

Malaysia

A robust recovery last year was driven by stronger domestic demand and a recovery in exports. Domestic demand is expected to stabilize and GDP growth will moderate in 2011. Inflation is forecast to rise from low levels, but remain contained. The official goal to reach high-income country status by 2020 rests on effective implementation of a landmark but intricate structural reform program launched in 2010.

Economic performance

Strong domestic demand and a recovery in merchandise exports drove a 7.2% rebound in GDP in 2010 (Figure 3.26.1), after the global recession had pushed the economy into a 1.7% contraction in 2009.

Private consumption rose by 6.6% in 2010, buoyed by positive consumer sentiment, favorable labor market conditions, and rising credit to households and businesses. Public consumption was flat, reflecting reductions in operational expenditure as part of the government's fiscal consolidation efforts, which resumed (after a recession-related hiatus) in 2010.

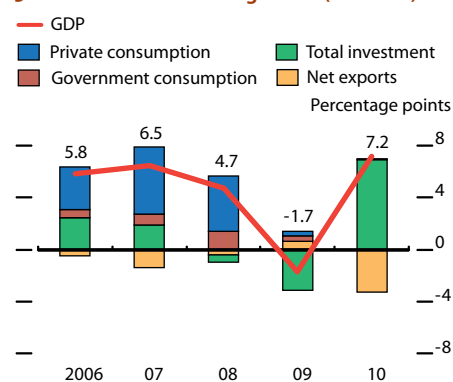
Investment, as measured by gross fixed capital formation and including public investment, surged by 9.4% and contributed most of the total growth in GDP last year. Private investment benefited from an expansion in production of domestically oriented manufacturing. The increase in exports of goods and services (9.8% in real terms) was more than offset by stronger growth of imports of goods and services (14.7%).

On the supply side, growth was supported by a relatively strong recovery in manufacturing output (11.4%) and by robust growth in services (6.8%) and construction (5.2%) (Figure 3.26.2). The recovery in manufacturing, which accounts for just over a quarter of total output, was driven by the strong growth in domestically oriented industries, notably those supplying construction and consumers. Export-oriented manufacturing was led by a surge in electrical and rubber products, and a more moderate expansion in chemical products.

Services, which account for 57% of GDP, experienced broad-based growth. The strongest gains were in real estate and business services, transport and storage, and wholesale and retail trade. Construction activity reflected a recovery in residential building, expansion in office and retail spaces, and progress in infrastructure projects. Agriculture, however, was subdued, as a rise in natural rubber production was largely offset by declines in crude palm oil and cocoa, while mining output was stagnant largely as a result of a 3.3% decline in crude oil production.

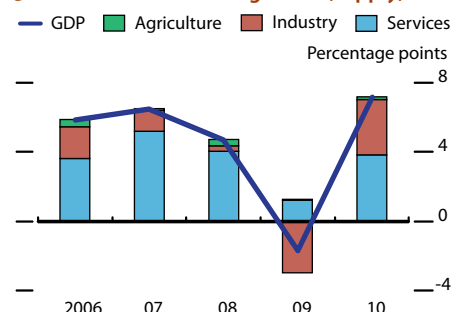
Inflation increased to average 1.7% in 2010, mainly owing to higher prices of food and drink and nondurable goods. Rising global commodity and energy prices lifted inflation to 2.4% year on year in January 2011 (Figure 3.26.3). An increase in the administered price of sugar in late 2010

3.26.1 Contributions to growth (demand)



Sources: Bank Negara Malaysia. 2011. *Monthly Statistical Bulletin*. January. <http://www.bnm.gov.my>; Department of Statistics Malaysia. <http://www.statistics.gov.my> (both accessed 16 March 2011).

3.26.2 Contributions to growth (supply)



Sources: Bank Negara Malaysia. 2011. *Monthly Statistical Bulletin*. January. <http://www.bnm.gov.my>; Department of Statistics Malaysia. <http://www.statistics.gov.my> (both accessed 16 March 2011).

contributed to inflation. Core inflation, which excludes the more volatile food and drinks, has been edging up steadily since February 2010.

Residential property prices rose quite sharply in 2010, with the house price index up by about 6% through end-September (the latest available data) reflecting higher prices in Kuala Lumpur and Selangor state.

As private sector demand rebounded, Bank Negara Malaysia, the central bank, unwound a good part of the monetary stimulus injected in 2009. It raised the overnight policy rate three times during March–July 2010, by a cumulative 75 basis points, to 2.75%, and kept it there through the rest of the year. The economy's output was still below its potential and there were no strong signs that rising inflation stemmed from demand pressures. Moreover, the appreciation of the ringgit against trading partner currencies, of around 10% in 2010, helped to damp imported inflation.

Labor market conditions generally mirrored the rebound in domestically generated economic activity. While the labor force increased by 2.2% in 2010, to 11.7 million, the number of people employed rose by 2.5%, to 11.3 million. The unemployment rate fell to 3.2% in December 2010, from 3.4% at end-2009.

In United States (US) dollar terms, total merchandise exports rebounded in 2010, by 26.4%, to \$198.6 billion (Figure 3.26.4)—following a contraction of 21.1% in 2009—recovering 2008's level of exports. Shipments of electrical and electronic products (40% of total exports), rose by 20%, and other manufactured exports by about 30%. Exports of petroleum products, palm oil, liquefied natural gas, and crude petroleum (together a quarter of total exports) recorded surges of 33%–44%. The top five export destinations—Singapore, the People's Republic of China, Japan, the United States, and Thailand (in that order)—represented just over half of total exports.

Imports rebounded faster than exports, surging by 33.6% to \$156.2 billion, more than offsetting the 21.0% contraction in 2009. Imports of intermediate goods, which account for over two-thirds of the total, rose by about 34%. The trade surplus of \$42 billion remained broadly unchanged from 2009 in US dollar terms.

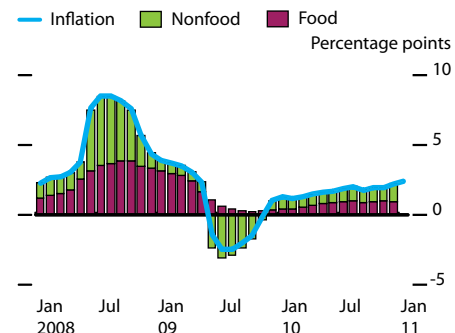
Higher payments for transport and other services linked to the initial sharp pickup in trade caused the services account to deteriorate. Deficits on the income and transfers accounts widened, the latter owing to higher remittances from foreign workers in Malaysia. As a result of these moves, the current account surplus declined by 11.7% to \$28.1 billion, equivalent to 11.8% of GDP.

The capital and financial account deficit narrowed greatly, owing to lower net foreign direct investment (FDI) outflows, and a surge in portfolio inflows of \$14.0 billion (Figure 3.26.5), reflecting a strengthening ringgit and sharply higher equity inflows, mostly from Europe, into government securities, corporate bonds, and stocks.

Inward FDI climbed to \$8.6 billion, with a particularly steep rise in investment in services, while outward FDI surged to \$13.2 billion. Other capital outflows decreased slightly, on account of lower private capital outflows. International reserves at end-February 2011 were up to \$109.8 billion, sufficient to finance 8.1 months of retained imports and equivalent to 4.3 times short-term external debt.

Following an expansionary fiscal policy in 2009, consisting of two

3.26.3 Monthly contributions to inflation



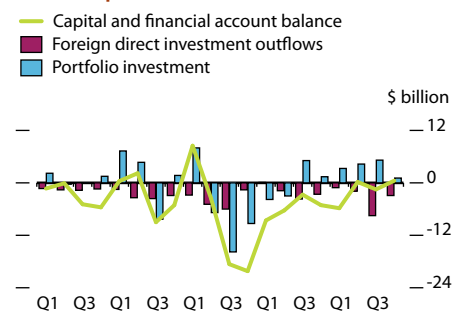
Sources: Bank Negara Malaysia. 2011. *Monthly Statistical Bulletin*. January. <http://www.bnm.gov.my>; Department of Statistics Malaysia. <http://www.statistics.gov.my> (both accessed 16 March 2011).

3.26.4 Trade growth



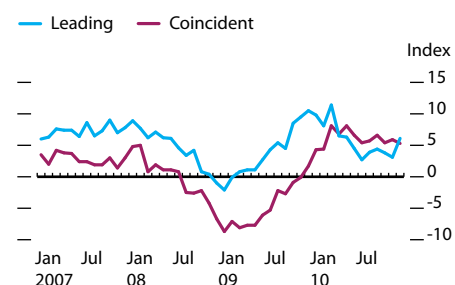
Source: CEIC Data Company (accessed 16 March 2011).

3.26.5 Capital account indicators



Source: CEIC Data Company (accessed 16 March 2011).

3.26.6 Growth of leading and coincident indexes



Source: CEIC Data Company (accessed 16 March 2011).

fiscal stimulus packages that widened the overall federal budget deficit to 7.0% of GDP, preliminary figures indicate that the deficit narrowed in 2010 to 5.6% of GDP, as budgeted. This outcome was achieved mostly through a modest increase in revenue and restrained operational spending.

By mid-2010, direct subsidies had risen to nearly 11% of federal government operating expenditure, with over half going for fuel subsidies. Moving to rein in this cost to the budget, three times in 2010 the government raised fuel prices (they are still lower than in neighboring countries) and sugar prices by just over 10%.

Reflecting the reduction in the federal budget deficit, the ratio of federal government debt to GDP declined from 54.0% in 2009 to 51.3% in 2010. Only 3.5% of the public debt was external.

Economic prospects

The outlook for the forecast period are predicated on two key assumptions (in addition to the *Asian Development Outlook 2011* baseline for the global economy). First, the surge in mostly short-term capital inflows stabilizes and does not generate inflation pressures. Second, the government can quickly start carrying out its structural reform program (Box 3.26.1), which will require not only effective horizontal coordination across line ministries and agencies but also vertical coordination between the federal and state governments.

On this basis—and against the backdrop of slowing growth in external demand from major industrial countries, continuing domestic fiscal consolidation, and dissipating base effects—GDP growth is projected to moderate to 5.3% in 2011.

Domestic demand is likely to be the key driver of growth, reflecting broadly positive consumer and investor sentiment. Net exports are expected to exert a continued (though lightening) drag as the rate of growth of imports of goods and services stabilizes following the rebound in 2010.

Private consumption is seen staying robust and benefiting from relatively favorable employment, good real wages in manufacturing, rising commodity prices, and the accommodative financing environment. Consumer sentiment, for example, rose in the fourth quarter of 2010.

Private investment is expected to pick up later in 2011—the Department of Statistics' leading index rose by 2.7% in December last year (Figure 3.26.6). With ample liquidity, private investment is seen gathering momentum as the government starts implementing its structural reforms.

Exports are projected to rise moderately in 2011, by 8.0%, as softer demand from Japan and the US is only partly compensated by more robust demand from Asia. Imports are foreseen to rise by 10.0%, reflecting continued imports of capital equipment and intermediate goods. The current account surplus is likely to decline further in 2011, to 10.0% of GDP. The capital and financial account deficit is set to shrink, on the back of healthy portfolio inflows and FDI, bringing about an increase in international reserves.

In 2012, growth is forecast to remain at 5.3%, as the projected modest rise in export growth is offset by the anticipated adverse impact on inflation and domestic demand stemming from increased global food prices this year. Also in 2012, higher capital imports associated with

3.26.1 Structural change

The goal of the structural reform program launched by the government in 2010 is to enable Malaysia to break free of a middle-income trap and reach high-income country status by 2020.

The intended structural sea-change is to be achieved by four main approaches:

- generating growth that is more inclusive and sustainable, through the implementation of eight “strategic reform initiatives” to ease constraints to higher private investment;
- implementing market-friendly affirmative action programs that target the bottom 40% of households, many of which are in Sabah and Sarawak;
- improving public service delivery while reducing large and persistent fiscal deficits stemming in part from high subsidies; and
- placing equal emphasis on protecting the environment and economic growth.

An Economic Transformation Program prepared with private sector input identifies about 130 projects that involve huge, primarily private, investment over 10 years. Another 60 projects have been identified for subsequent implementation.

The success of the structural transformation, the first phase of which begins under the recently endorsed Tenth Malaysia Plan 2011–2015, will be measured against set objectives and delivery of impacts over the next decade.

In the nearer term, the credibility of the program will be judged on how well strategic reform initiatives improve the investment environment, and how effectively the associated projects are implemented, as measured by consumer and investor sentiment and higher actual investment.

stronger private investment are likely to outweigh the rise in exports, and the current account surplus is expected to narrow to around 9.0% of GDP (Figure 3.26.7).

The 2011 budget aims for a slight reduction in the federal government deficit to 5.4% of GDP by reducing gross development expenditure by 9% in ringgit terms from the 2010 outturn.

Inflation is seen rising this year, mainly reflecting global increases in food and fuel prices and reductions in fuel subsidies domestically. Average inflation is put at 3.0% in 2011 and 2012 (Figure 3.26.8).

While the monetary stance remains accommodative, large shifts in global liquidity—including from potentially volatile portfolio inflows—are building liquidity in the domestic financial system. Bank Negara Malaysia, in a preemptive bid to help offset the risks of economic and financial imbalances arising from such a buildup, doubled the statutory reserve requirement of commercial banks to 2%, from 1 April this year. It had already indicated in March that it might need to raise interest rates if domestic demand rose and put upward pressure on prices.

The economy relies heavily on external markets, and the main downside external risk to the forecasts is a lower than expected recovery in demand from major industrial countries. The competitiveness of manufactured exports could be dented by further real appreciation of the ringgit.

Domestic risks center on any apparent lack of progress by the government's structural reform program, which includes steps to quickly improve the investment climate. Such perceptions could drag down investor sentiment, inhibiting the required increase in private investment.

Development challenges

Over three decades, Malaysia has largely eradicated poverty, built a world-class infrastructure, and become a major exporter. Yet the country is stuck in a middle-income trap—per capita gross national income was around \$7,350 in 2009—in which the strategies adopted to attain the current level are inadequate to take it to the next stage.

The ratio of private investment to GDP has stagnated at below 25% of GDP for a decade, compared with rates of over 30% of GDP in the mid-1990s, partly because doing business in Malaysia is still too difficult. The country is also losing its attractiveness as an investment destination, seen in its falling ranking in the Global Competitiveness Index—26 in 2010 (Figure 3.26.9).

Another vulnerability is that exports are heavily concentrated in electrical and electronic products—eventually destined for industrial-country markets where demand is volatile—and primary commodities (such as petroleum and palm oil) whose prices are volatile. Both types of export generate little value added and employ workers mainly of low-skills on low-wages. And although labor productivity is growing, it is doing so slowly, inhibiting creativity and innovation. Socially, the gap between rich and poor is widening.

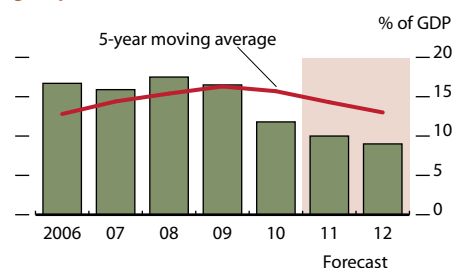
It is in this context that the government has embarked on its ambitious structural reform program (Box 3.26.1).

3.26.1 Selected economic indicators (%)

| | 2011 | 2012 |
|---|------|------|
| GDP growth | 5.3 | 5.3 |
| Inflation | 3.0 | 3.0 |
| Current account balance (share of GDP) | 10.0 | 9.0 |

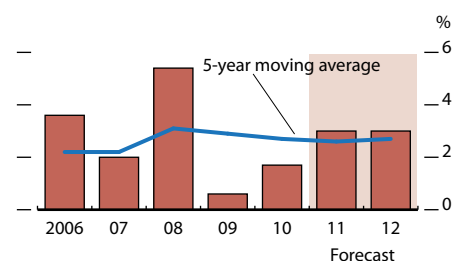
Source: ADB estimates.

3.26.7 Current account balance



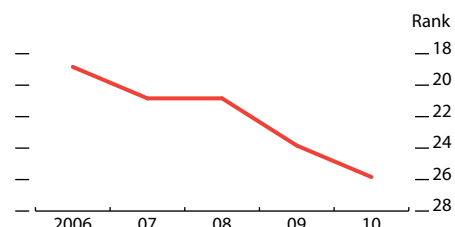
Sources: Asian Development Outlook database; ADB estimates.

3.26.8 Annual inflation



Sources: Asian Development Outlook database; ADB estimates.

3.26.9 Global competitiveness



Note: The Global Competitiveness Index covers 139 economies.

Source: World Economic Forum. *Global Competitiveness Report*. Various years. <http://www.weforum.org>