-2016.[1]

2. **The rise in the external debt-to-GDP ratio in the first nine months of 2016 was driven by valuation effects**.[2] This rise in external debt also reflects a further increase in nonresidents' holdings of domestically-issued medium- to long-term Malaysian government securities and private sector's offshore borrowings. The share of short-term debt in total external debt fell further. Short-term debt accounted for about 39 percent of total external debt as of 2016:Q3, down from a nearly one-half share recorded in 2014:Q3. Debt denominated in domestic currency accounted for about 40 percent of the total external debt as of 2016:Q1.

Malaysia: Profile of External Debt
(In percent of GDP; original maturity)

	2014	2015	2016Q3
Total external debt (staff estimate) 1/	63.1	65.6	71.8
Medium- and long-term	32.4	37.9	44.1
Offshore borrowing	17.8	22.5	24.6
Public sector	7.9	10.1	10.0
Federal government	1.4	1.7	1.7
Public enterprises	6.4	8.4	8.3
Private sector	9.9	12.4	14.6
Nonresident holdings of ringgit-denominated debt securities	13.7	14.5	18.5
Government securities	12.8	13.6	17.3
Other securities	1.0	0.9	1.3
Other	0.9	0.9	1.0
Short-term	*30.7*	*27.7*	*27.7*
Offshore borrowing	14.3	14.0	14.6
Nonresident holdings of ringgit-denominated debt securities	5.1	2.1	1.1
Government securities	0.0	0.3	0.3
Other securities	5.1	1.9	0.8
Nonresident deposits	6.6	6.4	6.9
Other	4.7	5.1	5.1
Memorandum items:			
Total external debt (authorities)	67.5	72.1	70.2
Total external debt (authorities; billions of U.S. dollars)	211.8	192.2	206.6
Total external debt (staff estimate; billions of U.S. dollars)	213.4	194.2	205.1

Sources: Data provided by the authorities; and IMF staff calculations.

1/ Used for the purpose of the Debt Sustainability Analysis and based on staff's estimate of external debt and nominal GDP in U.S. dollar. Authorities' data are in ringgit terms. Difference with the authorities' debt-to-GDP ratio is mainly on account of the exchange rate assumption for nominal GDP in U.S. dollar.

3. **Malaysia's net international investment position was in surplus as of 2016:Q3.** On the back of capital inflows, the surplus declined to about 3 percent of GDP from about 8½ percent of GDP as of end-2015. Official reserves stood at about 45½ of GDP and net direct investment assets amounted to about 1½ of GDP. Net portfolio liabilities accounted for nearly 38 percent of GDP.

4. **Over the medium term, the external debt-to-GDP ratio remains sustainable, falling to about 55 percent by 2021.** Staff's baseline macroeconomic assumptions for the medium-term projections are broadly unchanged since the 2016 Article IV consultation. Under the baseline, Malaysia enjoys a sustained current account (CA) surplus over the medium term, though at levels lower than the historical average. However, the medium-term external debt-to-GDP ratios have been

[1] The external debt sustainability analysis is based on data available through 2016:Q3. Between September and December 2016, the outstanding stock of nonresidents' holdings of Malaysian debt securities declined by about US$9.5 billion, equivalent to about 4½ percent of the stock of total external debt as of September 2016. The bilateral exchange rate also depreciated by 8½ percent since end-September.

[2] Staff's estimate of external debt-to-GDP ratio is based on U.S. dollar values. It differs from the ratio published by the authorities, based on ringgit value, mainly on account of exchange rate assumption for calculating GDP in U.S. dollar terms. Between end-2015 and 2016:Q3, the bilateral exchange rate against U.S. dollar saw an appreciation of about 3.7 percent on an end-of-period basis, which raised the dollar value of nominal debt, while on a 4-quarter average basis (2015:Q4–2016:Q3) it depreciated by 12.6 percent, owing to a strong depreciation in 2015:Q4, resulting in a lower GDP in U.S. dollar terms.

revised upward reflecting a higher-than-expected 2016 debt ratio. The share of short-term debt, by original maturity, is projected to gradually decline to about one-third of total external debt by the end of the medium term. Malaysia's net international investment position is projected to grow as the country continues to enjoy CA surpluses over the medium term.

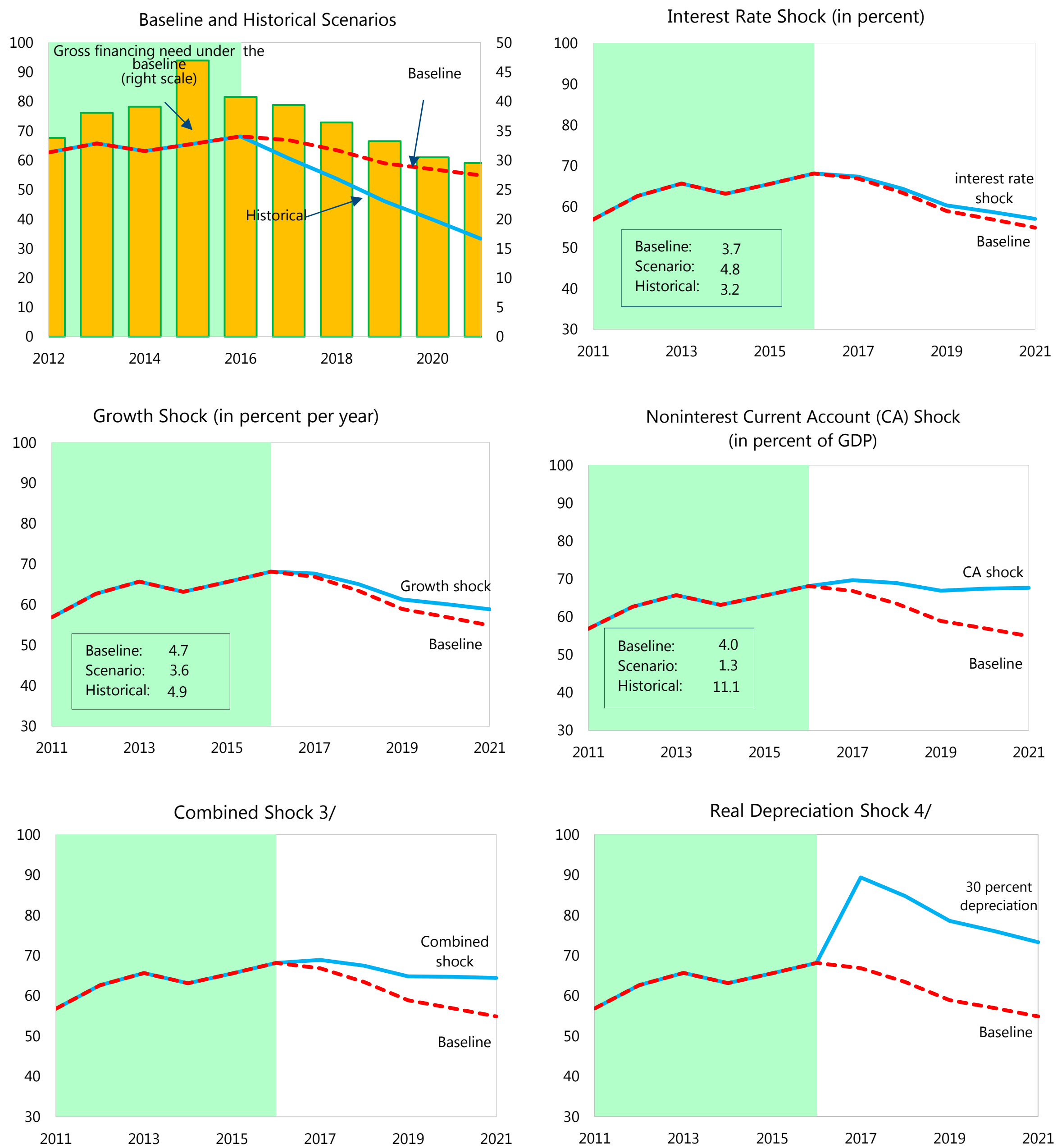
Malaysia: Comparison of Selected Medium-Term Macroeconomic Projections 1/

	2016 Article IV	2017 Article IV
Real GDP growth (in percent)	4.8	4.8
GDP deflator in U.S. dollars (change in percent)	5.1	3.7
Nominal external interest rate (in percent)	2.9	4.0
Growth of exports (U.S. dollar terms, in percent)	4.2	4.6
Growth of imports (U.S. dollar terms, in percent)	4.1	4.4
Current account balance, excluding interest payments (in percent of GDP)	3.4	4.1
Net nondebt creating captial inflows (in percent of GDP)	0.1	0.2

Source: IMF staff estimates.
1/ Covers the five-year periods of 2016-20 for 2016 Article IV and 2017-21 for 2017 Article IV.

5. **Standard stress tests under the external DSA indicate that external debt would remain manageable under a variety of shocks.** Under most of these scenarios, the external debt-to-GDP ratio rises above the baseline over the projection period by only modest margins. However, in the case of the exchange rate depreciation scenario, the debt ratio would rise close to 90 percent of GDP on impact, but would subsequently fall to about 73 percent of GDP by 2021. If CA balance (excluding interest payments) is permanently lower or the economy is impacted by a combined interest rate, growth, and the CA shock, the external debt-to-GDP ratio will remain closer to 65 percent of GDP over the medium term.

Figure 1. Malaysia: External Debt Sustainability: Bound Tests 1/ 2/
(In percent of GDP)



Sources: Data provided by the authorities; and IMFstaff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2017.

Table 1. Malaysia: External Debt Sustainability Framework, 2012–2021

(In percent of GDP, unless otherwise indicated)

	Actual						Est.	Projections					
	2012	2013	2014	2015			2016	2017	2018	2019	2020	2021	Debt-stabilizing non-interest current account 1/
Baseline: external debt 2/	62.6	65.7	63.1	65.6			68.1	66.8	63.4	58.9	56.9	54.9	-1.9
Change in external debt	5.8	3.1	-2.6	2.4			2.6	-1.3	-3.4	-4.5	-1.9	-2.1	
Identified external debt-creating flows (4+8+9)	-4.6	-4.6	-6.6	1.9			-4.6	-5.8	-5.3	-4.7	-4.1	-3.8	
Current account deficit, excluding interest payments	-6.3	-4.6	-5.5	-4.2			-3.7	-3.7	-4.2	-4.4	-4.1	-4.0	
Deficit in balance of goods and services	-10.8	-8.5	-9.3	-7.7			-6.4	-6.3	-6.0	-5.9	-5.8	-5.6	
Exports	79.3	75.6	73.8	70.9			67.2	68.4	65.2	61.4	58.4	55.5	
Imports	68.5	67.1	64.5	63.3			60.8	62.1	59.2	55.5	52.6	49.9	
Net nondebt creating capital inflows (negative)	3.7	1.0	1.5	-0.4			-1.6	-1.1	-0.6	-0.1	0.3	0.5	
Automatic debt dynamics 3/	-2.0	-1.1	-2.5	6.5			0.7	-1.0	-0.5	-0.3	-0.4	-0.2	
Contribution from nominal interest rate	1.1	1.1	1.1	1.2			1.7	1.9	2.4	2.5	2.3	2.3	
Contribution from real GDP growth	-2.9	-2.9	-3.8	-3.6			-2.8	-2.9	-2.9	-2.8	-2.6	-2.5	
Contribution from price and exchange rate changes 4/	-0.2	0.7	0.1	8.9			1.7	...	...	...	...	...	
Residual, including change in gross foreign assets (2–3) 5/	10.4	7.7	4.0	0.5			7.2	4.5	1.9	0.2	2.2	1.7	
External debt-to-exports ratio (in percent)	79.0	86.8	85.5	92.5			101.3	97.8	97.2	95.9	97.5	98.8	
Gross external financing need (in billions of U.S. dollars) 6/	106.3	122.9	132.2	139.1			120.9	122.1	123.2	124.7	125.2	132.4	
In percent of GDP	33.8	38.0	39.1	46.9			40.8	39.4	36.4	33.2	30.5	29.5	
Scenario with key variables at their historical averages 7/								60.7	53.7	46.1	39.8	33.4	0.8
Key macroeconomic assumptions underlying baseline					10-Year Historical Average	10-Year Standard Deviation							
Real GDP growth (in percent)	5.5	4.7	6.0	5.0	4.9	2.4	4.2	4.5	4.7	4.9	4.9	4.8	
GDP deflator in U.S. dollars (change in percent)	0.1	-1.8	-1.4	-16.5	2.7	10.6	-4.0	0.1	4.3	5.7	4.3	4.2	
Nominal external interest rate (in percent)	2.1	1.8	1.8	1.6	3.2	1.6	2.6	3.0	3.9	4.4	4.2	4.3	
Growth of exports (U.S. dollar terms, in percent)	-1.8	-2.0	2.0	-15.8	3.4	13.3	-5.1	6.3	4.1	4.4	4.1	3.8	
Growth of imports (U.S. dollar terms, in percent)	3.8	0.6	0.6	-14.1	4.5	13.6	-3.8	6.7	4.1	4.0	3.8	3.6	
Current account balance, excluding interest payments	6.3	4.6	5.5	4.2	11.1	5.6	3.7	3.7	4.2	4.4	4.1	4.0	
Net nondebt creating capital inflows	-3.7	-1.0	-1.5	0.4	-2.2	2.5	1.6	1.1	0.6	0.1	-0.3	-0.5	

Sources: Data provided by the authorities; and IMF staff estimates.

1/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and nondebt inflows in percent of GDP) remain at their levels.

2/ Staff estimates and projections. Malaysia has made a methodological change about external debt statistics. The new methodology statistics begin in 2009.

3/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

4/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

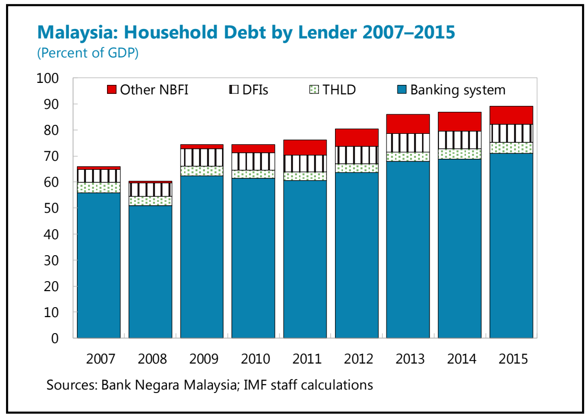
5/ For projection, line includes the impact of price and exchange rate changes.

6/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and nondebt inflows in percent of GDP.

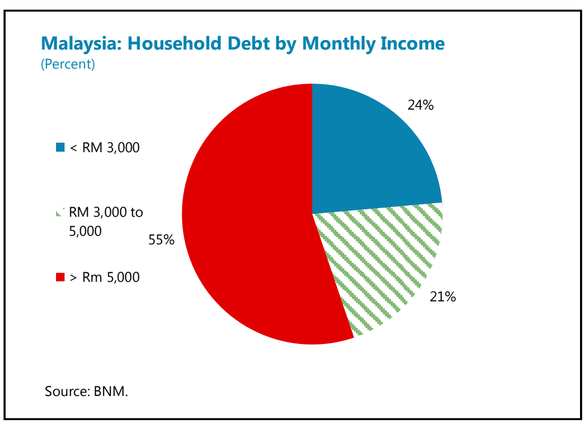
Appendix IX. Malaysia—Household Debt

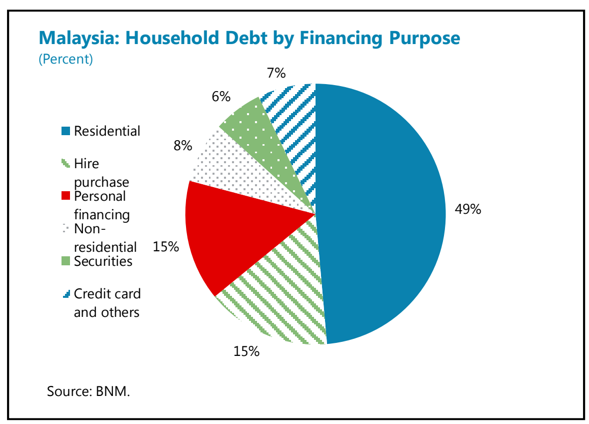
1. **Overview.** Household debt remains high and represents a key vulnerability. Macroprudential measures since 2010 were targeted at sources of systemic risk and have supported the resilience of the banking system while measures in July 2013 tamed the accumulation of debt, especially from the non-bank sector (Table 8). Risks are mitigated by high levels of household financial assets which amounted to 183 percent of GDP at end-2015.[1]



2. **Credit quality.** Banking sector credit quality has steadily improved with more stringent underwriting standards leading to reductions in NPLs by loan vintage. Overall banking system household NPLs remain low at 1.1 percent. Over half the debt is owed by higher income households (income above RM 5,000 per month) but about one-quarter is owed by lower income borrowers including some highly leveraged households.

3. **Housing-related debt.** Housing related debt accounts for about half of household debt. House price growth has moderated and is now close to its two-decade average of about 5.5 percent. This follows several years of elevated growth and rapid increases in the price-to-rent and price-to-income ratios. The risk of a sharp decline in house prices should be carefully monitored but is circumscribed by ongoing supply constraints, increases in public sector salaries and, from more structural perspective, Malaysia's relative young labor force and urbanizing population. Close to 30 percent of outstanding loans have an LTV ratio above 80 percent and, if rapid house price growth resumes, LTV caps on second and first mortgages could be considered.



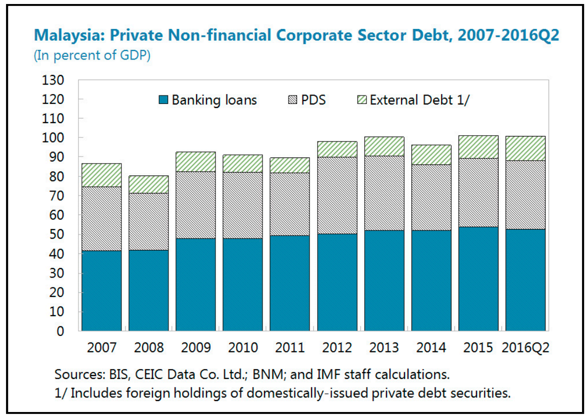


4. **Personal lending.** From the perspective of the financial sector, credit risk is reduced as most lending is to public sector employees and is serviced through automatic salary deductions. Nevertheless, this segment continues to pose a risk.

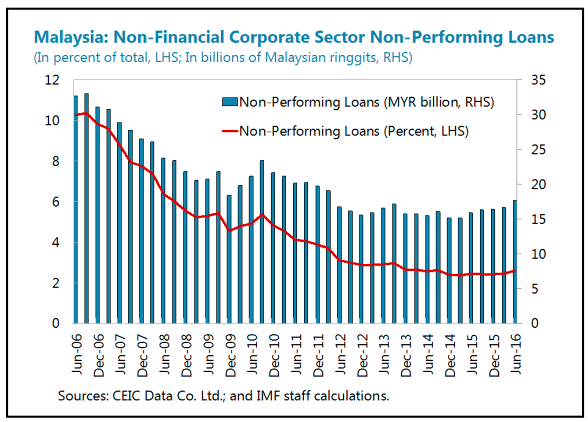
[1] These include deposits (43 percent of household financial assets), unit trust accounts (6.3 percent), equities (14 percent), EPF balances (30.8 percent) and insurance policies (5.9 percent).

Appendix X. Malaysia—Non-Financial Corporate Sector Debt

1. **Overview.** Malaysia's corporate sector does not appear to present a significant macro-financial risk, although there are pockets of vulnerability particularly in the construction sector. Corporate sector debt is close to 100 percent of GDP of which about half are banking loans, representing 43 percent of total banking sector loans. Offshore borrowing is about 10 percent of total debt and, in contrast to the MGS market, foreign holdings of local currency debt are very small, at about 1 percent of GDP. The increase in external debt in 2015 reflects exchange rate valuation effects and capital raising by PETRONAS.



2. **Vulnerabilities**. Balance sheet indicators, such as debt-to-equity ratios and interest coverage ratios, do not suggest widespread vulnerabilities. Furthermore, risks related to maturity and currency mismatches appear to be contained. More than 75 percent of non-financial corporate sector debt has a tenure greater than one year and less than 20 percent is denominated in foreign currency (of which about 70 percent is in US dollars). Corporations are required to obtain BNM's regulatory approval for aggregate foreign currency borrowing in excess of RM 100 million; it is required that borrowing be for productive purposes and most debt is either naturally hedged or is hedged through financial instruments. Furthermore, a significant share of external debt reflects the activities of multinational companies based in Malaysia. Stress testing indicates that Malaysian corporates are resilient to declines in income and exchange rate, and increases in interest rates,[1] while vulnerabilities are emerging in the construction and oil and gas sectors.



3. **Banking sector loans**. Banking sector loans are well-diversified, with commodity-related loans less than 12 percent of non-financial corporate sector loans. Although there has been little change in aggregate NPLs, there have been increases in the NPL ratio for construction loans (to 7.1 percent from 5.8 percent at end-2015).

4. **Property market.** Risks have increased in the non-residential property market, which amounts to about 4.5 percent of banking system loans. There is a large pipeline of new supply over the next 2–3 years, occupancy rates and the value and number of secondary market transactions have declined.

[1] International Monetary Fund, *Malaysia—Staff Report for the 2016 Article IV Consultation, Appendix XII.*

INTERNATIONAL MONETARY FUND

MALAYSIA

February 28, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of January 31, 2017)

I. Membership Status: Joined March 7, 1958; Article VIII

II. General Resources Account

	SDR Millions	Percent of Quota
Quota	3,633.80	100.00
Fund holdings of currency (exchange rate)	3110.64	85.60
Reserve tranche position	523.16	14.40
Lending to the Fund New Arrangement to Borrow	51.82	

III. SDR Department

	SDR Millions	Percent of Allocation
Net cumulative allocation	1,346.14	100.00
Holdings	821.86	61.05

Exchange Arrangement:

On July 21, 2005, Bank Negara Malaysia announced the adoption of a managed float with the exchange rate of the ringgit to be monitored against an undisclosed trade-weighted basket of currencies. Based on information on the exchange rate behavior, the de facto exchange rate regime is classified as "other managed."

Malaysia maintains bilateral payments arrangements with 7 countries. The authorities have indicated that these arrangements do not have restrictive features.

Malaysia continues to maintain a liberal foreign exchange administration policy. The current foreign exchange administration (FEA) rules are prudential measures to promote monetary and financial stability while safeguarding the balance of payments position and value of the ringgit. The FEA rules are continuously reviewed to ensure comprehensive policies conducive to the sustainable growth of the economy.

On December 2, 2016, BNM announced measures to develop onshore foreign exchange markets. It aimed at further facilitating onshore FX risk management; promoting settlement of trade and investment in ringgit; and enhancing the depth and liquidity of onshore financial markets.

The Malaysian authorities view remaining FEA rules as prudential in nature and necessary to ensure the availability of adequate information on the settlement of payments and receipts as part of the monitoring mechanism on capital flows. These controls do not contravene Malaysia's obligations under Article VIII.

Malaysia, in accordance with the UN Security Council resolutions implements the freezing without delay funds and other financial resources, including funds derived or generated from property owned or controlled directly or indirectly by the designated individuals and entities. These measures are maintained for the reasons of national and international security and have been notified to the Fund pursuant to the IMF Executive Board Decision No. 144 (52/51). Malaysia also restricts any dealings or transactions with Israeli/Israel-related entities/individuals as well as in Israeli Shekel; however, since these restrictions affect the underlying transactions themselves, they are not subject to Fund jurisdiction under Article VIII, Section 2(b)."

Article IV Consultation:

Malaysia is on the standard 12-month consultation cycle. Discussions for the 2016 Article IV consultation took place during January 11–22, 2016 (IMF Country Report No. 16/72). Staff discussions for the 2017 Article IV consultation were conducted on a mission to Kuala Lumpur during November 28–December 15, 2016. In addition, a staff visit took place during August 22–24, 2016.

Financial Sector Assessment Program (FSAP) Participation:

Malaysia conducted its first FSAP in 2012 (IMF Country Report Nos. 13/52, 13/53, and 13/56–13/60).

Technical Assistance:

Fiscal Affairs Department (FAD): A mission on strengthening outcome-based budgeting was conducted in February 2015. A tax administration mission took place in August 2015. A mission on international taxation and domestic tax-related issues was fielded in July 2016. Finally, a mission on expenditure review was conducted in December 2016.

Legal Department (LEG): Missions were fielded in May and September 2011 to help draft a Centralized Asset Management Corporations Bill, in the context of a three-year project to assist Malaysia in implementing an asset forfeiture regime.

Monetary and Capital Markets Department (MCM): A mission on macrofinancial risk analysis and vulnerability analysis for corporate and financial institutions was conducted in October 2009. A workshop on monitoring financial risks was held in in May 2010. Technical assistance missions on stress testing capital markets was conducted in 2013.

Statistics Department (STA): A mission to assist with implementing the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*) was conducted during May–June, 2013. Technical assistance missions on Government Financial Statistics were conducted during 2014.

Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT):

In November 2014, Malaysia's AML/CFT regime was subject of an on-site assessment by the Asia Pacific Group on Money Laundering (APG) under the new methodology of the Financial Action Task Force (FATF), the global standard setter for AML/CFT. The Mutual Evaluation Report was published in September 2015. It concluded that overall Malaysia has a broadly robust legal AML/CFT framework with generally well-developed and implemented policies, but with a moderate level of effectiveness. The country developed an action plan to address the key deficiencies identified in the report. In February 2016, the FAFT granted full membership to Malaysia based on its commitments to continue improving its AML/CFT regime. The FATF will continue to monitor the country's progress through its enhanced follow-up process.

Resident Representative/Advisor: None.

STATISTICAL ISSUES

(As of February 2017)

I. Assessment of Data Adequacy for Surveillance
General: Data provision is broadly adequate for surveillance. However, further efforts to improve statistics for the consolidated general government and public sector are necessary.
National accounts: Currently, the Department of Statistics Malaysia (DOSM) compiles and publishes annual and quarterly estimates of GDP by activity and by expenditure at current and constant prices, and annual estimates for gross disposable income, saving, and net lending for the economy based on the *2008 SNA*. The quarterly data are released about one and a half month after the reference quarter. **Price statistics**: The CPI and the PPI are available on a timely and comprehensive basis. From January 2016 onward, the CPI basket of goods and services has been updated based on the *Household Expenditure Survey* 2014.
Government finance statistics: There is a need to improve the timeliness, detail, and availability of data on nonfinancial public enterprises (NFPEs) and the state and local governments. Dissemination of more detailed data on nonlisted NFPEs' assets and liabilities and domestic and foreign financing by type of debt instrument and holder would be desirable; efforts in this direction will require continued close collaboration among the Economic Planning Unit (EPU), the Treasury, and Bank Negara Malaysia (BNM). There is also a need to disseminate more information on public private partnerships.
Monetary statistics: The monetary and financial statistics (MFS) are reported on a timely and regular basis and are broadly in conformity with the Fund's data needs. There is a need to improve the institutional coverage of the financial corporations, sectorization of the domestic economy, and classification and valuation of financial instruments to ensure full adherence to the IMF's *Monetary and Financial Statistics Manual*. In addition, due to the growing importance of insurance corporations, pension funds, and other financial intermediaries in Malaysia, coverage of MFS should be expanded to include these institutions. The MFS missions of January 2004 and 2005 developed an integrated monetary database to be used for publication and operational needs of the BNM, STA, and APD. The Bank Negara Malaysia reports data in STA's standardized report forms (SRFs) which provide more detailed classification of certain items, fuller sectoral and instrument breakdown, and currency aggregation. MFS based on the SRFs are published in the quarterly *IFS Supplement on Monetary and Financial Statistics*.
Balance of payments: Department of Statistics Malaysia compiles and publishes quarterly balance of payments estimates in accordance with the sixth edition of the Balance of Payments Manual and the SDDS. The quarterly data are released about one and a half month after the reference quarter. No data are shown for the capital transfers or acquisition/sale of nonproduced nonfinancial assets, and transactions in reserve assets are computed as differences in amounts outstanding and thus include valuation changes. The international investment position data on other investment—assets and liabilities—are reported only in an aggregate form.
II. Data Standards and Quality
Malaysia subscribes to the Special Data Dissemination Standard (SDDS). It is using a timeliness flexibility option for general government operations (within six quarter lags after the end of reference year).

Malaysia: Table of Common Indicators Required for Surveillance
(As of January 31, 2017)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	1/31/2017	1/31/2017	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	1/13/2017	1/20/2017	Bi W	Bi W	Bi W
Reserve/base money	12/29/2016	1/31/2017	Bi W	Bi W	Bi W
Broad money	11/2016	12/2016	M	M	M
Central bank balance sheet	12/29/2016	1/31/2017	Bi W	Bi W	Bi W
Consolidated balance sheet of the banking system	12/2016	1/2017	M	M	M
Interest rates[2]	1/31/2017	1/31/2017	D	D	D
Consumer price index	12/2016	1/2017	M	M	M
Revenue, expenditure, balance and composition of financing[3]—general government[4]	2015	2/2016	A	A	A
Revenue, expenditure, balance and composition of financing[3]—federal government	2016:Q3	1/2017	Q	Q	Q
Stocks of central government and central government guaranteed debt[5]	2016:Q3	1/2017	Q	Q	Q
External current account balance	2016:Q3	11/2016	Q	Q	Q
Exports and imports of goods and services	11/2016	1/2017	M	M	M
GDP/GNP	2016:Q3	11/2016	Q	Q	Q
Gross external debt	2016:Q3	11/2016	Q	Q	Q
International Investment Position	2016:Q3	11/2016	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing is only available on an annual basis.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A).

Authorities' Statement on 2017 Malaysia Staff Report

1. The Malaysian authorities would like to thank the mission team for the constructive 2017 Article IV Consultation. We are encouraged by staff's assessment that the Malaysian economy is resilient and that the current macroeconomic policy settings are appropriately calibrated to the outlook and risks facing the economy and the financial system.

2. Amid a challenging external environment, the resilience and strong performance of the Malaysian economy is underpinned by the economy's strong fundamentals, ample buffers and a robust financial system. Appropriate macroeconomic policy settings and timely policy responses have further reinforced the economy's resilience. The authorities remain vigilant to near-term risks while continuing with structural reforms to raise productivity and competitiveness. Policy priority will remain focused on ensuring inclusive and balanced growth, including assisting the lower income groups and promoting balanced development across the country.

3. As a small highly open economy, with a financial system that is integrated with the international financial system, Malaysia remains exposed to developments in the global financial markets and to volatile capital flows. In this environment, policymakers need at their disposal a full array of policy instruments to safeguard the economy and financial system from the highly volatile and disruptive capital movements. As the global environment evolves and new challenges emerge, the authorities will constantly review and assess the appropriate policy response as we strive to preserve domestic macroeconomic and financial stability.

4. The Fund has an important role to play. In particular, the Fund should recognize the need for its members to have the flexibility to take all necessary measures to preserve macroeconomic and financial stability. The Fund should be receptive and open to new approaches and policy instruments needed to maintain stability and promote financial market development. Country specific circumstances and context must be taken into account and a "one size fits all" assessment must be avoided. In addition, in keeping with the Fund's record of advancing reforms in the international monetary system, these efforts should be widened to include advocating for greater transparency in the offshore financial markets to reduce speculative activities and their disruptive cross-border implications.

Recent Economic Developments and Outlook

5. Despite the challenging global environment, the Malaysian economy continues to perform well, growing by 4.2 percent in 2016 (2015: 5.0 percent), led by private sector activity. Private consumption was supported by continued wage and employment growth, with additional impetus from Government measures. Capital spending in the services and manufacturing sectors contributed to private investment growth of 4.4 percent (2015: 6.4 percent) amid the slowdown in oil and gas investment. Both inflation and unemployment remained low at 2.1 percent and 3.5 percent, respectively (2015: 2.1 percent and 3.1 percent, respectively). The current account balance remained in surplus (2.1 percent of GNI) while international reserves were at a comfortable level of USD95 billion at end February 2017, sufficient to finance 8.5 months of retained imports and are 1.1 times short term external debt.

6. The economy is projected to grow at a steady pace of 4 - 5 percent in 2017, supported by continued expansion in domestic demand and an improving external environment. Private sector activity will remain the key driver of growth amid continued fiscal consolidation. The on-going implementation of infrastructure projects and capital spending in the manufacturing and services sectors will support investment activity. The economy is set to benefit from the expected improvements in the growth prospects of major economies and from higher commodity prices. Between November 2016 and January 2017, exports grew by 10.6 percent, underpinned by higher external demand for both manufactured goods and commodities. Inflation is expected to be higher in 2017, reflecting primarily the pass-through of the increase in global oil prices into domestic retail fuel prices.

7. The authorities concur that there are a number of downside risks, primarily arising from uncertainties in the external environment and policies of major economies. In coping with external uncertainties, Malaysia will, as staff noted, continue to benefit from its diverse economic structure and strong fundamentals that were built over the years. Policymakers have the capacity to undertake necessary policy measures in the event of shocks. At the same time, the authorities also see more potential for upside risks. Higher growth in major economies could result in better-than-expected demand for Malaysia’s exports, while faster recovery in oil and commodity prices would encourage more investment in the mining sector as well as contribute to higher oil-related income.

Adjusting to External Shocks

8. The authorities welcome staff’s assessment that balance sheet strengths and exchange rate flexibility have enhanced Malaysia’s resilience to capital outflows and that stress tests indicate external debt would remain manageable under a variety of shocks. These sources of strength reflect authorities continued focus on enhancing fundamentals and on implementing incremental reforms across a range of areas.

9. In 2016, the Malaysian financial markets experienced several episodes of capital flow volatility. As in past episodes of volatility and as acknowledged by staff, exchange rate flexibility and macroeconomic policy adjustments have played a central role in helping the economy adjust to these external shocks. Exchange rate flexibility remains a key shock absorber. Indeed, between May 2016 – February 2017, the ringgit depreciated by 12 percent against the US dollar. Where needed, Bank Negara Malaysia (BNM) intervened and provided liquidity to prevent excessive exchange rate volatility.

10. Despite these efforts, ringgit volatility intensified towards the latter part of 2016 and the exchange rate moved well beyond levels consistent with Malaysia’s economic fundamentals. To some extent, this was contributed by the growing imbalances in the demand and supply of foreign currencies in the onshore foreign exchange market as well as the speculative activity in the ringgit offshore non-deliverable forward (NDF) market which had a disproportionate and detrimental impact on the ringgit onshore market. These imbalances are not self-correcting and will continue to prevail if no specific measures are taken. In fact, the period of excessive volatility is expected to persist, underscoring the importance of a comprehensive and long term approach to further strengthen our resilience to external headwinds.

Measures to Develop Onshore Foreign Exchange Markets

11. The authorities view the IMF staff's recommendation for the authorities to reconsider the recent measures that were introduced on 5 December 2016 to develop onshore foreign exchange markets (Box 1, page 20) as inappropriate. Despite the measures being only recently introduced, the IMF staff found it appropriate to make an assessment, which in our view is a prejudgement. The IMF staff failed to appreciate and contextualise the broad policy intention of the authorities despite a series of clarifications. As reiterated by the authorities, the measures were implemented for the development of onshore FX market and were purely prudential in nature. These measures do not in any way limit the flow of funds in and out of Malaysia. It also reflected our conscious and continuous efforts towards sustaining domestic economic and financial stability in light of dynamic changes that were going on in the global financial landscape. Our efforts to put in place clear policy measures to support market stability are directly in line with the IMF's call on managing volatile capital flows. Thus, it is extremely perplexing for the authorities to hear the divergent stance of the IMF concerning this issue.

a. The measures introduced in 2016 are part of a comprehensive strategy to develop a highly liquid and deep foreign exchange market in Malaysia that is commensurate with the economic growth and increasingly sophisticated needs of businesses and investors. Through these measures, financial market resilience will also be strengthened.

b. The data on non-resident holdings of government bonds clearly shows that non-residents are not in any way hindered in their investment activities in Malaysia. They continue to be freely allowed to liquidate and exit from the Malaysian market. A report recently published[1] showed a significant increase in the inflows into the stock market. This is evidence of the continued free flow of funds in the Malaysian financial market and therefore, does not support the views that the measures have caused issues for investors at large.

c. The conversion of export proceeds into ringgit is meant to address the structural imbalances of supply and demand for foreign currencies in the onshore FX market. The requirement does not in any way hinder exporters from holding more than 25 percent of export proceeds in foreign currency if they have a business need to do so. Additionally, the framework allows reconversion to foreign currency at the same rate with no additional cost incurred by exporters for building up their foreign currency balances to meet their imports and current international obligations.

d. The measures are also intended to streamline the rules relating to investment in foreign currency assets with the broad objective of mitigating potential systemic risk to the financial system. This is done through the management of large investments by residents with domestic ringgit borrowing. The limit aims at mitigating any potential risk to financial stability. Residents, including exporters, without domestic ringgit borrowings can continue to freely invest in foreign currency assets onshore and offshore up to any amount. The prudential limit is also in line with the IMF's view that macroprudential measures are primarily designed to limit systemic financial risk and maintain financial system stability.

[1] Report published by Malaysian Industrial Development Finance, a private investment holding company.

12. Since the introduction of the policy measures, the success of these measures is self-evident: market adjustments have taken place and the authorities have seen encouraging signs of improvement:

a. The onshore FX market has been sustained, recording daily average volume of USD9.2 billion across all types of FX transactions, with spot and forward market transactions, particularly for ringgit currency pair, of above USD2 billion, similar to the level recorded in December 2016.

b. The NDF volume has reportedly declined by 75 percent and adverse spillovers have been curtailed. A number of global and regional financial institutions no longer participate in this market and have undertaken orderly liquidation of outstanding positions.

c. Exchange rate volatility has declined with average ringgit intraday movement narrowing to around 61 points from an average of 82 points in December last year and bid-offer spread had narrowed noticeably to 20 points in January, reducing foreign exchange transaction costs.

d. There has been a much improved balance between export and import related flows since the measures were introduced.

13. Based on our assessment, the IMF has not recognised the need of members to have flexibility in preserving macroeconomic and financial stability. Staff's recommendation for the authorities to reconsider the measures is certainly premature and has not been supported by a thorough and rigorous assessment. More importantly, this assessment is clearly inconsistent with staff's acknowledgment that the measures are aimed at deepening the onshore financial markets (paragraph 18, pages 12 and 13).

a. Malaysia is an open economy that is dependent on international trade and therefore, excessive ringgit volatility could be potentially destabilising. As such, the authorities are obligated to constantly review the environment and use appropriate policy tools to respond to new and emerging risks or developments.

b. The structural imbalances in the foreign exchange market and the destabilising influence of the unregulated and opaque non-deliverable forward (NDF) market will not be self-correcting and will continue to prevail without specific measures by the authorities. Other central banks in multiple fora have highlighted this issue and initiatives are being undertaken to contain this market from exacerbating risks to global financial stability. The IMF should be more supportive of these measures instead of 'promoting' the voice of the selected few, in particular the financial market players who profit from this market to the detriment of the onshore market stability. The IMF itself has identified these vulnerabilities in its FSAP report on Malaysia in 2014.

c. The staff's recommendation for the authorities to reconsider the measures will create confusion as it is in contradiction with the following statements:

   i. The staff's explicit acknowledgment on the effectiveness of the measures by recognising that *"liquidity in the onshore market has normalized, the spot exchange rate volatility has come down, and the bid-ask spread has declined"*; and

   ii. The staff's suggestion that *"BNM should keep the new FX market measures under review"*.

Monetary Policy

14. After maintaining the Overnight Policy Rate (OPR) since July 2014, the Monetary Policy Committee (MPC) decided to reduce the OPR by 25 basis points to 3.00 percent in July 2016. The reduction was intended to ensure that the degree of monetary accommodativeness remained consistent with the assessment on the balance of risks to the growth outlook, amid stable inflation. In its meeting in March 2017, the MPC reaffirmed that at the current level of the OPR, the degree of monetary accommodativeness is consistent with the policy stance to support growth amid a stable core inflation. On monetary operations, BNM will continue to ensure that liquidity is sufficient to support the orderly functioning of the domestic financial markets. The MPC will continue to closely assess the risks surrounding the outlook for growth and inflation in deciding the stance of monetary policy moving forward.

Fiscal Policy

15. The authorities welcome staff's assessment that the medium term fiscal policy is well anchored on achieving a near-balanced federal budget by 2020. Fiscal deficit declined to 3.1 percent of GDP in 2016 and is projected to reach 3 percent in 2017. Prudent fiscal management has led to the reduction in federal government debt over the years, to 52.7percent of GDP in 2016 (2015: 54.5 percent of GDP). Of importance, the federal government's foreign currency debt only accounted for 1.9 percent of GDP or 3.6 percent of total outstanding federal government debt. The debt profile is also favorable, with about 70 percent of the debt with maturities more than three years.

16. The overall fiscal strategy focuses on containing operating expenditure while protecting capital development spending, as well as increasing revenue generation and enhancing tax efficiency. In 2016, lower expenditure on supplies and services, and subsidies led to a 4.5 percent decline in operating expenditure (2015: -1.2 percent), while net capital development spending increased by 12.5 percent (2015: 2.2 percent).

17. On the revenue side, the implementation of the Goods and Services Tax (GST) in 2015 was instrumental in diversifying fiscal revenue. Collection of GST is expected to increase by 3.9 percent to account for 18.2 percent of total revenue in 2017. Engagements with businesses and government agencies have been intensified to improve GST collection. Initiatives are on-going to further enhance the effectiveness of the GST framework as well as minimizing leakage through enhanced enforcement of tax compliance with close coordination among the various government agencies.

18. Over the past several years, the authorities have undertaken comprehensive subsidy rationalization reforms, including the full removal of fuel subsidies in 2014 and subsidy cuts for food items such as sugar and cooking oil. The removal of these broad-based subsidies has been replaced with more targeted assistance to the low income group. Several measures were introduced in the 2017 Budget to this effect. These include an increase in the amount of direct cash transfers; supply- and demand-side measures to increase the construction and purchasing of affordable houses; and additional personal income-tax relief. The introduction of the new corporate income tax is aimed at enhancing tax efficiency and stimulate further growth of businesses, including the small and medium enterprises.

19. On contingent liabilities, it is important to note that growth in these liabilities has been on a declining trend since 2011 and guarantees have been extended selectively to nonfinancial entities to undertake productive and strategic investments. About 36 percent of the outstanding guarantees were given to entities that undertake public transportation infrastructure projects, while guarantees given to the National Higher Education Fund Corporation (PTPTN) accounted for about 22 percent of the total guarantees. Repayment risks from student loans provided by PTPTN are generally contained and further mitigated with the listing of loan defaulters in the Central Credit Reference Information System.

20. To strengthen the institutional capacity of fiscal management, the Fiscal Policy Committee has established the Fiscal Risk and Contingent Liability Technical Committee in May 2016, to evaluate and propose measures to manage fiscal risks and contingent liabilities. The authorities appreciated the Fund's TA on Spending Reviews and look forward to the TA on Public Investment Management Assessment in April 2017.

Financial Stability

21. The Malaysian financial sector is robust and continues to support the economy. Furthermore, near-term risks to financial stability remain low and as noted by staff, contained. As highlighted in the staff report, Malaysia's banking sector is bolstered by strong capital buffers, adequate provisioning and liquidity, and stable funding conditions. NPLs remain low and asset quality is supported by sustained debt servicing capacity of borrowers, and banks' strong credit underwriting and risk management practices. Stress tests by BNM demonstrates the resilience of the banking sector to major shocks. This has been underpinned by BNM's intensive and proactive approach to financial sector regulation and supervision. Deep domestic financial markets and the presence of well-diversified domestic institutional investors continue to support orderly financial market conditions, especially during periods of large capital outflows. Financial intermediation remains healthy, with continued financing to households and businesses, including small and medium enterprises.

22. Risks to financial stability arising from household debts remained manageable. Households maintained strong financial buffers at the aggregate level with financial assets account for two times the debt level. Impaired loans of households have remained low at 1.1 percent of total banking sector loans while about 41 percent of borrowers of newly approved loans have debt service ratios of less than 40 percent. This reflects prudent credit underwriting and risk management practices.

23. Growth in aggregate house prices has moderated since end-2013 following the implementation of macroprudential and other measures aimed at curbing excessive speculation and risk-taking. While there are risks of oversupply in the office space and shopping complex segments, risks to the banking system remain limited, impaired loans ratio for these segments is low at 1.3 percent as at end-2016. Similar to staff, the authorities view the current macroprudential measures as being sufficient at this juncture. However, the authorities stand ready to act pre-emptively to address any potential build-up of risks.

24. Funding of Malaysian business is predominantly (74.2 percent) sourced from the domestic financial institutions and capital market, and denominated in ringgit. The aggregate corporate debt expanded annually at a slower pace of 8.6 percent in 2016. Banking system domestic exposures (including off-balance sheet exposures) to the oil and gas related sectors (including water transport) is relatively low at about 5 percent of business loans and 6 corporate bond holdings, or about 14

percent of total capital of banks. Based on stress tests on the debt servicing capacity of large borrowers, excess capital of banks is sufficient to cover more than two times the potential losses from simulated shocks (exchange rate, borrowing costs and earnings). Corporate borrowings are supported by generally healthy balance sheets and financials, with the median interest coverage ratio (ICR)[2] of 9.4 times and cash to short term debt ratio at 1.2 times for the nine months ending September 2016[3]. For the same period[4], corporate debt-at-risk[5] remains below that observed in other emerging market economies, despite increasing to 7.7 percent (2015: 6.2 percent). The increase was mainly attributed to firms in the automotive, real estate and oil and gas sectors, and is within BNM's expectations given the more challenging conditions in these sectors.

25. Malaysia remains committed towards meeting its five year National AML/CFT Strategic Plan objectives. In 2016, the focus was on strengthening risk assessment on threats of serious crimes and increased vigilance on the vulnerable sectors of money services businesses and designated non-financial businesses and professions through adequate resource prioritization for increased supervision and surveillance. In line with international efforts to combat terrorism and proliferation financing, Malaysia has issued several guidance on Targeted Financial Sanctions relating to terrorism financing to reporting institutions for greater clarity and better reporting.

Reforms to Enhance Growth Potential

26. Malaysia's reform initiatives are guided by the 11th Malaysia Plan (2016-2020), which aims to accelerate Malaysia's transformation into a high-income economy by 2020, while promoting more inclusive growth and raising productivity and competitiveness. Of importance, Malaysia has made important strides in reducing poverty and inequality over the past decades with a combination of anti-poverty and rural development programs focusing on promoting inclusion, livelihood and employment. In recent times, the removal of blanket subsidies has been accompanied by more targeted measures to assist the low- and middle-income groups.

27. Productivity has generally increased in recent years but lags behind advanced economies. Malaysia has set a productivity growth target of 3.7 percent per year from 2016 to 2020. In this regard, efforts to boost productivity will focus on accelerating innovation and entrepreneurship; leveraging advancements in technology; and inculcating green technology.

28. A key focus area is human capital development. The Malaysian Education Blueprint (2013-2025) is aimed at elevating the quality of school education, primarily through curriculum transformation, improve quality of teachers and increase English proficiency. In addition, the Malaysia Education Blueprint (Higher Education) 2015 – 2025 outlines 10 strategic shifts aimed at enhancing the Malaysian higher education system. Currently, the authorities are embarking on Redesigning Higher Education agenda. This agenda focuses on several areas, including more holistic student assessment method, greater academia-industry collaboration, empowering and the enhancement of work-based learning programmes. Efforts are also ongoing to increase the appeal of technical and

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[2] Computed using earnings before interest, tax, depreciation and amortisation, consistent with the computation method used by the IMF.
[3] Based on 120 non-financial firms listed on Bursa Malaysia that account for 85% of market capitalisation (excluding financial institutions).
[4] For the 12 months ending September 2016.
[5] Measured as the share of debt borne by firms with an ICR of less than two times.

vocational education and training both to attract school leavers and to improve workforce participation rates through upskilling of unemployed, female and elderly workers. The measures have contributed to the improvement in graduate employability to 77.3 percent in 2016 (2012:74.4 percent).

29. The authorities have recently announced Transformasi Nasional 2050 (TN50), a 30-year national development initiative which spans the period 2020-2050. The TN50 policy document, which will be published in early 2020, will outline the economic, social, cultural and environmental targets that Malaysia aims to achieve by 2050. Engagement with various stakeholders is currently underway to develop the targets, which will provide continuity in the developmental goals for the nation beyond 2020.

Final Remarks

30. The external economic and financial environment will remain fraught with uncertainty and risks. As a small and highly open economy, Malaysia is highly exposed to external developments. The authorities, therefore, have to remain vigilant. Strengthening macroeconomic fundamentals, building up policy buffers and reducing imbalances will remain the authorities' priority. Proactive and well calibrated policies, supported by robust policy frameworks, will continue to be pursued as the authorities respond to the uncertain global environment in order to preserve macroeconomic and financial stability, and achieve sustainable and inclusive growth.