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Malaysia: 2010 Article IV Consultation—Staff Report; Staff Statement; 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 2010 Article IV consultation with Malaysia, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 2, 2010, 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 16, 2010. 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 staff statement.
- A Public Information Notice (PIN).
- A statement by the Executive Director for Malaysia.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

MALAYSIA

Staff Report for the 2010 Article IV Consultation

Prepared by the Staff Representatives for the 2010 Consultation with Malaysia

Approved by Mahmood Pradhan and David Marston

July 16, 2010

- **Discussions**: During May 21-June 2, 2010 with Mr. Husni (Minister of Finance II), Messrs. Yakcop and Jala (both Ministers in the Prime Minister's Department), Mr. Mustapha (Minister for International Trade and Industry), Mr. Wan Aziz (Secretary General of the Treasury), Governor Zeti and the then Deputy Governor Ooi of Bank Negara Malaysia, other senior officials, and private sector representatives. Ms. Vongpradhip and Mr. Toh (OED) attended the policy meetings.

- **Team**: Messrs. Zanello, Dodzin, Abdel-Rahman, Nabar, and Balakrishnan (all APD).

- **Context of past surveillance**: There has been broad agreement between the authorities and the Fund on desirable policies—a prudent fiscal stance, reforms of government-linked companies, measures to improve the investment climate, flexibility in monetary and exchange rate management, and further steps to strengthen 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. For the issues discussed in the 2009 Article IV consultation, see http://www.imf.org/external/pubs/cat/longres.cfm?sk=23189.0.

- **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 *de facto* exchange rate arrangement is classified as "other managed" and remains appropriate.

- **FSAP**: Malaysia has formally requested to participate in the *Financial Sector Assessment Program* next year.

- **Data**: Broadly adequate for surveillance. However, further efforts are necessary to improve statistics for the consolidated public sector.

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EXECUTIVE SUMMARY

Background. Malaysia has emerged from the world recession with strong forward momentum. Forceful counter-cyclical policies, sound balance sheets, and intra-regional trade have primed the recovery. Prospects for the near term are good. The global downturn has led to a rethinking of the development model, though. The government has formulated a multi-pillar strategy to double per capita income by the next decade.

Focus of the discussions. The Article IV discussions focused on the policy requirements to support the recovery and the priorities for structural reforms over the medium term. The authorities and the staff were in broad agreement on key issues.

Fiscal policy. The 2010 budget marks a return to consolidation. The deficit target, which seemed ambitious when the budget was unveiled, now looks within reach thanks to stronger-than-anticipated growth and oil revenues. The staff argued that budgetary gains would prove transitory, however, if the broader agenda of fiscal reforms remains unfinished. In particular, subsidy reform and the introduction of the goods and service tax should not be delayed. The authorities confirmed that both were high priorities but that a broad consensus on implementation modalities was still being forged.

Monetary policy. Policy normalization is underway. Bank Negara Malaysia has raised the policy rate in three quarter-point steps but the stance remains supportive. There was agreement that the gradual monetary exit was consistent with the improved outlook, absence of price pressures, and concerns about side-effects of abnormally low interest rates.

Financial sector policies. Malaysia's financial sector has withstood the global recession well. There was agreement that some Basel III requirements may be onerous for local banks. A new Central Bank of Malaysia Act further strengthens the underpinnings of the financial system. The Malaysian authorities have requested to participate in the Financial Sector Assessment Program.

Structural reforms. Malaysia's New Economic Model addresses supply-side impediments that have kept the country ensnared in a middle-income trap. The Tenth Malaysia Plan makes operational the economic strategy through 2015. The authorities shared the view that a meaningful uplift in trend growth requires structural reforms on a broad front. Like the staff, they saw signs of a renewed political commitment to push the agenda but cautioned that molding the necessary social consensus would require time.

Exchange rate. The authorities and the staff also shared the view that a stronger ringgit in real effective terms could facilitate over time the implementation of the economic transformation program by contributing to higher real incomes for households, greater capital deepening, faster productivity gains, and demand shifts in favor of services. The staff noted that the ringgit in real effective terms appears to be weaker than its estimated equilibrium level. The authorities disagree with this assessment.

I. INTRODUCTION

1. **Malaysia has come out strongly from the world recession**. Forceful counter-cyclical policies, sound balance sheets, and intra-regional trade have primed the recovery. With rebounding domestic and global demand, output losses have by now been largely reversed. Prospects for the near term are good, provided that the external environment does not deteriorate.

2. **The cyclical momentum has re-energized the policy debate**. The global downturn has led to a rethinking of the development strategy. The emerging view is that Malaysia is at a crossroads. The economic model that produced significant advances over three decades has lost the ability to drive the country forward. Old polices are under review and the political leadership is making the case for a national transformation to free Malaysia from the middle-income trap where it is now stuck.

3. **A multi-pillar strategy has taken shape**. It spans a vision to increase social cohesion while preserving Malaysia's cultural diversity ("1Malaysia"), a plan to improve governance and the delivery of public goods (the Government Transformation Program), a framework for far-reaching structural reforms (the Economic Transformation Program built on the New Economic Model, NEM) and a blueprint for economic change over the next five years (the Tenth Malaysia Plan, 10MP). Development policies have been dressed in rhetoric before but the sense of urgency seems higher now than in the past.

4. **Against this background, the 2010 Article IV discussions tackled both short-term and longer-term questions**. Exchanges of views focused on the policy requirements to support the expansion and the priorities for structural reforms. There was broad agreement on the key issues.

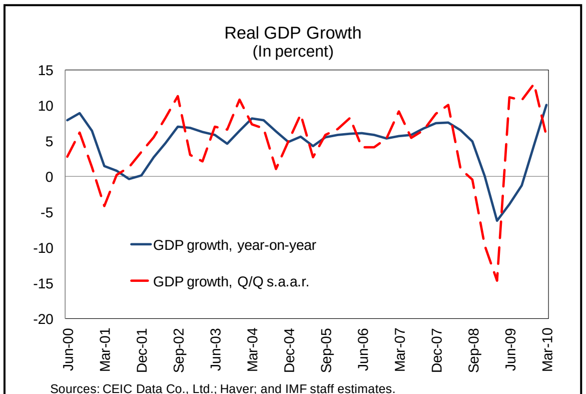
5. **Malaysia has requested to participate in the Financial Sector Assessment Program (FSAP)**. This is an important outcome of the 2010 Article IV discussions.

II. ECONOMIC DEVELOPMENTS AND OUTLOOK

Background

6. **A broad-based recovery is under-way and the economy has regained lost ground**.

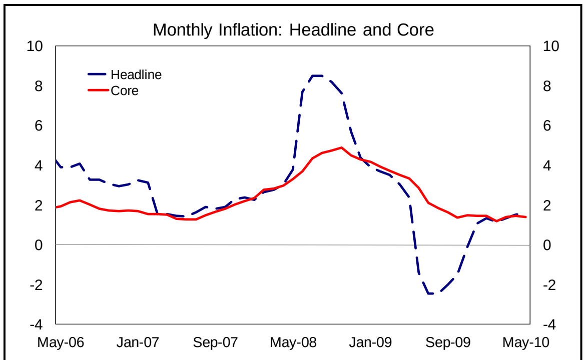
- After three quarters of contraction, GDP began growing in the last quarter of 2009 pulled by exports, private consumption, and public spending. With strong momentum in



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

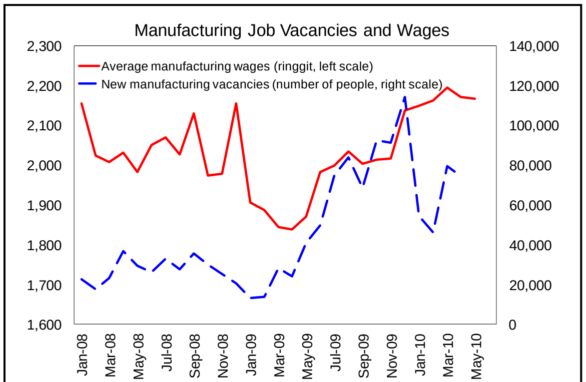
late 2009 and the first quarter of 2010, seasonally-adjusted GDP is now close to pre-crisis levels, reversing a 6½ percent peak-to-trough loss.

- As the output gap widened and global energy and food prices collapsed, headline inflation fell to below 1 percent (y/y) last year, after a stretch of monthly deflation. The momentum has shifted with the upswing. On a monthly basis, inflation has been positive since last December, with the latest reading in May at 1.6 percent.



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

- Labor markets are also tightening after showing resilience throughout the downturn. The unemployment rate for 2009 peaked at about 3¾ percent, better than anticipated at the time of the 2009 Article IV consultations. Job vacancies in manufacturing are now larger than before the crisis, but slack in other sectors remains.

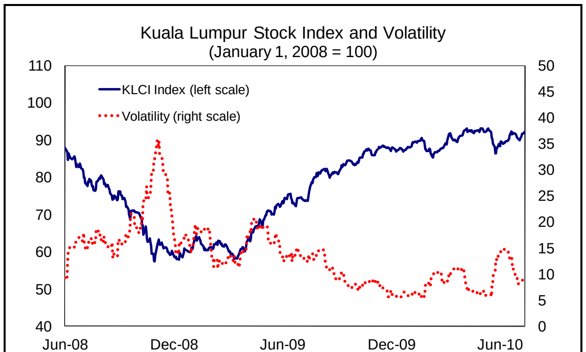


Sources: CEIC Data Co., Ltd.

7. **Domestic financial conditions have improved with the turn of the cycle**.

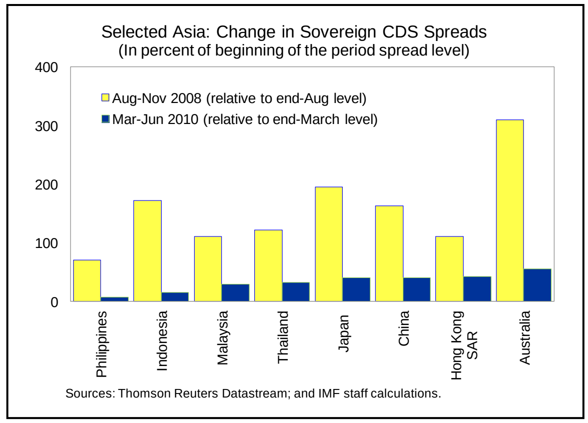
- Supported by policy, credit growth remained positive even as output shrunk. It is now gaining steam on its own benefitting from strong demand for consumer loans and mortgages. The recovery in business lending has also been robust. Base lending rates, which bottomed out at 5½ percent, have been trending up since March 2010.

- Equity prices have risen about 50 percent since the lows of March 2009, and about 5 percent so far this year. The rally has not been as strong as in other regional markets, reflecting Malaysia's weaker capital inflows and shallower correction in the sell-off.



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

- Corporate bond issuance, which remained relatively strong in 2008, has also been recovering. Sovereign CDS spreads have risen in recent months, reflecting global market jitters. The widening has been in line with that elsewhere in the region. A landmark issuance of a U.S. dollar government Islamic bond took place in June. Notwithstanding unsettled investor sentiment, the global *sukuk* was oversubscribed and priced at 180 basis points over U.S. treasuries, a more favorable pricing than for other regional issuers.

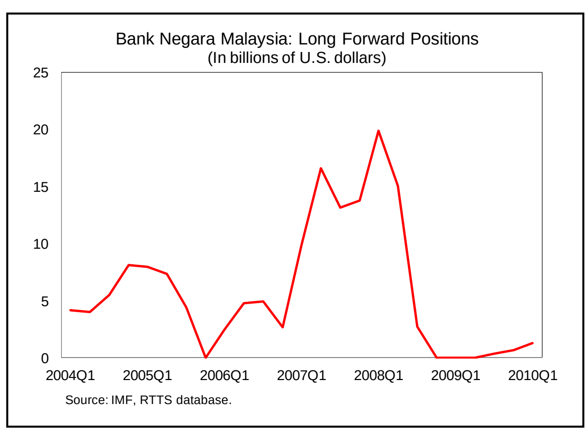


8. **Malaysia's external position continues to be strong**.

- The current account surplus fell modestly to 16½ percent of GDP in 2009. Imports of intermediate goods shadowed the decline of manufacturing exports and demand for commodities (mainly hydrocarbons, rubber, timber, and palm oil) held up better than expected. Despite a boost to the service account from tourism, the income balance remained in deficit, reflecting profit repatriation by multinationals and continued excess of payments over receipts in the investment account.

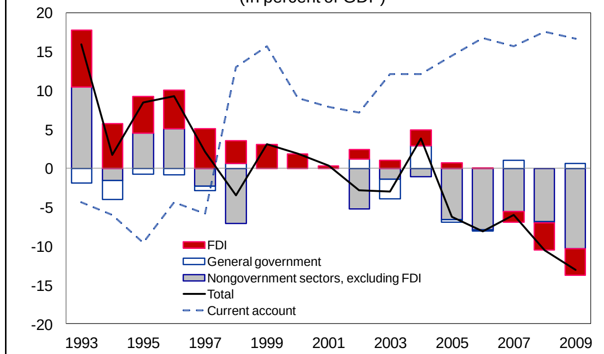
- Malaysia experienced net outflows throughout the year (Box 1). Portfolio inflows picked up in the second half of 2009, but outward FDI and "other investments" swamped the uptick. Both flows have been negative in net terms for years reflecting underlying trends—the expansion abroad of Malaysian businesses, trade financing flows, and the recycling of current account surpluses.

- The buildup of official reserves during the commodity up-cycle before the crisis helped accommodate large capital movements through 2009 in the global sell-off of emerging market assets. Reserves fell from nearly $126 billion in mid-2008 to just above $88 billion in March 2009, as Bank Negara Malaysia (BNM) intervened to support the ringgit. By the end of the year, the drawdown had been reversed. At end-June 2010, reserves were about $95 billion, roughly unchanged from a year earlier. A light forward book suggests limited intervention.



Box 1. Malaysia: Recent Trends in Capital Flows

Malaysia has experienced net capital outflows on the financial account since the late 1990s. These have been the reflection of current account surpluses after the Asia crisis as well as structural factors favoring investment abroad by residents. In particular, over the last few years net FDI outflows have grown, as a result of limited opportunities for domestic investment by foreigners (for example following the IT bubble crash), greater competition from China, Singapore, and Hong Kong SAR, as well as growing investment abroad by Malaysian companies seeking economies of scale, a regional exposure (e.g., in telecom), or supplies of natural resources (oil and gas field or land for plantations).



Malaysia: Selected Financial Account Items, Net
(In percent of GDP)

Sources: IMF, BPTS Database; and IMF staff estimates.

Malaysia: Capital Flows, Net

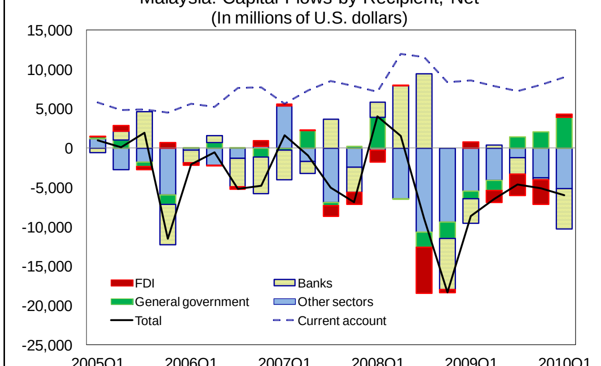
(Period average, in percent of GDP)

	1993–09	2001–09	2008–09
General government	-0.2	0.3	0.3
Nongovernment, excluding FDI	-2.1	-5.0	-8.6
Of which:			
Banks	-0.3	-0.4	1.4
Nonbanks	-1.8	-4.6	-10.0
FDI	1.9	-0.3	-3.5
In Malaysia	3.8	2.8	2.0
Abroad	-1.9	-3.1	-5.5
Total Non-government	-0.2	-5.3	-12.1
Memorandum item:			
Current account	7.5	13.4	17.1

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

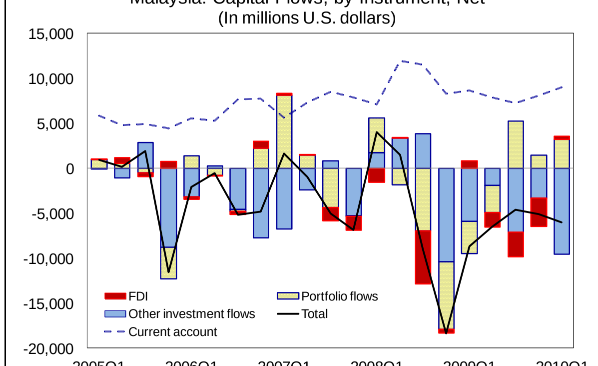
Over the last four quarters, capital flows on the financial account have rebounded somewhat but continue to be negative (charts at bottom of the Box).

- Net capital flows to the general government have bounced from crisis-lows into positive territory, reflecting increased appetite of foreign investors for government securities and related portfolio inflows.
- Net flows related to sectors other than the general government were negative and more than offset the government-related inflows. The main drivers were sustained current account surpluses, a revival of trade credit from exporters to importers overseas, and an increased willingness of the private sector to place funds abroad. In particular, net outflows related to loans and other non-portfolio investments have picked up for both banks and nonbanks, while net portfolio flows to nongovernment sectors, which spiked in the second quarter of 2009 mostly due to debt inflows, have since trailed off and turned into outflows.



Malaysia: Capital Flows by Recipient, Net
(In millions of U.S. dollars)

Sources: IMF, BPTS Database; and IMF staff estimates.



Malaysia: Capital Flows, by Instrument, Net
(In millions U.S. dollars)

Sources: IMF, BPTS Database; and IMF staff estimates.

Outlook and Risks

9. **Malaysia's near-term prospects are favorable**.

- *Near-term outlook*: GDP is projected to expand by around 7 percent in 2010, narrowing, but not closing, the output gap. As favorable base effects play out and policy support is reeled in, growth should moderate in 2011. Both external and private domestic demand will propel activity in the near term. Net exports should continue to benefit from the electronics cycle, commodity demand, and the regional upswing, while household consumption should be supported by higher rural incomes and improving labor markets. A pronounced bounce-back of private investment does not seem in the cards, given still unused capacity, but capital expenditure at public enterprises is expected to pick up. CPI inflation should continue to remain low at about 2 percent for the year while slack is being taken up, although it could spike if key administered prices are adjusted.

- *Risks:* The risks to the outlook are balanced. On the downside, withdrawal of policy support in advanced economies or adverse developments in Europe may undermine global demand and commodity trade, sapping domestic activity. Volatility in international markets could also spill onto local ones, although direct contagion from Europe through financial channels seems unlikely.[1] On the upside, confidence at home and abroad could improve further, intra-regional trade may get a boost from the ASEAN-China free trade agreement in force since January 2010, and revenues from commodity exports could keep trending up.

10. **The outlook for the medium term depends on the scope and speed of the government's own economic transformation program**.

- *Baseline.* Focusing on current policies, the baseline does not factor in the potential growth-dividend of a vigorous implementation of the economic transformation program. GDP growth thus converges to a rate short of that needed to double per capita income over the next decade, as the NEM envisages. At an approximately unchanged real exchange rate, the current account surplus remains sizeable—and probably larger relative to GDP than the ratio

Malaysia: Summary of Medium-Term Macroeconomic Framework, 2007–15

				Proj.					
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real sector (percent change)									
Real GDP growth	6.5	4.7	-1.7	6.7	5.3	5.2	5.1	5.1	5.0
Real domestic demand	9.4	6.0	-2.7	5.6	4.6	4.9	5.3	5.6	6.3
Inflation (period average)	2.0	5.4	0.6	2.0	2.1	2.3	2.5	2.5	2.5
GDP deflator	5.0	10.2	-6.7	2.6	2.6	2.7	2.7	2.7	2.7
Saving and investment (in percent of GDP)									
Gross domestic investment	21.6	19.3	14.5	17.6	18.5	19.3	19.8	20.6	21.1
Private, including stocks	11.9	10.5	3.9	8.5	9.8	10.8	11.7	12.6	13.1
Public	9.6	8.8	10.5	9.1	8.7	8.4	8.1	8.0	8.0
Gross national saving	37.5	36.8	31.0	32.4	32.5	32.4	32.1	32.0	31.6
Private	21.3	25.8	17.5	18.8	19.0	18.6	18.1	17.9	17.3
Public	16.2	11.0	13.5	13.6	13.5	13.8	14.0	14.2	14.3
Current account (in percent of GDP)	15.9	17.5	16.5	14.8	14.0	13.1	12.3	11.4	10.5

Source: IMF staff estimates.

[1] Direct exposure to fiscally strained European countries is small (less than ½ of 1 percent of total assets and 5 percent of capital).

consistent with Malaysia's demographic structure, fiscal position, productivity growth, and net foreign asset position in comparative terms. From a savings-investment perspective, the external imbalance reflects, among other things, impediments to investment and high precautionary savings, which current policies address only partially.

- *Reform scenario*. With stepped-up reforms on a broad front, GDP growth could reach 7 percent by the end of projection period, meeting the goal under the 10th Malaysia Plan. The growth-dividend materializes in the outer years, contingent on the implementation of a critical mass of initiatives. The pace of activity is set by private domestic demand. Private investment is revived by the end of the horizon, compensating for a roll back of public projects. Successful enhancement in social welfare and new business opportunities at home will curb private saving and offset the drag of fiscal consolidation. The current account ratio is some 3 percentage points lower than in the baseline.

Malaysia: Summary of Medium-Term Macroeconomic Framework, 2007–15
(Reform scenario)

				Proj.					
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real sector (percent change)									
Real GDP growth	6.5	4.7	-1.7	6.7	5.3	5.5	5.9	6.4	7.0
Real domestic demand	9.4	6.0	-2.7	5.6	4.6	6.1	7.0	8.7	8.8
Inflation (period average)	2.0	5.4	0.6	2.0	2.1	3.8	3.3	2.8	2.8
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Gross national saving	37.5	36.8	31.0	32.3	32.9	32.4	32.1	31.5	31.2
Private	21.3	25.8	17.5	18.7	18.7	17.7	17.1	15.9	15.0
Public	16.2	11.0	13.5	13.6	14.2	14.7	15.0	15.6	16.3
Current account (in percent of GDP)	15.9	17.5	16.5	14.8	14.0	12.3	10.8	8.9	7.7

Source: IMF staff estimates.

11. **The authorities broadly concurred with these assessments**. The latest official projection is for 2010 growth between 4½ percent and 5½ percent but it predates the first-quarter GDP outturn. The range will likely be revised up in the next forecasting round. There was also agreement at the BNM that inflation probably will remain in check and will not be a policy concern for the period ahead. Regarding the medium term, the authorities shared the view that a meaningful uplift in trend growth requires structural reforms on a broad front. Like the staff, they saw encouraging signs of a renewed political commitment to push the agenda but cautioned that grass-root support was still being harnessed.

III. FROM THE RECESSION TO A HIGH-GROWTH PATH

A. Monetary Policy

Background

12. **Policy normalization is underway**.[2] After aggressive loosening in 2009, the BNM started policy normalization in March 2010. It has since raised the policy rate to 2.75 percent in three quarter-point steps. The firming up of the recovery and the danger of excessive risk

[2] The BNM cut the overnight policy rate by 150 basis points between November 2008 and March 2009. It also slashed the statutory reserve requirements by 300 basis points.

taking in an environment of very low interest rates set the stage for the monetary exit. Robust activity in the second quarter motivated the latest rate increase on July 8, notwithstanding mixed signals from abroad. A flattening of the yield curve suggests a likely pause in the tightening cycle for the rest of the year.

Staff's Views

13. **The measured pace of monetary tightening so far has been on the mark**. It is in line with Taylor-rule calculations and sends a signal against investors' complacency in the pricing of risks after a year and a half of loose monetary conditions. With real rates still below their long-term average, the policy stance is nonetheless still supportive. In the staff's view, this is warranted for two reasons. First, the global recovery remains fragile; and second, fiscal risks suggest giving precedence to budgetary consolidation in sequencing the exits from policy support. In fact, using fiscal policy rather than interest rates to contain demand pressures in the period ahead may discourage speculative inflows.

14. **Moving forward, further withdrawal of monetary support should continue to be contingent on the evolving risks to growth and the need for policy insurance**. The latest hike (after the Article IV discussions) may have put the BNM slightly "ahead of the curve" and the case for staying the course is now even stronger than a month ago. Factors that need to inform monetary decisions in the period ahead include the vigor of the global recovery, second-round effects of possible subsidy reforms, and the spillovers on asset markets from volatile capital movements across borders.

Authorities' Views and Plans

15. **Bank Negara noted that a gradual monetary exit was consistent with the improved outlook, absence of price pressures, and concerns about side-effects of abnormally low interest rates**. In particular, financial imbalances arising from under-pricing of risk, excessive leverage, and financial disintermediation in the search for higher yields could not be ruled out in an environment of very low interest rates. The increase in the policy rate has shored up the return on bank deposits and reduced the risk of vulnerabilities on the asset side of households' balance sheets. From this angle, the latest rate hike has been part of a continued normalization process.

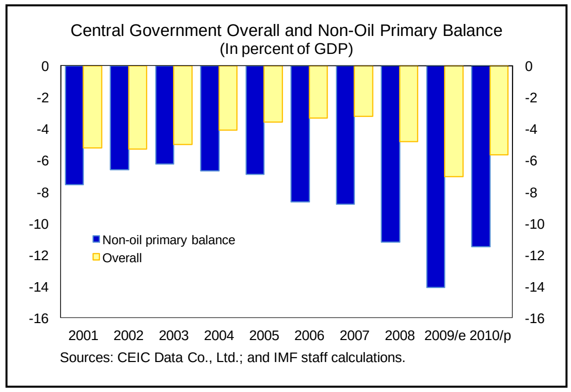
16. **There was agreement that the return to a neutral stance needs to be informed by external as well as internal considerations**. Policy will need to adapt flexibly over the next few quarters. A pragmatic approach had already been reflected in the decision not to reverse the November 2008 cut in reserve requirements which had lost relevance as a policy tool and undercut intermediation. Flexibility had also been shown earlier with the adoption of schemes to maintain the flow of credit to consumers and SMEs. Similar facilities could be re-activated if the conjuncture deteriorated. Finally, the BNM thought that the depth and sophistication of Malaysia's financial sector could spread the impact of sudden capital

movements across a wider set of markets and thus curb the risks posed by volatile flows. However, judicious exchange rate policies are still required to lessen their impact on the real economy.[3]

B. Fiscal Policy

Background

17. **The 2010 budget marks a return to consolidation**. The policy response to the global recession led to rising deficits in 2008 and 2009. While the stimulus was timely, diversified, and appropriate, it has exacerbated fiscal risks. The 2010 budget addresses this situation by targeting a reduction in the deficit for the central government to about 5½ percent of GDP (from 7 percent of GDP last year). The adjustment is skewed to the expenditure side, with economies expected from improved procurement as well as cuts in discretionary spending and transfers. Stimulus in the pipeline from the 2009 packages (which have not been fully deployed yet) offsets in part the policy withdrawal.



18. **Other fiscal initiatives are being considered**. The roll out of the long-delayed *goods and service tax* (GST) has been announced but legislative details are still in the works. The GST is intended to broaden—and stabilize—the tax base by replacing two existing taxes in a revenue-neutral fashion. *Tax incentives* to foreign and domestic companies are also under review as the mandate of the Malaysia Investment Development Agency is being revamped. According to a 2006 World Bank study, tax holidays represent a very large drain on the budget, estimated at about half of total tax revenues. On the expenditure side, the authorities are considering overhauling Malaysia's fragmented and ill-targeted *social safety nets*—a task which will gain prominence if a big push for reforms gets underway and programs to mitigate their transitional costs are developed. Finally, *subsidy reform* has taken center stage in the public discussions—and has become the poster-child of the costs and benefits of structural adjustment. Excluding those for education and health, subsidies account for some 20 percent of government spending or about 5 percent of GDP, with the bulk going to reducing the cost of fuel to consumers and industry.

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[3] Malaysia is the second most open economy in ASEAN after Singapore. Trade is about 1¾ times GDP.

Staff's Views

19. **Fiscal risks in Malaysia have grown over the years**. Policy has been procyclical in good times, setting the stage for unprecedented deficits when budget support was necessary during the crisis. Increased dependence on oil revenue further undermines the public finances.[4] Against this backdrop, the authorities are right in their commitment to strengthen the fiscal position.

20. **Consolidation is needed to reconstitute room for maneuver and forestall market concerns**. The 2010 budget marks a welcome step in this direction. The deficit target, which seemed ambitious when the budget was unveiled, now looks within reach thanks to stronger-than-anticipated growth and oil revenues. Budgetary gains will prove transitory, however, if the broader agenda of fiscal reforms remains unfinished.

21. **Savings can be achieved by rationalizing subsidies and tax structures**. Political realities suggest that s*ubsidy reform* needs to be gradual but sustained. The sooner it starts the better. The broad approach under consideration—centered on periodic reductions of key subsidies with compensatory cash transfers to the most vulnerable groups—seems broadly appropriate, provided that reform fatigue does not set in. Fuel subsidies are particularly ill-targeted and should be prime candidates for reform, unlocking efficiency gains across the economy. The roll out of the *GST* should also not be held back, although some delays on technical grounds may be unavoidable even after the relevant legislation is enacted. More focused outreach and clearer communication may be necessary to galvanize the public debate and mold a consensus. An overhaul of *tax incentives* could also mobilize savings and should be considered in the context of a future reform of corporate taxation.

22. **Malaysia should also strengthen its budget framework along three dimensions**. First, an *indicative consolidation path* along which the deficit is brought back to more manageable levels should inform fiscal plans. This approach could cast budget decisions in a starker multi-year perspective and provide discipline. Second, budget documents could include a *statement of fiscal risks* to assess vulnerabilities surrounding budget outcomes. Publication of the statement could improve transparency (as recommended in the NEM report) and market perceptions. Third, budget decisions could emphasize the evolution of the *non-oil balance* and be benchmarked against a framework that links spending to an equitable drawdown of oil wealth.[5] This approach would lessen the impact of oil price volatility on fiscal planning.

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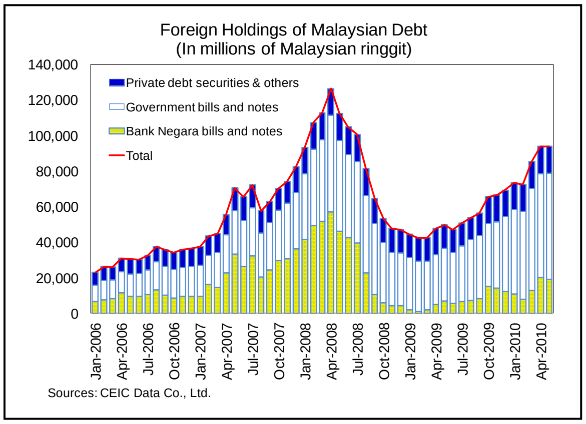
[4] Oil revenues, including the dividend paid to the budget by Petronas, are some 40 percent of total revenues—10 percentage points more than a decade ago.

[5] Malaysia's proven reserves of hydrocarbons amount to 5½ billion barrels of oil and 88 trillion cubic feet of natural gas. Oil is expected to be depleted in about 22 years at the current extraction rate of about 650,000 barrels per day, gas in about 35 years.

Authorities' Views and Plans

23. **Officials at the Ministry of Finance shared the staff's views on the desirable direction of fiscal policy**. They noted that, over the last decade, government demand had to compensate for sluggish private investment, giving the appearance of policy pro-cyclicality. This would likely change going forward, under the reform plans of the NEM and the macroeconomic objectives of the 10MP. The transition to sustainable public finances has started. The policy shift has not been forced by markets since Malaysia's government securities remain an attractive asset for domestic and foreign investors as shown by the successful launching of the global U.S. dollar *sukuk*.



24. **There was also agreement about possible enhancements to Malaysia's fiscal frameworks**. For example, the authorities noted that the 10MP includes an indicative consolidation path for the deficit over the next five years, as recommended in earlier consultations. Fiscal risks are also routinely assessed in the context of the budget process. Nonetheless, the suggestion to flesh out a more formal statement for possible inclusion in the budget documentation is worth considering.

25. **Reforming subsidies, social programs, and tax structures remains a top priority but the timing for action needs to be chosen carefully**. These reforms require spending political capital and need to be sequenced with care. Welfare schemes are under review and the general thrust of past recommendations from the IMF will be reflected in the policy design. Technical assistance from the IMF on tax incentives to corporates is also being sought ahead of the next budget cycle. Subsidy reform holds out the promise of significant budgetary savings in the short term. However, it must be gradual (to give households and firms time to adjust) and it must be complemented by targeted relief measures (to avoid a backlash). Savings from greater efficiency in public service delivery under the Government Transformation Program will also contribute to consolidation. Finally, the authorities agreed that, while the roll out of the GST is on track, a better outreach to the general public and SMEs will increase the buy-in. In the same vein, an anti-profiteering bill has been tabled in parliament to allay concerns that the introduction of the GST may provide a pretext for price gouging.

C. Financial Sector Issues

Background

26. **Malaysia's financial sector has withstood the global recession well**. Thanks to the BNM's proactive supervision, measures to ensure uninterrupted access to financing, and prudent lending practices, loan books did not deteriorate as much as feared and started improving in the second half of 2009. Banks remain well capitalized and liquid, as are insurance companies. There are no obvious vulnerabilities in corporate balance sheets as well.[6] SMEs have benefitted from government guarantee and credit-enhancing schemes as well as developmental programs run by SME Corp, a dedicated government agency. Household debt has been rising, though, partly as a result of official initiatives to promote home ownership. Nonetheless, there are no signs of strains in servicing debt. There are also no signs of systemic froth in property markets.

Key Financial Soundness Indicators for Commercial Banks

	2007	2008	2009	2010 April
Risk-weighted capital ratio	12.8	12.2	14.9	14.6
Share of loans to broad property sector	40.8	40.5	41.0	41.2
Nonperforming loans (gross) to total loans	6.4	4.7	3.6	3.5
Return on assets (ROA)	1.4	1.5	1.2	…
Loan-deposit ratio	77.4	77.0	75.7	78.2

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

27. **Islamic finance has performed as well as conventional finance in the downturn**. Although *sukuk* issuance was lower than in previous years, Malaysia strengthened its position as an Islamic finance hub by introducing last year the world's first *Shariah*-compliant commodity trading platform using palm oil as the underlying commodity.

28. **An international working group is coordinating the modalities of exit from blanket deposit guarantees**. The decisions of the group, which brings together officials from the BNM, the Monetary Authority of Singapore, and the Hong Kong Monetary Authority, will also pave the way for the adoption of enhanced deposit insurance schemes in 2011. In the case of Malaysia, deposit insurance will provide coverage for virtually all depositors including businesses and around 40 percent of deposits. The insurance premium will continue to be risk-based.[7]

29. **A new Central Bank of Malaysia Act was passed in 2009**. The act provides more clarity on the mandate of the BNM and vests with it the necessary powers. Overall, it strengthens the ability of the BNM to undertake surveillance and to avert risks to financial stability. The act also lays out a more robust and transparent governance framework.[8]

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[6] The aggregate debt-to-equity ratio remains below 50 percent and the interest coverage ratio is about 5 percent.

[7] A compensation scheme for holders of insurance and *takaful* products is also in the works.

[8] The act can be found at www.bnm.gov.my/documents/act/cba2009_01.pdf.

Staff's Views

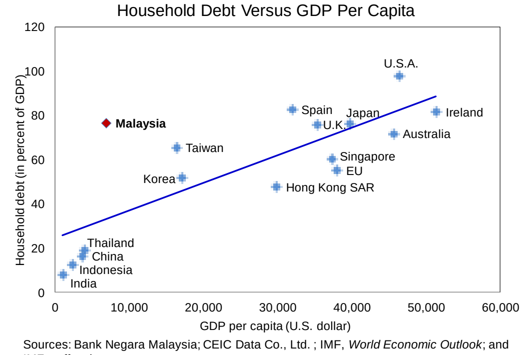
30. **The authorities' sustained efforts to develop capital markets, broaden intermediation, and strengthen risk management have paid off in the global downturn**. Built-in cushions softened the blows from market turbulence and collapsing activity. The Central Bank of Malaysia Act further reinforces the underpinnings of the financial system, among other things by expanding the BNM's ability to resolve financial institutions.

31. **Notwithstanding strong balance sheets, stricter regulations on capital, liquidity and leverage under discussion in international *fora* could be burdensome for local institutions**. For example, the proposed treatment of subsidiaries may put pressure on the capital adequacy of bank holding companies and the proposed treatment of wholesale deposits could erode liquidity buffers at banks. The impact of other reforms in the works (e.g., levies, surcharges on systemically important institutions, "through-the-cycle" provisioning) remains more speculative, given lack of specificity so far on the design of the reform package. As the prudential framework adapts, the BNM's commitment to a hands-on proactive approach will continue to serve Malaysia well. From this angle, there may be a case for a formal broadening of the regulatory perimeter to encompass financial holding companies—a step that would institutionalize current practices.

32. **Plans to unwind by year-end the blanket deposit guarantee and move to an insurance system with higher deposit coverage are welcome**. They ensure international consistency among economies with strong financial linkages and, in all likelihood, make the removal of support a non-event. More broadly, as the regulatory landscape evolves, efforts to upgrade contingency planning and coordinate with supervisors in other jurisdictions will continue to be helpful.

Authorities' Views and Plans

33. **The BNM broadly shared the staff's views on financial sector issues**. Officials noted, however, that the buildup of household debt largely reflected fundamentals and should be seen in the context of Malaysia's quickening pace of household formation. In their view, there are no imminent dangers from the liability side of households' balance sheets.[9]



Sources: Bank Negara Malaysia; CEIC Data Co., Ltd. ; IMF, *World Economic Outlook*; and IMF staff estimates.

[9] The ratio of financial assets to household debt is about 2.5, and the ratio of liquid financial assets to household debt is about 1.5. The fact that this debt is for the most part mortgages also limits risks to banks. Households' NPLs remain low at 3.1 percent at end 2009, down from 4.1 in 2008.

34. **There was also agreement that, despite ample Tier I capital at local institutions, the adoption of some Basel III norms could create pressures in the financial system**. Tighter requirements on liquidity and funding may place onerous demands on some banks, if the sizeable (and stable) deposits of the Employee Provident Fund are treated as wholesale funding for which liquid assets need to be set aside.[10] More broadly, the BNM noted that the international consultative process needs to become more inclusive and some discretion in implementation should be left to the national authorities who can best assess local conditions without compromising the outcome of the regulations.

35. **In the BNM's view, the global crisis has cast a sharp light on Islamic finance**. In the Islamic finance business model, financing can only be extended to real sector activities that have economic value. This principle establishes a close link between financial transactions and productive flows. Exposure to excessive leverage and risk taking is thus curtailed, giving the system added resilience when shocks originate in the financial sector. Accordingly, the appeal of Islamic banking as "ethical banking" has grown—and Malaysia, a hub of Islamic financial services, is well placed to capitalize on the trend. As recognized by the Task Force on Islamic Finance and Global Stability (chaired by Governor Zeti), additional development of *Shariah*-compliant liquidity management and hedging instruments would further underpin the soundness of the system.

36. **The Malaysian authorities have requested to participate in the Financial Sector Assessment Program**. Malaysia has undertaken more than a decade of capacity building and financial reforms under an ambitious Financial Sector Master Plan now in its final phase of implementation. As a result, the efficiency and stability of the financial system have been fundamentally strengthened. There was agreement that participation in the FSAP would reinforce the strong fundamentals already in place and facilitate the identification of areas for further enhancements. The BNM suggests that the FSAP take place next year at the earliest.

D. Priorities for Structural Reforms and Exchange Rate Assessment

Background

37. **Malaysia is stuck in a middle-income trap**. A low-income country at birth in 1957, Malaysia climbed the ladder to attain upper middle-income status in the early 1990.[11] Sectoral shifts (from the primary sector to advanced manufacturing) fuelled growth. Strong foreign investment, a proactive government, and high saving rates facilitated the transition.

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[10] The Employee Provident Fund administers a mandatory defined-contributions pension scheme for all non government employees and the self-employed in the formal economy. It covers some 6 million workers, about half of the labor force.

[11] The World Bank classifies countries as upper middle-income if GNI per capita is in the range \$4,000−\$12,000. Malaysia's per capita income is about \$7,000.

However, the momentum stalled in the run up to the Asia crisis and has never been recovered. Unlike some countries with comparable initial trajectories, Malaysia has so far been unable to breach the high-income threshold.[12]

38. **Growth underperformance in a small open economy suggests supply-side problems**. These are what the NEM tries to address by rolling back affirmative action, improving human capital, and spurring productivity growth—steps necessary to revive the business climate and double Malaysia's per capita income by 2020 (Box 2).

Box 2. The New Economic Model and the Tenth Malaysia Plan[1/]

The New Economic Model (NEM), prepared by the National Economic Advisory Council and unveiled by the government in March, is a program to transform Malaysia into an innovative, knowledge-intensive, and high-income economy by 2020. The overall framework of the NEM identifies strategic reform areas that include enhancing private sector participation in the economy, improving workforce skills, supporting innovation, developing new sources of growth, and strengthening public sector management.

The Tenth Malaysia Plan (2011–2015), released in June, provides the policy framework for implementing many of the NEM's strategic suggestions. Its main macroeconomic objectives are to sustain annual GDP growth at 6 percent on average and to bring gradually down the budget deficit to less than 3 percent of GDP by 2015. Microeconomic objectives include a competition law, further liberalization of services, divestment of some public enterprises, market prices for subsidized commodities, an innovation-friendly environment, and reduced dependence of on foreign labor.

1/ Details can be found at www.neac.gov.my/node/235 and www.epu.gov.my/html/themes/epu/html/RMKE10/rmke10_english.html

39. **The Tenth Malaysia Plan (10MP) makes operational the economic strategy through 2015**. The 10MP provides a broad framework for budgetary allocations. It is to be revised after about two years, in light of progress toward its macroeconomic and social goal-posts. These include raising the shares in GDP of private consumption and investment, promoting high value-added services over low-value added manufacturing, and improving the well-being of the most disadvantaged. The National Economic Advisory Council will refine implementation details later this year.

[12] More successful peers include Korea, Poland, Slovakia, and the Czech Republic.

Staff's Views

40. **The NEM report suggests a sea-change in the attitude toward comprehensive structural reforms**. It sets up a stark choice for Malaysians and their political leadership, a choice between muddling through in a business-as-usual mode and going for a historical transformation of the economy. The report takes on many of the recommendations raised in previous Article IV discussions—reform of government-linked companies, further product and labor market liberalization (including a review of employment protection), improved education and vocational training, and better targeted social safety nets and tax incentives. The agenda is daunting and will require difficult trade-offs, given the tight fiscal envelope.

41. **Implementation needs to be pragmatic but steady**. Acting at a measured pace on a broad front is probably the best way to exploit policy complementarities and harness the benefits of reform. Future elaborations of the roadmap could usefully develop "What if?" scenario analysis to take into account that unforeseen contingencies may force detours from the envisaged transformation plan.

42. **A stronger ringgit over the medium term will help achieve the objectives of the NEM and the 10MP**. An appreciated ringgit in real effective terms will over time facilitate the implementation of the authorities' economic transformation program and contribute to higher real incomes for households, greater capital deepening, faster productivity gains, and demand shifts in favor of services. Subject to the usual wide margin of uncertainty, model-based estimates suggest that the real effective exchange rate (REER) of the ringgit is currently weaker than the level implied by its estimated medium-term determinants (Appendix I). This assessment needs, however, to be seen in a context of structural rigidities that have generated a persistent excess of national savings over investment and significant share of commodities in exports. Moreover, there is no feasible reorientation of the policy mix in the near term (toward a more expansionary fiscal stance and a more restrictive monetary policy) that could speed up the external adjustment without compromising domestic stability—or potentially triggering speculative inflows. In fact, under established exchange rate policies (captured by the appreciation of the ringgit in effective terms since the beginning of the year) the undervaluation could be eliminated over the medium term, thus limiting concerns about Malaysia's external stability (Figure 2).

Authorities' Views and Plans

43. **There was agreement that the reform program needs to be calibrated to political realities**. The authorities' stressed that consensus is still being forged and there are limits to what may realistically be expected in the short run. Nonetheless, the leadership's

commitment to reform is strong and implementation questions are more a matter of "when" or "how" than "if." In their view, it is encouraging that measurable progress had already been made on a variety of fronts, for example in liberalizing services and rolling back social policies that had proved ineffective in addressing income inequality and lack of opportunity.

44. **The authorities share the staff's view that the ringgit will strengthen with the economy over the medium term but disagree strongly with the assessment of the current level of the exchange rate**. They stressed again that Malaysia's exchange rate policies: (i) do not target a particular exchange rate; (ii) have been informed by the need to prevent overshooting in both directions, as evidenced by the massive draw-down of reserves last year; and (iii) are consistent with a gradual appreciation of the currency, as shown by the recent gains of the ringgit REER. The BNM further argues that it is naïve to think that monetary policy can control the real exchange rate and that pre-committing to an appreciation path could at present invite disorderly capital inflows. Moreover, in the BNM's view, the machinery for the assessment is opaque as to the policy implications or the appropriate pace for balance of payments adjustment.[13]

IV. Staff Appraisal

45. **Malaysia has emerged from the global recession with strong forward momentum**. Countercyclical policies and sound fundamentals have paved the way for the broad-based recovery underway. Smooth exits from extraordinary interventions are in train and policy is returning to more normal settings. The authorities should be commended for skillful macroeconomic management.

46. **The cyclical upswing has galvanized the policy debate**. The realization that strategies used to achieve the current state of development are now inadequate to move further up the income ladder has motivated an ambitious agenda for social change. The reform program at the heart of Malaysia's New Economic Model could bring about a far-reaching transformation of the economy and achieve the authorities' goal of doubling per capita income by the next decade.

47. **The authorities have already taken first steps to bolster the public finances**. The 2010 budget marks a commendable return to consolidation. Sustained fiscal adjustment will be necessary to reconstitute policy space and put the debt ratio on a firmly declining path. The indicative consolidation path in the Tenth Malaysia Plan provides a useful benchmark for future budget decisions.

48. **Budgetary gains will prove transitory, however, if a broader agenda of fiscal reforms remains unfinished**. In particular, poorly targeted and distortionary fuel subsidies should be phased out sooner rather than later, and the introduction of a goods and service tax

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[13] Appendix I describes the CGER-methodologies used as well as the authorities' views.

should not be unduly delayed. Malaysia should also enhance its budget framework by articulating as part of the budget documents a statement of fiscal risks and by benchmarking budget decisions against a framework that links spending to an equitable drawdown of oil wealth.

49. **Monetary policy has been appropriately recalibrated to sustain non-inflationary growth**. Bank Negara Malaysia's measured pace of monetary tightening so far has been on the mark. With real rates below their long-term average, the policy stance is still supportive. This is warranted both because the global recovery remains fragile and because fiscal risks suggest giving precedence to budgetary consolidation in sequencing the exits from policy support. With subdued inflation in the forecast and the pace of activity likely to moderate going forward, a wait-and-see approach is appropriate for the period ahead.

50. **Malaysia's financial sector has shown resilience in the global downturn**. The authorities' sustained efforts to develop capital markets, broaden intermediation, and strengthen risk management have paid dividend during challenging times. The Central Bank of Malaysia Act of 2009 further reinforces the underpinnings of the financial system. As the regulatory framework adapts, Bank Negara's commitment to a hands-on proactive approach will continue to serve Malaysia well. Plans to unwind by year-end the blanket deposit guarantee and move to an insurance system with higher deposit coverage are welcome.

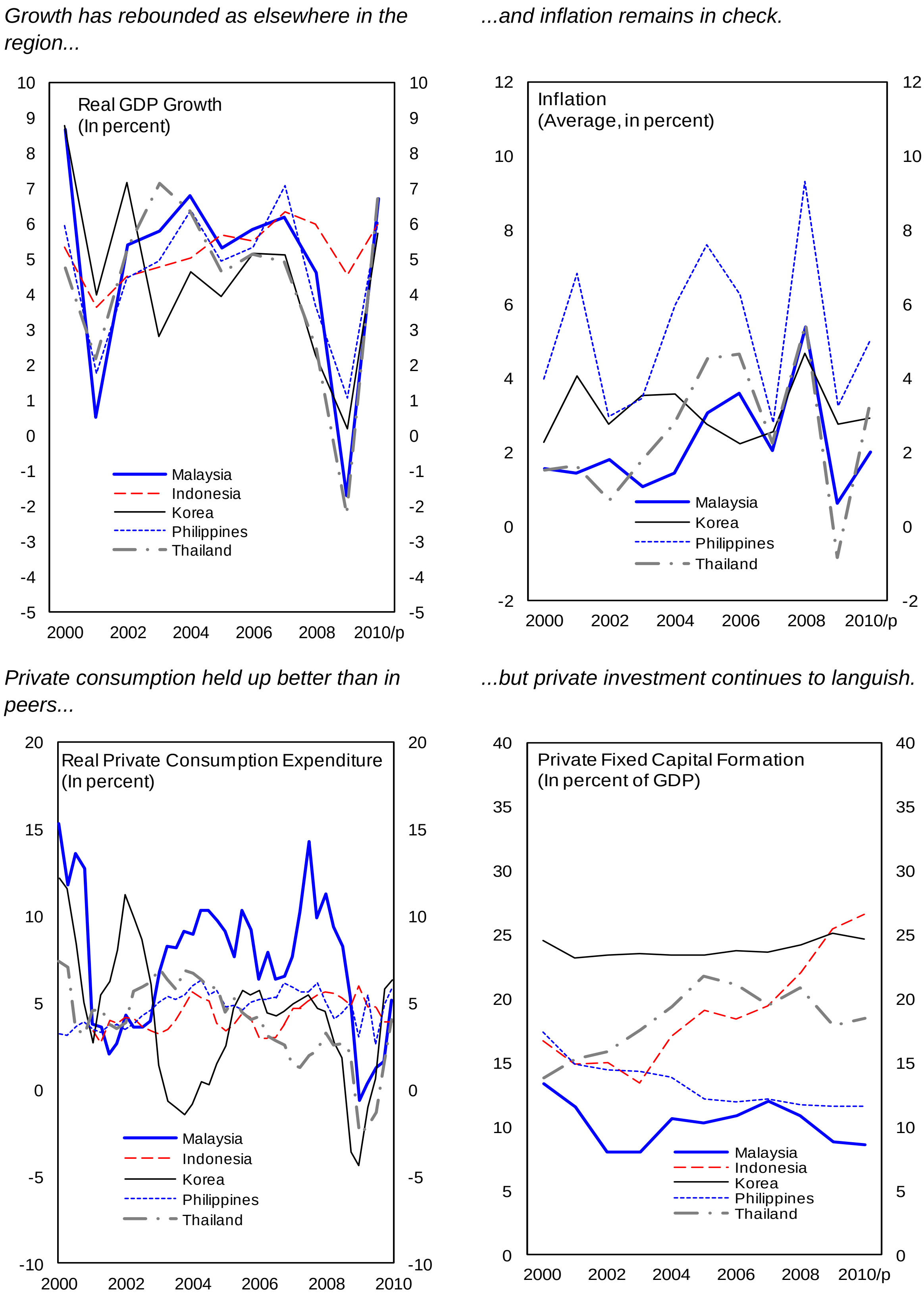
51. **The authorities have laid out a comprehensive vision for a national transformation over the longer term**. The structural reform agenda is daunting and will require difficult trade-offs, given the tight fiscal envelope. Yet, hard choices seem unavoidable to lift productivity growth and living standards. Accordingly, implementation will need to be calibrated to political realities. Acting at a measured pace on a broad front is probably the best way to exploit policy complementarities and harness the benefits of reform. However, careful communication will be needed to sustain the adjustment and pre-empt reform fatigue.

52. **A strengthening over time of the ringgit in real effective terms will facilitate the implementation of the authorities' economic transformation program**. Model-based estimates suggest that the real effective ringgit is below its equilibrium level. The currency is likely to continue to strengthen as structural reforms advance. This appreciation should facilitate the achievement of the authorities' goal of rebalancing the sources of growth toward domestic demand.

53. **Malaysia's request to participate in the Financial Sector Assessment Program (FSAP) is welcome**. A decade of capacity building and financial reforms has greatly strengthened the efficiency and stability of the financial system. Participation in the FSAP should reinforce the strong foundations already in place and facilitate the identification of areas for further enhancements.

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

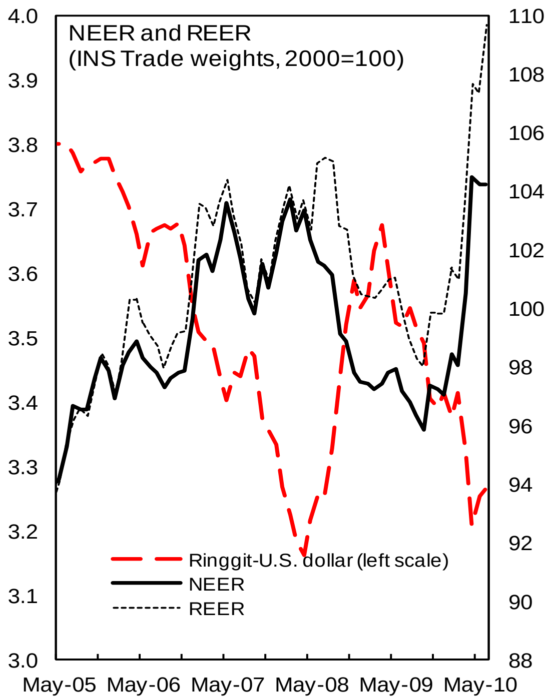
Figure 1. Malaysia: Real Sector Developments and Outlook



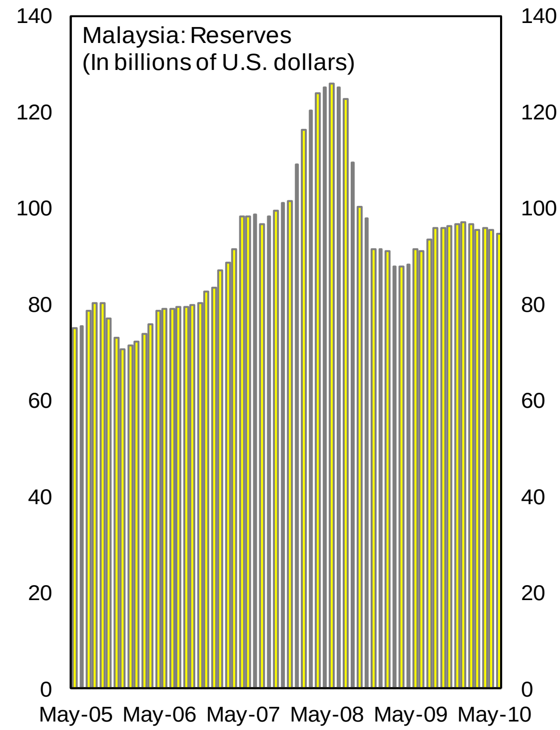
Sources: IMF, *World Economic Outlook*; and APD databases.

Figure 2. Malaysia: Exchange Rate and Monetary Developments

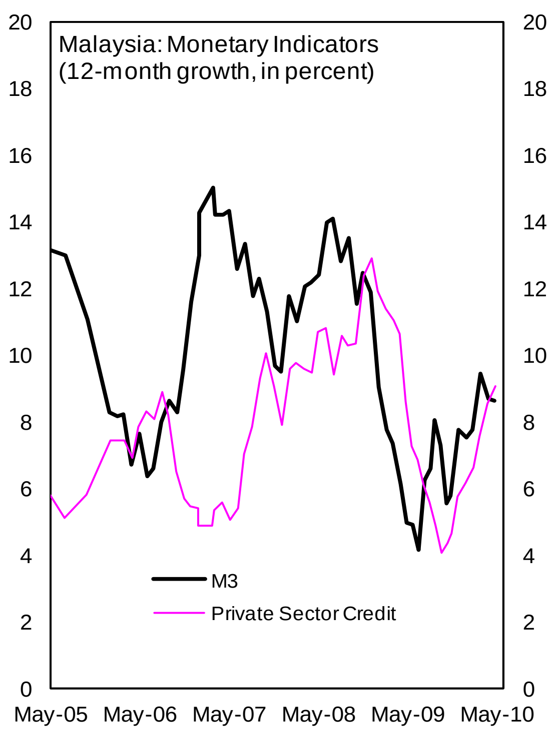
The exchange rate has more than regained lost ground…



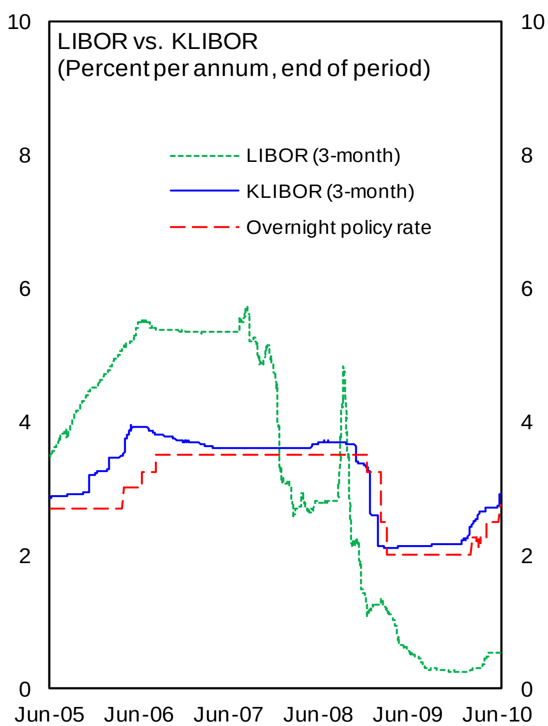
...and reserves have been stable.



The growth rates of broad money and credit are picking up...



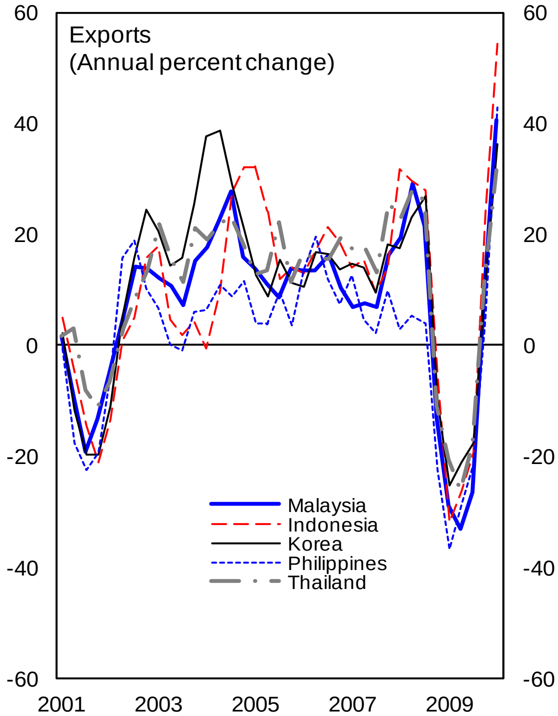
...but interest rates continue to remain relatively low.



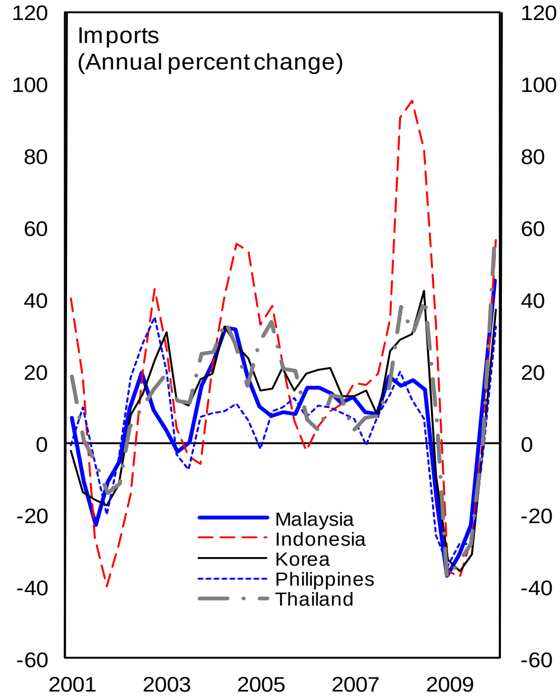
Sources: IMF, *World Economic Outlook*; and APD databases.

Figure 3. Malaysia: External Developments

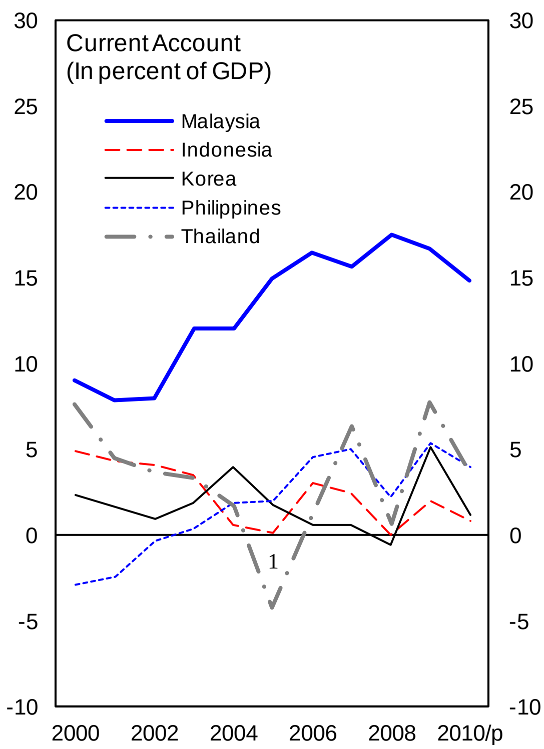
Exports are rebounding sharply...



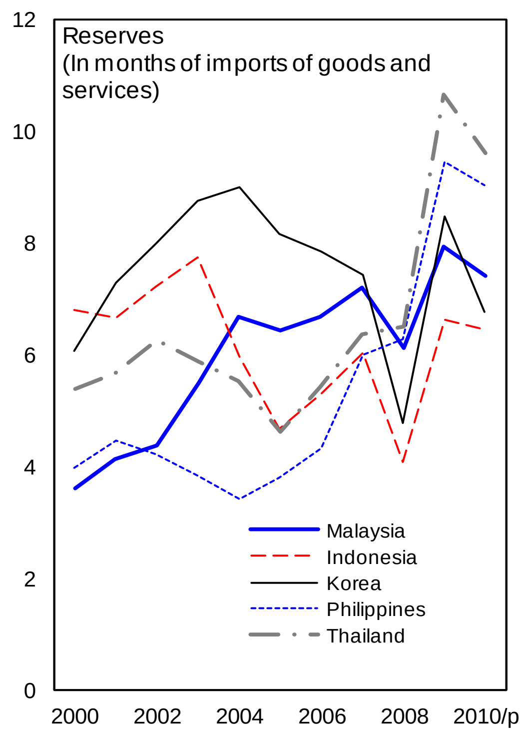
... as are imports.



The current account surplus remains large...



...and reserve coverage is ample.



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

Table 1. Malaysia: Selected Economic and Financial Indicators, 2005–11

Nominal GDP (2009): US$206 billion
Main export (percent of total): electrical & electronic products (39%), commodities (23%)
GDP per capita (2009): US$7,141
Population (2009): 28.3 million
Unemployment rate (2009): 3.7 percent

						Proj.	
	2005	2006	2007	2008	2009	2010	2011
Growth (percent change)							
Real GDP	5.3	5.8	6.5	4.7	-1.7	6.7	5.3
Total domestic demand	5.5	7.7	9.4	6.0	-2.7	5.6	4.6
Consumption	8.5	6.4	9.7	9.0	1.2	5.5	3.2
Private consumption	9.1	6.8	10.5	8.5	0.7	7.0	4.5
Gross capital formation	-2.5	11.3	8.4	-2.3	-14.6	6.1	9.5
Saving and investment (percent of GDP)							
Gross domestic investment	20.0	20.5	21.6	19.3	14.5	17.6	18.5
Gross national saving	35.0	37.2	37.5	36.8	31.0	32.4	32.5
Fiscal sector (percent of GDP)							
Federal government overall balance	-3.6	-3.3	-3.2	-4.8	-7.0	-5.7	-5.6
Revenue	20.3	21.5	21.8	21.6	23.3	22.0	22.1
Expenditure and net lending	23.9	24.8	25.0	26.4	30.4	27.7	27.7
Federal government non-oil primary balance	-6.9	-8.6	-8.8	-11.2	-14.1	-11.5	-10.8
Consolidated public sector overall balance 1/	1.4	-0.3	1.5	-5.6	-3.8	-1.3	-2.3
Total public sector gross debt 2/	59.3	54.2	48.6	48.7	61.7	62.3	63.2
Inflation and unemployment (period average,percent)							
CPI inflation	3.0	3.6	2.0	5.4	0.6	2.0	2.1
Unemployment rate	3.5	3.3	3.2	3.3	3.7	3.5	3.2
Money and credit (end of period, percentage change)							
Broad money (M3)	8.8	13.6	7.9	10.5	7.8	…	…
Lending to nonbank private sector	9.1	6.8	9.2	10.2	6.5	…	…
Three-month interbank rate (percent)	2.9	3.7	3.6	3.6	2.2	…	…
Balance of payments (US$ billions)							
Trade balance	34.1	37.4	37.6	51.2	40.2	40.7	41.4
Exports, f.o.b.	142.5	160.9	176.1	199.3	157.3	182.1	196.8
Imports, f.o.b.	108.5	123.5	138.5	148.1	117.2	141.4	155.4
Services and income account	-8.9	-6.7	-3.3	-7.1	-2.8	-2.6	-2.6
Current account balance	20.7	26.1	29.7	38.9	31.8	32.3	33.0
(In percent of GDP)	15.1	16.7	15.9	17.5	16.5	14.8	14.0
Financial account balance	-9.8	-11.7	-11.3	-35.4	-22.8	-23.0	-26.0
Overall balance	3.6	6.9	13.2	-5.5	3.9	9.3	7.0
Gross official reserves (US$ billions)	70.5	82.5	101.3	91.4	96.7	106.1	113.1
(In months of following year's imports)	5.8	5.9	6.8	7.6	6.8	6.9	6.8
(In percent of short-term debt) 3/	373.5	466.2	495.4	275.8	363.3	396.2	427.1
Total external debt (US$ billions)	52.3	52.2	56.7	68.2	68.3	68.2	67.4
(In percent of GDP)	38.0	33.5	30.3	30.7	35.4	31.2	28.5
Short-term external debt (percent of total) 3/	36.1	33.8	36.1	48.7	39.0	39.3	39.3
Debt-service ratio							
(In percent of exports of goods and services)	5.3	4.8	3.8	2.6	6.5	2.7	2.7

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

1/ Capital expenditure in the budget includes foreign fixed assets and other items, such as purchase of shares and land, which are excluded from public investment in the national accounts.
2/ Excludes financial public enterprises and nongovernment-guaranteed domestic debt of the nonfinancial public enterprises.
3/ By remaining maturity.

Table 2. Malaysia: Indicators of External Vulnerability, 2005–10

	2005	2006	2007	2008	Prel. 2009	Proj. 2010
Financial indicators						
Public sector debt (in percent of GDP) 1/	59.3	54.2	48.6	48.7	61.7	62.3
Total liquidity (M3: percent change, 12-month basis)	8.8	13.6	7.9	10.5	7.8	8.5
Private sector credit (percent change, 12-month basis)	9.1	6.8	9.2	10.2	6.5	7.5
Treasury bill interest rate (percent, 12-month basis, average) 2/	2.5	3.2	3.4	3.4	2.1	…
External indicators						
Exports (percent change, 12-month basis in U.S. dollars)	12.4	12.9	9.4	13.2	-21.1	15.7
Imports (percent change, 12-month basis in U.S. dollars)	9.3	13.9	12.1	7.0	-20.9	20.7
Current account balance (in billions of U.S. dollars)	20.7	26.1	29.7	38.9	31.8	32.3
Current account balance (in percent of GDP)	15.1	16.7	15.9	17.5	16.5	14.8
Capital and financial account balance (in billions of U.S. dollars)	-9.8	-11.7	-11.3	-35.4	-22.8	-23.0
Gross official reserves (in billions of U.S. dollars)	70.5	82.5	101.3	91.4	96.7	106.1
(In months of imports of goods and services of the following year)	5.8	5.9	6.8	7.6	6.8	6.9
Short-term foreign assets of the financial sector (in billions of U.S. dollars) 3/	9.8	15.6	29.8	21.1	21.9	...
Short-term foreign liabilities of the financial sector (in billions of U.S. dollars)	15.9	13.9	21.8	23.7	21.2	...
Gross official reserves/total liquidity (M3) (in percent)	39.6	38.5	40.6	34.9	32.4	...
Gross official reserves/monetary base (in percent)	506.0	502.4	528.5	474.6	601.9	...
Total short-term external debt by original maturity (in billions of U.S. dollars)	12.4	12.1	16.5	23.0	22.7	22.4
Total short-term external debt by remaining maturity (in billions of U.S. dollars)	18.9	17.7	20.5	33.2	26.6	26.8
Total short-term external debt by original maturity to reserves (in percent)	17.6	14.7	16.3	25.1	23.5	21.1
Total short-term external debt by original maturity to total debt (in percent)	23.7	23.2	29.1	33.7	33.3	32.9
Total short-term external debt by remaining maturity to reserves (in percent)	26.8	21.4	20.2	36.3	27.6	25.2
Total short-term external debt by remaining maturity to total debt (in percent)	36.1	33.8	36.1	48.7	39.0	39.3
Total external debt (in billions of U.S. dollars)	52.3	52.2	56.7	68.2	68.3	68.2
Of which: Public and publicly guaranteed debt	22.8	21.3	18.6	24.1	24.9	25.4
Total external debt to exports of goods and services (in percent)	31.2	27.5	26.1	28.2	34.7	30.2
External amortization payments to exports of goods and services (in percent)	4.0	3.4	2.6	1.7	5.2	1.7
Financial market indicators						
Kuala Lumpur Composite Index (KLCI), end of period	900	1,096	1,445	877	1,273	...
Ten-year sovereign bond spread (bps)	53	48	143	317	116	...

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

1/ Excludes unguaranteed domestic debt of the non-financial public enterprises.
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, 2005–11

	2005	2006	2007	2008	2009	Proj. 2010	Proj. 2011
	(In billions of U.S. dollars)						
Current account balance	20.7	26.1	29.7	38.9	31.8	32.3	33.0
Trade balance	34.1	37.4	37.6	51.2	40.2	40.7	41.4
Exports, f.o.b.	142.5	160.9	176.1	199.3	157.3	182.1	196.8
Imports, f.o.b.	108.5	123.5	138.5	148.1	117.2	141.4	155.4
Services and income balance	-8.9	-6.7	-3.3	-7.1	-2.8	-2.6	-2.6
Receipts	25.1	30.2	40.8	42.3	39.9	43.5	46.0
Of which: Income	5.4	8.5	11.4	12.0	11.2	11.7	12.0
Payments	33.9	36.9	44.1	49.4	42.7	46.2	48.6
Of which: Income	11.8	13.2	15.4	19.1	15.3	17.5	18.9
Net transfers	-4.5	-4.5	-4.6	-5.2	-5.6	-5.7	-5.8
Capital and financial account	-9.8	-11.7	-11.3	-35.4	-22.8	-23.0	-26.0
Capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-9.8	-11.7	-11.3	-35.4	-22.8	-23.0	-26.0
Net foreign direct investment	1.0	0.0	-2.7	-7.8	-6.5	-3.3	-3.5
Portfolio Investment	-3.7	3.5	5.4	-25.3	0.2	-2.2	-2.4
Other Investment	-7.1	-15.2	-14.0	-2.2	-16.5	-17.5	-20.1
Errors and omissions	-7.3	-7.5	-5.2	-9.0	-5.1	0.0	0.0
Overall balance	3.6	6.9	13.2	-5.5	3.9	9.3	7.0
Overall financing	-3.6	-6.9	-13.2	5.5	-3.9	-9.3	-7.0
Gross official reserves	70.5	82.5	101.3	91.4	96.7	106.1	113.1
In months of following year's imports of goods and nonfactor services	5.7	5.9	6.8	7.6	6.8	6.9	6.8
In percent of short-term debt 1/	373.5	466.2	495.4	275.2	362.9	396.2	427.1
	(In percent of GDP)						
Current account balance	15.1	16.7	15.9	17.5	16.5	14.8	14.0
(Excluding oil)	12.4	13.8	13.1	14.5	14.4	12.3	11.6
Trade balance	24.8	24.0	20.1	23.0	20.8	18.6	17.5
Exports	103.7	103.2	94.2	89.7	81.5	83.2	83.2
Imports	78.9	79.2	74.1	66.6	60.7	64.6	65.7
Services and income balance	-6.4	-4.3	-1.7	-3.2	-1.4	-1.2	-1.1
Capital and financial account	-7.1	-7.5	-6.0	-15.9	-11.8	-10.5	-11.0
Net foreign direct investment	0.7	0.0	-1.4	-3.5	-3.4	-1.5	-1.5
	(Annual percentage change)						
Memorandum items:							
Export value growth	12.4	12.9	9.4	13.2	-21.1	15.7	8.1
Export volume growth	7.2	6.9	1.3	2.8	-11.0	7.8	7.0
Import value growth	9.3	13.9	12.1	7.0	-20.9	20.7	9.9
Import volume growth	7.7	9.8	4.5	2.0	-17.7	20.7	8.5
Terms of trade	2.8	1.4	0.9	1.5	1.0	-1.9	-0.3

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

1/ By remaining maturity.

Table 4. Malaysia: Illustrative Medium-Term Macroeconomic Framework, 2008–2015 1/

			Proj.					
	2008	2009	2010	2011	2012	2013	2014	2015
Real sector (percent change)								
Real GDP growth	4.7	-1.7	6.7	5.3	5.2	5.1	5.1	5.0
Real domestic demand	6.0	-2.7	5.6	4.6	4.9	5.3	5.6	6.3
CPI inflation (period average)	5.4	0.6	2.0	2.1	2.3	2.5	2.5	2.5
Saving and investment (percent of GDP)								
Gross domestic investment	19.3	14.5	17.6	18.5	19.3	19.8	20.6	21.1
Private, including stocks	10.5	3.9	8.5	9.8	10.8	11.7	12.6	13.1
Public	8.8	10.5	9.1	8.7	8.4	8.1	8.0	8.0
Gross national saving	36.8	31.0	32.4	32.5	32.4	32.1	32.0	31.6
Private	25.8	17.5	18.8	19.0	18.6	18.1	17.9	17.3
Public	11.0	13.5	13.6	13.5	13.8	14.0	14.2	14.3
Fiscal sector (percent of GDP)								
Federal government overall balance	-4.8	-7.0	-5.7	-5.6	-5.3	-5.0	-4.7	-4.5
Revenue	21.6	23.3	22.0	22.1	22.3	22.2	22.1	21.9
Expenditure and net lending	26.4	30.4	27.7	27.7	27.6	27.2	26.8	26.4
Federal government non-oil primary balance	-11.2	-14.1	-11.5	-10.8	-10.1	-9.4	-8.6	-8.0
Consolidated public sector overall balance 2/	-5.6	-3.8	-1.3	-2.3	-2.1	-1.8	-1.6	-1.4
Total public sector debt 3/	48.7	61.7	62.3	63.2	63.8	64.1	64.1	63.9
Of which: federal government debt	41.4	53.3	54.4	55.9	57.0	57.8	58.3	58.5
Balance of payments (in billions of U.S. dollars)								
Trade balance	51.2	40.2	40.7	41.4	41.6	41.5	41.4	40.1
Services and income balance	-7.1	-2.8	-2.6	-2.6	-2.2	-1.7	-1.5	-1.2
Current account balance	38.9	31.8	32.3	33.0	33.5	33.9	34.0	33.7
(In percent of GDP)	17.5	16.5	14.8	14.0	13.1	12.3	11.4	10.5
Capital and financial account balance	-35.4	-22.8	-23.0	-26.0	-24.9	-25.5	-26.4	-27.4
Errors and omissions	-9.0	-5.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-5.5	3.9	9.3	7.0	8.6	8.4	7.6	6.3
International trade (annual percent change)								
Export value	13.2	-21.1	15.7	8.1	7.5	7.8	8.0	8.1
Import value	7.0	-20.9	20.7	9.9	9.4	9.7	9.9	10.4
Terms of trade	1.5	1.0	-1.9	-0.3	0.3	0.3	0.3	0.7
Gross official reserves (in billions of U.S. dollars)	91.4	96.7	106.1	113.1	121.7	130.0	137.6	143.9
(In months of following year's imports of GNFS)	7.6	6.8	6.9	6.8	6.7	6.6	6.3	6.3
(In percent of short-term debt) 4/	275.8	363.3	396.2	427.1	464.8	502.6	538.1	569.5
Total external debt (in billions of U.S. dollars)	68.2	68.3	68.2	67.4	66.6	65.7	64.9	64.0
(In percent of GDP)	30.7	35.4	31.2	28.5	26.1	23.8	21.8	19.9
Short-term external debt (percent of total) 4/	48.7	39.0	39.3	39.3	39.3	39.4	39.4	39.5
Debt-service ratio								
(In percent of exports of goods and non-factor services)	2.8	6.9	2.8	2.8	2.6	2.4	2.2	2.1
Memorandum item:								
Nominal GDP (In billions of ringgit)	741	680	744	804	868	937	1,012	1,091

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

1/ Period ending December 31.
2/ Capital expenditure in the budget includes foreign fixed assets and other items, such as purchase of shares and land, which are excluded from public investment in the national accounts.
3/ Staff projections; excludes non-government guaranteed domestic debt of the non-financial public enterprises (NFPEs). The projections assume no off-budget operations. Surplus NFPEs are assumed to roll over external debt.
4/ By remaining maturity.

Table 5. Malaysia: Federal Government Fiscal Operations, 2005–10

	2005	2006	2007	2008	Prel. 2009	Budget 2010	Staff Proj. 2010
			(In percent of GDP)				
Total revenues	20.3	21.5	21.8	21.6	23.3	20.0	22.0
Tax revenue	15.4	15.1	14.8	15.2	15.7	13.9	15.1
Non-oil tax revenue	12.3	11.1	11.3	11.6	11.5	11.1	11.6
Taxes on net income and profits 1/	7.5	7.1	7.6	7.8	7.5	7.6	7.8
Sales tax and excises 2/	4.1	3.5	3.3	3.4	3.7	3.3	3.5
Taxes on international trade	0.7	0.5	0.4	0.4	0.3	0.2	0.3
Oil tax revenue	3.2	4.0	3.5	3.6	4.2	2.8	3.6
Nontax revenue	4.9	6.4	7.0	6.3	7.7	6.0	6.9
Oil	2.7	3.9	4.4	4.8	5.1	4.5	4.6
Other	2.2	2.6	2.6	1.5	2.6	1.5	2.3
Total expenditures	23.9	24.8	25.0	26.4	30.4	25.4	27.7
Current expenditure	19.2	19.0	19.4	20.9	23.2	18.9	20.7
Wages and salaries	4.9	5.0	5.1	5.5	6.3	5.7	5.8
Other expenditure on goods and services	4.2	4.3	4.3	4.0	4.3	3.1	3.7
Interest payments	2.2	2.2	2.0	1.7	2.1	2.1	2.1
Subsidies and transfers	7.8	7.6	8.0	9.7	10.5	7.9	9.0
Of which: Fuel subsidies	2.1	1.3	1.2	2.4	0.9	1.3	1.3
Development expenditure	4.8	5.8	5.6	5.5	7.2	6.5	7.0
Overall balance	-3.6	-3.3	-3.2	-4.8	-7.0	-5.4	-5.7
Current balance	1.2	2.5	2.4	0.7	0.2	1.1	1.3
Primary balance 3/	-1.4	-1.2	-1.2	-3.1	-4.9	-3.3	-3.5
Non-oil primary balance 4/	-6.9	-8.6	-8.8	-11.2	-14.1	-10.5	-11.5
Financing	3.6	3.3	3.2	4.8	7.0	5.4	5.7
External	-0.7	-0.5	-0.7	-0.1	-0.9	0.0	0.0
Domestic	4.3	3.9	3.9	4.9	8.0	5.4	5.7
Memorandum items:							
Consolidated public sector							
Revenue and grants	34.5	35.5	37.6	33.6	39.0	35.2	37.1
NFPE operating surplus	10.9	10.5	12.3	8.0	12.0	11.3	11.2
NFPE development expenditure	6.6	8.0	8.0	10.0	9.7	7.4	7.6
Overall balance	1.4	-0.3	1.5	-5.6	-3.8	-0.9	-1.3
NFPE balance (incl. net lending and accounts payable)	4.4	1.8	4.0	-2.4	1.7	3.3	3.3

Sources: Data provided by the 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, 2007–09

	2007	2008				2009			
		Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
	(In millions of ringgit; end of period)								
Net foreign assets	290,797	311,076	313,936	278,389	257,381	267,976	268,092	278,022	287,990
Foreign assets	429,263	476,857	496,647	442,543	373,449	379,759	381,047	386,554	389,220
Foreign liabilities	138,466	165,781	182,711	164,154	116,068	111,783	112,955	108,533	101,230
Net domestic assets	542,225	571,048	575,248	627,056	663,403	668,228	667,181	677,621	704,579
Net domestic credit	713,458	738,848	755,303	807,787	842,779	859,310	875,638	897,061	930,348
Net credit to nonfinancial public sector	-5,380	-3,635	-13,716	2,865	27,676	36,888	40,408	45,272	56,385
Credit to private sector	675,853	690,796	715,703	743,182	744,912	751,597	759,734	776,793	792,975
Net credit to other financial corporations	42,985	51,688	53,315	61,741	70,191	70,824	75,495	74,995	80,988
Capital accounts	124,833	126,140	143,056	152,246	145,172	156,991	171,219	181,856	183,490
Other items (net)	-46,401	-41,660	-36,999	-28,485	-34,204	-34,091	-37,237	-37,584	-42,278
Broad money	833,022	882,124	889,184	905,445	920,784	936,204	935,274	955,643	992,569
Narrow money	174,305	178,485	181,475	187,429	191,271	188,719	196,891	203,863	213,871
Currency in circulation	36,246	38,612	39,102	43,117	40,431	40,795	40,883	42,467	43,438
Transferable deposits	138,059	139,872	142,373	144,313	150,840	147,923	156,008	161,397	170,433
Other deposits	610,065	656,301	656,906	665,318	681,748	706,980	701,634	720,160	750,070
Securities other than shares	48,556	47,317	50,705	52,620	47,606	40,326	36,628	31,620	28,628
Repurchase agreements	96	22	98	78	159	179	121	0	0
	(Contribution to 12-month growth in broad money)								
Net foreign assets	3.5	3.3	0.6	-0.9	-4.0	-4.9	-5.2	-0.1	3.3
Net domestic assets	4.4	7.0	9.5	12.1	14.5	11.0	10.3	5.6	4.5
Memorandum items:									
Broad money (12-month percent change)	7.9	10.3	10.1	11.2	10.5	6.1	5.2	5.5	7.8
Currency in circulation (12-month percent change)	14.9	14.1	16.3	20.5	11.5	5.7	4.6	-1.5	7.4
Money Multiplier (broad money/narrow money)	4.8	4.9	4.9	4.8	4.8	5.0	4.8	4.7	4.6

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

Table 7. Malaysia: Banks' Financial Soundness Indicators, 2005–10

	2005	2006 7/	2007	2008	2009	2010 April
			(In percent)			
Risk-weighted capital ratio (RWCR) 1/	13.7	13.5	13.2	12.6	15.4	15.1
Commercial banks	13.6	13.1	12.8	12.2	14.9	14.6
Merchant banks	19.1	20.8	23.0	30.2	35.3	32.4
Share of loans to broad property sector 2/	41.0	40.3	40.5	40.3	40.9	41.1
Commercial banks	42.5	40.5	40.8	40.5	41.0	41.2
Merchant banks	29.9	25.3	21.6	17.1	14.7	13.7
Nonperforming loans (gross) to total loans 3/	9.6	8.5	6.5	4.8	3.7	3.5
Commercial banks	9.2	8.4	6.4	4.7	3.6	3.5
Merchant banks	20.4	18.8	12.7	15.3	12.0	10.5
Nonperforming loans (net) to total loans 3/	5.8	4.8	3.2	2.2	1.8	1.8
Commercial banks	5.6	4.8	3.2	2.2	1.8	1.8
Merchant banks	12.1	8.4	4.9	3.7	2.9	3.9
General provisions of the banking system 4/	1.8	1.7	1.7	1.7	1.6	1.8
Commercial banks	1.7	1.7	1.7	1.7	1.6	1.8
Merchant banks	2.4	2.2	2.2	2.7	1.7	1.8
Total outstanding bad-debt provision of the banking system 5/	59.1	64.6	77.3	89.0	95.3	97.8
Commercial banks	59.2	64.4	77.2	88.9	95.4	98.1
Merchant banks	56.7	70.9	80.7	94.4	90.6	81.0
Return on Assets (ROA)	1.4	1.3	1.5	1.5	1.2	…
Commercial banks	1.3	1.2	1.4	1.5	1.2	…
Loan-deposit ratio 6/	80.5	72.9	74.1	74.7	73.6	76.0
Commercial banks	81.6	76.1	77.4	77.0	75.7	78.2
Merchant banks	27.6	17.0	16.4	13.2	12.2	12.6

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 provisions.
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. According to the CGER, the ringgit is weaker than its estimated equilibrium level. For example, according to the macroeconomic balance approach, the current account norm is significantly below the projected current account (based on unchanged real exchange rate), implying a relatively large undervaluation.

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 of the REER so far this year) would probably eliminate the bulk of the undervaluation over the medium term; and (ii) reforms in the works should reduce the savings-investment balance over time. In fact, under the Reform Scenario in paragraph 10 of the main report, the implied undervaluation under the macroeconomic balance approach would be modest.

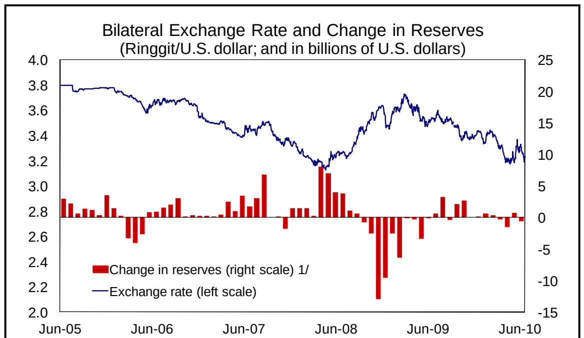
Authorities' Views

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 this and the previous 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 8½ percentage point increase in the current account as a share of GDP since 2001.

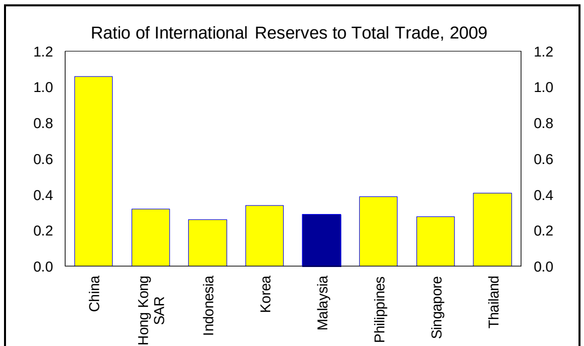
- *The current account surplus also has a large structural component.* It reflects high private saving because of demographics and underdeveloped social safety nets, and relatively weak investment demand in a context of market imperfections and structural shifts. (Tellingly, Malaysia's investment abroad 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 potentially volatile capital flows. 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 2009. 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—from August 2008 to June 2009.[1] In the presence of open capital markets and financial deepening, intervention has thus safeguarded financial stability.



Sources: Bloomberg L.P.; and Bank Negara Malaysia.
1/ Latest data reflect the reserve position as of end-December.

- *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). In the run up to the global crisis, reserve accumulation has also proved farsighted during a commodity upswing of uncertain duration.



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

- *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 policymaking.* 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.

[1] Data on market operations are not publicly available, but the size and direction of intervention can be inferred from the reported change in official foreign exchange reserves.

- *Regardless of its merit, public divulgation of the current staff assessment could trigger unwelcome capital inflows.* These would greatly complicate macroeconomic management. Even assuming for a moment that it is correct, the assessment provides no clue as to a desirable or feasible timeframe to manage external adjustment

- *Finally, the BNM argued that over-emphasis on the exchange rate to do the heavy-lifting for adjustment is too simplistic.* The ringgit appreciation should be seen as the complement of structural change not the main driver. The focus of policy is to ensure that the exchange rate does not inhibit the transformation.

INTERNATIONAL MONETARY FUND

MALAYSIA

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the Asia and Pacific Department

July 16, 2010

Contents Page

ANNEX I: MALAYSIA—MEDIUM-TERM DEBT SUSTAINABILITY ANALYSIS

1. **The public debt is projected to increase relative to GDP over the medium term**. Under the baseline scenario, the public debt would increase to about 59 percent of GDP by 2015. Bound tests indicate that the public debt ratio would increase more in case of shocks. The most severe shock—a decline in real GDP growth of about 1½ percentage point relative to the baseline—would take public debt to GDP ratio to about 70 percent in 2015. Several factors mitigate fiscal risks. First, ample domestic savings allow the government to meet its borrowing requirements with ease and without foreign borrowing. Second, the 2010 budget has marked the return to fiscal consolidation. Other enhancements in fiscal structures discussed in this report will also strengthen the sustainability of the public finances.

2. **The external debt is expected to decline relative to GDP to about 20 percent by 2015 in the baseline projection**. These dynamics reflects for the most part projected current account surpluses and a reduction in private and public indebtedness due to stepped-up repayments. 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 the external debt to GDP ratio at about 30 percent in 2015.

Table I.1. Malaysia: External Debt Sustainability Framework, 2005–2015

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2005	2006	2007	2008	2009			2010	2011	2012	2013	2014	2015	Debt-stabilizing non-interest current account
Baseline: External debt	37.9	33.5	30.3	30.7	35.4			31.2	28.5	26.1	23.8	21.8	19.9	1.6
Change in external debt	-4.4	-4.4	-3.2	0.4	4.7			-4.2	-2.7	-2.4	-2.2	-2.0	-1.9	
Identified external debt-creating flows (4+8+9)	-17.1	-23.2	-22.6	-7.4	-5.8			-14.4	-13.0	-12.0	-11.0	-10.0	-9.0	
Current account deficit, excluding interest payments	-16.6	-18.1	-16.9	-18.7	-18.0			-15.8	-14.8	-13.9	-13.0	-12.1	-11.2	
Deficit in balance of goods and services	-22.8	-22.5	-20.3	-23.0	-21.3			-20.0	-19.3	-18.4	-17.5	-16.6	-15.4	
Exports	117.5	116.5	110.1	103.3	96.1			97.8	97.6	97.1	96.8	96.7	96.7	
Imports	94.6	94.1	89.9	80.3	74.8			77.8	78.3	78.6	79.2	80.0	81.3	
Net nondebt creating capital inflows (negative)	2.0	-2.3	-1.4	14.9	6.1			2.5	2.5	2.5	2.5	2.5	2.5	
Automatic debt dynamics 1/	-2.5	-2.9	-4.3	-3.5	6.1			-1.1	-0.6	-0.5	-0.5	-0.4	-0.4	
Contribution from nominal interest rate	1.6	1.5	1.2	1.3	1.4			1.0	0.9	0.8	0.8	0.7	0.7	
Contribution from real GDP growth	-2.0	-2.0	-1.8	-1.2	0.6			-2.1	-1.5	-1.4	-1.2	-1.1	-1.0	
Contribution from price and exchange rate changes 2/	-2.0	-2.4	-3.8	-3.6	4.1			…	…	…	…	…	…	
Residual, including change in gross foreign assets (2-3) 3/	12.7	18.8	19.5	7.7	10.5			10.2	10.3	9.6	8.8	8.0	7.1	
External debt-to-exports ratio (in percent)	32.3	28.7	27.5	29.7	36.8			31.9	29.2	26.9	24.6	22.6	20.6	
Gross external financing need (in billions of US dollars) 4/	-2.5	-6.9	-11.6	-18.4	1.2			-5.7	-6.2	-7.0	-7.7	-8.1	-8.1	
In percent of GDP	-1.8	-4.5	-6.2	-8.3	0.6			-2.6	-2.6	-2.7	-2.8	-2.7	-2.5	
Scenario with key variables at their historical averages 5/						Average	Deviation	31.2	27.0	22.1	16.5	10.2	3.3	0.8
						Historical	Standard							
Key macroeconomic assumptions underlying baseline						Average	Deviation							
Real GDP growth (in percent)	5.3	5.8	6.5	4.7	-1.7	4.8	3.1	6.7	5.3	5.2	5.1	5.1	5.0	
GDP deflator in U.S. dollars (change in percent)	5.0	6.8	12.6	13.5	-11.7	4.5	7.2	6.3	2.6	2.7	2.7	2.7	2.7	
Nominal external interest rate (in percent)	4.2	4.5	4.4	5.0	4.0	4.3	0.5	3.2	3.1	3.1	3.2	3.2	3.2	
Growth of exports (U.S. dollar terms, in percent)	12.6	12.1	13.3	11.5	-19.2	7.5	12.5	15.3	7.9	7.4	7.6	7.8	8.0	
Growth of imports (U.S. dollar terms, in percent)	10.2	12.3	14.6	6.1	-19.1	7.4	13.3	17.8	8.8	8.4	8.8	9.1	9.6	
Current account balance, excluding interest payments	16.6	18.1	16.9	18.7	18.0	14.7	3.4	15.8	14.8	13.9	13.0	12.1	11.2	
Net nondebt creating capital inflows	-2.0	2.3	1.4	-14.9	-6.1	-1.0	6.2	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in 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 $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

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, 2005–2015

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	44.4	43.2	42.7	42.8	55.4	55.2	56.6	57.6	58.4	58.9	59.2	-1.7
Of which: foreign-currency denominated	5.7	4.4	3.1	2.7	2.0	2.3	2.0	1.7	1.5	1.3	1.1	
Change in public sector debt	-1.3	-1.3	-0.4	0.1	12.5	-0.2	1.4	1.0	0.8	0.5	0.3	
Identified debt-creating flows (4+7+12)	-1.3	-2.3	-2.2	-2.3	9.4	-0.2	1.4	1.0	0.8	0.5	0.3	
Primary deficit	0.7	-0.1	0.5	1.5	3.4	2.4	3.2	2.8	2.5	2.2	2.0	
Revenue and grants	23.7	25.0	25.3	25.6	27.0	25.9	26.0	26.2	26.1	26.0	25.8	
Primary (noninterest) expenditure	24.4	24.9	25.8	27.1	30.3	28.3	29.2	29.0	28.7	28.2	27.8	
Automatic debt dynamics 2/	-2.0	-2.2	-2.7	-3.8	6.0	-2.6	-1.8	-1.8	-1.7	-1.7	-1.7	
Contribution from interest rate/growth differential 3/	-2.0	-1.8	-2.5	-3.9	6.0	-2.6	-1.8	-1.8	-1.7	-1.7	-1.7	
Of which: contribution from real interest rate	0.2	0.6	0.0	-2.2	5.2	0.8	0.9	1.0	1.0	1.0	1.1	
Of which: contribution from real GDP growth	-2.2	-2.4	-2.5	-1.7	0.8	-3.4	-2.7	-2.7	-2.7	-2.8	-2.7	
Contribution from exchange rate depreciation 4/	0.0	-0.4	-0.3	0.1	0.0	…	…	…	…	…	…	
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 (2-3) 5/	0.0	1.0	1.8	2.5	3.2	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	187.9	172.6	168.7	167.4	205.2	212.9	217.7	219.8	223.4	226.7	229.7	
Gross financing need 6/	7.4	6.0	7.8	6.8	13.1	8.7	14.2	10.7	12.0	10.7	10.5	
In billions of U.S. dollars	10.2	9.4	14.7	15.2	25.3	19.0	33.5	27.4	33.2	32.0	33.8	
Scenario with key variables at their historical averages 7/						55.2	55.5	55.8	56.1	56.4	56.7	-1.3
Scenario with no policy change (constant primary balance) in 2010–2015						55.2	55.8	56.4	57.1	57.8	58.6	-1.7
Key macroeconomic and fiscal assumptions underlying baseline												
Real GDP growth (in percent)	5.3	5.8	6.5	4.7	-1.7	6.7	5.3	5.2	5.1	5.1	5.0	
Average nominal interest rate on public debt (in percent) 8/	5.4	5.5	5.4	4.8	4.7	4.3	4.6	4.6	4.7	4.7	4.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.8	1.6	0.4	-5.4	11.3	1.7	2.0	2.0	2.0	2.0	2.1	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	0.5	7.0	6.8	-4.5	1.2	…	…	…	…	…	…	
Inflation rate (GDP deflator, in percent)	4.6	3.9	5.0	10.2	-6.7	2.6	2.6	2.7	2.7	2.7	2.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	-1.1	8.0	10.5	9.7	10.3	-0.4	8.5	4.6	3.7	3.4	3.4	
Primary deficit	0.7	-0.1	0.5	1.5	3.4	2.4	3.2	2.8	2.5	2.2	2.0	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = 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 $\alpha\varepsilon(1+r)$.

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, 2010)

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	1,204.41	81.02
Reserve position in Fund	282.19	18.98

III. SDR Department:	**SDR million**	**Percent Allocation**
Net cumulative allocation	1,346.14	100.00
Holdings	1,355.27	100.68

IV. Outstanding Purchases and Loans: None.

V. Financial Arrangements: None.

VI. Projected Obligations to Fund: None.

VII. Exchange Arrangement:

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

Malaysia maintains bilateral payments arrangements with 23 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 2002−10. 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 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, and a relaxation of the conditions on residents and nonresidents to enter into foreign exchange forward contracts to hedge capital account transactions with licensed onshore banks. In 2008, further measures were undertaken, including easing of rules on residents' borrowing in foreign currency, and borrowing in ringgit by residents from nonresidents as well as lending in ringgit by residents to nonresidents for use in Malaysia.

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, in accordance with the UN Security Council resolutions, maintains restrictions on payments and transfers for current international transactions with respect to some designated individuals and entities. These measures are maintained for the reasons of national and international security and have been notified to the Fund pursuant to the IMF Executive Board Decision No. 144-(52/51). Malaysia also restricts 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 (IMF Country Report No. 09/253).

IX. FSAP Participation:

Malaysia has formally requested to participate in the FSAP next year.

X. Technical Assistance:

FAD: Mission in October 2008 to analyze the distributional impact of social safety net programs.

MCM: 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. Workshops in October 2009 on assessing the systemic implications of financial linkages and developing early warning indicators for the insurance and corporate sectors at BNM. Mission in October 2009 on macrofinancial risk analysis and vulnerability analysis for corporate and financial institutions.

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 on Money Laundering (APG). The full report was adopted by APG members in July 2007 (http://www.apgml.org/documents/docs/17/Malaysian%20MER%20-%20FINAL%20August%202007.pdf).

XII. Resident Representative/Advisor: None.

ANNEX IV: MALAYSIA—STATISTICAL ISSUES

As of June 17, 2010

I. Assessment of Data Adequacy for Surveillance
General: Data provision is broadly adequate for surveillance. However, further efforts to improve statistics for the consolidated public sector are necessary.
National accounts: Currently, the Department of Statistics Malaysia (DOSM) compiles and publishes annual and quarterly estimates of GDP by activity and by expenditure at current and constant prices, and annual estimates for gross disposable income, saving, and net lending for the economy based on the *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. **Price statistics**: 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.
Government finance statistics: There is a need to improve the timeliness, detail, and availability of data on NFPEs and the state and local governments. Dissemination of more detailed data on nonlisted NFPEs' assets and liabilities and domestic and foreign financing by type of debt instrument and holder would be desirable; efforts in this direction will require continued close collaboration among the Economic Planning Unit (EPU), the Treasury, and Bank Negara Malaysia (BNM).
Monetary statistics: The monetary and financial statistics (MFS) are reported on a timely and regular basis and are broadly in conformity with the Fund's data needs. There is a need to improve the institutional coverage of the financial corporations, sectorization of the domestic economy, and classification and valuation of financial instruments to ensure full adherence to the IMF's *Monetary and Financial Statistics Manual.* In addition, due to the growing importance of insurance corporations, pension funds, and other financial intermediaries in Malaysia, coverage of MFS should be expanded to include these institutions. The MFS missions of January 2004 and 2005 developed an integrated monetary database to be used for publication and operational needs of the BNM, STA, and APD. The Bank Negara Malaysia reports data in STA's standardized report forms (SRFs) which provide more detailed classification of certain items, fuller sectoral and instrument breakdown, and currency aggregation. MFS based on the SRFs are published in the quarterly *IFS Supplement on Monetary and Financial Statistics*.
Balance of payments: Department of Statistics Malaysia compiles and publishes quarterly balance of payments estimates in accordance with the 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.
II. Data Standards and Quality
Malaysia subscribes to the Special Data Dissemination Standard (SDDS). It is using a timeliness flexibility option for general government operations (within six-quarter lags after the end of reference year).

Malaysia: Table of Common Indicators Required for Surveillance

(As of June 15, 2010)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	06/15/10	06/15/10	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	05/10	06/10	Bi-W	Bi-W	Bi-W
Reserve/base money	05/10	06/10	Bi-W	Bi-W	Bi-W
Broad money	04/10	06/10	M	M	M
Central bank balance sheet	05/10	06/10	Bi-W	Bi-W	Bi-W
Consolidated balance sheet of the banking system	04/10	06/10	M	M	M
Interest rates[2]	06/15/10	06/15/10	D	D	M
Consumer price index	04/10	05/10	M	M	M
Revenue, expenditure, balance and composition of financing[3]—general government[4]	2008	09/09	A	A	A
Revenue, expenditure, balance and composition of financing[3]—federal government	2010:Q1	06/10	Q	Q	Q
Stocks of central government and central government-guaranteed debt[5]	2010:Q1	06/10	Q	Q	Q
External current account balance	2010:Q1	06/10	Q	Q	Q
Exports and imports of goods and services	04/10	06/10	M	M	M
GDP/GNP	2010:Q1	05/10	Q	Q	Q
Gross external debt	2010:Q1	05/10	Q	Q	Q

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

Statement by the IMF Staff Representative on Malaysia
July 30, 2010

The information below has become available following the issuance of the staff report. It does not alter the thrust of the staff appraisal.

Economic developments. High-frequency data suggest that Malaysia's expansion remains on track. Consumption indicators are strong, suggesting continued household confidence, while industrial production experienced in May the third consecutive month of double-digit year-on-year growth. Declining momentum for exports and industrial output suggest, however, a slower pace of activity in the quarters ahead. Inflation is not a concern at present. The June CPI was 1.7 percent higher than a year earlier and in line with the staff's projections.

Policy developments. On July 16, 2010, the government reduced subsidies for some key commodities. The price of sugar has been raised by 15 percent; low-octane gasoline and diesel prices have been increased by some 3 percent, and the price of liquefied petroleum gas has gone up by about 6 percent. High-octane gasoline is no longer subsidized. Although these measures fall short of earlier official proposals, they mark the beginning of the subsidy reform program highlighted in the New Economic Model and advocated by the Fund in past consultations.

INTERNATIONAL MONETARY FUND
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700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2010 Article IV Consultation with Malaysia

On July 30, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Malaysia.[1]

Background

Malaysia has come out strongly from the world recession. Forceful counter-cyclical policies, sound balance sheets, and intra-regional trade have primed the recovery. With rebounding domestic and global demand, output losses have by now been reversed. With strong momentum in late 2009 and the first quarter of 2010, seasonally-adjusted GDP is now close to pre-crisis levels, reversing a nearly 6½ percent peak-to-trough loss. Labor markets are also tightening after showing resilience throughout the downturn. The unemployment rate for 2009 peaked at about 3¾ percent, better than anticipated at the time of the 2009 Article IV consultations. Vacancies in manufacturing are now close to their pre-crisis peak but slack in other sectors remains. Malaysia's external position remains strong.

Malaysia's financial sector has withstood the global recession well. Thanks to the Bank Negara Malaysia's proactive supervision, measures to ensure uninterrupted access to financing, and

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[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

prudent lending practices, loan book did not deteriorate as much as feared and started improving in the second half of 2009. Banks and insurance companies remain well capitalized and liquid. Corporate balance sheets are sound. Supported by policy, credit growth remained positive even as output shrunk. It is now gaining steam on its own benefitting from strong demand for consumer loans and mortgages. The recovery in business lending is also robust.

With countercyclical support delivered and the recovery on firmer ground, policy normalization is underway. The monetary tightening so far has been broadly appropriate and the stance remains accommodative. The 2010 budget marks a welcome return to consolidation. The global downturn has energized a rethinking of the development strategy, and medium- and longer-term development issues top the policy agenda.

Malaysia's near-term prospects are favorable. GDP is projected to expand by around 7 percent in 2010. As positive base effects play out and policy support is reeled in, growth should moderate in 2011. Both external and private domestic demand will propel activity in the near term.

Executive Board Assessment

Executive Directors commended the authorities for their sound fundamentals and forceful countercyclical policies, which helped Malaysia emerge from the global downturn with a strong forward momentum. A broad-based recovery is underway and policies are returning to more normal settings. The challenge now is to make progress toward the authorities' target of economic growth and structural transformation.

Directors welcomed the consolidation effort in the 2010 budget. They stressed that a sound and sustained fiscal adjustment is necessary to put the public debt ratio on a downward path and encouraged the authorities to follow the indicative deficit path proposed in the Tenth Malaysia Plan. Directors commended the authorities for their decision to reduce subsidies and encouraged them to persevere with reforms in this area while being mindful of the impact on the poor. They welcomed the intention to introduce a goods and service tax, which would broaden the tax base and lessen the dependence on volatile oil revenues, and encouraged its timely implementation. In addition, the budget framework could be further enhanced by benchmarking budget decisions against a framework that links spending to an intergenerationally equitable drawdown of oil wealth.

Directors considered that monetary policy has been appropriately recalibrated to sustain non-inflationary growth. The measured pace of monetary normalization adopted by Bank Negara Malaysia will help prevent financial imbalances in an environment of low interest rates while still supporting aggregate demand and limiting the drag on growth from needed fiscal consolidation.

Directors took note of the staff's assessment that the ringgit appears to be weaker than its equilibrium level in real effective terms. They generally agreed with the authorities' view that a stronger ringgit could boost over time the role of domestic demand as a growth driver and promote a shift toward higher-value added industries.

Directors recognized that continued efforts by the authorities to develop capital markets, broaden intermediation, and strengthen risk management have paid dividend during challenging times. They welcomed the new Central Bank Act, which reinforces the underpinnings of the financial system. Directors also commended the authorities' decision to participate in the Financial Sector Assessment Program.

Directors acknowledged the authorities' ambitious vision for a far-reaching economic transformation over the longer term. They agreed that the comprehensive structural reform agenda, at the heart of the New Economic Model, holds out promise of faster and inclusive growth. Directors looked forward to a decisive effort and sustained momentum in implementing this agenda. An effective communication strategy could help forge broad public support for these efforts. Further gradual liberalization of product and labor markets will help exploit policy complementarities, encourage private investment and harness the benefits of reform.

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. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2010 Article IV Consultation with Malaysia is also available.

Malaysia: Selected Economic and Financial Indicators, 2005–11

	2005	2006	2007	2008	2009	Proj. 2010	2011
Growth (percent change)							
Real GDP	5.3	5.8	6.5	4.7	-1.7	6.7	5.3
Total domestic demand	5.5	7.7	9.4	6.0	-2.7	5.6	4.6
Consumption	8.5	6.4	9.7	9.0	1.2	5.5	3.2
Private consumption	9.1	6.8	10.5	8.5	0.7	7.0	4.5
Gross capital formation	-2.5	11.3	8.4	-2.3	-14.6	6.1	9.5
Saving and investment (percent of GDP)							
Gross domestic investment	20.0	20.5	21.6	19.3	14.5	17.6	18.5
Gross national saving	35.0	37.2	37.5	36.8	31.0	32.4	32.5
Fiscal sector (percent of GDP)							
Federal government overall balance	-3.6	-3.3	-3.2	-4.8	-7.0	-5.7	-5.6
Revenue	20.3	21.5	21.8	21.6	23.3	22.0	22.1
Expenditure and net lending	23.9	24.8	25.0	26.4	30.4	27.7	27.7
Federal government non-oil primary balance	-6.9	-8.6	-8.8	-11.2	-14.1	-11.5	-10.8
Consolidated public sector overall balance 1/	1.4	-0.3	1.5	-5.6	-3.8	-1.3	-2.3
Total public sector gross debt 2/	59.3	54.2	48.6	48.7	61.7	62.3	63.2
Inflation and unemployment (period average, percent)							
CPI inflation	3.0	3.6	2.0	5.4	0.6	2.0	2.1
Unemployment rate	3.5	3.3	3.2	3.3	3.7	3.5	3.2
Money and credit (end of period, percentage change)							
Broad money (M3)	8.8	13.6	7.9	10.5	7.8	…	…
Lending to nonbank private sector	9.1	6.8	9.2	10.2	6.5	…	…
Three-month interbank rate (percent)	2.9	3.7	3.6	3.6	2.2	…	…
Balance of payments (US$ billions)							
Trade balance	34.1	37.4	37.6	51.2	40.2	40.7	41.4
Exports, f.o.b.	142.5	160.9	176.1	199.3	157.3	182.1	196.8
Imports, f.o.b.	108.5	123.5	138.5	148.1	117.2	141.4	155.4
Services and income account	-8.9	-6.7	-3.3	-7.1	-2.8	-2.6	-2.6
Current account balance	20.7	26.1	29.7	38.9	31.8	32.3	33.0
(In percent of GDP)	15.1	16.7	15.9	17.5	16.5	14.8	14.0
Financial account balance	-9.8	-11.7	-11.3	-35.4	-22.8	-23.0	-26.0
Overall balance	3.6	6.9	13.2	-5.5	3.9	9.3	7.0
Gross official reserves (US$ billions)	70.5	82.5	101.3	91.4	96.7	106.1	113.1
(In months of following year's imports)	5.8	5.9	6.8	7.6	6.8	6.9	6.8
(In percent of short-term debt) 3/	373.5	466.2	495.4	275.8	363.3	396.2	427.1
Total external debt (US$ billions)	52.3	52.2	56.7	68.2	68.3	68.2	67.4
(In percent of GDP)	38.0	33.5	30.3	30.7	35.4	31.2	28.5
Short-term external debt (percent of total) 3/	36.1	33.8	36.1	48.7	39.0	39.3	39.3
Debt-service ratio							
(In percent of exports of goods and services)	5.3	4.8	3.8	2.6	6.5	2.7	2.7

Sources: Data provided by the authorities and IMF staff estimates.
1/ Capital expenditure in the budget includes foreign fixed assets and other items, such as purchase of shares and land, which are excluded from public investment in the national accounts.
2/ Excludes financial public enterprises and nongovernment-guaranteed domestic debt of the nonfinancial public enterprises.
3/ By remaining maturity.

Statement by Duangmanee Vongpradhip, Executive Director for Malaysia and Seng Guan Toh, Senior Advisor to Executive Director
July 30, 2010

Introduction

1. The authorities of Malaysia would like to thank the IMF team, led by Mr. Alessandro Zanello, for the 2010 Article IV Consultations. The discussions, which were cordial yet candid, have provided helpful views on the far-reaching reform plans that are now underway in Malaysia as it emerges from the impact of the global recession.

Recent Economic Developments and Outlook

2. Since experiencing the full brunt of the global recession in the first quarter of 2009, the Malaysian economy has established a clear recovery. Private consumption had already turned positive in Q2 2009, and combined with the upswing in external demand resulted in the resumption of solid positive growth by the fourth quarter. Consequently, a decline of only 1.7% was recorded for 2009 as a whole, significantly better than the contraction of 4-5% earlier envisaged. The growth momentum accelerated further to reach +10.1% (y-o-y) in the first quarter of 2010, reflecting a broad-based recovery. Growth is being driven by continued expansion in domestic demand due mainly to higher private consumption, a modest recovery in private investment and sustained support from public sector spending. Higher regional demand also provided further impetus to growth through positive spillover effects on production, employment and overall sentiments. On the supply side, both the manufacturing and services sectors are showing robust growth, while the contribution from Malaysia's agricultural and mining base remains substantial amidst favorable commodity prices.

3. The measures introduced by the Malaysian Government in response to the global crisis reinvigorated domestic demand, preventing the economy from slipping into a fundamental economic recession. The measures centered around three broad areas, namely, fiscal policy (two stimulus packages amounting to 9.9% of GDP), monetary easing (the Overnight Policy Rate was reduced by a total of 150 basis points to 2.0%), and comprehensive measures to ensure continued access to finance. Meanwhile, the stability in the domestic financial system allowed financial intermediation to continue smoothly and reinforced the expansionary fiscal and monetary influences on domestic demand. On external demand, the stabilization and subsequent gradual recovery in the global economy since mid-2009 provided support to Malaysia as a highly open economy. In particular, the strong recovery in the Asian regional economies benefited Malaysia. The recovery in exports became more broad-based towards end-2009 as exports to several advanced economies also began to recover.

4. For the rest of 2010, economic growth is expected to remain strong, supported by continued expansion in both domestic and external demand. While the pace of growth may taper off a little in the second half as base effects diminish, indicators of economic activity for April and May have continued to show strength. Going forward, growth would be increasingly driven by private sector activity as the fiscal stimulus starts to wind down going

into 2011. Private consumption would be supported by strengthened consumer confidence and improvements in already favorable employment conditions, which have not only recouped most of the crisis-related job losses but have also seen a recovery in wages. Private investment has also started to turnaround, in line with the strengthening of global trade and increasing domestic demand, reinforced by improved business confidence and supportive financing conditions. For external demand, while downside risks remain in the advanced economies, emerging economies in general, and Asia in particular, have shown a higher degree of resilience and better prospects for sustained recovery. In 2009, Malaysia's exports to Asia (excluding Japan) accounted for 56% of total exports. Moving forward, regional demand will become an increasingly important part of Malaysia's external demand profile as domestic demand across Asia strengthens further, spurred on by the region's better employment conditions and uninterrupted credit flows combined with planned investment in infrastructure and robust growth in intra-regional trade. In view of the foregoing trends, the authorities have projected that real GDP could expand by 6% in 2010 compared with 4.5 – 5.5% projected earlier.

5. Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), averaged 0.6% in 2009 (2008: 5.4%). Disinflationary pressures from the significant drop in global commodity prices, especially for crude oil, and the increasing slack in the economy over the course of the downturn drove the marked decline in headline inflation. Headline inflation would remain modest in 2010. In the first half of 2010, inflation averaged 1.4%. Inflation is expected to rise slightly in the second half of the year reflecting the improving economic conditions and adjustments to administered prices and subsidy reforms by the Government. In the absence of further price revisions and price-related external developments, inflation in Malaysia will remain contained.

6. The external position of Malaysia remained strong despite the weaker external environment in 2009. The trade surplus declined but remained sizeable as a sharp contraction in exports offset in part the decline in intermediate imports, while tourist arrivals from the Asian region were robust. As at end-March 2010, external debt declined further to the equivalent of 30% of GDP (less than a third of which is short-term), reflecting net repayments and the appreciation of the ringgit. After declining from a peak of almost US$126 billion due to the global crisis-related deleveraging of late 2008, the level of international reserves has remained relatively stable for over a year now and was equivalent to US$94.8 billion as at July 15, 2010.

7. On capital flows, while Malaysia has been a longstanding recipient of sizeable inward FDI, a recent development is a large increase in investment abroad (outward FDI) by Malaysian companies, as staff have also noted. These flows amounted to as much as 6.8% of GDP in 2008, and continued to a lesser extent in 2009 due to the effects of the global crisis. This reflects in part the strategy of a number of established Malaysian companies to "go regional" within Asia. Given the relatively small domestic market, regional and global expansions allow Malaysian companies to achieve greater economies of scale by tapping into new and larger markets. Generally, Malaysian companies that invested abroad have also enhanced their domestic operations by moving up the production value chain in order to establish an integrated supply chain with their overseas subsidiaries. These trends, over the

medium term, will benefit the economy by developing more competitive and globalized Malaysian companies, expanding job opportunities for Malaysians, and sustaining higher inflows from profit repatriation. On portfolio investment flows, while the magnitude of the reversals in late 2008 were larger than the net outflows recorded at the height of the Asian crisis, the impact on the domestic economy was limited. The continued development of the debt market over the years, together with strong and sound banking system, have allowed for the diversification of the composition of portfolio flows into Malaysia, spreading out the impact across markets and minimizing disruptions. The availability of foreign reserves has also enabled Bank Negara Malaysia to accommodate these outflows and minimize the volatility of the ringgit exchange rate.

Policy Discussions

Monetary Policy

8. With clear signs of an economic recovery, Bank Negara Malaysia (BNM) has taken steps to normalize interest rates since March 2010. The extraordinary conditions under which the interest rates were reduced no longer prevail. The concern was that maintaining an extremely low interest rate environment for an extended period could encourage excessive risk taking behavior, and the unhealthy build up of leverage. At the same time, it could lead to financial disintermediation. Such developments could lead to financial imbalances that would undermine the recovery process, while reducing the longer term growth potential of the economy. Notwithstanding the move to normalize interest rates, and given lingering uncertainties surrounding the future path of the global economy, the overall stance of monetary policy will continue to remain accommodative to provide support to domestic economic activity. Price pressures are expected to be modest going forward. On the demand side, output is still recovering from low levels, while on the supply side, the impact of the Government's subsidy reforms on consumer prices is assessed to be transitory and manageable. Thus, monetary policy in 2010 will focus on promoting the sustainability of economic recovery and ensuring that financing continues to be available to the private sector at reasonable cost.

Fiscal Policy

9. Fiscal policy is in the process of exiting from the large, well-timed stimulus provided in the past year. The process of fiscal consolidation which began in 2002 was interrupted by the 2008 global financial crisis. However, the Government remains steadfast in its commitment to pursue fiscal discipline and will resume fiscal consolidation in 2010. From a peak of 7.0% of GDP in 2009, the fiscal deficit is expected to decline markedly to 5.6% of GDP in 2010. The better-than-expected growth outturn in the last two quarters and improved oil revenues this year are expected to strengthen Government finances.

10. Measures to improve the effectiveness and efficiency of Government expenditure and revenue collection continue to be given utmost priority. The policy intent has been articulated in the 10th Malaysia Plan. Initiatives include, among others, cutting back on non essential spending, achieving greater value for money in Government procurement, optimizing the use

of Government assets, adopting outcome based budgeting, rationalizing existing government organizations and structures, intensifying public-private partnership programs as well as rationalizing subsidies. Fiscal sustainability will also be enhanced through specific targets set for deficit and debt reduction by 2015. The deficit is anticipated to be less than 3% of GDP while debt to GDP ratio, less than 50% by 2015. More importantly, the role of the Government over the medium term has been clearly spelt out – that of an enabler and facilitator for private sector activities. In this regard, to provide a more level playing field and business opportunities for the private sector, the Government will systematically reduce its holdings and divest non-core businesses of government-linked companies as well as undertake privatization of MOF Inc. companies.

11. In addition, concurrent efforts to broaden the non-oil revenue as well as the narrow tax base are being addressed comprehensively. The first reading of the bill on Goods and Services Tax (GST) was tabled in Parliament in December 2009. The Government is undertaking further outreach activities to educate the public and the business sectors as well as putting in place administrative measures to ensure smooth implementation of the GST. Changes to the tax assessment system for upstream petroleum-related activities in Budget 2010 have also assisted in eliminating lags in assessment, thereby facilitating budget planning.

12. The Government recently undertook a bold move to reduce subsidies for fuel (petrol, diesel, liquefied petroleum gas) and sugar. The rationalizing of selected subsidies, which were undertaken after wide public consultation, will yield savings of RM750 million in 2010. The health and education sectors will be the beneficiaries of the savings. Fuel subsidy remains the single largest expenditure item while reducing the subsidy on sugar will improve health outcomes. The subsidy rationalization program is part of the broader reform agenda to remove distortions in the economy, improve competitiveness and market efficiency as well as ensure a more optimal use of scarce resources. The politically courageous move by the Government exemplifies its determination for reform, not only to put the fiscal position on a long term sustainable footing, but also enhance efficiencies in the economy. In tandem with these measures, the Government is putting in place additional mechanisms to provide offsetting support to the poor. The existing social safety net is also being reviewed to achieve better targeting and effectiveness, and the authorities credited the Fund’s TA mission last year for bringing the issue into the central policy debate. No less important than fiscal savings is the relevance and quality of governance of the Government’s public delivery system. In this regard, the Government Transformation Program (GTP) launched late last year has shown good results, seen in new assistance reaching more than a quarter of the hardcore poor, declining crime indices, online publication of government contracts, and enhancements being put in place for pre-school and primary education.

Financial Sector

13. The Malaysian financial system displayed resilience despite the challenging conditions in 2009. Banking institutions and insurance companies remain well-capitalized and liquid. Prompt measures taken by banks as early as 2008 to shore up capital served to avoid a constriction in lending during the economic downturn. Loan growth expanded by

7%. Precautionary measures instituted to widen guarantees on deposits and expand access to BNM's liquidity facilities helped sustain a high level of confidence in the system and continued access to funding throughout the crisis period. None of these facilities have in fact been drawn upon. Banks were proactive in restructuring facilities with viable borrowers. Credit flows to small and medium enterprises (SMEs) were sustained, supported further by guarantee schemes that were put in place. Meanwhile, Islamic finance in Malaysia continued to progress on a path of sustained growth despite the global financial crisis. As an increasingly important component of the global financial system, there has been greater recognition of the significant prospects for Islamic finance to contribute towards global growth and financial stability. Over the past year, Malaysia reinforced its role as an international center for the issuance of *sukuk* while introducing innovations such as a *Shariah*-compliant commodity trading platform.

14. BNM in the recent period has further enhanced its prudential framework, supervisory arrangements and processes, and surveillance frameworks. The focus of work has spanned further refinements in stress testing approaches, improved supervisory cooperation across agencies and borders, enhancements to risk and information capture, liquidity support and resolution, and a further strengthening of the financial safety net. New approaches to analyze risks were explored, including through workshops conducted with Fund assistance. The coming into force of the new Central Bank of Malaysia Act 2009 (CBA) further strengthened BNM's mandate and powers for financial stability. In addition to formalizing governance frameworks, it significantly expands capabilities to deal with systemic risk. For example, the CBA allows resolution powers even for institutions beyond BNM's regulatory purview where such institutions present a risk to financial stability. With the implementation of the ten-year Financial Sector Master Plan almost completed, a new blueprint is being prepared to chart the transformation of the Malaysian financial sector over the next decade beginning 2011. The Financial Sector Assessment Program (FSAP) exercise that the authorities have agreed to would reinforce the strong fundamentals achieved, and at the same time, contribute to identifying areas for further improvements.

Exchange Rate Developments

15. For a small and highly open economy like Malaysia, the exchange rate policy has served the economy well in balancing between stability and flexibility. The focus has been to maintain orderly foreign exchange market conditions in the short term while ensuring that the ringgit is not misaligned against the country's fundamentals over the medium to longer term. It is important to note that under the managed float regime, the ringgit's exchange rate is determined by market forces and Malaysia has no particular target for the exchange rate level. Intervention operations have been limited to ensure orderly market conditions and to prevent extreme volatility in the currency.

16. On balance, since the adoption of the managed float regime in July 2005, the ringgit has been broadly on a path of appreciation, reaching a high of RM3.1315 in April 2008 (an appreciation of 21.3%), before subsequently depreciating as the global financial crisis began to exert downward pressure on regional currencies. Intervention by the authorities had been conducted in both directions to facilitate orderly adjustments in the ringgit during these

periods. The appreciating trend resumed from mid-2009 as the global recovery gathered momentum, and up to July 2010, the ringgit has been the fastest appreciating currency in the region for the year. This shows that the authorities are not averse to an appreciation of the ringgit. Going forward, the authorities agreed with the staff assessment that given the strong fundamentals in the economy, and further reinforced by the reform initiatives, the ringgit could appreciate further over the medium to long term.

17. The authorities remain unconvinced by the model-based estimates as they do not adequately incorporate salient country-specific features of the economic structure, including the significant role of non-renewable commodities such as oil. The staff assessment on the potential undervaluation of the ringgit is not corroborated with qualitative evidence, given the fact that core inflation remains low and there has been no evidence of asset price bubbles in the economy. In addition to what is already being put in place, the prescription of policies to force external adjustment is unclear. Staff themselves observed that at this juncture there is no feasible re-orientation of the policy mix that could more quickly reduce external surpluses without damage to macroeconomic stability. The authorities do not disagree that further exchange rate appreciation over time could complement the structural transformation agenda now underway, but point out that the extent of any changes in the exchange rate would remain fundamentally determined by market conditions and economic developments.

Structural Reforms

18. The progress that has been achieved by Malaysia over the past half-century has propelled it to become an upper middle-income economy. The old growth model provided three decades of strong performance, permitting Malaysia to provide for the health and education of her people, build a world class infrastructure and become a major trading nation globally. Nonetheless, growth has slowed in the past decade, and in the absence of deep-rooted changes, the Government's candid assessment is that Malaysia is caught in a "middle-income trap." In terms of restructuring the economy, the focus has been on both the public and private sectors. The Government concentrated on improving governance and the delivery of public goods under the GTP. At the same time, Malaysia's New Economic Model (NEM), to be achieved through the Economic Transformation Program (ETP), constitutes a pivotal set of economic structural reforms for Malaysia to double its per capita income by 2020 and achieve an advanced economy status.

19. The NEM comprises eight strategic reform initiatives to be translated into policies:

- Reenergizing the private sector, including by creating an entrepreneurship ecosystem, removing barriers and costs to doing business, and encouraging competition.
- Developing a quality workforce and reducing dependency on unskilled foreign labor.
- Creating a competitive domestic economy, including removing price controls and subsidies that distort market behavior.
- Strengthening the public sector, by creating a leaner, customer-focused government while widening the tax base and streamlining public finance management.
- Implementing transparent and market-friendly affirmative action, which will transition from ethnic considerations to emphasize the lower income 40% of households.

- Building the knowledge base and infrastructure, including an environment for innovation.
- Enhancing the sources of growth, of which 12 national key economic areas have been identified with high growth potential.
- Ensuring sustainability of growth, including environmental sustainability.

20. To operationalize these reforms, the 10^{th} Malaysia Plan outlines 10 Big Ideas to transform the nation towards achieving Vision 2020. Additionally, 5 key strategic thrusts have been identified to achieve the objectives and targets of the 10^{th} Malaysia Plan.

Final Remarks

21. The authorities welcome the input contained in the Staff Report and have found the consultations useful. Taking advantage of a firm recovery from the global downturn, Malaysia is embarking on a far-reaching reform agenda that would elevate it to the next stage of growth and development. The support of the international community, including the expertise of the Fund, remains welcome.