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2013 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MALAYSIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2013 Article IV consultation with Malaysia, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 7, 2014, following discussions that ended on December 16, 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 February 14, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its March 7, 2014 consideration of the staff report that concluded the Article IV consultation with Malaysia.
- A **Statement by the Executive Director** for Malaysia.

The following document will be separately released.

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

MALAYSIA

February 14, 2014

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

KEY ISSUES

Near-term outlook. Malaysia's healthy, noninflationary growth continued in 2013, albeit at a somewhat slower clip than earlier years. While domestic demand remained robust, the economy was buffeted by external headwinds, including from volatile capital flows in spring-summer and weak export growth. The current account surplus continued to narrow, although it remains comfortably in surplus. Continued strength in domestic demand, especially investment, and a pickup in external demand should help maintain robust growth going forward despite the welcome fiscal tightening.

Macroeconomic policy mix. Staff welcomes the timely, credible, and gradual recalibration of macroeconomic policies, which should help achieve a smooth transition to the post-UMP environment. The budget is being tightened and fiscal institutions strengthened. Bank Negara Malaysia (BNM), which maintains an accommodative monetary stance for now, possesses ample policy credibility and should be able to contain any second round price effects associated with fuel subsidy reductions.

Fiscal policy breakthrough. Amidst concerns about Malaysia's public finances and a sharp narrowing of the external surplus in spring-summer, the authorities took timely action to secure fiscal sustainability and assure markets. Staff welcomes the comprehensive and gradual approach to fiscal adjustment, which includes subsidy rationalization, broadening of revenue bases, and the strengthening of the social safety net. It urges the authorities to persevere in their efforts to rebuild fiscal buffers, improve the management of contingent liabilities, and address ageing-related fiscal challenges.

Financial stability. Malaysia's financial system is sound, supported by strong supervision and regulation. Targeted, yet escalating macroprudential policies (MAPs) are being employed to deal with the risks from high rates of credit growth and rising household debt. These risks, as well as the effectiveness of MAPs, should continue to be closely monitored. The exchange rate remains flexible and, together with Malaysia's ample financial buffers and sound monetary and fiscal policies; should safeguard the economy from potentially volatile capital flows.

Inclusive growth: the role of human capital. The authorities have designed and are implementing several ambitious transformation programs and blueprints to turn Malaysia into a high-income, knowledge and innovation based nation by 2020. Their efforts are on track, although skills mismatches need to be addressed through intensified human capital development efforts. Progress in education, as outlined in the Malaysia Education Blueprint, 2013–2025, is a high priority. This will call for achieving stronger performance in education in a tighter budgetary environment.

Approved By
Hoe Ee Khor and Ranil Salgado

Mission dates: December 5–16, 2013
The mission comprised Alexandros Mourmouras (Head), Niamh Sheridan, Elif Arbatli, Jade Vichyanond (all APD), Mustafa Saiyid (MCM), and Geoffrey Heenan (Singapore Resident Representative) and Seen Meng Chew (Resident Representative's Office). Hoe Ee Khor (APD Reviewer) participated in the policy discussions.

CONTENTS

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS 4

NEAR-TERM ECONOMIC POLICIES: ACHIEVING A SMOOTH TRANSITION 7

FISCAL POLICY: BREAKTHROUGH 10

FINANCIAL STABILITY 14

CAPITAL OUTFLOWS: VULNERABILITIES AND RESILIENCE 20

EXTERNAL SECTOR DEVELOPMENTS 22

BOOSTING GROWTH AND INCLUSION: THE ROLE OF HUMAN CAPITAL DEVELOPMENT 23

STAFF APPRAISAL 24

BOXES
1. Fiscal Policy Committee 27
2. Goods and Services Tax (GST) 28
3. Medium-Term Fiscal Consolidation 29
4. Household Debt 31

FIGURES
1. Growth and Exports 32
2. Inflation and Domestic Resource Constraints 33
3. Monetary Developments 34
4. Fiscal Policy Developments 35
5. Capital Inflows 36
6. Financial Sector Developments 37
7. Household Debt 38
8. House Prices 39
9. Financial Soundness Indicators, 2013:Q3 40

TABLES

1. Selected Economic and Financial Indicators, 2009–14 ____ 41
2. Indicators of External Vulnerability, 2008–12 ____ 42
3. Balance of Payments, 2009–14 ____ 43
4. Illustrative Medium-Term Economic Framework, 2009–18 ____ 44
5. Summary of Federal Government Operations and Stock Positions, 2009–14 ____ 45
6. Monetary Survey, 2009–13 ____ 46
7. Banks' Financial Soundness Indicators, 2009–13 ____ 47
8. Macroprudential Measures Since 2010 ____ 48

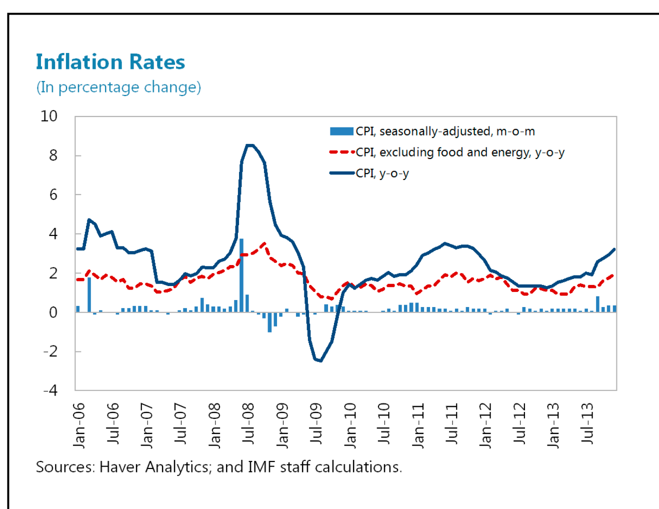
APPENDICES

1. Staff Policy Advice from the 2011 and 2012 Article IV Consultations ____ 49
2. Risk Assessment Matrix ____ 50
3. External Sector Assessment ____ 51
4. Public Debt Sustainability Analysis ____ 56
5. External Debt Sustainability Analysis ____ 63
6. 2013 FSAP—High Priority Recommendations ____ 66
7. Stress Tests of Banking, Household and Corporate Balance Sheets ____ 67
8. What Explains Malaysia's Resilience to Capital Outflows? ____ 70
9. Transformation Plans to Boost Growth and Inclusion ____ 74

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

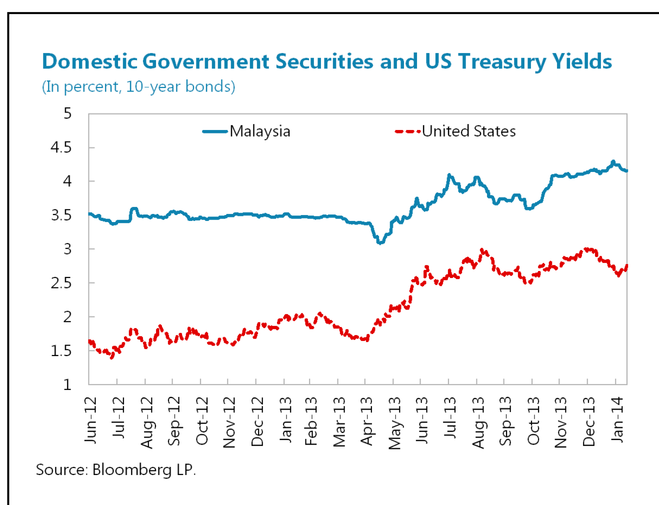
1. Context. General elections were held on May 5, 2013. Prime Minister Najib's incumbent coalition won narrow election, thus ensuring smooth policy transition. Amidst a difficult external environment for Emerging Market Economies (EMEs) last spring-summer, the administration has taken actions that signal its resolve to respond decisively to domestic and external challenges. A High-Level Fiscal Policy Committee (FPC) was created to improve management of the public finances, food and fuel subsidies and electricity tariffs are being rationalized, and a Goods and Services Tax (GST) will be introduced in 2015. These measures are key steps towards rebuilding fiscal buffers lost on account of expansionary policies during the global financial crisis.

2. Economic developments. Growth slowed to 4.7 percent in 2013, compared with 5.6 percent in 2012, but remained healthy. Weak external demand, especially in the first half of the year, weighed on activity, and a small negative output gap opened up. Domestic demand remained robust, supported by healthy labor markets, accommodative financial conditions and, during the first half, expansionary fiscal policies (Figure 1). Inflation remained subdued through the spring and summer despite the introduction of a minimum wage in 2013 but picked up recently. Headline inflation rose to 3.2 percent year-on-year in December, reflecting subsidy cuts. Core inflation has also increased but is still very low, less than 2 percent in December (Figure 2).



Sources: Haver Analytics; and IMF staff calculations.

3. Financial Market Developments. Like many other EMEs, Malaysia has been experiencing capital outflows during periods of market turbulence, including spring-summer and early this year. Between end¬May and end¬2013, the yield curve for Malaysian Government Securities (MGS) has steepened: 10-year yields have increased by 70 bps, and the spread against the U.S. dollar has widened by about 20 bps. During summer turbulence, the ringgit weakened by about 11 percent against the dollar (peak-to-trough) and after a brief period of strengthening is now back below the September



Source: Bloomberg LP.

trough. Deep financial markets and a flexible exchange rate have helped facilitate financial adjustment, and the economy has been able to absorb the shocks without appreciable harm to date.

4. Outlook. Growth is projected to accelerate to 5.0 percent in 2014. Consumption and investment growth are expected to moderate somewhat but should generally hold up amidst conditions of full employment and the long pipeline of large, multiyear investment projects. In addition, the pickup of export growth since the second half of 2013 should be sustained as the global economy continues to improve, and offset headwinds from fiscal consolidation (a fiscal impulse of about minus 1 percent of GDP in 2014, although staff views the fiscal multipliers as low). Over the medium term, growth is expected to average 5 percent, reflecting higher investment, including infrastructure upgrades, which should help boost productivity. The gradual removal of subsidies is expected to result in a modest increase in inflation during 2014. Second round price effects are, however, expected to be limited in light of the low initial level of inflation, and BNM's considerable monetary policy credibility. Inflation will likely reach about 4.0 percent in 2015 following the introduction of GST, but in staff's baseline scenario, is expected to gradually moderate to below 3.0 percent in the medium term.

5. Risks. The risks to the staff's baseline scenario are primarily on the downside and stem from both external and domestic sources (Appendix 2).

- External risks. A key risk is a potentially bumpy exit from unconventional monetary policies (UMP) in advanced economies (AEs), which could trigger bouts of financial market turbulence and dampen external demand. With foreign investors still holding sizeable positions in the domestic bond and equity markets, Malaysia is vulnerable to capital outflows during periods of heightened global financial stress, as evidenced during spring-summer 2013. Other risks include a further slowdown in China, a protracted period of slow growth in Europe, and commodity price shocks.

- Domestic risks. The relatively high level of federal debt (close to the government's self-imposed ceiling of 55 percent of GDP) and large contingent federal liabilities limit the room for countercyclical fiscal policy. And while recent fiscal actions are welcomed, there remain implementation risks associated with these comprehensive reforms. In particular, setbacks in the implementation of fiscal reforms could undermine investor sentiments and trigger outflows from the bond market and a jump in yields which, in the context of the government's high financing needs, could have a significant macro-fiscal impact. In staff's view, however, implementation risks are low—the authorities have demonstrated the political will and possess the technical expertise to carry reforms out. In addition, high house prices, rising household debt, and banks' large exposure to real estate remain a concern, particularly in light of UMP unwinding and a likely tightening in domestic financial conditions and higher interest rates. Other domestic risks include a higher and more persistent increase in inflation and inflation expectations, triggered by higher fuel and electricity prices as subsidies are being rationalized. Adjustments in fuel prices are expected to add about 0.5 percentage point to annual inflation in 2014–15, while the GST could add about 0.9 percentage point in 2015. The low starting level of inflation and the

substantial policy credibility of the monetary authorities, circumscribe, in staff's view, the risk of second round effects.

6. Policy advice. The authorities are taking decisive and proactive steps to reinforce Malaysia's macroeconomic and structural policies (Appendix 1). While specific measures are consistent with Fund policy advice, they are home grown and driven by the authorities' own multiyear adjustment and reform programs. Specifically, the authorities took action to strengthen Malaysia's public finances during the second half of 2013. These measures are framed in the context of a medium term fiscal adjustment program and are consistent with past Fund technical assistance and staff policy advice. The authorities are carefully monitoring financial sector risks and are implementing additional macro prudential measures; they are also in the process of strengthening their information base through the collection of granular data on household assets and liabilities. The authorities are allowing two-way exchange rate flexibility. They are also implementing wide ranging structural reforms, and their specific programs benefit from extensive technical and policy support from the IMF and other international organizations.

7. Authorities' views. The authorities were in broad agreement with staff's assessment of the economic outlook and balance of risks.

- They anticipate growth to increase in 2014 with the improvement in the external environment, although the fiscal consolidation can be expected to be a drag on growth. Private investment growth should remain robust at about 13 percent but some moderation in private consumption growth is likely.
- The authorities also see the main risks to the outlook are being primarily on the downside and they highlighted risks from external sources, with a slowdown in global growth a key concern. In addition, uncertainty surrounding the unwinding of UMPs and the potential for policy missteps along the way and heightened volatility are also key risks for Malaysia.
- On the domestic front, the authorities reiterated their commitment to steadfast implementation of fiscal reforms. The authorities acknowledged the risk of spillover to prices of other nonfuel goods and services from subsidy rationalization, which will raise headline inflation (albeit from low starting levels). They assess the risk of second-round effect at this point to be limited.
- The authorities are less concerned with risks to financial stability from high household debt and house prices. They pointed to the large cushions provided by high levels of household financial assets, healthy labor markets and low risk of unemployment. In addition, mortgage interest rates are largely tied to the policy rate (indirectly through the base lending rate), which has been relatively stable and makes sudden increases unlikely. Lastly, the authorities' targeted and phased approach to macroprudential policies, along with efforts to increase financial literacy, has curtailed risks.

NEAR-TERM ECONOMIC POLICIES: ACHIEVING A SMOOTH TRANSITION

8. Policy mix. The authorities' policy mix is appropriate in the present conjuncture, in which Malaysia's priority is to address fiscal vulnerabilities against a backdrop of low inflation, and an improving external environment that is nevertheless still subject to large uncertainties and potential capital flow volatility. The decisive, yet gradual tightening of fiscal policy should help Malaysia maintain market access at low funding costs while avoiding undue damage to economic growth or igniting higher inflation. The slightly accommodative monetary policy stance has been appropriately supportive of growth in the context of low inflation, a small negative output gap and, until mid-May 2013, strong capital inflows. Going forward, however, monetary policy may need to be recalibrated as UMPs unwind and if inflation risks rise. The tightening of macroprudential policies to date appears to have helped to address potential financial stability risks, but continued monitoring is appropriate and additional measures may be needed.

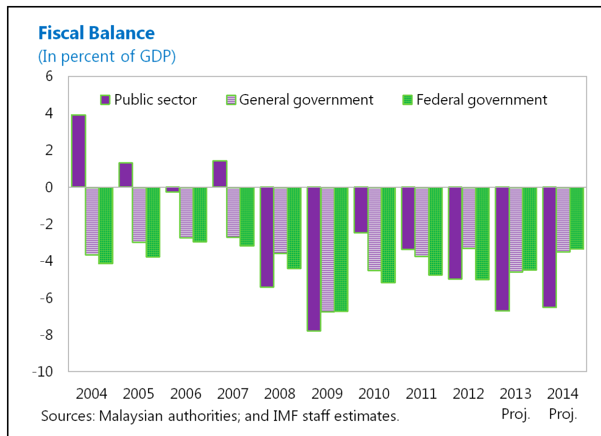
9. Fiscal policy. Following the market turmoil in spring-summer, the federal government recalibrated fiscal policy in September-October and is on track to reach its fiscal deficit target of 4.0 percent of GDP in 2013.[1] According to staff projections, fiscal adjustment in 2013 was significant (about 1 percent of GDP), driven by higher income taxes and lower development spending. Current spending, which has increased considerably in recent years, driven by wages and subsidies, was higher than budgeted in 2013 but is expected to remain stable relative to GDP. In particular, spending on subsidies, which increased by 0.6 percentage points of GDP in 2012, is expected to remain elevated in 2013 and would have been higher in the absence of the fuel price adjustments implemented in September. The 2014 federal deficit target of 3.5 percent of GDP seems feasible if, as assumed in the staff's baseline projection, growth in current spending is contained within a tight envelope and fuel prices are increased further during the year (Figure 4). Oil revenues are projected to decline by 0.5 percent of GDP, in line with a projected decline in international oil prices. Under the staff's baseline projection, fiscal adjustment in 2014 will be driven by subsidies (about 1 percent of GDP), the wage bill, while development spending as percent of GDP will also slow down.[2][3] The fiscal impulse (based on staff's

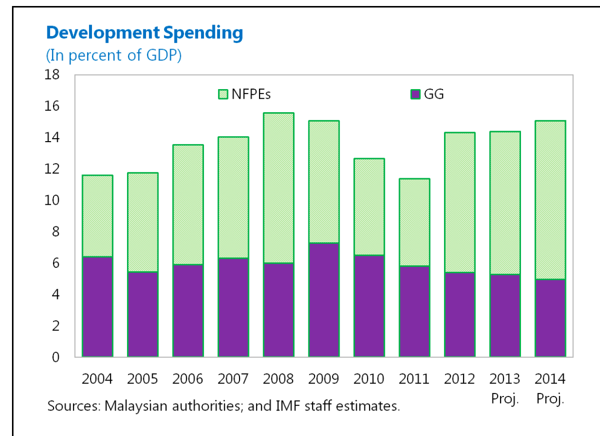
[1] The authorities' measure of the overall fiscal balance differs from staff's (net lending/borrowing) due to differences in methodology/basis of recording (Government Finance Statistics Manual 2001 versus the authorities' modified-cash based accounting), and differences in the treatment of certain items. These reasons account for a 0.4−0.7 percentage point difference in the measured fiscal deficits for 2012−13.

[2] The decline in fuel subsidies is driven by the carry-over effect of the September fuel price adjustments (0.4–0.5 percent of GDP). Staff assumes in its baseline projection an additional 20 sen hike to take place in mid-2014 with a half-year yield of 0.2-0.3 percent of GDP, which will be partially offset by higher direct cash transfers.

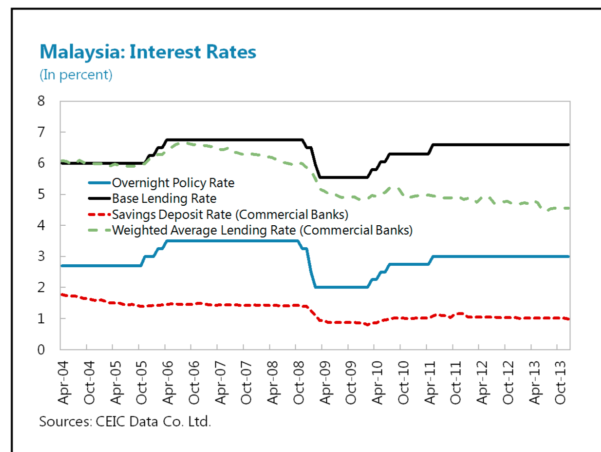
[3] Malaysia's development budget is determined for five year intervals and the current budget allocation covers the five year period ending in 2015. The 11th Malaysia plan, to be announced in 2015 will cover development spending during 2016-2020.

definition of fiscal balance) is about minus 1 percentage point of GDP.[4] Its impact on growth is expected to be relatively small, given that a significant share of the adjustment comes from subsidy rationalization, whose fiscal multipliers are low. The public sector deficit has widened in recent years, reaching 5 percent of GDP in 2012, and is expected to be about 6½ percent of GDP during 2013–2014. The increase in the public sector deficit was driven in part by higher development spending by Nonfinancial Public Enterprises (NFPEs), which has offset the decline in development spending at the federal government level. Fiscal impulse at the broader public sector level was positive in 2013 but is expected to turn negative in 2014.





10. Monetary policy. Bank Negara Malaysia (BNM) has kept its policy rate unchanged at 3 percent since May 2011 (Figure 3). This policy stance, reflecting BNM's dual mandate of ensuring medium-term price stability and sustainable growth, kept real interest rates low and supported growth, against a backdrop of uncertain global growth prospects and low domestic inflation rates. Looking ahead, staff expects BNM to begin a gradual tightening cycle. The gradualist approach is warranted by the unusual degree of uncertainty around the external environment and is also consistent with the need to safeguard domestic financial stability in an environment of high household debt. Furthermore, while inflationary expectations are well anchored at present, the succession of price increases stemming from subsidy rationalization and the introduction of the GST



[4] Fiscal impulse is defined as the change in cyclically-adjusted Federal Government overall balance as percent of potential GDP.

could lead to a pickup in inflation expectations. BNM's task in the near term is to allow pass-through of cost-related increases in prices (cost-push inflation) while detecting and preempting, in a timely and decisive fashion, any second round effects from becoming embedded in the wage-price structure.

11. Macroprudential policies (MAPs). BNM's current monetary policy stance is supported by macroprudential policies to curtail financial stability risks from rapid increases in household debt and house prices (see Box 3). Household debt reached 83 percent of GDP at end-September 2013, up from 55 percent five years earlier. Over half of the debt is on residential property, of which nearly 70 percent is contracted at variable rates tied to the Base Lending Rate (BLR), although lending rates have fallen recently even as the BLR has remained unchanged. Starting in November 2010 and continuing, most recently, with the 2014 budget in October 2013, the authorities have imposed a series of targeted, gradual, and escalating MAPs, which have been mainly directed at speculative purchases of homes and unsecured credit (see Table 8). The 2014 budget also addressed affordability issues through special financing schemes and measures to raise the supply of affordable housing.[5] There are early signs that the more recent measures have slowed down the approval of new loans and begun to cool the housing market; however, some inertia in loan growth due to drawdowns of loans already committed can be expected. Should credit growth remain strong, additional MAPs should be introduced, and their scope and stringency should depend on the evolving stance of monetary policy, and they should be carefully designed to ensure effectiveness and avoid circumvention. Options for additional macroprudential measures include capping loan-to-value ratios (LTV) on second and first mortgages, explicit limits on debt service-to-income ratios, or additional capital charges on high LTV loans.

12. Risks to the baseline and policy responses. In the present "inflection point" for growth in EMEs, staff's baseline scenario is subject to a wider-than-usual range of uncertainty. Should the growth outlook deteriorate significantly, the flexible exchange rate can act as a shock absorber and there is ample room for BNM to cut its policy rate to support growth. However, relatively high fiscal deficit and public debt levels afford limited space for a sustained countercyclical fiscal response. Any fiscal stimulus should be temporary, targeted and anchored in a credible medium term fiscal consolidation program. Importantly, structural reforms and the all important subsidy rationalization and GST implementation should not be delayed or compromised as sound public finances are paramount to macrofinancial stability. Exchange rate flexibility, complemented by foreign exchange intervention to smooth excessive volatility, should be the main response to unpredictable capital flows.

13. Authorities' views. The authorities reiterated their commitment to meeting their fiscal targets, and to press ahead with subsidy rationalization and the implementation of the GST. The

[5] The Private Affordable Ownership (MyHome) Scheme was introduced to incentivize private developers to build more low- and medium-cost houses, with the subsidy provision of up to RM 30,000 per unit built. A total of RM 300 million has been allocated in 2014 for the construction of 10,000 housing units. For *Perumahan Rakyat 1Malaysia* (PR1MA), the government has allocated RM 1 billion to provide 80,000 units of affordable housing to middle income households (combined income of RM 2,500–7,500 per month) for homes in the RM 100,000–400,000 price range.

creation of the high-level FPC provides additional assurance that Malaysia will push through with sound fiscal policies to ensure fiscal sustainability while safeguarding growth. The authorities view the current monetary policy stance as supportive of growth but acknowledged the risk to inflation from subsidy rationalization. Inflation developments are closely monitored, both in terms of the pervasiveness and persistence of price increases across all items of the CPI basket, using various qualitative and quantitative indicators including the newly developed survey of price expectations. In terms of the impact of unwinding of UMPs in AEs, the authorities welcomed the prospect of recovery in AEs and normalization of global interest rates as beneficial for Malaysia but were concerned about potential volatility and capital outflows. A monetary policy response to the unwinding of UMPs would depend on the implications to the overall outlook for growth and inflation for the Malaysian economy.

FISCAL POLICY: A BREAKTHROUGH

14. Background. The authorities took vital steps to shore up fiscal management and policy in the second half of 2013, and signaled their commitment to secure medium-term fiscal targets in the 2014 Budget. Fiscal management and institutions were strengthened substantially by the establishment of a high-level FPC (Box 1). In addition, subsidies on fuel, electricity, and sugar are being rationalized, and a GST will be introduced in April 2015 (Box 2). To mitigate the impact of fiscal consolidation on the poor, the authorities are taking steps to strengthen the social safety net by enhancing the existing cash transfer program to lower income groups. The authorities are committed to their large and complex fiscal reform agenda and are striving to carefully design and execute it in order to mitigate implementation risk.

15. Fiscal sustainability and medium-term fiscal adjustment. The authorities' decisions in 2013 are tantamount to a fiscal policy breakthrough aiming to contain federal debt and related fiscal risks. Federal debt has risen significantly in recent years, to an estimated 54.8 percent of GDP at end-2013, from about 40 percent of GDP at the start of the global financial crisis. Based on staff's debt sustainability analysis (see Appendix 4), under a no adjustment scenario (the constant primary balance scenario), the federal debt-to-GDP ratio would exceed the authorities' self-imposed debt ceiling of 55 percent in the medium-term and would continue to increase thereafter.

16. Staff position. Staff welcomes the authorities' comprehensive fiscal reform package, which is well timed, appropriately paced, and allows sufficient preparation time for the introduction of the GST, including an all important public education campaign. The authorities' plans to strengthen the social safety nets by better targeting them are also welcome. Finally, the management of fiscal policy has been strengthened by the establishment of the high-level FPC. Implementation and political risks from fiscal reforms are, in staff's view, circumscribed by the authorities' commitment to the reforms and by their sound preparation and technical plans to carry them out. Fiscal reforms are a marathon, not a sprint, and the large unfinished agenda in this area requires careful design and execution in order to mitigate implementation risk.

17. Staff supports the authorities' plans to reduce the federal deficit to 3 percent by 2015, and to about zero by 2020. The proposed fiscal adjustment signals the authorities' commitment to fiscal consolidation and is appropriately paced, with significant frontloading that is commensurate with the need to rebuild fiscal buffers. Under the mission's baseline assumptions, a cumulative improvement of about 4 percent of GDP in the cyclically-adjusted primary balance is required in order to lower the federal debt-to-GDP ratio to its pre-crisis level of about 40 percent. This medium-term debt target is needed to rebuild buffers to allow for countercyclical fiscal policy, absorb contingent liabilities, and ensure that the debt to GDP ratio remains below 55 percent.[6]

Malaysia: Potential Revenue and Expenditure Measures Beyond 2015

	Description	Potential Yield (Percent of GDP)
Revenue measures		
GST	Broaden the tax base through revising the list of zero-rated and exempt goods. Increase GST rate from 6 percent to 8 percent.	1-1.5
Property taxes	Broaden recurrent property taxes	0.3-0.5
Expenditure measures		
Rationalize non-fuel subsidies	Rationalize subsidies on rice, flour and cooking oil and partially replace them with targeted transfers.	0.2-0.3
Restrict wage growth	Continue to limit the establishment of new posts, restrict bonus payments and achieve savings in emoluments in the education sector.	0.2-0.5
Reduce inefficiencies in spending	Continue efforts to improve procurement, improve efficiency of education spending and spending on social safety nets.	0.5-1

- The authorities' target of reducing the deficit to 3 percent of GDP by 2015 is feasible if, as assumed in staff's baseline, the GST is implemented and fuel price subsidies are rationalized. However, further measures will be needed beyond 2015 to balance the federal budget by 2020 as oil revenues are projected to decline and nondiscretionary expenditures are expected to rise. Spending pressures will, inter alia, arise from civil service pensions and other aging-related costs; the need to repay previous off-budget stimulus spending; and other federal obligations, such as spending on the Mass Rapid Transit (MRT) project.[7] In this context, staff supports the authorities' plan to further elaborate, quantify and communicate their medium term fiscal consolidation strategy.

- To achieve the authorities' fiscal targets for 2020 and generate sustained fiscal savings, staff elaborated a medium-term fiscal strategy that relies on revenue and expenditure instruments with a desirable mix of stabilization, efficiency, growth, and distributional characteristics (see Box 3 and Selected Issues Paper on Malaysia's medium-term fiscal strategy). These characteristics include low fiscal multipliers; reduced reliance on corporate and oil revenues; and a progressive (or at least less regressive) distributional impact. This fiscal strategy should also be underpinned by concrete structural reforms to promote efficiency, growth and equity.

[6] The 2012 Malaysia Article IV report (Box 4) details the medium-term debt target and staff's stochastic Debt Sustainability Analysis (DSA).

[7] MRT is a public infrastructure project that is funded off-budget through a special vehicle that enjoys a federal guarantee; given the non-commercial nature of the project, it may be assumed that a fraction of the debt repayments associated with the MRT will be eventually funded through the budget.

- Viewed from this perspective, the authorities' plans to date to rationalize subsidies, introduce a GST, increase transfers and improve their targeting, and protect public investment spending are a step in the right direction. Staff also argued that there was a need to restrict wage growth and improve the efficiency of public spending in general, and education spending in particular. Finally, staff recommended raising contributions to the Civil Service Pension Fund (KWAP) to reduce the unfunded portion of federal pension liabilities and consider other measures to address its long-term sustainability.[8]

18. Tax policy. Staff strongly welcomed the authorities' efforts to implement the GST, which should help to broaden the tax base and reduce reliance on oil and gas revenues over time (Box 3). The GST should also help reduce informality and improve tax buoyancy.[9] The net revenue yield from GST, estimated at about 0.3 percent of GDP, is however expected to be relatively small initially. This is due to the relatively low standard rate, the reduction of income taxes and other offsetting measures adopted in the 2014 budget.

- Staff argued that, small initial revenue gains notwithstanding, the GST provides a powerful and flexible revenue-generating mechanism to respond to future economic shocks. If needed, GST base broadening, including the reduction of GST exemptions and zero-rated goods, should take precedence over increasing the standard rate.[10] Staff strongly urged the authorities to resist pressures to expand the list of exempt and zero-rated goods to ensure that the efficiency of GST is not compromised.

- Staff argued that recurrent property taxes, a growth-friendly and progressive revenue source, are currently underutilized in Malaysia relative to its peers and could also be used to broaden the revenue base going forward.[11]

- The authorities are also conducting an assessment of the effectiveness and costs of tax incentives. Staff recommended better targeting of incentives based on this cost-benefit analysis.

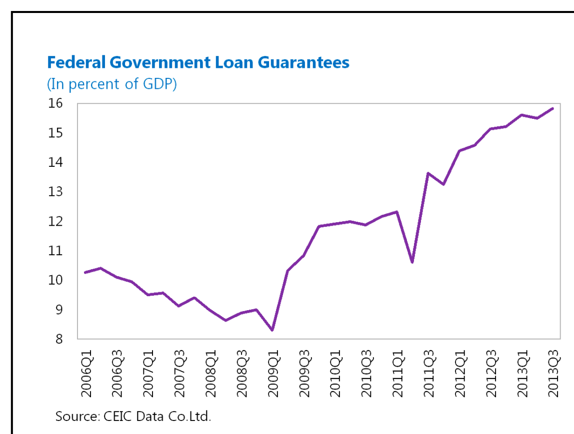
[8] The pension scheme for civil servants, Kumpulan Wang Persaraan (KWAP) is a defined benefit scheme that is partially funded by the budget, unlike the Employees Provident Fund (EPF), the scheme for private sector workers which is a fully funded defined contribution scheme. KWAP was incorporated in 2007, taking over the assets and liabilities of the Pension Trust Fund, which the government had established in 1991 to help fund its future pension liabilities. KWAP covers employees who joined civil service after 1991 (pension liabilities of civil servants who joined before 1992 are funded on a pay-as-you-go basis from the budget). KWAP was intended to be fully funded, by contributions from federal, state and local governments; however, federal contributions are currently below levels consistent with full funding.

[9] Being a value-added tax, the GST generates relevant information on different tax payers along the production chain.

[10] As a general principle, minimizing the number of GST exemptions, including at the implementation stage, is crucial to improve efficiency (already at the implementation stage).

[11] Taxes on financial and property transactions and other property-related taxes are about 1.1 percent of GDP in Malaysia, which is lower than the median of 1.6 percent of GDP in OECD countries.

19. Subsidy reform. At over 10 percent of federal spending, fuel subsidies are regressive and costly to the budget. Staff welcomed the price adjustments announced in September as a first step in replacing them with more targeted transfers to low-income Malaysians.[12] Staff made the following recommendations:



- Gradual but credible rationalization of fuel subsidies and a switch, eventually, to an automatic price adjustment mechanism for fuel prices would ensure that fiscal savings are preserved and the issue is depoliticized.[13] The authorities' plans to gradually reduce off budget subsidies on natural gas and electricity are also critical in this regard. Bringing on budget these implicit subsidies would improve the transparency of fiscal policy, and could bolster support for subsidy reform.

- Cash transfers (Bantuan Rakyat 1Malaysia (BR1M)), first introduced in 2012, were increased subsequently, their eligibility criteria were broadened, and these transfers now benefit over 55 percent of households. Staff noted that it would be desirable to improve the targeting of welfare transfers under different programs and welcome steps to create a comprehensive database on welfare recipients and programs, as announced in the 2014 budget.

20. Fiscal risks. Despite important recent progress, Malaysia still faces significant fiscal risks. Continued reliance on oil and gas revenues is a medium term risk to debt sustainability in view of the depletion of the oil and gas resources over time. Oil price shocks or exchange rate shocks can lead to unanticipated increases in the subsidy bill, offsetting the savings from domestic price adjustments. Federal contingent liabilities are sizeable, with loan guarantees alone amounting to 15 percent of GDP.[14] In staff's view, the FPC, which will be in charge of endorsing medium-term fiscal targets and strategy, should also play a critical role in monitoring, assessing, and managing fiscal risks going forward. In this context, staff

[12] Prices of gasoline and diesel were raised by 20 sen per liter in September, reducing the price gap (the difference between market price and subsidized price) from 30 to 23 percent for gasoline and from 36 to 29 percent for diesel. After the adjustment in September, there is still a subsidy of 63 sen per liter for gasoline (RON 95) and 80 sen per liter for diesel.

[13] Staff assumes in its baseline scenario that fuel prices are gradually increased to reach parity with international prices by end-2016.

[14] Federal contingent liabilities include loan guarantees (15 percent of GDP), potential obligations under user-funded PPPs, liabilities of NFPEs, insured deposits under the deposit insurance, the deposits of some development finance institutions and government linked investment funds, and credit guarantee schemes. About 20 percent of loan guarantees are to statutory bodies and the rest are to public companies.

- Argued for anchoring budget targets on the non-oil primary balance, which would help insulate the budget from these risks and also reduce the procyclicality of spending.

- Supported efforts to improve the monitoring and management of loan guarantees and other contingent liabilities, and recommended preparing a fiscal risks statement to be published with the budget documents.

- Highlighted the risk that as federal gross debt approaches the government's self-imposed ceiling, there could be pressure to push spending off-budget, which would undermine the credibility of the formal budget process and the medium term fiscal consolidation.

- Supported reforms to strengthen public financial management, including adopting accrual accounting, introducing a medium-term fiscal framework, and reducing the use of supplementary budgets, some of which are already underway.

- Welcomed the authorities' efforts to improve public procurement and move towards performance-based budgeting.

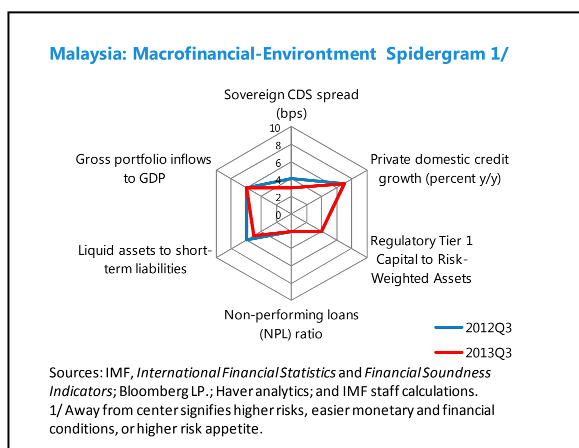
21. Authorities' views. The authorities stated their commitment to a medium-term fiscal consolidation, including subsidy rationalization and the introduction of the GST in 2015, underpinned by efforts to strengthen fiscal management and institutions and other structural reforms. The authorities emphasized the importance of adopting a gradual approach in implementing fiscal adjustment and subsidy rationalization, and the need to protect vulnerable households. In their view, implementation risks are small, as evidenced by the political commitment at the highest level to these reforms and the high level of their technical preparedness. They agreed with staff on the need to outline a medium-term fiscal plan, to be endorsed by the FPC, and indicated that work was underway to formulate a medium-term fiscal plan. The authorities stated that although federal loan guarantees have increased recently, government's loan guarantees are primarily to commercial nonfinancial public enterprises with evident capacity to service debt, and that contingent liabilities should be analyzed taking into account their (low) probability of default.

FINANCIAL STABILITY

22. Background. The 2012 IMF-World Bank Financial Assessment Program (FSAP) found that Malaysia's financial system is sound and backed by a strong supervisory and regulatory system. Malaysia's financial system is well diversified although banks continue to provide over 85 percent of credit domestically. Nonbanks, including development financial institutions, provide the remaining 15 percent of credit but constitute only 9 percent of financial system assets. Consistent with the FSAP, staff found that Malaysian banks are well-capitalized, profitable, and have adequate liquidity buffers. With a Tier 1 capital ratio of 13.9 percent at end-2012, banks are well-positioned to meet the

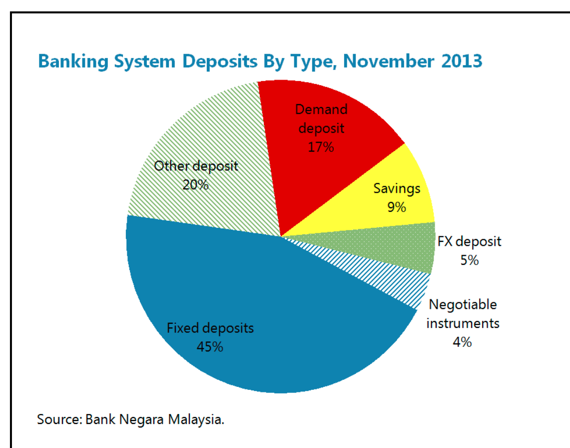
Basel III target of 8.5 percent by 2019.[15] Banks' liquidity coverage ratio (LCR) of 60 percent is consistent with the 2015 Basel III target but meeting the 2019 target of 100 percent, while attainable, is more challenging under current definition.[16] Banks' funding structure is dominated by deposits, which make up 80 percent of the total; 17 percent of these deposits are classified as strictly callable. Banks are moderately profitable, with return on equity averaging about 14 percent in recent years, although recent heightened competition for retail deposits has compressed net interest margins.[17] Looking ahead, banks' funding costs are likely to increase as deposit rates rise with the unwinding of UMPs but, with variable rate loans largely tied to the BLR (which has tended to only change when the OPR changes), banks could face further compression of their net interest rate margins.[18]

Malaysia: Macrofinancial-Environtment Spidergram 1/



Sources: IMF, *International Financial Statistics* and *Financial Soundness Indicators*; Bloomberg LP.; Haver analytics; and IMF staff calculations.
1/ Away from center signifies higher risks, easier monetary and financial conditions, or higher risk appetite.

Banking System Deposits By Type, November 2013



Source: Bank Negara Malaysia.

23. FSAP update. Staff noted that the authorities have made significant progress with implementation of the recommendations of the FSAP (see Appendix 6). Notably, the Financial Services Act (FSA) and the Islamic Financial Services Act (IFSA) came into force on June 30, 2013, strengthening BNM's powers, including the ability to take prompt corrective action for financial institutions and to carry out consolidated supervision of financial holding companies. In addition, the regulatory perimeter is widened to include onshore nonbank financial entities and nonbank financial entities operating in the offshore

[15] The decline in banks' CAR from 17.6 percent at end-2012 to 14.7 percent at Q3:2013, is reflective of banks' efforts to reduce capital that no longer qualifies as loss-absorbing capital under Basel III. The Tier 1 capital ratio of the banking system, the relevant Basel III metric, has remained stable over this period.

[16] Liquidity as measured by one-year coverage of liabilities with assets has come down slightly since 2012 but remains similar to the 2011 level. Under the LCR, the more stringent Basel III definition of liquidity, that measures one-month coverage of liabilities, banks are consistent with the global phase-in schedule.

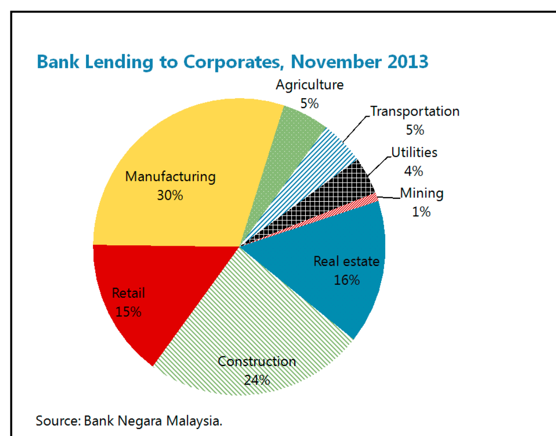
[17] Banks' spreads between lending and deposit rates have shrunk over the past 10 years (by about 100 bps) as lending rates have come down faster than deposit rates, reflecting, in part, increasing competition in the banking sector and improving borrower creditworthiness (as evidenced by falling amounts of impaired loans for the overall system).

[18] However, BNM issued an industry consultation paper in January 2014 proposing a new reference rate to replace the BLR. The proposed new reference rate is designed to reflect each financial institution's funding costs, enhancing transparency in setting the reference rate, and increasing the sensitivity of the reference rate to changes in an institution's funding costs, which will reduce their risk.

Labuan International Business and Financial Center (Labuan IBFC) other than those licensed by the Labuan Financial Services Authority. The IFSA provides a legal framework that is consistent with Shariah on regulation and supervision, from licensing to the winding up of institutions. Separately, a high-level committee, the Financial Stability Executive Committee, comprising the BNM, Perbadanan Insurans Deposit Malaysia (PIDM), and the fiscal authority, formed since 2010 to discuss systemic risk issues and decide on measures to address such risks, including those emanating from entities outside of the regulatory purview of BNM, has expanded its permanent membership to include the Securities Commission. With regard to the FSAP recommendation for improvement in granular data on household assets and liabilities, the authorities expect to complete collection of data by income group by end-2014.

24. Staff position. In staff's view, the following areas warrant attention:

- **Household debt**. Concerns have centered on rapidly growing household debt of 83 percent of GDP, amid rising exposure of banks to the household sector (47 percent of banks' assets), vigorous house price appreciation, and strong growth in unsecured consumer credit (see Box 4).[19] Given the rapid credit growth to households and growing credit intermediation by nonbanks to households, staff suggested that additional macroprudential measures may be needed and emphasized the importance of continuing to enhance monitoring. Options for additional macroprudential policies include explicit limits on debt service-to-income ratios, which would have to be supported by ongoing development of credit registries; capping LTVs on second and first mortgages, or additional capital charges on loans with high LTVs.[20] Recent independent policy actions by state governments to curb price increases also suggest there is scope for closer coordination between local and federal authorities to ensure that combined measures are not overly restrictive. Staff welcomed progress with the collection of granular data to support surveillance and steps recently taken by the authorities to issue guidelines for responsible financing to nonbanks that are similar to those applicable to banks.



- **Banks' exposure to real estate**. Banks carry significant exposure to the nonfinancial corporate sector (43 percent of banks' assets). Exposure to the real estate sector makes up about 30 percent of the total stock of corporate loans, and nearly 40 percent of recent flow, which suggests that a price correction in the real estate market could have a significant

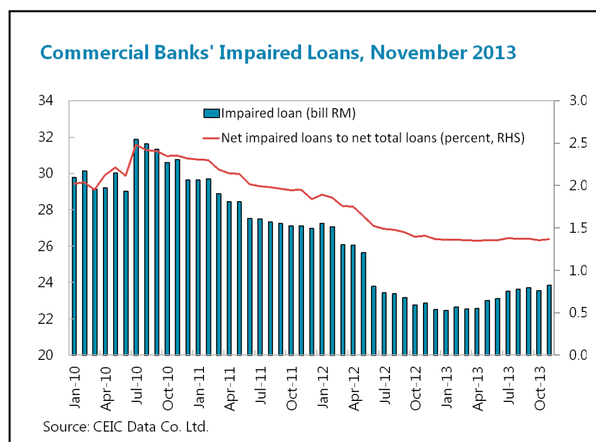
[19] In November 2013, S&P downgraded its rating outlook for one large bank and two mid-tier banks on concerns that asset quality could deteriorate in the future due to rising household indebtedness and potential for a correction in house prices. However, also during November 2013, Moodys' affirmed its stable ratings for 9 Malaysian banks, including the one large bank downgraded by S&P, while raising its future outlook to positive from stable.

[20] In its guidelines on responsible financing for financial institutions, the BNM already requires banks to set a prudent limit on the debt service ratio (DSR). Importantly, there is no set limit for all borrowers but rather banks are expected to vary the DSR based on borrower creditworthiness.

impact on the value of banks' collateral. The aggregate nonfinancial corporate sector has assets estimated to be more than 4 times GDP.

- **Corporate debt**. Corporates rely mainly on bank loans for financing, which make up nearly 60 percent of total liabilities. Debt issuance is long term in nature and mainly denominated in ringgit, averaging almost 80 percent of the total in recent years. Following the advent of the global financial crisis in 2008, there was a surge in U.S. dollar-denominated debt issuance by Malaysian corporates seeking to take advantage of low borrowing rates in global markets, but this has reverted to the average pre-crisis level since 2010. The aggregate solvency situation appears comfortable with earnings of nearly four times interest expense on debt liabilities, while the liquidity situation with current assets of nearly 1.6 times current liabilities is adequate. In aggregate, cash buffers estimated at 14 percent of assets are reasonable, and leverage is moderate with a debt-equity ratio of about 45 percent. Nevertheless, the solvency situation varies considerably across the corporate universe and the aggregate picture could change rapidly as earnings are volatile.[21] Resident companies including large multinational companies hedge their foreign currency exposure either with onshore banks or by relying on foreign currency earnings from abroad to meet the foreign currency commitment.[22] There were no reports of concerns in the corporate sector from the depreciation of the ringgit during the summer of 2013.

- **Asset quality**. Overall asset quality has improved significantly in recent years with nonperforming loans at a relatively low level of 2 percent of gross loans in 2013 compared with 6 percent at end-2007. Against a backdrop of strong credit growth, the long term improvement in asset quality is confirmed by a trend decline in the amounts of impaired loans, although there has been a slight reversal in this trend since March 2013. Providing a cushion, banks' provisions cover nearly 100 percent of all impaired loans. Banks' holdings of government and corporate securities comprised about 16 percent of total assets in August 2013, of which federal government securities are 4.5 percent, although accounting for government-guaranteed securities increases the potential exposure. Nevertheless, with many of these securities held to maturity, there was no significant impact on banks' capital from higher MGS yields in 2013.



Source: CEIC Data Co. Ltd.

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[21] Unlike the household sector, data on individually listed corporates is available on filings data and it is therefore possible to assess potential vulnerabilities at a granular level.

[22] Further detailed assessment of foreign currency assets and liabilities of domestic corporates is desirable. It would require access to banks' data on the size and nature of foreign currency hedging done by corporates as this is not publicly available information.

- **Foreign currency and cross-border exposures**. For the banking system as a whole, foreign currency exposure is 4 percent of loans and 5 percent of deposits. The authorities' own stress tests indicate a manageable level of FX liquidity risk in the banking system. Banks emphasize the need to strengthen fee-based income and to continue with plans to expand overseas in ASEAN. As cross-border banking activity continues to grow, the authorities are appropriately expanding the list of countries with which they have Memoranda of Understanding for cross-border supervision. At present, cross-border assets are mainly funded from host countries. Overseas lending by the top five banks makes up nearly 24 percent of total lending while loans-to-local deposit ratios are moderate at about 84 percent. Most of the exposure and international earnings contributions come from Singapore, Indonesia, Hong Kong, Thailand and Cambodia. Although Malaysian banking operations in Indonesia and Thailand remain profitable as of Q3:2013, asset quality could weaken in response to recent developments. Malaysian banks are likely to continue expanding abroad as ASEAN economic integration picks up steam in the years ahead. International experience suggests that substantial financial integration spearheaded by rapid bank expansion in new markets can pose challenges for bank risk management and supervisory monitoring. Going forward, it will thus be important to deepen home-host cooperation and supervision and strengthen crisis prevention and mitigation mechanisms, as outlined in Malaysia's Financial Sector Blueprint.

25. The impact of higher interest rates. In view of ongoing and prospective unwinding of UMPs in AEs and the normalization of global interest rates, staff conducted a simple solvency sensitivity analysis of the aggregate household, corporate and banking balance sheets to increases in MGS yields, the OPR, banks' deposits rates and nonperforming loans (NPLs) (see Appendix 7). From a financial stability perspective, plausible increases in domestic interest rates resulting from orderly tapering of UMP in advanced economies appear manageable at the aggregate level. For example, an increase in MGS yields by 100 bps combined with an increase in the OPR of 50 bps over the course of one year is estimated to have little impact on aggregate household balance sheets or bank capital because of earnings and savings buffers. However, the corporate interest servicing ratio rises by 2.6 percentage points to 27.6 percent, which could potentially lead to difficulties at some individual corporates but is unlikely to have a systemic impact.

26. More stringent stress tests. While an increase in borrowing costs by 100 bps over 12 months is plausible, more stringent tightening of financial conditions cannot be ruled out going forward. A 200 bps increase in the policy rate over a one-year period would:

- Increase the aggregate household debt servicing ratio (DSR) by 4 percentage points to nearly 48 percent ignoring the corresponding increase in income from savings; including the latter would raise the aggregate household DSR by only half a percentage point. However, the asset and liability positions may not match across all categories of households and some income groups may experience larger increases in their DSR and may become stressed.

- Raise the corporate interest service ratio by nearly 8 percentage points to 33 percent, assuming no change in corporate earnings and full rollover of debt coming due.

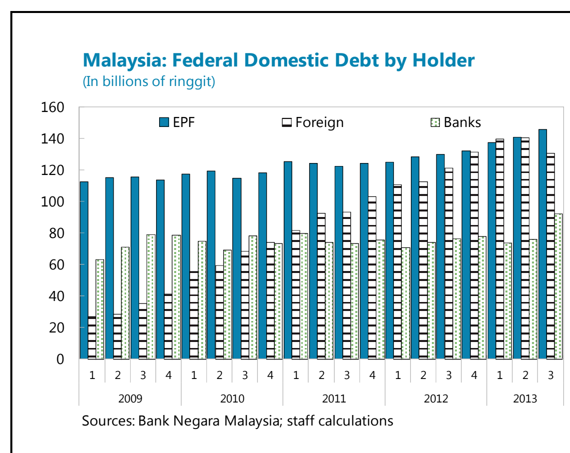
- Reduce the banking system's Tier 1 capital ratio by 1.1 percentage points to 12.8 percent (same as a doubling of NPLs).

The same rate shock over a 2 year period would have a much lower impact on bank capital as it would allow use of additional earnings as a buffer. It is important to emphasize that these results are obtained at the aggregate level; and the future availability of granular data on households together with more detailed analysis at individual corporate and banking level would provide more information on vulnerabilities of individual institutions.

27. Authorities' views. The authorities agreed with staff's assessment that the financial sector is well-diversified; and the banking system is strongly capitalized, very liquid and reasonably profitable. They noted recent enhancements in internal models used to stress-test banks' solvency and liquidity, addressing, for instance, the FSAP recommendation for multiyear bottom-up analysis. In terms of asset quality, the authorities commented that while the household debt burden has risen as a proportion of GDP in recent years, it remains well-supported by much larger financial asset buffers; while on the corporate side, leverage remains moderate. They described their approach to macroprudential policies as intentionally gradual in order to avoid unintended consequences and over-adjustment. They noted that rapidly increasing house prices are a concern but argued the increase is not solely driven by credit but primarily reflects mismatches between supply and demand, motivating increases in the Real Property Gains Tax (RPGT) and other budgetary measures to increase the supply of affordable housing. With regards to the impact of UMP withdrawal, the authorities believe that households will remain largely unaffected as potentially higher debt servicing costs would be offset by higher rates of return on savings including deposits. The authorities highlighted steps taken in strengthening regulation of the financial sector, in particular, the implementation of the Financial Services Act and the Islamic Financial Services Act, which significantly expand the scope of BNM's supervisory and regulatory powers. In particular, the power in relation to consolidated supervision allows BNM to extend the perimeter of its regulation and supervision to the subsidiaries of domestic banks operating in the Labuan International Business and Financial Center. The authorities pointed out the challenges faced by domestic banks in meeting the Basel III LCR requirement related to the Basel III standardized assumptions regarding run-off rates for deposits in comparison to BNM's behavioral modeling approach. Separately, the authorities have been monitoring closely the growth in credit provided by nonbanks to households and have taken steps to collaborate with the relevant regulator in issuing guidelines for responsible lending.

CAPITAL OUTFLOWS: VULNERABILITIES AND RESILIENCE

28. Background. Like other EMEs, Malaysia was affected by capital flow volatility in May-June 2013 and in early 2014. During May through end-July, foreign investors reduced their exposures to Malaysian bonds and equities (by 3.5 percent and 1.3 percent, respectively, of early-May allocations on a net basis). Over this period, the yield curve for government securities steepened, with 10-year yields rising by 102 bps peak-trough, while U.S. 10-year treasury yields rose 69 bps. Malaysian corporate bonds sold off during the summer turbulence with yields increasing by 120 bps (JP Morgan JACI Malaysia). On the equity side, there was no pronounced impact despite some foreign investor outflow, as domestic investors stepped in with purchases and stock prices rose by 1.3 percent between mid-May and end-July. The ringgit weakened by about 11 percent against the dollar (peak-to-trough).



Sources: Bank Negara Malaysia; staff calculations

29. Vulnerabilities and resilience. The spring-summer 2013 episode is the latest in a series of risk on/risk off cycles that Malaysia has endured in recent years, resulting in significant volatility in net portfolio flows (Figure 5). With UMP withdrawal and the normalization of interest rates in AEs, the carry trade advantage for Malaysian assets, especially government securities, will likely become less pronounced. While the mission's baseline assumption is that UMP exit is likely to be gradual, the possibility of sudden and significant portfolio outflows from Malaysia and other emerging market countries cannot be ruled out. Malaysia's vulnerability is related to its relatively high level of federal debt and large foreign holdings of government securities (42 percent). These risks were traditionally mitigated by Malaysia's strong external position but have come to the fore recently, following the decline in its current account surplus (to 3–4 percent of GDP in 2013–14 from an average of 12½ percent of GDP in 2009–11). But, similar to its experience during bouts of volatility in global capital flows in recent years, Malaysia dealt with the latest episode skillfully, allowing the exchange rate to act as a shock absorber while intervening to avoid excessive volatility.

30. The role of domestic institutional investors. The Malaysian economy's resilience during the May-June episode was facilitated by offsetting opportunistic purchases by large domestic institutional investors who provided depth to its financial markets. Staff confirmed that domestic investors, including banks and saving funds, resorted to significant purchases of equities as well as domestic government securities during the turbulent period, thus facilitating "financial" (as opposed to "real") adjustment (See Appendix 8 and WEO, October 2013, Chapter 3). Domestic investors play a stabilizing role in the market: if foreign investors were to reduce holdings of domestic assets sharply, the resulting depreciation of the ringgit would make sales of foreign assets by domestic investors

more attractive prompting an offsetting inflow. Staff's illustrative calculations using data for the third quarter of 2013 suggest domestic investors have additional capacity of about 6 percent of GDP for purchases of MGS. By comparison, foreign outflows from MGS during Q2:2013 amounted to about 1 percent of GDP, and foreign investors held about 13 percent of GDP in MGS as of Q3:2013. Nevertheless, caution is warranted: international exposure of domestic institutional investors, estimated at about 20 percent of GDP, is well below that of total foreign ownership of domestic equities and bonds; and, overseas holdings of domestic institutional investors may not be fully liquid.

Estimated Capacity for Additional Holdings of Malaysian Government Securities Domestically

Entity	Assets (In percent of GDP)	Estimated Target MGS Allocation	Q3:2013 Underweight	MGS Space in Stock of Assets	MGS Space in Flow	Total MGS Capacity
		(In percent)		(In percent of GDP)		
EPF--Domestic Pension Fund	52.9	30.0	2.0	1.1	0.5	1.5
KWAP--Civil Service Employees Pension	10.1	25.0	3.0	0.3	0.1	0.4
LTH--Haj Support Fund	4.9	28.0	3.0	0.1	0.1	0.2
Khazanah	12.2	--	--	--	--	--
PNB--Permodalan National Berhad	25.7	--	--	--	--	--
Banks	205.9	5.0	0.5	3.1	0.5	3.6
Total	311.8			1.5	0.6	5.8
Total stock of MGS	51.6					
Foreign holdings of MGS	13.2					
MGS outflow (June-September)	1.0					

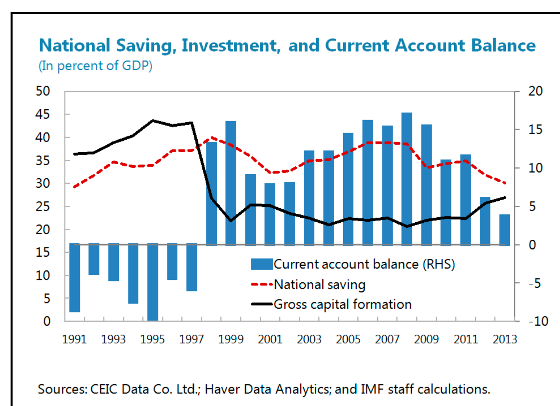
Sources: Bank Negara Malaysia; GLICs; and IMF staff estimates (December 2013).

31. Authorities' views. The authorities highlighted the growing depth of domestic capital markets, which has led to a structural increase in nonresident holdings of government and BNM securities. They noted that compared with past episodes of capital flight, Malaysia is now better prepared to deal with potential risks of capital outflows on account of higher levels of international reserves, better capitalized financial intermediaries, a wider range of monetary instruments to manage liquidity, and much deeper capacity of domestic institutional investors to absorb selling by nonresidents. The authorities also observed that the volatility in capital flows experienced during May-September 2013 did not have any significant adverse impact on the real economy.

EXTERNAL SECTOR DEVELOPMENTS

32. Background. In recent years, the Malaysian economy has undergone significant external rebalancing, reflecting robust domestic demand (including from large investment projects under the government's Economic Transformation Program (ETP)) and weak external demand. This has led to a dramatic narrowing in the external current account surplus, which declined to 3.8 percent of GDP in 2013, from 6.1 percent of GDP in 2012 and 11.6 percent in 2011, while the non-oil current account balance has swung into a deficit of about 2.4 percent of GDP from 4.2 percent surplus for 2011. From a savings-investment perspective, about two thirds of the adjustment was due to a strong surge in private investment and the large investment projects under the ETP, which bodes well for the medium term growth outlook. Over the past year, the exchange rate has fluctuated more widely than in 2010–2012, but around a fairly horizontal trend. International reserves have decreased slightly and the IMF's composite reserve adequacy metric stands at a comfortable 117 percent. The net international investment position was a small positive in 2011 but has turned negative and now stands at –2 percent of GDP.

33. Outlook and Assessment. Looking ahead, over the medium term, increased public sector savings will be offset by sustained private consumption and investment activity and is expected to result in a current account surplus of 3–4 percent over the medium term.[23] The significant reduction in Malaysia's current account surplus is reflected in a commensurate narrowing of Malaysia's estimated external imbalances or gaps (see Appendix 3). Staff views any remaining current account and real exchange rate gaps as reflecting inadequate social protection (beyond that captured by public health expenditure), the need to improve the risk sharing characteristics of the pension system, investment bottlenecks, infrastructure gaps, labor force skill mismatches, and rigidities in the labor market. Staff's estimate of the cyclically-adjusted current account norm for 2013 is 1.5 percent of GDP, compared to the External Balance Assessment's (EBA) norm of -0.1 percent. With a projected cyclically adjusted current account surplus of 4.1 percent of GDP, this implies a total current account gap of 2.6 percent of GDP, with the policy gap contributing to the bulk. Malaysia's real effective exchange rate (REER) is assessed as moderately undervalued by about 9 percent, reflecting savings and investment gaps and consistent with the identified current account gap, with the estimate subject to considerable uncertainty.



[23] Staff estimates indicate that every 1 percentage point improvement in the fiscal balance could strengthen the current account by about 0.4 percentage point.

34. Policies. Structural reforms aimed at strengthening social protection while safeguarding fiscal sustainability, together with improvements in the investment climate, and population aging should help reduce the saving-investment gap over time. However, these changes take time as they involve the creation and reform of institutions.

- Staff recommended the introduction of unemployment insurance, which the authorities are studying, and which would further strengthen the safety net and reduce precautionary savings.
- Staff also noted that there is scope to improve the coverage and adequacy of retirement schemes in the private sector in order to provide more effective protection against poverty in old age.
- These measures should be complemented by continued exchange rate flexibility with intervention limited to dampening excessive volatility, which will likely be associated with a gradual appreciation of the real exchange rate over time and support external rebalancing.

35. Authorities' views. The authorities agreed with staff that the current account will remain in small surplus for the foreseeable future; however, they disagreed with staff's assessment of external imbalances, particularly the exchange rate. They questioned the validity of the EBA exercise for Malaysia where there are large unexplained residuals and argued that EBA's cross-country approach may not fully capture Malaysia's unique characteristics. The authorities questioned the assessment of the exchange rate as undervalued in view of the selloff of the ringgit during periods of financial turbulence. They emphasized that they do not manage the level of the exchange rate but intervene only to smooth excessive volatility. In addition, the authorities questioned the staff's assessment that the current account surplus is too large in view of the sensitivity of the global financial markets to current account deficits in emerging market economies, as reflected in the vulnerability of deficit countries to capital outflows during crisis periods.

BOOSTING GROWTH AND INCLUSION: THE ROLE OF HUMAN CAPITAL DEVELOPMENT

36. Background. Malaysia is implementing an extensive agenda of structural reforms aimed at strengthening growth and making it more broadly shared, as elaborated in a number of multiyear transformation programs to upgrade human capital, foster technological readiness, inject greater competition in product markets, and strengthen the government's performance (Appendix 9). In this connection, and in the face of heightened international demand (and competition) for talents, efforts to strengthen Malaysia's education system have acquired heightened importance. Malaysia has made important progress in raising school enrollments: secondary net enrollment has risen sharply, as has enrollment in tertiary education. But Malaysia still faces shortages of high-skill workers, and skill mismatches are an important constraint in efforts to raise potential growth and reduce income inequality.

37. Policies. While Malaysia has achieved much in this area, additional reforms are needed to make the education system more efficient and cost effective.

- The authorities have created an array of initiatives but, in the context of scarce resources, some deliberate prioritization is needed. Priorities should include expanding access to tertiary education and increasing availability of financing to underserved groups.
- Quality control in private universities and retaining Malaysian-grown talent in the domestic economy are also important (World Bank, 2012).
- More work is needed to improve educational attainment (what students actually know) at the basic and secondary level. In this regard, staff welcomes the authorities' goal to place Malaysian students in the top third of international assessments and to reform and improve the performance of the Ministry of Education (see *Malaysian Education Blueprint* 2013–25).

38. Authorities' views. The authorities stressed that their ambitious transformation programs and blueprints are helping them achieve their goal of transforming Malaysia into an advanced, high-income nation by 2020. They pointed out that they are engaged in a multifaceted effort to improve skills, including through partnerships between businesses and higher education catalyzed by government funding. They recently merged the Ministry of Higher Education into the Ministry of Education and expect the requirement of greater accountability from teachers and researchers to result in improved results in teaching and academic research. They are also intensifying human capital development efforts in the elementary and secondary education with a view to bring Malaysian students to the top one third of countries tracked by the Program for International Student Assessment (PISA). Progress in improving educational attainment, as outlined in the *Malaysia Education Blueprint*, 2013–2025, is a high priority for them. They agreed with the call for achieving better performance in education in a tighter budgetary environment.

STAFF APPRAISAL

39. Outlook. The Malaysian economy's near-term growth prospects are favorable, and the transition to the post-UMP environment should be relatively smooth: real GDP growth picked up in the second half of 2013 and this momentum is likely to be sustained in 2014. Continued robust domestic demand, together with an improved external environment, should offset mild headwinds from the timely, decisive, yet gradual fiscal consolidation. Underlying inflationary pressures remain subdued, but headline inflation has picked up somewhat reflecting the effects of subsidy rationalization.

40. Risks. Downside risks to growth include a bumpy exit from UMP, which could be associated with a protracted period of economic and financial volatility in EMEs. However, Malaysia's current account should remain comfortably in surplus, and its financial system is deep and has demonstrated its capacity to withstand such volatility and contain the impact on the real economy. A flexible exchange rate regime combined with credible monetary policy have put Malaysia in a

strong position to manage the downside risks to the outlook, which include a sharp slowdown of growth in China or a protracted period of slow growth in Europe.

41. Fiscal policy. Amidst capital outflows from EMEs and concerns about Malaysia's relatively high federal debt, the authorities undertook a timely and decisive, yet gradual recalibration of their fiscal management and policies in 2013. In staff's view, these efforts amounted to a breakthrough in that they should secure the sustainability of Malaysia's public finances while promoting efficiency, equity and growth in the revenue and expenditure systems, and minimizing the drag on the economy from fiscal consolidation. Implementation and political risks from fiscal reforms are, in staff's view, circumscribed by the authorities' commitment to the reforms and by their sound preparation and technical plans to carry them out.

42. Medium term fiscal strategy. Beyond 2015, the authorities' policy priority is to gradually bring down federal debt in the face of declining oil revenues and a rise in age-related and other nondiscretionary spending. Staff supports this priority, which will require a concrete plan underpinned by a debt target for 2020. Staff has provided some specific and quantified revenue and expenditure measures evaluated according to their efficiency, equity and growth dimensions. Staff also supports the authorities' sustained efforts to strengthen public financial management and statistical reporting in accordance with the GFSM 2001 format. Enhanced monitoring of fiscal risks is a priority, including the publication of an annual fiscal risks statement.

43. Monetary policy. In view of its dual mandate, substantial downside risks to growth, and very low inflation, BNM has been appropriately maintaining an accommodative monetary stance to support the economy. Going forward, the central bank has to contend with higher headline inflation in 2014–15. In staff's view, while the risk of administered and tax-related price adjustments leading to an economy-wide spiral in wages and prices is low, the monetary authorities should stand ready to adjust their policy rates to curb second round effects. Their substantial policy credibility and close monitoring of price developments should help maintain price stability over the medium term.

44. Dealing with potential capital flow volatility. Malaysian policymakers may face renewed capital flow volatility going forward, amidst the gradual withdrawal of UMPs and lingering concerns over slower growth in China and other EMEs. The authorities' experience dealing successfully with volatile capital flows; the recalibration of fiscal policies; substantial reserves; a comfortable current account surplus; and a deep and sound financial sector should all help Malaysia weather bouts of capital flow volatility. In the event of renewed financial turbulence, the exchange rate should be the first line of defense, with intervention limited to smoothing excessive volatility.

45. Financial sector stability. Malaysia's financial system is sound and well placed to withstand potential stresses. As confirmed by the 2012 FSAP and again during the 2013 Article IV discussions, Malaysian banks have ample capital, adequate liquidity buffers, and are backed by a strong regulatory and supervisory framework. Nevertheless, ongoing global volatility, high household debt and rising house prices all warrant continued vigilance. Staff welcomes steps taken by the authorities to strengthen financial supervision and their targeted and phased approach to macroprudential

policy. In the event housing price increases continue unabated, the authorities should not hesitate to adopt additional macroprudential measures.

46. External assessment. The rebalancing of Malaysia's economy in recent years has been reflected in a substantial narrowing of its current account surplus. Nevertheless, Malaysia's external position is still stronger than warranted by medium-term fundamentals and desirable policies, and its current account surplus is still above the norm. From a saving-investment perspective, the remaining current account gap likely reflects inadequate social protection (beyond that captured by public health expenditure), the need to improve the risk sharing characteristics of the pension system, investment bottlenecks, infrastructure gaps, labor force skill mismatches, and rigidities in the labor market. Increased social spending related to population aging, as well as policies to strengthen social safety net and boost investment, combined with exchange rate flexibility, should help to gradually close the current account gap.

47. Strengthening human capital accumulation. Malaysia is undertaking a major effort to upgrade its human capital in the face of heightened international competition for talent. Despite important progress in human capital investments, Malaysia still faces shortages of high-skill workers, and skill mismatches are an important constraint. Staff supports the authorities' ambitious efforts to raise the effectiveness of Malaysia's education system further, make it more cost effective, increase the availability of financing to underserved groups, improve quality control in private universities, and retain Malaysian-grown talent in the domestic economy.

48. It is recommended that the next Article IV consultation with Malaysia take place on a standard 12-month cycle.

Box 1. Malaysia—Fiscal Policy Committee

Background. In June 2013, amidst market turbulence that also affected Malaysia and concerns about the sustainability of Malaysia's public finances (public debt is a relatively high 55 percent of GDP) and "stasis" in fiscal reforms, Malaysia announced the creation of a Fiscal Policy Committee (FPC), a strategic decision making body that includes the prime minister, finance minister, central bank governor and other key economic policymakers. Following its inaugural meeting on September 2, 2013, the FPC reinforced the government's commitment to reducing the budget deficit and public debt. It also announced strong fiscal measures to shore up the 2013–14 fiscal positions. These included price increases for fuel and diesel, with immediate effect, as a first step in a gradual, multiyear effort to rationalize subsidies. The FPC also indicated that additional fiscal measures would be forthcoming as needed, including the implementation of a GST, later included in the 2014 Budget.

Mandate. The FPC has been tasked to play a leading role in ensuring fiscal sustainability and long term macroeconomic stability. The FPC will develop guiding principles for the conduct of sound fiscal policy, endorse Malaysia's medium term fiscal strategy, review the government's fiscal performance, and ensure alignment across ministries and agencies in order to meet fiscal targets and manage fiscal risks. A Fiscal Policy Office (FPO) within the Treasury is being set up and will act as the secretariat to the FPC. The FPO will provide analytical guidance in the formulation of fiscal policy, produce fiscal forecasts and facilitate collaboration between the Treasury and different government agencies.

The FPC in international context. The creation of the FPC/FPO constitutes an important institutional innovation in Malaysia. Although it is not a fiscal council,[1/] the FPO's objectives are similar in spirit to nonpartisan institutions set up in recent years to monitor fiscal performance and enhance fiscal credibility and transparency. Thus lessons from the international experience with fiscal councils, analyzed in a recent IMF paper,[2/] can offer useful insights for Malaysia's FPO. For the FPO to be effective and deliver the credibility dividend associated with its creation, the following conditions will be critical.

- ***Operational independence***, ideally supported by legal guarantees. Although the FPO is not legally independent, ensuring that it has sufficient operational independence is important. Belgium's High Council of Finance (HCF) and Netherland's Bureau for Economic Policy Analysis (CPB) are examples of institutions that are not legally independent, but that have, over time, built a reputation of professionalism and independence.[3/]
- ***Resources*** commensurate to the FPO's remit. Ensuring the professional status of FPO staff and securing adequate staffing and resources will be critical to build operational independence.
- ***Full transparency and strong media presence***. Over time, publication of FPO analyses and assessments, including of annual fiscal risks statements, would help increase fiscal transparency and build the credibility of FPO. Both the HCF and the CPB have a strong media presence and publish their reports and analysis.

Evaluation. The FPC is a powerful high-level executive body. Unlike fiscal councils, which are independent advisory and evaluation entities, it exercises broad responsibilities over matters of fiscal policy that are analogous to the mandate of monetary policy committees over monetary policy. The FPC is thus a powerful decision-making and coordinating body committed to sustainable public finances and sound fiscal policy that serves the general public. Its creation bodes well for the design, execution and credibility of Malaysia's future fiscal policy. The effectiveness of the FPO can be enhanced over time by ensuring its operational independence, access to resources and a strong media presence.

1/ A fiscal council is defined as "an independent public institution informing the public debate on fiscal policy" (IMF, 2013).

2/ "The Functions and Impact of Fiscal Councils," International Monetary Fund, July 16, 2013.

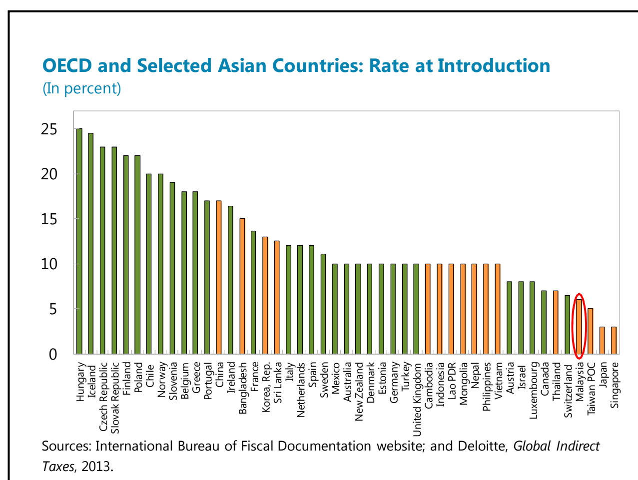
3/ HCF is headed by the Minister of Finance, is supported by staff from the Ministry of Finance and aims at providing high-quality inputs to budget discussions. But unlike the FPC/FPO, it is not a decision-making body and has a strong media presence, which has over time enhanced its reputation of professional excellence and unbiased analysis. The Netherland's Bureau for Economic Policy Analysis (CPB), a fiscal agency that provides the government with economic analysis and forecast and election platform and program costing, also has a similar framework. CPB is set up within the Ministry of Economic Affairs and is therefore not formally independent. However, CPB has over time established itself as fully independent in its operations and in its analysis and research. For instance, the CPB can set its own work agenda and is subject to regular independent evaluations mainly by academics, many of whom are not Dutch citizens.

Box 2. Malaysia—Goods and Services Tax (GST)

Background. Malaysia plans to introduce a Goods and Services Tax (GST) in April 2015, to replace its current sales tax. Unlike existing sales and services taxes,[1/] the GST will be designed as a value-added tax, and its coverage will be broader. The proposed standard rate at introduction is 6 percent, a relatively low rate compared to the current VAT rates in other ASEAN countries (7 percent in Thailand and Singapore, 10 percent in Vietnam and Indonesia, and 12 percent in Philippines). Relative to the standard rate at introduction in a group of OECD and Asian countries, Malaysia's 6 percent is also somewhat low. Under the GST, some essential food items will have a zero tax rate and some services such as public transport, financial services, education and government services will be exempt from tax. The GST will be introduced together with offsetting income tax cuts, one-off cash transfers to low income households and subsidies to SMEs for the purchase of accounting software. The GST registration threshold of 500,000 ringgit (about 160,000 U.S. dollars), is high compared to other peer countries; but will cover about 150,000 companies–a significant increase relative to the existing sales tax. Based on authorities' simulations, lowering the threshold would have no material impact on the revenue yield, while increasing the burden of tax administration.

Fiscal Impact. Staff projects the gross revenue yield of the GST to be about 2.3 percent of GDP, assuming a c-efficiency ratio[2/] of about 60 percent. The relatively low revenue yield is due to a low standard rate and a broad set of exempt and zero-rated products.[3/] From an efficiency perspective, a low standard rate applied on a broad tax base would have been preferable. However, lower rates on basic goods and services consumed by low income households are important to mitigate the regressive effects of the GST and to ensure political feasibility in the absence of an efficient social safety. The net direct revenue impact of the GST will be even smaller at about 0.2–0.3 percent of GDP initially, but increasing to about 0.5 percent of GDP in the medium term, given that it will replace the existing sales and service taxes and due to the introduction of offsetting measures mentioned above. However, GST will likely have indirect positive effects on revenue through improving compliance and generating incentives for firms to move to the formal sector. Although the net revenue yield at introduction will be small, once the tax is operational and a more efficient social safety net system is in place, the standard rate and the list of zero-rated and exempt goods can be revised to increase the revenue yield. The introduction of the GST is strategically important for fiscal sustainability and tax base broadening as it gives the government a new lever to use to respond to changes in fiscal conditions.

OECD and Selected Asian Countries: Rate at Introduction
(In percent)



Sources: International Bureau of Fiscal Documentation website; and Deloitte, *Global Indirect Taxes*, 2013.

GST Implementation. The authorities have already started an active public outreach program, organizing nationwide seminars, workshops and road shows to create awareness, explain the GST and how it will impact different prices. The authorities are also taking steps on tax administration as well as issues related to implementation such as the establishment of an efficient refund system and providing training to SMEs to ensure the smooth rollout of the tax. International experience has demonstrated that best results are generally achieved when all major domestic taxes are administered by a single inland revenue agency (In Malaysia, the GST will be administered by the Customs Agency). The voluntary registration procedures will need to be carefully instituted to ensure administrative efficiency by avoiding the registration of many small businesses. The authorities are fully aware of the importance of implementation and have formed a GST monitoring committee to better address potential problems and challenges.

1/ Malaysia's current sales tax is charged on taxable goods at the manufacturer's level. Its standard rate is 10 percent for most taxable goods and a 5 percent tax is charged on select products such as food items. Services tax applies to certain services provided by restaurants and hotels, telecommunications services and professional services.

2/ C-efficiency ratio is defined as the ratio of actual VAT revenues collected to the potential revenue base which is total consumption times the standard VAT rate. The c-efficiency ratio would be 1 if there are no exempt goods or multiple rates and if there is no tax avoidance. The c-efficiency ratio therefore reflects the productivity of the VAT. The median c-efficiency ratio in a group of OECD and Asian countries is about 60 percent. Typically, there is an inverse relationship between c-efficiency and the standard rate, reflecting lower tax avoidance and a broader tax base that is associated with tax systems with low rates.

3/ Based on staff's estimate of "tax gaps" in Malaysia, there is additional scope (about 2.7–3 percent of GDP) to raise indirect, consumption taxes.

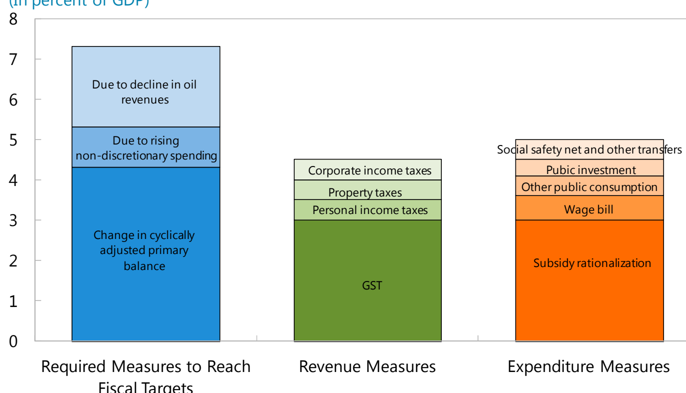
Box 3. Malaysia—Medium-Term Fiscal Consolidation

Background. The Malaysian authorities have reaffirmed their commitment to sound public finances and a medium-term fiscal consolidation which aims to lower the budget deficit to about 3 percent of GDP by 2015 and balance the budget by 2020. The objective of achieving a balanced budget by 2020 implies a consolidation of 4.0–4.1 percent of GDP in terms of the cyclically-adjusted primary balance. However, declining oil revenues and a rise in nondiscretionary spending pressures in the medium term is projected to drive up Malaysia's fiscal deficit going forward. These factors call for the adoption of further measures (above and beyond the announced adjustment) in order to secure fiscal targets for 2020.

Fiscal consolidation. This box summarizes considerations in designing the composition of Malaysia's medium-term fiscal consolidation.[1/] It first identifies revenue and expenditure measures that could be used and the size of potential savings. These measures are then ranked based on three criteria—short-term growth, long-term growth and equity—to determine the tradeoffs in using different measures. These trade-offs can be used to inform the composition of Malaysia's medium-term fiscal consolidation, based on the authorities' priorities.

Revenue measures. Malaysia's tax structure relies heavily on direct income taxes, especially on corporations, while indirect taxation is underutilized. A cross-country tax gap analysis is used to assess potential to raise revenues.[2/] The tax gap analysis suggests that there is considerable scope to raise Malaysia's indirect tax revenues. The predicted norm for Malaysia's consumption taxes is 6–6.3 percent of GDP, which suggests a gap of 2.7–3 percentage points. Non-oil income taxes in Malaysia are above the predicted norm, however, this is due to high levels of corporate income taxes (CIT), while personal income taxes are relatively low (at about 2.5 percent of GPD).[3/] This seems to reflect relatively low tax rates, in particular at the top of the income distribution, and thus personal income taxes can be made more progressive while generating additional revenues. CITs are relatively high in Malaysia, despite the existence of a broad set of exemptions and incentives. This is potentially driven by a high corporate income tax rate (25 percent) and an efficient system of revenue administration. The corporate income tax rate will be reduced by one percentage point effective 2016, as an offsetting measure for the GST. Rationalizing tax incentives is the only tool that can be used to generate additional revenues but it is hard to estimate the revenue yield from reducing tax incentives. We assume potential fiscal savings could be in the range of 0.1–0.5 percent of GDP, while noting the uncertainty around such assumptions. Finally, as in many other countries, property taxes are under-utilized in Malaysia and can be used more extensively. All of the revenue measures could together generate about 4.5 percent of GDP in savings.

Potential Revenue and Expenditure Measures for Medium-Term Fiscal Consolidation
(In percent of GDP)

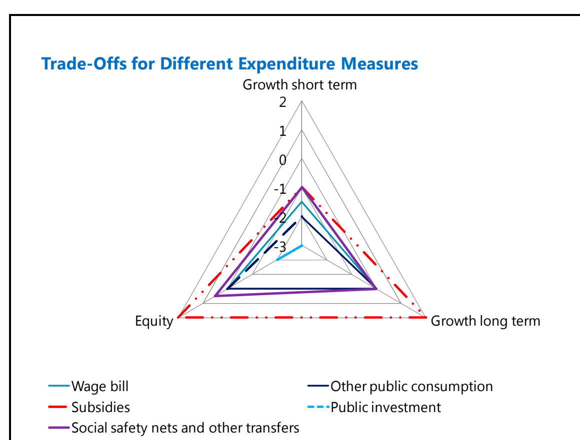


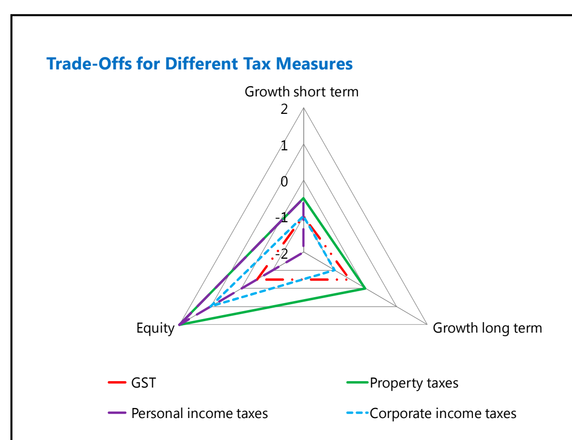
Source: IMF staff estimates.

Expenditure measures. Expenditure measures are identified using the level and composition of Malaysia's current federal spending. Subsidy rationalization has the greatest potential to generate large and immediate fiscal savings. Fuel subsidy rationalization alone could yield fiscal savings of 2.2–2.7 percent of GDP, taking into account offsetting cash transfers. Rationalization of other subsidies, such as on cooking oil, rice and flour, could generate additional savings of 0.2–0.3 percent of GDP. Containing growth in the public sector wage bill can also support the consolidation effort. The wage bill has increased by 0.9 percentage points since 2008, to 6.2 percent of GDP, reflecting improvements in the salary scheme, a time-based promotion scheme for teachers, and additional bonus payments. Restricting hiring to essential personnel and limiting the establishment of new posts (as already adopted by the authorities) can help going forward. Spending on education, in particular on emoluments, is not efficient and may offer additional scope for savings.[4/] Similarly, in the area of social safety net spending, there is scope to reduce budgetary costs while enhancing social effectiveness by consolidating several programs that offer different benefits (The authorities are already working towards establishing a comprehensive database of recipients). Broad-based efficiency gains in public expenditure, including through improved procurement (already underway) can also be a source of fiscal savings. Finally, there is limited scope (estimated at 0.2–0.4 percent of GDP) for fiscal savings in development spending given its decline in recent years.

Box 3. Malaysia—Medium-Term Fiscal Consolidation (Concluded)

Key considerations. The composition and timing of tax and expenditure measures that can be adopted as part of Malaysia's consolidation strategy should be guided by their growth and equity implications. Figures below show how different instruments rank along these dimensions. More negative values suggest a larger negative impact on growth or equity; the converse is true for the positive values. These rankings can guide policy makers in selecting the composition of fiscal consolidation, based on the preferences and weights they assign to different goals. All revenue and expenditure measures would have a negative impact on growth in the short run, with public investment and consumption having the largest impact. With respect to growth implications in the long run, public investment is expected to have the highest negative impact, whereas subsidy rationalization is the most growth-friendly fiscal measure, with an expected small positive impact on long-run growth. Subsidy rationalization, property taxes and a progressive increase in personal income taxes are expected to have positive distributional impact, while public investment and the GST are expected to have a relatively higher negative distributional impact.





Conclusions. Subsidy rationalization and property taxes come out clearly as a desirable set of instruments to use in fiscal consolidation from both growth and equity perspectives. Improvements in the efficiency of social safety nets and other transfers and a progressive increase in personal income taxes also come out high in the relative ranking of fiscal measures. In the context of Malaysia's high fiscal adjustment needs, the GST is also a necessary component of fiscal adjustment, given its large revenue-generating potential and its strategic importance. Public investment is the least desirable instrument with adverse effects on growth and equity. Exact ranking of different measures depend on many factors including societal choices regarding the role of government, but also on cyclical factors and monetary policy space, for example for short-term growth.

1/ This box summarizes the results in the accompanying selected issues paper (SIP) titled "A Medium-Term Fiscal Strategy for Malaysia."

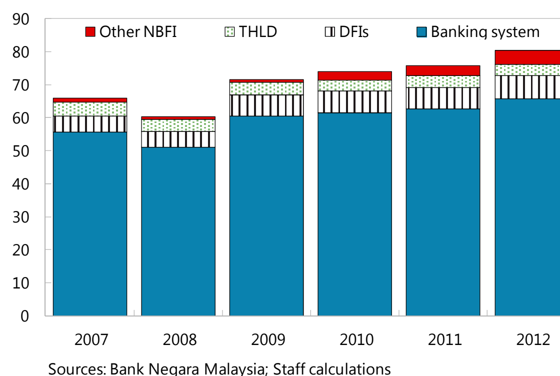
2/ We compare Malaysia's tax revenues with its peers, controlling for a range of characteristics relevant for tax revenues, using a regression analysis. We compare the predicted tax revenues from the regression model with Malaysia's actual revenues in 2012. The difference between the predicted and actual taxes is interpreted as a "tax gap." The regression controls for income per capita, the old-age dependency ratio, exports of oil and gas, and also includes dummies for geographical regions to capture other unobserved regional characteristics.

3/ Consideration could be given to a revenue-neutral additional reduction in the CIT rate that would be offset by rationalizing tax incentives, which would improve the efficiency of the CIT system, and raise investment and economic growth.

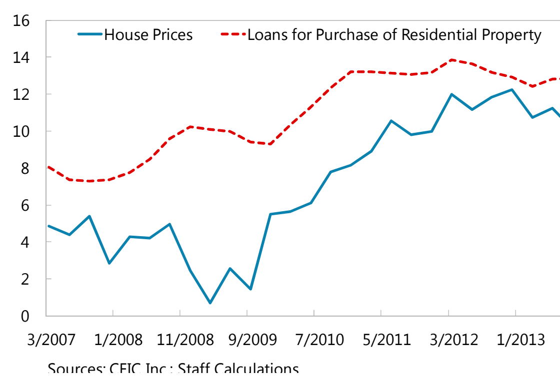
4/ Malaysia's Education Blueprint has found that spending on education in Malaysia has not resulted in better educational outcomes and that there are important potential efficiency gains.

Box 4. Malaysia—Household Debt

Household debt has grown rapidly in Malaysia since 2008, increasing from 60 percent of GDP to 83 percent of GDP by end-September 2013. While banks remain the most important source of credit to households in Malaysia, lending by Development Financial Institutions (DFIs) and Nonbank Financial Institutions (NBFIs) has grown rapidly since 2008 and accounts for about one-quarter of the increase in debt. Approximately 55 percent of the debt is owed on residential property, of which about 70 percent are variable rate mortgages. Mitigating the risks somewhat are strong financial buffers on aggregate, with household financial assets amounting to 189 percent of GDP. However, there may be pockets of vulnerability, including for example, lower income borrowers (with a monthly income of RM3,000 or less) that are more highly leveraged than other income groups.



House prices have increased rapidly, outpacing income and rental growth, along with strong demand for residential property loans, driven by a robust labor markets and falling lending rates. However, underwriting standards do not appear to have deteriorated, as evidenced by lower default rates by month on book for more recent vintages.



Loans for personal use have also grown rapidly, with a strong increase especially from the DFIs and NBFIs. Credit risk is reduced as most lending is to government workers, serviced through automatic salary deductions, and with an aggregate deduction cap of 60% of a borrower's net income. Loans for personal use from the NBFIs and DFIs increased to 9 percent of GDP in 2012, up from 5 percent in 2008. Growth was partially driven by increased offering of personal finance products with unfavorable terms, such as extended tenures and bullet payments on retirement. With borrowers from the DFIs and NBFIs tending to have lower incomes, the vulnerability of this segment has increased. In response to growing concerns, in July 2013, BNM limited the tenure of personal financing loans to 10 years (including prohibiting bullet payments on retirement) and prohibited the offering pre-approved personal financing products.

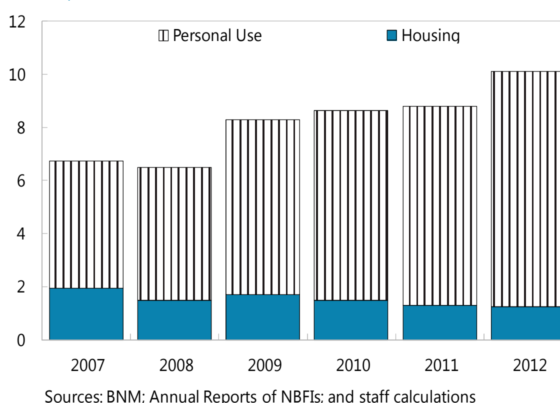
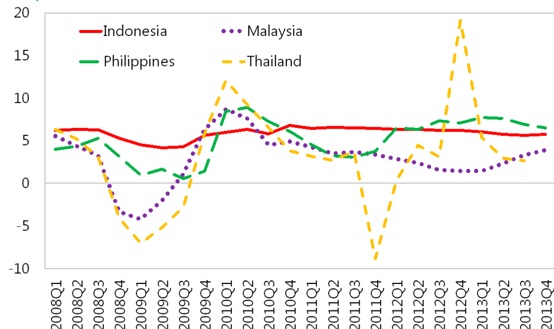


Figure 1. Malaysia: Growth and Exports

Growth has recovered following a slow start in the first half of the year…

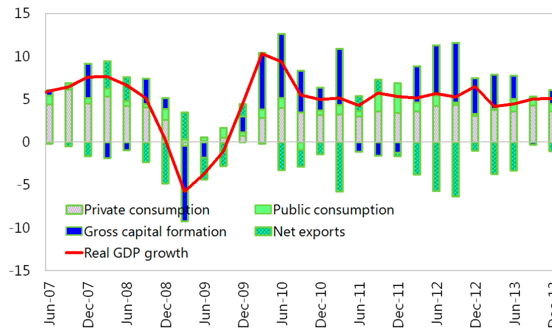
Real GDP Growth
(In percent)



Source: IMF, *World Economic Outlook*.

…as there is less drag from net exports, while domestic demand remain robust.

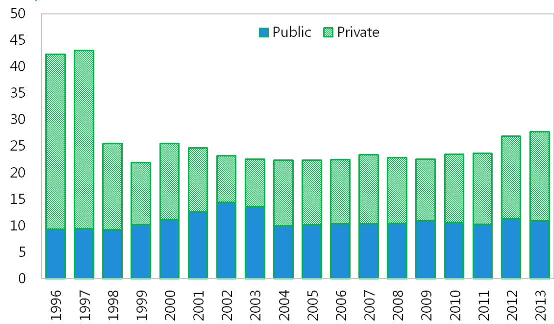
Contribution to Real GDP Growth
(Year-on-year percent change)



Source: CEIC Data Co. Ltd.

The strong pick-up 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.

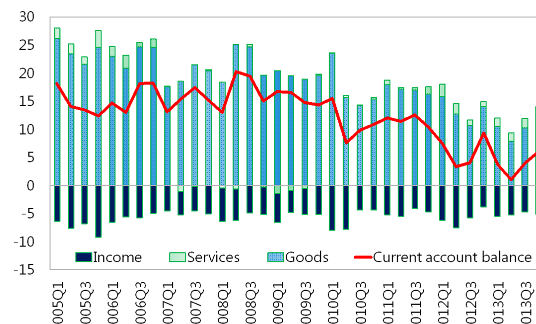
Real Gross Fixed Capital Formation
(In percent of GDP)



Source: CEIC Data Co. Ltd.

The current account surplus fell as net exports of goods declined.

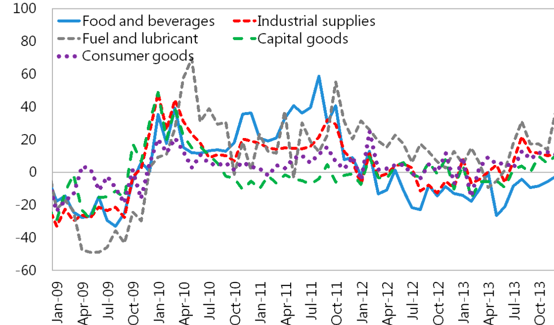
Current Account Balance
(In percent of GDP)



Source: CEIC Data Co. Ltd.

Exports disappointed at the end of 2012 and in the first half of 2013, but a recovery appears to be underway.

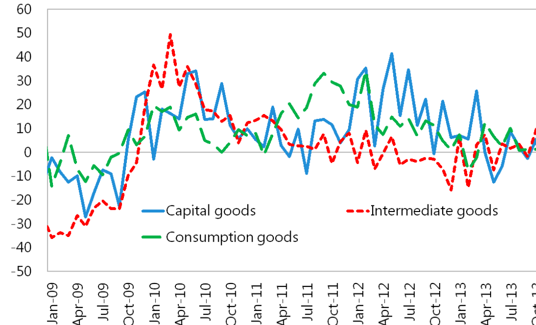
Exports Growth
(In percent, year on year)



Source: CEIC Data Co. Ltd.

Growth in imports of capital and consumer goods had been robust, compared with weaker intermediate goods demand.

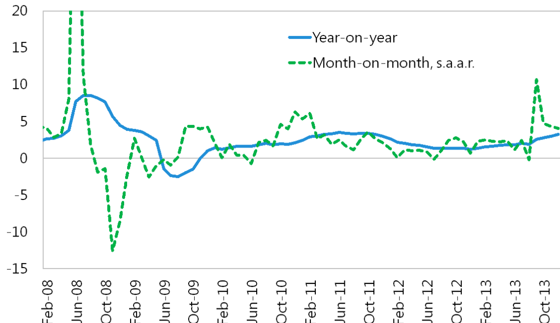
Imports Growth
(In percent, year on year)



Source: CEIC Data Co. Ltd.

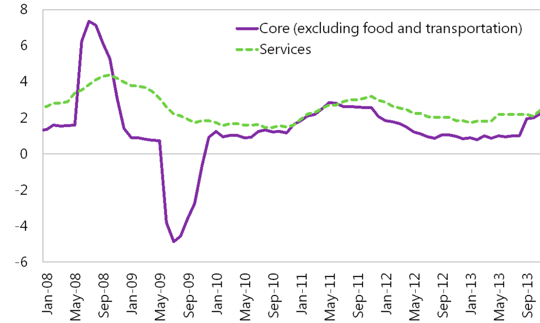
Figure 2. Malaysia: Inflation and Domestic Resource Constraints

Inflation remains low, although subsidy rationalization pushed up headline inflation in September.



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

Core inflation remains subdued but has increased slightly…

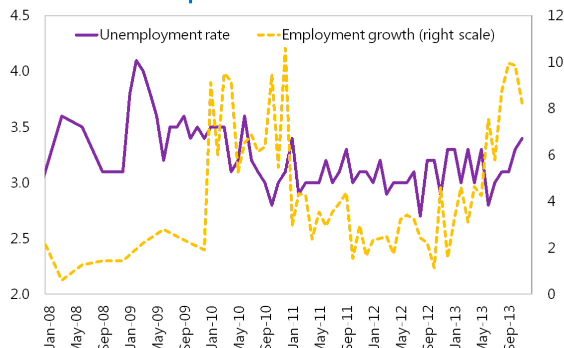


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

…as have producer prices.

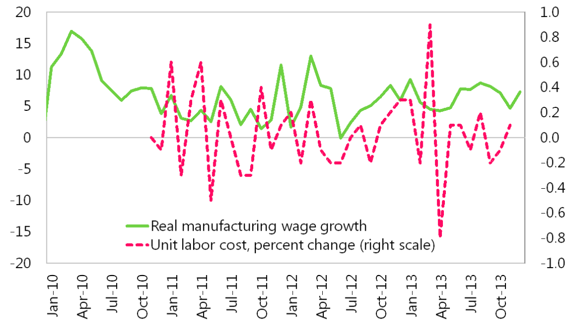
Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

The labor market remains tight with low unemployment and …



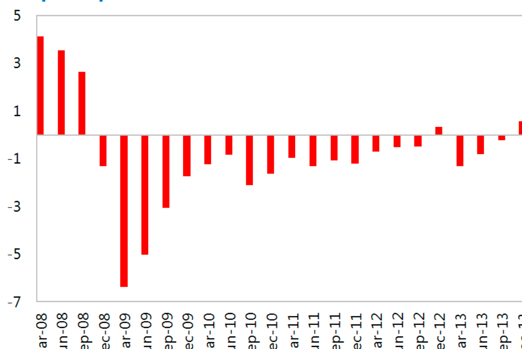
Source: CEIC Data Co. Ltd.

…strong wage pressures.



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

Dragged down by weak external demand, a small negative output gap opened up early in the year but closed at the end of the year.

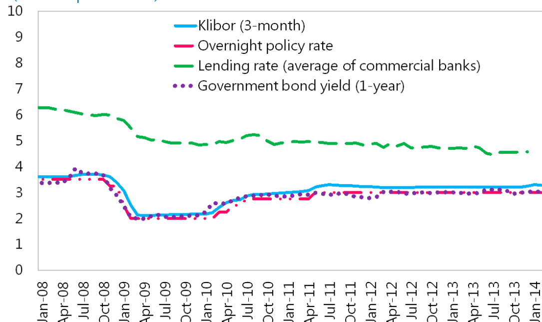


Source: CEIC Data Co. Ltd; and IMF staff estimates..

Figure 3. Malaysia: Monetary Developments

While interest rates are stable or declining…

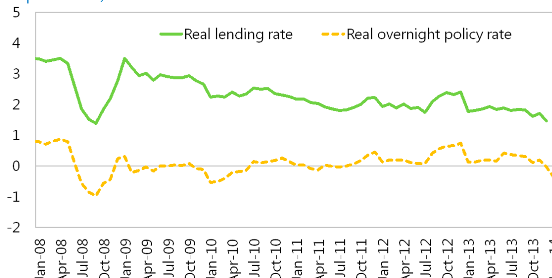
Interest Rates
(Percent per annum)



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

…real rates have declined again, as inflation picked up.

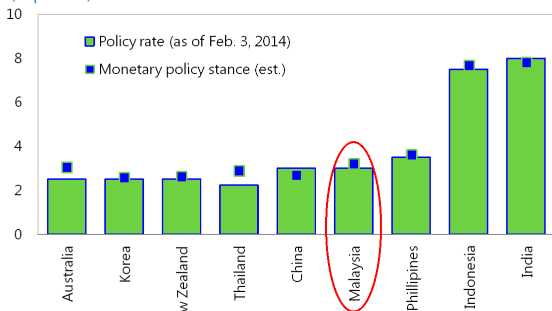
Real Interest Rates
(Percent per annum; nominal rates adjusted for 1–year ahead inflation expectations)



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

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

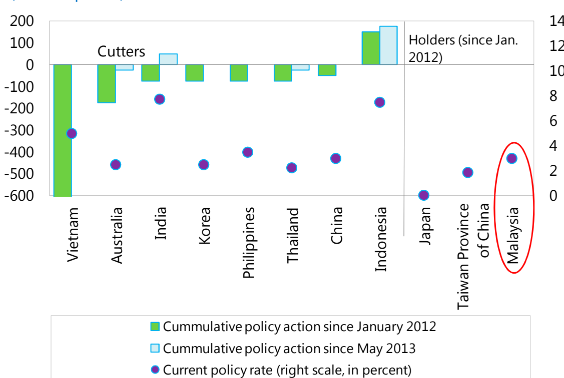
Monetary Policy Stances
(In percent)



Source: IMF staff calculations.

And, while other countries in the region have been more activist recently, Malaysia has stayed put.

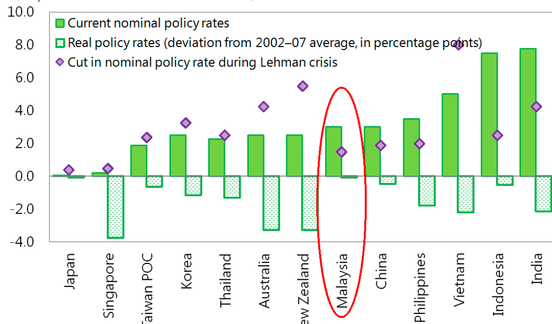
Selected Asia: Policy Rate Actions 1/
(In basis points)



Source: IMF staff calculations.
1/ Latest data as of December 2013.

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

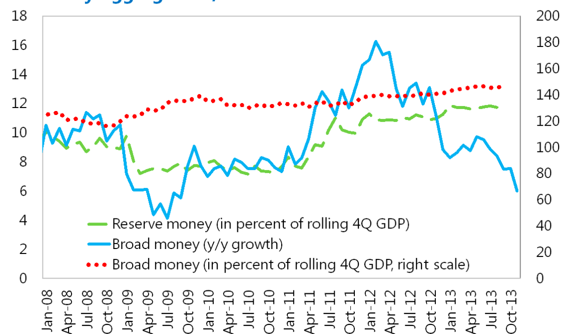
Selected Asia: Policy Rates
(In percent; as of December 2013)



Source: IMF, *Asia and Pacific Regional Economic Outlook*.

Against a stable monetary policy, broad money growth although slowing, has outpaced nominal GDP.

Monetary Aggregates 1/

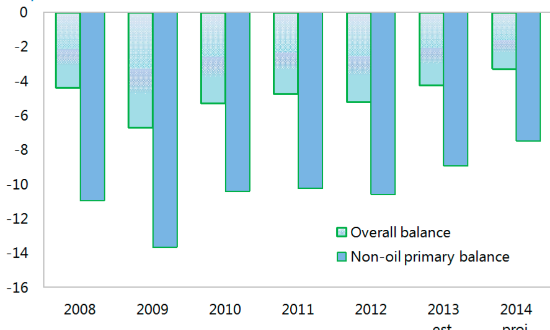


Sources: IMF, *Integrated Monetary database*; and IMF staff calculations.
1/ At depository corporations level.

Figure 4. Malaysia: Fiscal Policy Developments

The budget deficit is expected to decline in 2013–2014…

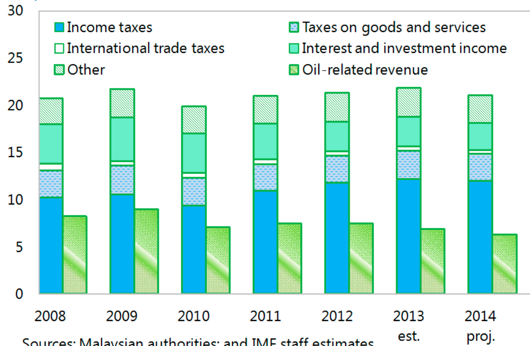
Federal Government Overall and Non-Oil Balance
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

… even as revenue declines.

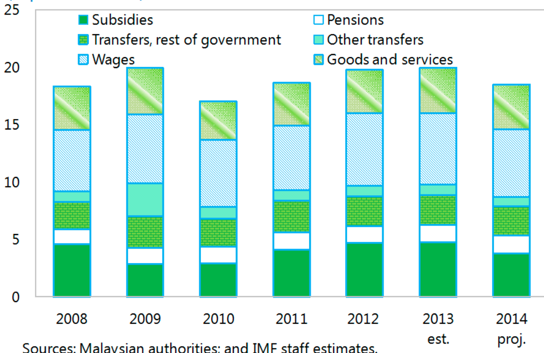
Federal Government Revenue
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

Expenditure on subsidies is expected to decline with the recent and projected fuel price hikes…

Federal Government Current Expenditures
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

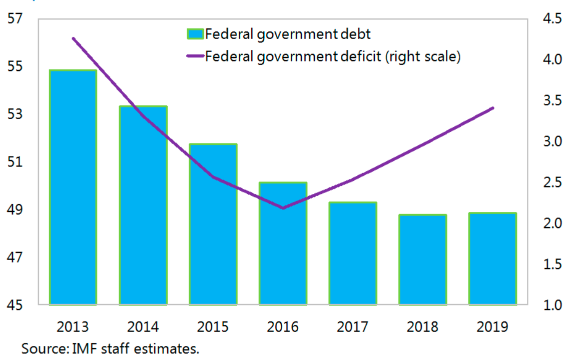
…along with development spending.

Federal Government Development Spending
(In percent of GDP)

Sources: Malaysian authorities; and IMF staff estimates.

Under staff's baseline projection, federal government debt would decline to 50 percent in the medium-term.

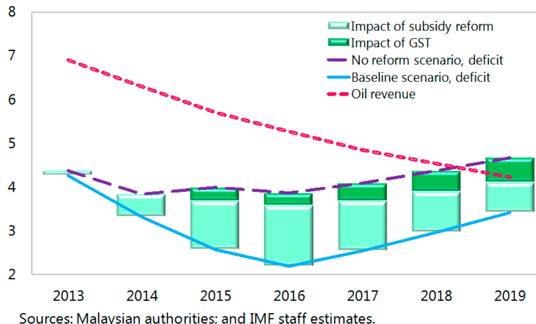
Medium–Term Fiscal Outlook
(In percent of GDP)



Source: IMF staff estimates.

GST and subsidy reforms are critical to achieve the medium-term fiscal consolidation as oil revenues are also projected to decline.

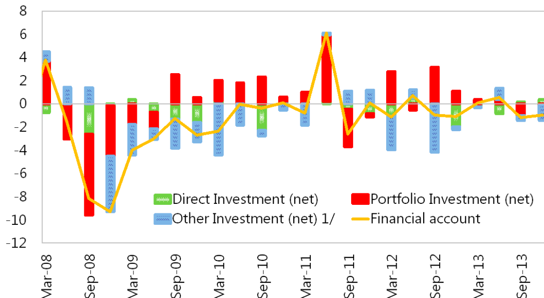
Federal Government Overall Deficit: Baseline Versus Alternate Scenarios
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

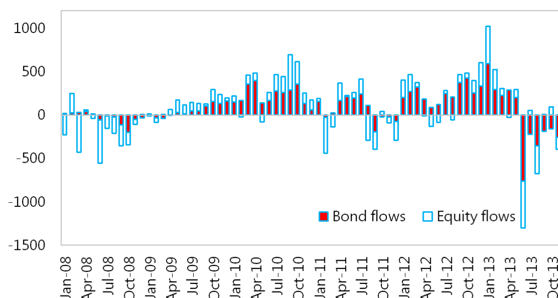
Figure 5. Malaysia: Capital Inflows

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



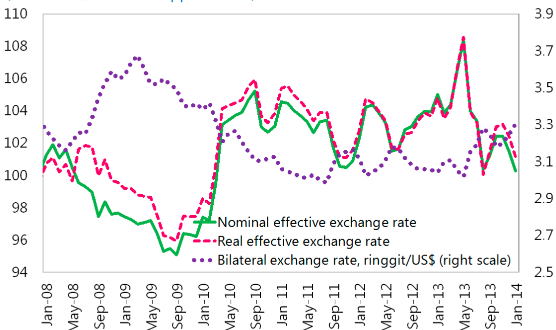
Sources: CEIC Data Co. Ltd.; and IMF staff calculations.
1/ Includes financial derivatives.

Malaysia, as with other emerging markets in Asia, experienced outflows after May 2013,



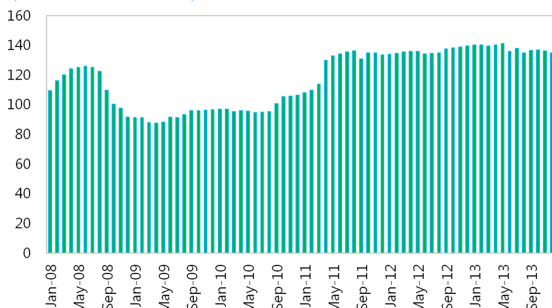
Source: Haver Analytics.
1/ Monthly flows. Includes exchange traded funds and mutual funds.

...which led to a depreciation of MYR from its May 2013 peak..



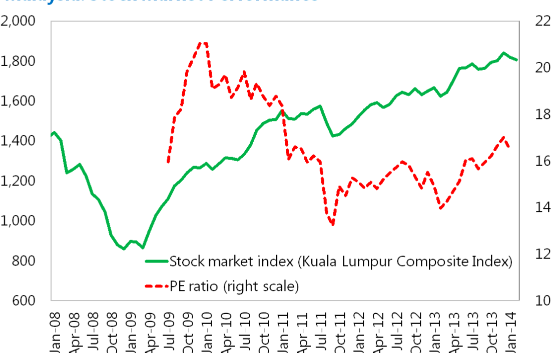
Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

...with a slight decline in reserves after May 2013.



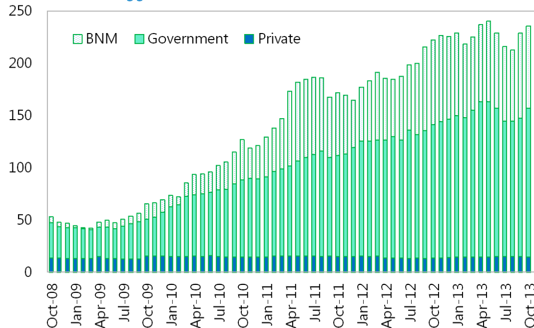
Source: CEIC Data Co. Ltd.
1/ As of mid-January 2014.

The equity market held up well...



Source: Bloomberg L.P.

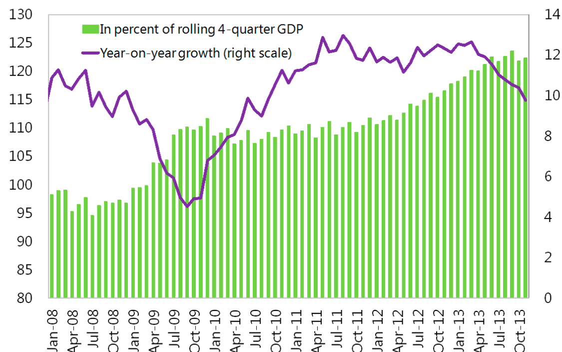
But the bond markets experienced an outflow and foreign holdings of Malaysian Government securities declined but have since recovered.



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

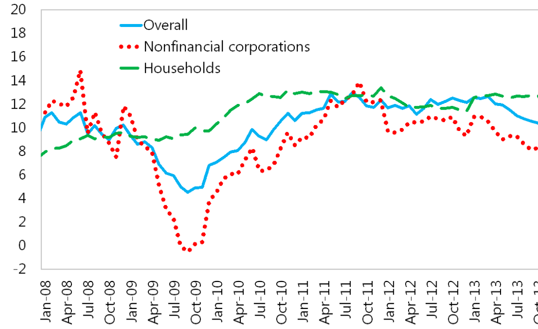
Figure 6. Malaysia: Financial Sector Developments

Aggregate credit growth has slowed slightly but remains close to 10 percent.



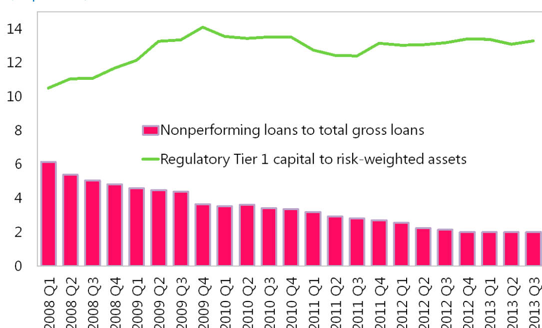
Sources: IMF, *Integrated Monetary database*; and IMF staff calculations.

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



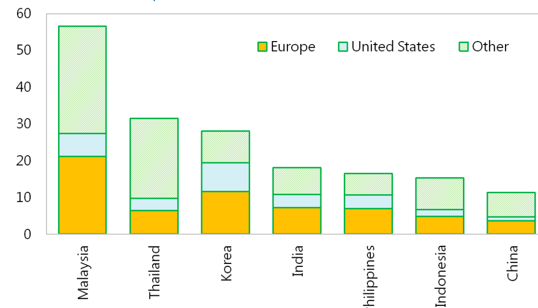
Sources: IMF, *Integrated Monetary database*; and IMF staff calculations.

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



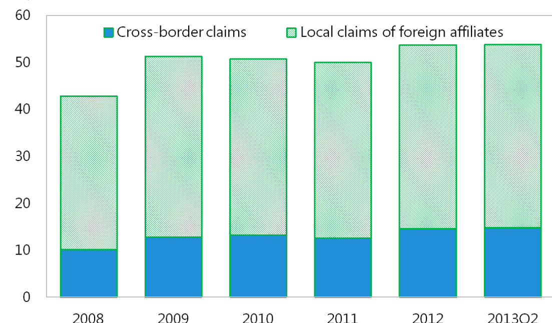
Source: IMF, *Financial Soundness Indicators* database.

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



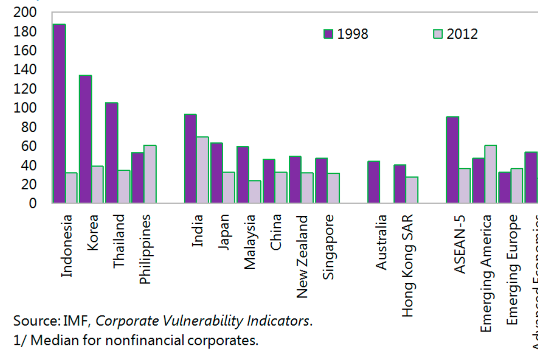
Sources: Bank for International Settlements; IMF, *World Economic Outlook*.

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



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

Corporate leverage has declined significantly since the Asian Crisis.

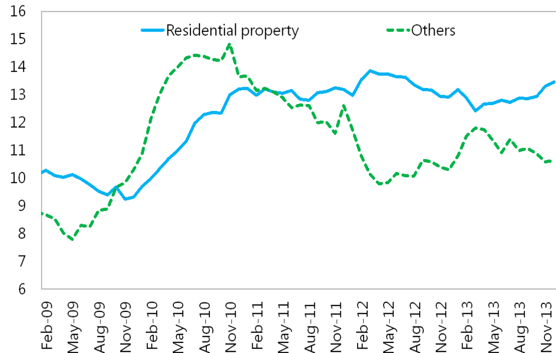


Source: IMF, *Corporate Vulnerability Indicators*.
1/ Median for nonfinancial corporates.

Figure 7. Malaysia: Household Debt

Housing and personal loans have been growing rapidly…

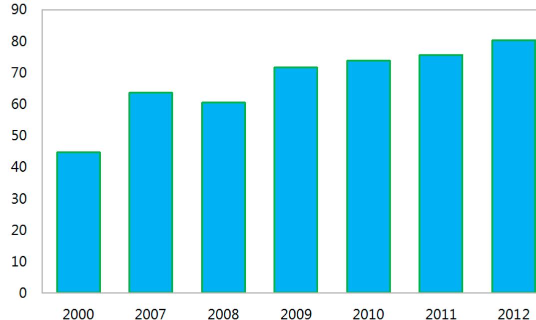
Household Loan Growth
(In percent, year-on-year)



Source: CEIC Data Co. Ltd.

… which has led to an increase in household debt…

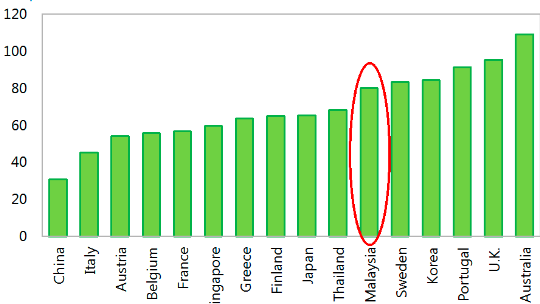
Household Debt
(In percent of GDP)



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

.. that is high compared to other countries…

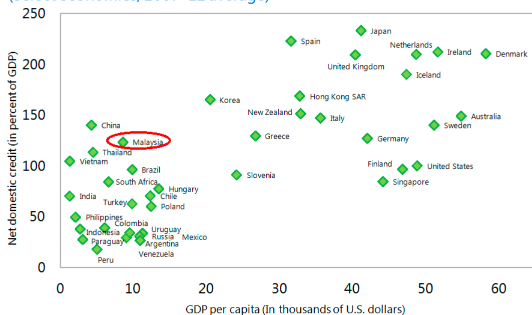
Household Debt, 2012
(In percent of GDP)



Sources: BIS Database; CEIC Data Co. Ltd.; IMF, *World Economic Outlook*; and IMF staff estimates.

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

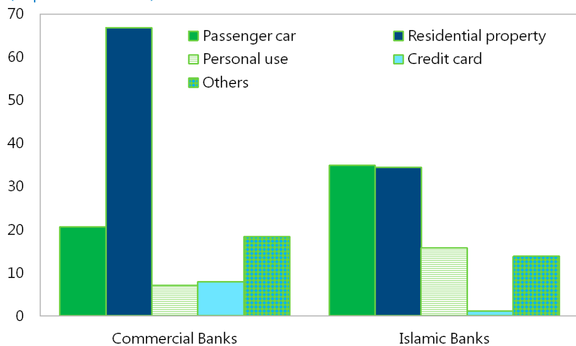
Net Domestic Credit and GDP per Capita
(Select economies, 2007–12 average)



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

Over half of household loans by commercial banks are for housing.

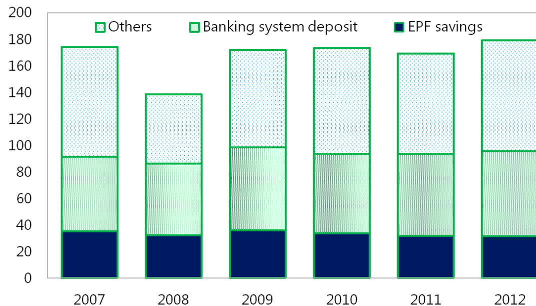
Household Lending, December 2013
(In percent of total)



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

High household financial assets mitigate this vulnerability.

Household Financial Assets
(In percent of GDP)

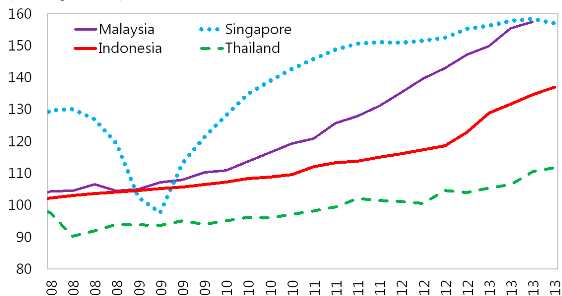


Sources: Malaysian Employee Provident Fund; CEIC Data Co. Ltd.; and IMF staff estimates.

Figure 8. Malaysia: House Prices

House prices have risen steadily...

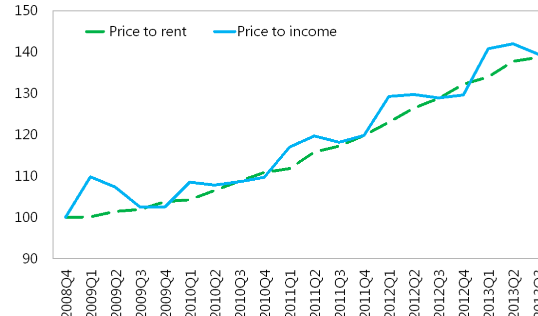
House Price Index
(2007:Q1 = 100)



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

... and have outpaced incomes and rents.

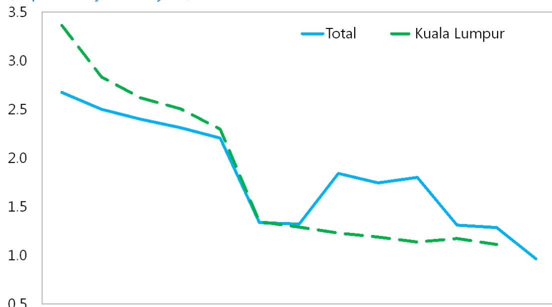
House Prices
(Ratio of indexes, 2008:Q4=100)



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

Although population growth is strong and urbanizing,,,

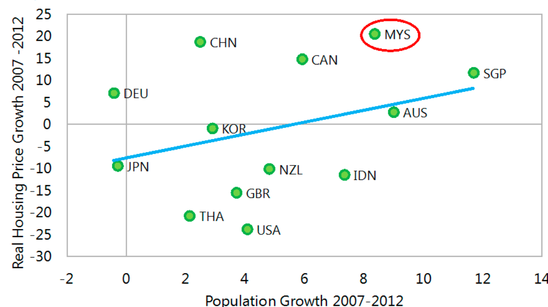
Population Growth
(In percent, year-on-year)



Source: CEIC Data Co. Ltd.

... nevertheless, this does not fully explain the increase in house prices compared with other countries.

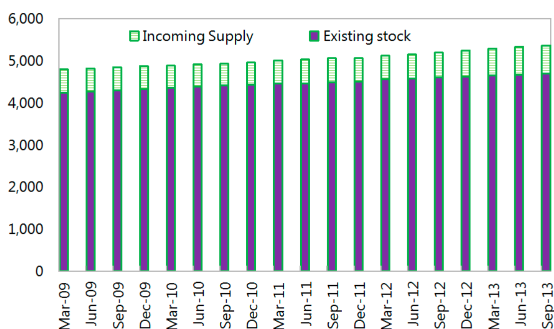
Housing Price and Population Growth
(In percent)



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

Residential supply is increasing..

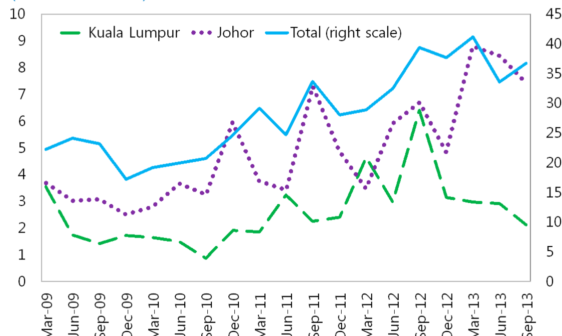
Residential Property Supply
(In thousand units)



Source: CEIC Data Co. Ltd.

...and is particularly strong in Johor.

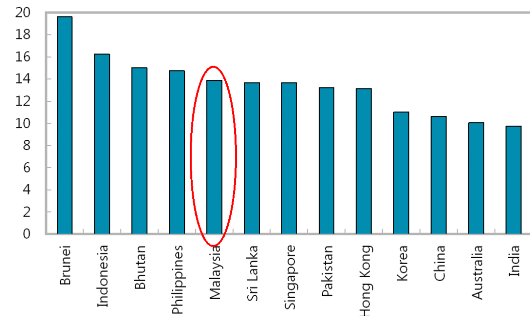
Residential Property: Construction Started
(In thousand units)



Source: CEIC Data Co.Ltd

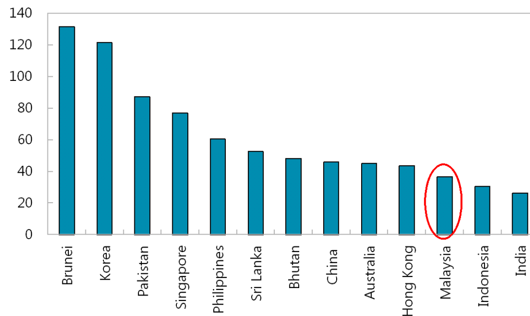
Figure 9. Financial Soundness Indicators, 2013:Q3

Malaysian banks' capital buffers are strong...



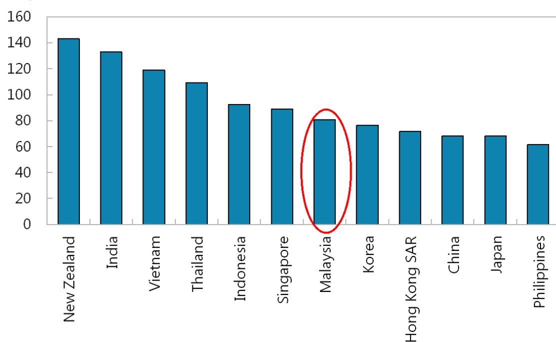
Source: IMF, *Financial Soundness Indicators*.

...but one-year liquidity coverage could improve further.



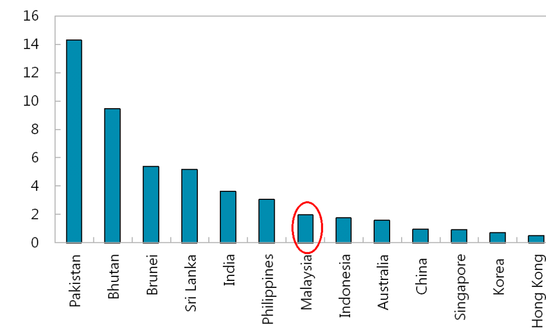
Source: IMF, *Financial Soundness Indicators*.

Lending in proportion to deposits is reasonable...



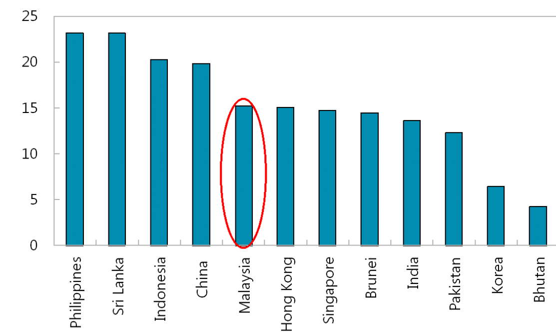
Sources: CEIC Data Co. Ltd.; Haver Analytics; and IMF staff calculations.

... while asset quality is moderately high



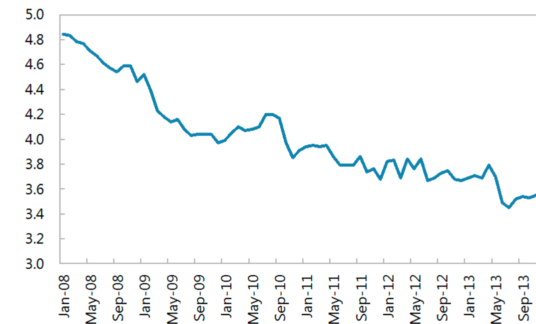
Source: IMF, *Financial Soundness Indicators*.

Banks are profitable



Source: IMF, *Financial Soundness Indicators*.

... but net interest margin is getting squeezed



Sources: Bank Negara Malaysia; and IMF staff calculations.

Table 1. Malaysia: Selected Economic and Financial Indicators, 2009–14

Nominal GDP (2012): US$305 billion
Main export (percent of total): electrical & electronic products (39%), commodities (23%)
GDP per capita (2012): US$10,387
Population (2012): 29.3 million
Unemployment rate (2012): 3.0 percent

	2009	2010	2011	2012	Est. 2013	Proj. 2014
Real GDP (percent change)	-1.5	7.4	5.1	5.6	4.7	5.0
Total domestic demand	-1.6	11.1	6.8	11.3	7.3	3.8
Consumption	1.4	6.2	8.6	7.1	7.3	3.4
Private consumption	0.6	6.9	6.8	7.7	7.6	3.3
Gross capital formation	-9.4	25.3	2.3	22.3	7.2	4.6
Saving and investment (in percent of GDP)						
Gross domestic investment	17.8	23.3	23.3	25.8	26.3	27.1
Gross national saving	33.4	34.2	34.9	31.9	30.1	31.4
Fiscal sector (in percent of GDP)						
Federal government overall balance 1/	-6.7	-5.3	-4.8	-5.2	-4.3	-3.3
Revenue	21.7	19.9	21.0	21.3	21.8	21.1
Expenditure and net lending	28.4	25.2	25.7	26.6	26.1	24.4
Federal government non-oil primary balance	-13.7	-10.4	-10.3	-10.6	-8.9	-7.5
Consolidated public sector overall balance 2/	-7.2	-2.6	-3.4	-5.2	-6.8	-6.5
General government debt	52.8	53.5	54.3	54.6	56.8	55.2
Inflation and unemployment (period average, in percent)						
CPI inflation (period average)	0.6	1.7	3.2	1.7	2.1	3.3
Unemployment rate	3.7	3.3	3.1	3.0	3.1	3.0
Money and credit (end of period, percentage change)						
Total liquidity (M3)	9.2	6.8	14.3	9.0	6.7	…
Credit to private sector	6.2	9.7	12.1	11.9	9.1	…
Three-month interbank rate (in percent)	2.2	3.0	3.2	3.2	3.2	…
Balance of payments (in billions of U.S. dollars)						
Current account balance	31.4	27.1	33.5	18.6	11.8	14.5
(In percent of GDP)	15.5	10.9	11.6	6.1	3.8	4.2
Trade balance	39.8	42.5	49.5	40.7	32.6	40.4
Services and income account balance	-2.8	-8.6	-9.2	-16.2	-15.9	-18.1
Capital and financial account balance	-22.8	-6.2	7.6	-7.4	-4.8	-7.5
Errors and omissions	-4.7	-21.7	-10.1	-9.9	-2.4	0.0
Overall balance	3.9	-0.8	30.9	1.3	4.6	7.0
Gross official reserves (US$ billions)	96.7	106.5	133.6	139.7	134.9	141.9
(In months of following year's imports)	6.1	5.9	7.0	7.2	6.9	7.2
(In percent of short-term debt) 3/	250.4	207.3	230.3	259.5	239.2	240.9
Total external debt (US$ billions)	68.0	74.1	81.1	82.7	89.2	96.2
(In percent of GDP)	33.6	29.9	28.1	27.1	28.6	28.1
Of which: short-term (in percent of total) 3/	56.8	69.3	71.5	65.2	63.2	61.3
Debt service ratio						
(In percent of exports of goods and services)	6.6	7.8	10.2	10.1	9.7	9.4
(In percent of exports of goods and nonfactor services)	7.0	8.2	10.8	10.7	10.2	10.0
Memorandum items:						
Nominal GDP (in billions of US$)	202	248	289	305	312	342

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

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

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

3/ By remaining maturity.

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

	2008	2009	2010	2011	2012	Est. 2013
Financial indicators						
General government debt (in percent of GDP) 1/	41.2	52.8	53.5	54.3	54.6	56.8
Total liquidity (M3: percent change, 12-month basis)	11.9	9.2	6.8	14.3	9.0	6.7
Private sector credit (percent change, 12-month basis)	12.9	6.2	9.7	12.1	11.9	9.1
Treasury bill interest rate (percent, 12-month average) 2/	3.4	2.1	2.6	2.9	3.2	3.2
External indicators						
Exports (percent change, 12-month basis in U.S. dollars)	12.6	-21.1	26.9	14.9	-0.4	-3.7
Imports (percent change, 12-month basis in U.S. dollars)	6.7	-20.7	33.8	14.4	4.4	-0.2
Current account balance (in billions of U.S. dollars)	39.4	31.4	27.1	33.5	18.6	11.8
Current account balance (in percent of GDP)	17.1	15.5	10.9	11.6	6.1	3.8
Capital and financial account balance (in billions of U.S. dollars)	-35.5	-22.8	-6.2	7.6	-7.4	-4.8
Gross official reserves (in billions of U.S. dollars)	91.5	96.7	106.5	133.6	139.7	134.9
In months of following year's imports of goods and nonfactor services	7.6	6.1	5.9	7.0	7.2	6.9
As percent of total liquidity (M3)	33.9	32.5	30.0	34.2	31.6	32.0
As percent of monetary base	461.3	603.8	532.6	440.2	420.7	451.8
Total short-term external debt by:						
Original maturity (in billions of U.S. dollars)	23.1	22.6	25.9	32.7	30.4	33.2
Remaining maturity (in billions of U.S. dollars)	33.4	38.6	51.4	58.0	53.9	56.4
Original maturity to reserves (in percent)	25.3	23.4	24.3	24.5	21.8	24.6
Original maturity to total external debt (in percent)	33.8	33.3	35.0	40.3	36.8	37.2
Remaining maturity to reserves (in percent)	36.4	39.9	48.3	43.4	38.5	41.8
Remaining maturity to total external debt (in percent)	48.7	56.8	69.3	71.5	65.2	63.2
Total external debt (in billions of U.S. dollars)	68.5	68.0	74.1	81.1	82.7	89.2
Of which : public and publicly guaranteed debt	25.8	26.2	28.4	27.7	27.1	27.6
Total external debt to exports of goods and services (in percent)	28.3	34.7	30.5	28.8	29.6	32.6
External amortization payments to exports of goods and services (in percent)	1.6	5.2	6.6	9.0	9.1	8.6
Financial market indicators						
Kuala Lumpur Composite Index (KLCI), end of period	877	1,273	1,519	1,531	1,689	1,867
10-years government securities yield (percent per annum, average)	4.1	4.1	4.0	3.9	3.5	3.7

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, 2009–14

	2009	2010	2011	2012	Est. 2013	Proj. 2014
			(In billions of U.S. dollars)			
Current account balance	31.4	27.1	33.5	18.6	11.8	14.5
Trade balance	39.8	42.5	49.5	40.7	32.6	40.4
Exports, f.o.b.	156.9	199.0	228.6	227.6	219.3	225.5
Imports, f.o.b.	117.1	156.6	179.1	187.0	186.7	185.1
Services and income account balance	-2.8	-8.6	-9.2	-16.2	-15.9	-18.1
Receipts	39.3	43.8	53.3	51.6	54.9	56.8
Of which: income	11.2	11.9	17.2	13.7	15.1	15.6
Payments	42.1	52.5	62.5	67.8	70.8	74.9
Of which: income	15.3	20.1	24.3	25.4	26.2	27.0
Net transfers	-5.6	-6.8	-6.9	-5.9	-4.8	-7.7
Capital and financial account balance	-22.8	-6.2	7.6	-7.4	-4.8	-7.5
Capital account	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-22.8	-6.2	7.6	-7.4	-4.8	-7.5
Net foreign direct investment	-6.3	-4.3	-3.1	-7.0	-5.3	-5.8
Portfolio investment	-0.5	15.0	8.5	18.9	14.1	15.4
Drawings	0.1	1.4	2.1	0.2	0.2	0.2
Repayments	1.9	0.3	2.0	0.2	0.3	0.3
Other investment	-15.9	-16.9	2.1	-19.3	-13.5	-17.1
Errors and omissions	-4.7	-21.7	-10.1	-9.9	-2.4	0.0
Overall balance	3.9	-0.8	30.9	1.3	4.6	7.0
Overall financing	-3.9	0.8	-30.9	-1.3	-4.6	-7.0
Gross official reserves	96.7	106.5	133.6	139.7	134.9	141.9
In months of following year's imports of goods and nonfactor services	6.1	5.9	7.0	7.2	6.9	7.2
In percent of short-term debt 1/	250.4	207.3	230.3	259.5	239.2	240.9
			(In percent of GDP)			
Current account balance	15.5	10.9	11.6	6.1	3.8	4.2
(Excluding oil and gas)	8.9	4.1	4.2	-0.6	-3.4	-1.6
Trade balance	19.7	17.2	17.1	13.3	10.4	11.8
Exports	77.6	80.4	79.1	74.7	70.2	65.9
Imports	57.9	63.3	62.0	61.4	59.7	54.1
Services and income account balance	-1.4	-3.5	-3.2	-5.3	-5.1	-5.3
Capital and financial account balance	-11.3	-2.5	2.6	-2.4	-1.5	-2.2
Net foreign direct investment	-3.1	-1.8	-1.1	-2.3	-1.7	-1.7
			(Annual percentage change)			
Memorandum items:						
Export value growth (in U.S. dollars)	-21.1	26.9	14.9	-0.4	-3.7	2.8
Export volume growth	-12.8	10.4	5.1	-4.0	-3.0	4.5
Import value growth (in U.S. dollars)	-20.7	33.8	14.4	4.4	-0.2	-0.8
Import volume growth	-23.5	18.1	4.6	0.3	-2.1	1.3
Terms of trade	-12.4	2.0	0.1	-0.7	-0.3	0.2
Net international investment position						
(In billions of U.S. dollars)	30.0	4.0	11.9	-4.8	…	…
(In percent of GDP)	14.8	1.6	4.1	-1.6	…	…

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

1/ By remaining maturity.

Table 4. Malaysia: Illustrative Medium-Term Economic Framework, 2009–18 1/

	2009	2010	2011	2012	Est. 2013	Proj. 2014	2015	2016	2017	2018
Real sector (percent change)										
Real GDP growth	-1.5	7.4	5.1	5.6	4.7	5.0	5.0	5.0	5.0	5.0
Total domestic demand	-1.6	11.1	6.8	11.3	7.3	3.8	4.9	5.2	5.1	5.2
CPI inflation (period average)	0.6	1.7	3.2	1.7	2.1	3.3	3.9	3.0	2.7	2.7
Saving and investment (in percent of GDP)										
Gross domestic investment	17.8	23.3	23.3	25.8	26.3	27.1	27.4	27.6	27.5	27.5
Private, including stocks	7.2	13.1	13.7	15.0	15.8	16.2	16.5	16.7	16.9	17.0
Of which: gross fixed capital formation	11.4	12.4	12.8	14.9	16.4	16.2	16.5	16.7	16.9	17.0
Public	10.6	10.2	9.5	10.8	10.5	10.9	10.9	10.9	10.6	10.5
Gross national saving	33.4	34.2	34.9	31.9	30.1	31.4	31.5	31.6	31.5	31.3
Private	25.4	23.9	26.8	22.8	22.3	22.8	21.8	21.5	21.6	21.7
Public	7.9	10.3	8.1	9.1	7.8	8.6	9.7	10.1	9.9	9.6
Fiscal sector (in percent of GDP)										
Federal government net lending/borrowing	-6.7	-5.3	-4.8	-5.2	-4.3	-3.3	-2.6	-2.2	-2.5	-3.0
Revenue	21.7	19.9	21.0	21.3	21.8	21.1	20.9	20.5	20.2	20.0
Tax	14.9	13.7	15.3	16.1	16.6	16.3	16.4	16.2	16.1	16.1
Non-tax	6.7	6.1	5.7	5.2	5.2	4.8	4.5	4.3	4.1	3.9
Expenditure	28.4	25.2	25.7	26.6	26.1	24.4	23.4	22.7	22.8	23.0
Current	22.0	19.1	20.8	22.0	22.3	20.7	19.7	19.0	19.1	19.2
Development	6.3	6.1	5.0	4.5	3.8	3.7	3.7	3.7	3.6	3.7
Federal government non-oil primary balance	-13.7	-10.4	-10.3	-10.6	-8.9	-7.5	-6.2	-5.4	-5.3	-5.3
Consolidated public sector overall balance 2/	-7.2	-2.6	-3.4	-5.2	-6.8	-6.5	-5.5	-4.9	-4.8	-4.9
General government debt	52.8	53.5	54.3	54.6	56.8	55.2	53.2	51.4	50.2	49.6
Of which: federal government debt	50.8	51.1	51.6	53.3	54.8	53.3	51.7	50.1	49.3	48.8
Balance of payments (in billions of U.S. dollars)										
Trade balance	39.8	42.5	49.5	40.7	32.6	40.4	45.5	49.9	54.0	58.1
Services and income account balance	-2.8	-8.6	-9.2	-16.2	-15.9	-18.1	-20.2	-22.3	-24.3	-26.4
Current account balance	31.4	27.1	33.5	18.6	11.8	14.5	15.5	16.8	17.9	19.0
(In percent of GDP)	15.5	10.9	11.6	6.1	3.8	4.2	4.1	4.0	4.0	3.9
Capital and financial account balance	-22.8	-6.2	7.6	-7.4	-4.8	-7.5	-16.0	-15.3	-14.8	-15.4
Errors and omissions	-4.7	-21.7	-10.1	-9.9	-2.4	0.0	0.0	0.0	0.0	0.0
Overall balance	3.9	-0.8	30.9	1.3	4.6	7.0	-0.5	1.5	3.1	3.6
International trade (annual percent change)										
Export value	-21.1	26.9	14.9	-0.4	-3.7	2.8	2.9	3.7	4.3	4.5
Import value	-20.7	33.8	14.4	4.4	-0.2	-0.8	0.7	2.2	3.3	3.6
Terms of trade	-12.4	2.0	0.1	-0.7	-0.3	0.2	0.0	-0.1	-0.1	-0.1
Gross official reserves (in billions of U.S. dollars)	96.7	106.5	133.6	139.7	134.9	141.9	141.4	142.9	146.0	149.6
(In months of following year's imports)	6.1	5.9	7.0	7.2	6.9	7.2	6.9	6.7	6.7	6.7
(In percent of short-term debt) 3/	250.4	207.3	230.3	259.5	239.2	240.9	231.9	227.8	226.8	224.9
Total external debt (in billions of U.S. dollars)	68.0	74.1	81.1	82.7	89.2	96.2	103.7	112.0	121.0	130.7
(In percent of GDP)	33.6	29.9	28.1	27.1	28.6	28.1	27.3	26.9	26.7	26.7
Short-term external debt (percent of total) 3/	56.8	69.3	71.5	65.2	63.2	61.3	58.8	56.0	53.2	50.9
Debt-service ratio										
(In percent of exports of goods and services)	6.6	7.8	10.2	10.1	9.7	9.4	9.1	8.7	8.0	7.3
Net international investment position (in billions of U.S. dollars)	30.0	4.0	11.9	-4.8	...	...	...	...	...	...
Memorandum items:										
Nominal GDP (in billions of ringgit)	713	797	884	941	984	1,081	1,177	1,273	1,371	1,477

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, 2009–14

	2009	2010	2011	2012	2013		2014	
					Budget	Proj.	Budget	Proj.
I. Statement of Government Operations								
				(In millions of ringgit)				
Revenue	154,539	158,453	185,419	200,913	208,150	214,789	224,094	227,725
Taxes	106,504	109,515	134,885	151,643	159,154	163,506	171,970	175,719
Other revenue	48,035	48,938	50,534	49,270	48,996	51,283	52,124	52,006
Expenditure	202,361	200,729	227,511	250,016	246,755	256,660	259,165	263,501
Expense	157,148	152,429	183,639	207,358	204,820	219,203	219,572	223,908
Compensation of employees	42,778	46,663	50,148	60,016	58,621	61,625	63,610	63,931
Use of goods and services	29,035	26,507	32,660	35,553	37,607	38,605	39,952	41,980
Interest	14,222	15,621	17,716	19,537	22,245	21,603	23,186	22,710
Subsidies	20,345	23,106	36,256	44,075	37,612	46,698	39,408	40,683
Of which: fuel subsidies	6,190	9,605	20,375	27,898	20,015	28,900	22,341	23,616
Grants	39,937	27,862	32,157	32,632	33,890	34,344	36,245	36,245
Social benefits and other expense	10,831	12,670	14,703	15,545	14,845	16,328	17,171	18,359
Net acquisition of nonfinancial assets	45,213	48,299	43,871	42,658	41,935	37,457	39,593	39,593
Gross operating balance	-2,609	6,024	1,779	-6,445	3,330	-4,414	4,522	3,817
Net lending/borrowing	-47,822	-42,276	-42,092	-49,103	-38,605	-41,871	-35,071	-35,776
Overall fiscal balance (authorities' definition) 1/	-47,424	-43,275	-42,509	-41,951	-39,993	-37,933	-37,109	-37,814
Net acquisition of financial assets	2,771	-2,156	3,527	-5,773	...	-4,938	...	2,038
By financial instrument								
Currency and deposits	3,168	-3,156	3,109	-2,621	...	-1,000	...	0
Loans and equity	-397	1,000	417	-3,152	...	-3,938	...	2,038
By holder residence								
Domestic	2,771	-2,156	3,527	-5,773	...	-4,938	...	2,038
Foreign	...	...	...	...	...	...	...	...
Net incurrence of liabilities	50,593	40,120	45,619	43,331	...	36,933	...	37,814
By financial instrument								
Debt securities	56,879	36,456	45,069	43,344	...	...	...	...
Loans	-6,286	3,664	550	-13	...	...	...	...
By holder residence								
Domestic	44,365	3,567	15,811	15,204	...	...	...	...
Foreign	6,227	36,553	29,808	28,127	...	...	...	...
				(In percent of GDP)				
Revenue	21.7	19.9	21.0	21.3	20.8	21.8	21.2	21.1
Taxes	14.9	13.7	15.3	16.1	15.9	16.6	16.3	16.3
Other revenue	6.7	6.1	5.7	5.2	4.9	5.2	4.9	4.8
Expenditure	28.4	25.2	25.7	26.6	24.6	26.1	24.5	24.4
Expense	22.0	19.1	20.8	22.0	20.4	22.3	20.8	20.7
Compensation of employees	6.0	5.9	5.7	6.4	5.9	6.3	6.0	5.9
Use of goods and services	4.1	3.3	3.7	3.8	3.8	3.9	3.8	3.9
Interest	2.0	2.0	2.0	2.1	2.2	2.2	2.2	2.1
Subsidies	2.9	2.9	4.1	4.7	3.8	4.7	3.7	3.8
Of which: fuel subsidies	0.9	1.2	2.3	3.0	2.0	2.9	2.1	2.2
Grants	5.6	3.5	3.6	3.5	3.4	3.5	3.4	3.4
Social benefits and other expense	1.5	1.6	1.7	1.7	1.5	1.7	1.6	1.7
Net acquisition of nonfinancial assets	6.3	6.1	5.0	4.5	4.2	3.8	3.7	3.7
Gross operating balance	-0.4	0.8	0.2	-0.7	0.3	-0.4	0.4	0.4
Net lending/borrowing	-6.7	-5.3	-4.8	-5.2	-3.9	-4.3	-3.3	-3.3
Overall fiscal balance (authorities' definition) 1/	-6.7	-5.4	-4.8	-4.5	-4.0	-3.9	-3.5	-3.5
II. Stock Positions								
				(In millions of ringgit)				
Liabilities (nominal value)	362,387	407,101	456,128	501,617	...	...	...	...
By financial instrument								
Debt securities	312,590	346,813	392,033	439,970	...	...	...	...
Loans	49,797	60,288	64,095	61,647	...	...	...	...
By holder residence								
Domestic	306,477	315,344	333,755	352,359	...	...	...	...
Foreign	55,910	91,757	122,373	149,258	...	...	...	...
Memorandum items:								
Cyclically adjusted balance (percent of potential GDP)	-4.6	-4.8	-4.9	-5.4	...	-4.3	...	-3.3
Structural primary balance (percent of potential GDP)	-2.6	-2.8	-2.9	-3.3	...	-2.1	...	-1.2
Primary balance (percent of GDP)	-4.7	-3.3	-2.8	-3.1	-1.6	-2.1	-1.1	-1.2
Non-oil primary balance (percent of GDP)	-13.7	-10.4	-10.3	-10.6	-8.2	-8.9	-7.3	-7.5
Oil revenues (percent of GDP)	9.0	7.1	7.5	7.4	6.6	6.9	6.1	6.3
General government balance (percent of GDP) 2/	-6.7	-4.7	-3.8	-3.6	...	-4.6	...	-3.5
Public sector balance (percent of GDP) 2/	-7.8	-2.6	-3.4	-5.2	...	-6.8	...	-6.5
Nominal GDP (in millions of ringgit)	712,857	797,327	884,457	941,238	1,001,800	984,451	1,056,558	1,080,737

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

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

2/ General government includes federal government, state and local governments and statutory bodies. Public sector includes general government and NFPEs.

Table 6. Malaysia: Monetary Survey, 2009–13

	2009	2010	2011	2012	2013 Jul
	(In millions of ringgit; end of period)				
Net foreign assets	288,170	284,190	356,968	347,381	332,373
Foreign assets	396,650	420,705	541,182	560,083	576,255
Foreign liabilities	108,480	136,514	184,214	212,702	243,882
Net domestic assets	703,882	780,755	863,756	981,330	1,067,960
Net domestic credit	929,831	1,005,859	1,127,900	1,254,165	1,339,798
Net credit to nonfinancial public sector	55,865	56,766	63,870	69,849	90,201
Credit to private sector	795,598	879,943	988,555	1,108,437	1,173,374
Net credit to other financial corporations	78,369	69,151	75,475	75,880	76,223
Capital accounts	182,714	164,564	191,463	207,478	221,247
Other items (net)	-43,235	-60,540	-72,681	-65,358	-50,591
Broad money	992,052	1,064,945	1,220,725	1,328,710	1,400,333
Narrow money	213,869	239,784	272,942	308,954	325,245
Currency in circulation	43,438	47,685	53,488	56,798	62,058
Transferable deposits	170,431	192,100	219,454	252,156	263,187
Other deposits	749,555	798,978	919,714	992,648	1,042,908
Securities other than shares	28,628	26,183	28,058	25,885	26,900
Repurchase agreements	0	0	10	1,223	5,281
	(Contribution to 12-month growth in broad money)				
Net foreign assets	3.4	-0.4	6.8	-0.8	-1.0
Net domestic assets	4.4	7.7	7.8	9.6	8.1
Memorandum items:					
Broad money (12-month percent change)	7.7	7.3	14.6	8.8	7.1
Currency in circulation (12-month percent change)	7.4	9.8	12.2	6.2	11.3
Money multiplier (broad money/narrow money)	4.6	4.4	4.5	4.3	4.3

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

Table 7. Malaysia: Banks' Financial Soundness Indicators, 2009–13

	2009	2010	2011	2012	2013 Sep.
			(In percent)		
Capital adequacy					
Regulatory capital to risk-weighted assets	18.2	17.5	17.7	17.6	14.7
Regulatory Tier 1 capital to risk-weighted assets	14.1	13.5	13.2	13.4	13.3
Asset quality					
Nonperforming loans net of provisions to capital 1/	11.8	13.9	11.6	8.3	8.6
Nonperforming loans to total gross loans	3.6	3.4	2.7	2.0	2.0
Total provisions to nonperforming loans	82.5	89.1	99.3	98.7	97.9
Earnings and profitability					
Return on assets	1.2	1.5	1.5	1.6	1.5
Return on equity	13.4	16.3	16.8	17.3	15.6
Interest margin to gross income	57.7	59.8	53.5	54.8	48.9
Non-interest expenses to gross income	45.2	41.5	45.2	45.0	52.5
Liquidity					
Liquid assets to total assets (liquid asset ratio)	14.3	15.7	12.9	13.8	11.2
Liquid assets to short term liabilities	43.0	48.1	36.6	42.5	36.4
Loan-deposit ratio 2/	77.9	81.3	80.9	82.1	83.9
Sensitivity to market risk					
Net open position in foreign exchange to capital	3.9	9.3	11.7	8.7	12.6
Sectoral distribution of total loans to nonbanking sector					
Residents	98.1	98.0	97.7	97.7	97.4
Other financial corporations	3.4	3.1	3.1	2.6	2.5
General government	2.0	2.7	2.7	2.6	2.4
Nonfinancial corporations	38.4	37.6	37.3	37.6	37.0
Other domestic sectors	54.4	54.6	54.4	54.9	55.4
Nonresidents	1.9	2.0	2.3	2.3	2.6

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.

Table 8. Malaysia: Macroprudential Measures Since 2010	
January 2010	Reintroduced 5 percent Real Property Gains Tax (RPGT) for properties sold in less than 5 years.
November 2010	Imposed caps of 70 percent on third and subsequent mortgages.
January 2011	Imposed a 5 percent RPGT on properties sold between 3 and 5 years and increased the RPGT rate to 10 percent on properties sold in less than 2 years.
March 2011	The minimum income eligibility for new credit card holders was set at RM 24,000 per annum. Cardholders earning less than RM 36,000 per annum were limited to two credit card issuers and the maximum credit per issuer capped at two times monthly income.
November 2011	Issued guidelines on responsible financing and the computation of debt service ratios (DSR) based on a borrower's net income. Capital risk-weights were raised to 100 percent for mortgages with LTVs exceeding 90 percent and were also raised for personal loans with a tenure more than 5 years.
December 2011	Introduced an LTV cap of 60 percent on housing loans for corporates.
April 2012	The minimum house price for foreigners was increased to RM 500,000 (from RM 250,000).
January 2013	Increased the RPGT rate to 15 percent on properties sold before 2 years and to 10 percent on properties sold between 3 and 5 years.
July 2013	Imposed a maximum mortgage term of 35 years and a maximum tenure of 10 years on financing extended for personal use. Prohibited the offering of pre-approved personal financing products.
October 2013	Distinguished between RPGT for Malaysians, foreigners and corporates. For foreigners, the RGPT is 30 percent for properties sold before 5 years and 5 percent after 5 years. For Malaysians, the RPGT is 30 percent for properties sold up to 3 years; 20 percent between 3 and 4 years; 15 percent between 4 and 5 years; after 5 years 0 percent for individuals and 5 percent for corporates. Increased Minimum house price for foreigners to RM 1,000,000. Banned Developers Interest Bearing Scheme (DIBS).

Appendix 1. Malaysia—Staff Policy Advice from the 2011 and 2012 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 (2011 and 2012).	The authorities agree on the need for fiscal consolidation and are targeting a fiscal deficit of 3 percent of GDP by 2015 and a balanced budget by 2020. They are in the process of developing a medium term budget framework and have established a Fiscal Policy Committee (FPC) that will endorse Malaysia's medium-term fiscal strategy.
Issue a statement of fiscal risks (2011 and 2012).	The authorities requested Fund technical assistance on fiscal risks. A mission was fielded in January 2013. The Fiscal Policy Office, which will act as the secretariat to the FPC, is tasked with preparing a fiscal risks statement.
Broaden tax bases by implementing a GST and rationalizing tax incentives (2011 and 2012).	The authorities announced the introduction of GST in the 2014 Budget, effective April 2015. The authorities are undertaking a study on the effectiveness and costs of tax incentives.
Phase out subsidies and replace with targeted cash transfers to the needy (2011 and 2012).	The authorities have already reduced some fuel and food subsidies, and plan to further rationalize subsidies going forward. The use of cash transfers has increased and now benefit over 55 percent of households. But the 2014 Budget announced the creation of a comprehensive database on welfare recipients which could facilitate better targeting of transfers.
Strengthen public financial management (2012).	The authorities have taken steps to improve public procurement and move towards performance-based budgeting. The authorities are also in the process of transitioning to accrual accounting.
Financial	
Continue to monitor the increase in household debt (2011 and 2012). Strengthen monitoring of risks through collection of granular data on household assets and liabilities.	The authorities have taken a variety of macroprudential measures to deal with rising household indebtedness. In addition, they have also issued guidelines on responsible lending practices and are trying to boost financial literacy. The BNM expects to complete collection of granular data on households by end-2014.
Continue to monitor regional exposures; deepen cooperation between home and host country supervisors (2012).	The authorities continue to expand the list of countries with which they have signed Memorandum of Understanding for information sharing and collaboration in cross border supervision.
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.	Many recommendations from previous Article IV reports also form part of the authorities' Economic Transformation Program and the Government Transformation Program. Some progress has been made on the strategic reform initiatives and the authorities' further plans to boost growth 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 and 2012).	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). Increase the retirement age for public workers to 60, in line with the private sector (2012). Provide an option for workers to receive their pensions in the form of annuities (2012).	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. The retirement age for civil servants was also raised from 58 to 60 in 2012.

Appendix 2. Malaysia—Risk Assessment Matrix 1/

Nature/Source of Main Threats	Likelihood of Risk	Transmission Channels	Expected Impact of Risk	Recommended Policy Responses
Side-effects from global financial conditions: Surges in global market volatility (related to UMP exit), leading to economic and fiscal stress, and constraints on country policy setting.	**High**	Higher financing costs and lower access to foreign financing for the sovereign, corporate and banks. FDI would slow. Weaker global growth would reduce export volumes and commodity prices, with second round effects on domestic demand.	**Low to Medium** High share of foreign holdings of sovereign and BNM securities makes these markets vulnerable to risk-on, risk-off cycles, but this is offset by demand by domestic institutional investors. Domestic credit is resilient as a very high share of bank funding is based on domestic deposits. Recent and earlier outflow episodes have had limited impact on credit or the real economy.	The exchange rate should be allowed to act as a shock absorber, intervening only to smooth excessive volatility. Monetary policy decisions should be calibrated to balance the trade-off between supporting growth and managing capital outflows. There is scope to provide liquidity support in 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.
Sharp slowdown in growth in China (buildup of excess capacity eventually resulting in large financial and fiscal losses (medium-term))	**Medium**	Trade (volumes and prices, including of commodities) would be the dominant channel, with adverse second round 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).	**Medium** 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.	Monetary easing should be the first line of defense, providing it is consistent with the inflation output trade-off. 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. Structural policies could be implemented to rebalance growth towards domestic demand
Protracted period of slower growth: Advanced economies: (larger than expected deleveraging or negative surprise on potential growth); and **Emerging markets:** (earlier maturing of the growth cycle and incomplete structural reforms leading to prolonged slower growth.	**High** (Europe) **Medium** (elsewhere)	Trade (both volume and price), as above, would be the dominant channel.	**Low to Medium** Prolonged weakness in external demand would likely affect the resilience of domestic demand, lowering growth, rising unemployment and falling house and asset prices, especially if it led to a protracted period of slow global growth. This in turn would weaken bank, corporate and sovereign balance sheets, in a negative feedback loop.	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.
Implementation risks associated with fiscal consolidation and reforms envisaged in the 2014 budget	**Low to Medium**	Reforms, such as fuel subsidy cuts and the GST introduction, entail political, design, and execution risks. Realization of these risk would slow down or derail reform implementation, with adverse consequences for the credibility of fiscal policies. Negative confidence effects could interact with the relatively high public debt and significant contingent liabilities to raise the sovereign's financing cost and result in higher interest rates throughout the economy.	**Medium to High** Higher financing costs for the sovereign, a relatively high public debt, and failure to implement fiscal reforms would exacerbate concerns about public debt sustainability together with a potential sovereign credit downgrade. The authorities' ability to mount countercyclical responses would be limited, and policy procyclicality would be heightened. Higher borrowing costs would affect investment and other interest-sensitive components of spending and put a further strain on fiscal finances. Capital outflows further compound the harmful effects of lack of fiscal resolve on the economy.	Recent steps to strengthen fiscal management, including the creation of the Fiscal Policy Committee, along with the decisive return of PM Najib to power following the May election, limit political and implementation risks. But it would be critical to adopt an appropriately paced fiscal consolidation path to increase room to absorb contingencies. It is imperative to introduce mechanisms to monitor and control fiscal risks, including from the granting of government guarantees.
Sharp decline in house prices in a rising global interest rate environment	**Low to Medium** (house price growth has been rapid in recent years)	The real economy would be adversely affected through weaker bank balance sheets and slower credit, as well as negative wealth and confidence effects.	**Medium** Household debt is high at 83 percent of GDP and one half of this is mortgages. Offsetting this are high household financial assets. The authorities are monitoring the risk and have adopted measures to cool the housing market.	As above, monetary policy easing, exchange rate flexibility and temporary fiscal stimulus anchored in a credible medium term fiscal sustainability framework. Financial sector policies, such as recapitalization, could mitigate the impact on the banking system.

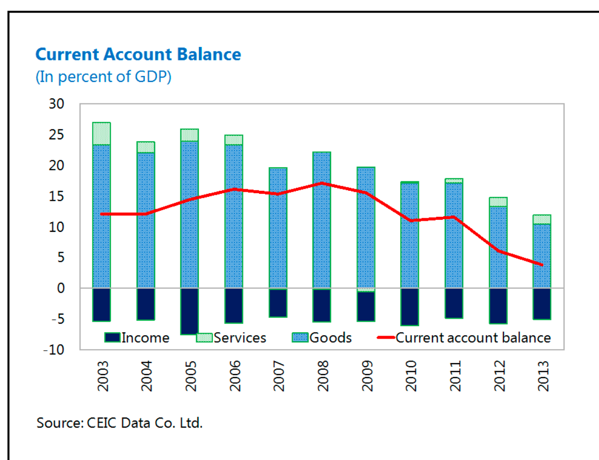
1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate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

Appendix 3. Malaysia—External Sector Assessment

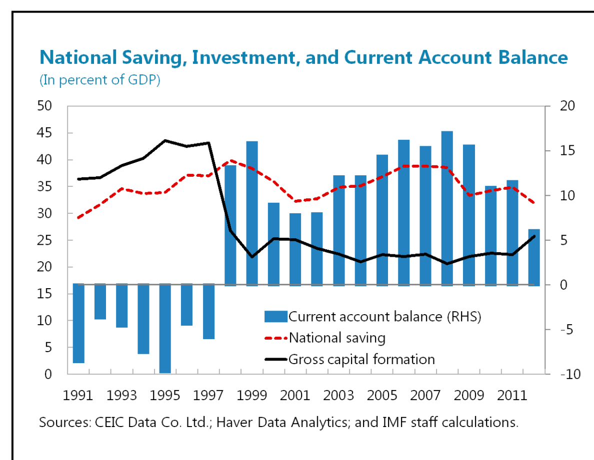
Current Account (CA)

Malaysia's economy has undergone spectacular external rebalancing in recent years, and its once mighty current account surplus has declined by almost 8 percentage points since 2011, to 3.8 percent of GDP in 2013. This turnaround has been primarily driven by a decline in the surplus of the merchandise trade in goods, reflecting robust domestic demand and weak external demand, although a significant decline in commodity prices also played a role. The current account narrowing is largely structural, reflecting Malaysia's comprehensive reform agenda, which has led to a broad-based boost in investment and a higher investment-to-GDP ratio, while domestic consumption growth has also been strong. Rebalancing by the rest of the world, as reflected in weak export growth, has also contributed to the decline in the structural balance.

In terms of the saving-investment balance, the narrowing of the current account surplus reflects both lower savings and higher investment. The savings rate declined sharply in 2008 at the onset of the crisis, from about 38 percent to 35 percent, and then declined further during 2012 to 32 percent. The fall in savings was driven by robust private consumption growth, while public saving has also declined. Gross domestic investment jumped from 22 percent in 2008 to 26 percent in 2013, driven by investment in large ETP-related projects, that are import intensive. This pickup in investment is a welcome development—the first time in which the investment ratio increased significantly following its slump during the Asian financial crisis—and could lead to an easing of supply bottlenecks and help boost productivity, and support efforts to modernize the economy and raise incomes.



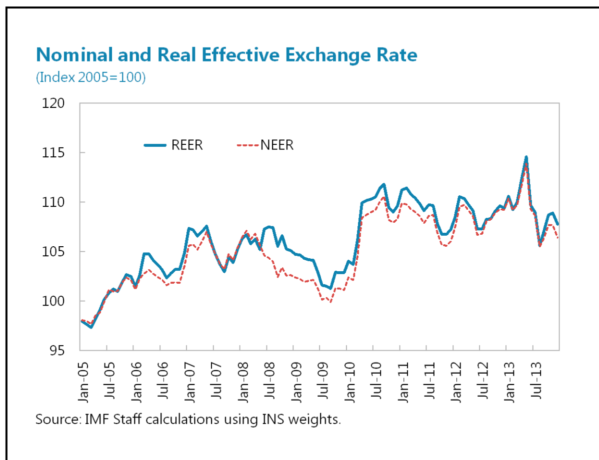
Source: CEIC Data Co. Ltd.

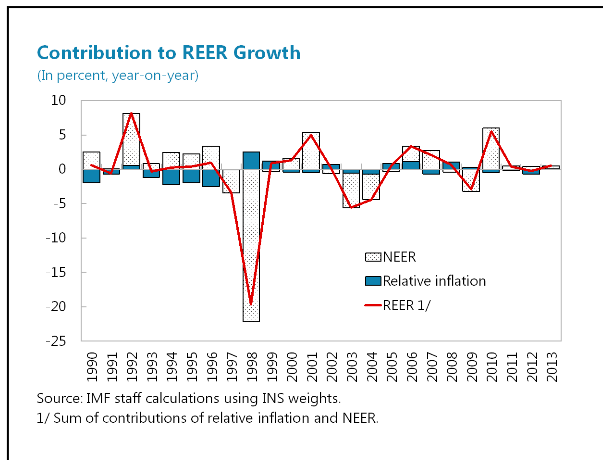


Sources: CEIC Data Co. Ltd.; Haver Data Analytics; and IMF staff calculations.

Real Effective Exchange Rate (REER)

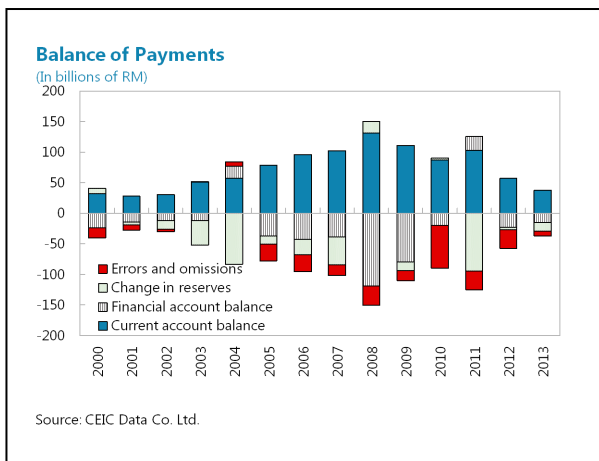
Over the past year, the real effective exchange rate has fluctuated more widely than in 2010–2012, as the currency came under stress during the capital outflow episode in spring-summer. In the absence of large movements in inflation differentials, nominal depreciation of the ringgit led to real depreciation. The REER depreciation was, however, short-lived and, overall, the REER moved around a fairly horizontal trend. Since 2000, movements in the REER have been driven almost entirely by the nominal exchange rate rather than inflation differentials. Fluctuations in the REER have been smaller than those of the ringgit against the U.S. dollar, since currencies of other trading partners have had similar movements against the dollar.

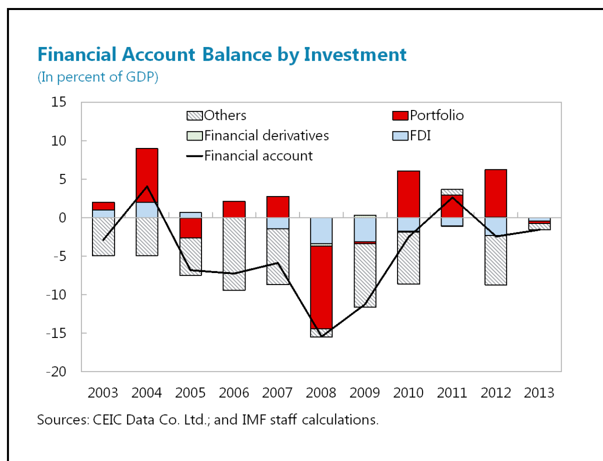




The Financial Account and Reserve Accumulation

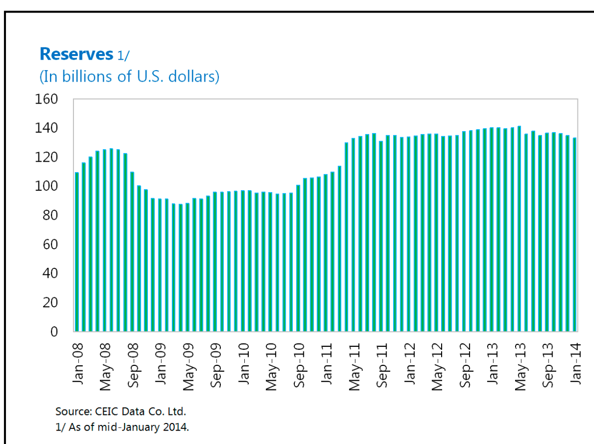
Malaysia has experienced volatile capital flows over the past few years reflecting both push and pull factors, including shifting global risk aversion, low policy rates in advanced economies and Malaysia's strong fundamentals, but a healthy financial sector has limited the impact on the overall economy (see Appendix 8). Malaysia has typically recorded net capital outflows. Although net FDI flows are generally small, there are large gross foreign direct investment flows. In 2013, net outflows were about 1.5 percent of GDP, with portfolio outflows accounting for 1.1 percent of GDP, and other outflows accounting for 0.4 percent of GDP.



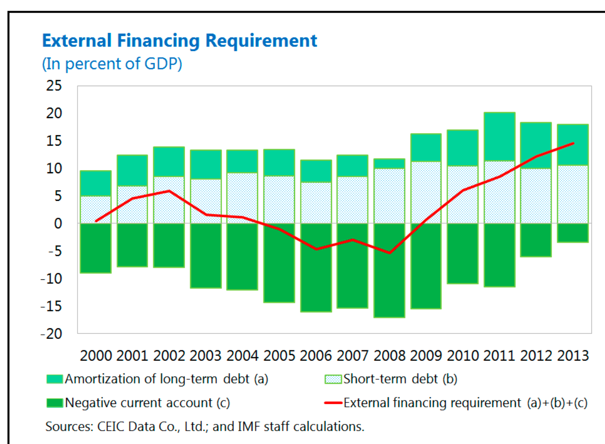


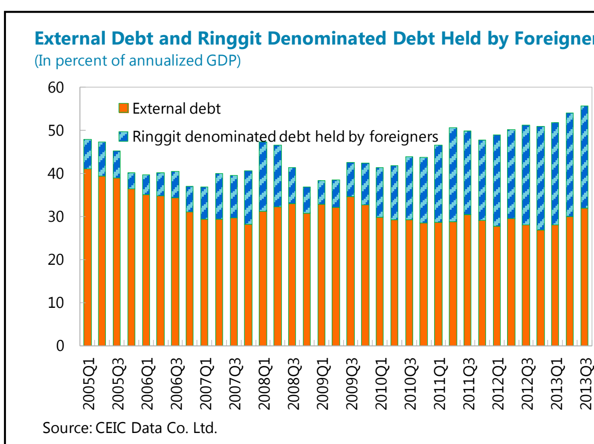
At end-2013, official reserves are about 117 percent of the IMF's composite reserve adequacy metric, and cover about 240 percent and 32 percent of short-term external debt and broad money, respectively. Therefore, current reserve levels are adequate and there is no need for additional

accumulation for precautionary purposes. BNM intervention seeks to limit excess exchange rate volatility and has generally been two-sided. Thus, during the global financial crisis foreign reserves fell by about 28 percent between August 2008 and March 2009; a decline was again recorded in August–September 2011 and in June 2013. During June 2013, reserves fell by in US$5 billion suggesting intervention by BNM. The authorities have continued to liberalize FX administration, including via greater flexibility for resident companies to undertake foreign direct investment abroad and obtain loans from related resident and nonresident companies.



External debt is relatively low at about 29 percent of GDP in 2013, of which about 18 percent is medium- and long-term debt. However, the current definition of external debt for Malaysia does not include ringgit-denominated debt held by nonresidents (23 percent of GDP); once included the external debt ratio shows a strong increase since the global financial crisis. Short-term external debt has risen recently in the last few years, largely due to banking sector activity, it is matched by an increase in short-term external assets and is well-covered by foreign reserves. The international investment position is small and negative (-2 percent of GDP at end-2012).





Standard Benchmarks

Model analysis (EBA) suggests that the cyclically-adjusted current account is stronger (by about 4.2 percentage points of GDP) than the level consistent with medium-term fundamentals and desirable policies. Applying the EBA methodology, based on data and projections available as of November 2013 the estimated 2013 current account norm for Malaysia is -0.1 percent of GDP, adjusted for relative output gaps and for commodity terms of trade. The current account balance in 2013 was 3.8 percent of GDP and the cyclically adjusted current account balance of 4.1 percent of GDP. The resulting EBA-estimated gap of +4.2 percent of GDP comprises policy gap contributions of about +1.5 percent of GDP, and an unexplained residual that needs to be interpreted.

However, Malaysia's current account surplus mainly reflects factors that are not well captured in the EBA; in particular: insufficient social safety nets (not fully captured by health spending), which drive up saving rates; 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, we assess the CA gap to be of the order of 2.6 percentage points of GDP.

Turning to Malaysia's real effective exchange rate (REER), the EBA estimates it to be 23 percent below levels warranted by fundamentals and desirable policies, although most of the gap is an unexplained residual.[1] Staff's preferred estimate of the degree of REER undervaluation is about 9 percent. This range is consistent with staff's view of the current account gap based on the macrobalance approach and relies on the semi-elasticity of the current account with respect to the REER. The estimate of the semi-elasticity takes into account Malaysia's trade openness and commodity exports and this approach yields a moderate REER undervaluation of less than 10 percent when an estimated semi-elasticity of -0.29 is used.

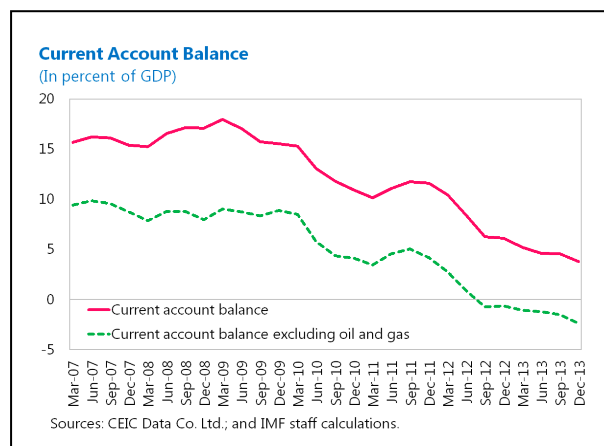
The Role of Fiscal Consolidation

Malaysia's multiyear fiscal consolidation also affects the current account in the medium term. Staff estimates that every 1 percentage point improvement in the fiscal balance could strengthen the current account by 0.4 percentage point, although the composition of the fiscal adjustment matters (see selected issues paper on "A Medium-Term Fiscal Strategy for Malaysia"). The impact on the current account depends on how different measures affect saving and investment of private agents. For example, fuel subsidy rationalization is likely to have a positive direct effect on the current account. From a macroeconomic perspective, a stronger fiscal position should help reduce concerns (evident during periods of EME market volatility) about Malaysia's current account deterioration.

The Role of Oil and Gas Exports

Malaysia is an important commodities producer and exporter, including non-reproducible resources. Its oil and gas trade balance reached 6.2 percent of GDP in 2013, and its current account balance excluding oil and gas, which became negative in 2012, widened to -2.4 percent of GDP in 2013. The EBA captures the fact that current account surpluses are a salient characteristic of oil- and gas-exporting countries. Two aspects are important: first, from an intergenerational perspective, it is optimal for countries to save part of their earnings from exporting nonrenewable resources, which results in an increase in their current account balance. Second, the fraction of their resource earnings that is saved and exported also depends on the longevity of these resources—according to the Permanent Income Hypothesis, short-lived increases in national income should be

Current Account Balance
(In percent of GDP)



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

[1] The fit of the EBA REER regression for Malaysia has fallen off in recent years, and part of the problem arises from the EBA proxy measure for trade openness.

primarily saved. Now, Malaysia's proven oil reserves are the equivalent of about 27 years worth of current production levels, while gas reserves are larger, about 42 years. In terms of the impact of oil and gas exports on Malaysia's current account, EBA estimates that Malaysia's oil and gas reserves contributes about 1.7 percent of GDP to the estimated current account norm.

Malaysia: Quantitative External Sector Assessment

	Norm 1/	Projection 1/	Gap
Current account	(In percent of GDP)		
EBA 2.0 current account	-0.1	4.1	4.2
of which: Contribution of identified policy gaps 2/			1.5
Unexplained residual			2.7
External sustainability approach 3/			2.8
Staff assessment	1.5	4.1	2.6
of which: Contribution of identified policy gaps (based on EBA 2.0)			1.5
Other			1.1
Exchange rate misalignment	(Percentage)		
EBA 2.0 Equilibrium real exchange rate approach 4/	...	...	-23.0
Of which: Contribution of identified policy gaps 2/	...	...	-6.0
Unexplained residual	...	...	-17.0
Staff estimate using elasticity approach			
Staff estimated elasticity 5/	...	...	-9.0

1/ Staff's estimate of the multi-laterally consistent cyclically-adjusted norm and projection for 2013, based on EBA 2.0 November 2013 update.

2/ Policy Gaps refers to policy distortions can arise either from domestic policies or as a result of the policies of other economies. See 2013 Pilot External Sector Report.

3/ Based on 2012 NFA/GDP ratio of -1.5 percent of GDP and an adjusted CA projection of 3.2 percent for 2018.

4/ Misalignment based on EBA 2.0 November 2013 update.

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

Overall Assessment

Malaysia's current account surplus is elevated on account of structural factors that boost private savings and constrain public investment. From a multilateral perspective, and consistent with the authorities' intentions, stronger social safety nets and efforts to remove bottlenecks to investment would help to further moderate the current account surplus.

Appendix 4. Malaysia—Public Debt Sustainability Analysis

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

2. **Macroeconomic assumptions**. Growth is projected at 4.7 percent in 2013, rising to 5 percent in 2014 on the back of a recovery in global demand and a sustained strong domestic demand. The GDP deflator is expected to increase in the medium term, from a low of about 0 percent in 2013 to 4.6 percent in 2014 on the back of fuel subsidy cuts, and improving terms of trade. Growth will average 5 percent in the medium term and the growth in GDP deflator is projected to fall gradually towards 2.5 percent.

3. **Fiscal assumptions**. In staff's baseline projections, federal government deficit is reduced in the near term from 4.3 percent of GDP in 2013 to 2.6 percent in 2015[1]. The projected fiscal consolidation is consistent with the authorities' targets and is supported by structural reforms announced in the 2014 budget. In particular, staff projections assume that the authorities gradually eliminate fuel subsidies and partially replace them with targeted cash transfers to the lower income group. It also assumes that a goods and services tax (GST) is introduced in 2015. Fiscal deficit starts to increase after 2016, due to the gradual decline in oil and gas related revenues, and increases in pension and health care related costs.

4. **Data coverage**. Consistent with the data on government debt reported by the authorities, the fiscal assumptions in this DSA are based on the federal government budget. This coverage excludes local and state governments and statutory bodies which typically borrow from the federal government or receive explicit government guarantees. The liabilities of these entities are therefore captured in federal government' gross debt and stock of loan guarantees[2]. Borrowing by state-owned enterprises, which are in some cases under federal government guarantees, has increased in recent years and is projected to continue to increase in the medium term.

5. **Malaysia's high level of government debt and gross financing requirement calls for using the higher scrutiny framework**. Government's gross debt increased sharply in 2009, reflecting sizable discretionary fiscal stimulus, declining real and nominal growth and a large fall in oil prices. Although growth has recovered since then, primary deficits have remained high, pushing the debt to GDP ratio to close to the authorities self-imposed debt ceiling of 55 percent. Gross financing

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

[2] Gross debt of consolidated general government is not published.

needs (GFN) are estimated at 11.1 percent of GDP in 2012 and are expected to remain around 9–10 percent in the medium term.

6. Realism of baseline assumptions. The median forecast error for real GDP growth during 2004−2012 is zero, suggesting that there is no evidence of a systemic projection bias that would undermine the assessment. The median forecast error for GDP deflator is 2.9 percent, suggesting that the staff forecasts have been more conservative. The median forecast error for primary balance suggests that staff projections have been slightly optimistic (a forecast bias of 0.72 percent of GDP), but the forecast bias has improved in the later years.

7. Cross-country experience suggests the projected fiscal adjustment is feasible. The maximum 3 year adjustment in the cyclically-adjusted primary balance (CAPB) over the projection period (2.75 percent of GDP) is ambitious but is premised upon concrete measures endorsed by the government. As highlighted earlier, staff does not rule out the existence of implementation risks and therefore considering a no adjustment scenario, as done in this DSA, is necessary to take that into account. Finally, the maximum level of the primary balance (-0.5 percent of GDP) that is assumed in the medium term is reasonable when compared to the experience in other market-access countries.

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

- Under the baseline, the debt-to-GDP ratio is projected to decrease to slightly below 50 percent by 2018, but if the projected consolidation does not take place, captured under the constant primary balance simulation, it increases to 56 percent by 2018. Under most macro-fiscal stress tests, debt-to-GDP ratio continues to decline, but if there is a one standard deviation shock to real GDP growth, debt-to-GDP ratio initially increases to 57 percent in 2015 and declines thereafter. The combined macro-fiscal shock and a permanent 20 percent oil price shock, imply a flat debt-to-GDP profile in the medium term. Stochastic simulations based on historical volatilities in Malaysia's macroeconomic variables also show that the 90th percentile of debt-to-GDP ratio simulations is below 70 percent. Gross financing needs under all scenarios remain at about 9 percent, and rise to just below 12 percent by the end of the projection horizon.

- A contingent liability shock whereby the government would have to absorb all of the government guaranteed loans (totaling 15 percent of GDP) over two years would increase risks significantly. If the economy is also hit by a persistent shock to growth and interest rates rise by 150 basis points, the debt-to-GDP ratio would remain just below 70 percent debt benchmark. Although this is a low probability scenario, the simulations underscore the growing vulnerability posed by contingent liabilities.

9. Heat map. Despite its low share of foreign currency and short-term debt, Malaysia faces risks arising from its external financing requirement and large share of public debt held by foreigners. At 13 percent, the external financing requirement is close to the upper threshold of early warning benchmarks and the share of debt held by foreigners is relatively high at about 30 percent of total. As discussed earlier, the existence of large domestic institutional investors who tend to make opportunistic investments; provides some comfort along this dimension.

Malaysia Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(In percent of GDP unless otherwise indicated)

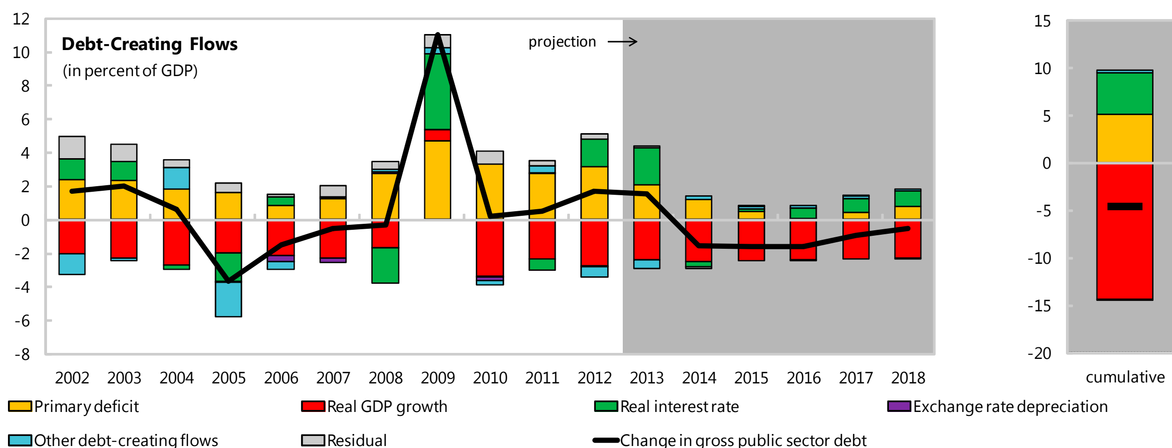
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018
Nominal gross public debt	44.3	51.6	53.3	54.8	53.3	51.7	50.1	49.2	48.7
Public gross financing needs	8.9	10.9	11.1	10.4	9.0	8.9	8.6	9.2	10.8
Real GDP growth (in percent)	5.1	5.1	5.6	4.7	5.0	5.0	5.0	5.0	5.0
Inflation (GDP deflator, in percent)	4.3	5.5	0.7	-0.1	4.6	3.8	2.9	2.6	2.6
Nominal GDP growth (in percent)	9.7	10.9	6.4	4.6	9.8	8.9	8.1	7.7	7.7
Effective interest rate (in percent) [4/]	5.4	4.4	4.3	4.3	4.2	4.2	4.3	4.5	4.7

As of January 13, 2014		
Sovereign Spreads		
EMBI (bp) 3/		135
CDS (bp)		112
Ratings	Foreign	Local
Moody's	A3	A3
S&Ps	A-	A
Fitch	A-	A

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.1	0.51	1.72	1.5	-1.5	-1.6	-1.6	-0.9	-0.5	-4.6	
Identified debt-creating flows	0.4	0.20	1.42	1.4	-1.4	-1.7	-1.5	-0.9	-0.4	-4.6	
Primary deficit	2.3	2.8	3.1	2.1	1.2	0.5	0.1	0.4	0.8	5.1	-1.3
Primary (noninterest) revenue and grants	20.9	21.0	21.3	21.8	21.1	20.9	20.5	20.2	20.0	124.4	
Primary (noninterest) expenditure	23.3	23.7	24.5	23.9	22.3	21.4	20.6	20.6	20.8	129.5	
Automatic debt dynamics [5/]	-1.7	-3.0	-1.1	-0.1	-2.8	-2.3	-1.8	-1.5	-1.4	-10.0	
Interest rate/growth differential [6/]	-1.6	-3.0	-1.0	-0.1	-2.8	-2.3	-1.8	-1.5	-1.4	-10.0	
Of which: real interest rate	0.4	-0.7	1.7	2.2	-0.3	0.1	0.6	0.8	0.9	4.4	
Of which: real GDP growth	-2.0	-2.4	-2.7	-2.4	-2.5	-2.4	-2.4	-2.3	-2.3	-14.3	
Exchange rate depreciation [7/]	-0.1	0.1	-0.1	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.3	0.4	-0.6	-0.5	0.2	0.2	0.2	0.1	0.1	0.3	
General government net privatization proceeds (negativ	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other change in financial assets	-0.3	0.4	-0.6	-0.5	0.2	0.2	0.2	0.1	0.1	0.3	
Residual, including asset changes [8/]	0.7	0.3	0.3	0.1	-0.1	0.1	-0.1	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ EMBI.

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

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

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

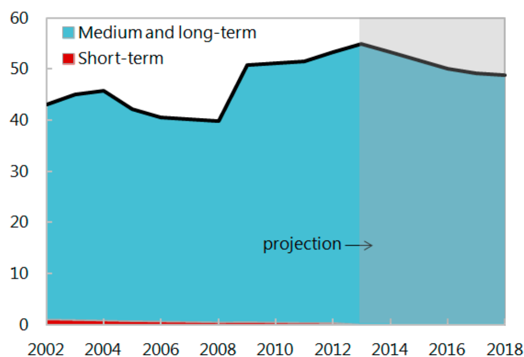
7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

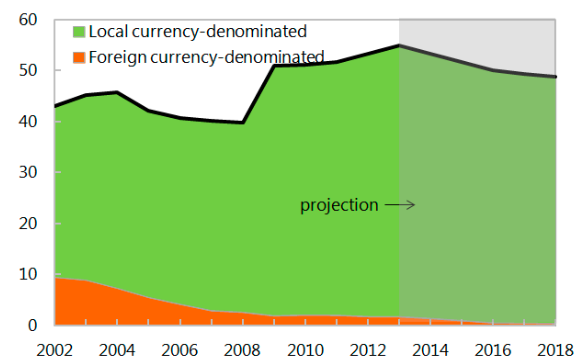
8/ For projections, this line includes exchange rate changes during the projection period.

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

Malaysia Public DSA—Composition of Public Debt and Alternative Scenarios

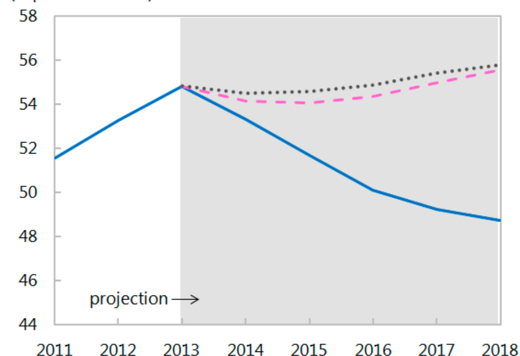
Composition of Public Debt

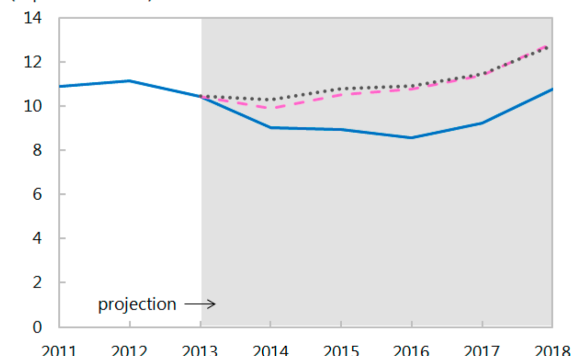




Alternative Scenarios

Baseline · Historical · Constant Primary Balance





Underlying Assumptions

(in percent)

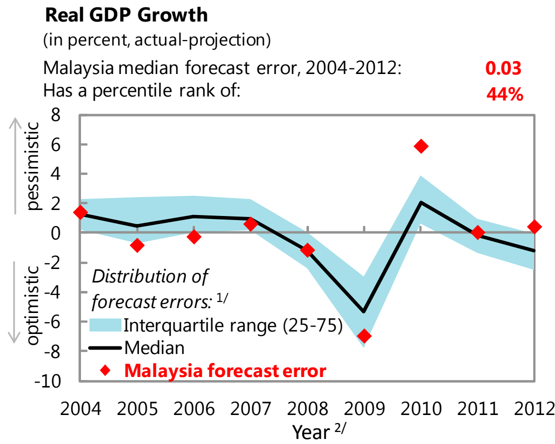
Baseline Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	4.7	5.0	5.0	5.0	5.0	5.0
Inflation	-0.1	4.6	3.8	2.9	2.6	2.6
Primary Balance	-2.1	-1.2	-0.5	-0.1	-0.4	-0.8
Effective interest rate	4.3	4.2	4.2	4.3	4.5	4.7
Constant Primary Balance Scenario						
Real GDP growth	4.7	5.0	5.0	5.0	5.0	5.0
Inflation	-0.1	4.6	3.8	2.9	2.6	2.6
Primary Balance	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1
Effective interest rate	4.3	4.2	4.2	4.3	4.5	4.7

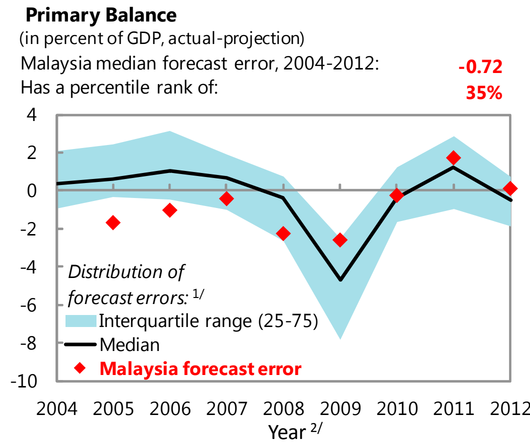
Historical Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	4.7	5.1	5.1	5.1	5.1	5.1
Inflation	-0.1	4.6	3.8	2.9	2.6	2.6
Primary Balance	-2.1	-2.5	-2.5	-2.5	-2.5	-2.5
Effective interest rate	4.3	4.2	3.9	3.7	3.6	3.6

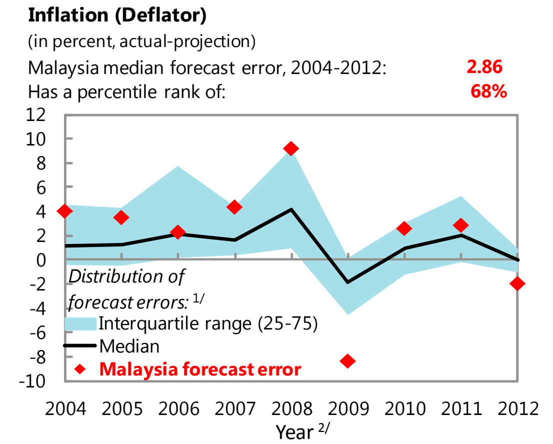
Source: IMF staff.

Malaysia Public DSA—Realism of Baseline Assumptions

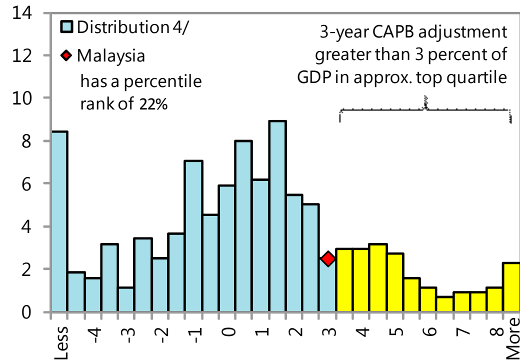
Forecast Track Record, versus surveillance countries

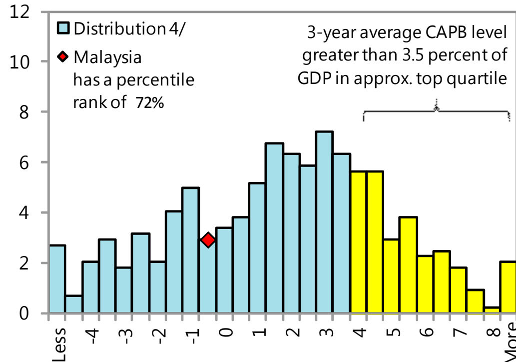




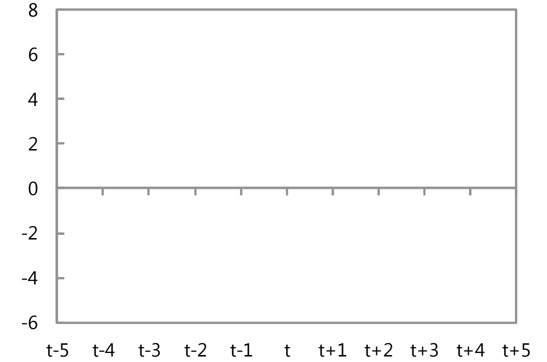


Assessing the Realism of Projected Fiscal Adjustment





Boom-Bust Analysis 3/



Source : IMF Staff.

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

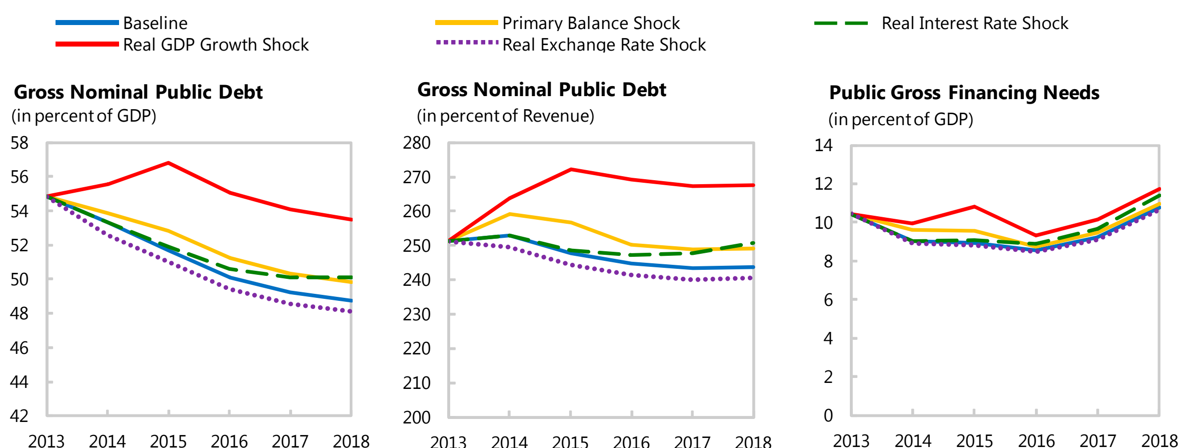
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Malaysia.

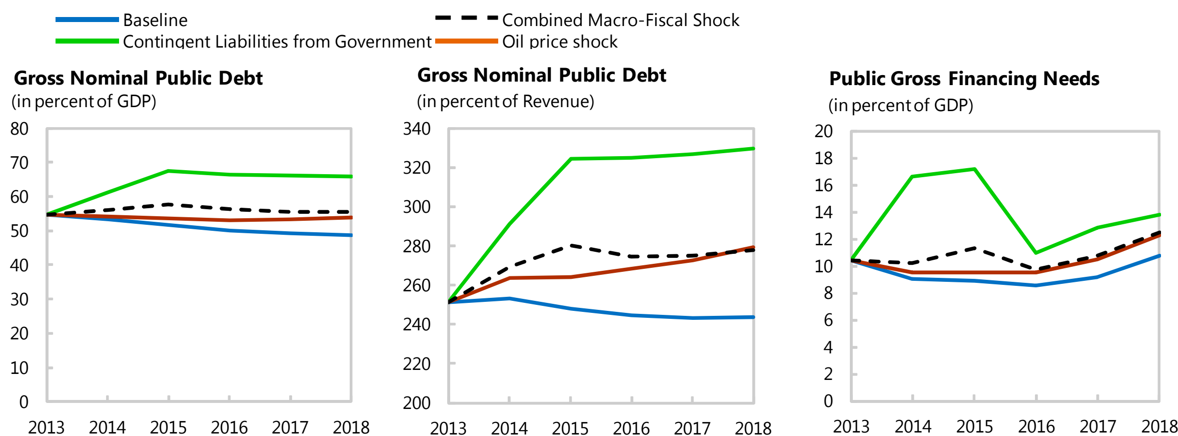
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Malaysia Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2013	2014	2015	2016	2017	2018
Primary Balance Shock						
Real GDP growth	4.7	5.0	5.0	5.0	5.0	5.0
Inflation	-0.1	4.6	3.8	2.9	2.6	2.6
Primary balance	-2.1	-1.8	-1.1	-0.1	-0.4	-0.8
Effective interest rate	4.3	4.2	4.2	4.4	4.5	4.7
Real Interest Rate Shock						
Real GDP growth	4.7	5.0	5.0	5.0	5.0	5.0
Inflation	-0.1	4.6	3.8	2.9	2.6	2.6
Primary balance	-2.1	-1.2	-0.5	-0.1	-0.4	-0.8
Effective interest rate	4.3	4.2	4.6	5.0	5.4	5.8
Combined Shock						
Real GDP growth	4.7	2.5	2.5	5.0	5.0	5.0
Inflation	-0.1	3.9	3.1	2.9	2.6	2.6
Primary balance	-2.1	-2.2	-2.1	-0.1	-0.4	-0.8
Effective interest rate	4.3	4.2	4.6	5.0	5.4	5.8
Contingent Liabilities from Government Guarantees						
Real GDP growth	4.7	4.0	4.0	4.0	4.0	4.0
Inflation	-0.1	4.6	3.8	2.9	2.6	2.6
Primary balance	-2.1	-8.7	-8.0	-0.1	-0.4	-0.8
Effective interest rate	4.3	4.2	4.6	5.0	4.9	5.0

	2013	2014	2015	2016	2017	2018
Real GDP Growth Shock						
Real GDP growth	4.7	2.5	2.5	5.0	5.0	5.0
Inflation	-0.1	3.9	3.1	2.9	2.6	2.6
Primary balance	-2.1	-1.9	-1.8	-0.1	-0.4	-0.8
Effective interest rate	4.3	4.2	4.2	4.4	4.6	4.7
Real Exchange Rate Shock						
Real GDP growth	4.7	5.0	5.0	5.0	5.0	5.0
Inflation	-0.1	6.3	3.8	2.9	2.6	2.6
Primary balance	-2.1	-1.2	-0.5	-0.1	-0.4	-0.8
Effective interest rate	4.3	4.2	4.2	4.3	4.5	4.7
Oil price shock						
Real GDP growth	4.7	4.0	4.0	4.0	4.0	4.0
Inflation	-0.1	4.6	3.8	2.9	2.6	2.6
Primary balance	-2.1	-1.6	-0.9	-0.7	-1.1	-1.5
Effective interest rate	4.3	4.2	4.2	4.3	4.5	4.7

Source: IMF staff.

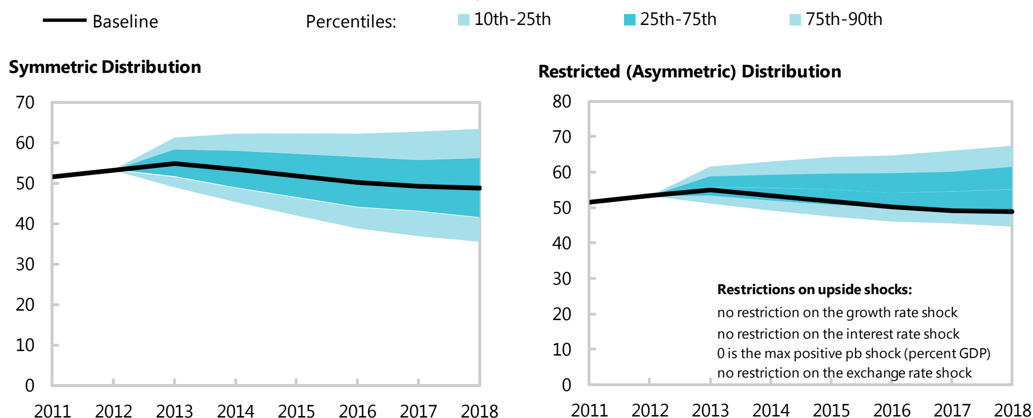
Malaysia Public DSA—Risk Assessment

Heat Map

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

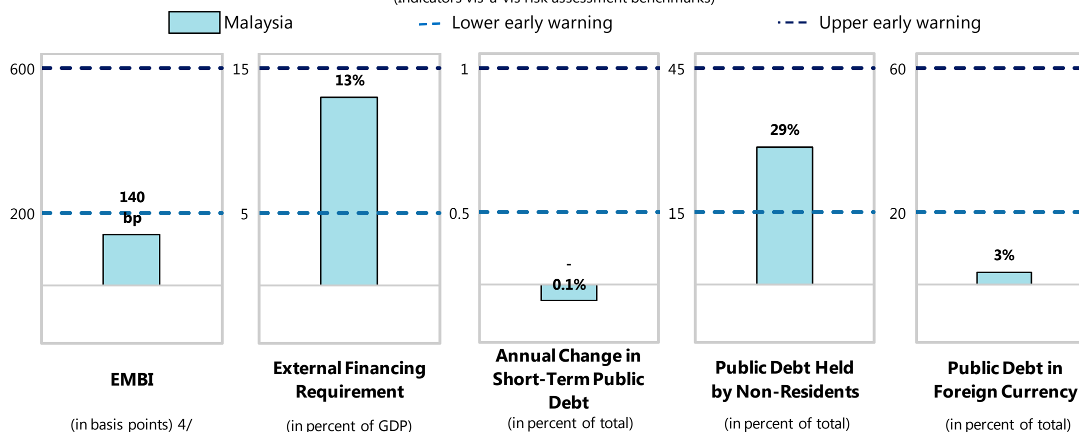
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

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

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

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

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

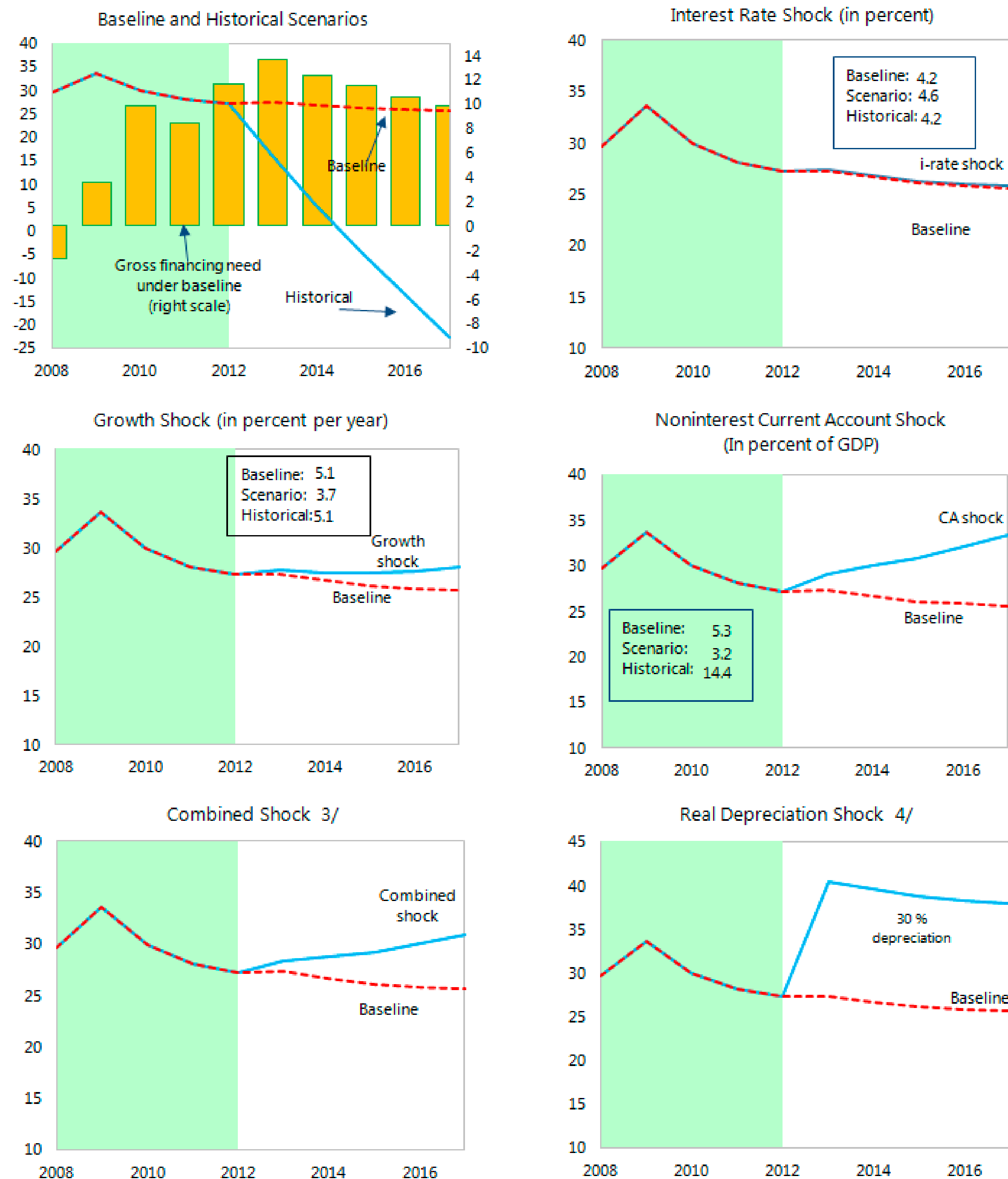
4/ An average over the last 3 months, 15-Oct-13 through 13-Jan-14.

Appendix 5. Malaysia—External Debt Sustainability Analysis

1. **Background**. Malaysia's external debt is expected to remain on a steady downward trend over the medium term, falling to 25 percent of GDP by 2018. The 2 percentage point decline in the external debt to GDP ratio from 2012 to 2018 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 40 percent of GDP in 2014, but would subsequently fall to 37 percent of GDP by 2018.

Figure 5.1. Malaysia: External Debt Sustainability: Bound Tests 1/ 2/

(External debt, in percent of GDP)



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.

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

Table 5.1. Malaysia: External Debt Sustainability Framework, 2008–2018

(In percent of GDP, unless otherwise indicated)

	Actual							Projections							
	2008	2009	2010	2011	2012	10-Year Historical Average	10-Year Standard Deviation	2013	2014	2015	2016	2017	2018	For debt stabilization	Debt-stabilizing non-interest current account 6/
1 Baseline: external debt	29.6	33.6	29.9	28.1	27.1			27.3	26.7	26.1	25.8	25.6	25.2		0.8
2 Change in external debt	0.4	4.0	-3.7	-1.9	-0.9			0.1	-0.6	-0.6	-0.3	-0.2	-0.5	0.0	
3 Identified external debt-creating flows (4+8+9)	-16.1	-13.0	-14.2	-13.1	-5.1			-3.2	-3.7	-3.5	-3.4	-3.4	-3.4	0.0	
4 Current account deficit, excluding interest payments	-18.3	-16.9	-12.1	-12.7	-7.1			-4.6	-5.0	-4.9	-5.0	-5.0	-5.0	-0.8	
5 Deficit in balance of goods and services	-22.3	-20.3	-17.0	-16.4	-11.9			-8.5	-9.3	-9.3	-9.1	-8.8	-8.4		
6 Exports	99.5	91.4	93.3	91.6	87.1			79.3	74.0	69.2	65.7	63.1	59.9		
7 Imports	77.2	71.1	76.3	75.2	75.3			70.7	64.7	59.9	56.6	54.2	51.5		
8 Net nondebt creating capital inflows (negative)	3.4	3.1	1.8	1.1	2.3			1.6	1.6	1.6	1.6	1.6	1.4	1.6	
9 Automatic debt dynamics 1/	-1.2	0.8	-3.9	-1.5	-0.4			-0.2	-0.3	-0.2	0.0	0.1	0.2	-0.8	
10 Contribution from nominal interest rate	1.3	1.2	1.2	1.2	1.0			0.9	0.9	1.0	1.2	1.3	1.3	1.2	
11 Contribution from real GDP growth	-1.3	0.4	-2.1	-1.4	-1.5			-1.2	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2	
12 Contribution from price and exchange rate changes 2/	-1.2	-0.8	-2.9	-1.3	0.1			...	...	...	...	...	...	-0.9	
13 Residual, including change in gross foreign assets (2–3) 3/	16.5	16.9	10.5	11.3	4.2			3.3	3.0	2.9	3.1	3.2	3.0	0.0	
External debt-to-exports ratio (in percent)	29.8	36.8	32.1	30.6	31.1			34.4	36.1	37.7	39.3	40.6	42.0		
Gross external financing need (in billions of U.S. dollars) 4/	-6.1	7.2	24.3	24.5	35.3			44.6	44.4	45.5	45.9	46.5	47.6		
In percent of GDP	-2.6	3.6	9.8	8.5	11.6			13.6	12.3	11.5	10.6	9.8	9.2		
Scenario with key variables at their historical averages 5/								15.8	5.4	-4.5	-13.9	-22.8	-31.1		2.5
Key macroeconomic assumptions underlying baseline															
Real GDP growth (in percent)	4.8	-1.5	7.4	5.1	5.6	5.1	2.5	4.7	5.0	5.0	5.0	5.0	5.0	5.0	
GDP deflator in U.S. dollars (change in percent)	4.4	2.9	9.6	4.5	-0.5	6.2	4.1	2.8	5.0	5.0	4.1	3.7	4.7	3.7	
Nominal external interest rate (in percent)	4.9	4.0	4.2	4.3	3.7	4.2	0.4	3.7	3.8	4.1	4.9	5.3	5.8	5.3	
Growth of exports (U.S. dollar terms, in percent)	11.9	-19.6	24.9	14.6	0.3	10.0	12.5	-2.4	3.0	3.1	3.8	4.4	4.6		
Growth of imports (U.S. dollar terms, in percent)	6.7	-19.3	31.3	15.0	5.6	10.4	13.3	0.8	0.8	2.1	3.3	4.2	4.5		
Current account balance, excluding interest payments	18.3	16.9	12.1	12.7	7.1	14.4	3.4	4.6	5.0	4.9	5.0	5.0	5.0		
Net nondebt creating capital inflows	-3.4	-3.1	-1.8	-1.1	-2.3	-0.9	1.8	-1.6	-1.6	-1.6	-1.6	-1.6	-1.4		

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

Appendix 6. Malaysia—2013 FSAP—High Priority Recommendations

Strengthening Financial Sector Oversight
Implement proposed new Financial Services Act (FSA) at an early date; and strengthen legal and regulatory requirements for Islamic banks. *The FSA and related Islamic Financial Services Act (IFSA) were implemented on June 30, 2013. The IFSA strengthens legal and regulatory requirements for Islamic banks including those for capital, financial reporting, and audit.*
Strengthen framework for consolidated supervision of financial holding companies (FHC) including capital standards and risk management. *The FSA / IFSA provide BNM with powers for consolidated supervision of FHCs in these areas.*
Ground the operational independence of the Securities Commission (SC) by changing the legal provisions on removal of Commission members and protections given to Commission members and its staff. *Related amendments to the SC Act are expected to be submitted to parliament in 2014.*
Strengthen the definition of connected lending. *The BNM expects to issue a revised policy document to the industry in 2014.*
Labuan International Business and Finance Center
Impose prudential and regulatory requirements on Labuan financial institutions in line with international standards and best practice. *During 2012–2013, the Labuan Financial Services Act (LFSA) has issued guidelines relating to classification and impairment provisions of loans, connected party lending, reinsurance, and single exposure limits.*
Undertake more proactive engagement and effective communication of LFSA with home supervisors and external auditors. *The BNM continues to sign new MoUs with home supervisors of Labuan entities (3 more added in 2013). These cover exchange of supervisory information and collaboration in enforcement. Separately, it is seeking confirmation that each Labuan entity is covered under consolidated supervision from the home jurisdiction.*
Systemic Risk Management
Formalize a high-level committee involving BNM, SC, PIDM and the fiscal authority with the responsibility for ongoing systemic risk monitoring, information sharing and crisis action. *The Financial Stability Executive Committee (FSEC) formed in 2010 has this mandate and, as of January 2013, includes permanent membership of the SC along with the BNM, PIDM and MoF.*
Macro-Financial Risks
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. *The BNM expects to complete collection of such granular data on households by end-2014.*
Adopt multiyear top-down and bottom-up macroeconomic stress testing, and introduce more conservative credit loss parameters in bottom up exercise. *The bank has already implemented a top-down multiyear framework, a bottom-up approach is expected to be implemented in 2014.*

Appendix 7. Malaysia—Stress Tests of Banking, Household and Corporate Balance Sheets

1. **Introduction**. This annex describes stress tests carried out for Malaysia's banks as well as household and corporate sectors in aggregate. The impact of stress was observed for banks' capital and earnings; household debt servicing ratios (debt servicing costs relative to total income including both wages and savings income); and corporate interest servicing ratios (interest expenses relative to total earnings including interest on corporate cash). Stress factors included the following: MGS yields; the OPR; banks' deposit rates; and, nonperforming loans (NPLs).

2. **Methodology**. Each of the factors above is assumed to affect banks' capital through its impact on earnings and asset quality. Banks' earnings are largely driven by spread between lending rates and banks' cost of funds (net interest margin) and also include contribution from fee-based income, which is estimated at one-third of total earnings for the overall system. In simplified form, banks' starting level of capital plus retained earnings is used as an estimate of capital at the beginning of the next period. Retained earnings are defined as gross earnings minus operational expenses, which are assumed to include loan losses, additional provisions, and taxes. Shocks to three of the stress factors: MGS yields, deposit rates and NPLs are applied independently; however, an increase in OPR is also assumed to raise deposit rates.

Malaysia Banking System Analysis

	2013 Q3 (RM millions)
Capital	
Tier 1 capital	165,329.67
Assets	2,059,702.06
Risk weighted assets	1,190,652.29
Tier 1 ratio	0.14
Earnings	
Earnings before expenses, taxes, dividends	29,000.96
Imputed Return on Assets (ROA)	0.01
Estimated expenses (before provisions and recovery)	14,507.34
Losses	
NPL ratio	0.02
Gross loans	1,204,478.76
Gross NPLs	23,861.11
Provisions	23,164.08
Estimated portfolio duration (yrs)	5.00
Estimated expenses (after provisions and recovery)	17,590.48
Retained earnings	
Corporate tax rate	0.25
Estimated earnings	
After taxes before dividends	8,557.86
Estimated dividend payout ratio	0.40
Retained earnings	5,134.72

Source: IMF Staff Estimates (November 2013)

3. **Banks**. Assets are comprised of loans (58 percent), interbank exposure (18 percent), government securities (5 percent), other securities, fixed and other assets (figure). Other than earnings, the impact of each factor was primarily tested on banks' loan portfolios, which are comprised of exposure to households and corporate, making up 47 percent and 43 percent of the total respectively; while the remainder is assumed to be lending to government-related entities at federal, state or local levels. In addition to loan assets, banks have securities exposure, which includes holdings of government as well as private debt securities. Although some of these securities would face a mark-to-market loss in case of higher MGS yields, the bulk are assumed to be held to maturity. Interbank exposure is assumed to net out for the overall system. Baseline system-wide interest rates on various types of loans, including mortgage, auto, personal and corporate loans, were estimated based on information available from websites of the four largest banks in the financial system.

4. **Transmission mechanism**. An increase in OPR is assumed to raise deposit rates by the same magnitude. For example, 100 bps increase in OPR is assumed to lead to 100 bps increase in deposit rates. Both factors are assumed to raise banks' funding costs independently. An increase in MGS yields will not have this impact because MGS are assumed to be held to maturity. It is assumed that banks will pass on any increase in funding costs to customers on existing variable-rate loans if the reference index allows; as well as on new loans. Both household and corporate borrowers will be affected. Based on data from individual banks, nearly 70 percent of banks' loans are variable-rate in nature; while the remaining 30 percent are fixed-term loans. The bulk of variable-rate loans are ultimately linked to OPR and will be subject to changes in that variable but will remain unaffected by changes in MGS yields.

5. Households. The impact of each factor was tested on the ratio of debt liabilities to wages plus income from assets or debt servicing ratio (DSR). Wages were assumed to remain unchanged. Making up aggregate liabilities of 83 percent of GDP, households carry exposure to mortgage, personal and auto loans, revolving credit, and margin loans for securities. Banks are assumed to pass on higher funding costs due to an increase in OPR to variable-rate loans in each category allowing them to maintain typical margins on such lending. On the asset side, financial assets of households, including cash, pensions savings, and stock and bond investments are 189 percent of GDP (based on BNM data), while physical assets, comprising mainly houses and autos, are estimated to make up nearly 67 percent of GDP (based on average LTV). Along with savings income, households benefit from additional interest income from cash holdings, which are more than one-quarter of financial assets. An increase in MGS yields has negligible impact on banks' cost of funds and correspondingly does not affect household debt servicing costs or income from cash deposits or savings instruments. It is assumed that households do not have access to EPF savings income for the purpose of debt servicing.

Household Balance Sheets (Q3:2013)

Assets	Amounts (RM billions)	Estimated annual rate return	Estimated annual yield (RM billions)
Physical	670.7		
House	526.3		
Auto	144.4		
Financial	1,874.9		
Margin-financed equities and bonds	94.9	2.0%	1.9
EPF savings	525.0	0.0%	...
Other savings	756.0	1.0%	7.6
Cash (deposits)	499.1	1.0%	5.1
Total (Assets)	2,545.6		
Savings income			14.5
Annual wages			591.8
Total annual income			620.9

	(RM billions)
Debt service	271.1
Total income	620.9
Result--HH DSR	43.7%

Liabilities	Amounts (RM billions)	Annual Interest Rate (Percent)	Annual Interest Payment (RM billions)	Annual Principal Payment (RM billions)
Mortgage loan	385.0	4.8%	18.3	12.8
Auto loan	144.4	5.3%	7.6	28.9
Credit cards	87.2	15.3%	13.3	87.2
Personal loans	146.4	7.8%	11.4	29.3
Loans for securities	47.4	3.1%	1.4	47.4
Other	13.1	3.1%	0.4	13.1
Total (liabilities)	823.4			
Debt service amounts			52.4	218.7

	(RM billions)
Debt service	271.1
Wage income only	591.8
Result--HH DSR	45.8%

Source: Bank Negara Malaysia, *IMF Staff Estimates (November 2013).*

6. Corporates. The impact of each stress factor was tested on the ratio of interest expense to earnings, as a measure of the ability of corporate to honor interest obligations. The aggregate corporate balance sheet for Malaysia is inferred from various ratios reported by the BNM, including leverage, the interest coverage ratio, and the size of corporate debt liabilities; it also uses data on the average level of cash held by corporates for a large sample of over 750 nonfinancial Malaysian corporates covered by Bloomberg. Corporate debt coming due in a given period is assumed to rollover completely. As for the household sector, an increase in OPR is assumed to raise rates on variable-rate loans to corporates as well as deposit rates by the same magnitude. Domestic and external corporate debt spreads to MGS and U.S. treasury securities respectively are assumed to be unaffected purely by an increase in OPR.

Corporate Balance Sheets

	(RM billions)	Baseline Rates
Assets	4,113.7	
Cash	613.6	3.2%
Liabilities	2,050.4	
Debt liabilities	928.5	
External debt	135.6	5.6%
Domestic debt securities	273.9	4.6%
Domestic bank loans	519.0	3.1%
Equity	2,063.4	
D/E	45%	
Interest expense	36.1	
Earnings	144.2	
Result--corporate ISR	25.0%	

Source: Bank Negara Malaysia, Bloomberg, IMF Staff Estimates (November 2013)

7. Results. Banks' capital remained well above the minimum regulatory capital requirement even with large shocks to stress factors. It is worth noting the following:

- Higher MGS yields raise corporate ISR but have no explicit impact on household DSR or bank capital. An increase in bank capital from 13. 9 percent to 14.3 percent is only because of retained earnings over the course of a year. Household DSR is unaffected because rates on liabilities do not adjust with MGS yields, and savings have a relatively small proportion of debt securities holdings. Bank capital is unaffected due to our modeling assumption, in which NPLs and debt servicing ability of households and corporates are considered separately.
- Higher policy rates have a significant impact on household and corporate DSRs as well as on bank capital. A scenario with a plausible increase in the OPR of 50 bps over the course of one year has virtually no impact on bank capital as earnings are expected to be strong enough to cushion such an increase, even though there would be some compression of net interest margins in such a situation. Also, corporate ISR rises by 130 bps while the household DSR rises only slightly by 11 bps. If savings income is excluded for households, the DSR rises by 50 bps.
- Higher deposit rates lower household DSR while raising the corporate ISR. The assumption is that higher funding costs for banks are passed on to both household and corporate lending wherever possible; however households benefit from a higher proportion of cash deposits in assets, 20 percent versus 15 percent for corporates; and also, the marginal benefit from an increase in deposit rates is much greater for households that typically carry deposits at much lower interest-rates compared with corporates.
- Finally, an increase of 200 bps in NPLs to 4 percent reduces bank capital significantly by 118 bps even though banks' net interest margins are unaffected by this stress factor. A gradual increase in NPLs has less impact on bank capital than a sudden shock as it allows banks to build buffers through additional earnings.

Results of Stress Tests

Factor	Increase (bps)	Bank T1 Capital Ratio (bps)	HH DSR (bps)	Corp ISR (bps)
MGS yields	50			64.1
	100			128.2
	200			256.4
OPR	50		10.6	132.2
	100	-7.4	20.9	259.0
	200	-110.6	41.2	497.7
Deposit rates	50		-36.3	36.3
	100	9.3	-71.6	71.1
	200	-54.3	-138.8	136.6
NPLs Over 1 year	50			
	100	-9.1		
	200	-117.8		
NPLs Over 2 years	50	118.9		
	100	92.3		
	200	38.9		

Source: IMF staff estimates (November 2013)

Appendix 8. What Explains Malaysia's Resilience to Capital Outflows?[1]

1. Background. Recent IMF research (World Economic Outlook, October 2013, Chapter 4) on the resilience of emerging market economies (EMEs) to capital flow volatility emphasizes the distinction between real and financial adjustment to capital outflows.[2] The starting point is the familiar balance of payments identity that, as a consequence of double entry accounting, the sum of the current account balance, net capital inflows, and changes in official international reserves must be zero. Countries experiencing outflows of foreign capital may respond through a combination of financial and real adjustment. Financial adjustment involves either a drawdown of official reserves or offsetting inflows by residents of non-reserve assets. Real adjustment involves changes in domestic absorption (the sum of private and government consumption and investment) which improve the current account through a combination of real exchange rate depreciation, and fiscal and monetary tightening. Real adjustment is usually more painful than financial adjustment, since it comes following a boom in inflows which has resulted in higher domestic spending and a widening of the current account deficit, which must now be reversed. Countries that can rely on financial adjustment in response to capital outflows are therefore bound to be more resilient.

2. The role of gross flows. The WEO examines the quantitative role of gross flows in financial adjustment, differentiating between capital movements initiated by foreigners from those initiated by domestic investors.[3] A regression of gross inflows on the current account deficit is used to assess whether countries adjust through real or financial adjustment in a sample of 38 EMEs during 2000–12. These EMEs are ranked according to the estimated regression coefficients, and the sample is split at the median. The group with larger positive coefficients, for which changes in gross inflows are associated with large changes in the current account deficit, is referred as the less resilient group, and those with a lower or negative coefficient, as the more resilient group. The economic, political and institutional characteristics of the more resilient EMEs are then compared with those of the less resilient ones and with those of a group of six resilient advanced economies.

3. Resilient EMEs. The resilient group of EMEs, Chile, the Czech Republic and Malaysia among them, managed to buffer inflows of foreign capital with resident outflows in the 2000s, thus achieving more stable current accounts , avoiding excessive real adjustment and insuring themselves more effectively to capital flow volatility. The repatriation of domestic financial resources when foreign investors flee helps to offset gross outflows and stabilizes net flows, thus enabling resilient countries to avoid sharp exchange rate depreciation and overshooting and painful current account

[1] Prepared by Jaime Guajardo (APD).

[2] Simon, Benes, Guajardo and Sandri, "The Yin and Yang of capital flow management: balancing capital inflows with capital outflows."http://www.imf.org/external/pubs/ft/weo/2013/02/pdf//4sum.pdf.

[3]The analysis is in the tradition of recent literature that has honed in the role of gross inflows for insights into the nature (and classification) of external vulnerabilities, including sudden stops and domestic capital flight. See, for example, Forbes and Warnock, 2011, "Capital Flow Waves: Surges, Stops, Flight and Retrenchment," NBER working paper 17351 (September). These authors find, inter alia, that indicators of global risk are significantly related to surges or stops when measured based on gross capital flows, but not when episodes are measured based on net flows. This is because actions by foreign and domestic investors can counteract each other: lower global risk is actually associated with an increase in both capital inflows from foreigners and capital outflows by domestic residents. These large shifts in both types of flows may counteract each other so that changes in the aggregated net capital flows are small.

reversals**.** This mechanism helped resilient countries experience smaller fluctuations in current accounts, lowered the impact of outflows on GDP and consumption growth, and contained unemployment increases.

4. Sources of resilience. The regression analysis demonstrates that EMEs that have demonstrated resilience to the vagaries of international capital flows tend to share some common characteristics, including

- Better indicators of macroeconomic management, such as lower inflation, more fiscal buffers, and room to engage in countercyclical macroeconomic policies.

- Strong central banks, more flexible exchange rate regimes, higher net international investment positions, more stable current accounts (net capital flows); and fewer restrictions on capital flows, so that local residents can efficiently move capital across borders and have the appropriate incentives to do so.

- Better institutions of economic management, including financial regulation and supervision that prevent financial intermediaries from taking undue risks during periods of strong capital inflows.

In addition to the regression analysis, the WEO study examines the experience of case studies from EMEs, including Chile, the Czech Republic, and Malaysia, for clues as to the identity of the players that facilitated financial adjustment by repatriating their external financial assets to offset outflows by foreigners. The nature of these domestic international investors varies by country. In Chile, the pension fund and the country's sovereign wealth fund were important. In Malaysia, the country's banks have played a big role.

5. Motives behind resilience. The emphasis on gross flows also allows a better understanding of why domestic investors may be repatriating assets at a time when foreign investors flee. One is consumption and investment smoothing by domestic agents in the face of temporary external shocks, as suggested by intertemporal models of the current account. Home bias of domestic investors in the face of a global shock like the one that hit EMEs this spring-summer recent would also lead domestic investors to repatriate assets. Information asymmetries may also lead to buying of domestic assets by investors with superior information. In sum, the stabilizing role of reserves, coupled with the greater flexibility of the exchange rate and strength of domestic financial institutions, which offset gross outflows, allowed Malaysia to weather this episode well, much as it had during the global financial crisis.

6. Malaysia's experience. Following the Asian financial crisis, Malaysia accumulated substantial foreign assets, and these played an important role in 2008–09 and more recent episodes, including in the spring-summer of 2013. Large domestic institutional investors have been investing abroad during periods of capital inflows. When foreign investors started selling Malaysian government securities and other domestic assets, these deep-pocketed domestic investors stepped in to offset sales by foreigners, thus helping to reduce the impact of the outflows on yields. This reality is reflected in the WEO analysis, where Malaysia belongs solidly to the group of resilient EMEs (its estimated regression coefficient is close to zero; Figure 7.1, panel 1). Malaysia scores high in most of these characteristics, even among the more resilient EMEs. It has a relatively flexible exchange rate regime (Figure 7.1, panel 2), low inflation (Figure 7.1, panel 3), countercyclical fiscal policy (Figure 7.1, panel 4), good institutions (Figure 7.1, panel 5), high net international investment

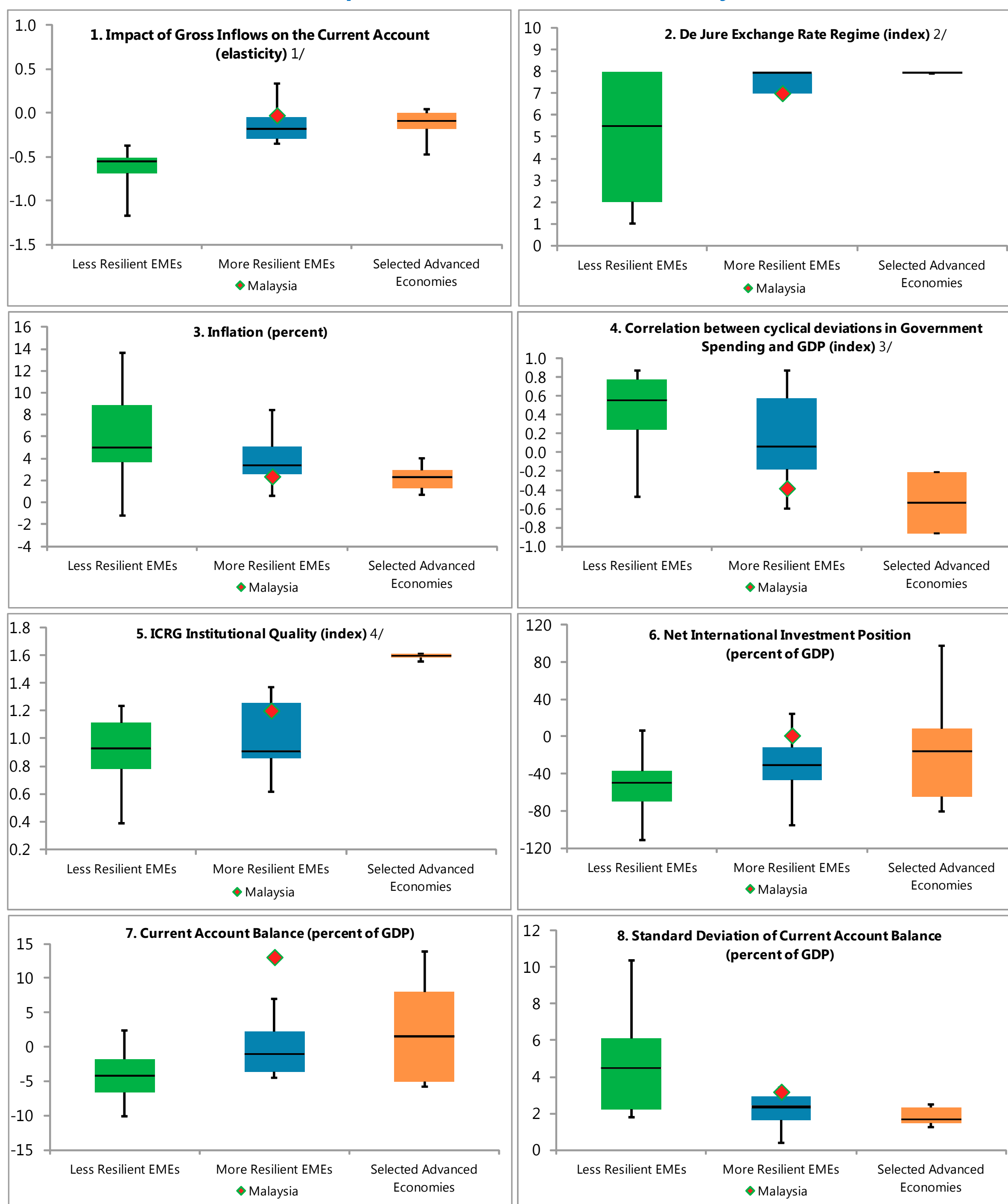
position (Figure 7.1, panel 6) and a high and stable current account balance (Figure 7.1, panels 7 and 8). Additional evidence comes from the latest outflow episode, in spring-summer 2013. As described in the main text, outflows by foreign residents did affect interest rates on Malaysian government securities, the exchange rate depreciated, and BNM intervened in foreign exchange markets, but the effects of outflows on Malaysia's real economy were muted compared with the experience of other, less resilient EMEs.

7. Malaysia's financial system. Malaysia's efforts to improve its financial system and make it more resilient following the Asian Financial Crisis have paid dividends. As explained in Malaysia's 2012 IMF-World Bank *Financial Sector Stability Assessment*, following the Asian Financial Crisis (AFC), the Malaysian authorities embarked on a decade-long program of financial sector reforms. Existing banks were strengthened, deregulation, liberalization and entry of new players all promoted competition in banking. Outside of banking, domestic equity and bond markets were nurtured, and financial regulation and supervision was strengthened. Malaysia's financial system has substantial strengths. Reforms in Malaysia's financial sector following the AFC were accompanied by a gradual easing of restrictions on capital flows. Initially, outflows were dominated by official reserves being accumulated under the fixed exchange rate regime. When Malaysia moved to a managed float in 2005, it also liberalized restrictions on international transactions. Accumulation of foreign assets by private entities rose dramatically during 2005–09 as nonfinancial and financial entities sought opportunities abroad and expanded foreign direct investment. The increase in gross private outflows contributed to a considerable improvement in Malaysia's net foreign asset position.

8. Growing resilience. The accumulation of foreign assets has played an important role in reducing the volatility of net flows. During the global financial crisis, the reduction in capital inflows was largely offset by sales of foreign reserves and the repatriation of domestic capital invested abroad. Large sales of domestic bonds by foreign investors were absorbed with minimal impacts on domestic yields. The stabilizing role of reserves and private outflows, coupled with the greater flexibility of the exchange rate and strength of domestic financial institutions, allowed Malaysia to weather the global financial crisis much better than during the crisis of the late 1990s, despite the larger reduction in gross capital inflows. Malaysia's resilience to swings in capital flows has also been facilitated by fiscal policy, which has become much more countercyclical during the 2000s, especially by providing fiscal stimulus during downturns.

9. Strengthening resilience further. Comparisons with other EMEs and AEs that exhibit substantial resilience to capital flow volatility, including Chile, Australia and New Zealand, contain lessons for ways in which Malaysia can further increase the extent of its resilience to volatile capital flows. In these AEs, for example, foreign exchange intervention is rare, which discourages one-way bets on the exchange rate and helps improve the buffering behavior of private domestic resident capital outflows; and, as discussed in the main text, Malaysia can do more to increase the size of its fiscal buffers, which have diminished following its effective countercyclical responses during the global financial crisis. In addition, Malaysia's institutional characteristics are still well below the levels in advanced economies. Improving in all these areas would greatly contribute to further enhance Malaysia's already considerable resilience to international capital flow volatility.

Figure 7.1. The Yin and Yang of Capital Flow Management: Balancing Capital Inflows with Capital Outflows—The Case of Malaysia



1/ Regression coefficient of the currect account as percent of GDP on gross capital inflows as percent of GDP.

2/ IMF AREAER exchange rate regime index, where 1 is the hardest peg and 8 is free floating.

3/ Bound between -1 and 1.

4/ ICRG Institutional quality indez, bound between 0 and 1.75.

Source: World Economic Outlook, Chapter 4, October 2013.

Appendix 9. Malaysia—Transformation Plans to Boost Growth and Inclusion

1. Malaysia has made substantial progress to strengthen the quality of economic growth and inclusiveness. Starting in 1969, the New Economic Policy (NEP) pursued growth, the creation of employment opportunities and income redistribution. More recently, these objectives have been further elaborated in a series of multiyear transformation programs.

- **The Government Transformation Program (GTP)**, launched in late 2009, aims to improve public service delivery, raise transparency and enhance collaboration among public entities. The GTP has achieved some good results, seen in new assistance reaching more than a quarter of the hardcore poor, declining crime indices, online publication of government contracts, and enhancements being put in place for pre-school and primary education. Malaysia has become a much more attractive country to do business.

- **The New Economic Model (NEM)** was unveiled in March 2010. It aims to transform Malaysia into an innovative, knowledge intensive, and high-income economy by 2020. The NEM identifies strategic reform areas that include enhancing private sector participation in the economy, improving workforce skills, supporting innovation, developing new sources of growth, and strengthening public sector management.

- **The Tenth Malaysia Plan (10MP)**, released in June 2010, provides the policy framework for implementing the NEM's strategic suggestions in 2011−2015. It aims to sustain annual GDP growth at 6 percent and to bring gradually down the budget deficit to 3 percent of GDP by 2015. Microeconomic objectives include a competition law, further liberalization of services, divestment of public enterprises, market prices for subsidized commodities, an innovation friendly environment, and reduced dependence on foreign labor.

- **The Economic Transformation Program (ETP)**, launched in October 2010, builds on the NEM and is part of a wider development agenda for Malaysia to become a high-income economy that is both inclusive and sustainable by 2020. The ETP builds on the strategy outlined in 10MP and specifies more concrete policy actions. In particular, the ETP: (1) focuses on the 12 key growth engines, (2) encourages private sector investment, and (3) introduces 131 entry point projects (EPPs) to jump start the program. In the 2011 Article IV consultation, the staff found that out of 131 EPPs, 113 projects with a total value of RM 177 billion had been announced, concentrated mainly in infrastructure, commodity related investments and construction.

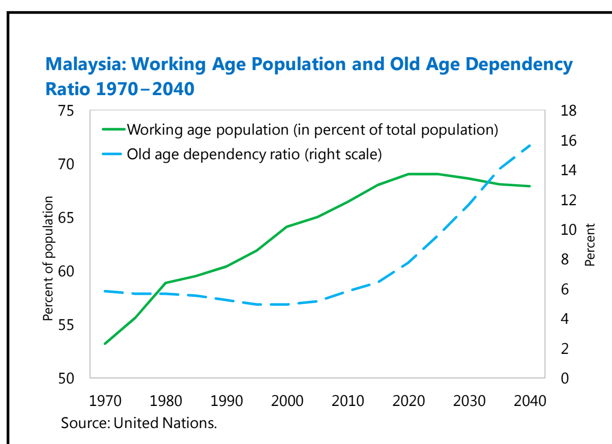
- **Malaysia Financial Sector Blueprint 2011−2020** was introduced by BNM. It lays out the vision to develop the financial sector that keeps pace with Malaysia's transition to the high-income status, as well as the growing financial needs of emerging Asia. It aims to: promote effective financial intermediation for a high-income country; develop deep and dynamic financial markets; enhance financial inclusion; strengthen regional and international financial integration; further strengthen regulatory and supervisory regimes; and raise risk management standards, and internationalize Islamic finance; promote electronic payments for greater economic efficiency; and empower consumers and develop talent to support a more dynamic financial sector.

2. Boosting growth. A key objective of these transformation programs and policies is to help Malaysia avoid a middle income trap, by fostering technological readiness (including better access to broadband internet) and injecting greater competition in product markets. Large-scale projects under the ETP are boosting Malaysia's infrastructure and helping to expand and rejuvenate strategic sectors (such as oil and gas). Recently, these efforts have helped catalyze private investment, which had declined significantly following the Asian financial crisis. 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. Malaysia is on its way to becoming a high-income country by 2020.

3. Strengthening Labor Policies and Institutions in the face of heightened international demand (and competition) for talent and dramatic demographic change in the coming decades is another key objective of Malaysia's transformation programs and policies:

4. Education. Wages and living standards are closely related to the length and quality of schooling. Malaysia has made important progress in raising school enrollment: secondary net enrollment has risen sharply to 68 percent in 2009 (up from 32.7 percent in 1970). Enrollment in tertiary education, which enjoyed a 10-fold increase since 1980, leads to a large wage premium of more than 50 percent. Despite these gains, Malaysia needs to do more: enrollment ratios must be further raised in order to increase the supply of skilled labor, meet the requirements of an innovation-led economy, and close the gap with OECD levels. Among the priorities are to expand access to tertiary education and availability of financing among under-served groups. Quality control in private universities and retaining Malaysian-grown talent in the domestic economy are also important. (World Bank, 2012). More work is also needed to improve educational attainment (what students actually know), at the basic and secondary level. Here the approach taken (see Malaysian *Education Blueprint* 2013–25) aims to put Malaysian students at the top third of international assessments and to transform the Ministry of Education. The key in this area, as in all others, will be sustained implementation.

5. Pensions. Malaysia's population of 29 million (mid-2012 estimate) has been growing at about 1.9 percent a year in the 2000s, compared to 2.7 percent in the 1990s. Fertility has been falling and the share of working age population (15–64) has been increasing, but the old age dependency ratio will start rising after 2020, which could pose economic and fiscal challenges. Malaysia recently introduced a Private Retirement Scheme (PRS), which helps supplement the government-mandated Employees Provident Fund (EPF).



Source: United Nations.

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.

6. Minimum wage. A minimum wage was introduced on January 2013, aimed at boosting wages of low-skilled workers and enhancing productivity. Initial indications are that the minimum wage will have a limited impact on inflation and unemployment, and should therefore help improve the incomes of the poor. The minimum wage should provide incentives for affected firms to shift to more capital-intensive production technologies and gradually raise their capital-labor ratios. Together with complementary reforms to improve the business climate, it could lead to higher productivity. The minimum wage is set at a relatively high level (50 percent of the mean wage in Peninsular Malaysia), but flexibility in its implementation and the low share of labor costs in Malaysia could offset its impact on employment. Firms were given (limited) time to adjust: micro and small and medium-sized firms were given six months, while migrant workers were exempted for a year. Consideration could have been given to granting more regional dispersion.

7. Female labor force participation. At 49.5 percent, the participation of women in the labor force is low by regional standards. Raising it is both quantitatively important from a growth accounting perspective and also helps promote gender equity and intra-family income distribution. The World Bank estimates that raising Malaysia's female labor participation by 11 percentage points to 57 percent during 2000–2010 would have boosted growth by around 0.4 percentage points per year (*Malaysia Economic Monitor*, October 2012.) Malaysia plans to boost this rate to 55 percent by 2015. Legal reforms and incentives are in train to establish childcare facilities, employ and train women after career breaks, and promote flexible work arrangements.

8. Strengthening social protection. Other dimensions of social protection need to be further developed. Labor redundancy costs are high (Malaysia is ranked 108th out of 144 countries in this area in the World Economic Forum's *Global Competitiveness Report*). Additional measures needed, 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.

9. Outward orientation. Policy choices in Malaysia are made following extensive debate and consultation internally and also after considerable input with international advisors and consultants. IMF, World Bank, the Asian Development Bank, the International Labor Office and other international organizations regularly provide technical input to the government in their fields of expertise. The recently completed Financial Sector Assistance Program (FSAP), jointly conducted with the IMF and the World Bank, provides a timely example. The FSAP confirmed the strong financial position of Malaysian financial institutions and its sound supervisory and regulatory frameworks, following extensive reform and consolidation in the period after 1997–98. In the public finances, areas of interest over the years include tax and expenditure reforms. Malaysia is a provider of technical services of its own, contributing to international development efforts of other countries.

The South-East Asia Center for Economic Research and Training (SEACEN), based in Kuala Lumpur, has been providing training services to officials of over 80 countries since the early 1980s.

10. The future. Malaysia has set itself the goal of becoming, by 2020, a high-income nation, one in which prosperity is broadly shared. This will require continuous transformation in Malaysia's economy and government. It is useful to ask what separates Malaysia from advanced countries like Korea. Using the growth accounting approach, Gylfason and Hochreiter (2008) provided a simple decomposition of differences in per capita income. Output per worker depends on endowments of human and physical capital and endowments of infrastructure and institutions. Compare, for instance, Malaysia with Korea. Roughly speaking, output per capita in Korea is 2.6 times that of Malaysia. Korea's capital-output ratio is 20 percent greater than Malaysia's, while Korea's human capital (as measured by average school years per worker) is 13.95 for Korea and 11.42 for Malaysia. Differences in institutions explain about half of the gap in output per worker in Korea and Malaysia; differences in education (human capital) explain about 30 percent, and differences in capital per worker explain the remaining 20 percent.

11. Conclusion. The comparison between Korea and Malaysia highlights several priorities for Malaysia. One is the need for Malaysia to push through with the transformation of its education system to ensure that graduates have the upgraded skills needed in an innovation-based economy. Reforming the education system to raise attainment level closer to international standards constitutes very good benchmarking. Second, Malaysia needs to modernize and upgrade infrastructure systems and networks and further simplify regulatory regimes to spur innovation and reward investment in skills. The Malaysian authorities are on the right track here—they have identified a wide range of structural reforms to boost investment, raise productivity, improve the effectiveness of education and enhance social insurance and protection. The minimum wage policy and the other reforms being debated, including unemployment insurance, should go a long way to insure workers from risk. Malaysia will also need to reform public spending to make it more equitable. Better targeting of public expenditure in the context of a tighter fiscal envelope in the coming years will be a priority, including the reform of costly fuel subsidies and the introduction of conditional cash transfers.

INTERNATIONAL MONETARY FUND

MALAYSIA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 14, 2014

Prepared By | Asia and Pacific Department

CONTENTS

FUND RELATIONS ____ 2

STATISTICAL ISSUES ____ 5

FUND RELATIONS

(As of January 31, 2014)

Membership Status: Joined March 7, 1958; Article VIII

General Resources Account

	SDR Millions	Percent of Quota
Quota	1,773.90	100.00
Fund holdings of currency (exchange rate)	1,186.97	66.91
Reserve tranche position	586.93	33.09
Lending to the Fund		
New Arrangement to Borrow	42.52	

SDR Department

	SDR Millions	Percent of Allocation
Net cumulative allocation	1,346.14	100.00
Holdings	1,286.16	95.54

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to the Fund: None.

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).

Article IV Consultation:

Malaysia is on the standard 12-month consultation cycle. Discussions for the 2012 Article IV consultation took place during November 29-December 12, 2012 (IMF Country Report No. 13/51). Staff discussions for the 2013 Article IV consultation were conducted on a mission to Kuala Lumpur during December 5–16, 2013. In addition, a staff visit took place during July 9−12, 2013.

FSAP Participation:

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

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.

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).

Resident Representative/Advisor: None.

STATISTICAL ISSUES

(As of January 10, 2014)

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 3, 2014)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	1/3/2014	1/3/2014	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	12/13/2013	12/20/2013	Bi W	Bi W	Bi W
Reserve/base money	12/13/2013	12/20/2013	Bi W	Bi W	Bi W
Broad money	11/13	12/31/2013	M	M	M
Central bank balance sheet	12/13/2013	12/20/2013	Bi W	Bi W	Bi W
Consolidated balance sheet of the banking system	11/13	12/31/2013	M	M	M
Interest rates[2]	1/3/2014	1/3/2014	D	D	D
Consumer price index	11/13	12/13	M	M	M
Revenue, expenditure, balance and composition of financing[3]—general government[4]	2012	2013	A	A	A
Revenue, expenditure, balance and composition of financing[3]—federal government	2013:Q3	12/13	Q	Q	Q
Stocks of central government and central government guaranteed debt[5]	2013:Q3	12/13	Q	Q	Q
External current account balance	2013:Q3	12/13	Q	Q	Q
Exports and imports of goods and services	10/13	01/14	M	M	M
GDP/GNP	2013:Q3	12/13	Q	Q	Q
Gross external debt	2013:Q3	12/13	Q	Q	Q
International Investment Position	2012	01/14	A	A	A

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

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

IMF Executive Board Concludes 2013 Article IV Consultation with Malaysia

On March 7, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Malaysia.

Malaysia's growth moderated but registered a healthy 4.7 percent in 2013, and inflation remained low. Activity was supported by strong investment, still-vigorous consumption and, in the face of much needed fiscal tightening in the second half of the year, by improved foreign demand. The momentum should continue in 2014, supported by a long pipeline of multiyear investment projects, consumption underpinned by strong labor markets and supportive, albeit gradually tightening, domestic financial conditions. Together with an improved external environment, these trends should offset mild headwinds from fiscal consolidation.

Amidst capital outflows from emerging market economies and concerns about Malaysia's relatively high federal debt, the authorities undertook a timely, decisive yet gradual recalibration of their fiscal policies in 2013. In addition to strengthening the sustainability of Malaysia's public finances, the authorities aim to promote efficiency, equity and growth in their revenue and expenditure systems and are taking steps to minimize the drag to the economy from fiscal consolidation. Their plans to rationalize fuel subsidies are appropriately measured, they have allowed sufficient preparation time for the introduction of the GST, and are strengthening their social safety nets. Last, but not least, the management of fiscal policy has been reinforced by the

[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.

creation of a high level Fiscal Policy Committee—a powerful new player in Malaysia's fiscal process.

Bank Negara Malaysia (BNM) has been focused on its growth objective in recent years, maintaining an accommodative monetary stance that is consistent with its dual mandate and appropriate in view of substantial downside risks to growth and subdued inflation, at 2.1 percent in 2013. Going forward, monetary policy makers must contend with somewhat higher headline inflation in 2014−15 as fuel, electricity and other administered prices gradually rise and the GST is implemented. BNM is well positioned to prevent second round effects from higher costs to prices from becoming embedded in the wage-price structure. Timely detection and decisive preemption, through gradual, well communicated, and credible interest rate action, will be needed.

Malaysia's financial system is sound, backed by a strong regulatory and supervisory framework, and well-placed to withstand stresses, including from a potentially bumpy exit from UMPs—as demonstrated most recently during the capital outflow episode of last spring-summer. Nevertheless, the potential for risk on-risk off cycles together with high household debt and rising house prices all warrant continued vigilance. Recent steps to strengthen financial supervision, including the Financial Services Act and the Islamic Financial Services Acts, and the targeted and phased approach to macroprudential policy, are welcome. The authorities are monitoring property prices and credit growth closely and stand ready to act with additional macroprudential measures as needed.

The authorities are implementing a wide range of multiyear transformation programs and blueprints to strengthen growth and make it more inclusive, and Malaysia has made important progress in human capital accumulation. The authorities are intent on reforming Malaysia's educational system, reduce shortages of high-skill workers, and alleviate skill mismatches, which are important in raising potential growth and promoting equity within and across generations.

Executive Board Assessment[2]

Executive Directors noted that near term growth prospects for the Malaysian economy are favorable but exposed to risks from tighter global financial conditions and slower growth in major trading partners. Directors agreed that Malaysia is well positioned to cope with the uncertain external environment, noting the authorities' skillful management during past periods of market turbulence, healthy reserves, the flexible exchange rate regime, and deep capital markets.

Directors supported the authorities' recalibration of fiscal policy aimed at reducing federal debt and rebuilding buffers. They welcomed the creation of the high level Fiscal Policy Committee and the plan to reduce subsidies gradually. Directors underscored the importance of improvements in targeting social transfers, restraining wage growth, and broadening the tax base, including through the planned introduction of the Goods and Services Tax (GST) and greater reliance on property taxes. These reforms should help secure the sustainability of Malaysia's public finances while promoting efficiency, equity, and growth objectives. Directors recommended formulating a credible concrete plan, underpinned by a debt target for 2020, to anchor consolidation efforts and reduce dependence on oil revenues in the face of rising age related spending. Fiscal risks from contingent liabilities also warrant close attention.

Directors agreed that the monetary policy stance is appropriately accommodative, and that the central bank's credibility should help maintain price stability. They encouraged the authorities to remain vigilant to inflationary pressures and stand ready to adjust their policy rates if subsidy rationalization and the introduction of GST lead to higher sustained headline inflation.

Directors noted that Malaysia's financial system remains sound, well capitalized, and resilient, thanks to a strengthened regulatory and supervisory framework. They also acknowledged the significant progress made in implementing the recommendations of the Financial Sector Assessment Program. Directors highlighted nevertheless that ongoing global volatility, high household debt, and banks' exposure to real estate warrant continued vigilance, and may require additional macroprudential measures.

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

Directors welcomed the substantial narrowing of Malaysia's current account surplus in recent years and the attendant shift of the sources of growth toward domestic demand. They agreed that increased social spending related to population aging, and structural reforms to strengthen social safety nets and boost investment, combined with continued exchange rate flexibility, should help facilitate further external rebalancing. Directors took note of the staff's assessment that the external position appears to be moderately stronger than the level implied by medium term fundamentals but stressed the uncertainty surrounding such assessment.

Directors commended the authorities for their ambitious reform agenda, which aims to transform Malaysia into a high income economy. They supported initiatives to upgrade human capital and promote inclusiveness, stressing in this regard that priority should remain on improving education and labor skills.

Malaysia: Selected Economic and Financial Indicators, 2009–14

	2009	2010	2011	2012	Est. 2013	Proj. 2014
Real GDP (percent change)	-1.5	7.4	5.1	5.6	4.7	5.0
Total domestic demand	-1.6	11.1	6.8	11.3	7.3	3.8
Saving and investment (in percent of GDP)						
Gross domestic investment	17.8	23.3	23.3	25.8	26.3	27.1
Gross national saving	33.4	34.2	34.9	31.9	30.1	31.4
Fiscal sector (in percent of GDP)						
Federal government overall balance 1/	-6.7	-5.3	-4.8	-5.2	-4.3	-3.3
Revenue	21.7	19.9	21.0	21.3	21.8	21.1
Expenditure and net lending	28.4	25.2	25.7	26.6	26.1	24.4
Federal government non-oil primary balance	-13.7	-10.4	-10.3	-10.6	-8.9	-7.5
Consolidated public sector overall balance 2/	-7.2	-2.6	-3.4	-5.2	-6.8	-6.5
General government debt	52.8	53.5	54.3	54.6	56.8	55.2
Inflation and unemployment (period average, in percent)						
CPI inflation (period average)	0.6	1.7	3.2	1.7	2.1	3.3
Unemployment rate	3.7	3.3	3.1	3.0	3.1	3.0
Money and credit (end of period, percentage change)						
Total liquidity (M3)	9.2	6.8	14.3	9.0	6.7	…
Credit to private sector	6.2	9.7	12.1	11.9	9.1	…
Three-month interbank rate (in percent)	2.2	3.0	3.2	3.2	3.2	…
Balance of payments (in billions of U.S. dollars)						
Current account balance	31.4	27.1	33.5	18.6	11.8	14.5
(In percent of GDP)	15.5	10.9	11.6	6.1	3.8	4.2
Capital and financial account balance	-22.8	-6.2	7.6	-7.4	-4.8	-7.5
Errors and omissions	-4.7	-21.7	-10.1	-9.9	-2.4	0.0
Overall balance	3.9	-0.8	30.9	1.3	4.6	7.0
Gross official reserves (US$ billions)	96.7	106.5	133.6	139.7	134.9	141.9
(In months of following year's imports)	6.1	5.9	7.0	7.2	6.9	7.2
(In percent of short-term debt) 3/	250.4	207.3	230.3	259.5	239.2	240.9
Total external debt (US$ billions)	68.0	74.1	81.1	82.7	89.2	96.2
(In percent of GDP)	33.6	29.9	28.1	27.1	28.6	28.1
Of which: short-term (in percent of total) 3/	56.8	69.3	71.5	65.2	63.2	61.3
Debt service ratio						
(In percent of exports of goods and services)	6.6	7.8	10.2	10.1	9.7	9.4
(In percent of exports of goods and nonfactor services)	7.0	8.2	10.8	10.7	10.2	10.0
Memorandum items:						
Nominal GDP (in billions of US$)	202	248	289	305	312	342

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

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

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

3/ By remaining maturity.

Statement by Abdul Ghaffour, Alternate Executive Director for Malaysia and Mohd Ripin, Advisor to Executive Director
March 7, 2014

1. On behalf of the 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 further encouraged by the assessment that the current policy stance is appropriately calibrated to reflect the outlook and risks facing the economy and the financial system. This statement will provide an update on the latest developments in Malaysia and elaborate on selected policy issues mainly for emphasis and clarification.

Economic Outlook for 2014

2. In September 2013, the authorities projected the Malaysian economy to expand between 5% and 5.5% in 2014, underpinned by resilient private domestic demand. Staff estimates are in line with this assessment. Of significance, private investment is expected to remain robust, supported by capital spending in the manufacturing and services sectors as well as on-going implementation of multi-year projects, including infrastructure-related projects. Private consumption will continue to be supported by sustained growth in income and favourable employment conditions. Reflecting the on-going public sector consolidation, the public sector growth is anticipated to moderate slightly but will remain supportive of growth. The gradual improvement in the external sector will provide additional impetus to the economy.

Monetary Policy

3. The current monetary policy stance is appropriate and consistent with the current assessment of the economic growth and inflation prospects. The authorities remain vigilant in monitoring risks to inflation including those arising from the subsidy rationalisation. Nevertheless, the risk of more pervasive and persistent inflation at this point is assessed to be not very significant. Going forward, in addition to domestic conditions, BNM will continue to carefully evaluate the global economic and financial developments and their implications on the overall outlook for inflation and growth of the Malaysian economy. The Malaysian authorities remain focused on ensuring medium-term price stability and ensuring a sustainable and balanced growth of the economy.

Fiscal Policy

4. The conduct of fiscal policy in 2014 continues to be centered on ensuring sound public finances while remaining supportive of policies for a sustainable and balanced economic growth. Supported by a resilient expansion in domestic demand, improving external sector as well as better expenditure and revenue management, the fiscal deficit is expected to further decline from 3.9% in 2013 to 3.5% of GDP in 2014. The Federal Government debt-to-GDP ratio will be contained within 55% of GDP.

5. The Malaysian authorities are committed to strengthening public finances. The establishment of the high-level Fiscal Policy Committee (FPC) in June 2013 is a testament to political commitment at the highest level. The FPC, chaired by the Prime Minister, will oversee the fiscal management of the nation. Its mandate includes charting policies and strategies to ensure healthy public finances over the longer term in line with the country's economic aspirations. The FPC has since met several times to consider various policy proposals. Fiscal reforms and a more strategic management of resources will be judiciously pursued on several fronts without undermining economic growth and the wellbeing of the population, in particular, the low-income and vulnerable groups. Subsidy rationalisation for fuel, sugar and electricity tariff has been implemented as part of a phased approach to improve resource allocation, minimise market distortions and reduce the fiscal burden of the Government. GST is on target to be introduced in April, 2015. The move is expected to streamline the present tax structure to make it more efficient, transparent and business friendly. Work is also underway to implement a comprehensive social safety net and develop an integrated database of all aid recipients to ensure targeted assistance across the public sector. Other initiatives to enhance fiscal sustainability include a review of fiscal incentives to industry, implementation of accrual accounting at the Federal level (2015) and the adoption of outcome based budgeting (2015). Apart from embracing fiscal reforms to fortify the Government's financial position, fiscal resources will be geared towards reinvigorating high value-added investments, intensifying development of human capital and enhancing public sector delivery.

Financial Sector

6. Financial stability continued to be preserved in 2013 supported by financial strength and capital buffers both at the system and institutional levels. Internal and IMF stress tests have demonstrated that the banking system is resilient to major economic and market shocks. Risk to domestic financial stability arising from household indebtedness in Malaysia remains manageable, supported by strong household fundamentals and financial capacity. Continued supervisory vigilance over risk management and underwriting practices of financial institutions and intensified financial education initiatives will further contain potential risks from household indebtedness.

7. The Central Bank has also undertaken additional macroprudential measures in 2013 to reinforce responsible lending practices by key credit providers. Among others, these include:

– Limiting the maximum tenure for personal financing to 10 years and loans for purchase of residential and non-residential properties to 35 years, applicable to both banks and non-bank financial institutions.
– Prohibiting the offering of pre-approved personal financing products.
– Requiring credit providers to observe a prudent debt service ratio in their credit assessment to ensure that there are sufficient financial buffers to protect households against rising costs and unexpected adverse events.

8. These measures have begun to show positive results, as evidenced by the substantial decline in the growth of personal financing extended by non-bank financial institutions. These

initiatives were also complemented by additional measures announced in the 2014 Budget to curb speculative property purchases which contribute to rising property prices and higher household debt burdens. These measures include further increases in the property gains tax, prohibition on the development and financing (both bridging and end-financing) of property projects with elements of interest capitalization schemes (including Developer Interest Bearing Scheme (DIBS)), requirement on greater transparency in property prices by developers and raising the threshold of property purchases by non-residents. Moving forward, BNM is taking steps to capture more granular data on households in collaboration with several Government agencies. The newly established National Housing Council by the Government is an important platform that will ensure a more holistic and coordinated approach in efforts to address structural issues confronting the residential property market. Corporate sector leverage remained well-contained despite a gradual increase in the overall debt level of businesses in recent years in tandem with economic expansion. The higher leverage is supported by sustained financial strength and debt servicing capacity of businesses that will continue to provide support against potential challenges in the operating environment. Given these developments, BNM will continue to focus its surveillance and supervisory vigilance over developments taking place in the household, business and property sectors, and stands ready to introduce additional measures to prevent the buildup of excesses in these sectors.

9. The regulatory and supervisory framework for the financial sector was further strengthened with the coming into force of the Financial Services Act 2013 (FSA) and Islamic Financial Services Act 2013 (IFSA) on 30 June 2013. This ensures that laws governing the conduct and supervision of financial institutions in Malaysia continue to be relevant and effective in maintaining financial stability, supporting a sustainable, balanced and inclusive growth of the economy, as well as providing adequate protection for consumers. The laws further strengthen BNM's supervisory and regulatory powers, including comprehensive powers to carry out consolidated supervision of financial groups and to extend the regulatory perimeter to systemically important non-bank entities that undertake financial intermediation activities.

Reforms to Enhance Growth Potential

10. Reform initiatives to accelerate Malaysia's transformation into a high-income economy by 2020 have also made further progress. Under the Economic Transformation Programme, total announced investments have amounted to USD66.8 billion (RM219.3 billion). These investments will increase Malaysia's productive capacity and competiveness over the medium term. Various workplace transformation initiatives have also been undertaken by the Government, focused on modernizing labour laws in line with the needs of a high-income economy. This includes raising the private sector minimum retirement age from 55 to 60 years to retain experienced and knowledge workers, and pave the way for higher productivity. In addition, the minimum wage policy was implemented in 2013 to improve worker's welfare and incentivize firms to move up the value chain. In the long run, the minimum wage is expected to contribute positively to productivity, mainly through higher automation and training. The education system has also been enhanced through the introduction of the National Education Blueprint 2013-2015. Improvements in the access, quality, equity, unity and efficiency of the

education will help facilitate human capital accumulation that is in line with the transition of the economy toward higher value-added activities.

External Sector Assessment

11. In our authorities' assessment, the external sector development in Malaysia reflects the changing global environment and on-going structural transformation of the domestic economy. The current account has narrowed in recent years as the robust import growth continued to outpace exports. Exports remained modest following the gradual recovery in the global economy and lower commodity prices. At the same time, import growth was driven by strong domestic demand, particularly the expansion of investment activity. Malaysia has also experienced greater two-way capital flows in view of its increasing integration with the global economy and financial markets. Importantly, these flows have been effectively intermediated by the financial system, supported by a well-developed capital market and the presence of a large domestic institutional investor base. Greater exchange rate flexibility and the availability of a wide range of monetary instruments also accorded authorities the policy flexibility to absorb external shocks. This is further reinforced by Malaysia's healthy level of international reserve, a prudent external debt position and a stronger financial system. As such, the resilience of Malaysia's external position remains intact despite heightened uncertainty in the global economic environment. Consequently, despite a sharp reversal of inflows from the region, including Malaysia, in the recent period, orderly market conditions prevailed and the impact on the domestic economy was rather muted.

Final Remarks

12. As Malaysia continues to embark on growth-enhancing reforms, the authorities remain vigilant of the downside risks posed by the challenging external environment. As a highly open economy, Malaysia is not insulated from the risks emanating from the uncertain global economic landscape. Nevertheless, the country's underlying fundamentals remain robust, creating resilience against potential vulnerabilities. The strong external position accords policy flexibility to absorb external shocks. Greater regional cooperation and policy coordination through collaborative surveillance efforts, bilateral swap agreements between regional central banks, and the Chiang Mai Initiative Multilateralisation liquidity support arrangement also provides Malaysia with buffers against potential shocks. The authorities will monitor closely developments in the external environment and will respond appropriately.

13. Finally, the authorities are pleased to inform the Executive Board that they agree to the publication of the full suite of reports associated with the 2013 Article IV consultation.