INTERNATIONAL MONETARY FUND

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MALAYSIA

2012 ARTICLE IV CONSULTATION

February 2013

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 2012 Article IV consultation with Malaysia, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 12, 2013, 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 January 28, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its February 11, 2013 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Malaysia.

The documents listed below have been or will be separately released.

Financial System Stability Assessment
Report on the Observance of Standards and Codes

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 2012 ARTICLE IV CONSULTATION

January 28, 2013

KEY ISSUES

Near-term outlook. Along with a handful of neighboring countries, Malaysia has bucked global trends and posted strong growth in 2012, supported by domestic demand. In the face of weak external demand, this has led to a significant moderation in the current account surplus. Growth is expected to remain robust in the near term, fueled by resilient domestic demand and a modest uptick in exports. Inflation should remain restrained. Risks to the outlook are mainly external and tilted to the downside. General elections, which must be held by June 2013, may add to short-term market volatility. Macroeconomic policies are well calibrated to the current conjuncture, and monetary policy has ample room to respond in a downside scenario. The economy's external rebalancing is expected to continue over the medium term.

Safeguarding financial stability. The 2012 FSAP found that the Malaysian financial system is sound and supported by a strong regulatory and supervisory framework. Risks to financial stability from high household debt or, potentially, from capital flow volatility, should continue to be monitored closely, but are contained by high bank capital buffers, ample international reserves, and sound monetary and financial policies.

Strengthening fiscal sustainability. Malaysia must regain the fiscal space it lost after the global financial crisis. Staff welcomes the authorities' commitment to medium-term fiscal consolidation, which should be underpinned by a concrete and comprehensive plan. Consolidation must be accompanied by structural reforms to improve the efficiency and equity of fiscal policy: the revenue base must be broadened and diversified away from energy-related receipts; universal fuel subsidies must be gradually replaced by targeted social transfers; and public financial management must be strengthened to better deal with risks associated with growing federal government contingent liabilities.

Promoting higher and more inclusive growth. Malaysia's record of economic development since independence has been impressive. Achieving the authorities' goal of turning Malaysia into a high-income nation by 2020 will require sustained implementation of the wide ranging structural reforms they have identified to boost investment and productivity. The authorities are also committed to enhancing social protection. A new minimum wage policy has taken effect from January 2013, and other reforms to strengthen social safety nets are being considered. Together, these reforms will help boost growth, support the ongoing rebalancing, and promote inclusiveness.

Approved By
Jerry Schiff and Dhaneshwar Ghura

Discussions took place in Kuala Lumpur during November 29-December 12, 2012. The staff team comprised Alex Mourmouras (head), Rodrigo Cubero, Elif Arbatli, Phurichai Rungcharoenkitkul, Sarah Zhou (all APD), Ravi Balakrishnan (Resident Representative, Singapore), and Simon Gray (MCM). Chikahisa Sumi (APD) also participated as part of his focus on financial sector developments across Asia.

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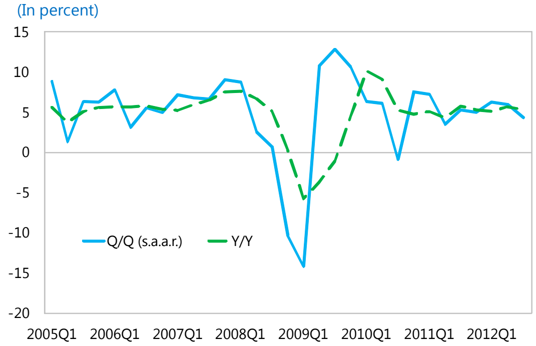
APPENDICES

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

1. **Political context**. Malaysia has a parliamentary political system. General elections must be held at least once every five years, but can be called at any time by the Prime Minister before the five-year period has expired. The next general election must be held by June 2013, but has been expected since 2011, leading to a pre-election political climate for the past two years or so.

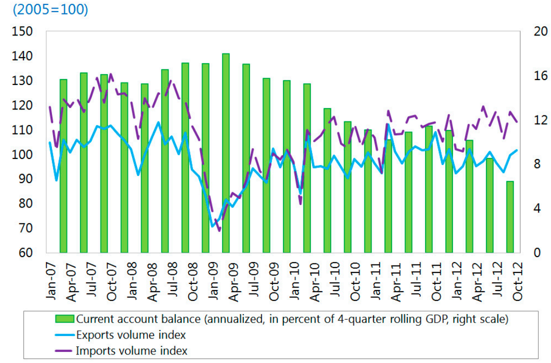
2. **Developments**. Malaysia's economic performance in 2012 surpassed expectations. Robust domestic demand is offsetting external weakness and is fueling growth, now estimated by staff at 5.1 percent in 2012 (Figure 1). Private and public investment has been a key driver of the expansion, supported by low interest rates and the catalytic effects of large projects under the Economic Transformation Program (ETP), particularly in oil, gas, and infrastructure. Consumption growth has also been vigorous, supported by a strong labor market, credit to households, and government transfers. Net exports, on the other hand, have declined. This has led to a significant external rebalancing, with the current account surplus moderating by about 5 percentage points of GDP relative to 2011 (paragraph 31). Inflation eased in 2012, on lower global commodity prices and base effects. Average CPI inflation was 1.7 percent in 2012. Indicators of underlying inflation have also remained relatively subdued. With growth above potential in 2011−12, the output gap has closed (Figure 2).

GDP Growth
(In percent)



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

Trade Volume Index and Current Account Balance
(2005=100)



Source: CEIC Data Co. Ltd.

3. **Growth outlook**. The robust pace of economic activity is expected to continue in 2013 and over the medium term. Consumption in 2013 will remain supported by low unemployment and by fiscal transfers. Investment should also remain strong, reflecting in part a large pipeline of ETP-related projects.[1] Exports are expected to pick up slightly next year, in line with the WEO baseline. The federal government (FG), on the other hand, will provide a modest drag, with a fiscal impulse of -0.6 percent in 2013. Overall, staff projects growth in 2013 at 5.1 percent. Over the medium term, growth is projected at about 5 to 5.5 percent, as ETP-related investments boost productivity and female labor force participation rates increase (paragraph 27).

[1] In the year to November 2012, 48 projects with a total committed investment of RM 52 billion were announced, bringing the cumulative total since ETP was launched in October 2010 to 158 projects and RM 231 billion (just under 25 percent of GDP) of investment commitments, to be realized over the coming years.

4. Inflation outlook. With output at about potential and dissipating base effects, inflation is projected to rise slightly to 2.2 percent in 2013. In addition, the introduction of a minimum wage in 2013 (Box 1), the gradual removal of fuel price subsidies, and the planned adoption of a goods and services tax (GST) are expected to have small one-off effects on inflation in the period 2013–15, tapering off subsequently.

5. Risks. The principal risks to Malaysia's outlook are external and tilted to the downside (Appendix I). An intensification of the euro area crisis, a sharp slowdown in China (Malaysia's main trading partner) or other shocks to global growth or risk aversion (for instance from a sharp fiscal contraction in the United States) would impact Malaysia through trade, commodity prices, and financial channels and could trigger capital flow volatility.[2] The continued strength of intra-ASEAN trade, supported by robust domestic demand in several ASEAN economies, is however providing some resilience against these risks (Box 2). Domestically, elevated housing prices and growing household debt may pose risks for the financial sector. Also, a slower-than-expected pace of implementation of fiscal and structural reforms could pose risks. For instance, a protracted increase in unit labor costs resulting from slower-than-envisaged medium-term productivity increases or a higher-than-anticipated impact from the minimum wage could harm potential growth. Finally, the upcoming general elections could lead to some market volatility.

6. Authorities' views. The authorities agreed that growth would remain robust in 2013 and beyond.

- They argued that the existing pipeline of ETP projects would continue to support investment in 2013–14 while private consumption would hold up, partly due to fiscal transfers in early-2013 and continued growth in disposable incomes. They project growth at 4.5 percent to 5.5 percent in 2013, with potential growth boosted over the medium term to 5 percent to 5.5 percent by higher private investment.

- The authorities agreed that the inflation outlook was fairly benign. While it may increase slightly, they expect inflation to remain modest in 2013 given subdued global commodity prices. They also argued that the impact of the minimum wage or any further gradual fuel subsidy cuts on inflation would likely be minor.

- The authorities concurred that the principal risks to the outlook were external and skewed to the downside. They remained concerned about developments in the euro zone, uncertainty about the direction of U.S. fiscal policy, and the risk of a sharper slowdown in China. They did, however, point to the upside potential of the growth outlook associated with continued implementation of ETP-related investment projects and reforms.

[2] The transmission of, and policy responses to, these external spillovers were assessed in detail in the 2011 Article IV staff report.

THE NEAR-TERM: KEEPING THE ECONOMY ON AN EVEN KEEL

A. Near-Term Macroeconomic Policy Stance

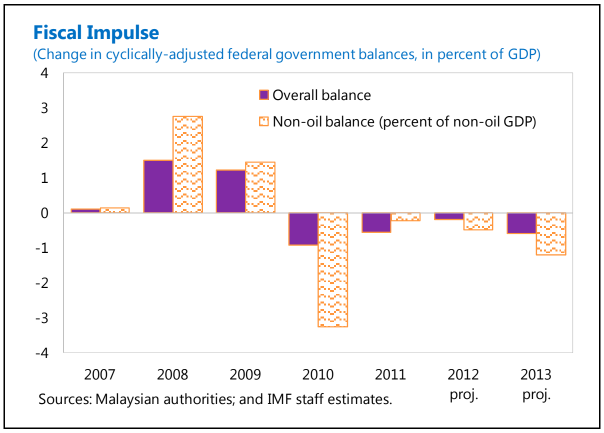
7. Monetary policy. Monetary conditions remained accommodative in 2012. Having been one of the first central banks in the region to start a tightening cycle after the 2008–09 global crisis, Bank Negara Malaysia (BNM) has now kept its policy rate at 3 percent since May 2011, resisting a renewed trend among regional peers toward lowering rates (Figure 3). BNM characterizes its stance as supportive of growth in an environment that combines robust domestic demand and narrowing spare capacity with subdued inflation and well-anchored inflationary expectations.

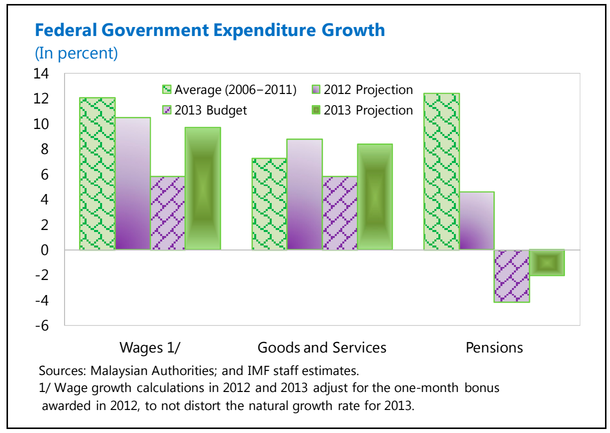
8. Fiscal policy. The FG's fiscal turnout in 2012 has been better than expected. Additional spending on fuel subsidies, wages, pensions, and transfers to target groups has been more than offset by buoyant revenue and one-off factors (including an extraordinary dividend payment). As a result, the FG deficit is estimated to decline to 4.5 percent of GDP this year, compared with 4.8 percent in 2011 (Figure 4). The 2013 FG budget envisages a further decline in the FG deficit to 4 percent of GDP, consistent with the government's plan to reduce its deficit to 3 percent of GDP by 2015 (although the budget does not include measures to rationalize fuel subsidies). The 2013 fiscal effort is actually stronger if measured in terms of the non-oil primary balance, as oil-related revenues are projected to fall. The FG debt is projected to rise to about 53 percent of GDP in 2012–13, close to the authorities' self-imposed ceiling of 55 percent of GDP. On the other hand, the overall public sector deficit is projected to have risen to 5.1 percent of

Major NFPEs	Sector	Selected Investment Projects (Ongoing, unless otherwise indicated)
PETRONAS	Oil and gas	Enhanced oil recovery projects, regasification terminal, international investments in exploration and production. Downstream investments in petrochemical production and refineries are key future projects.
Tenaga Nasional Bhd	Energy	Hydro, coal and biomass power plant projects.
MRT Corp	Transportation	Mass Rapid Transit Project (MRT), a three-line metro system in Klang Valley/Kuala Lumpur.
Malaysia Airlines	Transportation	Replacement of aircraft fleet.
Prasarana	Transportation	Railway line extension, station maintanence.
Telekom Malaysia Bhd	Telecommunications	High speed broad band project, submarine cable network, ICT infrastructure including for the migration to Next Generation Network (NGN).
Axiata Group Bhd	Telecommunications	Investments in data networks, 3G infrastructure, mainly outside Malaysia.

Sources: Annual Reports; and webpages of various NFPEs.

GDP in 2012 (from 3.3 percent in 2011), partly reflecting higher investments by nonfinancial public enterprises (NFPEs), and is expected to widen to 6.3 percent of GDP in 2013 (Figure 5).[3]





9. Staff position. In staff's view, the macroeconomic policy mix in 2012–13 is well calibrated for the current conjuncture.

- Bank Negara Malaysia's slightly accommodative monetary policy stance strikes the right balance between supporting growth and keeping inflation in check, a view also supported by a simple Taylor rule (Figure 3). While domestic demand is robust and spare capacity is narrowing, inflation is subdued and inflationary expectations are well anchored—a testimony to BNM's deft monetary management. The 2013 fiscal stance is also appropriate, balancing concerns about growing public debt with the need to avoid excessive or premature fiscal adjustment. While the 2013 budget likely understates spending, it is also conservative in its revenue projections. The deficit target seems feasible if, as assumed in the staff's baseline, there are only minor slippages in current spending and a modest fuel subsidy reform is adopted in the second half of 2013.

- Should downside risks to the growth outlook materialize, BNM has ample room to cut rates and allow the exchange rate to act as a shock absorber. However, the FG's relatively high debt level affords limited space for a fiscal response in a downside scenario. Any fiscal stimulus should be well targeted, temporary, and anchored in an ambitious medium term consolidation plan.

- In response to commodity price shocks, the exchange rate should be allowed to adjust. If the shock pushes prices up, monetary policy tightening ought to be considered only if second round price effects risk unhinging inflation expectations. Any fiscal revenue windfalls from higher commodity prices should be saved.

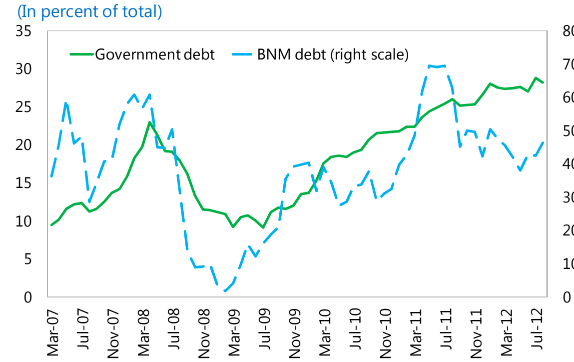
[3] The macroeconomic impulse from NPFE capital spending is dampened by its high import content and the fact that much of these investments (about one third in 2012) are estimated to take place outside Malaysia.

10. Authorities' views. The authorities agreed with staff's assessment on near-term macroeconomic policies. If downside risks were to materialize, the authorities agreed that they had ample room to cut interest rates and that two-way exchange rate flexibility would help respond to weak external demand. The authorities also argued that the 2013 budget reflected their commitment to fiscal consolidation while providing for policies (including cash transfers to low-income households) that would support domestic demand in a weak external environment.

B. Dealing with Capital Flow Volatility

11. Background. Capital flow volatility continues to be a fact of life for emerging markets like Malaysia. Flows have been influenced by both push and pull factors, including global risk appetite, expansionary monetary policies in systemically large economies, as well as macroeconomic fundamentals in recipient countries (Figure 6). Further inflows could fuel credit growth and lead to asset price exuberance. But global shocks, against the backdrop of a high share of foreign holdings in Malaysian bond and equity markets, could also trigger sudden outflows (Appendix I).

Foreign Holdings of Government and BNM Debt
(In percent of total)



Sources: Data provided by the authorities.

12. Policy response so far. Malaysia has successfully dealt with volatile capital flows in recent years. Its sound banking system and liquid capital markets facilitate the absorption of flows, while a stable core of domestic institutional investors and comfortable levels of official international reserves provide additional buffers against any volatility in external demand for domestic securities. But the policy response has also been appropriate: the authorities have coped with capital flows by allowing two-way exchange rate adjustment while smoothing out excessive exchange rate volatility. Macroprudential policies (MPPs) have been used selectively to tackle specific markets or risks, such as credit to households, but not as a direct response to capital flows.

13. Staff position. In case of large and sustained inflows, the exchange rate should be allowed to appreciate gradually and fiscal policy could be tightened at a faster pace. MPPs could also be adopted or tightened as needed to mitigate potential risks (paragraph 15), and could be complemented by liquidity management measures, including higher reserve requirements. Staff welcomes measures to liberalize outflows adopted by the authorities in recent years, such as the elimination of the requirement on residents to convert export earnings into ringgit. Regional initiatives under way, including regional crisis management and resolution frameworks, will bolster regional communication and cooperation in case of an emerging crisis.

14. Authorities' views. The authorities agreed that capital flows would likely be volatile in the near term but felt the impact on the broader economy was manageable. While the share of foreigners in the sovereign bond market had risen since the global financial crisis, risk-off cycles over the last two years had not affected domestic credit provision. Moreover, domestic investors stood ready to step in if foreign demand for sovereign bonds slackened. The authorities expressed concern about the extended easy monetary policy in advanced economies and the challenges this was creating for emerging economies. The authorities took note of the Fund's view that capital flow management measures should be part of the policy toolkit.

SAFEGUARDING FINANCIAL SECTOR STABILITY

15. Background. The 2012 IMF-World Bank Financial Sector Assessment Program (FSAP), and the accompanying Financial System Stability Assessment (FSSA), found that Malaysia's financial system is sound, well capitalized, and backed by a strong regulatory and supervisory framework.[4] Malaysian banks have high capital adequacy ratios and are expected to comfortably meet Basel III capital requirements by 2019. FSAP stress tests indicate that the banking system has sufficient capital buffers to absorb credit losses under tail-risk scenarios. However, the capital of some small banks could fall below the regulatory minimum if a prolonged recession in Malaysia led to higher unemployment and lower housing prices. The quality of bank assets has improved. Liquidity is adequate, and while the share of corporate "at call" deposits is high, these appear to be stable. Banks' exposure to currency risk is limited, as is their reliance on interbank and cross-border funding (Figure 7). Malaysia is a global leader in Islamic finance. This sector is playing a central role in promoting financial development through product diversification and financial inclusion. And the Financial Sector Blueprint, launched in 2011, strikes the right balance between tighter regulations in line with global trends and measures to foster further financial development.

16. Staff position.[5] In line with the FSSA, the following areas warrant attention:

- Strong growth of credit to households and house price appreciation (Figure 8). Housing prices are running ahead of household incomes and housing rents. Household debt is high, as is bank exposure to households (55 percent of bank credit) (Figure 8).[6] In response, the authorities have introduced a number of MPPs and fiscal measures since 2010.[7] These measures have succeeded in slowing down household credit growth, particularly for unsecured loans, while preliminary data suggest housing price appreciation may have decelerated. Some pressure points do remain, however: growth in credit to households remains in double digits, the supply of low-cost housing is tight, and prices are still rising strongly in some housing segments. The government is putting in place measures to increase the supply of more affordable housing, and the real property gains tax rate was further

[4] The FSSA's main recommendations are listed in Appendix II.

[5] See Appendix III for a summary of staff's advice during previous Article IV consultations and the authorities' response so far.

[6] About half of this (that is, 27 percent of total bank credit) is mortgage loans. Total bank exposure to real estate is over 40 percent if loans for nonresidential properties and construction are added.

[7] These include limits on credit card debt; lower loan-to-value (LTV) caps on third and subsequent mortgages (LTV of 70 percent) and for corporate borrowers (LTV of 60 percent); higher capital risk weights (100 percent) for mortgages with LTVs over 90 percent; reintroduction of the real property gains tax; and increased minimum prices for house purchases by foreigners.

raised on January 1, 2013. However, if household credit growth and housing prices remain high, additional measures could be taken, including lower loan-to-value (LTV) caps, further increases in capital gains taxes on properties, higher stamp duties on real estate transactions, and a further tightening of regulations on unsecured personal loans. As noted by the FSSA, continued efforts to capture granular data on household assets and liabilities by income segment would strengthen monitoring of risks in this sector.

- Malaysia's extensive cross-border banking activities. Risks include foreign bank deleveraging and exposure of the domestic financial system to developments abroad. On balance, these risks appear manageable (Box 3). However, regional exposures should continue to be monitored closely. Deepening cooperation between home and host country supervisors is also important.

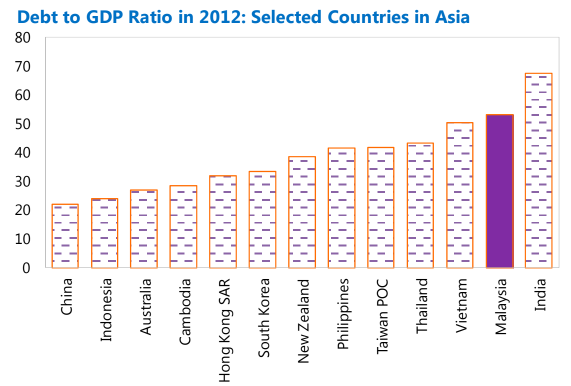
- Consolidated supervision of financial holding companies. There is scope to enhance the framework for consolidated supervision of financial groups, including on capital and liquidity standards. Passage in December 2012 of the Financial Services Act, the Islamic Financial Services Act, and Amendments to the Central Banking Act 2009 is a welcome step in this direction.

17. Authorities' views. The authorities concurred with the FSAP assessment that the financial system is sound and that the regulatory and supervisory framework is strong. They also agreed with the findings from stress tests suggesting that the banking system has sufficient capital buffers even under tail-risk scenarios, except for some small banks. They have been closely monitoring household leverage and the housing market as well as lending practices of banking institutions. The increased vigilance has resulted in the issuance of a number of macroprudential policies and supervisory responses as well as fiscal measures. They said some of the measures already taken were working, as demonstrated by the recent moderation in the growth of household credit, a substantial decline in multiple housing loan accounts, and improvements in the repayment behavior of credit card holders. The ramping up of the supply of low-cost housing, improvements in public transportation, and the increase in the real property gains tax would help to further ease house price pressures. The recently passed financial services legislations and amendments to the Central Banking Act 2009 strengthen BNM's powers to extend regulations to nonbank lenders as well as bringing them under the direct oversight of BNM where necessary. The authorities stand ready to take additional measures as and when needed.

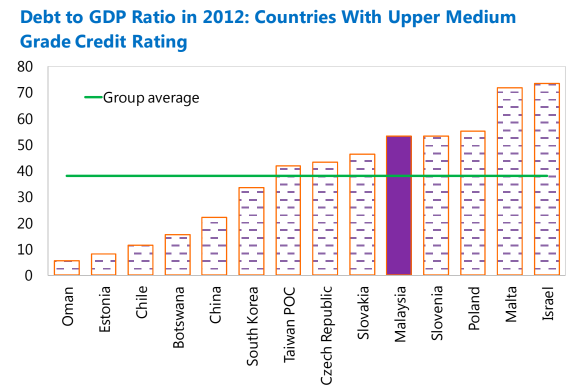
STRENGTHENING FISCAL SUSTAINABILITY AND EFFICIENCY

A. Fiscal Sustainability and Resilience

18. Background. Malaysia's fiscal space has shrunk considerably following the global financial crisis. The FG debt-to-GDP ratio has increased by 12 percentage points since 2008, reflecting both substantial discretionary fiscal stimulus and declining growth and oil prices in the aftermath of the crisis. This debt ratio is elevated compared to countries with similar credit ratings. The structural fiscal position has also deteriorated, as evidenced by the persistent decline in the non-oil primary balance and the current balance. The significant increase in operating expenditures in recent years may put at risk the FG's golden rule of maintaining a positive current fiscal balance. A weak structural fiscal position and a relatively high debt ratio reduce the ability to mount countercyclical fiscal responses in the future.



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



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

19. Outlook. In the absence of policy changes, Malaysia's debt-to-GDP ratio would remain above current levels into the longer term (Annex I, Debt Sustainability Analysis). The staff's fiscal baseline[8] assumes some adjustment, consistent with the authorities' target of reducing the FG deficit to 3 percent of GDP by 2015. However, the FG deficit would start rising again thereafter, reflecting declining oil revenue and rising pension and healthcare costs. These pressures are expected to intensify in the long term. Moreover, while the debt ratio is projected to decline slowly under the baseline, shocks to growth and interest rates could push it over the authorities' 55 percent of GDP debt ceiling (Box 4). Lower-than-expected growth, because of slower reforms or a protracted global growth slowdown, could also push up the debt ratio.

20. Staff position. Staff welcomes the authorities' commitment to fiscal consolidation and encourages them to underpin it with a comprehensive medium-term plan based on concrete measures, targets and timelines to be announced and put in place as early as feasible. This fiscal consolidation strategy should:

- Take into account the potential decline in oil- and gas-related receipts and the increase in age-related government spending associated with demographic change in coming decades.
- Be anchored, as suggested by staff analysis (Box 4), on the objective of gradually lowering FG debt to around 40 percent of GDP by 2020—the debt ratio prevailing before the global financial crisis. This target is also consistent with the authorities' New Economic Model. Adhering to it

[8] The baseline assumes: (i) fuel subsidy reform; (ii) introduction of the GST (to replace existing sales taxes) at a rate of 5 percent along with offsetting revenue measures, yielding net revenue gains of about 0.5 percent of GDP in the medium term; and (iii) an increase in direct transfers to low-income households of ½ percent of GDP per year.

would require strengthening the FG's non-oil primary fiscal balance by 1.5 percentage points of GDP on average relative to the baseline.

- Include increases in non-oil and gas-related tax revenues, as well as a rationalization of subsidies (see paragraphs 22–23).

21. Refocusing budget targets. Anchoring budget targets on the non-oil primary balance instead of the overall balance would help insulate government spending from volatile oil prices. This, in turn, would render fiscal policy more counter-cyclical.

B. Structural Fiscal Reforms

22. Broadening the revenue base. The FG's revenue base is narrow and overly reliant on volatile oil and gas receipts, which account for about a third of the total. The planned introduction of the GST would help broaden the revenue base. In addition, the authorities should streamline fiscal incentives for investment, with their budgetary costs made more transparent.

23. Making government spending more cost-effective and equitable. Some components of spending, especially fuel and food subsidies, are not well targeted. Staff welcomes the authorities' plans to gradually rationalize fuel subsidies, which will help reduce spending pressures while staggering the impact on inflation and real incomes. Subsidy reform should be accompanied by targeted support measures for vulnerable groups. Spending on emoluments, which increased by 0.6 percent of GDP in 2012 (in part reflecting a public sector salary review), must also be contained. Recent measures to reduce civil service growth and improve payroll management should help. Parametric reforms to the civil service pension system (a defined benefit scheme with no employee contributions) would also help contain long-term spending pressures.

C. Public Financial Management and Fiscal Risks

24. Growing fiscal risks. The public sector deficit is rising, reflecting a large increase in NFPE spending (Figure 5). Due to long reporting lags, the latter is difficult to monitor and control. Contingent liabilities for the FG are also growing from the rise in government's statutory guarantees (which increased to 15 percent of GDP, partly reflecting borrowing by special purpose vehicles set up to finance large public infrastructure projects), and from public-private partnerships (PPPs) more generally. An IMF technical assistance mission will assess these risks and recommend mechanisms to monitor and manage them.

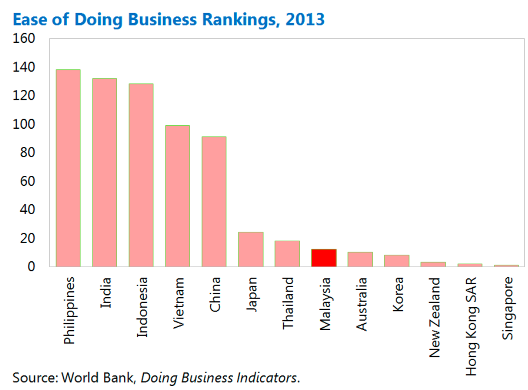
25. Strengthening public financial management. Staff welcomes the authorities' planned shift to accrual-based fiscal accounting and outcomes-based budgeting by 2015, and work underway to formulate a medium-term fiscal framework. Fiscal transparency should also be improved by expanding the coverage of the budget to include pension funds and all autonomous entities, and by reporting on PPPs, new revenue and expenditure measures, and fiscal risks more generally.

D. Authorities' Views

26. The authorities stressed their commitment to fiscal consolidation, tax reform and expenditure rationalization. They reiterated the government's commitment to implement the GST, rationalize energy subsidies, and strengthen public financial management, including through a medium-term budget framework. They also highlighted their intention to address long-term spending pressures, including through reforms to the public pension scheme, to housing and student loan programs, and to the civil service.

REFORMS TO BOOST GROWTH AND ENHANCE INCLUSIVENESS

27. Boosting growth. Malaysia's record of economic development since independence has been remarkable, but growth slowed after the Asian financial crisis. Efforts are now underway to turn Malaysia into a high-income country by 2020. Thus, private investment has been propelled in recent months by the catalytic effect of large scale projects under the ETP. And significant progress has been made in improving the business climate: Malaysia's ranking in the World Bank's 2013 Doing Business survey has improved to 12th, from 14th in 2012. But important challenges remain that still hinder investment and growth:



Source: World Bank, *Doing Business Indicators*.

- A key bottleneck is the scarcity of skilled workers. Planned reforms to improve the education system and enhance equality of educational opportunities are therefore welcome.
- Also, redundancy costs are high (Malaysia is ranked 108th out of 144 countries in this area in the World Economic Forum's Global Competitiveness Report).
- At 46 percent, female labor force participation is low by regional standards. Staff thus welcomes the authorities' plans to boost this rate to 55 percent by 2015, including through incentives for the establishment of childcare facilities and the employment and training of women after a career break, and legal reforms to promote flexible work arrangements.[9]

[9] The World Bank estimates that raising Malaysia's female labor participation by 11 percentage points to 57 percent between 2000–2010 would have boosted growth by around 0.4 percentage points per year (*Malaysia Economic Monitor*, October 2012).

- Fostering technological readiness (including better access to broadband internet) and greater competition in product markets is also important.

28. Minimum wage. A minimum wage has been introduced with effect from January 2013, aimed at boosting wages of low-skilled workers and enhancing productivity. Preliminary analyses suggest that it is likely to have a limited impact on inflation and unemployment (Box 1), and should therefore help improve the incomes of the poor. The authorities could however consider whether highly affected firms should be granted more time to adjust, and whether further allowance should be made for regional wage dispersion. While the minimum wage should provide incentives for affected firms to shift to more capital-intensive production technologies, a sustained increase in productivity would require implementing the complementary reforms discussed in the previous paragraph.

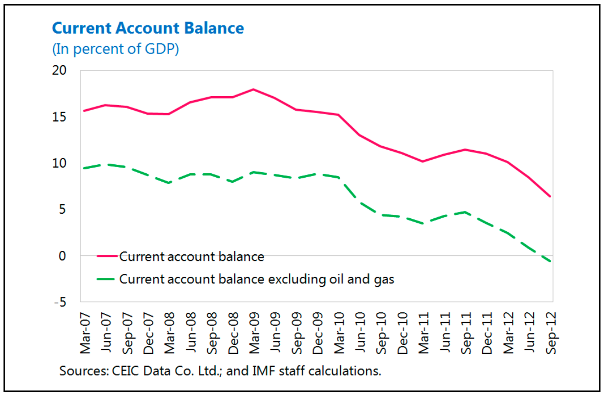
29. Enhancing social protection mechanisms. The authorities could consider other measures to strengthen inclusiveness, such as introducing an unemployment insurance scheme funded by employers and employees; improving the targeting of cash transfer programs; and making them conditional on access to education and health care. Such conditional cash transfer schemes have proven effective in a number of countries. Stronger social safety nets should also help reduce precautionary savings and narrow the current account.

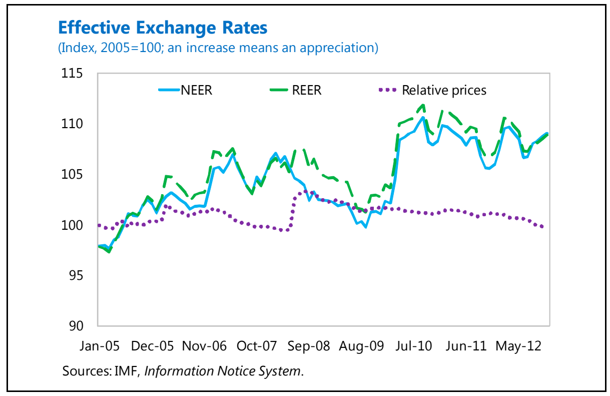
30. Pension reforms. Staff welcomes the recently introduced Private Retirement Scheme (PRS), which will help supplement the Employees Provident Fund (EPF). Consideration could be given to increasing the risk-sharing characteristics of Malaysia's existing pension system by: (i) introducing a publicly funded, pillar-one pension scheme for low or noncontributors; and (ii) providing an option for workers to receive their pensions in the form of annuities, to help reduce longevity risk. The minimum age for pension withdrawals for existing EPF contributors should be gradually raised from 55 to 60 to match the increase in the retirement age in the private sector.

31. Authorities' views. The authorities stressed that they remained committed to increasing potential growth and enhancing inclusiveness. The ETP was gaining traction in terms of boosting investment. However, they view it as a marathon and not a sprint, with progress on structural reform initiatives remaining essential. The authorities noted that there was broad support in the private sector for the adoption of a minimum wage. While they expect limited impact on employment, they would monitor implementation closely, and would consider modifications as and when needed. The authorities said they would study the case for greater use of conditional cash transfers and had tasked the International Labor Office with producing a report on how to design an appropriate unemployment insurance scheme.

EXTERNAL SECTOR ASSESSMENT

32. Staff position. The Malaysian economy is undergoing a significant external rebalancing, reflecting surging domestic demand and weak external demand. As a result, the current account is projected to decline to 6 percent of GDP in 2012−13, from 11 percent in 2011 and 17 percent in 2008, while the non-oil current account has swung into deficit. Notwithstanding the significant narrowing of the current account, staff assesses the external position to be stronger than is consistent with medium-term fundamentals and desirable policies (Box 5). As explained in Box 5, Malaysia's strong external position mainly reflects structural factors, including insufficient social safety nets, investment bottlenecks, and large exports of nonrenewable resources.[10]





33. Outlook and policy implications. Over the medium term, the current account is expected to continue moderating. This reflects the impact on national saving of population aging and of reforms to strengthen social protection, which are expected to more than offset the effect of the envisaged fiscal consolidation. The structural reforms discussed earlier in this report to boost investment would further help narrow the current account. Reserve levels are adequate and no further accumulation is therefore needed for precautionary purposes. In that regard, continued exchange rate flexibility, with two-way intervention limited to dampening excessive volatility, should allow for a gradual appreciation of the trend real exchange rate. This, in turn, will underpin the continued external rebalancing and facilitate a gradual shift of resources from tradable to nontradable sectors.

34. Authorities' views. The authorities concurred that the current account gap likely reflects structural characteristics, and stressed that it is not rooted in currency undervaluation. They noted that tackling it therefore calls for structural reforms rather than a shift in exchange rate policies. They also agreed on the need to consider the role of gas and oil trade when assessing the current account. The authorities questioned the capacity of EBA-based regressions to capture country-specific factors, and strongly disagreed with the conclusion from those regressions that the real exchange rate is undervalued. They also noted that typical symptoms of currency undervaluation are notably absent. In particular, there is no evidence of overheating and inflation has remained low (averaging just over 2 percent over the past decade); there are no financial

[10] Net oil and gas exports amount to over 7 percent of GDP. A significant fraction of this hydrocarbon wealth is being saved by PETRONAS, the state-owned oil company, in the form of capital spending outside Malaysia (averaging around 1.5 percent of GDP per year in 2009-11) and, to a lesser extent, the acquisition of financial assets. Saving an important fraction of wealth generated from non-renewable resources is consistent with intergenerational equity and efficiency considerations. Therefore, the presence of non-renewable resource wealth drives up optimal national saving.

imbalances (such as excessive credit growth); and the trade balance has shrunk considerably in the past three years.

STAFF APPRAISAL

35. Outlook and risks. The Malaysian economy performed strongly in 2012, and is undergoing a significant external rebalancing. The near-term outlook is positive, with domestic demand expected to continue propelling activity and inflation remaining benign. Downside risks, however, remain substantial, and are predominantly external. A sharp intensification of the euro area crisis or a further growth shock in China could impact Malaysia through lower export volumes, lower commodity prices, and increased financial market volatility.

36. Near-term policies. Malaysia's strong economic record in recent years reflects skillful and pragmatic economic management in the face of large external shocks. The current policy stance is no exception, with macroeconomic policies appropriately calibrated to the outlook and risks. Monetary policy is slightly accommodative, providing support for an economy with very low inflation and still subject to substantial external headwinds. The moderately contractionary fiscal stance provides a welcome step towards fiscal consolidation. In case downside risks materialize, monetary policy has ample room for easing. There is, on the other hand, less room for a countercyclical fiscal response given the relatively high level of FG public debt.

37. Dealing with capital flows. Malaysia has been exposed to volatile capital flows, and this is likely to continue in the near term. The policy response so far, characterized by two-way exchange rate flexibility while smoothing excessive exchange rate fluctuations, has been successful. This policy should continue going forward, and could be complemented with MPPs if needed to mitigate potential risks.

38. Safeguarding financial sector stability. The 2012 FSAP found that Malaysia's financial system is sound, and backed by a strong regulatory and supervisory framework. Relatively high levels of household indebtedness and rising house prices could, however, pose some risks. Their impact would likely be low unless accompanied by a protracted growth slowdown in Malaysia, and policies so far seem to have helped cool off household credit growth and housing prices. Continued close monitoring is nonetheless warranted, and additional MPPs and other measures should be considered if needed.

39. Strengthening fiscal sustainability. Bringing down FG public debt over the medium term is a key policy priority of the authorities. Fiscal consolidation must be underpinned by a concrete plan, anchored on a debt target. This plan should account for the potential long-term decline in oil-related revenue and increases in age-related government spending, and be complemented by reforms to: (i) broaden the revenue base away from volatile oil- and gas-related receipts, including through expeditious passage of the GST; and (ii) boost the efficiency and inclusiveness of government spending, including through continued gradual reform of universal fuel subsidies, accompanied by targeted support measures for vulnerable groups.

40. Addressing fiscal risks. Fiscal risks, arising from the rising public sector deficit and government guarantees, have increased substantially in recent years. Staff supports the authorities' efforts to monitor these risks more closely through sustained efforts to improve public financial management and statistical reporting, supported by Fund technical assistance.

41. Boosting growth. Realizing the authorities' goal to turn Malaysia into a high-income nation by 2020 will require the sustained implementation of the broad structural reforms already identified by the authorities in their many initiatives. Particular priorities should be to improve education and develop the skills needed for a high-tech, high value-added economy; to increase labor market flexibility, including by reducing redundancy costs; and to raise female labor force participation.

42. Enhancing social protection. The introduction of a minimum wage policy from January 2013 should support the incomes of poorer workers, provided any negative impact on employment is small. The authorities should remain flexible to adjust the policy as experience is gained from its implementation. Introducing an unemployment insurance system, currently under consideration, and a pillar-one (noncontributory) pension scheme, would further strengthen social protection.

43. External assessment. Malaysia's external position is stronger than warranted by medium-term fundamentals and desirable policies. In particular, despite having narrowed significantly in recent years, the current account is still above the norm. This current account gap likely reflects structural factors, such as inadequate social protection and investment bottlenecks, as well as the role of hydrocarbon exports. Population aging, as well as policies to boost investment and social protection, supported by continued two-way exchange rate flexibility, should help moderate the current account over the medium term.

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

Box 1. Malaysia: Minimum Wage

In May 2012, Malaysia announced the adoption of a minimum wage (MW) policy, with effect from January 2013. It follows significant recent increases in MWs across the region—in China, India, the Philippines, Thailand, and Vietnam—and the introduction by Hong Kong SAR of a MW policy in May 2011.

Justification. The Malaysian authorities gave three main reasons for adopting a MW: (i) ensuring basic needs of employees are met; (ii) encouraging firms to move up the value chain by investing in better technology and increasing labor productivity; and (iii) reducing dependence on unskilled foreign labor.

Key facets. The rate was set at RM 900 per month for Peninsular Malaysia; and RM 800 for Sabah, Sarawak, and the Federal Territory of Labuan. It will cover all sectors and employees except domestic servants. The main criteria used for calculating rates were poverty-line income and the median wage. While the median wage is much lower in Sabah and Sarawak than Peninsular Malaysia, poverty-line income is much higher (given higher costs of living). This is why the chosen rates do not differ much. The rate applies to the basic wage, which can include some regular, fixed allowances but not variable allowances. Small firms (no more than five workers), except those in professional services, will be allowed to defer it for up to 6 months.

Likely impact. The theoretical and empirical literature suggests that the impact of a MW depends on multiple factors. A key factor is the ratio of the MW to the average wage: if the rate is set too low, the MW does not bind; if too high, it will lead to significant employment losses. But other factors matter too, such as the degree of competition in the labor market and the degree of enforcement. For Malaysia, the impact on employment and inflation will likely be conditioned by the following:

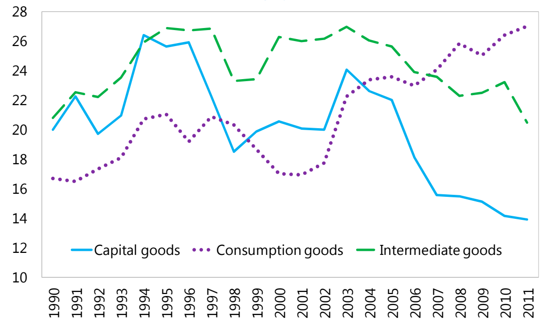
- ***Employment***. The ratio of the chosen MW rates to mean wages is high, at around 50 percent for Peninsular Malaysia and above 60 percent for Sabah (levels in most OECD countries cluster around 40 per cent), suggesting there may be a negative impact. An estimated ¼ of the formal workforce currently have incomes below the set MW, and employers say that the MW will have an impact on the whole pay structure, even for wages above the MW. Employers have also complained that the adjustment period is too short, particularly for poorer states in Peninsular Malaysia and in Sabah and Sarawak, where the MW will likely be more binding. Over the medium term, many firms are likely to increase capital-labor ratios given the change in relative prices, potentially reducing employment growth (including of foreign workers). But several factors will provide important offsets: (i) the authorities and many analysts think that labor costs make up a small share of total business costs in many sectors, with profit margins able to absorb the hit; (ii) employers were given some flexibility in terms of allowances to be included in the MW rate; (iii) there is a sizable informal sector (the MW itself may lead to an increase in informality); and (iv) the current environment of robust growth and low unemployment is favorable.

- ***Inflation***. The inflationary impact will likely be mitigated by the low share of labor costs in total production costs. Moreover, wage growth has been slower than productivity growth in recent years, suggesting there is some room for additional wage increases before unit labor costs rise materially. The muted impact on inflation of substantial MW hikes in Thailand in 2012 provides some reassurance in this regard.

Box 2. Malaysia: ASEAN Trade Integration: A Source of Resilience? 1/

Intraregional trade among ASEAN-5 economies (Indonesia, Malaysia, Philippines, Singapore, and Thailand) grew much faster than total trade between 1990–2003, and currently accounts for over 20 percent of the region's total trade with the world, a larger share than trade with any country or trading bloc outside the region. While ASEAN-5's trade with China has risen substantially over the last decade, this largely reflects increasing trade in intermediate goods as ASEAN-5 and China integrate to form a new supply chain network.[2/] By contrast, trade within ASEAN-5 has become increasingly oriented to final consumer goods (Figure 1), pointing **to growing significance of domestic consumption as a source of growth for the region**. These patterns also hold for Malaysia, which has seen a growing share of exports going to ASEAN-5 countries (except Singapore).

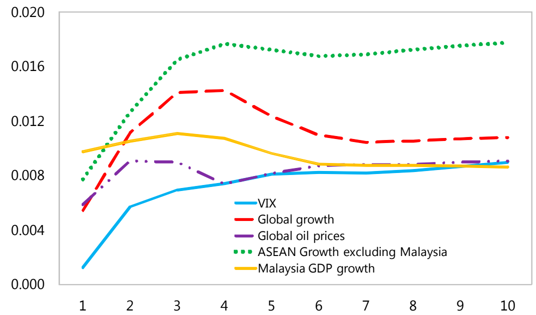
Intraregional Exports by Category
(In percent of total exports in each category)



Sources: UN, Comtrade; and staff calculations

How important is intraregional trade for Malaysia's near-term growth? A Bayesian-VAR analysis suggests that **intraregional demand is an important driver of Malaysian growth**, alongside global demand, global financial shocks, and commodity price movements (Figure 2). Meanwhile, shocks to China's growth do not have a statistically significant impact on Malaysia's or ASEAN's GDP growth, once global demand is controlled for. This suggests that, despite its increasing share in Malaysia's and the region's trade, China serves mainly as a conduit in transmitting global shocks through the supply chain network.

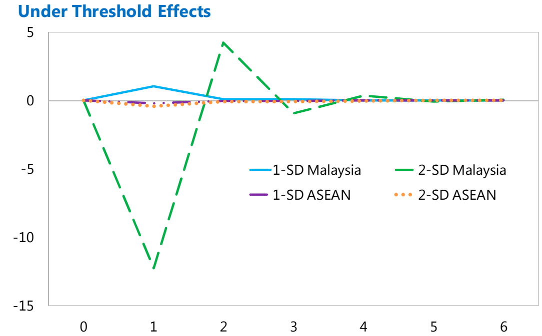
Accumulated Response of Malaysia GDP Growth to Cholesky One S.D. Innovations



Source: IMF staff estimates.

Moreover, results from a threshold model indicate that **in Malaysia (as in Thailand), domestic demand is able to withstand external shocks up to a certain magnitude**. Thus, Malaysian domestic demand is almost immune to a one standard deviation shock to external demand, but is substantially affected once the shock size is doubled (Figure 3). ASEAN as a bloc also exhibits similar nonlinear responses, but it takes a much larger external shock to materially affect aggregate domestic demand (Figure 3): even a two standard deviations shock does not exceed the estimated threshold. Domestic demand for ASEAN as a whole is therefore more resilient, reflecting the role of Indonesia, the region's largest country and the most resilient to external shocks, as well as the synergy afforded by greater intraregional integration.

Impulse Response of Domestic Demand to Export Shocks Under Threshold Effects



Source: IMF staff calculations.

1/ Cubero, Peiris, Rungcharoenkitkul and Seneviratne, IMF Working Paper (forthcoming).

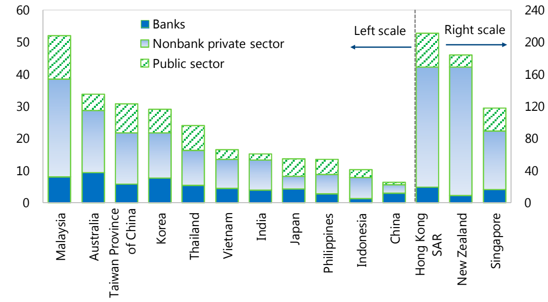
2/ See Unteroberdoerster and others (2010).

Box 3. Malaysia: Cross-Border Banking Spillovers 1/

The problems at the heart of advanced economy banking systems and the expansion of Malaysia's banks abroad raise two important issues: (i) the implications for Malaysia of foreign banks deleveraging from Malaysia; and (ii) the exposure of the Malaysian financial system to developments abroad.

Foreign bank claims on Malaysia are relatively large but are mainly held by long-established U.K. and Singaporean banks. BIS-reported foreign bank claims are over 50 percent of GDP, significantly higher than for other countries in the region excluding the financial centers (see chart). These claims comprise mainly the local operations of the foreign banks in Malaysia (approximately 40 percent of GDP) which are predominantly funded in the form of local currency deposits. The longest established banks are the U.K. and Singapore ones, with total claims of around 35 percent of GDP, and which have extensive local branch networks.

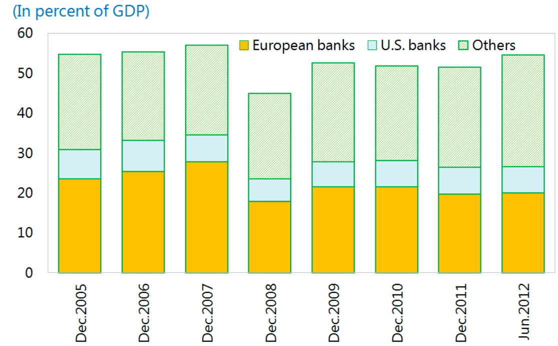
Total Foreign Bank Claims by Country 1/



Sources: Bank for International Settlements; CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.
1/ Claims are on an ultimate risk basis. The sum of quarterly GDP in U.S. dollars between 2011:Q3 and 2012:Q2 is used in the denominator.

The euro zone crisis may lead to some deleveraging but the impact appears manageable. The pullout of U.S. banks from emerging markets following the Latin American debt crisis and the deleveraging by Japanese banks in South East Asia after Japan's financial crisis in the 1990s are cautionary tales. However, the U.K. banks with a systemic presence in Malaysia—HSBC and Standard Chartered—are not strongly interconnected with the euro zone: the bulk of their assets is outside of Europe, the U.K., and the United States. Singaporean banks are also well capitalized and appear able to withstand major shocks. Moreover, a high share of foreign bank claims resides in local affiliates and is in local currency. As a result, deleveraging by foreign banks has been small over the past few years (see chart). And overall credit provision has remained robust, as it did even during the global financial crisis when foreign bank deleveraging was marked (see chart). However, BNM should continue to monitor developments closely, especially any rating downgrades of relevant U.K. banks.

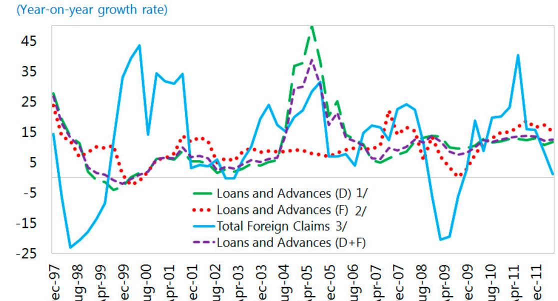
Malaysia: Foreign Banks' Claims
(In percent of GDP)



Sources: Bank for International Settlements; IMF, *World Economic Outlook*.

Over the last decade, Malaysian banks have expanded abroad significantly. The six biggest banking groups in Malaysia all have an overseas presence (Maybank, CIMB, Public Bank, Hong Leong, RHB Capital, and AmBank). Branches, subsidiaries, representative offices, and associate companies have been established in 20 countries. The largest affiliates are in ASEAN (Indonesia, Philippines, Singapore, and Thailand) and Hong Kong SAR, where exposures of the biggest three Malaysian banks are just below 30 percent of GDP. Over 30 percent of assets of the two largest Malaysian banks are in overseas operations.

Malaysia: Relationship between Domestic Credit and Foreign Bank Claims
(Year-on-year growth rate)



1/(D) refers to banking system loans made by Malaysian banks.
2/(F) refers to banking system loans made by foreign banks in Malaysia.
3/ Total foreign claims refers to foreign bank claims on Malaysia as reported to BIS, including by banks outside Malaysia.

Relative to other jurisdictions, Malaysian banks' expansion overseas so far looks moderate but will require continued careful monitoring. Austrian, U.K., and Spanish banks also have significantly expanded overseas operations in recent times, but have much higher exposures (ranging from 60–400 percent of GDP). Looking ahead, Malaysian banks are likely to continue expanding abroad in light of increasing ASEAN economic integration and the opportunity provided by European bank deleveraging. International experience suggests that rapid bank expansion in new markets can pose challenges as bank risk management and supervisory monitoring may fail to keep pace. Uneven supervisory quality in host markets can also contribute to the masking of vulnerabilities. Thus, further deepening of home-host cooperation in supervision and crisis prevention—as outlined in the Malaysia's Financial Sector Blueprint—will be important going forward.

1/ This Box is a summary of a similarly titled technical note produced for the 2012 Malaysia FSAP.

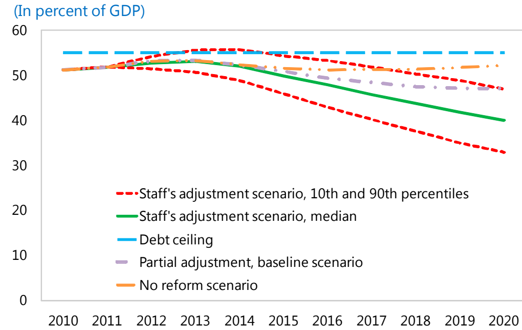
Box 4. Malaysia: Anchoring Fiscal Consolidation—A Stochastic Debt Sustainability Analysis (SDSA)

Background. Malaysia's debt-to-GDP ratio has increased by 12 percentage points since the global financial crisis, reflecting both substantial discretionary fiscal stimulus and declining growth and oil prices. The debt ratio is projected to reach 53 percent of GDP in 2012, just below the government's self-imposed ceiling of 55 percent. The authorities are committed to bringing debt down to ensure sustainability and create sufficient space to conduct counter-cyclical fiscal policy. The consolidation path should be anchored on a reasonable medium-term debt target and use the non-oil primary balance as an intermediate target. However, any consolidation plan is subject to potential shocks and therefore to uncertainty. A possible approach to estimating the debt target is thus to consider a path that ensures that debt remains below a certain debt ceiling with sufficiently high probability. This is the essence of the SDSA exercise presented in this box.

Methodology and assumptions. In this approach, two parameters must be chosen. The first is a debt ceiling. This exercise uses the government's debt ceiling of 55 percent, which is also close to those adopted in other countries and recent estimates of debt thresholds for emerging markets.[1/] The second parameter is the probability of remaining below the ceiling, given historical uncertainty in key macroeconomic variables such as real interest rates, economic growth, the real exchange rate and oil prices. In line with standard statistical analysis, a probability of 90 percent is chosen. The distribution of debt profiles reflects shocks to macroeconomic and fiscal variables around the baseline based on a small quarterly VAR. The SDSA also reflects: (i) a gradual decline in oil- and gas-related revenue in the medium term; and (ii) an increase in pension and healthcare related spending.

Results. A consolidation path consistent with remaining below the given debt ceiling with about 90 percent probability would reduce debt to around 40 percent of GDP by 2020. This medium-term debt target has two additional strengths. First, it is similar to the average debt ratio for emerging and developing countries and for countries with similar sovereign credit ratings. Secondly, it would allow for absorption in its entirety of liabilities arising from loan guarantees (15 percent of GDP as of mid-2012) should they be called upon.[2/] By contrast, the authorities' fiscal consolidation plan (the baseline) is projected to lower debt to about 48 percent of GDP by 2017. However, under this scenario macroeconomic and commodity price shocks could lead to breaching the ceiling with a relatively high probability. The figures also show, as benchmark, a no-reform (passive) scenario, which would most likely keep debt on an upward path and breach the ceiling.

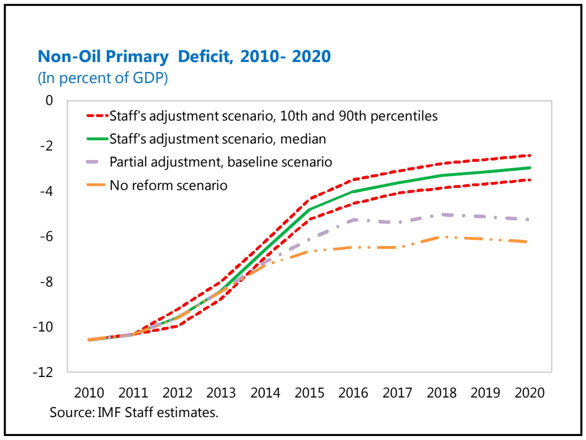
Debt Simulations, 2010- 2020
(In percent of GDP)



Source: IMF Staff estimates.

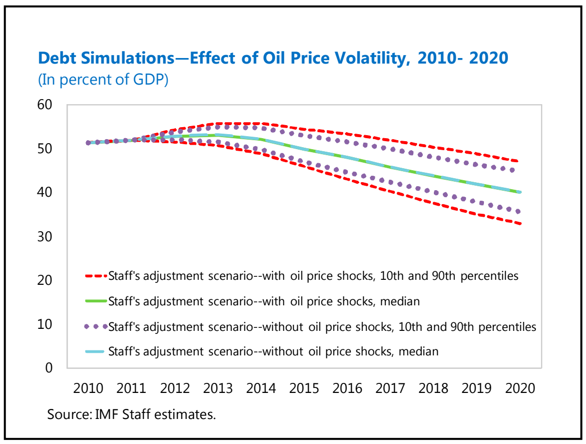
Box 4. Malaysia: Anchoring Fiscal Consolidation—A Stochastic Debt Sustainability Analysis (SDSA) (Concluded)

Implied medium-term fiscal consolidation and possible measures. Achieving the proposed debt target involves reducing the non-oil primary deficit to 3 percent of GDP by 2020. Relative to the baseline scenario, the non-oil primary balance needs to be higher on average by about 1.5 percentage points of GDP in the medium term (about 2.5 percentage points relative to a no-reform scenario). Possible measures could include: a reform that eliminates fuel subsidies by end-2015 and replaces them with transfers targeted to low-income households of about ½ percent of GDP (net savings of ½ percent of GDP); introducing the GST at a higher rate of 8 percent (net savings of 1 percent of GDP);[3/] restraining public sector wage growth by limiting new hiring (½ percent of GDP); improving the efficiency of government spending; adopting measures to improve tax administration; and closing tax loopholes and exemptions.



Source: IMF Staff estimates.

Oil price volatility and fiscal risks: Oil price volatility contributes importantly to debt dynamics through its effect on revenues and subsidies. The resulting volatility of oil-related revenue adds to the uncertainty about debt. Eliminating shocks to the deviation of real oil price from its long-run trend (based on WEO) shrinks the uncertainty around debt simulations significantly: the 90th percentile of possible debt outturns shifts down by 2 percent of GDP by 2017. This highlights the importance of employing mechanisms to hedge against the volatility in oil-related revenue.



Source: IMF Staff estimates.

Longer-term challenges. In the long term, oil revenues are expected to continue to decline and aging-related costs to rise further. These pressures will require sizable additional measures beyond 2020.

1/ Although the empirical estimates of debt thresholds for debt distress have a wide range, Fund staff estimates it to be about 63 percent for emerging markets based on recent data

2/ Unfortunately, there is no data on other types of government contingent liabilities.

3/ The average VAT rate in the Asia and Pacific region is about 10 percent.

Box 5. Malaysia: External Sector Assessment

Current account (CA). Although there is a significant ongoing moderation in the CA, econometric analysis based on the IMF's Consultative Group on Exchange Rate Assessments (CGER) and the pilot External Balance Assessment (EBA) methodologies suggests that the cyclically-adjusted CA is still stronger (by between 4½ to 6½ percentage points of GDP) than the level consistent with medium-term fundamentals and desirable policies (the CA "norm"). However, Malaysia's CA has been erratic and the models contain large residuals, which account for most of the difference between the actual CA and the fitted CA norm (the CA "gap"). In the staff's view, Malaysia's CA surplus predominantly reflects structural factors that are not fully captured in the econometric models; in particular:

- Insufficient social safety nets (which are not fully captured by health spending) as well as large exports of nonrenewable resources (net oil and gas exports are 7 percent of GDP), both of which drive up the actual and optimal rates of saving.
- Bottlenecks to investment, resulting in relatively low private investment rates (despite the recent increase).

Taking these factors and the uncertainty surrounding model estimates into consideration, staff assesses the CA gap to be of the order of 2−5 percentage points of GDP.

Real effective exchange rate (REER). After a strong appreciation between September 2009 and April 2010, the REER has fluctuated around a fairly horizontal trend. CGER and EBA-based estimates suggest that the REER is undervalued relative to the level consistent with fundamentals and desirable policies. However, as noted above, these methodologies do not fully capture Malaysia's structural characteristics.

Capital account. Malaysia, like other emerging markets, has experienced volatile portfolio flows over the past few years. Overall net capital flows, however, have typically been negative in Malaysia, driven by net foreign direct investment (FDI) and nonportfolio investment outflows. In 2012, the capital account is projected to have returned to a net negative balance. The authorities have continued to liberalize restrictions on foreign exchange administration, including via greater flexibility for companies to undertake FDI abroad and obtain loans from related resident and nonresident companies.

Reserves. Foreign exchange intervention by BNM seeks to limit excess exchange rate volatility and is two sided. In line with this, official reserves have fluctuated around a relatively flat trend over the past two years. They stand at about 131 percent of the IMF's composite reserve adequacy metric (the benchmark range is 100−150 percent), and cover about 247 percent of short-term external debt and 31 percent of broad money. Thus, current reserve levels are adequate.

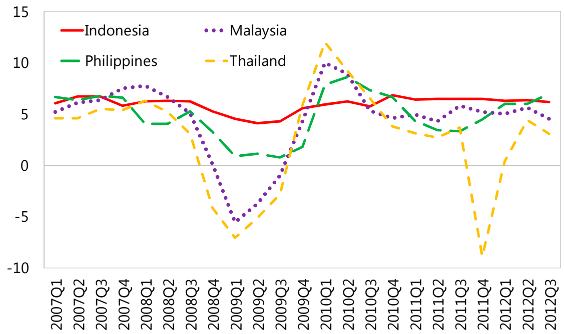
Net foreign assets. The net international investment position remains small and positive, at about 4 percent of GDP. Gross liabilities (118 percent of GDP) consist primarily of FDI and portfolio equity. External debt is relatively low at less than 30 percent of GDP, and only about 40 percent of this is short term, by original maturity. The overall net foreign asset position is thus not a source of risk.

Overall assessment. In sum, the external sector position appears stronger than that consistent with estimates of medium-term fundamentals and desirable policies.

Figure 1. Malaysia: Growth and Exports

As in other ASEAN countries, growth is holding up well…

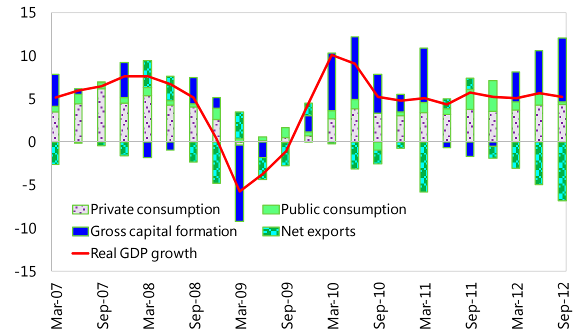
Real GDP Growth
(In percent)



Source: IMF, World Economic Outlook.

…driven by robust domestic demand, despite a significant drag from weak external demand.

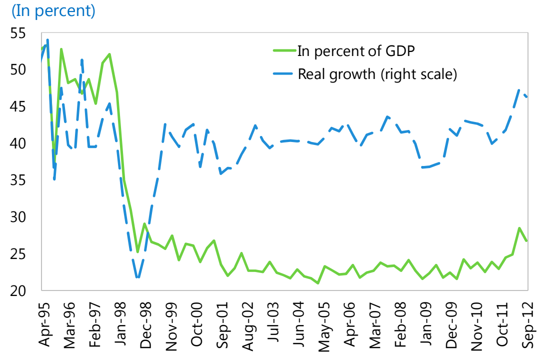
Contribution to Real GDP Growth
(Year-on-year percent change)



Source: CEIC Data Co. Ltd.

The strong pickup in investment, which is growing at its fastest rate since the Asian crisis, has been a key driver, but investment is still below its pre-Asian crisis levels.

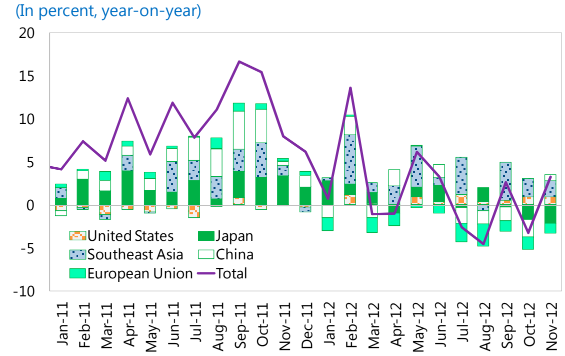
Real Gross Fixed Capital Formation
(In percent)



Source: CEIC Data Co. Ltd.

Export weakness has been driven by waning demand from Europe, China, and more recently Japan, partially offset by resilient demand from other ASEAN countries.

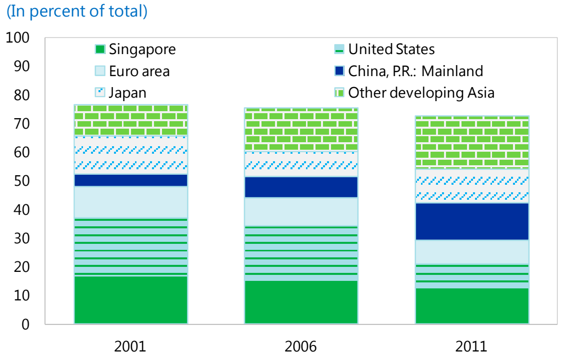
Contributions to Export Growth by Destination
(In percent, year-on-year)



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

China has overtaken Singapore, Japan, and the United States to become Malaysia's main trading partner.

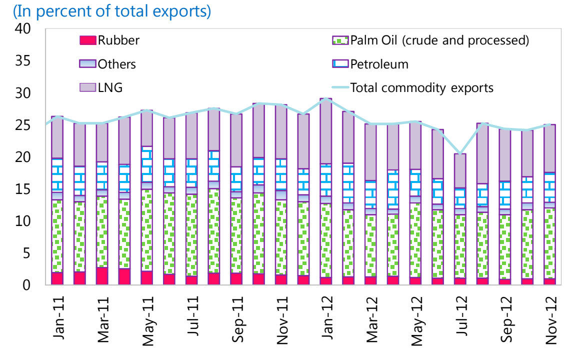
Main Export Destinations
(In percent of total)



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

Exports of commodities remain at around one-fourth of the total, with gas and palm oil as the main items.

Commodity Exports
(In percent of total exports)

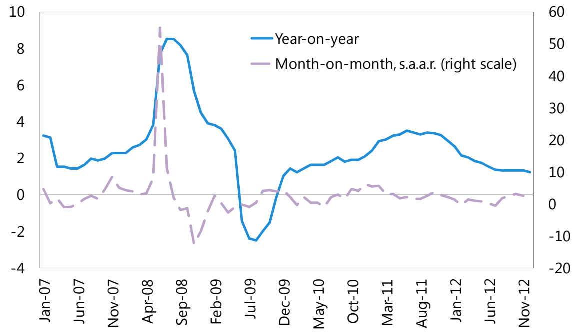


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 2. Malaysia: Inflation and Domestic Resource Constraints

Consumer price inflation has stabilized at low levels.

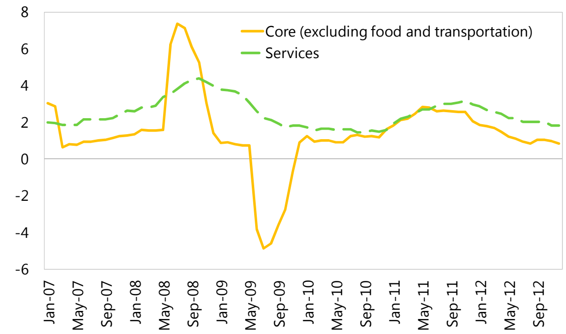
Inflation
(Percent change)



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

Measures of underlying inflation have also eased...

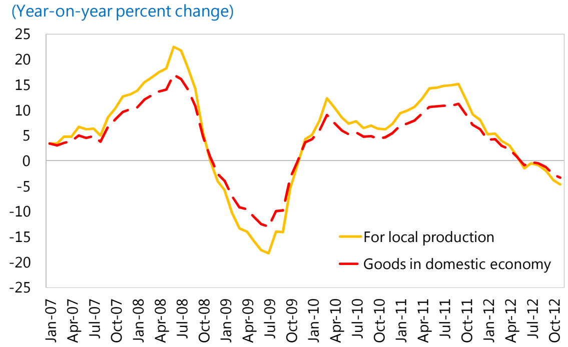
Inflation
(Year-on-year percent change)



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

...as have producer prices.

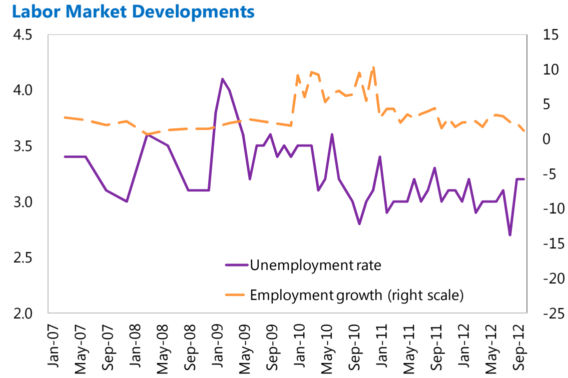
Producer Price Index
(Year-on-year percent change)



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

However, a tight labor market...

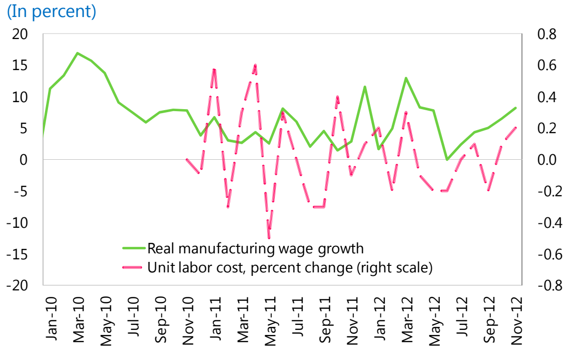
Labor Market Developments



Source: CEIC Data Co. Ltd.

...resurgent wage pressures...

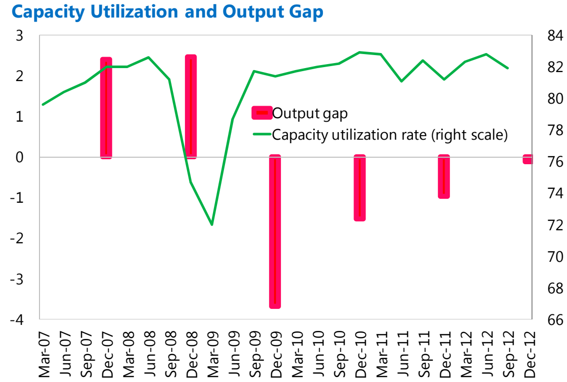
Real Wages and Unit Labor Costs in Manufacturing
(In percent)



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

...high capacity utilization, and a closing output gap, all point to potential inflationary pressures going forward.

Capacity Utilization and Output Gap



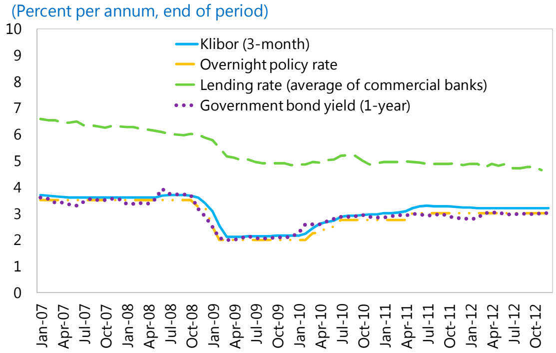
Source: CEIC Data Co. Ltd; and IMF staff estimates..

Figure 3. Malaysia: Monetary Developments

While nominal interest rates are stable or declining…

Interest Rates

(Percent per annum, end of period)

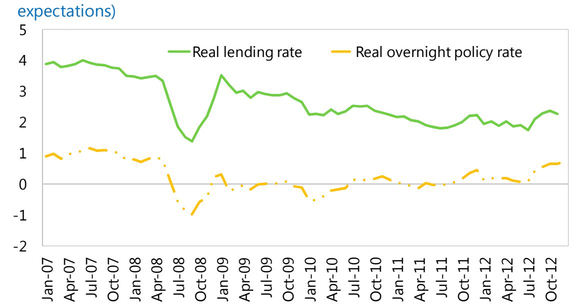


Sources: Bloomberg L.P.; and CEIC Data Co. Ltd.

…real rates have been pushed up recently by falling inflation.

Real Interest Rates

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

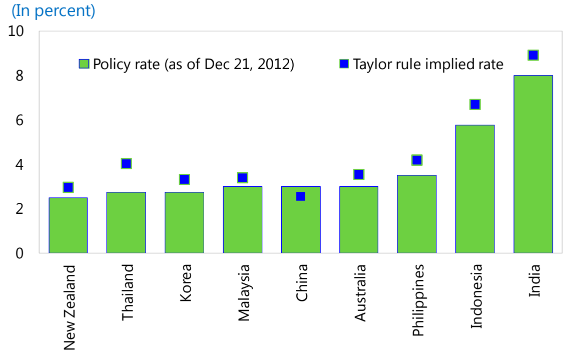


Sources: Bloomberg L.P.; CEIC Data Co. Ltd; Consensus Economics Inc; IMF staff estimates.

Malaysia's current monetary policy rate is well calibrated to cyclical conditions.

Nominal Policy Rates and Taylor Rule Implied Rates

(In percent)

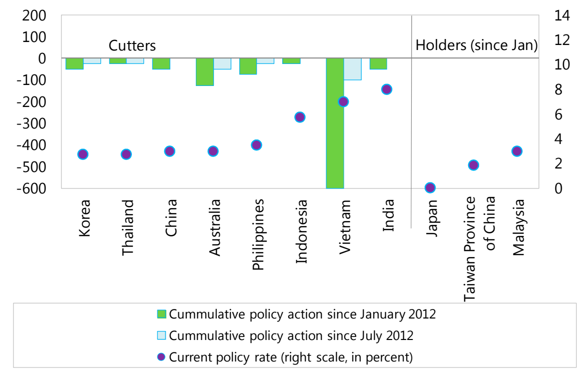


Source: IMF staff calculations.

And, while other countries in the region have started a monetary easing cycle, Malaysia has stayed put.

Selected Asia: Policy Rate Actions 1/

(In basis points)



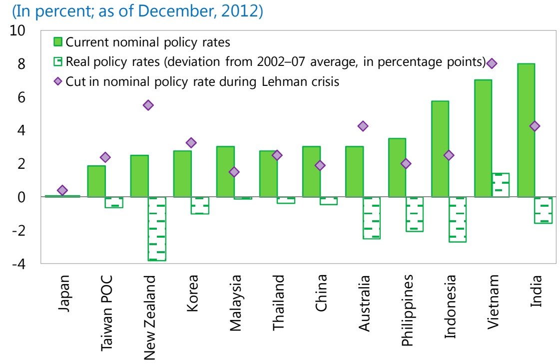
Source: IMF staff calculations.

1/ Latest data as of December 2012

Yet, it has ample space to ease policy in a downside scenario.

Selected Asia: Policy Rates

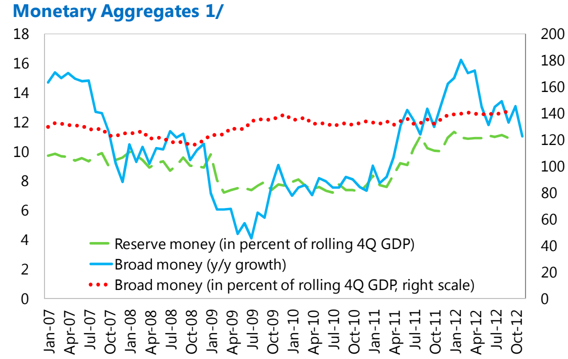
(In percent; as of December, 2012)



Source: IMF, Asia and Pacific Regional Economic Outlook.

Against a stable monetary policy, money has been growing roughly in line with GDP.

Monetary Aggregates 1/



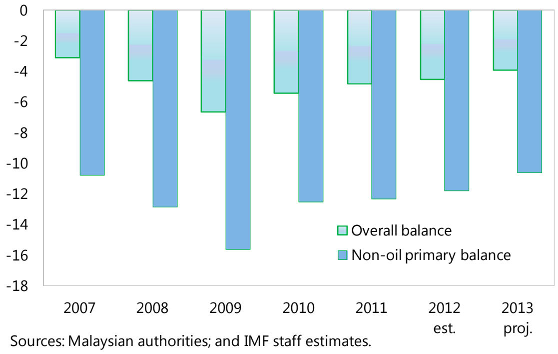
Sources: IMF, *Integrated Monetary Database*; and IMF staff calculations.

1/ At depository corporations level.

Figure 4. Malaysia: Federal Government Balance

The budget deficit is expected to decline in 2012–2013…

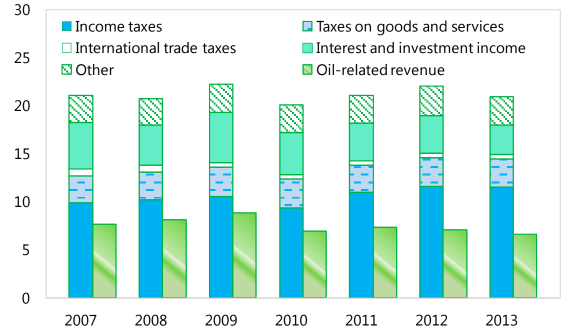
Federal Government Overall and Non-Oil Balance
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

This reflects in part strong revenue performance.

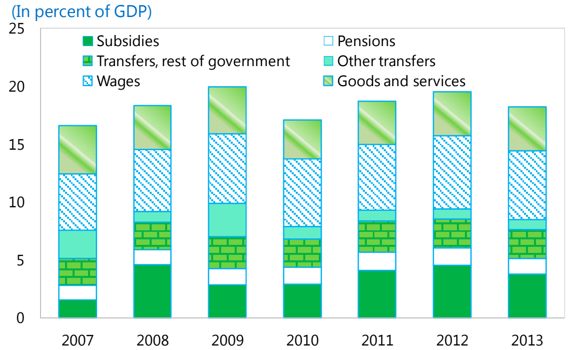
Federal Government Revenue
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

Wages, subsidies and transfers have increased…

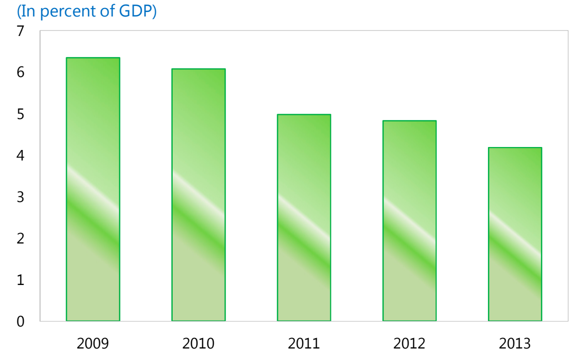
Federal Government Current Expenditures
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

…while development spending has declined.

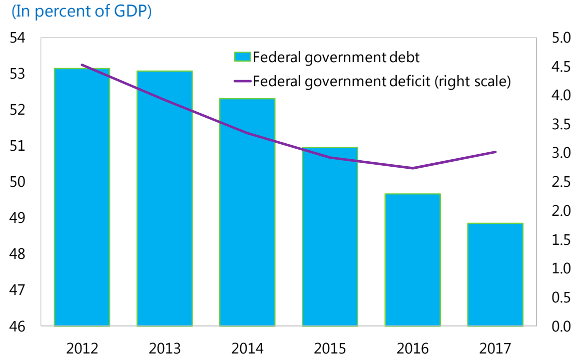
Federal Government Development Spending
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

The authorities' medium-term deficit target would put debt on a declining path.

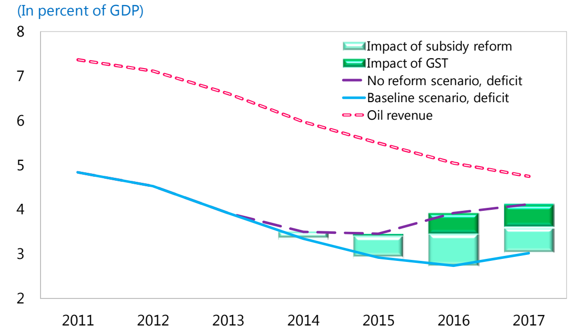
Medium-Term Fiscal Outlook
(In percent of GDP)



Source: IMF staff estimates.

GST and subsidy reforms are critical to achieve these targets as oil revenues are projected to decline.

Federal Government Overall Deficit: Baseline vs. Alternate Scenarios
(In percent of GDP)

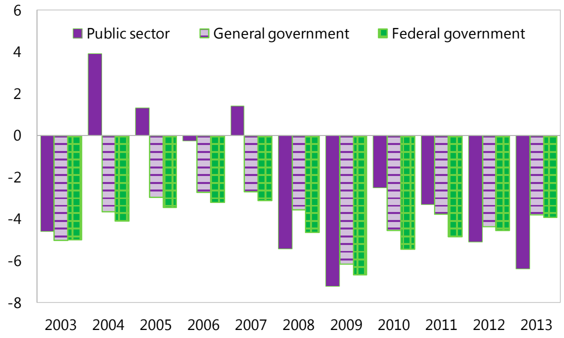


Sources: Malaysian authorities; and IMF staff estimates.

Figure 5. Malaysia: Public Sector Balance

The public sector balance turned into a persistent deficit since 2008...

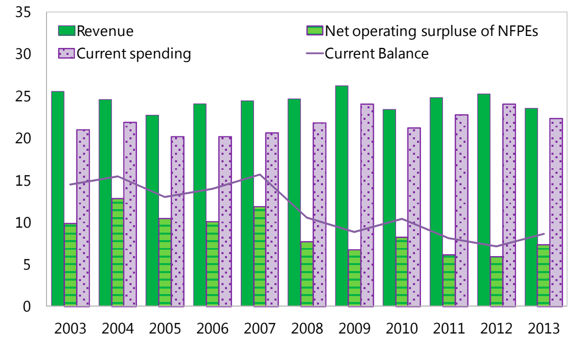
Fiscal Balance
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

...driven mainly by a decline in the net operating surplus of NFPEs and higher current spending.

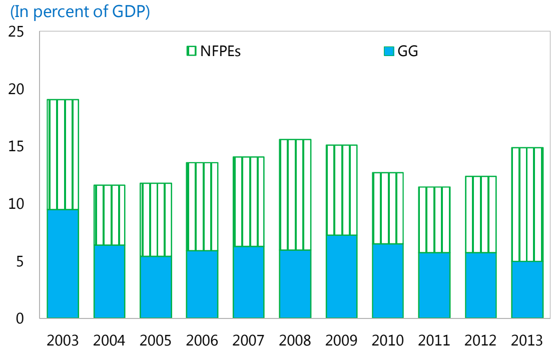
Current Balance of the Public Sector
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

Development spending (in particular by NFPEs) increased during the crisis and again recently, contributing to the projected widening in the public sector deficit.

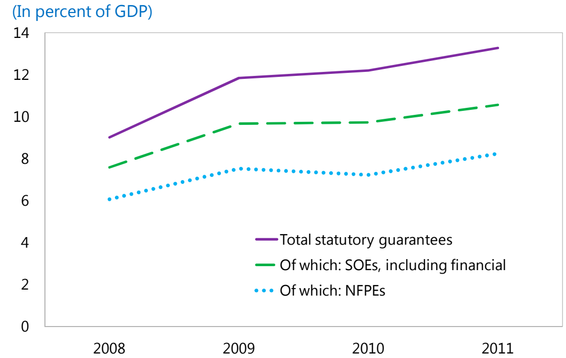
Development Spending
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

NFPEs have been a significant recipient of guarantees from the federal government.

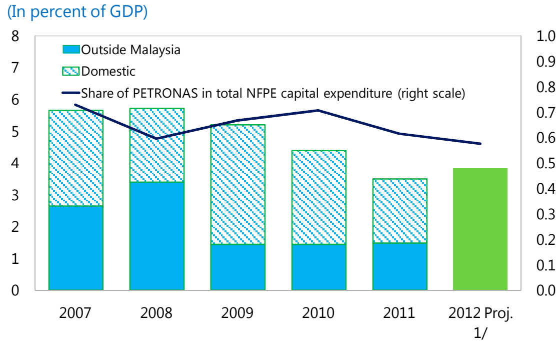
Loan Guarantees to NFPEs
(In percent of GDP)



Source: Malaysian authorities.

The oil and gas sector has been an important driver of capital expenditure by NFPEs.

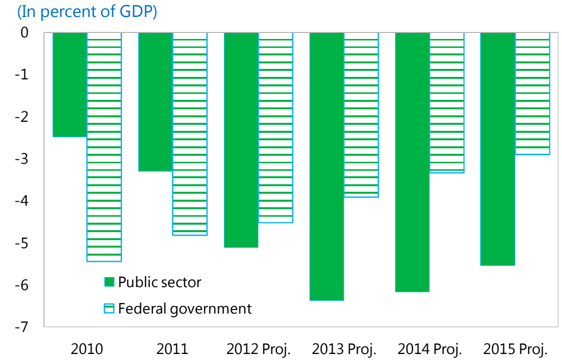
Capital Spending by PETRONAS
(In percent of GDP)



Sources: PETRONAS, Malaysian authorities; and IMF staff calculations.
1/ Breakdown of investment by location is not yet available for 2012.

The public sector deficit is expected to widen in 2013, in contrast with the projected decline in the federal government deficit.

Fiscal Balance
(In percent of GDP)



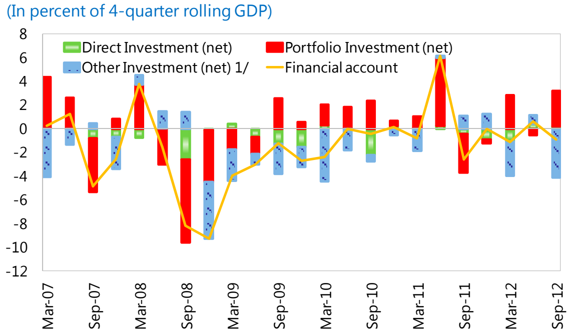
Sources: Malaysian authorities; and IMF staff estimates.

Figure 6. Malaysia: Capital Inflows

Capital inflows have been volatile, but have remained generally small in net terms as a share of GDP.

Financial Account

(In percent of 4-quarter rolling GDP)

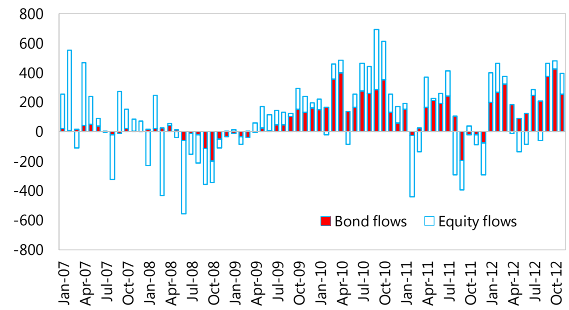


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.
1/ Includes financial derivatives.

Malaysia, as other emerging markets in Asia, is currently experiencing a return of portfolio flows....

EPFR Global Funds Flows: Equity and Bond Funds 1/

(In millions of U.S. dollars)

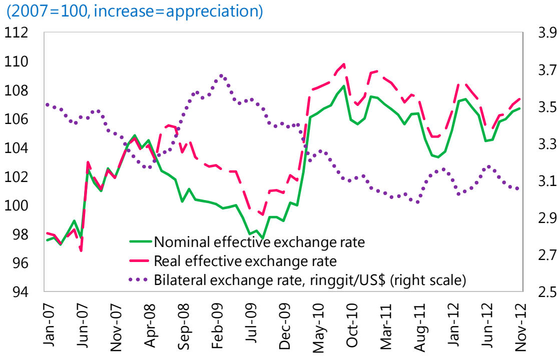


Source: Haver Analytics.
1/ Monthly flows. Includes exchange traded funds and mutual funds.

...which has driven up the MYR,...

Effective Exchange Rate

(2007=100, increase=appreciation)

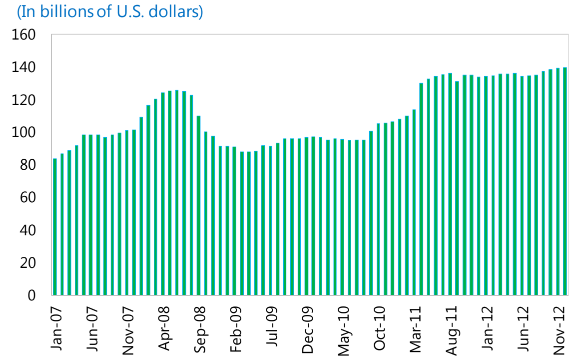


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

...propped up reserves slightly...

Reserves

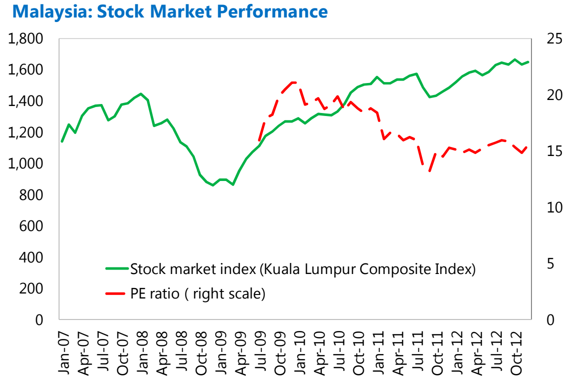
(In billions of U.S. dollars)



Source: CEIC Data Co. Ltd.

...and boosted stock market prices.

Malaysia: Stock Market Performance

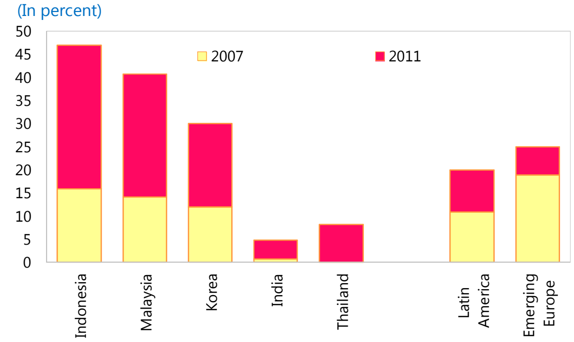


Source: Bloomberg L.P.

The share of foreign holdings of domestic sovereign bonds is one of the highest in the region and beyond.

Foreign Holdings of Local Sovereign Bonds

(In percent)

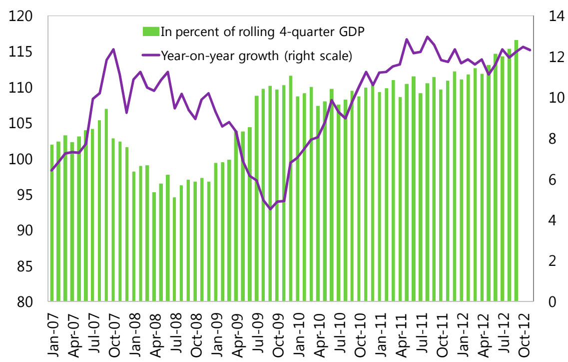


Source: JP Morgan; CEIC Data Co. Ltd.; Data from the authorities; and IMF staff calculations.

Figure 7. Malaysia: Financial Sector Developments

Aggregate credit growth has stabilized but at a rate higher than nominal GDP growth.

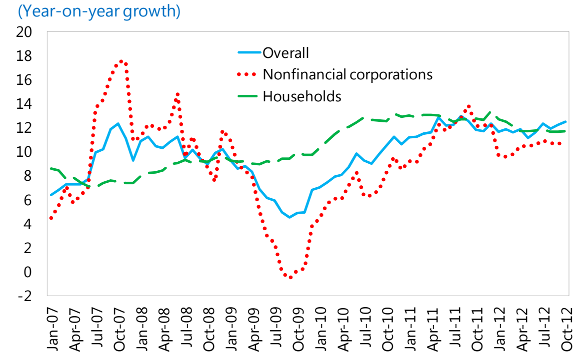
Banks' Claims on Private Sector



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

Credit to households has moderated somewhat but remains higher than credit to businesses.

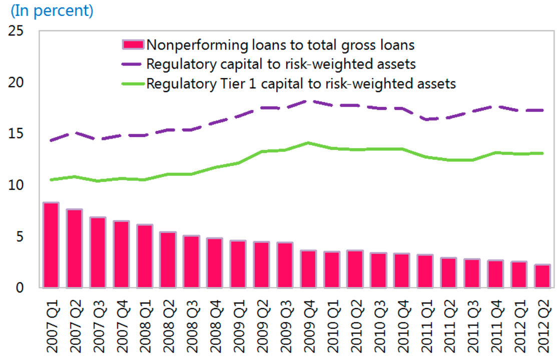
Banks' Claims on Private Sector
(Year-on-year growth)



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

The banking system is well capitalized, while credit quality has steadily improved.

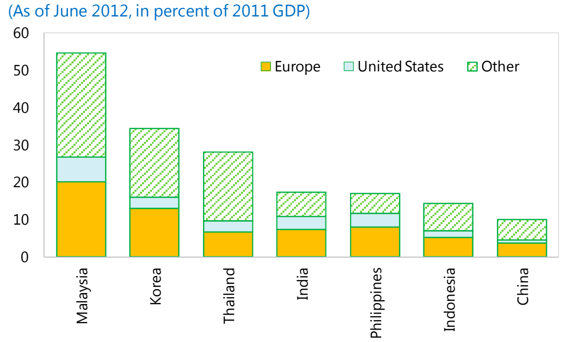
Banks' Financial Soundness Indicators
(In percent)



Source: IMF, *Financial Soundness Indicators* Database.

While claims by foreign banks in Malaysia are high as a share of GDP…

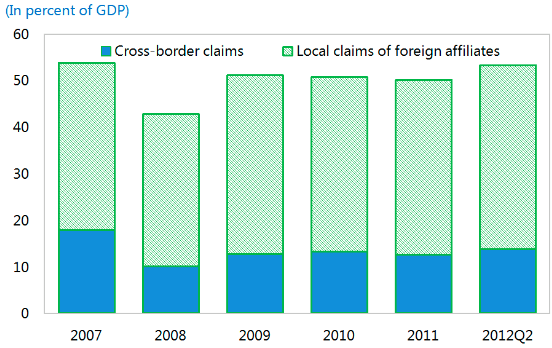
Foreign Banks' Claims on Selected Asian Countries
(As of June 2012, in percent of 2011 GDP)



Sources: Bank for International Settlements; IMF, World Economic Outlook.

…they reflect mostly claims by local affiliates, which tend to be deposit-funded.

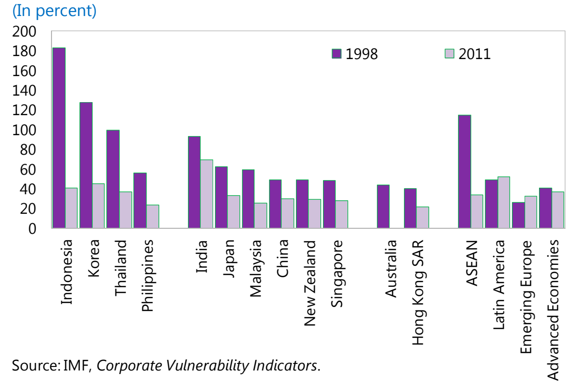
Cross Border Claims
(In percent of GDP)



Sources: Bank for International Settlements; and IMF staff calculations.

Corporate leverage has declined significantly since the Asian Crisis.

Corporate Debt to Equity Ratio
(In percent)

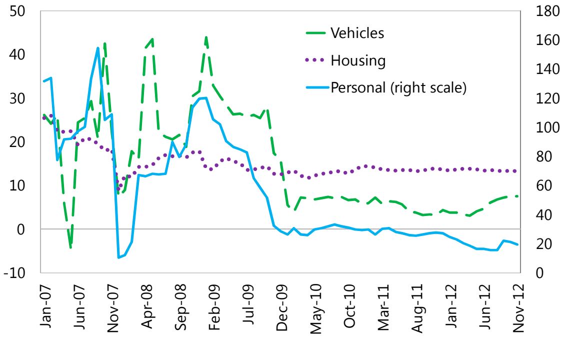


Source: IMF, *Corporate Vulnerability Indicators*.

Figure 8. Malaysia: Banks' Exposure to the Household Sector

Housing and (particularly) personal loans have been growing at high rates.

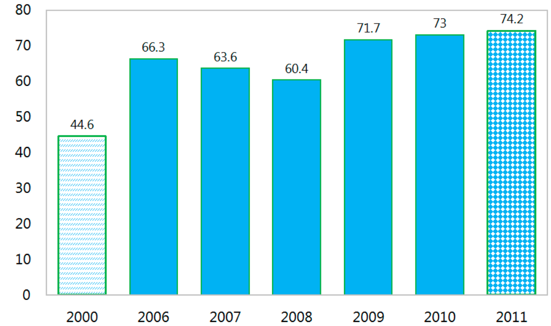
Household Loan Growth
(In percent, year-on-year)



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

This has led to a sustained increase in household debt…

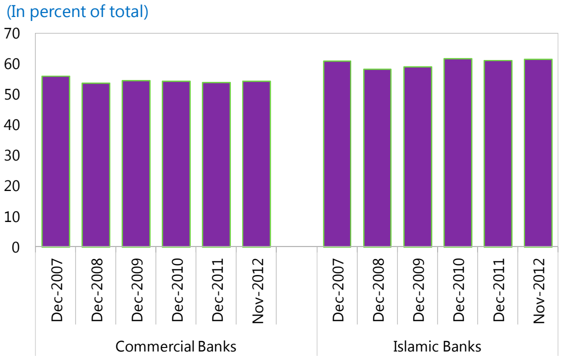
Household Debt-to-GDP Ratio
(In percent)



Source: Bank Negara Malaysia.

…and has left banks (especially Islamic ones) highly exposed to the household sector.

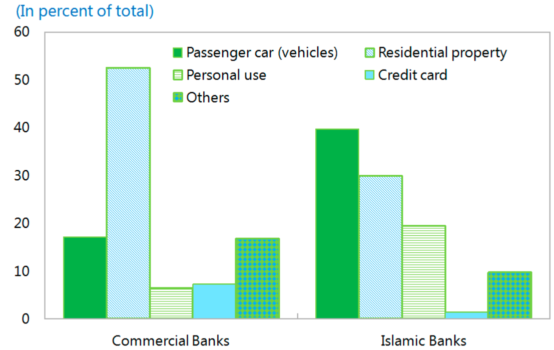
Household Loans
(In percent of total)



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

Over half of household loans by commercial banks are for housing. By contrast, Islamic banks are more exposed to car loans.

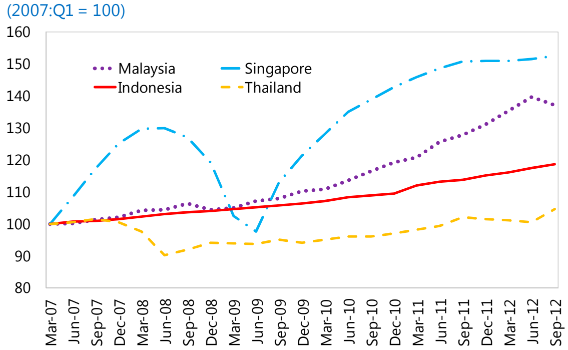
Household Lending, December 2011
(In percent of total)



Source: CEIC Data Co. Ltd.

Rapid growth in housing loans has supported housing prices…

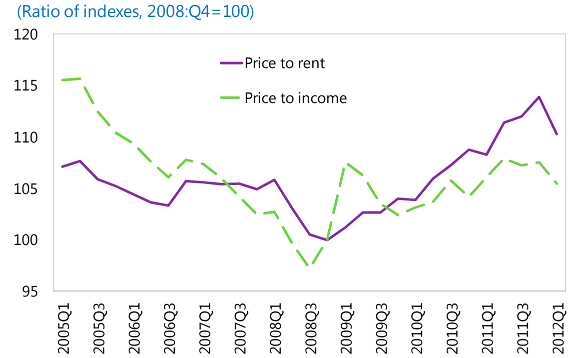
House Price Index
(2007:Q1 = 100)



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

…which have been rising faster than rentals and income for over two years.

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



Sources: *Global Property Guide*; and IMF staff calculations.

Table 1. Malaysia: Selected Economic and Financial Indicators, 2008–13

Nominal GDP (2011): US$288 billion
Main export (percent of total): electrical & electronic products (39%), commodities (23%)
GDP per capita (2011): US$10,085
Population (2011): 28.6 million
Unemployment rate (2011): 3.1 percent

	2008	2009	2010	2011	Est. 2012	Proj. 2013
Real GDP (percent change)	4.8	-1.5	7.2	5.1	5.1	5.0
Total domestic demand	6.4	-1.6	10.4	7.3	11.6	6.9
Consumption	8.4	1.4	5.8	8.9	7.4	6.4
Private consumption	8.7	0.6	6.6	7.1	7.3	7.8
Gross capital formation	1.8	-9.4	23.8	3.2	22.5	8.2
GDP deflator	10.4	-6.0	4.1	5.5	1.5	3.0
Saving and investment (in percent of GDP)						
Gross domestic investment	21.5	17.8	23.1	23.6	28.0	29.4
Gross national saving	38.5	33.4	34.2	34.6	34.0	35.3
Fiscal sector (in percent of GDP)						
Federal government overall balance	-4.6	-6.7	-5.4	-4.8	-4.5	-3.9
Revenue	20.8	22.3	20.1	21.0	22.0	21.0
Expenditure and net lending	25.4	28.9	25.5	25.9	26.6	24.9
Federal government non-oil primary balance	-11.2	-13.6	-10.6	-10.3	-9.6	-8.4
Consolidated public sector overall balance 1/	-5.4	-7.2	-2.5	-3.3	-5.1	-6.4
General government debt	41.2	52.8	53.7	54.5	55.4	55.1
Inflation and unemployment (period average, in percent)						
CPI inflation	5.4	0.6	1.7	3.2	1.7	2.2
Unemployment rate	3.3	3.7	3.3	3.1	3.0	3.0
Money and credit (end of period, percentage change)						
Total liquidity (M3)	11.9	9.2	6.8	14.3	…	…
Credit to private sector	12.9	6.2	9.7	12.1	…	…
Three-month interbank rate (in percent)	3.4	2.2	3.0	3.2	3.2	…
Balance of payments (in billions of U.S. dollars)						
Current account balance	39.4	31.4	27.3	31.7	18.1	20.1
(In percent of GDP)	17.1	15.5	11.1	11.0	6.0	5.9
Trade balance	51.6	39.9	41.8	48.4	41.1	38.4
Services and income account balance	-6.9	-3.0	-7.7	-9.8	-16.5	-10.9
Capital and financial account balance	-35.6	-22.8	-6.2	7.2	-3.8	-19.4
Errors and omissions	-9.4	-4.7	-22.0	-8.0	-8.2	0.0
Overall balance	-5.5	3.9	-0.8	30.9	6.1	0.7
Gross official reserves (US$ billions)	91.5	96.7	106.5	133.6	139.7	140.4
(In months of following year's imports)	7.6	6.1	5.9	7.0	6.7	6.4
(In percent of short-term debt) 2/	274.4	250.4	207.3	256.2	251.1	235.0
Total external debt (US$ billions)	68.5	68.0	74.1	81.1	85.5	90.0
(In percent of GDP)	29.6	33.6	30.0	28.2	28.1	26.6
Of which: short-term (in percent of total) 2/	48.7	56.8	69.3	64.3	65.1	66.4
Debt service ratio						
(In percent of exports of goods and services)	2.8	6.6	7.7	10.2	8.2	7.6
(In percent of exports of goods and nonfactor services)	2.9	7.0	8.1	10.8	8.8	8.1
Memorandum items:						
Nominal GDP (in billions of US$)	231	202	247	288	304	339
Nominal GDP (in billions of ringgit)	770	713	795	881	939	1,016

Sources: CEIC; 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/ By remaining maturity.

Table 2. Malaysia: Indicators of External Vulnerability, 2008–12

	2008	2009	2010	2011	Est. 2012
Financial indicators					
General government debt (in percent of GDP) 1/	41.2	52.8	53.7	54.5	55.4
Total liquidity (M3: percent change, 12-month basis)	11.9	9.2	6.8	14.3	...
Private sector credit (percent change, 12-month basis)	12.9	6.2	9.7	12.1	...
Treasury bill interest rate (percent, 12-month average) 2/	3.4	2.1	2.6	2.9	3.2
External indicators					
Exports (percent change, 12-month basis in U.S. dollars)	13.1	-21.2	26.6	14.6	0.7
Imports (percent change, 12-month basis in U.S. dollars)	6.7	-20.7	34.0	14.3	4.9
Current account balance (in billions of U.S. dollars)	39.4	31.4	27.3	31.7	18.1
Current account balance (in percent of GDP)	17.1	15.5	11.1	11.0	6.0
Capital and financial account balance (in billions of U.S. dollars)	-35.6	-22.8	-6.2	7.2	-3.8
Gross official reserves (in billions of U.S. dollars)	91.5	96.7	106.5	133.6	139.7
In months of following year's imports of goods and nonfactor services	7.6	6.1	5.9	7.0	6.7
As percent of total liquidity (M3)	33.9	32.5	30.0	34.2	...
As percent of monetary base	461.3	603.8	532.6	440.2	...
Total short-term external debt by:					
Original maturity (in billions of U.S. dollars)	23.1	22.6	25.9	32.7	36.1
Remaining maturity (in billions of U.S. dollars)	33.4	38.6	51.4	52.2	55.6
Original maturity to reserves (in percent)	25.3	23.4	24.3	24.5	25.8
Original maturity to total external debt (in percent)	33.8	33.3	35.0	40.4	42.2
Remaining maturity to reserves (in percent)	36.4	39.9	48.2	39.0	39.8
Remaining maturity to total external debt (in percent)	48.7	56.8	69.3	64.3	65.1
Total external debt (in billions of U.S. dollars)	68.5	68.0	74.1	81.1	85.5
Of which: public and publicly guaranteed debt	25.8	26.2	28.4	27.7	28.7
Total external debt to exports of goods and services (in percent)	28.3	34.7	30.5	28.9	30.6
External amortization payments to exports of goods and services (in percent)	1.6	5.2	6.6	9.1	7.0
Financial market indicators					
Kuala Lumpur Composite Index (KLCI), end of period	877	1,273	1,519	1,531	1,689
10-years government securities yield (percent per annum, average)	4.1	4.1	4.0	3.9	3.5

Sources: Haver Analytics; data provided by the authorities; and Fund staff estimates.

1/ Gross debt.
2/ Discount rate on 3-month treasury bills.

Table 3. Malaysia: Balance of Payments, 2008–13

	2008	2009	2010	2011	Est. 2012	Proj. 2013
			(In billions of U.S. dollars)			
Current account balance	39.4	31.4	27.3	31.7	18.1	20.1
Trade balance	51.6	39.9	41.8	48.4	41.1	38.4
Exports, f.o.b.	199.2	157.0	198.7	227.7	229.2	243.8
Imports, f.o.b.	147.7	117.1	156.9	179.3	188.1	205.5
Services and income account balance	-6.9	-3.0	-7.7	-9.8	-16.5	-10.9
Receipts	42.8	39.2	44.6	53.1	50.3	59.0
Of which: income	12.1	11.2	11.9	17.1	17.6	17.7
Payments	49.7	42.1	52.3	62.9	66.8	69.9
Of which: income	19.0	15.3	20.1	24.3	24.5	26.1
Net transfers	-5.2	-5.6	-6.8	-6.9	-6.5	-7.5
Capital and financial account balance	-35.6	-22.8	-6.2	7.2	-3.8	-19.4
Capital account	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-35.6	-22.8	-6.2	7.2	-3.8	-19.4
Net foreign direct investment	-7.8	-6.3	-4.2	-3.3	-2.1	-3.4
Portfolio investment	-25.0	-0.5	15.0	8.4	18.2	10.2
Drawings	0.1	0.1	1.4	2.1	0.1	1.9
Repayments	0.3	1.9	0.3	2.0	0.3	2.0
Other investment	-2.8	-15.9	-17.0	2.1	-19.9	-26.2
Errors and omissions	-9.4	-4.7	-22.0	-8.0	-8.2	0.0
Overall balance	-5.5	3.9	-0.8	30.9	6.1	0.7
Overall financing	5.5	-3.9	0.8	-30.9	-6.1	-0.7
Gross official reserves	91.5	96.7	106.5	133.6	139.7	140.4
In months of following year's imports of goods and nonfactor services	7.6	6.1	5.9	7.0	6.7	6.4
In percent of short-term debt 1/	274.4	250.4	207.3	256.2	251.1	235.0
			(In percent of GDP)			
Current account balance	17.1	15.5	11.1	11.0	6.0	5.9
(Excluding oil and gas)	8.0	8.9	4.2	3.6	-0.7	0.0
Trade balance	22.3	19.7	16.9	16.8	13.5	11.3
Exports	86.2	77.6	80.5	79.1	75.4	72.0
Imports	63.9	57.9	63.6	62.3	61.8	60.7
Services and income account balance	-3.0	-1.5	-3.1	-3.4	-5.4	-3.2
Capital and financial account balance	-15.4	-11.3	-2.5	2.5	-1.3	-5.7
Net foreign direct investment	-3.4	-3.1	-1.7	-1.1	-0.7	-1.0
			(Annual percentage change)			
Memorandum items:						
Export value growth (in U.S. dollars)	13.1	-21.2	26.6	14.6	0.7	6.4
Export volume growth	-6.0	-13.0	10.1	4.9	0.5	3.0
Import value growth (in U.S. dollars)	6.7	-20.7	34.0	14.3	4.9	9.3
Import volume growth	-5.1	-23.5	18.1	4.6	7.3	6.8
Terms of trade	7.0	-12.4	2.0	0.1	-0.6	0.8
Net international investment position						
(In billions of U.S. dollars)	31.4	30.0	4.1	12.3	…	…
(In percent of GDP)	13.6	14.8	1.7	4.3	…	…

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

1/ By remaining maturity.

Table 4. Malaysia: Illustrative Medium-Term Macroeconomic Framework, 2008–17 1/

	2008	2009	2010	2011	Est. 2012	Proj. 2013	2014	2015	2016	2017
Real sector (percent change)										
Real GDP growth	4.8	-1.5	7.2	5.1	5.1	5.0	5.1	5.2	5.2	5.2
Total domestic demand	6.4	-1.6	10.4	7.3	11.6	6.9	6.5	6.2	6.2	6.2
CPI inflation (period average)	5.4	0.6	1.7	3.2	1.7	2.2	2.4	2.6	2.4	2.2
Saving and investment (in percent of GDP)										
Gross domestic investment	21.5	17.8	23.1	23.6	28.0	29.4	29.4	28.8	28.6	28.3
Private, including stocks	12.1	7.2	13.0	14.1	18.5	17.2	17.1	17.0	16.9	16.9
Of which: gross fixed capital formation	11.2	11.4	12.1	12.7	17.8	17.2	17.1	17.0	16.9	16.9
Public	9.4	10.6	10.2	9.4	9.5	12.2	12.3	11.8	11.7	11.4
Gross national saving	38.5	33.4	34.2	34.6	34.0	35.3	35.1	34.0	33.6	33.1
Private	28.0	24.5	23.9	26.5	26.8	26.7	26.2	24.9	24.2	24.0
Public	10.6	8.9	10.4	8.1	7.2	8.6	8.9	9.1	9.4	9.1
Fiscal sector (in percent of GDP)										
Federal government overall balance	-4.6	-6.7	-5.4	-4.8	-4.5	-3.9	-3.3	-2.8	-2.7	-3.0
Revenue	20.8	22.3	20.1	21.0	22.0	21.0	20.5	20.2	20.2	20.0
Expenditure and net lending	25.4	28.9	25.5	25.9	26.6	24.9	23.8	23.1	23.0	23.0
Federal government non-oil primary balance	-11.2	-13.6	-10.6	-10.3	-9.6	-8.4	-7.2	-6.1	-5.5	-5.4
Consolidated public sector overall balance 2/	-5.4	-7.2	-2.5	-3.3	-5.1	-6.4	-6.1	-5.5	-5.1	-5.0
General government debt	41.2	52.8	53.7	54.5	55.4	55.1	54.2	53.1	52.0	51.3
Of which: federal government debt	39.8	50.8	51.2	51.8	53.1	53.1	52.3	50.8	49.5	48.8
Balance of payments (in billions of U.S. dollars)										
Trade balance	51.6	39.9	41.8	48.4	41.1	38.4	39.5	39.7	40.5	41.3
Services and income account balance	-6.9	-3.0	-7.7	-9.8	-16.5	-10.9	-10.4	-9.9	-9.3	-8.3
Current account balance	39.4	31.4	27.3	31.7	18.1	20.1	21.0	21.0	21.6	22.7
(In percent of GDP)	17.1	15.5	11.1	11.0	6.0	5.9	5.7	5.2	5.0	4.8
Capital and financial account balance	-35.6	-22.8	-6.2	7.2	-3.8	-19.4	-16.3	-15.5	-11.4	-10.9
Errors and omissions	-9.4	-4.7	-22.0	-8.0	-8.2	0.0	0.0	0.0	0.0	0.0
Overall balance	-5.5	3.9	-0.8	30.9	6.1	0.7	4.7	5.5	10.2	11.8
International trade (annual percent change)										
Export value	13.1	-21.2	26.6	14.6	0.7	6.4	5.5	5.5	6.1	6.6
Import value	6.7	-20.7	34.0	14.3	4.9	9.2	6.0	6.4	6.8	7.3
Terms of trade	7.0	-12.4	2.0	0.1	-0.6	0.8	0.9	-0.3	-0.3	-0.2
Gross official reserves (in billions of U.S. dollars)	91.5	96.7	106.5	133.6	139.7	140.4	145.1	150.6	160.8	172.6
(In months of following year's imports)	7.6	6.1	5.9	7.0	6.7	6.4	6.2	6.0	6.0	6.0
(In percent of short-term debt) 3/	274.4	250.4	207.3	256.2	251.1	235.0	227.6	223.6	224.2	308.3
Total external debt (in billions of U.S. dollars)	68.5	68.0	74.1	81.1	85.5	90.0	94.2	97.8	102.1	106.6
(In percent of GDP)	29.6	33.6	30.0	28.2	28.1	26.6	25.7	24.5	23.5	22.7
Short-term external debt (percent of total) 3/	48.7	56.8	69.3	64.3	65.1	66.4	67.7	68.9	70.2	52.5
Debt-service ratio										
(In percent of exports of goods and services)	2.8	6.6	7.7	10.2	8.2	7.6	7.4	7.1	6.9	6.7
Net international investment position (in billions of U.S. dollars)	31.4	30.0	4.1	12.3	…	…	…	…	…	…
Memorandum items:										
Nominal GDP (in billions of U.S. dollars)	231	202	247	288	…	…	…	…	…	…
Nominal GDP (in billions of ringgit)	770	713	795	881	939	1,016	1,101	1,199	1,301	1,410

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

1/ Period ending December 31.

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

3/ By remaining maturity.

Table 5. Malaysia: Summary of Federal Government Operations and Stock Positions, 2008–13

	2008	2009	2010	2011	2012		2013	
				Prel.	Budget	Est.	Budget	Proj.
I. Statement of Government Operations								
				(In millions of ringgit)				
Revenue	159,793	158,639	159,653	185,419	186,907	207,031	208,650	213,630
Taxes	112,897	106,504	109,515	134,885	135,618	150,627	159,154	162,535
Other revenue	46,896	52,135	50,138	50,534	51,289	56,404	49,496	51,096
Expenditure	193,740	202,361	200,729	227,511	228,508	250,314	247,255	252,092
Expense	154,784	157,148	152,429	183,639	184,022	205,032	204,820	209,657
Compensation of employees	41,011	42,778	46,663	50,148	52,017	59,197	58,621	60,780
Use of goods and services	29,317	29,035	26,507	32,660	34,042	35,529	37,607	38,513
Interest	12,797	14,222	15,621	17,716	20,453	20,453	22,245	22,245
Subsidies	35,166	20,345	23,106	36,256	30,408	42,404	37,612	39,084
Of which: fuel subsidies	17,556	6,190	10,000	20,400	14,211	25,200	20,000	21,472
Grants	25,623	39,937	27,862	32,157	30,863	31,899	34,029	34,029
Social benefits and other expense	10,022	10,146	11,515	13,565	14,877	14,188	13,597	13,897
Net acquisition of nonfinancial assets	38,956	45,213	48,299	43,871	44,486	45,282	42,435	42,435
Gross operating balance	5,009	1,491	7,224	1,780	2,885	1,999	3,830	3,974
Net lending/borrowing	-33,946	-43,722	-41,076	-42,092	-41,601	-43,283	-38,605	-38,461
Overall fiscal balance (authorities' definition) 1/	-35,595	-47,424	-43,276	-42,509	-43,020	-42,513	-39,994	-39,850
Net acquisition of financial assets	1,234	6,871	-956	3,527	1,469	-236	1,509	1,509
By financial instrument								
Currency and deposits	-414	3,168	-3,156	3,109	50	534	120	120
Loans	1,648	3,703	2,200	417	1,419	-770	1,389	1,389
By holder residence								
Domestic	1,234	6,871	-956	3,527	1,469	-236	1,509	1,509
Foreign	0	0	0		...	...	...	...
Net incurrence of liabilities	35,180	50,593	40,120	45,619	43,071	43,047	40,114	39,970
By financial instrument								
Debt securities	35,654	56,879	36,456	45,069	43,603	43,560	40,527	40,383
Loans	-474	-6,286	3,664	550	-532	-513	-413	-413
By holder residence								
Domestic	37,799	44,365	3,567	15,811	43,603	43,560	40,527	40,383
Foreign	-2,619	6,227	36,553	29,808	-532	-513	-413	-413
				(In percent of GDP)				
Revenue	20.8	22.3	20.1	21.0	20.0	22.0	20.8	21.0
Taxes	14.7	14.9	13.8	15.3	14.5	16.0	15.9	16.0
Other revenue	6.1	7.3	6.3	5.7	5.5	6.0	4.9	5.0
Expenditure	25.2	28.4	25.2	25.8	24.4	26.6	24.7	24.8
Expense	20.1	22.0	19.2	20.8	19.7	21.8	20.4	20.6
Net acquisition of nonfinancial assets	5.1	6.3	6.1	5.0	4.8	4.8	4.2	4.2
Gross operating balance	0.7	0.2	0.9	0.2	0.3	0.2	0.4	0.4
Net lending/borrowing	-4.4	-6.1	-5.2	-4.8	-4.4	-4.6	-3.9	-3.8
Overall fiscal balance (authorities' definition) 1/	-4.6	-6.7	-5.4	-4.8	-4.6	-4.5	-4.0	-3.9
II. Stock Positions								
				(In millions of ringgit)				
Liabilities (nominal value)	306,437	362,387	407,101	456,128	...	499,174	...	539,145
By financial instrument								
Debt securities	260,621	312,590	346,813	392,033	...	...	...	...
Loans	45,816	49,797	60,288	64,095	...	...	...	...
By holder residence								
Domestic	256,483	306,477	315,344	333,690	...	...	...	...
Foreign	49,955	55,910	91,757	122,438	...	...	...	...
Memorandum items:								
Cyclically adjusted balance (percent of GDP)	-4.9	-6.2	-5.2	-4.7	...	-4.5	...	-3.9
Primary balance (percent of GDP)	-3.0	-4.7	-3.5	-2.8	-2.4	-2.3	-1.8	-1.7
Non-oil primary balance (percent of GDP)	-11.2	-13.6	-10.6	-10.3	-9.1	-9.6	-8.4	-8.4
Oil revenues (percent of GDP)	8.2	9.0	7.1	7.5	6.7	7.3	6.6	6.7
General government balance (percent of GDP)	-3.6	-6.2	-4.5	-3.8	...	-4.4	...	-3.8
Public sector balance (percent of GDP)	-5.4	-7.2	-2.5	-3.3	...	-5.1	...	-6.4
Nominal GDP (in millions of ringgit)	769,951	712,857	795,036	881,079	936,200	939,445	1,001,800	1,016,010

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

1/ Overall fiscal balance includes net lending (net acquisition of loans) as part of total expenditures, whereas net lending/borrowing excludes it.

Table 6. Malaysia: Monetary Survey, 2009–12

	2009	2010	2011	2012		
				March	June	Sept
	(In millions of ringgit; end of period)					
Net foreign assets	288,170	284,190	356,968	361,376	357,534	346,025
Foreign assets	396,650	420,705	541,182	546,278	554,838	560,998
Foreign liabilities	108,480	136,514	184,214	184,903	197,304	214,973
Net domestic assets	703,882	780,755	863,756	896,735	915,397	961,728
Net domestic credit	929,831	1,005,859	1,127,900	1,158,458	1,192,264	1,218,947
Net credit to nonfinancial public sector	55,865	56,766	63,870	67,242	66,679	64,092
Credit to private sector	795,598	879,943	988,555	1,009,979	1,044,929	1,077,588
Net credit to other financial corporations	78,369	69,151	75,475	81,237	80,657	77,268
Capital accounts	182,714	164,564	191,463	188,449	203,252	199,915
Other items (net)	-43,235	-60,540	-72,681	-73,274	-73,615	-57,305
Broad money	992,052	1,064,945	1,220,725	1,258,111	1,272,931	1,307,752
Narrow money	213,869	239,784	272,942	277,846	281,642	289,637
Currency in circulation	43,438	47,685	53,488	53,413	54,296	55,777
Transferable deposits	170,431	192,100	219,454	224,433	227,346	233,859
Other deposits	749,555	798,978	919,714	946,386	962,352	989,589
Securities other than shares	28,628	26,183	28,058	33,879	28,757	28,280
Repurchase agreements	0	0	10	0	180	246
Net foreign assets	3.4	-0.4	6.8	6.7	2.5	0.3
Net domestic assets	4.4	7.7	7.8	8.6	9.2	11.7
Memorandum items:						
Broad money (12-month percent change)	7.7	7.3	14.6	15.3	11.8	12.0
Currency in circulation (12-month percent change)	7.4	9.8	12.2	9.4	9.1	8.5
Money multiplier (broad money/narrow money)	4.6	4.4	4.5	4.5	4.5	4.5

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

Table 7. Malaysia: Banks' Financial Soundness Indicators, 2008–12

	2008	2009	2010	2011	2012 June
			(In percent)		
Capital adequacy					
Regulatory capital to risk-weighted assets	16.1	18.2	17.5	17.7	17.2
Regulatory Tier 1 capital to risk-weighted assets	11.7	14.1	13.5	13.2	13.1
Asset quality					
Nonperforming loans net of provisions to capital 1/	17.7	11.8	13.9	11.6	9.6
Nonperforming loans to total gross loans	4.8	3.6	3.4	2.7	2.2
Total provisions to nonperforming loans	74.7	82.5	88.6	99.4	99.7
Earnings and profitability					
Return on assets	1.5	1.2	1.5	1.5	1.6
Return on equity	17.6	13.4	16.3	16.8	18.1
Interest margin to gross income	58.2	57.7	59.8	53.5	52.2
Non-interest expenses to gross income	39.8	45.2	41.5	45.2	47.1
Liquidity					
Liquid assets to total assets (liquid asset ratio)	14.8	14.3	15.7	12.9	13.6
Liquid assets to short term liabilities	42.1	43.0	48.1	36.6	37.7
Loan-deposit ratio 2/	74.7	77.9	81.3	80.9	82.1
Sensitivity to market risk					
Net open position in foreign exchange to capital	5.1	3.9	9.3	11.7	10.4
Sectoral distribution of total loans to nonbanking sector					
Residents	98.3	98.1	98.0	97.7	97.6
Other financial corporations	3.2	3.4	3.1	3.1	3.2
General government	0.9	2.0	2.7	2.7	2.7
Nonfinancial corporations	40.6	38.4	37.6	37.3	37.9
Other domestic sectors	53.6	54.4	54.6	54.4	53.8
Nonresidents	1.7	1.9	2.0	2.3	2.4

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

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

Appendix I. Malaysia—Risk Assessment Matrix 1/

<table>
<tr><th>Nature/Source of Main Threats</th><th>Likelihood of Risk</th><th>Transmission Channels</th><th>Expected Impact of Risk</th><th>Recommended Policy Responses</th></tr>
<tr><td>Strong intensification of the euro area crisis</td><td>Medium</td><td>Trade. Weaker global growth would reduce export volumes and commodity prices, with knock-on effects on domestic demand.
Finance. FDI inflows would slow. Heightened global risk aversion may lead to large capital outflows. Significant deleveraging by European banks could reduce trade finance.</td><td>Medium to High
Malaysia's overall export exposure (both direct and indirect) to the EU is around 1. But the overall growth impact would be dampened by the current strength of domestic demand in Malaysia and the ASEAN region (Box 2).
Foreign investor holdings account for about one fifth of the domestic bond/equity market.
European banks' claims on Malaysia are about one quarter of GDP, but U.K. banks account for about 80 percent of the total claims, and most of the claims are funded through domestic deposits.</td><td>There is ample space for monetary easing.
The exchange rate should be allowed to act as a shock absorber, intervening only to smooth excessive volatility.
There is scope to provide liquidity support (in domestic and foreign currency) to maintain financial stability.
There is only limited room for countercyclical fiscal support given the relatively high fiscal deficit and debt levels. Any temporary fiscal expansion should be well targeted and anchored in a credible medium-term consolidation plan.</td></tr>
<tr><td>China hard landing</td><td>Low</td><td>Trade (volumes and prices, including of commodities) would be the dominant channel, with adverse knock-on effects on domestic demand.
Limited financial spillovers (directly through exposure of Malaysian banks to Greater China and indirectly via slowdown domestically and in rest of ASEAN).</td><td>High
China is Malaysia's largest trading partner, with an export share of 13 percent. Staff analysis in the 2012 Spillover Report finds that a 1 percentage point investment slowdown in China would reduce Malaysia's growth by 0.6 percentage points.
The impact would be compounded by spillover effects in other Asian countries strongly integrated with both China and Malaysia, particularly ASEAN countries.</td><td>Similar to above:
A monetary easing should be the first line of defense.
There is also scope to let the exchange rate absorb the shock, using reserves to smooth excessive volatility.
However, only limited room exists for countercyclical fiscal support.</td></tr>
<tr><td>Protracted global slump (large advanced economies slide into prolonged recession and debt-deflation spirals)</td><td>Low</td><td>Trade (both volume and price), as above, would be the dominant channel.
Finance. There may be financial outflows initially as risk aversion increases, with flows remaining volatile. FDI would likely remain subdued.</td><td>High
Prolonged weakness in external demand would likely break the resilience of domestic demand (Box 2), leading to low growth, rising unemployment and falling house and asset prices. This in turn would weaken bank, corporate and sovereign balance sheets, in a negative feedback loop.</td><td>The ability of policy to provide a long-lived cushion against a protracted slump is limited; excessive stimulus could lead to macro and financial instability. Policymakers would need to adjust to slower medium-term growth.</td></tr>
<tr><td>Materialization of contingent liabilities for the federal government</td><td>Low to Medium</td><td>Higher financing costs for the government and higher economy-wide interest rates.
Negative confidence effects.</td><td>Low to Medium
The federal government's explicit loan guarantees are 15 percent of GDP, and there are other significant contingent liabilities arising from government-linked companies and other entities.
A sudden increase in fiscal debt would affect investment and may force a stronger pace of fiscal adjustment. However, Malaysia has monetary policy room to counter the shock.</td><td>A preventive approach would be critical:
Adopt a sufficiently ambitious fiscal consolidation path to increase room to absorb contingencies.
Introduce mechanisms to monitor and control fiscal risks, including from the granting of government guarantees.
If the risk materializes, monetary policy could be eased that the extent this is consistent with the growth-inflation trade-off.</td></tr>
<tr><td>Sharp reversal in capital inflows (could be triggered by a sharp rise in global risk aversion or domestic shocks)</td><td>Low to Medium (strong domestic drivers of capital inflows would help offset outflow triggers)</td><td>Lower external financing to banks, the government and private sector.
Decline in asset prices.</td><td>Low
High share of foreign holdings of sovereign and BNM securities (33 percent) makes these markets vulnerable to risk-off cycles, but there is pent-up domestic demand from a stable core of domestic institutional investors.
Domestic credit is resilient to deleveraging by foreign banks given high share of domestic deposit funding.
Previous isolated capital outflow episodes have had little visible impact on credit or the real economy.</td><td>Let the exchange rate depreciate; use reserves to prevent overshooting.
Provide foreign currency liquidity to maintain market stability if needed.</td></tr>
<tr><td>Sharp decline in house prices</td><td>Low to Medium (house price growth has been rapid)</td><td>The real economy would be adversely affected through weaker bank balance sheets and slower credit, as well as negative wealth and confidence effects.</td><td>Low
Household debt is high at 74 percent of GDP. One half of this is mortgages. However, a stand-alone house price bust is unlikely to significantly affect credit quality unless accompanied by a protracted growth slowdown that affects employment and income. The authorities are monitoring the risk and have adopted measures to cool the housing market.</td><td>Ease monetary policy, resolve insolvent banks, and provide liquidity support for viable banks.
A preemptive approach would combine further targeted macroprudential policies and continued sound bank lending and risk management practices.</td></tr>
</table>

1/ The Risk Assessment Matrix shows events that could materially alter the baseline path discussed in this report (which is the scenario most likely to materialize in the view of staff). The relative likelihood of risks reflects the staff's subjective assessment (at the time of discussions with the authorities) of the risks surrounding this baseline.

Appendix II. Malaysia: FSAP—High Priority Recommendations

Systemic Risks and Vulnerabilities
Enhance data capture for household sector to facilitate a more robust and granular monitoring and assessment of household sector leverage and issues especially in accordance to income category; and review effectiveness of macroprudential measures.
Adopt multiyear top down and bottom up macroeconomic stress testing, and introduce more conservative credit loss parameters in bottom up exercise.
Strengthening Financial Sector Oversight
Strengthen framework for consolidated supervision to address FHCs in such areas as consolidated capital standards and risk management expectations.
Ground the operational independence of SC by changing the legal provisions on removal of commission members and protections given to the members of the Commission and to its staff.
Implement proposed new FSA at an early date; and strengthen legal and regulatory requirements for Islamic banks.
Strengthen the definition of connected lending.
Labuan International Business and Finance Center
Impose prudential and regulatory requirements on Labuan financial institutions in line with international standards and best practice.
Undertake more proactive engagement and effective communication of LFSA with home supervisors and external auditors so as to continue to rely on their work.
Managing Systemic Risks
Formalize a high-level committee involving BNM, SC, PIDM and the fiscal authority with the responsibility for ongoing systemic risk monitoring and information sharing and crisis action.

Appendix III: Malaysia—Staff Policy Advice from the 2010 and 2011 Article IV Consultations

Staff Advice	Policy Actions
Fiscal	
Bring down debt to sustainable levels (e.g., pre-2008 levels by 2020) and articulate credible revenue and spending measures to achieve that target (2010 and 2011).	The authorities agree on the need for fiscal consolidation and are targeting a fiscal deficit of 3 percent of GDP by 2015. The target of reducing federal government debt to 40 percent of GDP by 2020 is also in their plans. They are in the process of developing a medium term budget framework with the help of the World Bank.
Issue a statement of fiscal risks (2010 and 2011).	The authorities requested Fund technical assistance on fiscal risks. A mission was fielded in January 2013.
Broaden tax bases by implementing a GST and rationalizing tax incentives (2010 and 2011).	The authorities agree on the need for a GST and are planning to introduce it as soon as feasible.
Phase out subsidies and replace with targeted cash transfers to the needy (2010 and 2011).	The authorities fully agree with this goal. They have already reduced some fuel and food subsidies, and plan to further rationalize subsidies going forward. They have increased the use of cash transfers in recent budgets and are studying how to further condition these transfers.
Anchor budget decisions on the non-oil balance (2010).	The authorities monitor the non-oil balance but anchor budget decisions on the overall federal government deficit.
Financial	
Broaden the regulatory perimeter to include financial holding companies (2010).	The new Financial Services Act (passed in December 2012) gives BNM the powers to regulate and supervise financial holding companies.
Continue to monitor the increase in household debt (2011).	The authorities have taken a variety of macroprudential measures to deal with rising household indebtedness (LTV cap on third and subsequent mortgages, 100 percent risk weights on mortgages with LTV above 90 percent, and stricter limits on credit card debt). They have also issued guidelines on responsible lending practices.
Structural	
Boost growth and productivity through steady implementation of structural reforms, including reforms to government-linked companies; liberalization of labor and product markets; and enhanced education and training.	The New Economic Model (NEM) takes on many recommendations from previous Article IV reports. Via the Economic Transformation Program and the Government Transformation Program, the authorities have started implementing some of the recommendations of the NEM. Some progress has been made on the strategic reform initiatives (e.g. setting up a competition commission, and further divestment of GLCs). The authorities' further plans to boost growth are discussed in this staff report.
Consider introducing a carefully-designed minimum wage (2011).	The authorities enacted a minimum wage in 2012 and it came into effect in January 2013.
Consider implementing an unemployment insurance scheme (2011).	The ILO has been tasked with drafting a paper on the appropriate design of an unemployment insurance scheme for Malaysia.
Develop defined contribution private pension plans and increase the age of withdrawal from EPF accounts from 55 (2011).	A private retirement scheme (defined contribution) has been introduced. The retirement age for private workers has been increased to 60 from 55, although workers can still withdraw savings from the EPF at 55.

MALAYSIA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 28, 2013

Prepared By

Asia and Pacific Department

CONTENTS

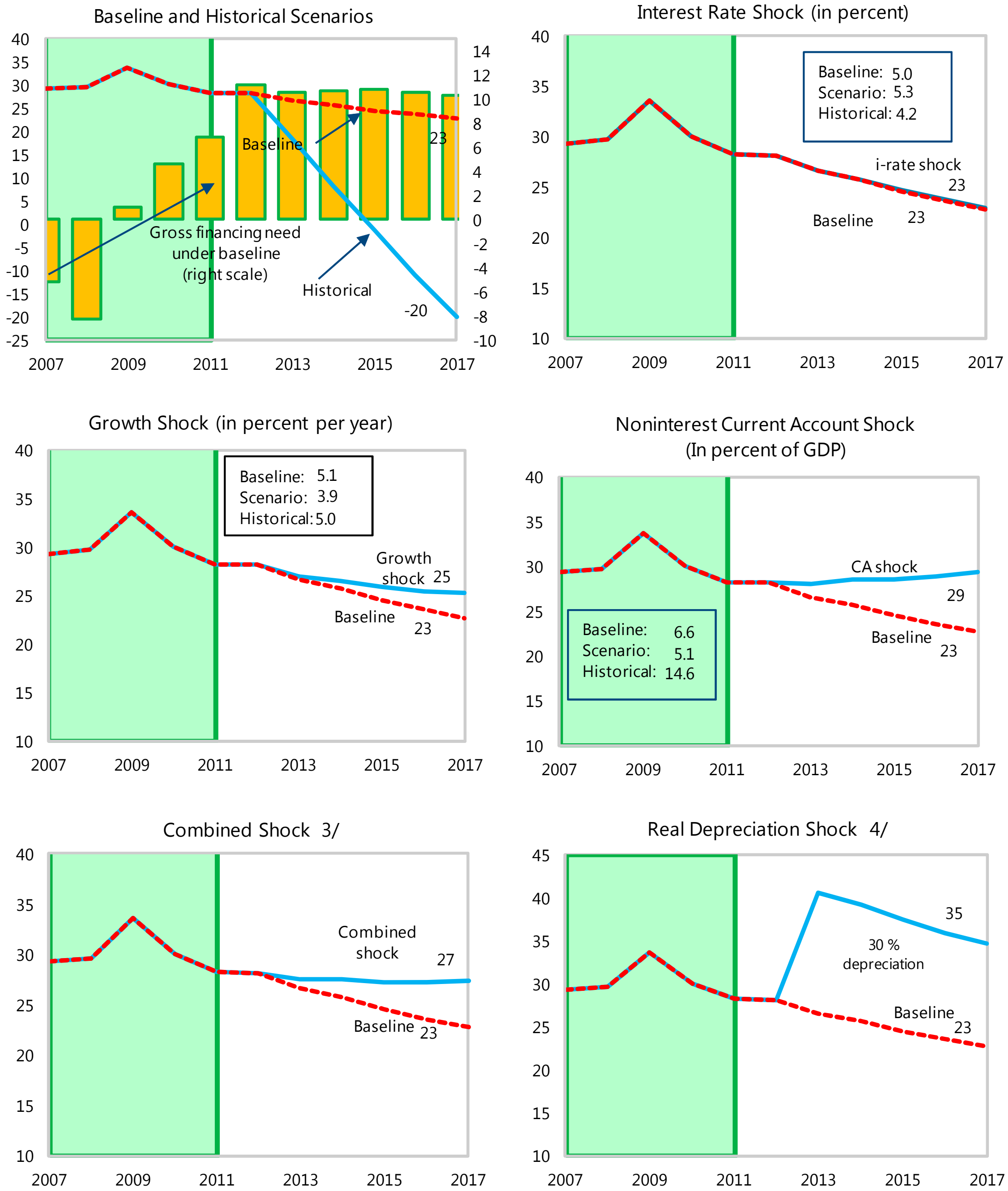
MALAYSIA—MEDIUM-TERM DEBT SUSTAINABILITY ANALYSIS

1. **Malaysia's external debt is expected to remain on a steady downward trend over the medium term, falling to 23 percent of GDP by 2017**. The 6 percentage point decline in the external debt to GDP ratio from 2011 to 2017 mostly reflects sustained current account surpluses and some shift towards domestic debt. Stress tests indicate that external debt would remain manageable under a variety of shocks, including weaker GDP growth, a lower current account balance, and a one-time 30 percent depreciation of the ringgit. Under these scenarios, the external debt to GDP ratio rises above the baseline over the projection period by only modest margins. In the case of the exchange rate depreciation scenario, the debt ratio would rise sharply to 41 percent of GDP in 2012, but would subsequently fall to 35 percent of GDP by 2017.

2. **The gross debt to GDP ratio for the general government is expected to decrease modestly over the medium term**. Under the baseline scenario, debt is expected to decline gradually relative to GDP over the next five years, reaching about 51 percent of GDP by 2017. Bound tests indicate that the debt path is highly vulnerable to growth and interest rate shocks. Indeed, as a result of plausible shocks the federal government's self-imposed debt ceiling of 55 percent of GDP would be breached. For instance, a decline in real GDP growth of about 1.2 percentage point relative to the baseline would increase the debt to GDP ratio to about 58 percent in 2017. Stronger and more front-loaded consolidation efforts can help reduce the probability of breaching the debt ceiling and ensure that the government's goal of reducing debt to 40 percent of GDP by 2020 can be achieved. This consolidation effort would require clearly articulated revenue and expenditure measures, including a phased reduction of subsidies, a broadening of the tax base, and more targeted and efficient social spending.

Figure 1. Malaysia: External Debt Sustainability: Bound Tests 1/ 2/

(External debt, in percent of GDP)

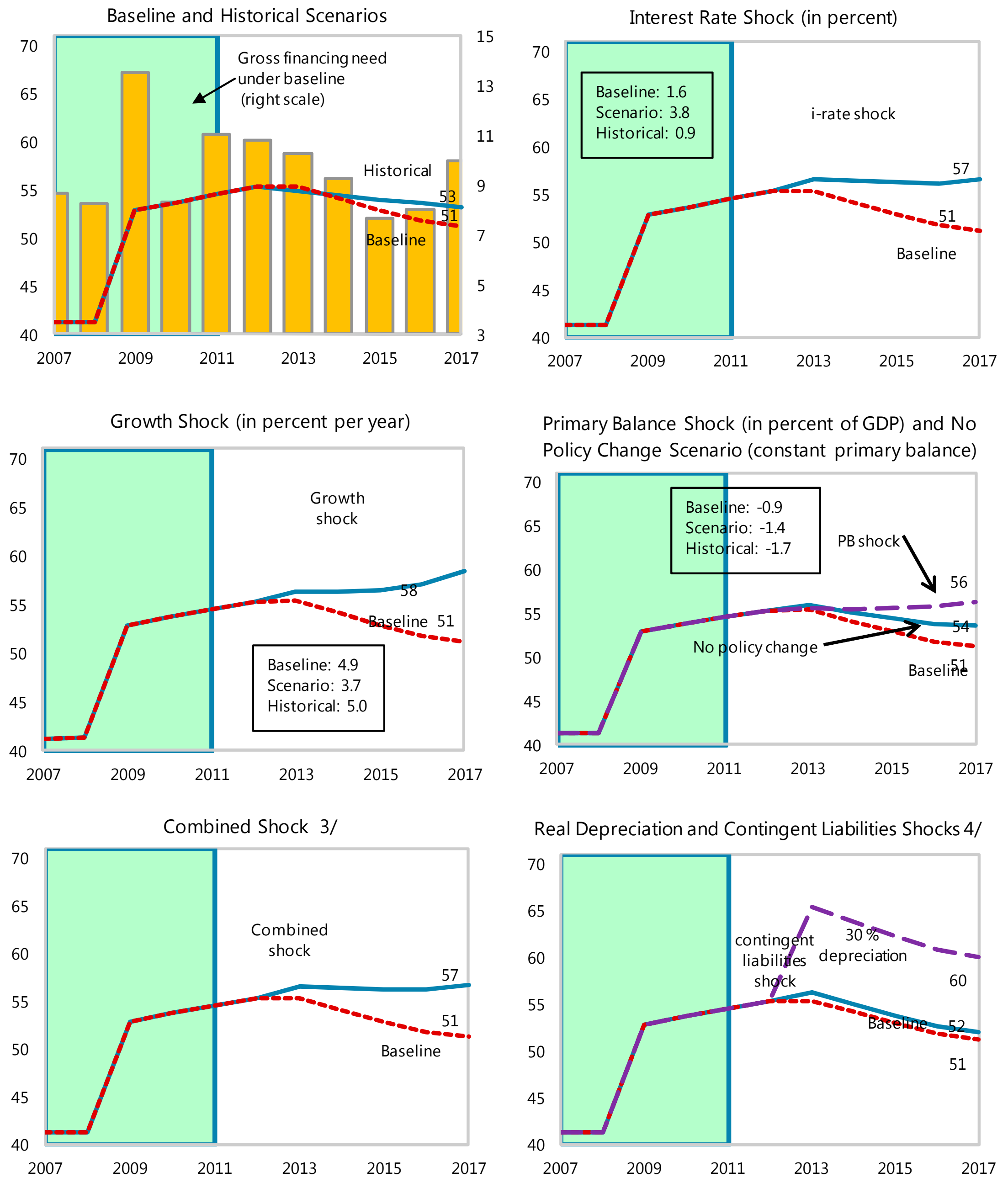


Sources: International Monetary Fund, country desk data; and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2010.

Figure 2. Malaysia: Public Debt Sustainability: Bound Tests 1/ 2/

(Public debt, in percent of GDP)



Sources: International Monetary Fund, country desk data; and staff estimates.

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

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

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

4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2013, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 1. Malaysia: External Debt Sustainability Framework, 2007–2017

(In percent of GDP, unless otherwise indicated)

	Actual							Projections							
	2007	2008	2009	2010	2011			2012	2013	2014	2015	2016	2017		Debt-stabilizing non-interest current account 6/
1 Baseline: external debt	29.3	29.6	33.6	30.0	28.2			28.1	26.6	25.7	24.5	23.5	22.7		0.6
2 Change in external debt	-2.8	0.4	4.0	-3.6	-1.9			-0.1	-1.5	-0.9	-1.2	-0.9	-0.9	0.0	
3 Identified external debt-creating flows (4+8+9)	-19.1	-18.4	-8.2	-15.4	-14.2			-6.7	-6.1	-5.9	-5.5	-5.2	-5.0	0.0	
4 Current account deficit, excluding interest payments	-16.6	-18.3	-16.9	-12.2	-12.1			-7.2	-7.0	-6.7	-6.4	-6.3	-6.3	-0.6	
5 Deficit in balance of goods and services	-19.9	-22.3	-20.3	-17.2	-15.9			-10.4	-10.3	-9.9	-9.4	-9.1	-8.9		
6 Exports	106.2	99.5	91.4	93.7	91.6			86.5	84.3	82.2	80.1	78.9	77.9		
7 Imports	86.3	77.2	71.1	76.6	75.7			76.1	73.9	72.2	70.7	69.8	69.0		
8 Net nondebt creating capital inflows (negative)	1.4	3.4	3.1	1.7	1.1			0.7	1.0	1.0	1.0	1.0	1.0	1.0	
9 Automatic debt dynamics 1/	-3.9	-3.5	5.6	-4.9	-3.2			-0.2	-0.2	-0.1	-0.1	0.1	0.3	-0.4	
10 Contribution from nominal interest rate	1.2	1.2	1.4	1.2	1.1			1.2	1.1	1.1	1.1	1.3	1.4	1.3	
11 Contribution from real GDP growth	-1.7	-1.2	0.5	-2.0	-1.3			-1.4	-1.3	-1.3	-1.2	-1.2	-1.1	-1.1	
12 Contribution from price and exchange rate changes 2/	-3.4	-3.6	3.7	-4.1	-3.0			...	...	...	...	...	...	-0.7	
13 Residual, including change in gross foreign assets (2−3) 3/	16.2	18.8	12.2	11.9	12.3			6.6	4.6	5.0	4.3	4.2	4.2	0.0	
External debt-to-exports ratio (in percent)	27.6	29.8	36.8	32.0	30.8			32.5	31.5	31.2	30.6	29.8	29.1		
Gross external financing need (in billions of U.S. dollars) 4/	-10.1	-19.1	1.9	11.3	19.6			33.9	35.7	39.1	42.8	45.7	48.6		
In percent of GDP	-5.2	-8.3	1.0	4.6	6.8			11.1	10.5	10.7	10.7	10.5	10.3		
Scenario with key variables at their historical averages 5/								28.1	18.2	8.3	-1.5	-11.0	-20.1		2.0
Key macroeconomic assumptions underlying baseline						10-Year Historical Average	10-Year Standard Deviation							For debt stabilization	
Real GDP growth (in percent)	6.3	4.8	-1.5	7.2	5.1	5.0	2.4	5.1	5.0	5.1	5.2	5.2	5.2	5.2	
GDP deflator in U.S. dollars (change in percent)	11.9	13.8	-11.1	13.9	11.0	6.9	7.4	0.6	6.0	3.1	3.5	3.2	3.0	3.0	
Nominal external interest rate (in percent)	4.4	4.9	4.0	4.2	4.2	4.2	0.4	4.4	4.3	4.6	4.8	5.6	6.4	6.4	
Growth of exports (U.S. dollar terms, in percent)	12.6	11.9	-19.6	25.1	13.9	10.6	12.1	-0.2	8.5	5.7	6.1	6.9	7.0		
Growth of imports (U.S. dollar terms, in percent)	13.6	6.7	-19.3	31.4	15.3	10.5	13.3	6.3	8.1	5.9	6.5	7.2	7.2		
Current account balance, excluding interest payments	16.6	18.3	16.9	12.2	12.1	14.6	2.8	7.2	7.0	6.7	6.4	6.3	6.3		
Net nondebt creating capital inflows	-1.4	-3.4	-3.1	-1.7	-1.1	-0.6	1.9	-0.7	-1.0	-1.0	-1.0	-1.0	-1.0		

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate,

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

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

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and nondebt 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 nondebt inflows in percent of GDP) remain at their levels

Table 2. Malaysia: Public Sector Debt Sustainability Framework, 2007–2017

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing primary balance 9/
Baseline: public sector debt 1/	41.2	41.2	52.8	53.7	54.5	55.4	55.1	54.2	53.2	52.1	51.4	-1.4
Of which: foreign-currency denominated	2.9	2.6	1.9	2.1	2.1	1.9	1.7	1.5	1.4	1.2	1.1	
Change in public sector debt	-0.3	0.0	11.6	0.9	0.8	1.0	-0.4	-0.9	-1.0	-1.1	-0.7	
Identified debt-creating flows (4+7+12)	-1.8	-1.9	9.4	-1.1	-1.4	1.0	-0.4	-0.9	-1.0	-1.1	-0.7	
Primary deficit	0.7	1.8	4.1	2.5	1.7	2.1	1.5	1.1	1.0	0.5	0.8	
Revenue and grants	24.4	24.6	26.2	23.4	24.8	25.2	23.6	23.1	22.8	22.8	22.5	
Primary (noninterest) expenditure	25.1	26.5	30.3	25.8	26.4	27.3	25.1	24.2	23.8	23.3	23.3	
Automatic debt dynamics 2/	-2.5	-3.8	5.4	-3.6	-3.1	-1.1	-2.0	-2.0	-2.0	-1.6	-1.5	
Contribution from interest rate/growth differential 3/	-2.3	-3.9	5.4	-3.4	-3.1	-1.1	-1.9	-2.0	-2.0	-1.6	-1.5	
Of which: contribution from real interest rate	0.1	-2.2	4.7	0.0	-0.7	1.5	0.7	0.6	0.6	0.9	1.0	
Of which: contribution from real GDP growth	-2.3	-1.7	0.7	-3.4	-2.5	-2.6	-2.6	-2.6	-2.6	-2.5	-2.5	
Contribution from exchange rate depreciation 4/	-0.3	0.1	0.0	-0.2	0.1	0.0	-0.1	0.0	0.0	0.0	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/	1.5	1.9	2.1	2.0	2.2	0.0	0.1	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	168.7	167.4	201.6	229.8	219.8	219.6	233.7	235.0	233.2	228.7	227.8	
Gross financing need 6/	8.7	8.2	13.5	8.7	11.0	10.9	10.0	9.5	8.0	8.0	9.8	
In billions of U.S. dollars	16.8	19.0	27.3	21.4	31.8	33.2	33.9	34.9	32.0	34.7	46.3	
Scenario with key variables at their historical averages 7/						55.4	55.0	54.6	54.2	53.8	53.4	-2.1
Scenario with no policy change (constant primary balance) in 2011−2016						55.4	55.6	55.7	55.7	56.1	56.6	-1.6
Key macroeconomic and fiscal assumptions underlying baseline												
Real GDP growth (in percent)	6.3	4.8	-1.5	7.2	5.1	5.1	5.0	5.1	5.2	5.2	5.2	
Average nominal interest rate on public debt (in percent) 8/	5.4	4.8	4.7	4.3	4.4	4.4	4.4	4.5	4.8	5.3	5.3	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.5	-5.6	10.6	0.3	-1.1	3.0	1.4	1.4	1.3	2.1	2.3	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	6.7	-4.2	0.8	11.8	-3.5	-0.9	2.9	0.0	0.0	0.0	0.0	
Inflation rate (GDP deflator, in percent)	4.9	10.4	-6.0	4.1	5.5	1.5	3.0	3.1	3.5	3.2	3.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	8.4	10.5	12.6	-8.6	7.6	8.7	-3.6	1.4	3.3	3.1	5.2	
Primary deficit	0.7	1.8	4.1	2.5	1.7	2.1	1.5	1.1	1.0	0.5	0.8	

1/ General government gross debt .

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

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

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

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

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

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

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

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

MALAYSIA—FUND RELATIONS

(As of December 31, 2012)

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

II. General Resources Account

	SDR Millions	Percent of Quota
Quota	1,773.90	100.00
Fund holdings of currency (exchange rate)	1,245.97	70.24
Reserve tranche position	527.93	29.76
Lending to the Fund New Arrangement to Borrow	36.50	

III. SDR Department

	SDR Millions	Percent of Allocation
Net cumulative allocation	1,346.14	100.00
Holdings	1,285.83	95.52

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements: None

VI. Projected Payments to the Fund: None.

VII. Exchange Arrangement:

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

Malaysia maintains bilateral payments arrangements with 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 licensed onshore banks, 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. Further measures were also taken to ease 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 2011 Article IV consultation took place during October 27-November 9, 2011 (IMF Country Report No. 12/43). Staff discussions for the 2012 Article IV consultation were conducted on a mission to Kuala Lumpur during November 29-December 12, 2012. In addition, a staff visit took place during July 11–13, 2012.

IX. FSAP Participation:

Malaysia conducted its first FSAP in 2012.

X. Technical Assistance:

FAD: Mission in October 2008 to analyze the distributional impact of social safety net programs. A fiscal ROSC mission was fielded in May-June 2011. A mission on debt management was fielded in June 2012 to look at the institutional, legal, organizational and operational aspects of debt management, monitoring of fiscal risks, and reporting of debt operations. A mission on fiscal risks took place in January 2013.

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

MCM: Workshop in November 2008 on stress testing. Workshop 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. Workshop in May 2010 on monitoring financial risks. A technical assistance mission on stress testing is scheduled for April 2013.

STA: A mission to assist with the migration to the Government Finance Statistics Manual (GFSM) 2001 was conducted during October-November 2012.

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.

MALAYSIA—STATISTICAL ISSUES

(As of January 10, 2013)

I. Assessment of Data Adequacy for Surveillance
General: Data provision is broadly adequate for surveillance. However, further efforts to improve statistics for the consolidated general government and public sector are necessary.
National accounts: Currently, the Department of Statistics Malaysia (DOSM) compiles and publishes annual and quarterly estimates of GDP by activity and by expenditure at current and constant prices, and annual estimates for gross disposable income, saving, and net lending for the economy based on the *1993 SNA*. The quarterly data are released about two months after the reference quarter. **Price statistics**: The CPI and the PPI are available on a timely and comprehensive basis. A revised CPI was introduced in January 2011; it covers all 14 states and features a more disaggregated measure of the consumption basket and updated expenditure weights based on a 2009/10 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). There is also a need to disseminate more information on public private partnerships.
Monetary statistics: The monetary and financial statistics (MFS) are reported on a timely and regular basis and are broadly in conformity with the Fund's data needs. There is a need to improve the institutional coverage of the financial corporations, sectorization of the domestic economy, and classification and valuation of financial instruments to ensure full adherence to the IMF's *Monetary and Financial Statistics Manual.* In addition, due to the growing importance of insurance corporations, pension funds, and other financial intermediaries in Malaysia, coverage of MFS should be expanded to include these institutions. The MFS missions of January 2004 and 2005 developed an integrated monetary database to be used for publication and operational needs of the BNM, STA, and APD. The Bank Negara Malaysia reports data in STA's standardized report forms (SRFs) which provide more detailed classification of certain items, fuller sectoral and instrument breakdown, and currency aggregation. MFS based on the SRFs are published in the quarterly *IFS Supplement on Monetary and Financial Statistics*.
Balance of payments: Department of Statistics Malaysia compiles and publishes quarterly balance of payments estimates in accordance with the 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 January 10, 2013)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	1/10/2013	1/10/2013	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	31/12/2012	1/8/2013	Bi W	Bi W	Bi W
Reserve/base money	31/12/2012	1/8/2013	Bi W	Bi W	Bi W
Broad money	11/12	1/8/2013	M	M	M
Central bank balance sheet	31/12/2012	1/8/2013	Bi W	Bi W	Bi W
Consolidated balance sheet of the banking system	11/12	1/13	M	M	M
Interest rates[2]	1/10/2013	1/10/2013	D	D	M
Consumer price index	11/12	1/13	M	M	M
Revenue, expenditure, balance and composition of financing[3]—general government[4]	2011	2012	A	A	A
Revenue, expenditure, balance and composition of financing[3]—federal government	2012:Q3	12/12	Q	Q	Q
Stocks of central government and central government guaranteed debt[5]	2012:Q3	12/12	Q	Q	Q
External current account balance	2012:Q3	12/12	Q	Q	Q
Exports and imports of goods and services	11/12	1/13	M	M	M
GDP/GNP	2012:Q3	12/12	Q	Q	Q
Gross external debt	2012:Q3	12/12	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).

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

IMF Executive Board Concludes 2012 Article IV Consultation with Malaysia

On February 11, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Malaysia.[1]

Background

Malaysia's economy continues to perform well. Robust domestic demand has offset external weakness and fueled growth, estimated at 5.1 percent in 2012. Key drivers of the expansion have been private and public investments, particularly in oil, gas, and infrastructure, including large projects under the government's Economic Transformation Program. Consumption growth has also been strong, supported by a strong labor market and by government transfers to households. Net exports, on the other hand, have been a drag on growth, reflecting weak external demand. Inflation has continued to ease, on lower commodity prices and base effects. Average consumer price inflation eased to 1.7 percent in 2012, the lowest in three years and one of the lowest in the Asia-Pacific region.

With inflation subdued, Bank Negara Malaysia has kept its policy interest rate at 3 percent since May 2011, and market interest rates have remained also low and stable. Malaysia has experienced significant and volatile portfolio flows in recent years, reflecting unsettled global financial conditions. However, Malaysia's sound financial system, liquid capital markets, and two-way exchange rate flexibility have facilitated the absorption of flows. Credit growth has

[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.

continued to be robust. While credit to households has moderated somewhat, unsecured personal loans have continued to grow rapidly, and household debt remains high. Housing prices have also continued to climb.

The federal government's deficit is estimated to have declined to about 4.5 percent of GDP in 2012, from 4.8 percent in 2011. Spending in 2012 exceeded original budget projections by about 2 percent of GDP, particularly in wages, pensions, fuel subsidies, and transfers. This, however, was offset by buoyant revenue, reflecting strong economic growth and one-off factors. The federal government's debt is estimated to have risen to about 53 percent at end-2012, from about 52 percent in 2011.

Executive Board Assessment

Executive Directors commended the authorities for their skillful policies, which have underpinned Malaysia's strong macroeconomic performance despite a weak external environment. Directors noted that the external rebalancing of Malaysia's economy has gained momentum, and that domestic demand is increasingly driving economic growth. Looking ahead, Directors considered that Malaysia's medium term prospects are favorable, as the authorities continue to focus on safeguarding financial stability, strengthening fiscal sustainability, and securing high and inclusive growth.

Directors endorsed the current settings for monetary policy and the mildly contractionary fiscal stance in the 2013 budget. They nonetheless encouraged the authorities to further develop their medium-term plans to restore a prudent level of federal government debt and rebuild fiscal space. Directors emphasized that fiscal consolidation would need to be supported by structural fiscal reforms and a move away from oil- and gas-related revenues. Accordingly, they welcomed the authorities' plans to introduce a goods and services tax, and to gradually replace universal fuel subsidies with targeted support for the most vulnerable. Directors took note of the authorities' efforts to reform public financial management, and encouraged them to adopt the recommendations of the recent Fund technical assistance on fiscal risks.

Directors noted with satisfaction that the 2012 Financial Sector Assessment Program review found Malaysia's financial sector to be robust, highly capitalized, and underpinned by a sound supervisory and regulatory framework. They welcomed the recent passage of legislation to further strengthen financial supervision. Directors also commended the use of targeted macroprudential policies to curb risks associated with rising household debt and housing prices, and the authorities' readiness to take additional action as needed.

Directors welcomed the authorities' intention to implement wide ranging reforms to boost growth and inclusiveness. In this context, they underscored the importance of increasing labor market flexibility, raising female participation, and fostering the skills needed for a high value-added economy. Directors welcomed the introduction of a minimum wage, and considered that adopting unemployment insurance and pension system reforms would further strengthen social protection.

Directors took note of the staff's assessment that, despite the significant narrowing of the current account, Malaysia's external position appears stronger than warranted by fundamentals and desirable policies. However, they agreed with the authorities that this mainly reflects structural factors. A few Directors also pointed to underlying methodological limitations in the assessment of the external position. Directors considered that the authorities' policy of maintaining two-way exchange rate flexibility remains appropriate, and that a flexible exchange rate and ongoing structural reforms would facilitate the economy's continued rebalancing.

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 2012 Article IV Consultation with Malaysia is also available.

Malaysia: Selected Economic and Financial Indicators, 2008–13

	2008	2009	2010	2011	Est. 2012	Proj. 2013
Real GDP (percent change)	4.8	1.5	7.2	5.1	5.1	5.0
Total domestic demand	6.4	1.6	10.4	7.3	11.6	6.9
Consumption	8.4	1.4	5.8	8.9	7.4	6.4
Private consumption	8.7	0.6	6.6	7.1	7.3	7.8
Gross capital formation	1.8	9.4	23.8	3.2	22.5	8.2
GDP deflator	10.4	6.0	4.1	5.5	1.5	3.0
Saving and investment (in percent of GDP)						
Gross domestic investment	21.5	17.8	23.1	23.6	28.0	29.4
Gross national saving	38.5	33.4	34.2	34.6	34.0	35.3
Fiscal sector (in percent of GDP)						
Federal government overall balance	4.6	6.7	5.4	4.8	4.5	3.9
Revenue	20.8	22.3	20.1	21.0	22.0	21.0
Expenditure and net lending	25.4	28.9	25.5	25.9	26.6	24.9
Federal government non oil primary balance	11.2	13.6	10.6	10.3	9.6	8.4
Consolidated public sector overall balance 1/	5.4	7.2	2.5	3.3	5.1	6.4
General government debt	41.2	52.8	53.7	54.5	55.4	55.1
Inflation and unemployment (period average, in percent)						
CPI inflation	5.4	0.6	1.7	3.2	1.7	2.2
Unemployment rate	3.3	3.7	3.3	3.1	3.0	3.0
Money and credit (end of period, percentage change)						
Total liquidity (M3)	11.9	9.2	6.8	14.3	…	…
Credit to private sector	12.9	6.2	9.7	12.1	…	…
Three month interbank rate (in percent)	3.4	2.2	3.0	3.2	3.2	…
Balance of payments (in billions of U.S. dollars)						
Current account balance	39.4	31.4	27.3	31.7	18.1	20.1
(In percent of GDP)	17.1	15.5	11.1	11.0	6.0	5.9
Trade balance	51.6	39.9	41.8	48.4	41.1	38.4
Services and income account balance	6.9	3.0	7.7	9.8	16.5	10.9
Capital and financial account balance	35.6	22.8	6.2	7.2	3.8	19.4
Errors and omissions	9.4	4.7	22.0	8.0	8.2	0.0
Overall balance	5.5	3.9	0.8	30.9	6.1	0.7
Gross official reserves (US$ billions)	91.5	96.7	106.5	133.6	139.7	140.4
(In months of following year's imports)	7.6	6.1	5.9	7.0	6.7	6.4
(In percent of short term debt) 2/	274.4	250.4	207.3	256.2	251.1	235.0
Total external debt (US$ billions)	68.5	68.0	74.1	81.1	85.5	90.0
(In percent of GDP)	29.6	33.6	30.0	28.2	28.1	26.6
Of which: short term (in percent of total) 2/	48.7	56.8	69.3	64.3	65.1	66.4
Debt service ratio						
(In percent of exports of goods and services)	2.8	6.6	7.7	10.2	8.2	7.6
(In percent of exports of goods and nonfactor services)	2.9	7.0	8.1	10.8	8.8	8.1
Memorandum items:						
Nominal GDP (in billions of US$)	231	202	247	288	304	339
Nominal GDP (in billions of ringgit)	770	713	795	881	939	1,016

Sources: CEIC; 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/ By remaining maturity.

Statement by Abdul Rasheed Ghaffour, Alternate Executive Director for Malaysia and Zainal Abidin, Senior Advisor to Executive Director
February 11, 2013

1. On behalf of our Malaysian authorities, we would like to thank the IMF team for the focused and constructive discussions on macroeconomic developments and policy issues in Malaysia. For the most part, there is broad agreement on almost all of the major policy thrusts. We are encouraged by the assessment that the current policy stance is appropriately calibrated to the outlook and risks facing the economy and the financial system. We are further encouraged by the FSAP assessment that the Malaysian financial system is sound, well capitalized and backed by a strong regulatory and supervisory framework. This statement will provide an update on recent developments and elaborate on selected issues mainly for emphasis and clarifications.

Economic Outlook for 2013

2. In September 2012, the authorities projected the Malaysian economy to grow between 4.5% and 5.5% in 2013, underpinned by continued strong domestic demand, particularly firm private sector activity. Staff's estimates are in line with this assessment. Private consumption is expected to expand, driven by higher disposable incomes and favourable labour market conditions. Meanwhile, private investment will be supported by capital spending in the domestic-oriented sectors, the oil and gas industry and the on-going implementation of infrastructure projects. External demand is also expected to gradually improve and provide additional support to the economy.

Monetary Policy

3. Our authorities welcome Staff's assessment that monetary policy strikes the right balance between supporting growth and containing inflation. Going forward, BNM will continue to carefully assess the global economic and financial developments and their implications on the overall outlook for inflation and growth of the Malaysian economy.

Fiscal Policy

4. The conduct of fiscal policy in 2013 will continue to be aimed at bringing about structural changes in the economy to support inclusive and balanced regional growth while ensuring sound public finances. Supported by stable revenue collection, the fiscal deficit is projected to be lower at 4% of GDP in 2013 with Federal Government debt to GDP ratio contained within 55%.

5. Fiscal reforms are also underway to strengthen public financial management. This includes consolidating the fiscal deficit to 3% by 2015, broadening the tax base, rationalizing subsidies and revisiting the medium term fiscal framework. Outcome-based budgeting and accrual accounting are expected to be operational in 2015. Comprehensive approaches are also being considered to better manage the Government's long-term fiscal obligations. Areas being looked at include Federal Government debt management strategies; pension liabilities; administration of housing loan fund for civil servants and higher education student's loan fund. Concerted efforts

will continue to be made to ensure the timely implementation of development plans and reform initiatives.

Financial Sector

6. Financial stability has been preserved, supported by strong financial buffers both at the system and institutional level. In line with the FSAP assessment, the capacity of the domestic financial sector to withstand potential economic and financial shocks continues to be well supported by strong capitalization. The banking sector is also well positioned to smoothly transition to Basel III. Risk to domestic financial stability arising from household indebtedness in Malaysia remains manageable. The FSAP team expects low to medium impact on financial stability arising from any potential higher unemployment, slowdown in economic growth or decline in property prices. This is based on:

- Sustained growth in income levels and conducive employment conditions;
- Sound aggregate household balance sheet position and financial buffers, with financial assets-to-debts ratio of more than two times, sustained high savings rate and growth of deposits (2012: 11.3% yoy);
- Strengthened risk management infrastructure (comprehensive credit information via the Central Credit Reference Information System, use of credit scoring in loan approvals, robust administration and monitoring of loans) and sustained underwriting practices of banks;
- Majority of borrowings are for wealth accumulation purposes, while unsecured financing only accounted for 20% of household debts or 8% of bank loans; and
- Positive trend in loan repayments and low levels of delinquencies.

7. Developments on the following areas continue to be under BNM's close surveillance:

- Borrowers earning less than USD1,000 a month – these individuals have higher leverage positions than other classes of borrowers, although loans to this group only comprised 12.7% of bank loans, with potential loss of RM2.3 billion or 1.3% of the capital base of banking institutions; and
- Lending activities of non-bank entities (e.g. building society and cooperatives) to households, particularly in the personal financing segment.

8. The Government and BNM have undertaken comprehensive measures (monetary, macroprudential, supervisory, fiscal, financial education and debt resolution) to manage the rising trend of household indebtedness, house prices and the higher cost of living in urban centres. These measures have shown some positive outcomes, as evidenced by the substantial decline in multiple housing loan accounts and improvements in the repayment behavior of credit card holders. The effectiveness of these measures continues to be assessed by the authorities. Moving forward, BNM is establishing a database to match borrowers' debts and income data for more granular analyses, in collaboration with several Government agencies.

9. BNM's assessment revealed that risks from foreign bank deleveraging and the regional presence of Malaysian banks remain manageable, in line with the FSSA.

- While claims of foreign banks on Malaysia are relatively large, 80% of such claims comprise the Malaysian operations of locally-incorporated foreign banks;
- Overall domestic credit growth and financial intermediation were sustained even when foreign claims on Malaysia fell during the global financial crisis; and
- The financial positions of major overseas establishments of Malaysian banks are strong, supported by strong capitalization, profitability and local currency funding.

10. As part of BNM's consolidated supervision of financial institutions, potential risks from overseas operations are assessed regularly. This is supported by ongoing exchange of information and supervisory assessments and actions through existing home-host supervisory arrangements (e.g. Memorandum of Understanding with Indonesia, Cambodia, Vietnam and China; and supervisory colleges for three domestic banking groups). BNM also leverages on multilateral platforms e.g. Executives' Meeting of East Asia Pacific (EMEAP) Central Banks to discuss and cooperate on international regulatory and supervisory issues, as well as crisis management and resolution.

11. The FSAP assessment recognises that the regulatory and supervisory regimes for banking, insurance, securities and financial market infrastructures in Malaysia are well developed and exhibit a high degree of compliance with international standards. Similarly, Malaysia's deposit insurance framework and AML/CFT regime conform to international best practices. BNM wishes to highlight that remaining legislative shortcomings in the banking and insurance supervision frameworks, such as those relating to consolidated supervision, are eliminated with the coming into force (in 2Q 2013) of the Financial Services Bill and Islamic Financial Services Bill – both legislations were passed by the Parliament on 19 December 2012.

12. While the FSAP assessment opined that the Government has significant equity ownership in the main Malaysian financial and banking groups via Government Linked Investment Companies, the FSAP team recognised that these entities are operationally independent and commercially run with no interference from the Government. The authorities wish to highlight that these financial institutions are held to the same high standards of governance and risk management as other financial institutions. The board members and senior management are also subject to similarly stringent and robust fit and proper criteria and due diligence in the appointment and reappointment processes.

13. FSAP stress tests indicate that the banking system is resilient to economic and market shocks. Although some smaller banks could be more affected under adverse conditions, this is due to the capital management strategy of the group which allocates relatively smaller capital at the subsidiary level with the commitment that the capital needs will be met when needed. The parents of these banks have strong capacity and capital positions. The FSAP team indicated that recapitalization needs of banks under the adverse macroeconomic scenario (S2) of the

Top-Down stress test are limited at RM2 billion (0.2% of nominal GDP in 2011) under the existing Basel II requirements. While the recapitalization needs are higher based on Basel III standards, these capital requirements are only taking effect in 2019, in line with the global implementation timeline.

14. The FSAP assessment opined that the building blocks for a comprehensive crisis management framework are in place, including deposit insurance, emergency liquidity assistance arrangements and powers to resolve financial institutions. The Financial Stability Executive Committee (FSEC), set up in 2010, enables BNM to address risks to financial stability arising from entities outside its regulatory sphere. In December 2012, the Minister of Finance has approved the appointment of the Executive Chairman of the Securities Commission Malaysia as an ex-officio (permanent and voting) member of the FSEC – hence enhancing the role of FSEC as a platform for coordinating domestic crisis management and resolution measures.

15. The FSAP team recognised that the prudential and systemic risks spillovers on the onshore financial system may be modest, although reputational risk remains, due to the current size of the Labuan International Business and Financial Centre. The authorities have initiated a number of steps to address these areas, including legislative and regulatory reforms in 2010. The FSAP team recommended for further enhancements to the legislative, regulatory and supervisory frameworks for the Labuan International Business and Financial Centre and recognized the steps that are already being taken towards this end. These include the formation of the Financial Stability Committee in 2012 with representatives from BNM and Securities Commission Malaysia, to strengthen the risk management and surveillance practices.

16. The FSAP team recognised that the authorities are addressing potential challenges relating to the growth of profit sharing Islamic finance products, such as market perception of the level of protection for depositors and investors, and other regulatory, supervisory and market conduct issues. While the FSAP team highlighted that tax incentives granted to Islamic finance are significant, the authorities wish to highlight that these are commonly used in other jurisdictions to compensate for extra issuance costs associated with Islamic products. In some other cases, these incentives are finite and time-bound and are accorded to specific contracts to promote new markets.

Reforms to Boost Growth and Enhance Inclusiveness

17. Initiatives to transform Malaysia into a high-income economy by 2020 are progressing well. The second phase of the Government Transformation Programme was launched in mid-2012, building on initiatives that have already been put in place as well as the introduction of new initiatives. Under the Economic Transformation Programme, total committed investments have amounted to USD71 billion, with most of these going into the oil, gas and energy sector.

18. To achieve a more inclusive financial sector, BNM had also introduced a framework for agent banking which will allow financial institutions to reach out to the underserved segments, in a more cost efficient manner through the use of non-bank retail outlets whilst still maintaining prudent and responsible banking practices.

External Sector Assessment

19. Our authorities would like to reiterate that the current account gap is not rooted in currency undervaluation. This is evidenced by the notable absence of symptoms of undervaluation; there is no evidence of overheating, inflation has been low, there are no financial imbalances, trade balances are shrinking and intervention has been two-directional. Besides the absence of these symptoms, it is also important to note that notwithstanding the depreciation pressure during the global financial crisis, the ringgit has generally been on an appreciating trend since the adoption of the managed float regime in July 2005. In fact, the ringgit has appreciated by 22.6% against the U.S. dollar and 7.5% on a real effective basis.

20. The authorities agree that estimates of the current account gap likely reflect structural factors of the economy, which are not present in the econometric analysis of the current account. It is important to note that the bulk of the high savings in Malaysia is accounted for by the business sector. Household savings are mainly in the forms of mandatory contribution to the Employees' Provident Fund and other forms of private savings and financial assets to address the partial availability of social safety nets in Malaysia. Meanwhile, private investment has been on a strong trajectory since 4Q 2011 and into 2012. This development has been facilitated by various structural reforms to improve the domestic investment climate.

21. Indeed, our authorities have asserted through our Chair that the EBA and ESR should not only be quantitative exercises, which are highly sensitive to the choice of models and assumptions, but should aim to establish country-specific explanations behind the changes in the country's current account, REER, and external balance in general. In this instance, we are encouraged to note that the technical discussion between Staff and the authorities on EBA methodology recognised the limitations of the methodology and encompassed discussions on structural characteristics of the economy and the structural reforms needed to address the desired outcome.

Final Remarks

22. While Malaysia continues to implement its long-term reform agenda to elevate it to the next stage of growth and development, the authorities remain mindful of the downside risks posed by the current challenging global economic and financial environment. As a highly open economy, Malaysia is not insulated from the uncertainty in the global environment. Nevertheless, the economy is expected to remain resilient, underpinned by favourable macroeconomic and financial fundamentals and policy flexibility. The authorities will closely monitor developments in the external environment and will respond as appropriate.