

Malaysia: 2009 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Malaysia

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 2009 Article IV consultation with Malaysia, the following documents have been released and are included in this package:

- The staff report for the 2009 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 2, 2009, 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 July 1, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 16, 2009 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for Malaysia.

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INTERNATIONAL MONETARY FUND

MALAYSIA

Staff Report for the 2009 Article IV Consultation

Prepared by the Staff Representatives for the 2009 Consultation with Malaysia

Approved by Kalpana Kochhar and Ranil Salgado

July 1, 2009

- **Discussions:** During May 21-June 2, 2009 with the Minister of Finance II Mr. Hanadzlah, the Secretary General of the Treasury Mr. Wan Aziz, Governor Zeti and Deputy Governor Ooi Sang Kuang of Bank Negara Malaysia, other senior officials, and private sector representatives. Ms. Vongpradhip and Mr. Toh (OED) participated in policy meetings.
- **Team:** Messrs. Zanello, Guimarães-Filho, Rozhkov, and Zebregs (all APD).
- **Context of past surveillance:** There has been broad agreement between the authorities and the Fund on the policy desiderata—a prudent fiscal stance, reforms of government-linked companies, efforts to improve the investment climate, flexibility in exchange rate management and monetary conduct, and steps to further strengthen the stability and efficiency of Malaysia’s financial system. Views have differed, however, on the pace of reform. The authorities have favored a more gradual approach, perhaps better attuned to political realities and implementation constraints.
- **Exchange arrangement:** Malaysia has accepted obligations under Article VIII, Sections 2, 3, and 4. Its exchange system is free of restrictions on payments and transfers for current international transactions. The exchange rate arrangement is a floating regime and remains appropriate.
- **Data:** Broadly adequate for surveillance. However, further efforts to improve statistics for the consolidated public sector are necessary.

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EXECUTIVE SUMMARY

Background and outlook. Malaysia has been hit hard by the global downturn. The economy is set to contract for the first time in ten years. However, Malaysia is coping with the crisis from a position of strength. It has ample foreign exchange reserves; the balance sheets of banks, corporates, and households are generally in good shape; trade has become more diversified; and internal demand has gained importance as a driver of growth. The export-led recession is expected to last through end-2009, with quarterly growth returning in early 2010.

Policy issues. The Article IV discussions focused on macroeconomic and financial policies to cushion the impact of external shocks and on reforms to meet medium-term challenges. Policymakers have responded vigorously to the deteriorating growth outlook. There was broad agreement on the policy settings and the reform priorities.

Fiscal policy. The countercyclical fiscal response has been appropriately large, but room for further maneuver is limited. To broaden the room for maneuver, fiscal decisions need to be cast in a framework that includes consolidation plans further along the recovery path. The staff and the authorities shared the view that a better articulation of the medium-term evolution of the public finances would safeguard the credibility of fiscal plans and the confidence effects of actions already taken.

Monetary policy. Bank Negara Malaysia has taken decisive action and there is now considerable monetary support in the pipeline. There was agreement that, barring a significant deterioration of the outlook for growth or inflation, monetary policy should stay the course until a recovery is well established. However, Bank Negara still has ammunition that could be used if tail risks materialize.

Financial sector policies. Reforms and proactive policies have helped the financial system withstand the global crisis. Although banks are generally well capitalized and liquid, asset quality will deteriorate as the recession drags on and regulators need to focus on further preventive steps to ensure that banks' capital positions are robust.

Beyond the current crisis. The authorities intend to continue to pursue policies and reforms to strengthen long-term economic prospects and boost resilience. The staff and the authorities agreed that priority should be given to bolstering the fiscal framework and rebalancing the sources of growth toward domestic demand. The latter would be facilitated by accelerating the implementation of structural reforms and allowing the ringgit to resume its trend appreciation. According to staff estimates, the real effective ringgit is undervalued, but a number of indicators suggest that the undervaluation is not extreme. Once the global turmoil subsides, however, a pace of real appreciation faster than that experienced so far would be desirable.

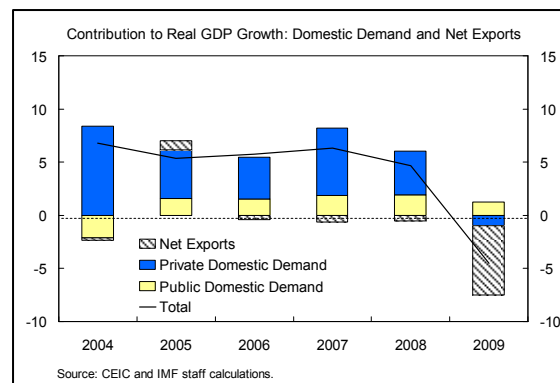
I. INTRODUCTION

1. **Malaysia has been hit hard by the global downturn.** The impact has been mostly through the trade channel but global financial market turbulence has also been felt. Exports have plunged, capital inflows have reversed, and local financial markets have experienced heightened volatility. The economy is now set to contract for the first time in ten years. Continued weakness in export demand and investor confidence weighs on the outlook.
2. **Encouragingly, Malaysia is coping with the crisis from a position of strength.** It has ample foreign exchange reserves and a net international creditor position; financial supervision has been proactive; and the balance sheets of banks, corporates, and households are generally in good shape. Moreover, external trade has become more diversified with respect to both products and markets, and internal demand has gained importance as a driver of growth over the last decade.
3. **The 2009 Article IV discussions focused on macroeconomic and financial policies to cushion the impact of external shocks and on reforms to meet medium-term challenges.** The recession has added urgency to outstanding structural issues—fiscal consolidation and strengthening domestic-oriented activity. In fact, the crisis presents an opportunity to revisit the development model that has served Malaysia well but may need adjusting as the global economic landscape changes.

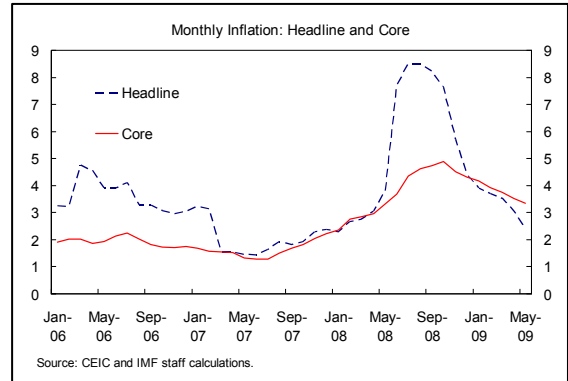
II. ECONOMIC DEVELOPMENTS

Background

4. **Since mid-2008, GDP growth and inflation have slowed sharply.**
 - GDP contracted by 10½ percent (q/q saar) in 2009Q1, after a decline of about 12 percent in 2008Q4 (Figure 1 and Table 1). The drop in GDP was driven by faltering external demand: exports—which account for about 110 percent of GDP and are concentrated in electronics and commodities—have fallen by more than 15 percent y/y in the first quarter. Domestic demand, which showed resilience last year, has also been affected by the inward spillovers of external shocks: private consumption fell by nearly 1 percent (y/y), and gross fixed investment by some 11 percent, in 2009Q1.



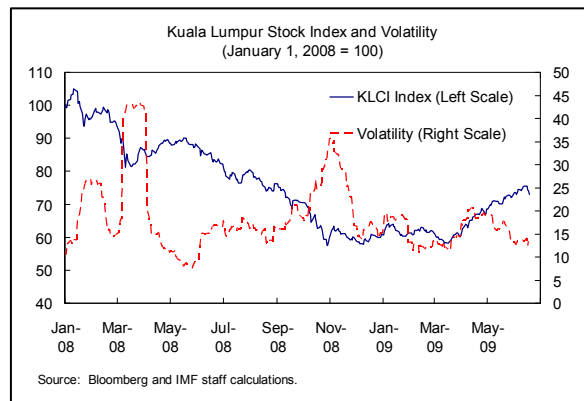
- Inflation reached a 26-year high in mid-2008, but has since declined as commodity prices have collapsed and slack in demand has put a lid on pricing power. Core inflation has also edged down.



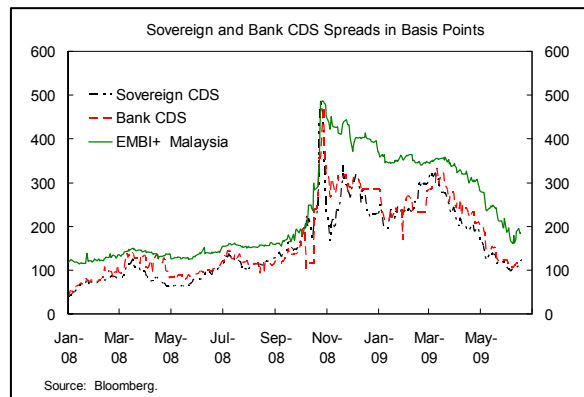
- The reduction in employment has been relatively small so far. Manufacturing employment has fallen by 7¾ percent y/y in the first quarter (compared with a contraction in industrial production of about 15 percent), and the overall unemployment rate has increased modestly to 3.2 percent in the first quarter. Lags may still have to play out fully, but there is survey evidence that foreign workers (not fully captured in labor market statistics) have borne the brunt of the adjustment. Furthermore, unlike what happened during the Asian Crisis, many export-oriented companies have reportedly been able to lessen the blow of shrinking orders through shortened workweeks rather than labor-shedding. As a result, consumer confidence has generally held up.

5. Global turbulence has spilled into the domestic financial markets.

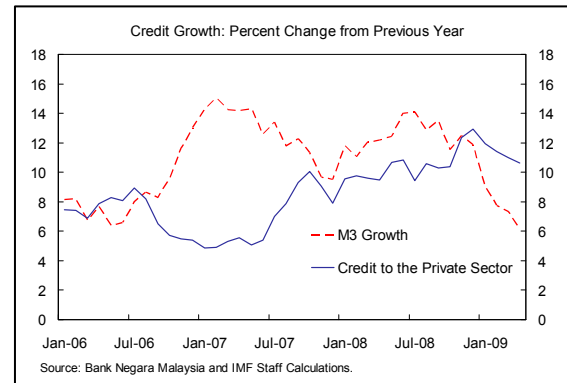
- The benchmark equity price index declined by more than 30 percent between mid-2008 and March 2009, although it rebounded by some 25 percent in April-May. The market rally has reflected renewed optimism about near-term prospects and an upturn in commodity prices.



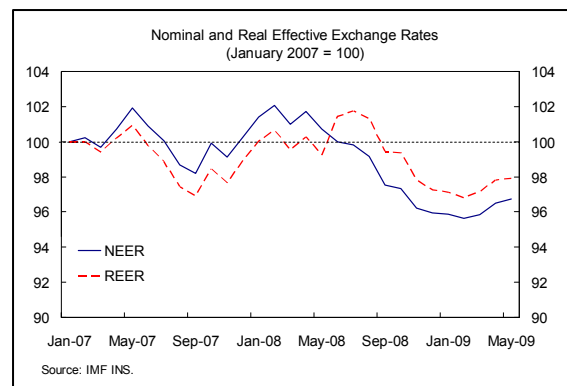
- Government bond yields have remained broadly stable, but sovereign spreads have declined with the recent pickup in risk appetite. The EMBI spread is now below 200 basis points, just over one-third of its level in October 2008. The spread on sovereign credit default swaps (CDS) and the CDS spread on Maybank, Malaysia's largest bank, are also off last year's peaks.



- Money markets have remained orderly. Interbank rates have edged down in line with the cuts in the overnight policy rate. Bank Negara Malaysia (BNM) injected liquidity as global financial conditions tightened last fall.¹ To safeguard short-term funding, the BNM announced in October 2008 its willingness to back interbank lending, if needed. Credit has continued to decelerate, but its growth remained at a reasonable 10½ percent y/y through April, well above nominal GDP growth.



- The ringgit has appreciated slightly vis-à-vis the U.S. dollar since April, after experiencing depreciation pressures last fall and early this year as capital outflows intensified (Figure 2). The real effective exchange rate (REER) has strengthened by about 10 percent between mid-2005 (when Malaysia exited a fixed exchange rate regime) and September 2008, owing to both a nominal appreciation and relatively higher domestic inflation. Since then, the REER has depreciated by about 1½ percent.



6. Despite capital reversals and the unwinding of the commodity boom, Malaysia's external position remains strong (Table 2).

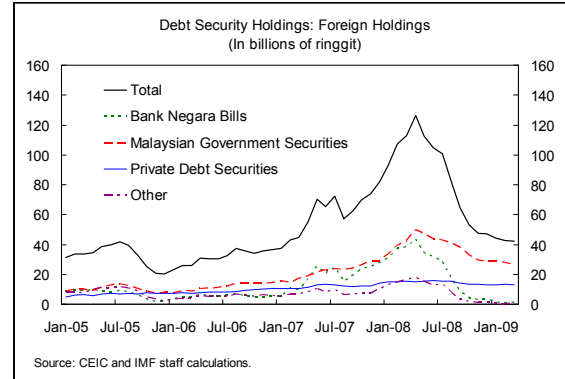
- The current account surplus reached 17 percent of GDP in 2008, as the trade balance surged thanks to strong demand for commodities and a better-than-expected performance of electronics through the third quarter (Figure 3 and Table 3).² The collapse of exports in 2008Q4 was accompanied by an equally strong import compression, leaving the current account surplus (in relation to GDP) broadly unchanged by year-end. With rising tourism receipts, the services account has

¹ The BNM has several tools for liquidity management. They include: (i) daily deposit auctions at different maturities; (ii) daily repo operations; (iii) Bank Negara Monetary Notes; and (iv) a *wadiah* interbank acceptance facility. To further develop the Islamic money market, the BNM introduced a commodity *murabahah* program as an additional Islamic investment tool. Liquidity facilities have been opened to conventional and Islamic insurers since October 2008.

² Hydrocarbons, rubber, timber, and palm oil account for one-third of Malaysia's exports.

registered a small surplus in 2007–08. However, the income balance has remained negative, reflecting greater profit repatriation by multinational companies.

- In the financial account, outward investment by Malaysian corporates continued to grow—and FDI outflows outstripped inflows. Driven by global deleveraging and the rise in financial home bias, portfolio flows, which had been positive in 2006 and 2007, turned negative in mid-2008, reaching a record outflow of US\$27 billion for the year. Other investment (not including that associated with the official sector) also turned negative as bank outflows surged in the second half of 2008.



- With capital flowing out rapidly, reserves shrunk by US\$35 billion in the second half of 2008. Reserves have continued to slip, albeit at a slower rate, through March 2009. They stood at about US\$87 billion (40 percent of GDP or four times short-term debt) in June.

Outlook and Risks

7. External developments will probably shape Malaysia's recovery path.

- *Near-term:* GDP is projected to contract by 4–5 percent in 2009 (Table 4). The export-led recession is expected to last through end-2009, with quarterly growth returning in early 2010. Private domestic demand will likely shrink this year, but the public sector should provide some offset. The current account surplus is expected to decline in 2009 relative to GDP as exports continue to weaken while import compression slows. Inflation is projected to fall to about 1 percent (yearly average). Risks to growth relate to the duration of the global recession (which could drag down exports), the evolution of commodity prices (which influence disposable incomes in rural areas), and adverse macro-financial interactions (which could crimp the recovery of private demand or blunt policy effectiveness).³ Downside risks are mitigated by Malaysia's strong reserve position, well-capitalized and liquid banks, and under-gearred corporates. Inflation is unlikely to be a policy concern in the period

³ Econometric analysis shows that a 1 percentage point decline in GDP growth in the United States would reduce growth in Malaysia by almost the same amount (*Regional Economic Outlook: Asia and Pacific*, April 2008).

ahead. Entrenched deflation seems a remote possibility at present although, because of base effects, Malaysia may experience a few months of negative headline inflation in mid-year.

- *Medium term:* GDP growth is expected to pick up modestly in 2010, in line with global developments, but it would remain below trend for a few years. Furthermore, shifts in the pattern of global demand and in the global financial landscape could depress the return on capital and growth prospects over a long horizon. While staff's projections reflect a downward revision of potential growth, the extent of the mark-down is for now speculative.⁴ This complicates estimates of the underlying current account. In the baseline, the current account surplus estimated at the current real exchange rate (REER) is projected to shrink to about 10 percent of GDP by 2014, as investment activity remains hostage to uncertainty and national savings decline.

	2005	2006	2007	Proj.						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Real sector (percent change)										
Real GDP growth	5.3	5.8	6.3	4.6	-4.5	2.5	4.1	5.5	6.0	6.0
Inflation (period average)	3.0	3.6	2.0	5.4	0.9	2.5	2.5	2.5	2.5	2.5
Saving and investment (in percent of GDP)										
Gross domestic investment	20.0	20.9	21.9	19.1	20.8	21.2	21.5	21.8	21.9	22.0
Private, including stocks	9.7	10.8	11.9	9.9	10.1	10.8	11.4	11.6	11.8	12.0
Public	10.2	10.2	10.1	9.2	10.7	10.4	10.1	10.2	10.1	10.0
Gross national saving	35.0	36.6	37.3	36.5	33.6	31.3	31.1	31.5	31.8	32.0
Private	21.3	22.1	21.1	20.5	21.3	18.4	18.4	19.8	21.0	22.1
Public	13.7	14.5	16.2	15.9	12.2	12.9	12.6	11.7	10.8	9.9
Current account (in percent of GDP)	15.0	15.6	15.4	17.4	12.8	10.1	9.6	9.7	9.9	10.0

Source: IMF staff estimates.

8. **The authorities broadly concurred with these assessments.** According to official projections, GDP would contract by 4–5 percent in 2009 and recover somewhat in 2010 with the global economy. Looking further ahead, there was agreement that the crisis underscored the need for Malaysia to step up deregulation in product and labor markets with a view to improving the resilience of the economy. The authorities noted that a revamped development model for Malaysia has taken shape. This New Economic Model (NEM) is designed to meet medium-term challenges that have so far received insufficient attention. In broad contour, the NEM focuses policymaking on market liberalization, support of private investment, new sources of growth, long-term fiscal sustainability, and human capital accumulation.⁵

⁴ Potential growth has been marked down from 6 percent to about 4¼ percent for the next 3 years.

⁵ This vision will likely be reflected in the upcoming Tenth Malaysia Plan (10MP). Background work is set to start next year.

III. THE MACROECONOMIC RESPONSE TO THE GLOBAL CRISIS

A. Fiscal Policy

Background

9. **Budget consolidation was reversed in 2008.** The central government deficit, which had declined from 5 percent of GDP in 2003 to 3¼ percent of GDP in 2007, rose back to nearly 5 percent of GDP last year (Table 5).

On the whole, fiscal policy was pro-cyclical in good times. Oil revenues increased on the back of (lagged) energy prices through 2008. However, spending increased even faster as fuel and food subsidies soared and other current spending kept up with revenues.⁶ Against the backdrop of a trend erosion of non-oil revenue, the headline deficit widened—and the non-oil deficit

Uses of Oil Revenue (Cumulative change in percentage points of GDP)	
2004–08	
Oil revenue	3.4
Change in non-oil primary balance	-4.5
Non-oil revenue	-2.8
Primary expenditure	1.7

Source: IMF staff.

surged to 11 percent of GDP. A subsidy reform in mid-2008 provided little budgetary relief as savings were later spent when the cycle turned.⁷ Malaysia's fiscal position is projected to deteriorate further in 2009 as revenue begins to decline and countercyclical support comes on-stream, pushing the headline deficit to nearly 8 percent of GDP.

10. **Two stimulus packages have been rolled out.**

- In early November 2008, the authorities announced a fiscal package of about 1 percent of GDP in new spending to support growth. The original 2009 budget (in August 2008) envisaged a reduction in the deficit of the central government to 3¾ percent of GDP through sizeable cuts in current expenditure. The revised deficit target (of about 5 percent of GDP) reflected lower projected revenues and broadly unchanged outlays. However, spending priorities have shifted in favor of “high-impact” projects financed by savings on fuel subsidies (i.e., public works,

⁶ Around 20 percent of the items in Malaysia's CPI basket have administered prices, including fuel and energy, certain foodstuff, and some construction materials. In mid-2008, the subsidized component accounted for about 12 percent of the CPI.

⁷ Among other things, retail prices for gasoline and diesel were raised toward international prices; the price of gas for industrial use was more than doubled; and a price setting mechanism for gasoline was proposed. Offset measures were also introduced to cushion the impact of the domestic fuel price hike on consumers. In May 2009, subsidies for some foodstuff were also abolished. Notwithstanding progress, the reform remains incomplete.

education programs, and some pro-business initiatives). Additional measures include a temporary reduction in employees' contributions to the pension fund.⁸

- The second fiscal stabilization package, announced in March 2009, amounts to about 9 percent of GDP. The package includes loan guarantees (about 40 percent of the total) and will be implemented over two years. The fiscal impulse is estimated at about 2 percent of GDP in 2009. The second package aims at limiting the depth of the recession and includes an array of expenditure and revenue measures. The former account for the bulk of the package (excluding loan guarantees). They relate primarily to infrastructure expenditure, worker training programs, and the recruitment of public sector employees. Tax measures include exemptions for interest on housing loans and some income tax deductions for laid-off workers.

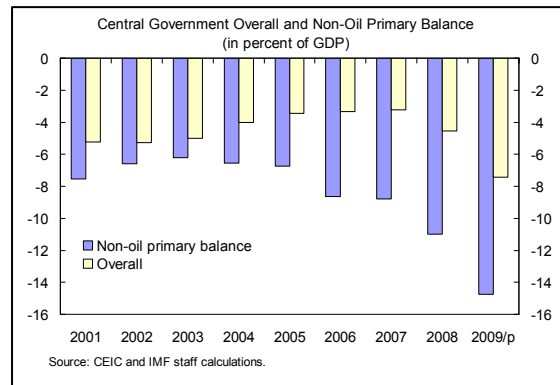
Staff's Views

11. **The fiscal easing has been appropriately large and diversified, but room for further maneuver is limited.**

The non-oil primary balance is set to widen to a record 15 percent of GDP in 2009, and the

debt-to-GDP ratio (including guaranteed debt of public enterprises) has already surpassed 50 percent. Furthermore, the budget deficit is projected to remain large over the medium term under current policies. While ample domestic savings allows the government to meet its borrowing requirements without external financing,

market concerns about the size of the deficit and the lack of a consolidation strategy have led to the first local currency downgrade since the 1997 crisis. To broaden the room for maneuver, the authorities should start casting their fiscal decisions (particularly on a new stimulus, if needed) in a framework that articulates consolidation plans once a self-sustaining recovery is under way. Reassurances about the medium-term evolution of the public finances would safeguard the credibility of fiscal plans and the confidence effects of actions already taken.



Authorities' Views and Policy Intentions

12. **The authorities noted that the global downturn had warranted vigorous fiscal action, notwithstanding weaknesses in the fiscal position.** Special procedures had been put

⁸ The contribution rate to the Employee Provident Fund, a mandatory saving scheme, has been lowered by 3 percentage points for the next two years, increasing disposable incomes by an estimated 1 percent of GDP each year.

in place to accelerate execution of the budget and bolster accountability.⁹ Nonetheless, in their view, the full impact of the package is unlikely to be felt until the second half of this year or early the next. There was agreement that restoring the fiscal position to a sustainable path is a paramount post-crisis priority. In fact, the authorities noted that this had been a policy goal for some time, and some progress had been made until early 2008 when the burden of soaring subsidies had forced the policymakers' hand. The New Economic Model has brought fiscal adjustment at the top of the medium-term policy agenda once again. The emphasis in the stimulus packages on public spending to increase productivity and support structural changes gives hope that faster growth down the line might help restore fiscal sustainability sooner rather than later.

B. Monetary Policy

Background

13. Monetary policy has been also loosened decisively.

- Since November 2008, the BNM has slashed its policy rate by 150 basis points to 2 percent. Reserve requirements have also been cut to reduce the cost of financial intermediation. Timely liquidity support in the interbank market has kept the overnight interbank rate close to the policy rate, suggesting orderly market conditions throughout. As elsewhere in the region, U.S. dollar funding pressures appeared late last year, as indicated by widening cross-currency basis spreads and sporadic evidence of more difficult access to trade credit. However, on the whole dollar liquidity has remained adequate.
- More broadly, the monetary transmission mechanism has not been undermined by the global market turbulence. The base lending rate has declined, and broad money has continued to grow (Table 6). Credit has expanded (y/y) although the rate of expansion has decelerated (on a m/m basis) as banks tightened lending standards and loan demand moderated in tandem with economic activity.

Staff's Views

14. The monetary easing has been appropriately proactive and there is now considerable monetary support in the pipeline. Staff calculations show that interest rates are lower than suggested by a Taylor rule. With risks to growth trumping inflation concerns, the monetary settings are broadly on the mark. Barring a significant deterioration of the

⁹ In particular, stimulus-related spending can be tracked at http://www.rangsanganekonomi.treasury.gov.my/index.php?option=com_content&view=category&layout=blog&id=38&Itemid=1&lang=en.

outlook for growth or inflation, monetary policy should stay the course until a recovery is well established. However, the BNM still has ammunition that could be used if tail risks materialize.

Authorities' Views and Policy Intentions

15. **BNM officials noted that decisive action was justified in light of the worsening outlook for growth and receding inflation risks.** The preference had been for a front-loaded response to head off tail risks. Among other considerations, the policy response had to strike a balance between reducing the costs of funds for households (to stimulate aggregate demand) and supporting the interest income of savers.¹⁰ There was agreement that policy could stay on hold for now. The BNM thought that further interest rates reductions would be considered only if the economic situation deteriorates significantly. In the meantime, ensuring a smooth flow of credit to the economy (*inter alia* through the BNM's management of facilities to broaden SMEs' access to funds (¶17) and other guarantee schemes) will take center stage in monetary policymaking.

C. Financial Sector Policies

Background

16. **Malaysia's financial sector has faced the crisis from a position of strength and so far has coped well.**

- Financial markets are relatively deep by regional standards. Total assets of the financial sector (bank and nonbank) were about 350 percent of GDP in 2008.¹¹ Within ASEAN, stock market capitalization is the second largest and the bond market is the largest. Although bank financing remains the predominant source of funding, the corporate sector has increasingly tapped the debt market. Significant steps have been taken to increase the openness of the financial sector, and most foreign exchange controls introduced during the Asian crisis have been lifted.¹²

¹⁰ The BNM has introduced savings bonds with a guaranteed minimum rate of return that exceeds the yield on the savings deposits to ensure an appropriate return for savers.

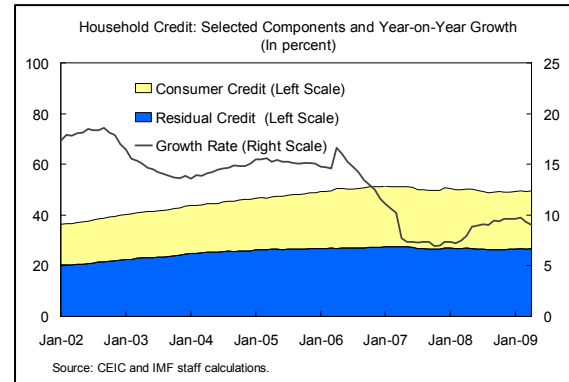
¹¹ Malaysia has an offshore financial center in Labuan, where, as of end-2008, 59 banks operated with assets totaling US\$29 billion (about 4 percent of Malaysia's financial sector asset). Labuan-based institutions are supervised by the Labuan Offshore Financial Services Authority. The BNM can also conduct on-site inspections as necessary.

¹² Remaining restrictions concern financial account transactions financed with ringgit borrowing and the offshore trading of the ringgit.

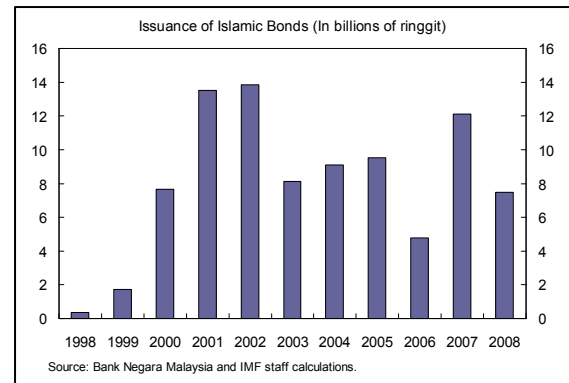
- Banks (which account for the bulk of financial sector assets) are well capitalized, have low NPLs and sufficient liquidity (Table 7). Reliance on external funding is minimal, and there are no material rollover risks.
- Generally strong balance sheets of Malaysian corporates and households have also contributed to the strength of the financial sector. Corporates have low leverage and adequate liquidity, despite sluggish profitability.¹³ Households' debt is high relative to regional peers, but is equal to about 50 percent of households' liquid assets and debt service appears to be manageable.

Key Financial Soundness Indicators for Commercial Banks			
	2007	2008	2009 April
(In percent)			
Risk-weighted capital ratio	12.8	12.2	13.7
Share of loans to broad property sector	40.8	40.5	40.9
Nonperforming loans (gross) to total loans	6.4	4.7	4.5
Return on Assets (ROA)	1.4	1.5	...
Loan-deposit ratio	77.4	77.0	77.1

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



- Islamic finance has become an important element of Malaysia's financial sector (Box 1). Islamic banking is gaining market share, both through entry of foreign players and new product offerings. The issuance of Islamic securities (*sukuk*) now exceeds that of conventional corporate bonds. In the view of many observers, Islamic finance has added stability to the system, *inter alia* by anchoring banking practices to underlying real economic transactions and limiting leverage.



- Malaysia's capital markets have been rattled by the international market turbulence, but the impact has by and large been contained. Asset prices have plummeted and spreads (sovereign, bank CDS, and cross-currency basis swap) have spiked during the periods of most acute global strains. Nevertheless, Malaysia's stock price correction and increase in volatility have been among the least pronounced in the region.

¹³ As of end-2008, listed nonfinancial corporations had a debt-equity ratio of about 40 percent and an interest coverage ratio of 7¼—both better than the corresponding averages for emerging Asia.

Box 1. Islamic Finance in Malaysia

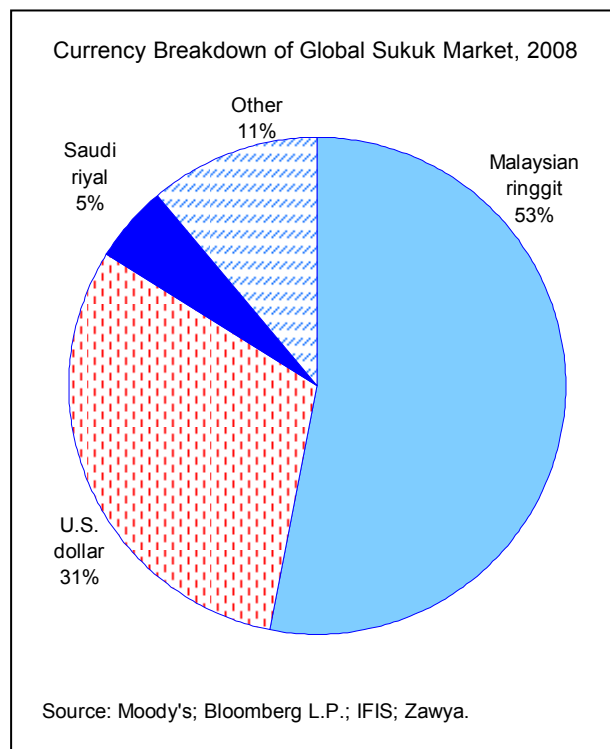
Since the early 1980s, the development of Islamic financial industry and institutions has been one of the central objectives for the Malaysian policymakers. The regulatory and tax systems have been developed to support the market-driven environment in which Islamic finance coexists with conventional finance. As a result, Malaysia now has robust Islamic and conventional financial systems that operate parallel to each other.

	Islamic Banks			Banking system
	2004	2006	2008	2008
	(In percent)			
Number of institutions	2	10	17	54
Pre-tax profits to average assets	1.0	1.6	1.0	1.5
Pre-tax profits to average equity	16.8	18.7	12.4	18.5
Costs to net income	28.0	40.7	55.5	69.3
Risk-weighted capital ratio	...	...	13.3	12.7
Core capital ratio	...	...	11.0	10.6
Equity to assets	...	...	6.5	6.8

Source: Bank Negara Malaysia.

Islamic finance has grown rapidly. Assets of Islamic banks have doubled since 2000, and accounted for about 17 percent of total banking sector assets as of May 2009. *Shariah*-compliant stocks account for about 88 percent of stocks listed and 64 percent of total market capitalization of the Malaysian stock market. *Takaful* (Islamic insurance) operators have a 7 percent share of total insurance and *takaful* assets, and about 13 percent of funds managed by unit trust management companies are Islamic.

Malaysia has made steady progress toward becoming an international Islamic financial hub. Malaysia hosts the world's largest *sukuk* (Islamic bonds) market (estimated at RM 155 billion or 59 percent of total outstanding bonds in Malaysia). As of end-2008, Malaysian *sukuk* accounted for about 61 percent of the total global *sukuk* outstanding (both domestic and international issues). In 2008, Malaysia also led in terms of global *sukuk* issuance with a share of 53 percent, followed by the United Arab Emirates, Saudi Arabia and Bahrain. The current global crisis has more than halved the global issuance of *sukuk* in 2008 (54 percent decline y/y), but medium-term prospects remain positive. The share of ringgit-denominated issuance declined to one-third of total global issuance in 2008 from about 78 percent during the same period last year, while other currencies such as the Emirati dirham and the Saudi riyal experienced increases. In other sectors of Islamic finance, international Islamic stock indices have been developed and new licenses issued to foreign Islamic banks, Islamic fund management companies and *takaful* operators.



17. Financial sector reforms and proactive policies have helped the financial system withstand the global crisis.

- Prudential oversight and the regulatory framework have kept up with—and facilitated—changes in the financial landscape. A deposit insurance scheme was introduced in 2005 and a credit-scoring database aids lenders’ decisions. Further reforms to strengthen regulations and market infrastructure have been implemented in recent years. These included steps to bolster risk management and monitoring systems. Notably, Basel II was adopted in 2008, with little impact on capital requirements and the majority of banks opting for the standardized approach.
- In October last year, as a preventive measure amid heightened distress in mature markets and similar moves in the region, the BNM extended a blanket guarantee on all domestic and foreign currency deposits through 2010. At the same time, to safeguard short-term funding, it announced the willingness to back interbank lending, if needed. The BNM has also injected liquidity at times by drawing down official foreign exchange reserves. Furthermore, the authorities have introduced new financing facilities for the SMEs to ensure that viable companies adversely affected by the slowdown continue to have access to financing.¹⁴

Staff’s Views

18. Looking ahead, the global crisis is likely to continue to have an impact on Malaysia’s financial sector. Strains are expected to intensify as the recession drags on. Financial institutions are exposed to credit risks (mostly related to mortgages and loans to exporters) and a slowdown in activity will put pressure on the corporate and household sectors’ ability to service their debt. As deleveraging continues in advanced markets, funding through domestic securities and loans could become costlier and access to external funds could become more difficult.

19. The fluid situation puts a premium on crisis preparedness and proactive supervision. With little fiscal space to repair balance sheets in a worst-case scenario, regulators should focus on further preventive steps to ensure that banks’ capital positions are robust. Rigorous stress tests encompassing multi-year scenarios, tail events, and correlated shocks should remain a high priority for the BNM in the period ahead.¹⁵ More broadly, staff

¹⁴ The BNM has established an SME Assistance and Modernization facility (worth RM 2 billion) which expands previously existing facilities. In addition, the government has introduced two schemes (the Working Capital Guarantee and the Restructuring Loan Guarantee, each worth RM 5 billion) under which the government’s risk-sharing is up to 80 percent of a bank loan.

¹⁵ The BNM is in fact engaged in a dialog with IMF staff of the Monetary and Capital Markets Department on ways to enhance stress-testing.

noted the importance of: (i) reviewing the adequacy of emergency liquidity assistance, including the triggers for resolving institutions before support is needed; (ii) ensuring that risk management practices are robust to new channels of financial contagion; (iii) strengthening oversight of systemically important institutions with cross-border activities, including through enhanced regional cooperation; and (iv) adopting emerging best practices in crisis management and prevention, as appropriate.

Authorities' Views and Policy Intentions

20. Although there was broad agreement on the policy priorities, the authorities emphasized that financial sector risks were limited by a number of factors.

- Household balance sheets are sound. In particular, aggregate liquid financial assets of households continue to cover total liabilities, and debt service remains manageable. Mechanisms to facilitate restructuring of household debt have also been in place for some time.
- Banks have pursued conservative business models since the Asian crisis, and have not been allowed by regulators to have significant positions in complex structured products. Their capital base is comfortable. Furthermore, the principles of profit and risk sharing intrinsic to Islamic finance add stability to the system—and, post-crisis, the appeal of Islamic finance is likely to grow. The implementation of Basel II has also enhanced the risk management culture at banks.
- Stress tests indicate that banks have sufficient capital buffers and would prove resilient in circumstances even more dire than currently expected. The BNM has conducted scenario-based tests that incorporate prolonged global financial market instability and large spillovers to the real sector. The resulting shocks to the banking system include corporate defaults and valuation losses on corporate debt, as well as sharp increases in NPLs. Under the most adverse scenario, the aggregate risk-weighted capital ratio would decrease by about 4½ percentage points, but remain above the 8-percent minimum requirement.¹⁶
- The BNM had been implementing for some time aspects of macroprudential regulation by requiring progressively higher provisioning regardless of the value of collateral, if NPL resolution is delayed. Furthermore, dividend pay-outs are subject to BNM approval, unlike in many other jurisdictions. The fact that the BNM supervises banking groups on a consolidated basis and the Malaysia Deposit Insurance Corporation is empowered to intervene troubled banks underpins the institutional capabilities for crisis prevention and management. Finally, through a variety of international *fora* the BNM has established an extensive network of contacts with supervisors in other jurisdictions.

¹⁶ These results appear consistent with those obtained by Fitch Ratings (see *Banks in Asia: Outlook for 2009*, January 2009).

IV. POLICY CHALLENGES ALONG THE RECOVERY PATH

21. **Looking beyond the current crisis, the authorities should continue to pursue policies and reforms to strengthen Malaysia's long-term economic prospects and boost resilience.** The staff and the authorities agree that priority should be given to bolstering the fiscal framework and restoring the sustainability of the fiscal position, as well as rebalancing the sources of growth toward domestic demand.

A. Bolstering the Fiscal Policy Framework and Restoring Sustainability

The two main issues are: the dependence of the budget on oil revenues and the absence of multi-year indicative budget targets. Tackling these issues should support consolidation and improve public resource management.

Staff's Views and Policy Issues

22. **Exposure of the budget to oil prices should be reduced over the medium term through a combination of revenue and expenditure measures.**

- *Improving non-oil revenue.* The groundwork for the rollout of the goods and services tax (GST) has been completed and implementation should not be delayed unduly. Special tax incentives (which represent a large hidden cost to the budget) could also be rationalized, in the context of a reform of corporate taxation.¹⁷
- *Phasing out oil and gas subsidies.* Poorly targeted fuel subsidies, which at their peak in 2008 amounted to about 2½ percent of GDP, remain a vulnerability to the public finances. Recent steps to reform the scheme are welcome, but more could be done. For example, lower energy prices provide an opportunity to move away from the proposal to lock in a specific amount of subsidy, a proposal that would freeze the costs to the budget and pass on to consumers all the benefits of falling prices. In fact, as a first-best policy, universal fuel subsidies should be eliminated over time with due consideration for the impact on the less well-off.¹⁸

23. **The authorities' medium-term fiscal framework could be enhanced by an indicative consolidation path and a more explicit consideration of the drawdown of oil wealth.** Further along the recovery path, the macroeconomic policy mix will have to be recalibrated with a view to facilitating needed budgetary consolidation. Early communication of the direction of fiscal policy could allay concerns in volatile markets. From this perspective, it would be useful that once a self-sustained recovery is in train, the authorities articulate consolidation plans that could help anchor market expectations. The deterioration

¹⁷ Tax incentives have amounted to roughly half of total tax revenues, according to World Bank estimates.

¹⁸ Malaysia has several social programs in place, but lacks a comprehensive social safety net and targeted measures to offset the impact of lower subsidies on the poor.

in the non-oil primary deficit suggests also a framework that could make more explicit how budgetary decisions affect fiscal sustainability. Better informed budget decisions could be achieved by an approach that links spending to an intergenerationally equitable management of Malaysia's oil wealth.¹⁹ This approach would strengthen the design and evaluation of policies, and mitigate the impact of oil price volatility on fiscal decisions.

Authorities' Views and Policy Intentions

24. **The authorities agreed on the need to reverse the erosion of the non-oil tax base and reduce the deficit.** As recognized in the New Economic Model, ensuring fiscal sustainability is a medium-term goal. To that end, the following policies are being considered:

- *GST and tax exemptions.* Legislation has been drafted and the necessary administrative infrastructure has been laid out. However, in the current uncertain environment, no timetable for a rollout has been set. In the authorities' view, exemptions will remain important for certain sectors and regions. International tax competition limits the extent to which incentives can be streamlined. Nonetheless, the authorities are introducing sunset clauses when possible.
- *Subsidies.* Rationalization remains high on the agenda, but changes will be implemented gradually to fine-tune the modalities of reform. The adjustments put in place in June 2008 have been a first step, and additional options are being considered to better target subsidies going forward. In this context, the authorities also intend to reassess the adequacy of Malaysia's social safety net—a task in which input from IMF staff would be welcome. The authorities noted that the overhaul of subsidy schemes and social safety net are key tasks of a newly established, high-level Economic Council chaired by the prime minister.
- *Medium-term fiscal framework.* The authorities agreed that a multi-year budget framework could be useful in guiding fiscal planning and safeguard oil wealth. However, they stressed that oil revenue has been spent prudently to enhance productive capacity (including human capital), which would benefit future generations. There was also agreement that adopting an indicative consolidation path for the non-oil primary deficit could bolster the credibility of fiscal plans.

B. Rebalancing Growth

Shifting the sources of growth toward domestic demand would be facilitated by accelerating the implementation of structural reforms and allowing the ringgit to resume its trend appreciation.

¹⁹ Malaysia's proven reserves of hydrocarbons amount to 5½ billion barrels for oil and 88 trillion cubic feet for natural gas. Oil is expected to be depleted in about 22 years, gas in about 35 years.

Staff's Views and Policy Issues

25. **In spite of advances, the structural reform agenda remains challenging.** Areas where further efforts are necessary include competition policy and labor market liberalization. The June 2008 Mid-Term Review of the Ninth Malaysia Plan (launched in 2005) addressed some of the outstanding issues.²⁰ The New Economic Model under development by the authorities is also focusing on these areas.

26. **A priority is to support the revival of private investment demand:**

- The authorities are accelerating the pace of deregulation. The recent decision to further *liberalize segments of the manufacturing and service sectors*, including the financial sector, is a significant step in the right direction.²¹ It clearly signals the government's commitment to outward-oriented policies and its desire to modernize Malaysia's development model. However, more remains to be done to improve the business climate and address long-standing structural impediments to investment. Staff emphasized the need to address skills mismatches and push ahead with further product market and legal reforms to promote competition.
- *The reform of government-linked companies (GLCs)* appears to be paying off and should continue apace.²² Care should be taken to strike a balance between exploiting the catalytic role of GLCs and promoting a level playing field, for example, in the area of procurement.

²⁰ Background work for the resumption of negotiations of a free trade agreement with the United States also tackles these issues.

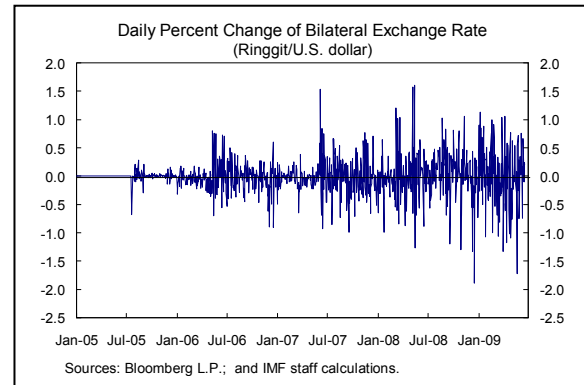
²¹ In April, a 30-percent bumiputra (ethnic Malay) equity requirement in 27 services subsectors was eliminated and foreign ownership limits for all nonbank domestic financial institution was raised to 70 percent. In mid-June, it was announced that import restrictions in the iron and steel industries would be lifted. On June 30, it was announced *inter alia* that: the Foreign Investment Committee regulations covering acquisition of equity stakes, mergers, and takeovers have been repealed; the 30-percent bumiputra ownership requirement in publicly listed companies has been abolished (although 50 percent of IPOs still need to be reserved for native Malays); and the fund management industry has been wholly open to foreign competition. Most of these steps dilute 38-year old affirmative action guidelines and reflect the authorities' intent to further transform Malaysia in line with the New Economic Model.

²² Most GLCs are listed companies partly owned by Khazanah, the government holding company. They account for 50 percent of stock market capitalization, about 10 percent of value added, and 3 percent of employment. GLCs span sectors as diverse as rubber plantations, power generation, and car production. Although Khazanah meets the definition of a sovereign wealth fund specified in the Santiago Principles, it does not receive government funding nor manages official reserves (although in the context of the second stimulus package it will benefit from a RM 1 billion government's injection). Its operations do not appear to undercut the formulation and conduct of domestic macroeconomic policies.

- Additional measures to *improve the business climate* would also be beneficial. As flagged in the World Bank's latest *Doing Business* report, areas of focus include land registration, contract enforcement (e.g., as regards NPL resolution), business ownership restrictions, and labor skills mismatches.

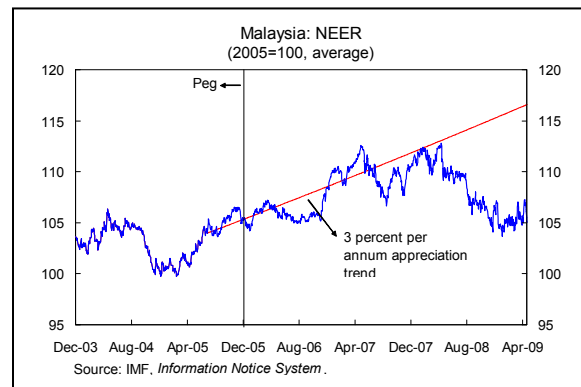
27. Rebalancing growth in the medium term would also be facilitated by a stronger ringgit.

According to staff estimates, the ringgit in real effective terms is weaker than the level implied by medium-term fundamentals, but a number of indicators suggest that the undervaluation is not extreme (Appendix I). In particular, core inflation has been low, there have been no asset price bubbles, and—importantly—intervention has been two-sided (Box 2). Exchange rate volatility, uncertainty about fundamentals, and hard-to-filter-out transitory factors (e.g., global deleveraging) complicate the analysis. The staff's exchange rate assessment does not imply the need for policy adjustments at present but points to an appreciation of the real exchange rate over the medium term. In fact, given limited fiscal space, there is no obvious reorientation of the policy mix that would help strengthen the ringgit in the short run without prejudice to domestic stability.



28. Once the global turmoil subsides, a pace of real appreciation faster than that experienced to date would be desirable.

From a domestic perspective, it would accelerate progress toward the authorities' goals of boosting domestic sources of growth. More specifically, a faster real effective appreciation combined with greater (bilateral) exchange rate flexibility would: (i) lessen the need for intervention by reducing the expected risk-adjusted return on ringgit assets—and hence speculative inflows; (ii) support private consumption by raising the real wage in foreign-currency terms; (iii) spur investment by lowering the cost of imported capital goods; and (iv) rotate spending toward nontradables. From a multilateral perspective, a faster appreciation would foster external stability by facilitating balance of payments adjustment and reducing the burden on countries with more flexible currencies.



Box 2. Global Deleveraging and Foreign Exchange Intervention in Malaysia

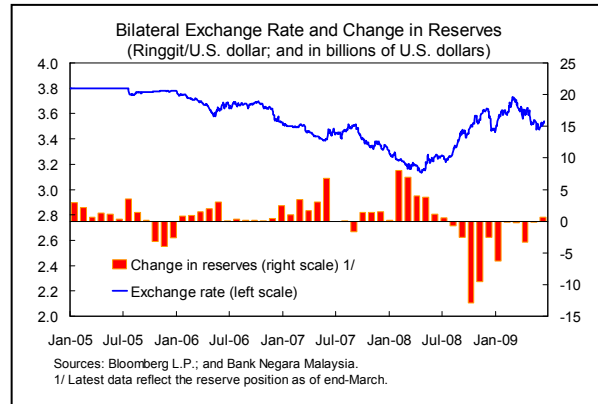
In the face of massive capital outflows, the BNM has supported the external value of the ringgit since mid-2008. Interventions have aimed at smoothing volatility and have not fully countered depreciation pressures. The resulting drawdown in official reserve (including the forward position) has been in excess of US\$55 billion over the span of 10 months. Reserves remain nonetheless ample at about US\$87 billion.

Stabilization of foreign exchange market conditions is a key objective of Malaysia's exchange rate policies.

Since the 2005 exit from the U.S. dollar peg, the BNM has intervened in the foreign exchange market to dampen fluctuations in the value of the nominal effective ringgit against an undisclosed basket of currencies. Data on market operations are not publicly available, but the direction of intervention can be inferred from the reported change in official foreign exchange reserves.

On this basis, the BNM sold foreign exchange in late 2005, May-June 2006, February 2007, July-August 2007 and—on an unprecedented

scale—since April 2008. In other periods, intervention has leaned in the opposite direction, slowing a trend appreciation of the ringgit in the presence of surges in capital inflows or increases in the prices of key commodity exports (hydrocarbons and palm oil). Most notably, reserves have increased during mid-2005 to early 2008, but over the long haul, intervention has been two-sided and stabilizing. Furthermore, since the BNM targets an overnight interest rate, its foreign exchange interventions are mostly sterilized: the growth in the monetary base induced by net foreign assets has been largely offset by the decline in net domestic assets.



An estimated reaction function captures these trends. In the empirical model, estimated over the July 2005-April 2009 period, intervention is proxied by the bi-weekly change in reserves.^{1/} According to the estimated equation, intervention is persistent, a ringgit depreciation is followed by foreign currency sales, and an increase in volatility (relative to its moving average) leads to foreign currency sales, although the effect of volatility is small.

1/ The estimated model is given by:

$$I_t = \beta_1 + \beta_2(L)I_{t-1} + \beta_3 I_{t-2} + \beta_4 \Delta \ln s_t + \beta_5 \Delta \ln s_{t-1} + \beta_6 (i_t - i_t^F) + \beta_7 (\sigma_t - \bar{\sigma}_{t-1}) + \gamma DUM + \varepsilon_t$$

where I is intervention ($I > 0$ equals foreign currency purchases), s is the spot exchange rate (ringgit per U.S. dollar), i and i^F are domestic and foreign interest rates (respectively), σ is a measure of realized volatility, $\bar{\sigma}$ is a moving average of volatility, and DUM is a set of exogenous dummies. The model is estimated by least squares (with HAC standard errors) and GMM. The GMM estimates are generally less significant than those obtained by least squares, perhaps indicating endogeneity of the regressors, especially the change in the exchange rate.

The Authorities' Views and Policy Intentions

29. **The authorities are committed to push ahead with structural reforms, but noted that the pace of implementation has to be tuned to political and economic realities.**

- They noted that the decision to liberalize some services, encouraging foreign entry in the midst of a global downturn, exemplifies the government's commitment to resist protectionism.
- The authorities view the role of the public sector as a facilitator of private sector's participation in the economy. In the implementation of regional development plans, the public sector will only provide needed infrastructure in support of private sector-led growth.²³
- The GLC transformation program is aimed at strengthening the underpinning for private sector activity. The program, which will span a decade, is already paying dividends in terms of the improved performance of several GLCs. During the current phase (2007–2010) company-specific restructurings are being undertaken.

30. **There was broad agreement that improving the business climate will help Malaysia move up the value chain.** Lower costs of doing business remain key to a vigorous investment recovery over the medium term. In order to boost competitiveness, import duties on raw materials and intermediate goods used for domestic manufacturing and construction activities have been abolished. Other steps underway include initiatives to improve public service delivery and measures to address the labor skills mismatches through education reforms and less regulation in labor markets.

31. **The authorities disagreed with staff's assessment of the current level of the exchange rate** (Appendix I). They stressed that Malaysia's exchange rate policies: (i) do not target a particular exchange rate; (ii) have been informed by the need to prevent exchange rate overshooting in both directions; and (iii) are consistent with a return to a gradual trend appreciation of the currency once the crisis subsides, if fundamentals and other determinants of the real exchange rate indeed point in this direction. In the authorities' view, the models used by staff to assess the exchange rate do not adequately capture Malaysia's structural changes. They believe that the current account surplus is driven by a number of factors in addition to the exchange rate, including the recent commodity boom (which has inflated exports revenues but does not represent increased competitiveness), structural rigidities (that

²³ The authorities have long-term development plans for five regions or "corridors." The plans identify infrastructure requirements and industries that could spearhead private sector-led growth. The most ambitious plan aims at supporting growth of services in the South Johor region in part through further product and labor market deregulation.

have resulted in low investment), and high precautionary savings (related to underdeveloped safety nets). Past reserve accumulation has provided self-insurance against the external shocks and capital flow reversals at the heart of the global crisis of 2008.

V. STAFF APPRAISAL

32. **Malaysia has been hit hard by the global crisis but is well placed to weather it.** Weaker export demand, worsened terms of trade, and volatile investor sentiment will test the resilience of the economy in the period ahead. However, a strong external position, a more flexible exchange rate regime, robust balance sheets, and a sound financial system should lessen the blow from adverse external shocks. Policies should remain supportive and aim at blunting the effects of the global downturn.
33. **Fiscal policymakers have risen to the challenge.** The large stimulus for 2009–10 should mitigate the impact of the output contraction on households and businesses. As recognized by the authorities, further measures could be considered if the economy’s trajectory proves more fragile than expected. However, high prospective budget deficits and a rising debt to GDP ratio point to risks to fiscal sustainability and adverse reactions in financial markets, which could raise the cost of financing. To broaden the room for maneuver, the authorities should cast any further stimulus (and fiscal decisions more broadly) in a framework that includes consolidation plans once a self-sustaining recovery is under way. Reassurances about the medium-term evolution of the public finances would safeguard the credibility of fiscal plans and the confidence effects of actions taken.
34. **Monetary policy settings are appropriate.** The BNM’s actions to shore up market confidence and access to credit have supported bank intermediation and the transmission mechanism of monetary policy in difficult circumstances. There is now considerable monetary support in the pipeline. Credit growth is holding up and Taylor-rule calculations show that interest rates provide cyclical support. Barring a significant deterioration of the outlook for growth or inflation, monetary policy should stay the course until a recovery is well established. The BNM still has ammunition that could be used if tail risks materialize. Monetary policymaking needs to remain data-dependent and forward-looking, providing a first line of defense against any deterioration of growth prospects, especially given limited fiscal space. In a context of heightened market volatility, the BNM should also continue to communicate clearly its assessment of risks—and give early indication of the direction of policy.
35. **Financial policies are rightly focused on the challenges ahead.** Although the financial sector appears sound and is benefiting from the growth of Islamic finance, volatile global markets put a premium on crisis preparedness and proactive supervision. The authorities have rightly focused on preventive steps, including recent measures to reinforce liquidity support and deposit insurance. Their efforts appear to be appropriately concentrated

on upgrading their stress testing framework; on reviewing the triggers for resolving institutions; on ensuring effective risk management; and on strengthening supervisory cooperation and oversight of institutions with cross-border activities.

36. **Further along the recovery path Malaysia's resilience will be boosted by strengthening fiscal frameworks.** As the economy regains a solid footing, it will be important to address outstanding issues that pose fiscal risks. The necessary steps include broadening the non-oil tax base, moving ahead with subsidy reform, and putting fiscal policy on an indicative consolidation path.

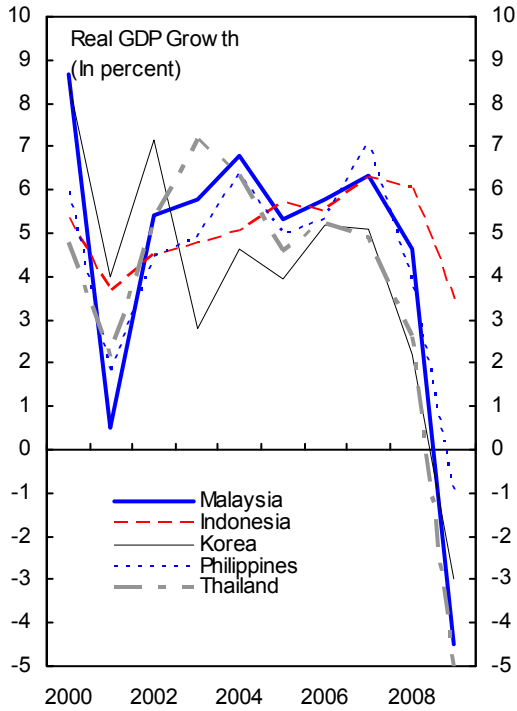
37. **Another key medium-term challenge is to shift the sources of growth toward domestic demand.** The authorities should continue to focus on promoting private investment and deepening economic reforms in labor and product markets. The recent decision to open up services, including in the financial sector, sends an important signal. However, more remains to be done to enhance the business climate and address long-standing structural impediments to investment. Staff recommendations include addressing skills mismatches, pushing ahead with further product market reforms, and allowing the real exchange rate to appreciate over the medium term.

38. **The ringgit in real effective terms remains weaker than its equilibrium level, but Malaysia's exchange rate policies are broadly appropriate.** Recent foreign exchange interventions by the BNM have been two-sided and have helped maintain orderly market conditions, without unduly leaning against market trends. Although at present there is no obvious reorientation of the policy that could help strengthen the ringgit without prejudice to domestic stability, the ringgit is likely to return to a gradual trend appreciation once the recovery is firmly established. A pace of real appreciation faster than that experienced so far would then be desirable. This appreciation would facilitate the achievement of the authorities' goal of rebalancing the sources of growth toward domestic demand, thus boosting resilience and reducing Malaysia's vulnerability to external shocks.

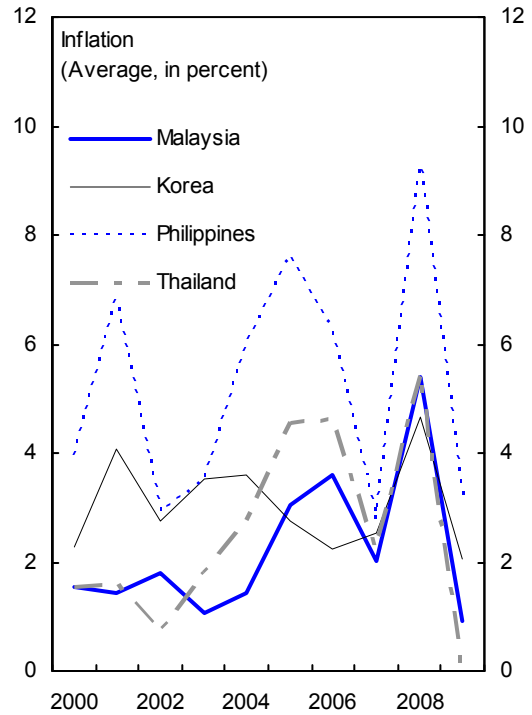
39. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Malaysia: Real Sector Developments and Outlook

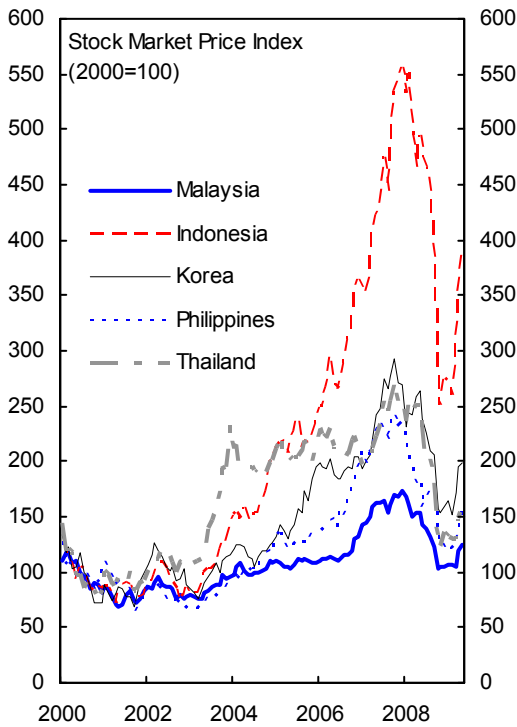
Growth has collapsed as elsewhere in the region...



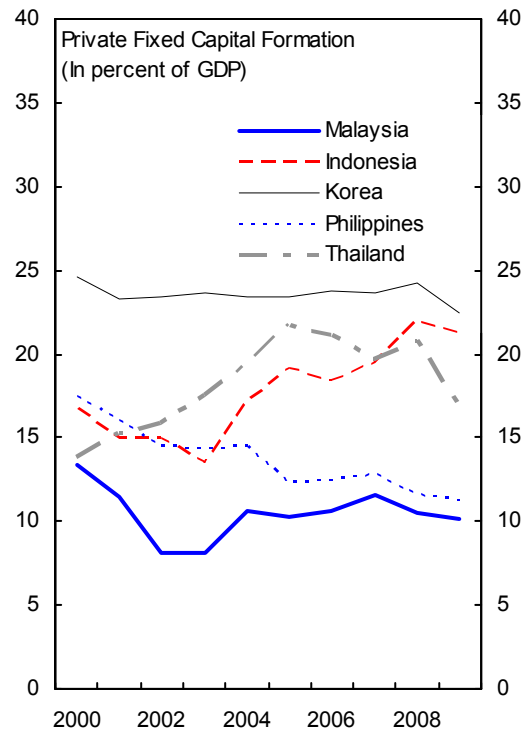
...and price pressures have receded.



Equity prices declined sharply but have recently rebounded...



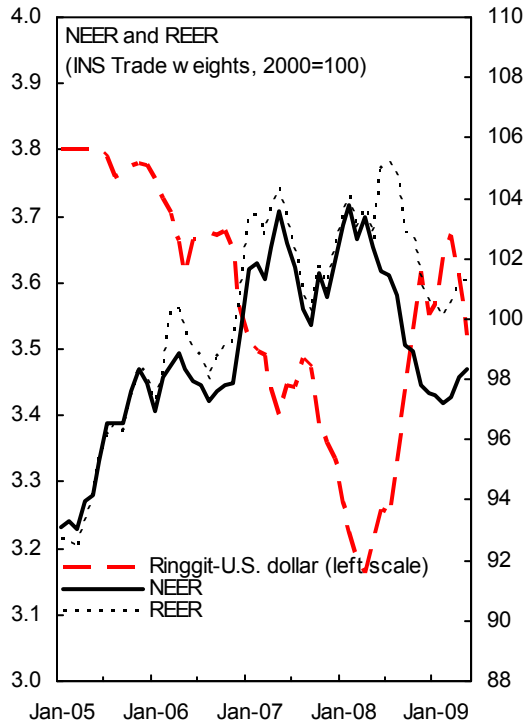
...but the recovery in private investment has stalled.



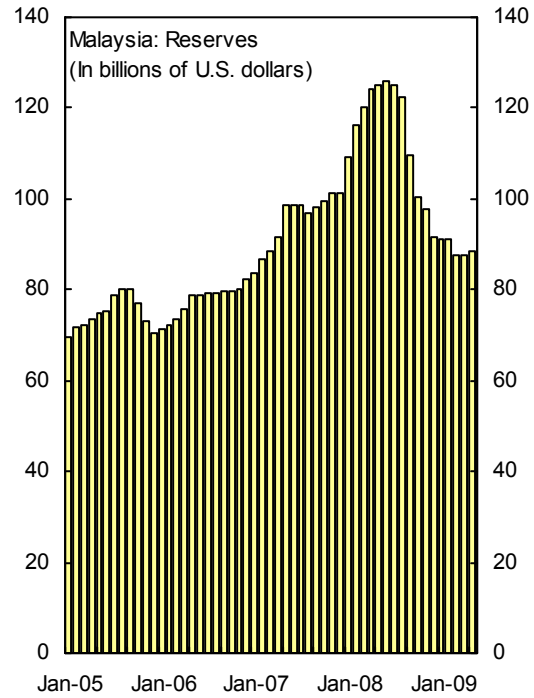
Sources: IMF, *World Economic Outlook*, and APD databases.

Figure 2. Malaysia: Exchange Rate and Monetary Developments

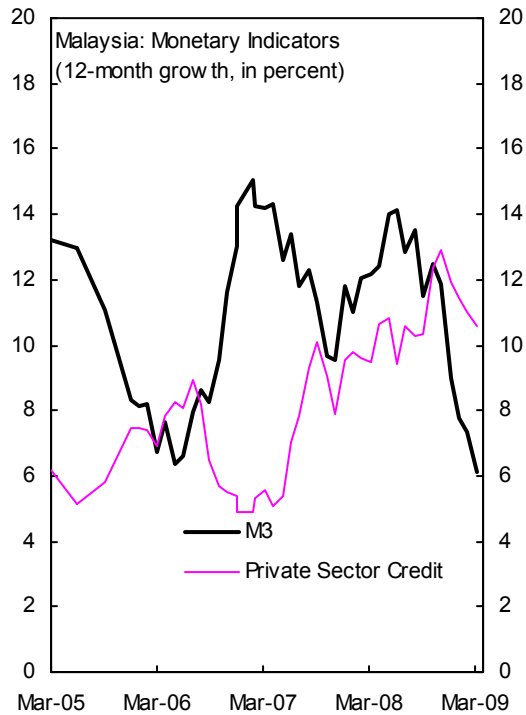
The exchange rate has depreciated...



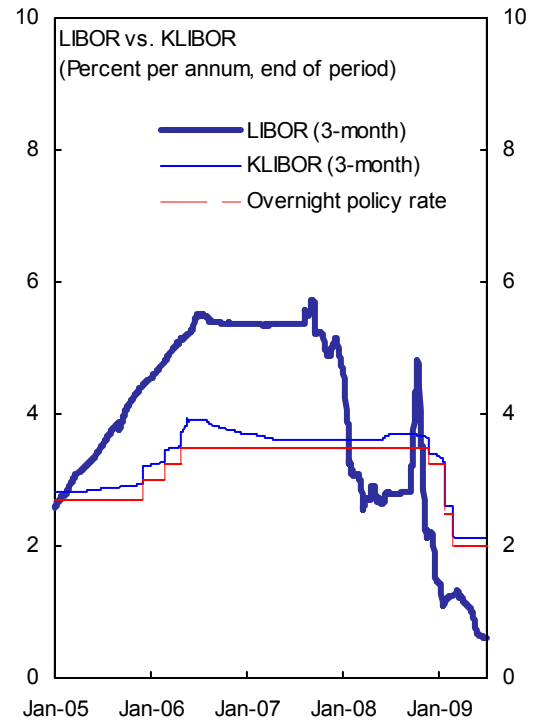
...and reserves have fallen since mid-2008.



Broad money and private sector credit growth moderated...



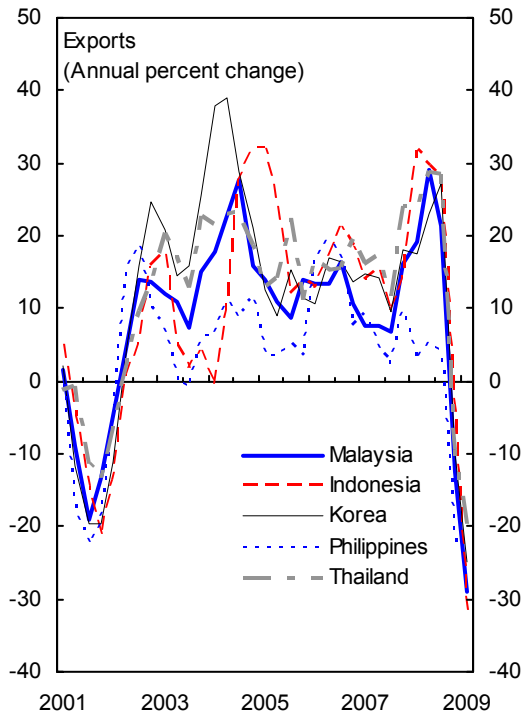
...despite lower domestic interest rates since late 2008.



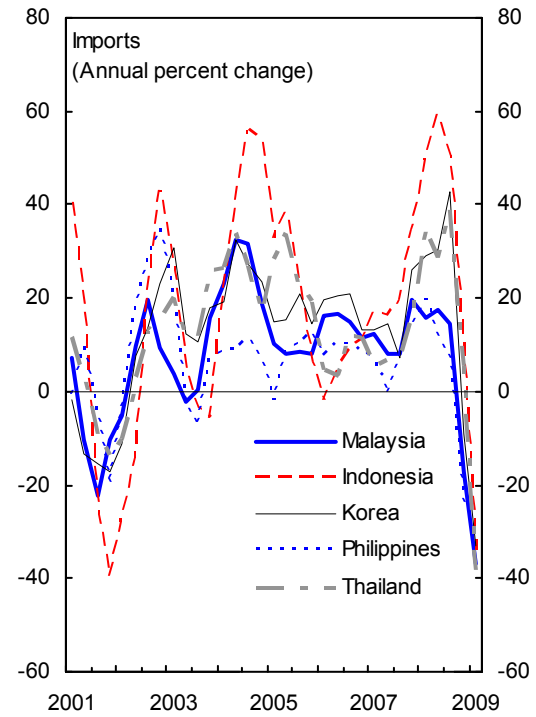
Source: IMF, *World Economic Outlook*, and APD databases.

Figure 3. Malaysia: External Developments

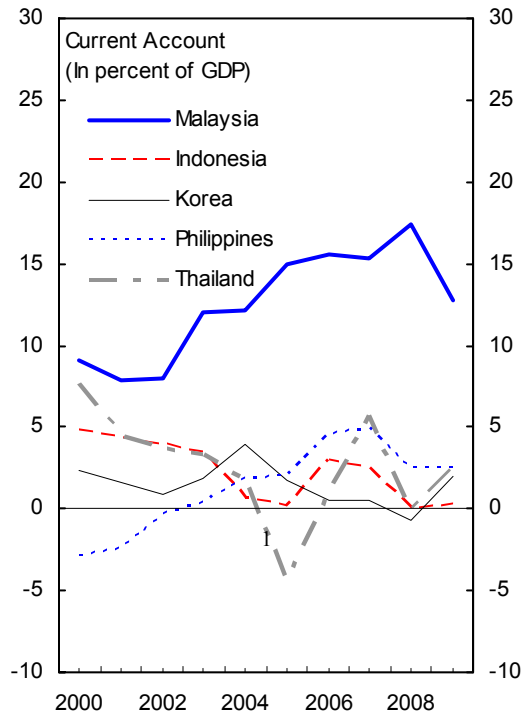
Exports have plunged...



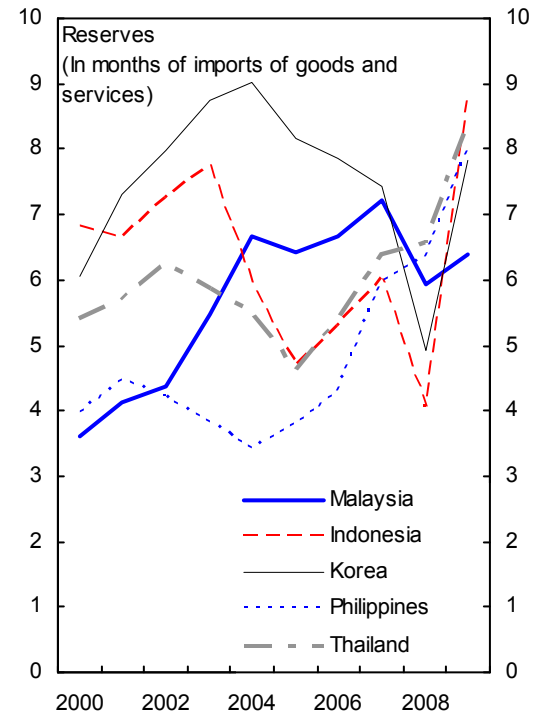
...as have imports, reflecting the high import content of exports.



The current account surplus is declining....



...but the external position remains comfortable.



Source: IMF, *World Economic Outlook*, and APD databases.

Table 1. Malaysia: Selected Economic and Financial Indicators, 2004–10

Nominal GDP (2008): US\$222 billion

Main export (percent of total, 2008): Electronics (45)

GDP per capita (2008): US\$8,006

Unemployment rate (2008): 3.2 percent

Inward FDI (2008): US\$6.6 billion

	2004	2005	2006	2007	Prel. 2008	Proj. 2009 2010	
Real sector (percent change)							
Real GDP growth	6.8	5.3	5.8	6.3	4.6	-4.5	2.5
Real domestic demand	8.6	5.5	7.5	8.3	6.1	2.3	5.8
CPI inflation (period average)	1.4	3.0	3.6	2.0	5.4	0.9	2.5
Saving and investment (percent of GDP)							
Gross domestic investment	23.0	20.0	20.9	21.9	19.1	20.8	21.2
Private, including stocks	12.8	9.7	10.8	11.9	9.9	10.1	10.8
Public	10.3	10.2	10.2	10.1	9.2	10.7	10.4
Gross national saving	35.1	35.0	36.6	37.3	36.5	33.6	31.3
Private	19.7	21.3	22.1	21.1	20.5	21.3	18.4
Public	15.5	13.7	14.5	16.2	15.9	12.2	12.9
Fiscal sector (percent of GDP)							
Federal government overall balance	-4.1	-3.5	-3.3	-3.2	-4.6	-7.7	-7.1
Revenue	21.0	20.5	21.5	21.8	21.6	22.6	22.4
Expenditure and net lending	25.1	23.9	24.9	25.0	26.2	30.3	29.4
Federal government non-oil primary balance	-6.7	-6.8	-8.6	-8.8	-11.7	-15.1	-13.8
Consolidated public sector overall balance	3.9	1.5	-0.3	1.5	1.1	-6.6	-5.4
Total public sector gross debt 1/	63.3	60.3	55.2	50.6	48.4	56.9	61.3
Monetary sector (annual percent change)							
M3 growth	12.7	8.8	13.6	7.9	10.6	8.0	16.6
Three-month interbank rate (period average, in percent)	2.8	2.9	3.3	3.6	3.6	...	...
Balance of payments (in billions of U.S. dollars)							
Trade balance	27.6	34.1	36.7	37.1	47.9	35.4	30.3
Exports, f.o.b.	126.8	142.5	160.8	176.3	196.5	170.8	171.4
Imports, f.o.b.	99.2	108.5	124.1	139.1	148.6	135.3	141.1
Services account	-8.6	-8.9	-7.6	-3.9	-4.1	-2.1	-1.2
Current account balance	15.1	20.7	24.5	28.7	38.6	26.8	22.3
(In percent of GDP)	12.1	15.0	15.6	15.4	17.4	12.8	10.1
Financial account balance	4.9	-9.6	-5.7	-4.6	-41.4	-27.6	-12.6
Errors and omissions	1.9	-7.4	-6.8	-5.2	-7.4	0.0	0.0
Overall balance	21.9	3.8	12.0	18.9	-10.2	-0.8	9.7
International trade (annual percent change)							
Export value	21.4	12.4	12.8	9.6	11.5	-13.1	0.4
Import value	26.0	9.3	14.4	12.1	6.8	-9.0	4.3
Terms of trade	2.1	2.7	1.0	0.3	2.3	-2.6	-1.8
Gross official reserves (in billions of U.S. dollars)							
(In months of following year's imports of GNFS)	6.1	5.7	5.9	6.8	6.7	6.4	6.7
(In percent of short-term debt) 2/	365.8	379.2	432.6	518.0	397.9	405.1	421.5
Total external debt (in billions of U.S. dollars)	52.8	52.3	52.2	56.7	57.1	57.4	57.6
(In percent of GDP)	42.3	38.1	33.7	27.9	24.9	25.8	24.2
Short-term external debt (percent of total) 2/	34.6	35.5	36.5	34.5	40.1	38.9	41.2
Debt-service ratio							
(In percent of exports of goods and services)	4.6	5.3	4.4	4.2	2.3	3.6	2.7
Memorandum items:							
Nominal GDP (in billions of ringgit)	474	522	574	642	741	728	765
Stock market index (end of period)	907	900	1096	1445	877	...	...

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

1/ Excludes financial public enterprises and nongovernment-guaranteed domestic debt of the NFPEs.

2/ By remaining maturity.

Table 2. Malaysia: Indicators of External Vulnerability, 2004–09

	2004	2005	2006	2007	Prel. 2008	Proj. 2009
Financial indicators						
Public sector debt (in percent of GDP) 1/	63.3	60.3	55.2	50.6	48.4	56.9
Total liquidity (M3: percent change, 12-month basis)	13.2	9.7	10.3	11.9	15.4	8.0
Private sector credit (percent change, 12-month basis)	5.0	7.0	9.8	11.9	15.4	-1.7
Treasury bill interest rate (percent, 12-month basis, average) 2/	2.4	2.5	3.5	3.6	...	...
External indicators						
Exports (percent change, 12-month basis in U.S. dollars)	21.4	12.4	12.8	9.6	11.5	-13.1
Imports (percent change, 12-month basis in U.S. dollars)	26.0	9.3	14.4	12.1	6.8	-9.0
Current account balance (in billions of U.S. dollars)	15.1	20.7	24.5	28.7	38.6	26.8
Current account balance (in percent of GDP)	12.1	15.0	15.6	15.4	17.4	12.8
Capital and financial account balance (in billions of U.S. dollars)	4.9	-9.6	-11.1	-12.7	-51.4	-27.6
Gross official reserves (in billions of U.S. dollars)	66.7	70.5	82.5	101.3	88.6	87.8
(In months of imports of goods and services of the following year)	6.1	5.7	5.9	6.8	6.5	6.2
Short-term foreign assets of the financial sector (in billions of U.S. dollars) 3/	11.8	9.8	11.4	25.4	...	...
Short-term foreign liabilities of the financial sector (in billions of U.S. dollars)	14.6	15.8	18.4	22.8	...	...
Gross official reserves/total liquidity (M3) (in percent)	42.4	40.8	41.7	43.0	...	...
Gross official reserves/monetary base (in percent)	506.1	509.4	536.3	581.8	...	...
Total short-term external debt by original maturity (in billions of U.S. dollars)	11.5	12.4	12.1	16.5	17.5	18.5
Total short-term external debt by remaining maturity (in billions of U.S. dollars)	18.2	18.6	19.1	19.6	22.9	22.3
Total short-term external debt by original maturity to reserves (in percent)	17.3	17.6	14.7	16.3	19.7	21.0
Total short-term external debt by original maturity to total debt (in percent)	21.8	23.7	23.2	29.1	30.6	32.2
Total short-term external debt by remaining maturity to reserves (in percent)	27.3	26.4	23.1	19.3	25.9	25.4
Total short-term external debt by remaining maturity to total debt (in percent)	34.6	35.5	36.5	34.5	40.1	38.9
Total external debt (in billions of U.S. dollars)	52.8	52.3	52.2	56.7	57.1	57.4
<i>Of which</i> : Public and publicly guaranteed debt	25.5	22.8	21.3	18.6	18.5	18.1
Total external debt to exports of goods and services (in percent)	35.6	31.2	27.5	26.2	23.9	27.0
External amortization payments to exports of goods and services (in percent)	3.4	4.0	3.2	3.2	1.3	2.6
Financial market indicators						
Kuala Lumpur Composite Index (KLCI), end of period	907	900	1096	1445	877	...
Ten-year sovereign bond spread (bps)	62	53	51	143	n.a.	...

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

1/ Excludes unguaranteed domestic debt of the NFPEs.

2/ Discount rate on three-month treasury bills.

3/ Includes net external position of banking system, portfolio investment, and errors and omissions.

Table 3. Malaysia: Balance of Payments, 2004–10

	2004	2005	2006	2007	Prel. 2008	Proj. 2009	2010
(In billions of U.S. dollars)							
Current account balance	15.1	20.7	24.5	28.7	38.6	26.8	22.3
Trade balance	27.6	34.1	36.7	37.1	47.9	35.4	30.3
Exports, f.o.b.	126.8	142.5	160.8	176.3	196.5	170.8	171.4
Imports, f.o.b.	99.2	108.5	124.1	139.1	148.6	135.31	141.1
Services and income balance	-8.6	-8.9	-7.6	-3.9	-4.1	-2.1	-1.2
Receipts	21.4	25.1	29.4	40.2	42.8	41.9	43.2
<i>Of which</i> : Income	4.3	5.4	7.5	10.7	11.3	11.5	11.8
Payments	30.0	33.9	37.0	44.1	46.9	44.0	44.4
<i>Of which</i> : Income	10.8	11.8	13.2	15.3	17.1	14.9	14.9
Net transfers	-3.9	-4.5	-4.6	-4.6	-5.2	-6.5	-6.9
Capital and financial account	4.9	-9.6	-5.7	-4.6	-41.4	-27.6	-12.6
Capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	4.9	-9.6	-5.7	-4.6	-41.4	-27.6	-12.6
Net foreign direct investment	2.6	1.0	0.0	-2.7	-0.1	-2.3	-2.4
Portfolio Investment	9.1	-2.0	-1.5	-2.5	-19.6	-20.6	-10.6
Other Investment	-6.8	-8.6	-4.3	0.5	-21.7	-4.7	0.4
Errors and omissions	1.9	-7.4	-6.8	-5.2	-7.4	0.0	0.0
Overall balance	21.9	3.8	12.0	18.9	-10.2	-0.8	9.7
Overall financing	-21.9	-3.8	-12.0	-18.9	10.2	0.8	-9.7
Gross official reserves	66.7	70.5	82.5	101.3	91.2	90.4	100.1
In months of following year's imports of goods and nonfactor services	6.1	5.7	5.9	6.8	6.7	6.4	6.7
In percent of short-term debt 1/	365.8	379.2	432.6	518.0	397.9	405.1	421.5
(In percent of GDP)							
Current account balance	12.1	15.1	15.6	15.4	17.4	12.8	10.1
(Excluding oil)	9.2	12.5	12.9	12.8	14.4	10.8	7.8
Trade balance	22.1	24.8	23.5	19.9	21.6	16.9	13.7
Exports	101.7	103.9	102.8	94.4	88.4	81.2	77.6
Imports	79.6	79.1	79.3	74.5	66.9	64.3	63.9
Services and income balance	-6.9	-6.5	-4.9	-2.1	-1.8	-1.0	-0.5
Capital and financial account	3.9	-7.0	-3.7	-2.5	-18.6	-13.1	-5.7
Net foreign direct investment	2.1	0.7	0.0	-1.4	0.0	-1.1	-1.1
(Annual percentage change)							
Memorandum items:							
Export value growth	21.4	12.4	12.8	9.6	11.5	-13.1	0.4
Export volume growth	14.5	7.2	7.2	1.4	8.1	-11.2	1.6
Import value growth	26.0	9.3	14.4	12.1	6.8	-9.0	4.3
Import volume growth	22.1	7.7	9.6	3.9	6.1	-9.4	3.7
Terms of trade	2.1	2.7	1.0	0.3	2.3	-2.6	-1.8

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

1/ By remaining maturity.

Table 4. Malaysia: Medium-Term Macroeconomic Framework, 2007–14 1/

	2007	Prel. 2008	Proj.					
			2009	2010	2011	2012	2013	2014
Real sector (percent change)								
Real GDP growth	6.3	4.6	-4.5	2.5	4.1	5.5	6.0	6.0
Real domestic demand	8.3	6.1	2.3	5.8	4.6	5.1	5.5	5.7
CPI inflation (period average)	2.0	5.4	0.9	2.5	2.5	2.5	2.5	2.5
Saving and investment (percent of GDP)								
Gross domestic investment	21.9	19.1	20.8	21.2	21.5	21.8	21.9	22.0
Private, including stocks	11.9	9.9	10.1	10.8	11.4	11.6	11.8	12.0
Public	10.1	9.2	10.7	10.4	10.1	10.2	10.1	10.0
Gross national saving	37.3	36.5	33.6	31.3	31.1	31.5	31.8	32.0
Private	21.1	20.5	21.3	18.4	18.4	19.8	21.0	22.1
Public	16.2	15.9	12.2	12.9	12.6	11.7	10.8	9.9
Fiscal sector (percent of GDP)								
Federal government overall balance	-3.2	-4.6	-7.7	-7.1	-7.1	-7.1	-7.5	-7.9
Revenue	21.8	21.6	22.6	22.4	21.5	21.4	20.9	20.4
Expenditure and net lending	25.0	26.2	30.3	29.4	28.6	28.5	28.4	28.2
Federal government non-oil primary balance	-8.8	-11.7	-15.1	-13.8	-12.8	-12.8	-12.7	-12.7
Consolidated public sector overall balance	1.5	1.1	-6.6	-5.4	-5.1	-6.2	-7.2	-8.2
Total public sector debt 2/	50.6	48.4	56.9	61.3	64.5	66.8	68.9	71.7
Of which : Federal government debt	41.8	40.8	49.2	53.9	57.6	60.4	63.1	65.9
Balance of payments (in billions of U.S. dollars)								
Trade balance	37.1	47.9	35.4	30.3	30.2	32.2	34.7	37.2
Services and income balance	-3.9	-4.1	-2.1	-1.2	-0.4	0.5	1.3	2.1
Current account balance	28.7	38.6	26.8	22.3	22.6	24.8	27.4	30.0
(In percent of GDP)	15.4	17.4	12.8	10.1	9.6	9.7	9.9	10.0
Capital and financial account balance	-4.6	-41.4	-27.6	-12.6	-9.0	-11.2	-16.5	-17.9
Errors and omissions	-5.2	-7.4	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	18.9	-10.2	-0.8	9.7	13.6	13.5	10.9	12.0
International trade (annual percent change)								
Export value	9.6	11.5	-13.1	0.4	5.2	7.9	8.4	8.5
Import value	12.1	6.8	-9.0	4.3	6.3	8.2	8.6	8.7
Terms of trade	0.3	2.3	-2.6	-1.8	-0.3	0.1	0.0	0.0
Gross official reserves (in billions of U.S. dollars)								
(In months of following year's imports of GNFS)	6.8	6.7	6.4	6.7	7.1	7.3	7.4	7.4
(In percent of short-term debt) 3/	518.0	397.9	405.1	421.5	459.3	494.0	516.3	639.5
(In percent of GDP)	54.3	41.0	43.0	45.3	48.2	49.9	49.9	49.9
Total external debt (in billions of U.S. dollars)								
(In percent of GDP)	30.4	25.7	27.3	26.1	24.6	22.8	21.1	19.4
Short-term external debt (percent of total) 3/								
(In percent of exports of goods and nonfactor services)	34.5	40.1	38.9	41.2	42.7	44.3	45.8	40.1
Debt-service ratio								
(In percent of exports of goods and nonfactor services)	4.5	2.4	3.8	2.9	2.9	2.7	2.5	2.3
Memorandum item:								
Nominal GDP (in billions of ringgit)	642	741	728	765	816	883	959	1,042

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

1/ Period ending December 31.

2/ Staff projections; excludes nongovernment guaranteed domestic debt of the NFPEs. The debt to GDP ratios starting in 2007 are calculated by adding the yearly deficit financing flows to the previous year stock of debt divided by the corresponding yearly GDP. The projections assume no off-budget operations. Surplus NFPEs are assumed to roll over external debt.

3/ By remaining maturity.

Table 5. Malaysia: Federal Government Fiscal Operations, 2004–09

	2004	2005	2006	2007	Prel. 2008	Original Budget 2009	Staff Proj. 2009
(In percent of GDP)							
Total revenues	21.1	20.5	21.6	21.8	21.6	24.2	21.9
Tax revenue	15.3	15.6	15.5	14.8	14.4	17.1	14.8
Non-oil tax revenue	12.5	12.4	11.1	10.9	10.7	11.8	10.4
Taxes on net income and profits 1/	7.9	7.5	7.1	7.3	7.0	7.7	6.7
Sales tax and excises 2/	3.9	4.3	3.5	3.3	3.3	3.7	3.3
Taxes on international trade	0.8	0.7	0.5	0.4	0.3	0.3	0.4
Oil tax revenue	2.7	3.2	4.4	3.9	3.7	5.3	4.4
Nontax revenue	5.8	4.9	6.1	7.0	7.3	7.1	7.1
Oil	2.4	2.7	3.9	4.4	4.9	5.1	5.1
Other	3.3	2.2	2.2	2.6	2.4	2.0	2.0
Total expenditures	25.1	23.9	24.9	25.0	26.2	29.1	29.6
Current expenditure	19.7	19.2	19.0	19.4	20.4	21.3	21.5
Wages and salaries	5.0	4.9	5.0	5.1	4.9	5.2	5.2
Other expenditure on goods and services	4.3	4.2	4.3	4.3	4.1	4.1	4.9
Interest payments	2.3	2.2	2.2	2.0	1.8	1.8	1.8
Subsidies and transfers	8.1	7.8	7.6	8.0	9.6	10.1	9.5
<i>Of which</i> : Fuel subsidies	0.7	2.1	1.3	1.2	2.2	2.9	1.2
Development expenditure	5.4	4.8	5.8	5.6	5.7	7.8	8.1
Overall balance	-4.0	-3.5	-3.3	-3.2	-4.6	-4.9	-7.7
Current balance	1.4	1.3	2.5	2.4	1.2	2.9	0.4
Primary balance 3/	-1.7	-1.2	-1.1	-1.2	-2.8	-3.0	-5.9
Non-oil primary balance 4/	-6.6	-6.8	-8.6	-8.8	-11.0	-13.1	-15.0
Financing	4.0	3.5	3.3	3.2	4.6	4.9	7.7
External	0.0	-0.7	-0.5	-0.7	-0.1	-0.2	-0.2
Domestic	4.0	4.1	3.8	3.9	4.6	5.0	7.9
Memorandum items:							
Consolidated public sector							
Revenue and grants	37.2	34.6	35.3	37.5	38.5	34.7	35.4
NFPE operating surplus	12.6	10.8	10.3	12.2	14.2	10.2	11.2
NFPE development expenditure	5.2	6.6	8.0	8.0	8.0	9.0	9.4
Overall balance	3.9	1.5	-0.3	1.5	1.5	-6.5	-5.3
NFPE balance (incl. net lending and accounts payable)	7.8	4.9	2.6	4.8	6.5	1.6	2.2

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

1/ Includes taxes on property.

2/ Includes other tax revenue.

3/ Overall balance plus interest payments.

4/ Excludes oil and gas related revenues (corporate taxes, dividends and royalty payments).

Table 6. Malaysia: Monetary Survey, 2006–08

	2006	2007				2008			
		Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
(In millions of ringgit; end of period)									
Net foreign assets	263,858	284,418	309,057	285,320	290,183	311,076	313,936	278,389	257,355
Foreign assets	340,977	376,799	425,328	419,561	429,556	476,857	496,647	442,543	373,473
Foreign liabilities	77,119	92,381	116,271	134,242	139,372	165,781	182,711	164,154	116,118
Net domestic assets	508,012	515,375	498,333	528,914	542,838	571,087	575,248	627,056	663,560
Net domestic credit	666,560	676,439	670,934	710,910	715,107	738,883	755,299	807,783	843,858
Net credit to nonfinancial public sector	5,508	7,678	-14,286	-10,424	-4,339	-3,635	-13,716	2,865	27,274
Credit to private sector	618,649	625,298	643,343	679,204	676,571	690,902	715,699	743,178	746,128
Net credit to other financial corporations	42,402	43,462	41,877	42,130	42,875	51,617	53,315	61,741	70,456
Capital accounts	121,213	120,708	125,822	131,928	125,064	126,134	143,056	152,246	145,783
Other items (net)	-37,335	-40,356	-46,779	-50,069	-47,205	-41,662	-36,995	-28,480	-34,514
Broad money	771,870	799,793	807,390	814,234	833,021	882,163	889,184	905,445	920,915
Narrow money	155,133	156,398	163,980	162,124	174,305	178,485	181,475	187,429	191,431
Currency in circulation	33,500	33,835	33,611	35,785	36,246	38,612	39,102	43,117	40,434
Transferable deposits	121,632	122,563	130,369	126,338	138,059	139,872	142,373	144,313	150,997
Other deposits	481,401	502,918	555,451	602,476	610,065	656,301	656,906	665,318	681,720
Securities other than shares	61,773	63,444	56,410	49,567	48,556	47,317	50,705	52,620	47,605
Repurchase agreements	73,563	77,033	31,549	67	96	60	98	78	159
(Contribution to 12-month growth in broad money)									
Net foreign assets	6.4	8.6	10.0	4.6	3.4	3.3	0.6	-0.9	-3.9
Net domestic assets	7.2	6.4	4.7	8.0	4.5	7.0	9.5	12.1	14.5
Memorandum items:									
Broad money (12-month percent change)	13.6	15.0	14.8	12.6	7.9	10.3	10.1	11.2	10.6
Currency in circulation (12-month percent change)	11.1	12.0	9.4	13.4	14.9	14.1	16.3	20.5	11.6
Money Multiplier (broad money/narrow money)	5.0	5.1	4.9	5.0	4.8	4.9	4.9	4.8	4.8

Source: International Monetary Fund, *International Financial Statistics*; and Bank Negara Malaysia.

Table 7. Malaysia: Banks' Financial Soundness Indicators, 2004–09

	2004	2005	2006 7/	2007	2008	2009 April
	(In percent)					
Risk-weighted capital ratio (RWCR) 1/	14.4	13.7	13.5	13.2	12.7	14.2
Commercial banks	14.3	13.6	13.1	12.8	12.2	13.7
Merchant banks	22.9	19.1	20.8	23.0	32.2	33.7
Share of loans to broad property sector 2/	40.5	41.0	40.3	40.5	40.3	40.7
Commercial banks	43.0	42.5	40.5	40.8	40.5	40.9
Merchant banks	30.0	29.9	25.3	21.6	17.1	16.1
Nonperforming loans (gross) to total loans 3/	11.7	9.6	8.5	6.5	4.8	4.6
Commercial banks	10.8	9.2	8.4	6.4	4.7	4.5
Merchant banks	26.5	20.4	18.8	12.7	15.3	13.4
Nonperforming loans (net) to total loans 3/	7.5	5.8	4.8	3.2	2.2	2.2
Commercial banks	6.8	5.6	4.8	3.2	2.2	2.2
Merchant banks	19.4	12.1	8.4	4.9	3.7	2.3
General provisions of the banking system 4/	1.9	1.8	1.7	1.7	1.7	1.7
Commercial banks	2.0	1.7	1.7	1.7	1.7	1.7
Merchant banks	2.7	2.4	2.2	2.2	2.7	2.5
Total outstanding bad-debt provision of the banking system 5/	55.0	59.1	64.6	77.3	89.0	88.5
Commercial banks	57.2	59.2	64.4	77.2	88.9	88.3
Merchant banks	42.7	56.7	70.9	80.7	94.4	101.6
Return on Assets (ROA)	1.4	1.4	1.3	1.5	1.5	...
Commercial banks	1.3	1.3	1.2	1.4	1.5	...
Loan-deposit ratio 6/	82.2	80.5	72.9	74.1	74.7	74.7
Commercial banks	81.3	81.6	76.1	77.4	77.0	77.1
Merchant banks	32.8	27.6	17.0	16.4	13.2	12.8

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

1/ The minimum RWCR is currently 8 percent for all institutions.

2/ Lending for construction, real estate, nonresidential property, and housing purchases; excludes loans sold to Cagamas Berhad.

3/ 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

4/ In percent of total loans including housing loans sold to Cagamas Berhad, minus interest-in-suspense and specific provisions; minimum requirement is 1.5 percent.

5/ Aggregate of provisions for general, specific, and interest-in-suspense. In percent of NPLs.

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

7/ From January 2006, data for commercial banks include finance companies.

APPENDIX I: MALAYSIA—EXCHANGE RATE ASSESSMENT

Staff's Assessment

The IMF Consultative Group on Exchange Rates (CGER) applies three approaches to assess the level of the real effective ringgit in relation to the level implied by medium-term fundamentals (see IMF Occasional Papers No. 167, 1998; and No. 261, 2008). According to the CGER, the ringgit is weaker than its equilibrium level.¹ For example, according to the macroeconomic balance approach, the current account norm is estimated to be significantly below the projected medium-term current account (based on an unchanged real exchange rate), pointing to a relatively large undervaluation by this metric. Other methodologies give broadly similar results.

A number of qualitative indicators suggest, however, that the undervaluation is not extreme: core inflation has been low, there have been no asset price bubbles, and intervention has been two-sided. Nonetheless, Malaysia's current account surplus has been large and protracted, although a sizeable portion of its increase since 2001 can be traced to the commodity boom.

Risks to external stability are mitigated by two considerations: (i) established exchange rate policies (as captured by the trend appreciation that prevailed before the crisis) would probably eliminate the bulk of the undervaluation over the medium term, once downward pressures on the currency unwind; and (ii) reforms in the works should reduce the savings-investment balance over time.

Authorities' Views

The authorities disagreed with the assessment that the real effective exchange rate is weaker than the value implied by medium-term fundamentals. In the course of the Article IV discussions, they noted that:

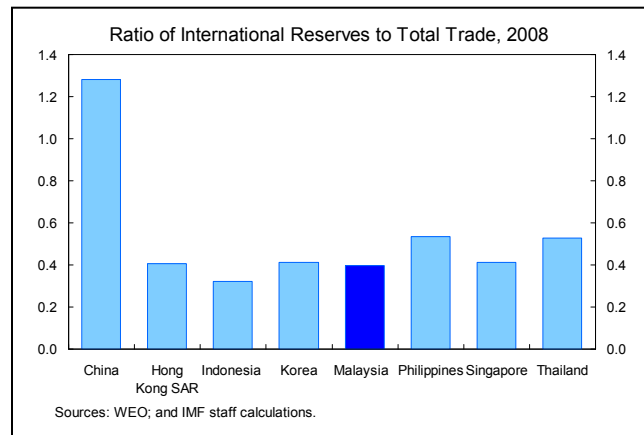
- *Malaysia's current account surplus has reflected to a large extent a temporary commodity boom rather than durable gains in competitiveness.* Exports of raw materials make up about two-thirds of the current account balance and have accounted for nearly half of the 8 percentage point increase in the current account as a share of GDP since 2001.
- *The current account surplus also has a large structural component.* It reflects high private saving because of demographics and underdeveloped social safety nets, and relatively weak investment demand in a context of market imperfections and

¹ This probably includes a temporary undervaluation since the nominal exchange rate has depreciated by 12 percent vis-à-vis the U.S. dollar since the onset of the crisis.

structural shifts. (Tellingly, Malaysia's investment abroad exceeds inward foreign investment.) Reforms to strengthen the social security system and address rigidities in product and labor markets will take time to bear fruit.

- *Official intervention has been two-sided and in response to volatile capital flows.* The objective has been to smooth

volatility and avoid overshooting in a market that remains relatively shallow. Development of a ringgit bond market has exposed Malaysia to the risk of capital reversals. Exchange rate policies thus need to shield the economy from related instability and dislocations. Sterilized intervention has provided a



buffer against past surges in capital inflows—and the war-chest to cope with their reversal in recent months. Following the exit from the peg in July 2005, the BNM has intervened by selling dollars in late 2005, May–June 2006, February 2007, July–August 2007 and—on an unprecedented scale—since August 2008. In the presence of open capital markets and financial deepening, intervention has thus safeguarded financial stability.

- *Ample reserves are good policy in an open economy.* Malaysia does not stand out by some metrics of reserve adequacy (e.g., reserves to total trade). Reserve accumulation has also proved far-sighted during a commodity upswing of uncertain duration.
- *There are no signs of instability or financial imbalances typically associated with an undervalued currency.* The absence of demand-push price and wage pressures, or pockets of overinvestment, suggests that the exchange rate is basically in line with fundamentals.
- *Model-based estimates are too imprecise to be useful for policy making.* In addition, they are marred by methodological shortcomings, such as the difficulty in accounting for country-specific factors and structural changes. In fact, the Fund should be more cautious in the application of these models—and more evenhanded in its exchange rate assessments.

INTERNATIONAL MONETARY FUND

MALAYSIA

Staff Report for the 2009 Article IV Consultation—Informational Annex

Prepared by the Asia and Pacific Department

July 1, 2009

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ANNEX I: MALAYSIA—MEDIUM-TERM DEBT SUSTAINABILITY ANALYSIS

1. **The public debt ratio is projected to increase over the medium term, while the external debt would decline in relation to GDP.** This reflects the challenging external environment but still broadly favorable medium-term growth prospects, as well as a reversal of the fiscal consolidation trend of the last few years. For the federal government, the debt ratio would exceed 50 percent of GDP.
2. **Under the baseline scenario, public sector debt would increase sharply, reaching about 72 percent of GDP by 2014.** Ample domestic savings allow the government to meet its borrowing requirements without external financing. Nevertheless, market concerns about the size of public deficit and debt and the lack of a consolidation strategy have led to the first local currency downgrade since the 1997 crisis. Bound tests indicate that public sector gross debt would increase further in the event of shocks, with the most extreme shock (a decline in growth) leaving debt at 90 percent of GDP.
3. **External debt is projected to decline to 19 percent of GDP by 2014,** reflecting mostly the large current account surpluses and a drawdown in private external debt. Sustainability does not appear to be at risk. Bound tests indicate the external debt would remain manageable under all shocks considered, including a one-time 30 percent depreciation of the ringgit, which would leave it at about 37 percent of GDP.

Table I.1. Malaysia: External Debt Sustainability Framework, 2000–14

(In percent of GDP, unless otherwise indicated)

	Actual									Projection						Debt-stabilizing non-interest current account 6/			
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014				
Baseline: External debt	45.2	49.2	48.4	44.6	42.3	38.1	33.4	30.4	25.7	27.3	26.1	24.6	22.8	21.1	19.4	4.8			
Change in external debt	-6.8	4.0	-0.7	-3.9	-2.3	-4.2	-4.7	-3.0	-4.7	1.6	-1.2	-1.5	-1.8	-1.7	-1.6				
Identified external debt-creating flows	-14.6	-7.0	-11.5	-18.1	-26.3	-16.9	-22.6	-22.2	-13.4	-0.6	-4.8	-4.9	-5.3	-5.4	-5.4				
Current account deficit, excluding interest payments	-11.5	-9.9	-9.8	-13.6	-13.5	-16.7	-17.0	-16.5	-18.4	-13.8	-11.0	-10.4	-10.5	-10.6	-10.6				
Deficit in balance of goods and services	-19.2	-17.4	-17.3	-19.6	-20.4	-23.0	-22.2	-20.3	-22.3	-17.4	-14.6	-14.1	-14.3	-14.6	-14.8				
Exports	119.8	110.4	108.3	106.3	115.4	118.2	116.7	110.2	102.6	95.6	91.8	90.5	90.1	89.7	89.3				
Imports	100.6	93.0	91.1	86.7	95.0	95.2	94.6	89.9	80.3	78.2	77.2	76.4	75.7	75.0	74.5				
Net nondebt creating capital inflows (negative)	0.8	0.4	0.4	-2.0	-9.0	2.0	-2.3	-1.4	8.9	10.9	5.9	5.7	5.7	5.7	5.7				
Automatic debt dynamics 1/	-3.9	2.6	-2.1	-2.5	-3.8	-2.2	-3.3	-4.2	-3.8	2.3	0.3	-0.1	-0.5	-0.5	-0.5				
Contribution from nominal interest rate	2.4	2.1	1.8	1.6	1.4	1.6	1.4	1.2	1.0	1.0	0.9	0.9	0.8	0.7	0.7				
Contribution from real GDP growth	-3.9	-0.2	-2.4	-2.6	-2.7	-1.9	-2.0	-1.8	-1.2	1.2	-0.7	-1.0	-1.2	-1.3	-1.2				
Contribution from price and exchange rate changes 2/	-2.4	0.7	-1.5	-1.5	-2.5	-1.9	-2.6	-3.6	-3.7	...	...	...	...	...	...
Residual, including change in gross foreign assets 3/	7.9	11.0	10.7	14.2	24.0	12.7	17.8	19.1	8.7	2.2	3.6	3.3	3.5	3.7	3.8				
External debt-to-exports ratio (in percent)	37.7	44.6	44.7	41.9	36.7	32.3	28.6	27.6	25.0	28.5	28.4	27.1	25.3	23.5	21.8				
Gross external financing need (in billions of U.S. dollars) 4/	5.1	2.9	1.8	-1.4	-0.7	-6.9	-6.2	-10.1	-19.5	-19.5	-7.3	0.6	-0.3	-1.0	-2.6				
In percent of GDP	5.4	3.2	1.8	-1.3	-0.6	-5.0	-4.0	-5.4	-8.8	-9.8	-3.6	0.3	-0.1	-0.4	-1.0				
Scenario with key variables at their historical averages 5/										10-year historical average	10-year standard deviation	27.3	26.6	25.5	24.5	23.6	22.7	9.4	
Key macroeconomic assumptions underlying baseline																			
Real GDP growth (in percent)	8.7	0.5	5.4	5.8	6.8	5.0	6.1	6.3	4.6			-4.5	2.5	4.1	5.5	6.0	6.0		
GDP deflator in U.S. dollars (change in percent)	8.6	0.5	5.4	5.8	6.8	5.0	6.1	6.3	4.6	5.6	2.1	-4.5	2.5	4.1	5.5	6.0	6.0		
Nominal external interest rate (in percent)	4.9	-1.6	3.1	3.3	6.0	4.7	7.5	12.3	13.7	5.6	4.6	13.7	-0.9	2.5	2.5	2.5	2.5		
Growth of exports (U.S. dollar terms, in percent)	5.3	4.6	4.1	3.6	3.6	4.2	4.1	4.2	4.0	4.2	0.5	3.9	3.5	3.5	3.4	3.4	3.4		
Growth of imports (U.S. dollar terms, in percent)	17.0	-8.8	6.6	7.3	22.8	12.6	12.6	12.7	10.9	10.9	8.3	-11.8	0.9	5.2	7.6	8.1	8.2		
Current account balance, excluding interest payments	23.8	-8.6	6.5	4.1	24.0	10.2	13.2	13.5	6.3	10.5	9.5	-7.9	3.7	5.6	7.2	7.6	7.8		
Net nondebt creating capital inflows	11.5	9.9	9.8	13.6	13.5	16.7	17.0	16.5	18.4	14.5	3.3	13.8	11.0	10.4	10.5	10.6	10.6		
	-0.8	-0.4	-0.4	2.0	9.0	-2.0	2.3	1.4	-8.9	0.4	4.4	-10.9	-5.9	-5.7	-5.7	-5.7	-5.7		
B. Bound tests																			
B1. Nominal interest rate is at historical average plus one standard deviation												27.3	26.1	24.7	23.0	21.3	19.7	4.8	
B2. Real GDP growth is at historical average minus one standard deviations												27.3	26.4	25.2	23.8	22.4	21.2	4.9	
B3. Non-interest current account is at historical average minus one standard deviations												27.3	27.7	27.8	27.5	27.2	26.9	4.4	
B4. Combination of B1-B3 using 1/2 standard deviation shocks												27.3	27.1	26.6	25.8	24.9	0.0	4.7	
B5. One time 30 percent real depreciation in 2009												27.3	39.2	39.0	38.4	37.7	37.2	3.9	

1/ Derived as $[r - g - r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

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

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

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

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

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

Table I.2. Malaysia: Public Sector Debt Sustainability Framework, 2004–2014
(In percent of GDP, unless otherwise indicated)

	Actual				2008	Projections						Debt-stabilizing primary balance 9/
	2004	2005	2006	2007		2009	2010	2011	2012	2013	2014	
Baseline: Public sector debt 1/	64.3	60.3	55.2	50.6	48.4	56.9	61.2	64.5	66.7	68.8	71.5	-3.7
Of which : foreign-currency denominated	20.4	16.5	11.5	8.3	9.6	9.6	9.0	8.3	7.6	6.9	6.3	
Change in public sector debt	-1.5	-4.0	-5.1	-4.6	-2.2	8.5	4.3	3.2	2.2	2.1	2.7	
Identified debt-creating flows	-11.6	-7.6	-6.1	-8.0	-8.5	7.3	2.6	1.2	1.3	1.9	2.7	
Primary deficit	-7.1	-4.6	-2.5	-3.9	-3.6	4.4	3.2	3.0	4.3	5.4	6.5	
Revenue and grants	37.2	34.6	35.3	37.5	38.5	34.7	35.4	35.2	34.1	33.2	32.3	
Primary (noninterest) expenditure	30.0	30.0	32.8	33.6	34.9	39.1	38.7	38.2	38.4	38.6	38.8	
Automatic debt dynamics 2/	-4.4	-3.0	-3.6	-4.1	-5.0	3.0	-0.7	-1.8	-3.0	-3.6	-3.8	
Contribution from interest rate/growth differential 3/	-4.4	-2.9	-2.6	-3.4	-4.7	3.0	-0.7	-1.8	-3.0	-3.6	-3.8	
Of which : contribution from real interest rate	-0.5	0.2	0.6	-0.3	-2.6	0.7	0.7	0.5	0.3	0.1	0.0	
Of which : contribution from real GDP growth	-3.9	-3.1	-3.2	-3.1	-2.0	2.2	-1.4	-2.3	-3.3	-3.7	-3.8	
Contribution from exchange rate depreciation 4/	0.0	-0.1	-1.0	-0.7	-0.3	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes 5/	10.1	3.6	1.0	3.4	6.3	1.2	1.7	2.0	1.0	0.3	0.0	
Public sector debt-to-revenue ratio 1/	172.8	174.4	156.3	134.9	125.8	163.8	172.8	183.3	195.3	207.4	221.6	
Gross financing need 6/	3.5	4.7	7.8	6.3	3.6	14.6	8.1	9.9	9.9	10.7	11.4	
In billions of U.S. dollars	4.4	6.5	12.2	11.7	8.1	29.5	17.3	22.4	24.3	28.4	34.2	
Scenario with key variables at their historical averages 7/						56.9	66.6	77.5	87.8	98.0	108.3	6.2
Scenario with no policy change (constant primary balance) in 2008–2013						56.9	54.4	51.2	46.2	40.5	34.7	-2.1
Key macroeconomic and fiscal assumptions underlying baseline												
Real GDP growth (in percent)	6.8	5.3	5.8	6.3	4.6	-4.5	2.5	4.1	5.5	6.0	6.0	
Average nominal interest rate on public debt (in percent) 8/	5.6	5.2	5.1	4.9	4.8	4.3	3.8	3.5	3.1	2.8	2.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-0.4	0.6	1.2	-0.3	-5.5	1.4	1.3	1.0	0.6	0.3	0.1	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	0.0	0.5	7.0	6.7	4.2	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	6.0	4.6	3.8	5.2	10.3	3.0	2.5	2.5	2.5	2.5	2.5	
Growth of real primary spending (deflated by GDP deflator, in percent)	-11.4	5.2	15.7	9.0	8.6	7.0	1.3	2.8	6.1	6.5	6.5	
Primary deficit	-7.1	-4.6	-2.5	-3.9	-3.6	4.4	3.2	3.0	4.3	5.4	6.5	
B. Bound tests												
B1. Real interest rate is at historical average plus one standard deviation						56.9	62.3	66.7	70.1	73.3	77.1	-3.1
B2. Real GDP growth is at historical average minus one standard deviation						56.9	63.3	69.6	75.5	82.1	89.9	-3.5
B3. Primary balance is at historical average minus one standard deviation						56.9	62.6	67.2	70.7	74.0	77.8	-4.6
B4. Combination of B1-B3 using 1/2 standard deviation shocks						56.9	63.1	68.3	72.4	76.3	80.7	-2.6
B5. One time 30 percent real depreciation in 2006 10/						56.9	61.2	73.6	75.4	77.0	77.0	-4.1
B6. 10 percent of GDP increase in other debt-creating flows in 2006						56.9	71.2	74.2	75.9	77.6	79.7	-4.2

1/ Gross debt of consolidated public sector, including nonfinancial public enterprises. Does not include nongovernment guaranteed domestic debt of NFPEs.

2/ 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).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

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

5/ For projections, this line includes exchange rate changes.

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

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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.

ANNEX II: MALAYSIA—FUND RELATIONS

(As of May 31, 2009)

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

II. General Resources Account:	SDR million	Percent Quota
Quota	1,486.60	100.00
Fund holdings of currency	1,246.41	83.84
Reserve position in Fund	240.19	16.16

III. SDR Department:	SDR million	Percent Allocation
Net cumulative allocation	139.05	100.00
Holdings	147.54	106.10

IV. Outstanding Purchases and Loans: None.**V. Financial Arrangements:** None.**VI. Projected Obligations to Fund:** None.**VII. Exchange Arrangement:**

On July 21, 2005, the BNM 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 floating.

Malaysia maintains bilateral payments arrangements with 22 countries. The authorities have indicated that these arrangements do not have restrictive features.

Capital control measures imposed in early 1994 and in 1998 in the wake of the Asian crisis have mostly been lifted, except for the internationalization of the ringgit. In particular, since May 2001, nonresident portfolio investors are freely allowed to repatriate their principal sums and profits out of the country at any time. Malaysia further liberalized exchange control regulations during 2002–07. The main measures were a relaxation of regulations on investment abroad by domestic institutions, an easing of regulations on domestic credit facilities extended to nonresidents, abolition of overnight limits on all foreign currency accounts maintained by residents and of the net open position limit imposed on a licensed onshore bank, allowing residents to open and maintain joint foreign currency accounts for any purpose, easing requirements on foreign currency and ringgit credit facilities from nonresidents, relaxation of rules on the provision of financial guarantees, abolition of several reporting requirements, allowing domestic institutions to enter into repo transactions with

non-residents, granting flexibility for domestic institutions to sell nonperforming loans to external parties, and a relaxation of the conditions on residents to enter into foreign exchange forward contracts to sell foreign currency receivables for ringgit for any purpose (prior to April 2003, only export proceeds and services receivables—excluding interest receivables—were allowed to be sold on a forward contract basis). The authorities also allowed local investors to buy foreign-listed securities and foreign firms to sell shares in the local market. In 2008, further measures were undertaken, including the lifting of limits on residents' borrowing in foreign currency, and the easing of rules on borrowing in ringgit by residents from nonresidents and lending in ringgit by residents to non-residents.

The Malaysian authorities view remaining exchange control regulations 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 maintains restrictions on payments and transfers for current international transactions with respect to the Taliban and individuals and economic entities associated with terrorism. These measures, taken in accordance with relevant UN Security Council resolutions, 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 current international transactions between Malaysian residents and Israeli companies and individuals; however, since these restrictions affect the underlying transactions themselves, they are not subject to Fund jurisdiction under Article VIII, Section 2(b).

VIII. Article IV Consultation:

Malaysia is on the standard 12-month consultation cycle. Discussions for the 2009 Article IV consultation took place during November 9-20, 2007, September 9-16, 2008, and May 21-June 1, 2009.

IX. FSAP Participation:

Undertaking an FSAP remains a priority for the authorities. Next year they expect to be in a better position to propose a timeline.

X. Technical Assistance:

MFD: Workshop in February 2000 on bank supervision, focusing on the issues of consolidated supervision, risk-based supervision, and accounting requirements. Mission in October 2003 on Islamic banking, and December 2003 on AML/CFT. Workshop in November 2008 on stress testing.

STA: Mission in August 2003 on Malaysia's IIP data, which were subsequently published in the 2003 *BOPSY*. Mission in January 2005 on integrated monetary database, and in November 2005 on government finance statistics.

XI. AML/CFT:

Malaysia (including the Labuan International Offshore Financial Center) underwent its second Mutual Evaluation in February 2007 that was conducted by the Asia Pacific Group (APG). The full report (<http://www.apgml.org/documents/docs/17/Malaysian%20MER%20-%20FINAL%20August%202007.pdf>) was adopted by APG members in July 2007.

XII. Resident Representative/Advisor: None.

ANNEX III: MALAYSIA—STATISTICAL ISSUES

Data provision to the Fund is broadly adequate for surveillance. However, further efforts to improve statistics for the consolidated public sector are necessary. 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).

- **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 *1968 SNA*. The quarterly data are released about two months after the reference quarter. In addition, DOSM has developed experimental institutional sector accounts in accordance with the *1993 SNA*. There are significant differences in the estimates for key aggregates, particularly for GDP, final consumption expenditures (government, household, NPISH, and gross capital formation) common to both the *1968 SNA*-based GDP compilation system and the *1993 SNA*-based institutional sector accounts system.
- **Prices:** The CPI and the PPI are available on a timely and comprehensive basis. A revised CPI was introduced in January 2006; it covers all 14 states and features a more disaggregated measure of the consumption basket and updated expenditure weights based on a 2004/05 comprehensive household income and expenditure survey. The PPI features a 2000 base year with weights derived from the 2000 Input-Output tables. The implicit GDP deflator does not appear to track well changes in the prices of exported and imported products following the large exchange rate fluctuations in 1997 and 1998.
- **Labor market statistics:** Data on employment and unemployment are disseminated quarterly, and wages/earnings data are disseminated monthly.
- **Monetary and financial 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 (MFSM)*. 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 (BNM) 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 (BOP):** DOSM compiles and publishes quarterly BOP estimates in accordance with the fifth edition of the *Balance of Payments Manual* and the SDDS. The quarterly data are released three months 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.
- **Fiscal accounts:** There has been limited progress in improving the consolidation of accounts across various levels of government, and broadening the coverage of major nonfinancial public enterprises (NFPEs). With assistance from STA, the authorities are working on improving the consolidation of the public sector accounts, particularly the treatment of taxes and dividends paid by key nonfinancial public enterprises to the central government. There is a need to improve the timeliness, detail, and availability of data on NFPEs and the state and local governments, as well as for ensuring that quasi-fiscal and off-budget operations are adequately recorded. Dissemination of more detailed data on 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 BNM.

Malaysia: Table of Common Indicators Required for Surveillance
(As of June 11, 2009)

	Date of Latest Observation	Date Received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of Publication ⁶
Exchange rates	06/11/09	06/11/2009	D	D	D
International reserve assets and reserve liabilities of the monetary authorities ¹	05/09	06/09	Bi-W	Bi-W	Bi-W
Reserve/base money	05/09	06/09	Bi-W	Bi-W	Bi-W
Broad money	04/09	06/09	M	M	M
Central bank balance sheet	05/09	06/09	Bi-W	Bi-W	Bi-W
Consolidated balance sheet of the banking system	04/09	06/09	M	M	M
Interest rates ²	06/11/09	06/11/09	D	D	M
Consumer price index	04/09	05/09	M	M	M
Revenue, expenditure, balance and composition of financing ³ —general government ⁴	2007	09/08	A	A	A
Revenue, expenditure, balance and composition of financing ³ —federal government	03/09	06/09	Q	Q	Q
Stocks of central government and central government-guaranteed debt ⁵	03/09	05/09	Q	Q	Q
External current account balance	12/08	03/09	Q	Q	Q
Exports and imports of goods and services	04/09	06/09	M	M	M
GDP/GNP	03/09	05/09	Q	Q	Q
Gross external debt	12/08	03/09	Q	Q	Q

¹Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

²Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.

³Foreign, domestic bank, and domestic nonbank financing is only available on an annual basis.

⁴The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵Including currency and maturity composition.

⁶Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A).



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 09/106
FOR IMMEDIATE RELEASE
August 14, 2009

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

IMF Executive Board Concludes 2009 Article IV Consultation with Malaysia

On July 16, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Malaysia.¹

Background

Malaysia has been hit hard by the global downturn. The economy is set to contract for the first time in ten years. GDP growth and inflation have slowed sharply since mid-2008. However, the reduction in employment has been relatively small so far, and as a result, consumer confidence has generally held up.

Malaysia's financial sector has faced the crisis from a position of strength and so far has coped well. Nevertheless, global turbulence has spilled into the domestic financial markets. Equity prices fell sharply in late 2008 and early 2009, but rebounded more recently, reflecting renewed optimism about near-term prospects and an upturn in commodity prices. Credit growth has decelerated, but remained at a reasonable 10½ percent y/y in April 2009, well above nominal GDP growth.

Despite capital reversals and the unwinding of the commodity boom, Malaysia's external position remains strong. The current account surplus reached 17 percent of GDP in 2008, as the collapse of exports in late 2008 was accompanied by an equally strong import compression. The ringgit has appreciated slightly vis-à-vis the U.S. dollar since April, after experiencing depreciation pressures last fall and early this year as capital outflows intensified.

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. 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.

Budget consolidation was reversed in 2008. The central government deficit rose to almost 5 percent of GDP and is set to reach nearly 8 percent of GDP in 2009. Two stimulus packages have been announced in late 2008 and early 2009, totaling about 10 percent of GDP, to be implemented over two years. The packages include an array of expenditure and revenue measures, as well as loan guarantees.

Monetary policy has been loosened decisively. Bank Negara Malaysia has slashed its policy rate by 150 basis points to 2 percent, and reserve requirements have also been cut to reduce the cost of financial intermediation. On the whole, dollar liquidity has remained adequate, and the monetary transmission mechanism has not been undermined by the global market turbulence.

External developments will probably shape Malaysia's recovery path. The export-led recession is expected to last through end-2009, with quarterly growth returning in early 2010. Risks to growth relate to the duration of the global recession, the evolution of commodity prices, and adverse macro-financial interactions.

Executive Board Assessment

Executive Directors commended the Malaysian authorities for sound macroeconomic management in difficult circumstances, and observed that Malaysia is well positioned to weather the severe impact of the global downturn. A strong external position, robust balance sheets of household and corporate sectors, and sound financial system should lessen the blow from adverse external shocks.

Directors agreed that the countercyclical fiscal response has been appropriately large, and should mitigate the impact of output contraction on households and businesses. They saw some limited room for additional stimulus if the downturn proves longer or deeper than expected. At the same time, noting the high prospective budget deficits and a rising debt to GDP ratio, they strongly encouraged the authorities to cast any future fiscal decisions in a medium-term framework. Directors highlighted that the necessary steps to reduce medium term fiscal risks include broadening the non oil tax base, moving ahead with subsidy reform, and putting fiscal policy on a credible consolidation path.

Directors considered monetary policy settings to be broadly appropriate. They suggested that monetary policy should continue to provide the first line of defense against any deterioration of growth prospects, especially in light of the limited fiscal space. Nevertheless, directors felt that, unless the outlook for growth or inflation deteriorates significantly, monetary policy should stay the course until a recovery is firmly underway.

Directors emphasized that, although the financial sector appears sound and benefited from the growth of Islamic finance, volatile global markets put a premium on crisis preparedness and proactive supervision. Directors welcomed the authorities' focus on further preventive steps,

including upgrading the stress-testing framework; ensuring effective risk management; and strengthening supervisory cooperation and oversight of institutions with cross border activities. Directors underscored that a key medium-term challenge will be strengthening domestic demand as a source of growth. They encouraged the authorities to continue to focus on promoting private investment and deepening reforms in labor and product markets. Directors welcomed the recent decision to push ahead with further liberalization in selected sectors, but stressed that more remains to be done to enhance the business climate and remove long standing structural impediments to investment.

Most Directors generally considered that Malaysia's current exchange rate policy is broadly appropriate. They also noted the staff's assessment that the ringgit appears to be weaker than its equilibrium level in real effective terms. However, many Directors were unconvinced by the exchange rate assessment, and underlined the uncertainty about fundamentals and transitory factors related to Malaysia's commodity exports and the global crisis. They concurred with the authorities' view that the exchange rate policy is consistent with a return to a gradual trend appreciation of the currency once the crisis subsides. Some Directors supported the staff's position that, once the recovery is firmly established, a faster pace of real appreciation would facilitate a rebalancing of sources of growth toward domestic demand.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Malaysia: Selected Economic and Financial Indicators, 2005–10

	2005	2006	2007	Prel. 2008	Proj.	
					2009	2010
Real sector (percent change)						
Real GDP growth	5.3	5.8	6.3	4.6	-4.5	2.5
Real domestic demand	5.5	7.5	8.3	6.1	2.3	5.8
CPI inflation (period average)	3.0	3.6	2.0	5.4	0.9	2.5
Saving and investment (percent of GDP)						
Gross domestic investment	20.0	20.9	21.9	19.1	20.8	21.2
Private, including stocks	9.7	10.8	11.9	9.9	10.1	10.8
Public	10.2	10.2	10.1	9.2	10.7	10.4
Gross national saving	35.0	36.6	37.3	36.5	33.6	31.3
Private	21.3	22.1	21.1	20.5	21.3	18.4
Public	13.7	14.5	16.2	15.9	12.2	12.9
Fiscal sector (percent of GDP)						
Federal government overall balance	-3.5	-3.3	-3.2	-4.6	-7.7	-7.1
Revenue	20.5	21.5	21.8	21.6	22.6	22.4
Expenditure and net lending	23.9	24.9	25.0	26.2	30.3	29.4
Federal government non-oil primary balance	-6.8	-8.6	-8.8	-11.7	-15.1	-13.8
Consolidated public sector overall balance	1.5	-0.3	1.5	1.1	-6.6	-5.4
Total public sector gross debt 1/	60.3	55.2	50.6	48.4	56.9	61.3
Monetary sector (annual percent change)						
M3 growth	8.8	13.6	7.9	10.5	8.0	16.6
Three-month interbank rate (period average, in percent)	2.9	3.3	3.6	3.6	...	...
Balance of payments (in billions of U.S. dollars)						
Trade balance	34.1	36.7	37.1	47.9	35.4	30.3
Current account balance	20.7	24.5	28.7	38.6	26.8	22.3
(In percent of GDP)	15.0	15.6	15.4	17.4	12.8	10.1
Financial account balance	-9.6	-5.7	-4.6	-41.4	-27.6	-12.6
Errors and omissions	-7.4	-6.8	-5.2	-7.4	0.0	0.0
Overall balance	3.8	12.0	18.9	-10.2	-0.8	9.7
Gross official reserves (in billions of U.S. dollars)	70.5	82.5	101.3	91.2	90.4	100.1
(In months of following year's imports of GNFS)	5.7	5.9	6.8	6.7	6.4	6.7
(In percent of short-term debt) 2/	379.2	432.6	518.0	397.9	405.1	421.5
Total external debt (in billions of U.S. dollars)	52.3	52.2	56.7	57.1	57.4	57.6
(In percent of GDP)	38.1	33.7	27.9	24.9	25.8	24.2
Short-term external debt (percent of total) 2/	35.5	36.5	34.5	40.1	38.9	41.2
Debt-service ratio						
(In percent of exports of goods and services)	5.3	4.4	4.2	2.3	3.6	2.7
Memorandum items:						
Nominal GDP (in billions of ringgit)	522	574	642	741	728	765
Stock market index (end of period)	900	1,096	1,445	877	...	...

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

1/ Excludes financial public enterprises and nongovernment-guaranteed domestic debt of the NFPEs.

2/ By remaining maturity.

**Statement by Duangmanee Vongpradhip, Executive Director for Malaysia
and Seng Guan Toh, Senior Advisor to Executive Director
July 16, 2009**

1. On behalf of our Malaysian authorities, we would like to thank Mr. Zanello and his team for the focused discussions on macroeconomic developments and policy issues in Malaysia. Indeed the discussions this year have been candid yet constructive, and our authorities appreciate the good work and helpful advice provided by the team. In fact, there is broad agreement on almost all the major policy thrusts. We are further encouraged by the assessment that the policy mix is appropriate as Malaysia, like many other small open economies around the world, is striving hard to counter the severe impact of the current global crisis. This statement thus seeks mainly to provide an update on the latest economic developments in Malaysia and elaborates on selected policy issues for emphasis and clarification.

Recent Economic Developments and Outlook

2. On economic performance, the Malaysian economy averaged a growth rate of 4.6 percent in 2008, but the two halves of the year contrasted sharply. Growth remained strong in the first half of 2008, with the economy expanding by 7.1 percent. This was supported by strong domestic demand and the continued expansion in Asian intra-regional trade together with buoyant commodity markets at that time, despite signs of softness already emanating from the major advanced economies. However, as the global financial crisis escalated to an unprecedented level in the second half of 2008, Malaysia, being among the world's most highly open economies with total trade exceeding 160 percent of GDP, was not spared. Due to the steep contraction in external demand, the Malaysian economy barely recorded year-on-year growth in the fourth quarter of 2008, despite continued strong impetus from domestic-oriented activities.

3. In response to the weakness in the global economy, the Government announced its first stimulus package of about 1 percent of GDP for implementation at the beginning of 2009. As the global downturn deepened even more than expected going into 2009, the effects of the vicious external contraction spilled over into domestic demand. Economic growth contracted by 6.2 percent in the first quarter of 2009, and latest indications are that while less severe, the contraction in growth has persisted into the second quarter of the year. In response, the Government announced its second stimulus package in March 2009, for implementation over two years – 2009 and 2010. While the second stimulus package had elements that would support growth, it further introduced elements to spur structural transformation in the economy that would position Malaysia for the global recovery in the medium term, as noted in the Staff Report under the theme of the New Economic Model.

4. The effects of the two stimulus packages on growth are expected to be more strongly felt beginning in the second half of 2009. However, despite some recent positive signs, our authorities have remained conservative on the prospects for the global economy, and

consequently, the latest official forecast is for Malaysia's economic growth to record a contraction of between 4 to 5 percent in 2009, similar to what is envisaged in the Staff Report.

5. On inflation, during 2008 the Malaysian economy faced supply-driven inflationary pressures from the sharp surge in global food and fuel prices. Inflation averaged a higher-than-usual 5.4 percent for the year, reflecting largely the effects of the government's sharp upward adjustment to fuel prices in conjunction with a reduction in fuel subsidies in June 2008. This caused inflation to spike to a peak of 8.5 percent in July, which for monetary policy presented an acute challenge due to elevated risks to both inflation and growth.

6. Notwithstanding the widespread trend to raise interest rates during that period, it was assessed, however, that in the latter part of 2008 the balance of risks would shift from higher inflation to slower growth. It was evident by then that the sharp rise in food and fuel prices had eroded the purchasing power of consumers. There were few indications of second round effects of inflation, with wage pressures remaining contained. Importantly, it was assessed that the ongoing financial turmoil in the advanced economies had turned acute and would affect economic activity going forward. Hence, Bank Negara Malaysia (BNM) decided to stay the course in the third quarter of 2008, with policy rates kept unchanged at accommodative levels.

7. As it became clear by the fourth quarter of 2008 that the global economy was decelerating even more sharply than expected, monetary policy action was frontloaded. In the four months from November 2008 to February 2009, the Overnight Policy Rate (OPR) was brought down by a total of 150 basis points to a historical low of 2 percent. The Statutory Reserve Requirement (SRR) was also lowered by 3 percentage points in conjunction with the reductions in policy rates to reduce further the cost of intermediation and accelerate the monetary transmission to retail interest rates. As anticipated, headline inflation has moderated from its July 2008 peak to below 4 percent by end-2008 and to only 2.4 percent by May 2009, and is expected to average less than 2 percent for 2009.

8. Despite the strains on growth and inflation from global developments, the external position of Malaysia remains strong. Supported in part by commodity prices, the current account surplus recorded a larger surplus in 2008, and thus far in 2009 has continued to remain in surplus in the first quarter of 2009 as the decline in exports has been more than offset by import compression¹ following the steep cutbacks in production due to falling global demand. Meanwhile, external debt declined further to 35.1 percent of Gross National Income (GNI) as at end-March 2009, with only about a third of that short-term debt. The international reserves of BNM, which at its peak reached the equivalent of over US\$125 billion in March 2008, has stabilized since early 2009 following a period of the

¹ Intermediate imports for processing and subsequent exports account for about 70 percent of total exports

unwinding of portfolio capital flows due to the global deleveraging process. As at 30 June 2009, reserves stood at the equivalent of US\$91.5 billion, sufficient to finance 8.5 months of retained imports and was 3.8 times the short-term external debt.

9. The Malaysian financial sector has remained resilient in the current environment, which has allowed sustained growth in credit flows. With negligible exposure to troubled assets overseas, the soundness of the banking system combined with a situation of ample domestic liquidity has facilitated the transmission of fiscal and monetary policy. Targeted credit guarantee schemes have also been introduced as a mechanism to sustain and enhance access to credit for viable firms, particularly for the small and medium-enterprise segment, as well as to encourage industrial upgrading. The stronger position of the banking system is due to both large liquidity and capital buffers built up over the past decade, as well as strengthened institutional capacity, risk management and governance standards, and supporting infrastructure, reflecting the lessons learnt during the Asian crisis of 1997-1998. In particular, bank regulation and supervision have generally been counter-cyclical in the past decade by encouraging banks to raise capital and provide for loans in better times. As a result, the risk-weighted capital ratio (RWCR) and core capital ratio has increased to 14.2 percent and 12.3 percent respectively as of May 2009, while loan quality remained sound with the net non-performing loans (NPL) ratio unchanged at a low of 2.2 percent since end-2008, despite the significant deceleration in economic growth seen so far. Nonetheless, my authorities concur with the Staff that some amount of deterioration in credit quality will naturally occur if the global recession is prolonged, and both the authorities and the banks will remain vigilant and proactive in managing the risks.

Policy Discussions

Monetary Policy

10. Our authorities welcome Staff's assessment that monetary policy action has been decisive and appropriate. Indeed the forward-looking assessment by BNM has proven well founded thus far, as BNM was one of the few central banks that did not raise interest rates in 2008. This was further reinforced by the aggressive reduction in interest rates to historical lows shortly after it was assessed that the global economy would take a turn for the worse in late 2008. Measures were also undertaken to affect the translation from policy rate cuts to reductions in retail rates in order to increase the monetary impact on households and businesses. Undertaken in collaboration with the banking community, these measures included an automatic reduction of installment payments for housing loans and reductions in credit card rates. Learning from their experiences during the Asian crisis, banks in Malaysia have been proactive as early as mid-2008 to work with viable borrowers to restructure loans where needed to overcome temporary cash flow constraints. As also noted in the Staff Report, these measures were balanced by other measures, including floors on some fixed deposit rates and issuance of savings bonds to safeguard the real rate of return to depositors. These measures are particularly important since Malaysia is a high savings society, with the

household sector being net lenders in the economy. At this stage, the authorities judge that there is adequate monetary stimulus in the pipeline to support the economy going forward. The average lending rate of commercial banks is now at a historic low of 5 percent. The focus of efforts now is directed at sustaining access to credit.

Fiscal Policy

11. Our authorities are fully in agreement with Staff that, in view of the higher fiscal deficit levels following the implementation of the two stimulus packages, there is the need for a return to a fiscal consolidation path in the medium-term. It is also agreed that there is the need to reduce reliance on oil-related revenue. In fact, the commitment and urgency for medium-term consolidation was communicated to Staff in meetings with the fiscal authorities. The authorities had been consolidating since 2000 when the fiscal deficit peaked at 5.5 percent of GDP, and by 2007, the deficit was successfully reduced to 3.2 percent of GDP. These efforts, however, were disrupted in 2008 because of the difficult global environment. The authorities are fully committed to undertake fiscal consolidation as soon as the economy recovers and is on a firmer footing.

12. We also concur with Staff that the immediate priorities -- given the severity of the global downturn and Malaysia's still manageable level of public debt and low level of external indebtedness -- are to implement forceful fiscal measures to act in a countercyclical, yet targeted fashion. The focus of the measures in the first stimulus package has thus been on fast-acting small projects with high multiplier effects. To date, over 30 percent of that package has been spent and some impact on the economy has emerged in the first quarter of 2009 as the construction sector was the only sector to register positive growth. Meanwhile, the scope of the second stimulus package is broader, encompassing assistance to vulnerable groups and measures to encourage structural reforms for Malaysia's competitiveness. As significant portions of both stimulus packages comprise capital spending, this means that the impact on the fiscal balance will be unwound as they are completed.

13. The priority to consolidate the fiscal position in the medium-term is being articulated through a key thrust for long-term sustainability as part of the aforementioned New Economic Model which the authorities are working on. They envisage, among others, a broadening of revenue collection, review of subsidies and Government procurement, accelerating privatisation, monetizing Government assets and increasing efficiency in public spending. Measures such as a goods and services tax (GST) are ready to be implemented, but an early timing for a rollout is judged to be counter-productive in the present downturn. The bulk of the reduction in subsidies has already taken place, progressively undertaken since June 2008, for both fuel and for others forms of subsidies. Nonetheless, the authorities remain determined to further rationalize subsidies going forward to streamline the fiscal position and enhance economic efficiency.

Financial Sector Developments

14. Our authorities thank Staff for their assessment that the Malaysian financial sector has faced the global crisis from a position of strength and has shown a degree of resilience in the current global turmoil. This achievement has been due significantly to the reforms and determined measures put in place over the past decade, building on the lessons forged in the depths of the Asian crisis. As a result, the Malaysian financial sector has been significantly transformed, with a well-capitalized banking system, relatively deep capital markets including a vibrant bond market – the largest in Southeast Asia. Furthermore, a new dimension to the financial system has taken shape as Malaysia has become an international centre for Islamic finance.

15. Regulatory and supervisory frameworks and practices have not only kept pace with global practices, but in some cases have gone beyond, by in effect encouraging counter-cyclical capital requirements and loan provisioning. Over the past ten years, the introduction of an extensive credit-scoring database, deposit insurance scheme, and systems to strengthen risk management, including the adoption of Basle II's standardized approach last year, have added strength to the system. The sustained growth of the Islamic financial system, in which a key tenet of Islamic finance ensures the grounding of financing activities to underlying economic transactions, has further added stability to the system as was acknowledged by Staff. The relatively strong balance sheets of households and corporates have also added resilience to the financial sector, notwithstanding the effects of slowing growth. The corporate sector, broadly speaking, may even be somewhat under-leveraged relative to norms, thus explaining why profitability has not been unusually high, as Staff have noted², but this has added an additional degree of comfort in the present environment.

16. Nonetheless, the authorities have maintained their vigilance and have been active in managing risks in the financial system through preemptive measures, several of which were noted in the Staff Report, including the extension of a blanket guarantee in October 2008 on all domestic and foreign currency deposits till 2010 and ready access to foreign exchange liquidity to banks for trade financing if needed. These measures have contributed to preserving a highly liquid funding market and ensured the smooth functioning of the financial intermediation process. Stress testing activities, which have been a staple since the Asian crisis, have been enhanced further in the past two years, including through a workshop conducted in collaboration with the Fund. BNM's scenario-based stress tests focus on implications on both solvency (credit and market risks) and liquidity positions of the banks.

² Thus far, sectors that are more defensive in nature have generally displayed more resilient earnings e.g. retailers, packaged F&B, tobacco and liquor manufacturers, rubber glove producers, gaming operators, oil and gas support service providers, toll road concessionaires and the independent power producers.

17. Notably, in a global environment where protectionist tendencies are increasing in influence, the authorities have pressed ahead with the third and final stage of the 10-year Financial Sector Master Plan that began in 2001 to further liberalize the financial sector to foreign ownership and increase further Malaysia's integration with the international financial system. While foreign presence in the Malaysian financial sector is already significant, accounting for approximately 25 percent of banking assets and including the presence of major global banks, the authorities have assessed that the domestic financial institutions had achieved a greater state of readiness to compete in an even more liberalized environment. The liberalization measures included the issuance of 5 new commercial banking licenses (including 2 for specialized institutions), a further 2 new Islamic licenses with paid up capital of at least US\$1 billion, and 2 new family *takaful* licenses. Foreign equity limits for Islamic financial institutions were further raised to 70 percent for domestic Islamic banks that have paid up capital of at least US\$1 billion to strengthen Malaysia's role as an Islamic financial hub. Foreign equity limits for investment banks, insurance companies and *takaful* operators were also increased to 70 percent. Significant operational flexibilities were also granted to foreign-owned banks, including on branching policies, employment, and offshore-onshore presence. In bringing the country to the next phase of development, the liberalization plan aims to pursue opportunities that would bring net benefits and contribute to the development of the Malaysian financial sector and the economy as a whole, while ensuring that overall financial stability and soundness is preserved.

Exchange Rate Developments

18. Since the transition of the exchange rate arrangement in July 2005 from a peg to a managed float regime, the ringgit has generally been on a path of appreciation. By end-2006, the ringgit had risen by 7 percent against the US dollar. In 2007, a further 7 percent appreciation was recorded, together with relatively wide trading fluctuations in the exchange rate. By April 2008, the ringgit had appreciated a further 6 percent against the dollar in less than four months. Clearly at that point, with a cumulative appreciation of over 21 percent against the US dollar in less than 3 years, the authorities had demonstrated that they are not averse to sustained appreciation when the market trend and fundamentals call for it. Following these developments, with the massive reversal of portfolio capital flows amidst the global deleveraging associated with the escalation of the global financial crisis in the latter part of 2008, reversal in the capital flows caused the currency to weaken. It is during this period that the central bank undertook intervention to counter the degree of depreciation, with the result that international reserves declined from a peak of about US\$125 billion to about US\$90 billion by early-2009, an almost 30 percent decline in reserves. This episode should lay to rest the notion that intervention has been anything less than two-sided, as Staff also clearly acknowledge in their analytical box (p. 21), and that the broad objective of exchange rate management for a small highly open economy like Malaysia has been to mitigate extreme volatility in the exchange rate, and not to target any particular level of the exchange rate. Our authorities would like to reiterate that for a small and open economy, an

orderly exchange rate market is important for achieving sustainable growth with price stability.

19. Our authorities take note of Staff's view that "the ringgit in real effective terms remains weaker than its equilibrium level, but Malaysia's exchange rate policies are broadly appropriate" (p. 24), which is clearly the case when viewed in the larger context of the overall counter-cyclical policy mix.

20. First, we continue to assert, as we often have in our constituency, that equilibrium exchange rate estimates yielded by models cannot be taken as definitive, and even more so at the current juncture when the global crisis has introduced a unusually high degree of uncertainty in the assessment. At best, they can be used as part of an overall assessment process that should also take into account other factors which cannot be readily incorporated into such models. While Staff have noted that "a number of qualitative indicators suggest that the undervaluation is not extreme" (p. 35), our Malaysian authorities are firm with the view that there is limited evidence of undervaluation in the economy, given the fact that core inflation has been low, there has been no asset price bubble, and intervention has been two-sided.

21. Secondly, while the current account surplus is sizeable, Malaysia is a commodity producer. Over two-thirds of the current account surplus can be attributed to commodities including oil. It is fundamentally inappropriate to apply the 3-model CGER estimations when an economy is a significant producer of non-renewable resources. A Fund working paper by Thomas, Kim and Aslam (2008)³ estimated that by applying an alternative methodology for assessing the external balance in countries with large stocks of non-renewable resources, the non-oil current account position for Malaysia was in fact in equilibrium, as oil resources can be expected to be depleted in the future. Our authorities would also welcome accelerated work on the commodity-based CGER approaches that we understand is being undertaken at the Fund.

22. Thirdly, going forward, the surplus is expected to decline dramatically, roughly halving this year compared to the levels in 2008, reflecting both lower commodity prices and the effects of the global recession, and would thus yield a much different level of equilibrium exchange rate.

23. Finally, other structural factors are also at play in widening the savings-investment gap as noted in the Staff report, including demographics, social safety net constraints, and relatively limited investment opportunities for expansion in the small domestic economy, which as Staff have also pointed out, is corroborated by the large flow of outward direct investment that already exceeded the flow of inward direct investment last year.

³ Thomas, Alun, Kim, Jun Il and Aqib Aslam, July 2008, Equilibrium Non-Oil Current Account Assessments for Oil Producing Countries, IMF Working Paper, International Monetary Fund, Washington.

Structural Reforms

24. Our authorities concur with Staff that further structural reforms are critical for Malaysia to ensure sustained long-term growth, and have initiated work on new approaches to development under the umbrella of the New Economic Model. The Model is envisaged to be a holistic approach to accelerating Malaysia's development by emphasizing private sector participation, with the aim of fostering a high income, high productivity and innovation-driven economy. The consultative work on the Model has already started as part of the process of drafting the latest five-year development plan, the 10th Malaysia Plan. Further economic liberalization will be a key component of the Model and the 10th Malaysia Plan. Indeed, since the beginning of the crisis, the authorities have announced a number of bold steps to further open up the Malaysian economy. Recent key measures, some of which have been noted by Staff include:

- significant equity liberalization announced in June, including the removal of affirmative action ownership targets for publicly listed companies, abolishment of requirements to receive approval for most types of foreign investments, and increasing the limits on foreign participation in capital market players;
- ownership liberalization in 27 services sub-sectors announced in April 2009, together with the significant liberalization in financial services as mentioned above. This liberalization includes new growth areas with significant potential such as health and social services, transport and computer-related services; and
- commitment to free up product markets, especially for intermediate products such as steel, which would reduce costs for businesses.

With these actions, and a commitment to further liberalization, the authorities have demonstrated that crises need not inevitably lead to less openness. Indeed, the current crisis can also be an opportune time to build domestic consensus for bold reforms.

Conclusion

25. Our authorities have welcomed the input contained in the Staff Report and found the consultations useful. They wish to note that with a recovery in global growth far from certain, the challenges to achieving a sustained recovery and navigating a successful transformation to a new development model remain large and significant. Like many other small open economies around the world, Malaysia is still facing the brunt of the crisis and is doing its utmost, in concert with the regional and global authorities, to respond effectively and mitigate its severity. The good support of the international community, including the expertise of the Fund, will remain appreciated.