INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/71

MALAYSIA

March 2019

2019 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; 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 2019 Article IV consultation with Malaysia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 15, 2019 consideration of the staff report that concluded the Article IV consultation with Malaysia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 15, 2019, following discussions that ended on December 12, 2018, with the officials of Malaysia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 30, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Malaysia.

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

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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COMMUNICATIONS DEPARTMENT

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March 11, 2019

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

IMF Executive Board Concludes 2019 Article IV Consultation with Malaysia

On February 15, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the 2019 Article IV consultation[1] with Malaysia.

Malaysia's economy continues to perform well despite external headwinds. Growth has averaged above 5 percent over the past 5 years, leading to higher per capita income and reducing already-low poverty. Economic growth is now moderating, and is estimated at 4.7 percent in 2018, underpinned by robust domestic and external demand. Headline inflation dropped from an average of 3.7 percent in 2017 to an estimated 1 percent in 2018 as domestic fuel price adjustment was suspended, the GST was zero-rated and replaced by the narrower-base SST, and food price inflation declined. The credit-to-GDP ratio is declining. On the external side, the current account surplus is estimated at 2.2 percent of GDP in 2018, having gradually narrowed in recent years as growth drivers have shifted towards domestic demand.

Growth is expected to stabilize in 2019 and over the medium term, with inflation picking up and the current account surplus continuing to narrow. Domestic demand will remain the main driver of growth, with private consumption and investment supported by an improved business environment and investor confidence. This would counterbalance the negative drag from the external environment and fiscal consolidation, leaving growth flat at 4.7 percent in 2019 and close to potential (about 4¾ percent) over the medium term. Inflation would rise above 2 percent in 2019, as the effect of the GST removal dissipates and oil subsidies become targeted. Over the medium term, growth is expected to converge to potential and inflation will remain subdued.

Risks to the growth outlook are to the downside and stem largely from external factors. Malaysia's highly open economy is vulnerable to rising protectionism, weaker-than-expected growth in trading partners, or a significant slowdown in China. A sharp tightening of global financial conditions could cause financial stress, while lower-than-projected oil prices could reduce exports and growth. Domestically, contingent liabilities could necessitate additional

[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.

(continued…)

measures to ensure medium-term fiscal sustainability, while delays or resistance to the governance reform agenda could undermine confidence, leading to lower investment and growth.

Executive Board Assessment[2]

Executive Directors commended the authorities for the resilient performance of the Malaysian economy over recent years, noting that growth was solid, without signs of inflationary pressures. Directors concurred that, while the medium-term outlook remains favorable, risks are tilted to the downside stemming primarily from the external environment. They encouraged the authorities to continue implementing credible macroeconomic policies while safeguarding growth and financial stability, and undertaking structural reforms to boost sustainable, inclusive growth.

Directors agreed with the planned gradual pace of fiscal consolidation in 2019 and over the medium term to support debt reduction and strengthened fiscal buffers. They encouraged the authorities to embed the medium-term fiscal path in a strengthened fiscal framework that would rely on credible revenue and expenditure measures. Noting Malaysia's low tax revenue ratio, Directors emphasized that revenue mobilization should be a priority, not only to support medium-term consolidation, but also to help finance needed expenditure to achieve government priorities identified under the Mid-Term Review of the Eleventh Malaysia Plan. They welcomed continued efforts to increase fiscal transparency.

Directors supported the broadly neutral monetary policy stance. Going forward, domestic economic and financial conditions should continue to guide monetary policy decisions, with exchange rate flexibility the first line of defense against shocks. Directors noted that exchange rate flexibility should help further financial market deepening. A number of Directors encouraged the authorities to phase out the 2016 FX market measures with due regard to market conditions. Some Directors were of the view that such measures could be helpful in preserving overall financial stability.

Directors agreed that the financial sector appears resilient, with sound profitability and liquidity indicators and low NPLs. They encouraged the authorities to continue close monitoring of risks stemming from large household debt and the real estate market, noting that household debt is high compared to peers, with a large share of mortgages and with pockets of vulnerability among lower-income groups. A number of Directors agreed that the measures related to the residency-based differentiation in the property market should be gradually phased out as systemic risks dissipate. A few Directors suggested a more cautious approach should be taken in phasing out these measures. Directors commended the authorities' ongoing efforts to enhance

[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.

crisis preparedness noting that they could be strengthened by a comprehensive review of the overall framework.

Directors commended the authorities' initiatives to improve governance and strengthen anti-corruption institutions and emphasized the importance of anchoring them in appropriate legislation, particularly to help secure their independence. Directors encouraged continued strengthening of the AML/CFT framework.

Directors agreed with the authorities' emphasis on raising productivity and achieving inclusive and regionally balanced development. They encouraged prioritizing human capital development and increasing female labor force participation and productivity, including through improving education; accelerating innovation and technology adoption; and encouraging a move up the value chain.

Malaysia: Selected Economic and Financial Indicators, 2014–20

Nominal GDP (2018, est.): US$353.6 billion
Population (2018, mid-year): 32.4 million
GDP per capita (2018, current prices, est.): US$10,919
Poverty rate (2016, national poverty line): 0.4 percent
Unemployment rate (August 2018): 3.4 percent
Adult literacy rate (2017): 95.9 percent
Main goods exports (share in total, 2017): electrical & electronics (36.7 percent), commodities (13.6 percent), and petroleum products (7.7 percent).

	2014	2015	2016	2017	Est. 2018	Proj. 2019	2020
Real GDP (percent change)	6.0	5.1	4.2	5.9	4.7	4.7	4.8
Total domestic demand	5.3	6.0	4.5	6.6	4.6	5.1	4.8
Private consumption	7.0	6.0	6.0	7.0	7.3	6.8	5.8
Public consumption	4.4	4.5	0.9	5.4	0.8	0.2	0.6
Private investment	11.1	6.3	4.3	9.3	4.4	5.5	6.0
Public gross fixed capital formation	-4.7	-1.1	-0.5	0.1	-1.6	-2.5	1.1
Net exports (contribution to growth, percentage points)	1.2	-0.3	0.1	-0.2	0.5	0.0	0.3
Saving and investment (in percent of GDP)							
Gross domestic investment	25.0	25.1	25.8	25.6	24.5	24.2	24.2
Gross national saving	29.4	28.2	28.3	28.5	26.7	26.0	25.8
Fiscal sector (in percent of GDP) 1/							
Federal government overall balance	-3.4	-3.2	-3.1	-3.0	-3.7	-3.4	-3.0
Revenue	19.9	18.9	17.3	16.3	16.6	17.2	15.0
Expenditure and net lending	23.3	22.1	20.4	19.3	20.3	18.2	18.0
Tax refunds (Arrears) 2/						2.4	
Federal government non-oil primary balance	-7.3	-5.1	-3.5	-3.5	-5.2	-6.6	-4.1
Consolidated public sector overall balance 3/	-7.4	-7.7	-5.1	-3.2	-5.5	-5.8	-5.1
General government debt 3/	56.2	57.9	56.6	55.2	56.3	56.5	56.0
Of which: federal government debt	52.7	54.4	52.7	50.7	51.9	52.1	51.5
Inflation and unemployment (annual average, in percent)							
CPI inflation	3.2	2.1	2.1	3.7	1.0	2.2	2.6
CPI inflation (excluding food and energy) 4/	2.1	3.2	2.6	1.6	0.4	1.2	2.4
Unemployment rate	2.9	3.2	3.5	3.4	3.4	3.4	3.4
Macrofinancial variables (end of period)							
Broad money (percentage change) 5/	6.3	3.0	2.7	4.8	5.5	...	...
Credit to private sector (percentage change) 5/	9.2	8.6	5.3	5.4	6.0	...	...
Credit-to-GDP ratio (in percent) 4/ 6/	130.1	134.6	133.9	128.3	129.1	...	...
Credit-to-GDP gap (in percent) 4/ 6/	12.7	13.5	9.4	2.5	2.6	...	...
Overnight policy rate (in percent)	3.25	3.25	3.00	3.00	3.25	...	...
Three-month interbank rate (in percent)	3.9	3.8	3.4	3.5	3.7	...	...
Nonfinancial corporate sector debt (in percent of GDP)	98.6	106.7	109.5	102.8	104.3	...	...
Nonfinancial corporate sector debt issuance (in percent of GDP)	3.2	2.6	3.2	3.4	3.7	...	...
Household debt (in percent of GDP)	86.8	88.4	87.8	83.8	83.0	...	...
Household financial assets (in percent of GDP)	182.1	183.1	181.5	177.6	...	...	...
House prices (percentage change)	9.4	7.4	7.1	6.5	...	...	...
Exchange rates (period average)							
Malaysian ringgit/U.S. dollar	3.27	3.91	4.15	4.30	4.04	...	...
Real effective exchange rate (percentage change)	-0.7	-7.9	-4.3	-1.7	4.1	...	...
Balance of payments (in billions of U.S. dollars) 4/							
Current account balance	14.8	9.0	7.2	9.4	7.7	6.5	6.4
(In percent of GDP)	4.4	3.0	2.4	3.0	2.2	1.8	1.6
Goods balance	34.6	28.0	24.6	27.2	30.7	29.8	31.3
Services balance	-3.3	-5.3	-4.6	-5.3	-6.6	-6.5	-6.9
Income balance	-16.5	-13.7	-12.8	-12.5	-16.5	-16.9	-18.0
Capital and financial account balance	-24.3	-14.5	0.0	0.9	2.3	5.5	7.0
Of which: Direct investment	-5.5	-0.5	3.3	3.8	4.1	4.3	4.6
Errors and omissions	-1.7	6.4	-5.8	-6.4	-11.0	0.0	0.0
Overall balance	-11.2	1.0	1.4	3.8	-1.0	12.0	13.4
Gross official reserves (US$ billions) 4/	115.9	95.3	94.5	102.4	101.4	113.4	126.8
(In months of following year's imports of goods and nonfactor services)	7.5	6.3	5.6	5.8	5.5	5.9	6.2
(In percent of short-term debt by original maturity)	111.6	116.2	112.5	109.9	105.8	112.1	121.1
(In percent of short-term debt by remaining maturity)	78.3	74.4	72.6	72.5	70.4	76.1	82.3
Total external debt (in billions of U.S. dollars) 4/	213.4	195.0	204.2	218.3	221.1	225.9	233.2
(In percent of GDP)	63.1	65.7	68.8	69.4	62.5	61.0	58.7
Of which: short-term (in percent of total, original maturity)	48.7	42.0	41.2	42.7	43.4	44.8	44.9
short-term (in percent of total, remaining maturity)	69.4	65.7	63.7	64.7	65.1	66.0	66.0
Debt service ratio 4/							
(In percent of exports of goods and services) 7/	17.9	21.5	23.4	21.0	21.3	21.1	20.5
(In percent of exports of goods and nonfactor services)	19.1	22.7	24.8	22.2	22.5	22.3	21.7
Memorandum items:							
Nominal GDP (in billions of ringgit)	1,106	1,159	1,231	1,353	1,427	1,522	1,633

Sources: Data provided by the authorities; CEIC Data Co. Ltd.; World Bank; UNESCO; and IMF, *Integrated Monetary Database* and staff estimates.
1/ Cash basis. The authorities plan to adopt accrual basis by 2021. For 2019, overall and primary balance includes the payment of outstanding tax refund (arrears) amounting to RM37 billion.
2/ Tax refunds in 2019 are allocated for payment of outstanding tax refunds.
3/ Consolidated public sector includes general government and nonfinancial public enterprises (NFPEs). General government includes federal government, state and local governments, and statutory bodies.
4/ IMF staff estimates. U.S. dollar values are estimated using official data published in national currency.
5/ Based on data provided by the authorities, but follows compilation methodology used in IMF's *Integrated Monetary Database*.
6/ Based on a broader measure of liquidity. Credit gap is estimated on quarterly data from 2000, using one-sided Hodrick-Prescott filter with a large parameter.
7/ Includes receipts under the primary income account.

INTERNATIONAL MONETARY FUND

MALAYSIA

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

January 30, 2019

KEY ISSUES

Context. The Malaysian economy has shown resilience and continues to perform well. A peaceful political transition following the May 2018 elections demonstrated the strength of Malaysia's institutions. Although vulnerabilities exist, capital outflows have been manageable. The new government has launched multiple initiatives to address governance weaknesses and corruption. Policy priorities are governance reforms and fiscal consolidation while safeguarding growth and financial stability. Structural reforms are needed to boost productivity and help further rebalancing growth towards domestic demand.

Macroeconomic setting. Growth is moderating, and inflation has come down. Domestic demand is expected to remain the main driver of growth over the medium term. Risks to the outlook are to the downside and stem mainly from external sources.

Main economic policy recommendations:

- The targeted gradual fiscal consolidation path is appropriate and should be underpinned by credible policy measures that prioritize higher tax revenue while continuing to protect growth-enhancing spending.
- With growth returning to sustainable levels and no underlying inflation pressures, maintaining the current broadly neutral monetary policy stance is appropriate. Exchange rate flexibility should remain the first line of defense against external shocks.
- The financial sector seems well positioned to cope with most shocks, but household debt is elevated and risks emanating from the real estate market should be closely monitored.
- Governance reforms should be anchored in legislation to ensure the independence of anti-corruption institutions and appropriate separation of powers. Focus should be on improving the transparency and efficiency of public services.
- Structural reforms are needed to boost productivity and help external rebalancing. Priority should be given to: (i) improving education; (ii) accelerating innovation and technology adoption; and (iii) encouraging a move up the value chain.

Approved By
Odd Per Brekk and Maria Gonzalez

Mission dates: November 28–December 12, 2018
Mission Team: Nada Choueiri (Head), David Grigorian, Xin Li, Kazuaki Miyachi, Katsiaryna Svirydzenka (all APD), and Jochen Markus Schmittmann (Resident Representative). Mohamad Hasni Shaari (OED) joined the mission. Odd Per Brekk (APD) and Juda Agung (Executive Director) joined the concluding meetings. Yun He, Justin Flinner, and Ross Rattanasena (APD) assisted in the preparation of this report. Data used in this report for staff analyses are as of January 24, 2019, unless otherwise noted.

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Glossary

AML	Anti-money laundering
ARA	Assessing reserve adequacy
BNM	Bank Negara Malaysia
CA	Current account
CFM	Capital flow management measures
CFT	Combatting the financing of terrorism
CPTPP	Comprehensive and Progressive Agreement for Trans-Pacific Partnership
DFI	Development financial institution
DSA	Debt sustainability analysis
EBA	External balance assessment
ELA	Emergency liquidity assistance
FDI	Foreign direct investment
FMC	Financial Markets Committee
FRA	Fiscal Responsibility Act
FSAP	Financial sector assessment program
FX	Foreign exchange
GIACC	National Centre for Governance, Integrity and Anti-Corruption, the
GDP	Gross domestic product
GFC	Global financial crisis
GLCs	Government-linked companies
GST	Goods and services tax
IV	Liberalization and Management of Capital Flows: An Institutional View, the
LTV	Loan-to-value ratio
MACC	Malaysian Anti-Corruption Commission, the
MGS	Malaysian Government Securities
MGII	Malaysian Government Investment Issues
MHPI	Malaysian house price index
MOF	Ministry of Finance
NBFI	Non-bank financial institutions
NDF	Non-deliverable forwards
NFPS	Nonfinancial public sector
NID	Negotiable Instruments of Deposit
NPL	Non-performing loans
OECD	Organization for Economic Co-operation and Development, the
PIT	Personal income tax
PPP	Public-private partnerships
R&D	Research and development
RPGT	Real property gains tax, the
SOE	State-owned enterprises
SST	Sales and services tax
US	United States, the
WEO	World Economic Outlook, the
y/y	Year-on-year

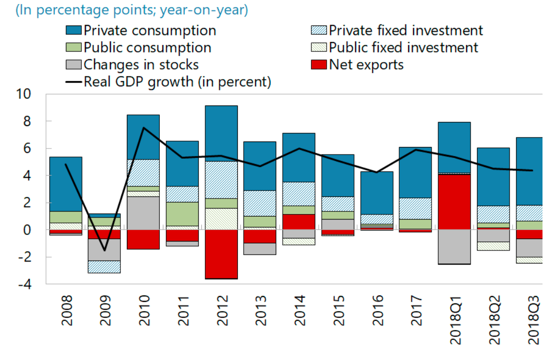
ECONOMIC DEVELOPMENTS AND OUTLOOK: CONTINUED FAVORABLE PERFORMANCE WITH DOWNSIDE RISKS

1. **Malaysia's economy continued to show resilience as a smooth political transition took place in May 2018.** The opposition coalition led by former PM Mahathir secured a surprise victory in Malaysia's 14th General Election, resulting in the first ruling party change since independence in 1957. The peaceful political transition was a demonstration of the strength of Malaysia's institutions, and robust economic activity also endured.

2. **Growth is moderating** (Figure 1)**.** Growth is estimated at 4.7 percent in 2018 (5.9 percent in 2017), narrowing the output gap. While improved labor market conditions and the zero-rating of the GST boosted private consumption, public investment declined due to the winding down of large projects. Tightening global financial conditions, trade tensions, and a temporary spike in uncertainty regarding the new government's policy agenda have affected confidence and private investment. That said, exports have risen, driven by electronics, and investment strengthened in the third quarter. On the supply side, disruptions in the oil and gas sector and adverse weather conditions contributed to lower growth.

Chart 1. Malaysia: Contributions to Real GDP Growth

(In percentage points; year-on-year)

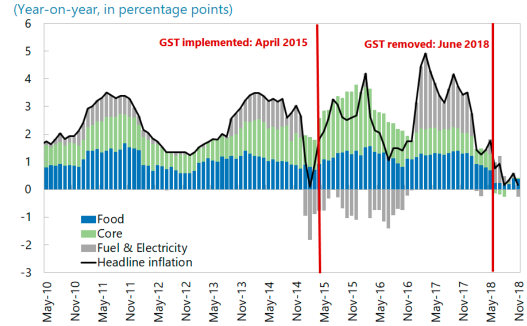


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

3. **Inflation has come down** (Figure 2)**.** Headline inflation dropped from an average of 3.7 percent in 2017 to 1.0 percent in 2018 as domestic fuel price adjustment was suspended in March, the GST was zero-rated in June, and food price inflation declined. The pass-through to prices from the re-introduction of the Sales and Services Tax (SST) in September, with a smaller tax base than the GST, was moderate. In addition, the price-cutting pressures faced by government contractors partly offset the effect of the SST. While credit growth has rebounded recently, driven by lending to corporations, the credit-to-GDP ratio is declining, and the credit gap has almost closed (Figure 3).

Chart 2. Malaysia: Contributions to CPI Inflation

(Year-on-year, in percentage points)



Sources: Haver Analytics; and IMF staff calculations.

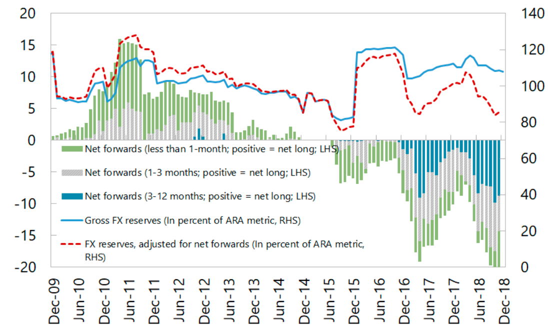
4. **The 2018 fiscal deficit exceeded the budgeted level** (Figures 4 and 5)**.** The new government took immediate steps to increase transparency over the fiscal accounts, recognizing additional tax refund obligations (about 0.3 percent of GDP in 2018) and bringing on budget

identified off-budget spending. The latter, together with additional spending needs (partly on social assistance), has raised net government spending by 0.5 percent of GDP, despite the review of existing infrastructure projects. Moreover, the re-introduction of subsidies for lower-grade petroleum added 0.2 percent of GDP in spending. On the revenue side, replacing the GST by the SST has narrowed the tax base and has created an estimated revenue shortfall of 1.2 percent of GDP in 2018. Higher oil revenues and transfers from Petronas and other government-linked companies (GLCs) raised 1.2 percent of GDP. Consequently, the 2018 deficit is estimated at 3.7 percent of GDP, 0.9 percent of GDP higher than budgeted.

5. **Although vulnerabilities exist, capital outflows have been manageable.** During the second quarter of 2018, Malaysia experienced large capital outflows in face of the general EM risk-off sentiment and post-election policy uncertainty. Nonetheless, the impact on the exchange rate, stock market prices, and government bond yields was contained due to increased domestic investor participation and central bank foreign exchange market intervention to counter disorderly market conditions (Figure 6). The share of resident holding in government paper (MGS, MGII, Treasury Bills, and Islamic Treasury Bills) increased from an average of 71 percent post-GFC to 75 percent in October, amid robust demand for government bonds from domestic institutional investors.

Chart 3. Malaysia: Official Foreign Reserves

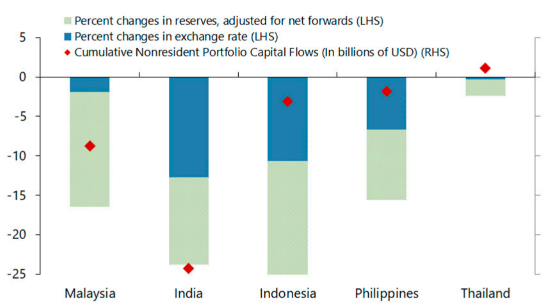
(In billions of US dollars and percent of ARA metric)



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

Chart 4. Capital Flows and Exchange Market Pressure Index 1/

(EMPI = percent change in U.S. dollar/local currency exchange rate plus percent change in reserves; since end 2017)

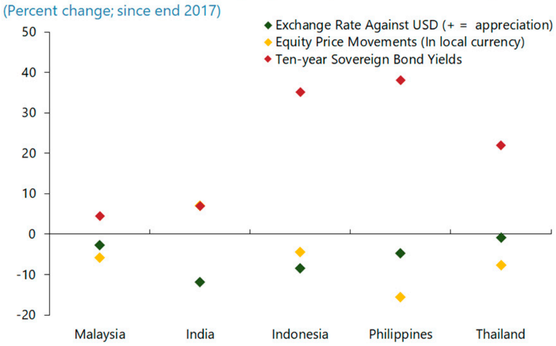


Source: Institute of International Finance; Haver Analytics; and IMF staff calculations.

1/ As of Oct 2018

Chart 5. Exchange Rate, Equity Price, and Bond Yield 1/

(Percent change; since end 2017)



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

1/ As of Oct 2018

6. **While moving towards equilibrium, the external position remains stronger than warranted by fundamentals and desired policies** (Appendix I)**.** In recent years, Malaysia's growth drivers have shifted towards domestic demand and its current account surplus has narrowed. In 2018, the real effective exchange rate (REER) appreciated by 4.1 percent and the current account surplus declined to an estimated 2.2 percent of GDP. Although this surplus has helped reassure foreign investors during the recent EM sell-off, it represents a current account gap that cannot be

explained by fundamentals nor by desired policies identified by the Fund's external balance modeling. While identified domestic policy gaps have offsetting effects, low public healthcare spending contributes to the excess surplus, and so does saving by private nonfinancial corporations, as suggested by national accounts data (Appendix II). Going forward, creating fiscal space to expand social safety nets and increase health spending would help reduce precautionary household savings. This, together with structural reforms aimed at enhancing investment and productivity, would facilitate external rebalancing.

7. Policies have been largely in line with past Fund advice, with some exceptions (Appendix III). In line with IMF recommendations, the authorities are anchoring fiscal policy to their medium-term consolidation objective, improving efficiency of spending via zero-based budgeting, and are working on a Fiscal Responsibility Act. However, the GST was zero-rated against IMF staff advice, creating a revenue shortfall. The current monetary policy stance is consistent with advice to carefully calibrate monetary policy in response to economic conditions. The authorities continue to indicate a firm commitment to exchange rate flexibility as the main defense against external shocks. Structural reforms are largely in line with IMF advice.

8. Growth is expected to stabilize in 2019 and over the medium term, with inflation picking up and the current account surplus continuing to narrow. Domestic demand will remain the main driver of growth. Given Malaysia's position in global value chains, the U.S. tariffs on imports from China could reduce Malaysia's growth rate by 0.2 percentage points in 2019 via traditional trade channels and through financial and confidence effects, despite some trade diversion.[1] While public investment will contribute negatively to growth in the near term due to the ongoing review of infrastructure projects, private consumption and investment are expected to be robust, underpinned by an improved business environment and greater confidence. The latter factors are expected to counterbalance the negative drag from the external environment and fiscal consolidation, leaving growth flat at 4.7 percent in 2019. Inflation should rise above 2 percent in 2019, as the effect of the GST removal dissipates, and oil subsidies become targeted. Over the medium term, growth is expected to converge to potential (4.8 percent) and inflation will remain subdued.

9. Risks to the growth outlook are to the downside (Appendix IV)**.** With a highly open economy, Malaysia is vulnerable to rising protectionism and weaker-than-expected growth in trading partners. Output shocks could undermine households' ability to service their debts. A sharp tightening of global financial conditions could cause financial stress for banks and corporations. Lower-than-projected oil prices could reduce exports and growth, complicating the authorities' fiscal consolidation efforts. Domestically, contingent liabilities could necessitate additional measures to ensure medium-term fiscal sustainability, while delays or resistance to the governance reform agenda could undermine confidence, leading to lower investment and growth. Sharp adjustment in

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[1] See the 2018 October IMF Regional Economic Outlook for Asia and Pacific Background Paper No. 2 "The Evolving Role of Trade in Asia: Opening a New Chapter".

real estate prices or a deterioration in households' debt service ability could affect financial stability and growth.

Authorities' Views

10. The authorities broadly agreed with staff's assessment of the economic outlook and risks. They expected growth to be 4.9 percent in 2019, driven by domestic demand and underpinned by strong fundamentals, particularly favorable labor market conditions, in addition to an improved business environment and greater confidence. They expected inflation to rebound to between 2.5–3.5 percent in 2019, contingent on the timing of fuel subsidy reform and oil prices. Over the medium term, the authorities saw growth at 4.5–5.5 percent, with risks stemming from external sources and tilted to the downside. The authorities took positive note of the 2018 methodological refinements to staff's external balance assessment but continued to see limitations in the IMF's analytical framework given the relatively weak explanatory power of the current account regression model in the Malaysian context. They agreed with the structural reforms advised to address policy gaps, noting that their reform plans aim to boost investment and productivity and improve infrastructure.

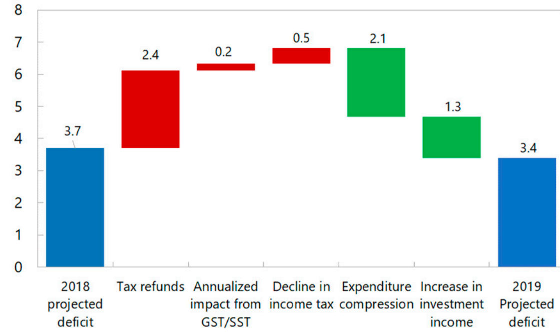
MACROECONOMIC AND FINANCIAL POLICIES: ACHIEVING FISCAL CONSOLIDATION WHILE SAFEGUARDING GROWTH AND FINANCIAL STABILITY

11. Policies should aim at achieving fiscal consolidation while protecting growth and financial stability. A credible fiscal consolidation plan is needed to rebuild fiscal buffers, put public debt on a clear downward path, and boost market confidence. Monetary policy should continue to be geared towards domestic stability, and macroprudential policies should help maintain financial stability. External imbalances should be addressed over the medium term by creating fiscal space to expand social safety nets and reduce precautionary household saving and structural reforms aimed at enhancing investment and productivity.

A. Fiscal Policy

12. The 2019 budget entails a welcome consolidation and transparency over fiscal accounts (Chart 6). The new government continued its efforts to increase fiscal transparency by budgeting for full clearance of tax refund arrears in 2019 and enhancing the analysis of fiscal risks and liabilities. Expenditure rationalization and improvements in targeting social assistance and subsidies are expected to save 2.1 percent of GDP. Higher non-tax revenue (1.3 percent of GDP), mainly due to additional one-off transfers from Petronas (2 percent of GDP) will partly finance one-off tax refunds (2.4 percent of GDP). The full year impact of replacing the GST with the SST and additional provision for 2019 tax refunds will raise the deficit by 0.7 percentage point of GDP. Consequently, the deficit is budgeted at 3.4 percent of GDP in 2019. Additional, albeit small, revenue measures[2] could potentially deliver higher revenue relative to the 2019 budget and IMF staff baseline. While expenditure compression could weigh on growth, particularly through a slowdown in public investment, the adverse impact should be mitigated by the improvement in the targeting of transfers and the tax refunds. More importantly, the anticipated fiscal consolidation should help shore up market confidence. Nevertheless, the one-off dividends from Petronas, together with the revenue shortfall from replacing the GST with the SST, has increased the dependence on oil-related revenue, calling for further adjustment over the medium term.

Chart 6. Malaysia: 2019 Projected Fiscal Deficit
(Percent of GDP)



Sources: IMF staff estimates.

13. The authorities plan to further reduce the deficit over the medium term. Malaysia's fiscal policy is anchored by a commitment to keep the federal government debt below 55 percent of GDP. However, the federal government debt is estimated at 51.9 percent of GDP at end-2018, implying that the limit could be breached if downside risks materialize. Besides, federal government guarantees (18 percent of GDP, as of June 2018) and possible future payment obligations related to Public-Private-Partnerships (PPPs) projects (13 percent of GDP, on an undiscounted cash basis over next 30 years, also as of June 2018) could pose an upside risk to public debt. These factors imply that Malaysia's fiscal space is at risk[3] absent fiscal consolidation. Against this backdrop, the 2019 budget announced a medium-term consolidation path—with the deficit reduced to 3 percent of GDP in 2020, 2.8 percent of GDP in 2021, and 2 percent of GDP over the medium term. This gradual consolidation path would put debt on a downward trajectory, allowing it to reach 47 percent of GDP

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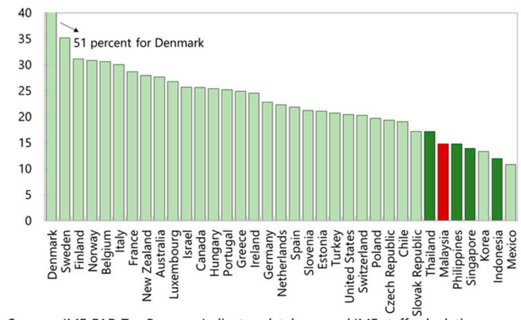
[2] These are increases in excise taxes, in the real property gains tax and in the stamp duty on properties, and an eight-month reduced penalty rate on unpaid taxes under the Special Voluntary Disclosure Program. While these measures were announced in the 2019 Budget Speech and are intended to be implemented over the course of 2019, the expected revenues have not been included in the 2019 budget targets nor in staff's baseline.

[3] This is not a substantive change from the fiscal space assessment for Malaysia in the 2018 IMF Country Report No. 18/61. The different terminology reflects the recent change in the IMF's categorization of the bottom line assessment of fiscal space. The previous category of "limited fiscal space"— indicating that no (or at most only marginal) fiscal loosening compared to the baseline can be contemplated—was split into two new categories: (i) "no fiscal space" for countries where fiscal sustainability and market financing are patently in question, or market financing is already prohibitively expensive; and (ii) "fiscal space at risk" for countries where there are clear, but not imminent, risks to fiscal sustainability and at most marginal fiscal loosening is possible compared to the baseline. As a result, the new classification system stands as: (i) "substantial fiscal space"; (ii) "some fiscal space"; (iii) "fiscal space at risk"; and (iv) "no fiscal space." The new classification helps clearly distinguish Malaysia from countries with no fiscal space.

by 2024 (Appendix V). This would provide welcome buffers vis-a-vis the federal government debt limit, thereby enhancing fiscal space.

14. Revenue mobilization is a priority given Malaysia's low tax revenue (13.1 percent of GDP in 2017, Chart 7). Based on theory and international best practice, the value-added tax (GST) is a preferable form of taxation. At the current juncture, other measures will be needed, such as strengthening the SST, revisiting existing tax incentives for corporate investment, increasing excise taxes, broadening the PIT base, and introducing a capital gains tax (text table). With this objective in mind, the authorities have established a high-level Tax Reform Committee, tasked to carry out a comprehensive review of the Malaysian tax system including tax incentives and possible new sources of sustainable revenues.

Chart 7: Tax Revenue: OECD and ASEAN-5, 2014
(In percent of GDP)



Sources: IMF *FAD Tax Revenue Indicators* database; and IMF staff calculations.

Options for Fiscal Policy Adjustment, 2020-2024
(In percent of GDP)

Adjustment needs	**2-2.5**
Bringing fiscal deficit to 2 percent of GDP	1
Additional social and development spending	1 - 1.5
Social protection and healthcare spending	
Investment in human capital	
Infrastructure and R&D	
Options for adjustment	**Up to 2.5**
Additional sources of revenue	**1.7**
Expanding SST coverage	0.5
Reducing investment incentives in CIT	0.5
Broadning PIT base	0.5
Increase excise taxes (e.g., tobacco)	0.1
Capital gains tax	0.1
Expenditure savings measures	**0.8**
Rationalizing subsidies and transfers	0.3
Wage bill savings	0.2
Enhancing procurement policy	0.3

15. Revenue measures should be coupled with expenditure rationalization. The authorities' zero-budgeting process has rightly increased focus on existing spending but could be further strengthened by a targeted and strategic spending review mechanism, on a rolling basis, which would also help to realize expenditure savings (possible measures are illustrated in the text table). Revenue mobilization and expenditure rationalization should create space for additional social and development spending. Such spending should be prioritized in accordance with the main pillars in the Mid-Term Review of the Eleventh Malaysia Plan and include further improvements in social protection and healthcare spending. This would help put the economy on a path of sustainable, inclusive growth towards high-income status.

16. Fiscal adjustment should be embedded in a strengthened fiscal framework. The government plans to table a Fiscal Responsibility Act (FRA) and adopt accrual accounting by 2021. The FRA should clearly stipulate fiscal objectives, the fiscal anchor, and the key components of the medium-term fiscal framework including operational targets and the institutional setup. Over the medium-term, to further strengthen the fiscal framework, introducing an expenditure rule (capping the growth rate of expenditure at an appropriately calibrated level that meets the government's strategic objectives while ensuring fiscal sustainability) could be considered to help prevent procyclical fiscal policy and meet the government's strategic spending objectives without undermining fiscal space (Appendix VI).

Authorities' Views

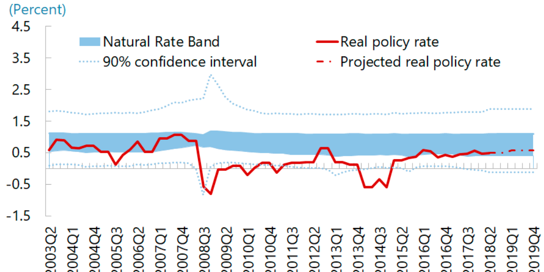
17. The authorities reaffirmed their commitment to medium-term fiscal consolidation. They stressed that the higher deficit in 2018–2019 is temporary and reflects efforts to improve fiscal transparency and governance. They noted that the revenue shortfall from replacing the GST with the SST will be addressed through revenue mobilization measures to be identified by the Tax Reform Committee and further expenditure rationalization. The authorities noted their commitment to reducing the deficit to 2 percent of GDP over the medium term. While the authorities agreed on the importance of revenue mobilization, they indicated that additional spending needs can also be accommodated by improving expenditure efficiency. They agreed with the need for a strengthened medium-term fiscal framework, including better fiscal risk management, and highlighted their plan to propose a Fiscal Responsibility Act and adopt accrual accounting by 2021.

B. Monetary, Exchange Rate, and Financial Markets Policies

18. The monetary policy stance should remain broadly neutral. Domestic economic and financial considerations continue to guide monetary policy decisions, within a policy framework that has been delivering broad price and output stability despite economic shocks. After raising the policy rate by 25 bps to 3.25 percent in January 2018, the Monetary Policy Committee has kept the rate unchanged in its five subsequent meetings, thus maintaining the real policy rate within the natural rate band (Chart 8). Looking forward, at unchanged policy rates, the monetary policy stance will remain broadly neutral. Given gradual growth deceleration toward sustainable levels, no evident underlying inflation pressures, and gradually tightening financial conditions (Chart 9 and Appendix VII), monetary policy should remain on hold.

Chart 8. Real Policy Rate versus Natural Rate, 2013:Q2-2019:Q4

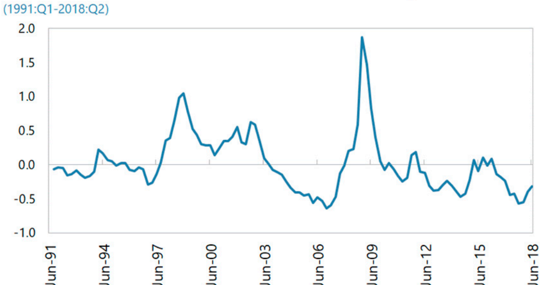
(Percent)



Sources: IMF staff calculations.
Note: Natural rate band derived using TV VAR with inflation expectations proxies by backward looking inflation moving average and forward looking Consensus Forecasts. Projected real policy rate assuming no change in the nominal monetary policy rate through end 2019.

Chart 9. Financial Conditions Index For Malaysia

(1991:Q1-2018:Q2)



Note: Based on the model outlined in 2017 April GFSR, estimated using 10 financial indicators covering credit, foreign exchange, debt, and equity markets for 43 advanced and emerging market economies for 1990–2016. An increase in the index means tightening financial conditions.

19. Exchange rate flexibility is essential. BNM intervention in the foreign exchange market following the surprise election results helped ensure orderly market conditions. Looking forward, and in the context of protracted uncertainty in global financial conditions, foreign exchange market intervention should continue to be limited to preventing disorderly market conditions and the exchange rate should continue to play the role of shock absorber. This would safeguard reserves and help to further develop and deepen financial markets. Gross foreign reserves are adequate (US$101.4 billion as of end 2018—about 108 percent of the Assessing Reserve Adequacy (ARA) metric for a floating exchange rate regime). When adjusted for net forward positions, which is also relevant given the forward-looking nature of the ARA metric, reserves are below 100 percent of the metric. In case of an inflow surge, some reserve accumulation would be appropriate to increase the reserve coverage. Although banks and corporates could resort to their own external liquid assets to service their maturing external debt, foreign currency debt still represents a potential claim on BNM's foreign exchange reserves.

20. Malaysia's external debt remains manageable, although external financing vulnerabilities are higher than in the median peer country (Appendix VIII)**.** Malaysia's external debt-to-GDP ratio has risen by about 11 percentage points of GDP between 2009 and 2018Q3, to 65.4 percent of GDP, measured in U.S. dollars (2009: 54¼ percent of GDP). About one-half of this increase in the debt ratio was due to the rise in other investment liabilities, including intercompany loans and interbank borrowing. Portfolio debt inflows accounted for about 3 percentage points of GDP of the increase, despite large portfolio outflows in 2018Q2. Standard stress tests under the IMF's External Debt Sustainability Analysis indicate that the external debt-to-GDP ratio would remain close to the baseline level under a variety of shocks over the medium term, except under an exchange rate depreciation shock. However, close to one-third of external debt is denominated in ringgit, which provides some cushion against exchange rate risks.

21. The measures introduced by the authorities in December 2016[4] have reduced volatility in the onshore FX market, but at the likely cost of creating distortions. The attestation requirement for banks' noninvolvement in offshore ringgit derivatives trading is motivated by the authorities' goal of closely monitoring activity in the FX market and dissuading speculative activities. A removal of this ban would have to proceed with caution as conditions for further liberalization allow. While domestic FX markets appear to be functioning well (Appendix IX), the export proceed conversion requirement and limit on foreign currency investments by residents with domestic ringgit borrowing (including the limit by resident non-exporters) can be distortive, potentially leading to resource misallocation, and therefore may not support market development. In August 2018, the BNM eased the conversion requirement by allowing exporters to keep FX earnings in excess of 25 percent of export proceeds when these are needed to meet import or debt service obligations in the next six months without going through a process of conversion/reconversion as previously required. These measures should be gradually phased out with due regard to market conditions.

[4] Assessed to be capital flow management measures in IMF Country Report No. 18/61.

Authorities' Views

22. The authorities agreed with staff's assessment, albeit with caveats. They viewed monetary policy as still accommodative and noted that growth and inflation remain the key determinants of monetary policy. The authorities stressed that, in the post-election months, FX interventions were needed to prevent disorderly market conditions. However, they also noted that exchange rate flexibility will continue to be the first line of defense against external shocks. They viewed BNM reserves to be adequate and external debt to be manageable, highlighting several buffers against external shocks: (i) BNM's reserves account for a quarter of total foreign assets, with the remainder held by resident banks and corporates, which can be drawn upon to meet external obligations without creating a claim on international reserves; (ii) about one-third of external debt is ringgit-denominated; (iii) three-quarters of FX-denominated external debt is subject to prudential requirements; (iv) over half of external debt has medium/long-term maturity; and (v) three-quarters of short-term interbank borrowing is intragroup, which must comply with local liquidity regulations and is deemed more stable. Regarding the 2016 FX market measures, the authorities disagreed that these created distortions, noting that they helped reinforce Malaysia's long-standing policy on the non-internationalization of the ringgit, limit speculation that causes excessive exchange rate volatility, and deepen onshore markets.

C. Financial Sector

23. The financial system seems well positioned to cope with most shocks (Figures 7, 8). Banks are well-capitalized and liquid, with capital and liquidity buffers exceeding regulatory levels. Loan quality is strong, with aggregate NPLs at 1.5 percent of gross loans as of 2018 Q3, and provisions are sizable. The impaired loans in the oil and gas sector are adequately provisioned for, have been written off, or restructured. The real estate sector (especially its commercial segment) represents a vulnerability, but risks are mitigated by large developers' sizable cash buffers. While some small property developers have faced cash flow problems recently, the risks appear to be contained.

24. The potential for spillovers from the non-bank financial institutions (NBFIs) to the banking sector appears limited. NBFIs include retirement funds, investment funds, credit cooperatives, Development Financial Institutions (DFIs), and the National Higher Education Fund, among others. NBFIs' investments in equities and bonds continue to be the main transmission channel of contagion risk to the financial sector. Also, some segments of the sector are government-owned, posing potential fiscal risk in case a large adverse shock materializes. To help manage these risks, the BNM has taken steps to improve the flow of NBFIs' financial reporting.

25. Household debt is elevated compared to regional peers, but declining (Figure 9)**.** Total household debt stood at 83.2 percent of GDP as of 2018Q3. High household financial assets (twice the size of total household debt) help mitigate the vulnerability for all but the lowest income group (with income below RM 3,000 per month). Households in the second income group (earning between RM3,000 and RM5,000 per month) would face the largest cash flow shortages under income, interest rate, or cost-of-living shocks, according to BNM stress tests. Macroprudential norms and credit underwriting standards have been effective in containing household NPLs at 1.4 percent. Mortgages, which represent 60 percent of total household debt, have mostly a variable rate structure and are subject to interest rate risk. Despite high loan quality and the positive outcome of the BNM's latest stress testing, household debt continues to require close monitoring.

26. The authorities continue to closely monitor risks emanating from the housing market, although the risks are deemed manageable (Figure 10). House price growth has declined from 6.5 percent in 2017 to 3 percent in 2018H1, and the volume of transactions has also declined. The number of unsold housing units that have been completed or are currently under construction is increasing and is mostly concentrated in high-rise buildings. Banks' direct exposure to developers remain small and is closely monitored by the BNM.[5] According to BNM stress tests, potential bank losses originating from a possible sharp real estate price adjustment and shocks to income and interest rates are small relative to the banks' capital buffers. The BNM, MOF, and Ministry of Housing and Local Government have introduced new measures that help reduce the cost of property or of contracting a mortgage loan, with the objective to strengthen the demand for housing and facilitate leasing, and therefore gradually reduce the supply overhang. The impact of these measures should be evaluated on an ongoing basis to ensure effectiveness and correct potential distortions.

27. As systemic risks from the housing market dissipate, the residency-based differentiation in the real estate measures introduced in 2014[6] should be gradually phased out. Given banks' sizable exposure to mortgage lending and to the construction industry, a real estate market price correction, through a reduction in household and corporate wealth, and these agents' debt servicing capacity, could have a significant impact on growth and financial stability as NPLs rise. During 2012–13, the Malaysian House Price Index (MHPI) grew by a cumulative 24 percent, well-above its long-run annual average of 6 percent and, in 2014, amid further significant price increases, the number of transactions by non-citizens surged by 30 percent (Appendix X). The measures introduced in 2014 helped cool down the market (cutting growth in property purchases by non-citizens by over 50 percent in 2015 and by another 38.9 percent in 2016, and slowing the growth rate of MHPI to 9.4 and 7.4 percent in 2014 and 2015, respectively), avoid significant price adjustments, and reduce the rate of future debt build-up, thus reducing the probability of systemic distress. In the absence of a capital inflow surge for the time-being, but still high household

[5] Risks to banks' mortgage portfolio are mitigated by: (i) large household liquid assets; (ii) a large share of primary homeowners (85 percent); and (iii) a small share (3 percent of total) of investment property mortgages, which are also subject to conservative LTV ratios (70 percent for individual owners of 3+ properties and 60 percent for all legal entities).

[6] Two measures that the authorities introduced in 2014 to cool down the property market – an increase in the real property gains tax (RPGT) on property disposals by non-citizens and floor price for property purchases by non-citizens – are classified as residency-based capital flow management measures (CFMs) and macroprudential measures (MPMs), or CFM/MPMs. These measures limit capital flows while differentiating between residents and nonresidents, but also aimed to address systemic financial risk from the overheating housing market and strong credit growth. The differentiation in the property market measures applies to non-Malaysian citizens residing in Malaysia or abroad, but not to Malaysian citizens regardless of where they reside.

leverage, gradually removing the residency-based differentiation in both measures is recommended as systemic risk dissipates. Carefully calibrated changes to the measures could have the additional benefits of helping to reduce the excess supply of high-end housing where nonresident buyers are concentrated and thereby the probability of a sharp downward price correction.[7] Should the activity in certain segments again threaten financial stability, the authorities may consider macroprudential measures that target the specific segments, without a differentiated treatment of non-residents.

28. The corporate sector is moderately leveraged. Intercompany loans in 2018 have increased as a share of GDP, driven largely by multinational companies' lending to local subsidiaries, which is considered relatively stable (compared to other market-based funding). Corporations remain resilient to interest rate shocks: the interest cover ratio is above 8 sector-wide, against a prudent threshold of 2. The overall corporate sector NPLs are at 2.5 percent, suggesting strong debt service capacity. However, some corporations are presently experiencing declining margins due to ongoing renegotiations of public sector projects and delays in infrastructure projects, which represents a risk to their profitability.

29. Although the financial sector is deemed resilient at present, the authorities continue to closely monitor risks and consider measures to mitigate them. The authorities are making ongoing efforts to enhance operational resilience and crisis preparedness. These actions could be further strengthened by a comprehensive internal review of crisis preparedness, resolution framework, and related facilities (ELA or Deposit Insurance payout framework) and legislation. This would help ensure, inter alia, seamless inter- and intra-agency functioning at a time of distress. Over the medium term, to strengthen the macroprudential framework, consideration could be given to introducing sector-wide LTVs (on the second and first properties) and debt-service-to-income limits for all income groups to replace the ones that are presently self-imposed by the banks.

30. The framework governing BNM's financial oversight functions appears robust. The 2012 FSAP found that the BNM's role is clearly defined in the law; it is well funded; and its staff has credibility based on their professionalism and integrity. It also found that the overall supervision of the banking sector and some non-bank financial institutions, as mandated, is sound and delivers effective oversight. The main gaps identified by the 2012 FSAP—specifically, improving the administration of licensing standards, extending information-sharing arrangements with foreign supervisors, and strengthening the supervisory powers in the insurance sector—have been addressed.

31. The authorities should continue strengthening the implementation of AML/CFT measures, which would also assist in mitigating risks from corruption. Ensuring that financial institutions effectively apply enhanced customer due diligence measures on high risk politically exposed persons can help detect and deter the laundering of corruption proceeds. In this regard, efforts to strengthen the asset declaration system should be stepped up, in particular expanding the coverage of high-level public officials and improving mechanisms for verification, sanctions and

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[7] The number of unsold residential properties stood at a decade-high of 167 thousand in June 2018, underscoring the risk of a sharp price correction.

public access. The proposed study by the Companies Commission of Malaysia on the implementation of beneficial ownership requirements should identify measures to enable competent authorities to have access to accurate and up-to-date ownership information of legal persons and legal arrangements established in Malaysia.

Authorities' Views

32. **The authorities viewed financial sector risks as appropriately monitored and contained.** They noted that the financial sector has the necessary buffers to cope with sizable shocks. While agreeing that household balance sheet risks require close monitoring, the authorities noted that the associated problems do not pose systemic financial stability risks at this juncture. They were of the view that, with real estate price increases moderating, and given the strength of the macroprudential framework, the likelihood of a sizable adjustment with systemic implications is low. The authorities viewed sector-wide LTVs on first and second mortgages as unwarranted given existing supervisory measures and prudent risk management practices at banks. They noted staff's recommendation to phase out the residency-based differentiation in the RPGT and property floor price but consider these measures necessary to limit speculative demand and minimize financial sector risks, given the rebound in growth of property purchases by non-citizens in 2017-2018H1. Regarding crisis preparedness, they indicated that, in addition to periodic reviews of such preparedness, resolution frameworks, and related liquidity facilities, they were increasingly focused on testing the banking system's operational resilience, including to cyber risks.

MEDIUM–TERM CHALLENGES: IMPROVING GOVERNANCE AND ACHIEVING SUSTAINABLE GROWTH

33. **Weaknesses have been identified in fiscal governance and anti-corruption frameworks.** Vulnerabilities on the fiscal side include off budget spending, weaknesses in managing large infrastructure projects and in procurement systems, and a budget process that could be more transparent. Significant reliance on off budget initiatives, including government guarantees and PPPs, have made it difficult to form a comprehensive assessment of the government fiscal position. The governance of large infrastructure projects in terms of project appraisal, approval, costing, and extension of government guarantees presents further challenges and exposes the country to corruption vulnerabilities. Malaysia ranks low compared to the OECD average on the strength of procurement systems and on a range of indicators of corruption and anti-corruption institutions (Appendix XI).

34. **The new government has launched multiple initiatives to address governance weaknesses and corruption.** The Mid-Term Review of the Eleventh Malaysia Plan reoriented government priorities towards improving transparency and public services efficiency. The National Centre for Governance, Integrity and Anti-Corruption (GIACC) was established to develop a national

anti-corruption plan[8] and to coordinate governance and anti-corruption reforms. The intention is to move forward with important legislation to secure these reforms, as well as take firm steps towards ensuring public participation and key institutional reforms. Special committees were established to tackle specific governance weaknesses, such as procurement, and existing institutions are being strengthened, including the Malaysian Anti-Corruption Commission (MACC), the Economic Planning Unit, the PPP framework, and the SOE legal framework.

35. The governance reform agenda will take time to implement and will require legislative changes. Several important reforms require constitutional changes (Annex XI). Legislative reforms will be needed covering freedom of information, political financing, and declaration of assets. Improvements in the public investment management framework will require a number of additional legislative and procedural changes. Measures will also be needed to avoid future tax refund arrears, improve financial oversight of SOEs, and publish a more detailed set of accounts and a fiscal risks statement. Tax administration could be improved by merging the multiple tax collection roles under the umbrella of the Inland Revenue Authority.

36. The authorities' structural reform agenda, laid out in the Mid-Term Review of the Eleventh Malaysia Plan, aims to help Malaysia reach high-income status and inclusive economic development. In addition to governance reforms, the government is prioritizing inclusive and balanced regional development, investing in human capital, enhancing environmental sustainability, and strengthening economic growth. In this vein, accelerating the ratification of the CPTPP[9] (currently under review) and increasing female labor force participation and productivity would be essential. Despite robust growth and substantial improvement in export sophistication, Malaysia's total factor productivity growth slowed recently. Policies to help lift productivity growth should focus on improving education and encouraging innovation, technology adoption, and a move up the value chain.

37. Improvements in education would help raise productivity. Priority should be given to policies that raise the quality of human capital, by improving the quality of teachers and design of curricula and by expanding vocational and technical training to address skills mismatches. This would also help ease labor shortages and prepare Malaysia to better face automation challenges.

38. Productivity gains can also be achieved by accelerating innovation and technology adoption, another objective of the Mid-Term Review of the Eleventh Malaysia Plan. In this respect, aligning research and innovation to business needs and fostering firm dynamism would help. Given the positive but limited technology spillovers from FDI, the authorities place an equal emphasis on the creation of own technologies. In this respect, the authorities are rightly preparing measures to address the lack of coordination in research, development, commercialization and innovation activities and the low commercialization of R&D output.

[8] Launched on January 29, 2019.

[9] The CPTPP entered into effect December 30, 2018, for the 7 members that have ratified it to-date.

39. Encouraging a move up the value chain through market-based measures would also help. Digital technology and automation provide an opportunity for Malaysia to upgrade its industries. While the government intends to provide targeted incentives and funding under its Industry 4.0 initiative, concerted efforts by the private sector to invest in digitalization are needed. The authorities view the easy access to low-skilled foreign workers as a drag to the upgrade effort and are working on an updated foreign worker policy to increase the cost of hiring foreign labor and clamp down on illegal foreign workers employment. Any reform to foreign labor policies should be market-based, clearly communicated, and gradually phased-in to allow sectors that rely on foreign workers to adjust.

Authorities' Views

40. On governance, the authorities agreed with the identified weaknesses and the steps needed to close the gaps. They are firmly committed to enhancing governance and combatting corruption at all levels. In this regard, the implementation of principles of good governance, strong institutions, and integrity and accountability in the public sector will be the pillars of the strategy. The authorities emphasized that they are looking at numerous reforms in the areas of administration, legislation, and judicial system, as well as public financial management and relevant institutions.

41. The authorities reaffirmed their goals of achieving high-income status and inclusive development. Guided by the Mid-Term Review of the Eleventh Malaysia Plan, the authorities are prioritizing reforms to improve governance, accelerate innovation, boost productivity, move up the value chain, enhance the wellbeing of the people, and achieve inclusive growth. The new government is reviewing the CPTPP to ensure it will be beneficial to Malaysia, a necessary condition for ratification in the authorities' view. They are focusing on improving the quality of teachers and design of the curricula and are prioritizing quality over quantity of vocational and technical training. The authorities intend to provide targeted incentives to promote adoption of improved standards under their Industry 4.0 initiative and better integration of R&D. They stressed that, while foreign workers contribute to economic growth, there is also a need to reassess the costs of the high presence of low-skilled foreign workers and the overreliance of certain economic sectors on these workers.

STAFF APPRAISAL

42. The Malaysian economy has shown resilience in recent years. Real GDP growth is moderating towards potential, and there are no evident signs of inflationary pressures presently. The risks to the growth outlook are to the downside. Developments in 2018 suggest that Malaysia's external position remains stronger than warranted by fundamentals and desired policies. Policy priorities are anchoring governance reforms in appropriate legislation and achieving fiscal consolidation while safeguarding growth and financial stability.

43. Fiscal policy should follow a gradual consolidation path, prioritizing revenue mobilization to create space for social and development spending. The announced medium-term consolidation path is appropriate and should help build fiscal buffers and bolster market confidence without disrupting growth. The adjustment should be embedded in a strengthened fiscal framework and rely on credible revenue and expenditure measures. Given Malaysia's low tax revenues, revenue mobilization is a priority. It will help finance needed expenditure to achieve government priorities identified under the Mid-Term review of the Eleventh Malaysia Plan and help with external rebalancing.

44. The broadly neutral monetary policy stance is appropriate. Malaysia's monetary policy framework has performed well, delivering price stability and robust growth in recent years. The broadly neutral stance is appropriate given close-to-potential growth, no underlying inflationary pressures, and still-supportive albeit gradually tightening financial conditions. Domestic economic and financial considerations should continue to guide monetary policy decisions. Given constraints on fiscal policy and limited reserve buffers, exchange rate flexibility remains the recommended first line of defense against shocks and should help further financial market deepening. The December 2016 FX market measures should be gradually phased out with due regard to market conditions.

45. The financial sector appears resilient, but household debt and the real estate market require close monitoring. Bank profitability and liquidity are sound, and NPLs low. The corporate sector is moderately leveraged and appears resilient. While potential spillovers from NBFIs appear limited, BNM's steps to improve NBFI financial reporting are welcome. Household debt is high compared to peers, with a high share of mortgages and with pockets of vulnerability in lower-income groups. The real estate sector (especially its commercial segment) represents a vulnerability, which requires close monitoring. The residency-based differentiation in the property market measures should be gradually phased out as systemic risks dissipate. The authorities' ongoing efforts to enhance operational resilience and crisis preparedness are welcome and could be strengthened by a comprehensive review of the overall framework, covering associated facilities and legislation.

46. Fiscal governance reforms and strengthening of anti-corruption institutions are fundamental. It will be important to see through the intended governance reforms and anchor them in legislation. This is particularly needed to secure the independence of anti-corruption institutions and appropriate separation of powers. Legislative reforms are needed on freedom of information, political financing law, and declaration of assets. The authorities should avoid future tax refund arrears, improve financial oversight of SOEs, enhance the effectiveness of the AML/CFT framework, and consider adopting all staff's past recommendations regarding public investment management.

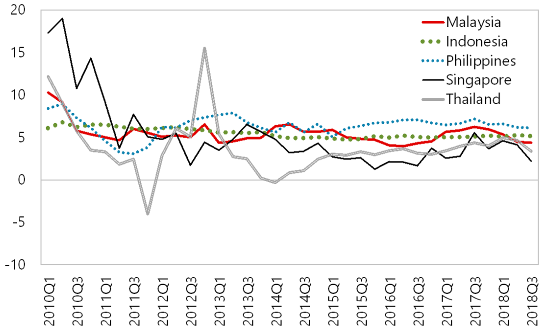
47. The emphasis on raising productivity and inclusive development is welcome. The government is rightly prioritizing inclusive and balanced regional development, improving human capital, boosting environmental sustainability, and putting economic growth on a strong, sustainable footing. Priority should be given to increasing female labor force participation and productivity by, among others: (i) improving education; (ii) accelerating innovation and technology adoption; and (iii) encouraging a move up the value chain.

48. It is recommended that the Article IV consultation with Malaysia be held on the standard 12-month cycle.

Figure 1. Malaysia: Growth and Exports

Malaysia has been one of the faster growing economies among the large ASEAN countries.

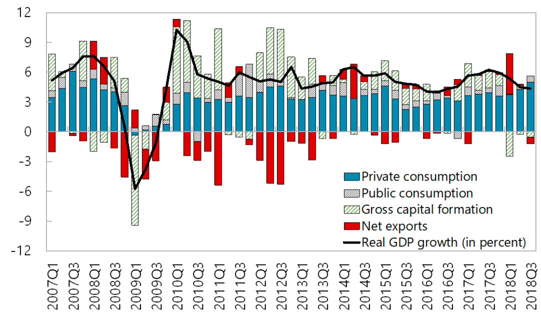
Real GDP Growth
(In percent)



Sources: CEIC Data Co. Ltd.; and IMF, *World Economic Outlook*.

Private domestic demand has been the main driver of growth in recent years.

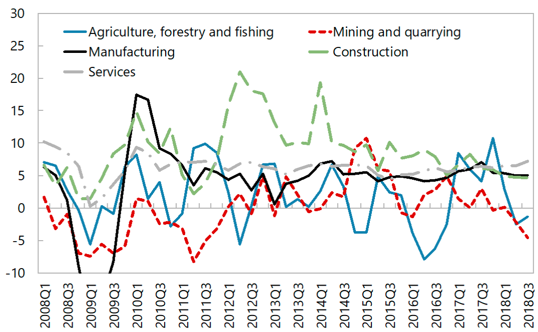
Contributions to Real GDP Growth
(Year-on-year; in percentage points)



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

On the supply side, the mining sector and agriculture production experienced negative shocks, while growth in other major sectors were sustained.

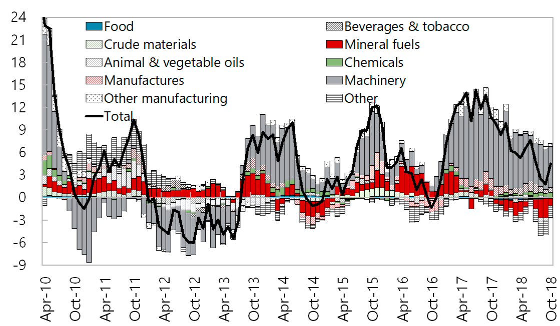
Malaysia: Real GDP by Industy
(Year-on-year percent change)



Sources: Haver Analytics; and IMF staff calculations.

Electronics remain the main driver of export growth up to 2018Q3; commodity exports declined on account of lower palm-oil and LNG exports.

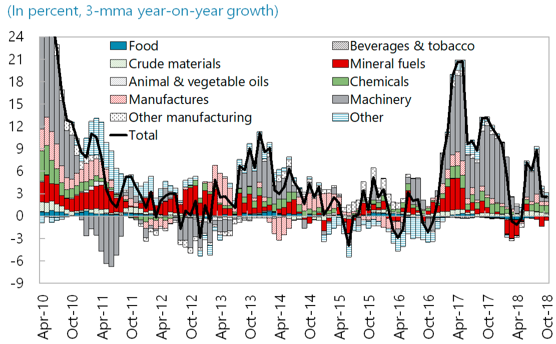
Export Volumes Growth Contribution
(In percent, 3-mma year-on-year growth)



Sources: IMF, *Direction of Trade Statistics*; and IMF Staff calculations.

Strong import growth was supported mainly by robust imports for re-export activities up to 2018Q3 and by strong domestic consumption growth in 2018Q3.

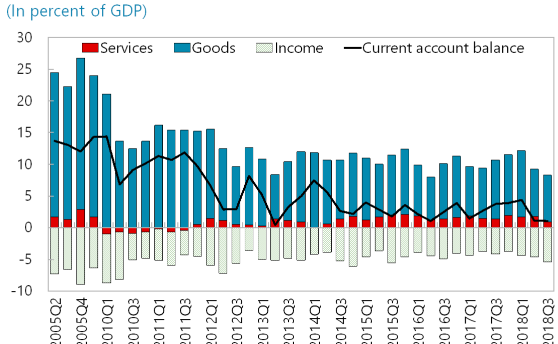
Import Volumes Growth Contribution
(In percent, 3-mma year-on-year growth)



Sources: IMF, *Direction of Trade Statistics*; and IMF Staff calculations.

As a result, while the current account has remained in surplus in 2018, it has declined relative to last year.

Current Account Balance
(In percent of GDP)



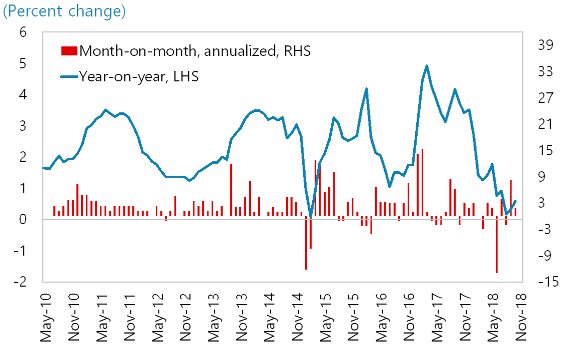
Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 2. Malaysia: Inflation and Domestic Resource Constraints

Headline inflation has experienced a temporary drop in 2018, reflecting zero-rating of the GST and suspension of domestic fuel price adjustments …

Consumer Price Index

(Percent change)

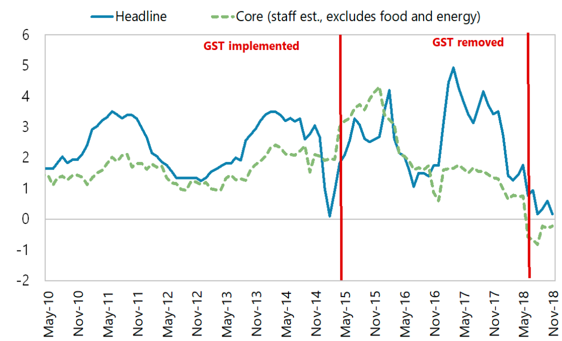


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

… notably, core inflation turned to negative following the removal of the GST in June and rebounded slowly after the reintroduction of the SST in September.

Inflation Developments

(Year-on-year; in percent)

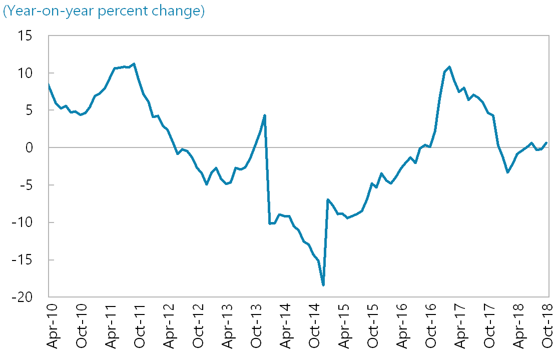


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Producer prices have moderated in 2018, as the impact of rising global commodity prices has been offset by the decrease in intermediate and final good prices.

Producer Price Index

(Year-on-year percent change)

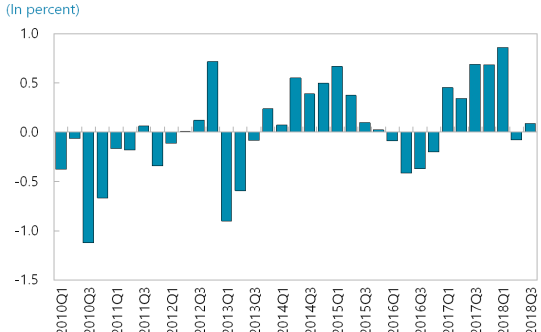


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Following slower growth, the output gap has declined to close to zero in 2018Q2 and Q3.

Output Gap

(In percent)

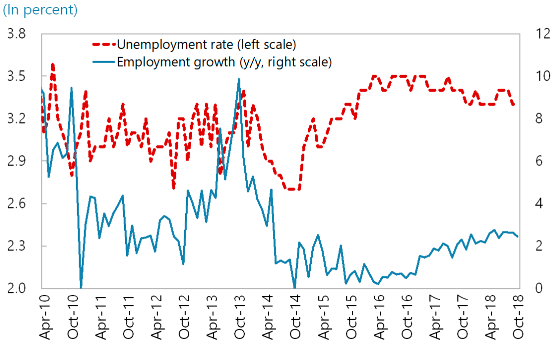


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

The unemployment rate has stabilized as labor force expansion continues to match employment growth …

Labor Market Developments

(In percent)

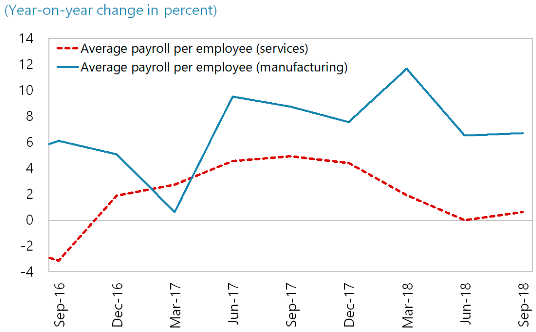


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

…and payrolls continue to rise both in the services and the manufacturing sectors, with the latter growing at a faster pace throughout 2018Q3.

Manufacturing and Services: Payroll

(Year-on-year change in percent)



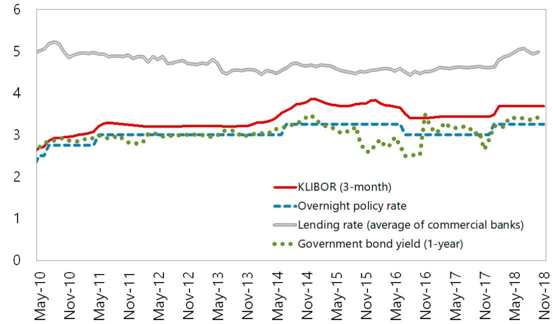
Sources: CEIC Data Co. Ltd; Haver Analytics; and IMF staff calculations.

Figure 3. Malaysia: Monetary Developments

The BNM hiked its policy rate in January 2018 and has remained on hold since. Market interest rates have been largely stable.

Interest Rates

(In percent per annum)

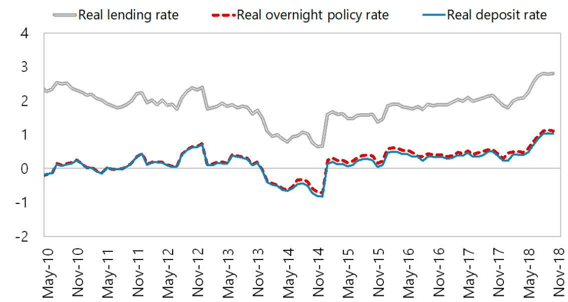


Sources: Bloomberg L.P.; and CEIC Data Co. Ltd.

Real interest rates have increased as the expected inflation rate has declined.

Real Interest Rates

(In percent per annum)

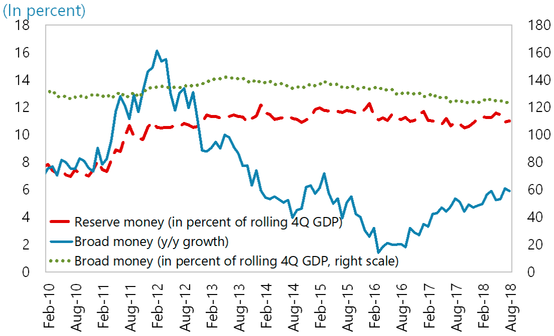


Sources: Bloomberg L.P.; CEIC Data Co. Ltd; Consensus Economics Inc.; and IMF staff calculations.
Note: Nominal rates adjusted for 1-year ahead of inflation expectations.

Monetary aggregates are growing in line with GDP...

Monetary Aggregates 1/

(In percent)

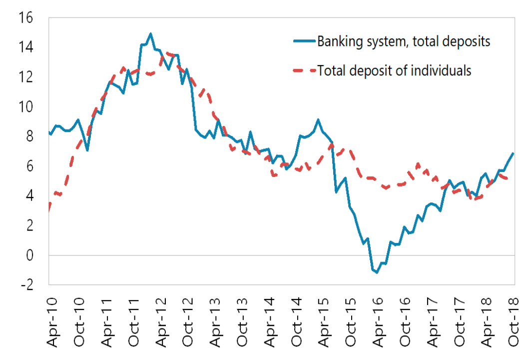


Sources: IMF, *Integrated Monetary database*; and IMF staff calculations.
1/ At depository corporations level.

... and deposit growth is rising moderately.

Banking System Deposit Growth

(In percent, y-o-y)

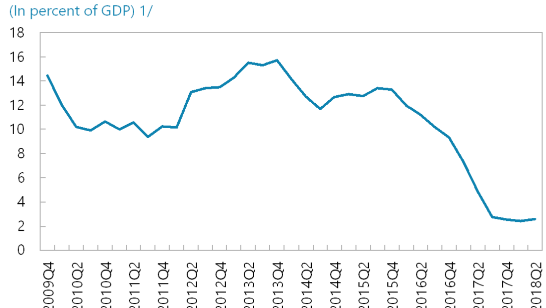


Source: Bank Negara Malaysia; and IMF staff calculations.

The credit gap has declined to a post-GFC low.

Credit Gap

(In percent of GDP) 1/

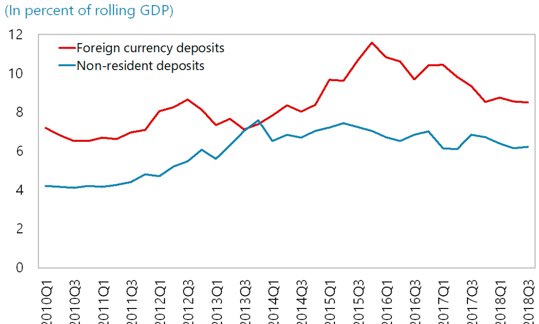


Source: IMF staff estimates.
1/ Credit gap is measured using deviation of credit-to-GDP ratio from a one-sided Hodrick-Prescott filter with a large parameter over 2000Q1–2017Q4.

As a share of GDP, foreign currency deposits have been largely stable in recent quarters, but nonresident deposits have slightly declined.

Foreign Currency and Non-resident Deposits

(In percent of rolling GDP)



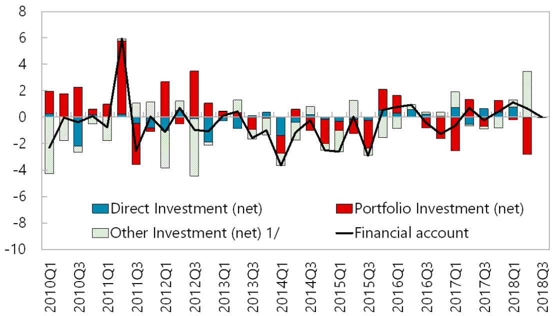
Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 4. Malaysia: Capital Flows

Despite higher other investment inflows, large outflows of non-resident portfolio investments in 2018Q2 lead to a deterioration in the financial account.

Financial Account Balance

(In percent of 4-quarter rolling GDP; positive = net inflows)

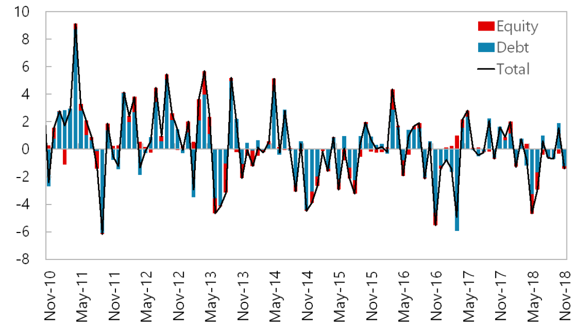


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.
1/ Includes financial derivatives.

The bulk of bonds and equity outflows occurred after the election in May and June and stabilized in July and August, …

Malaysia: Nonresident Portfolio Capital Flows 1/

(In billion U.S. dollar; as of Nov 2018)

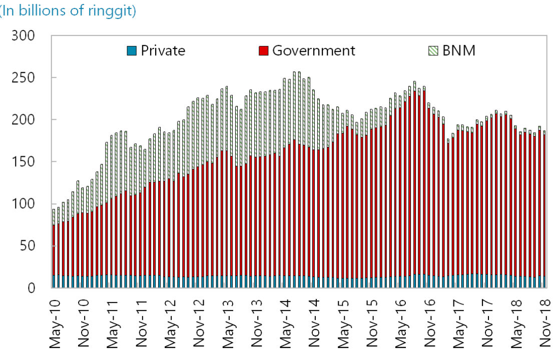


Sources: CEIC Data Co. Ltd.; and IMF staff estimates.
1/ Based on staff estimates from debt and equity markets data.

…notably outflows from the ringgit-denominated Malaysian government securities market.

Foreign Holdings of Local-Currency Debt Securities

(In billions of ringgit)

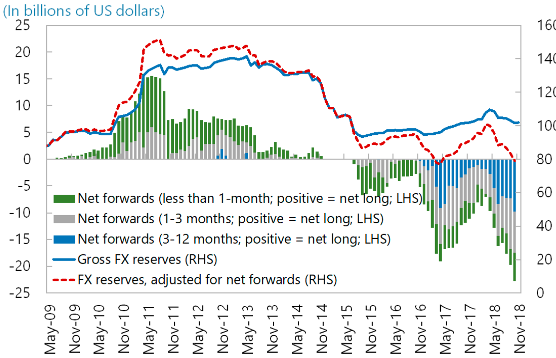


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

While BNM's gross FX reserves have stabilized after 2018Q2, its growing net short position in forwards has led to a continued decline in net FX reserves in recent months.

Official Foreign Reserves

(In billions of US dollars)

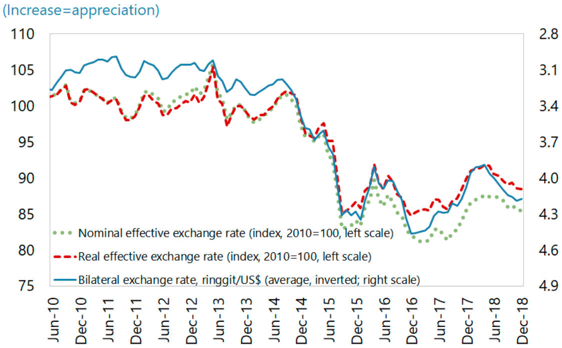


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Faced with a series of external shocks in recent years, the currency has depreciated from its 2013 peak.

Exchange Rates

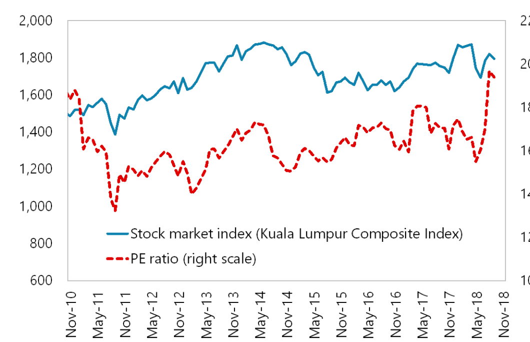
(Increase=appreciation)



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

The stock market has gained since late 2016, depicting a jump in the PE ratio in 2018.

Stock Market Performance



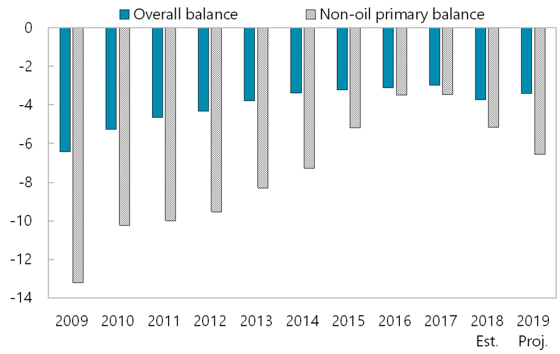
Source: Bloomberg L.P.

Figure 5. Malaysia: Fiscal Policy Developments

The federal deficit has fallen gradually but is estimated to have widened in 2018.

Federal Government: Overall and Non-Oil Balance

(In percent of GDP)

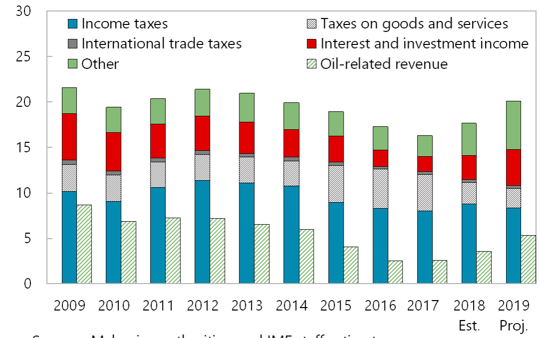


Sources: Malaysian authorities; and IMF staff calculations.

The zero rating of the GST has reduced tax revenue, with higher oil-related revenue partly compensating for the decline.

Federal Government Revenue

(In percent of GDP)

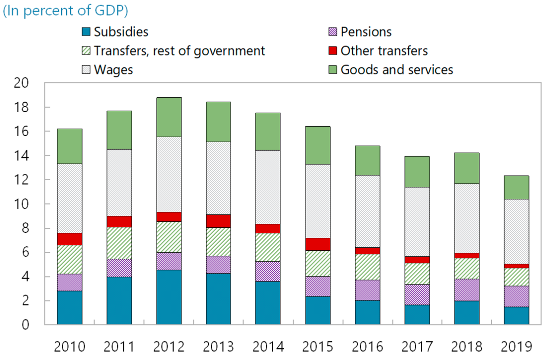


Sources: Malaysian authorities; and IMF staff estimates.

Increases in social spending has reversed the declining trend of current expenditures in 2018.

Federal Government Current Expenditures

(In percent of GDP)

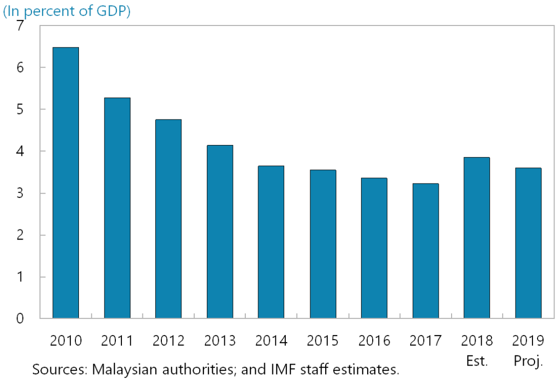


Sources: Malaysian authorities; and IMF staff calculations.

Development spending has risen on a cash basis, despite existing projects being put on hold pending further review.

Federal Government Development Spending

(In percent of GDP)

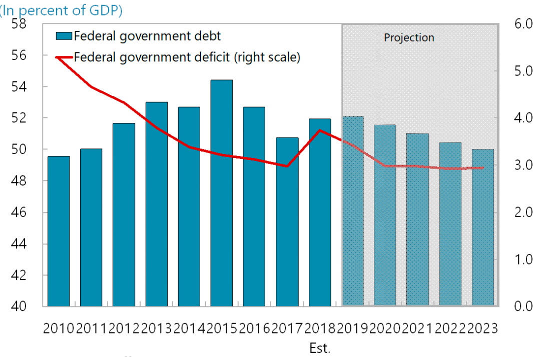


Sources: Malaysian authorities; and IMF staff estimates.

The federal debt will remain high at around 50 percent of GDP, absent additional fiscal consolidation.

Medium–Term Fiscal Outlook

(In percent of GDP)

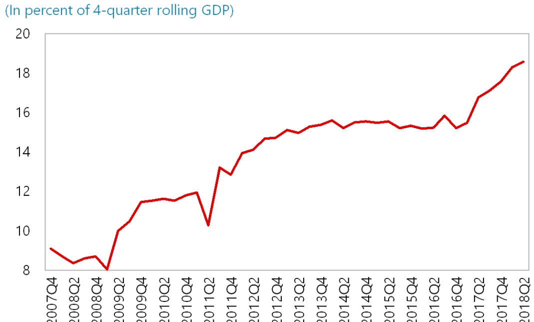


Source: IMF staff estimates.

Guarantees, as a share of GDP, jumped up recently after remaining stable for several years.

Federal Government Loan Guarantees

(In percent of 4-quarter rolling GDP)

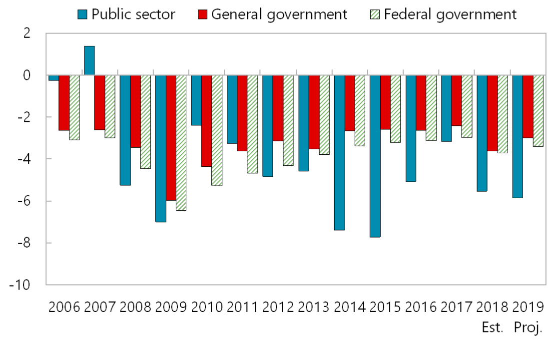


Source: CEIC Data Co. Ltd.

Figure 6. Malaysia: Public Sector Fiscal Stance and Prospects

Non-Financial Public Sector (NFPS) deficit has improved after peaking in 2015.

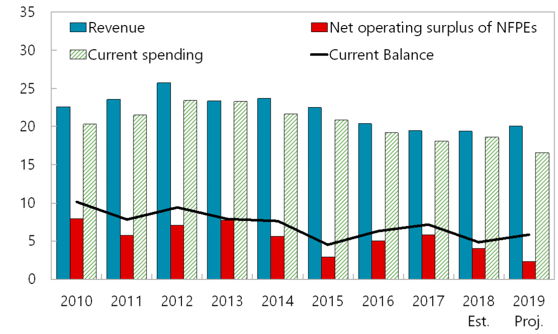
Fiscal Balance
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

Public companies' surpluses has been sustained.

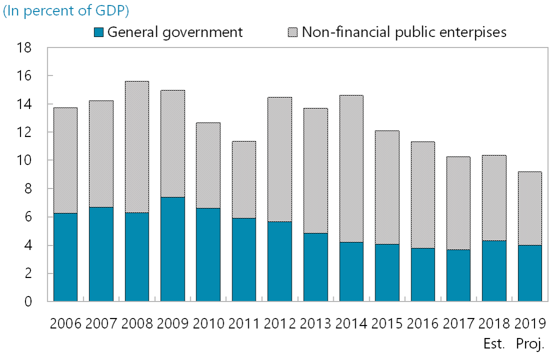
Current Balance of the Public Sector
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

General government development spending has declined…

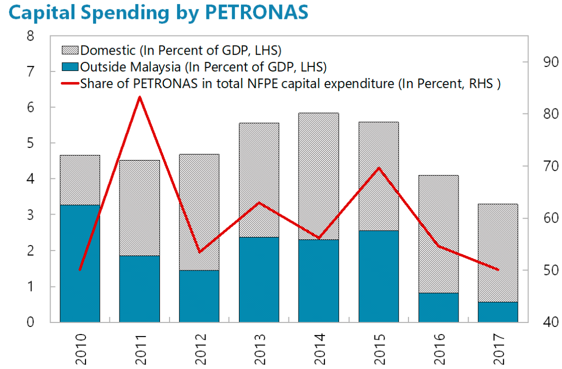
Development Spending
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

… with Petronas' share lower than before.

Capital Spending by PETRONAS

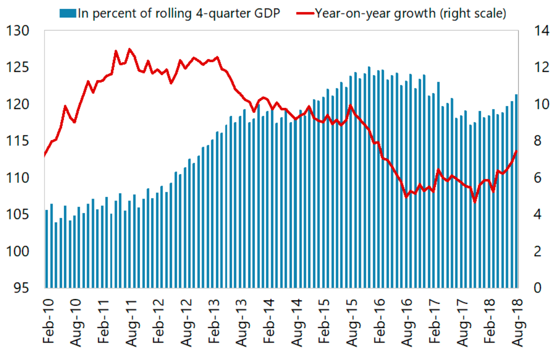


Sources: PETRONAS; Malaysian authorities; and IMF staff calculations.

Figure 7. Malaysia: Financial Sector Developments

Credit growth, which had slowed down considerably in recent years, picked up moderately in 2018.

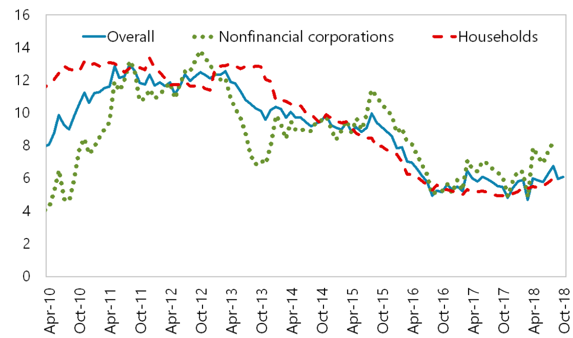
Banks' Claims on Private Sector



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

This pattern had been observed across the board.

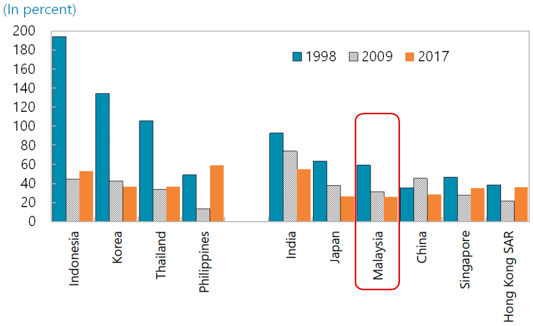
Banks' Claims on Private Sector
(Year-on-year growth)



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

Overall corporate sector leverage is below levels prior to the Asian Financial Crisis.

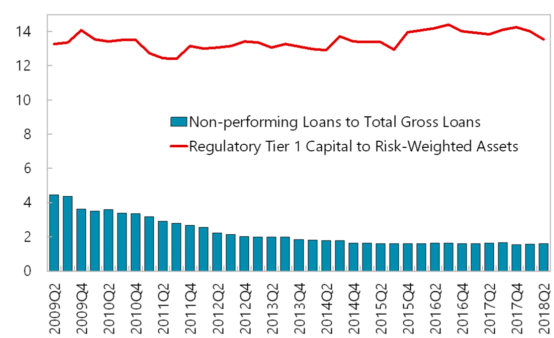
Corporate Debt-to-Equity Ratio 1/
(In percent)



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

The banking system is well capitalized and gross non-performing loans are low.

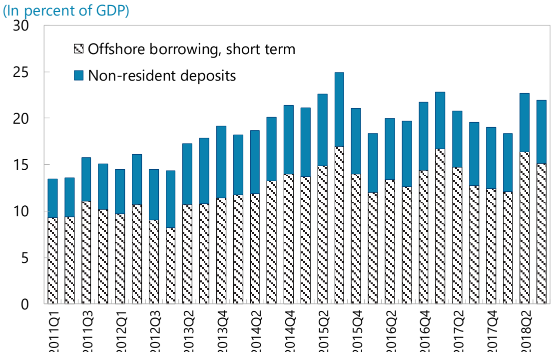
Banks' Financial Soundness Indicators
(In percent)



Source: IMF, *Financial Soundness Indicators* database.

The banking system's reliance on short-term external debt, as a share of GDP, increased in 2018…

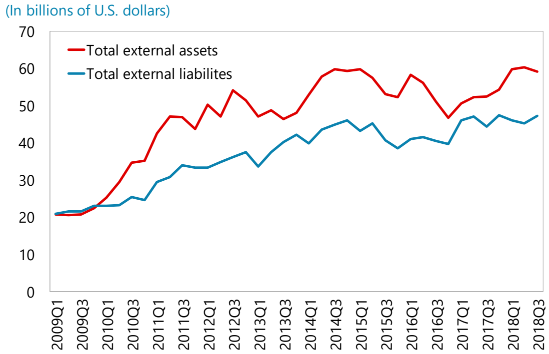
Banks' Short-Term External Debt: 2011:Q1–2018:Q3
(In percent of GDP)



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

… accompanied by growing banks' net external asset position since mid-2017.

Banking System: External Assets and Liabilities
(In billions of U.S. dollars)

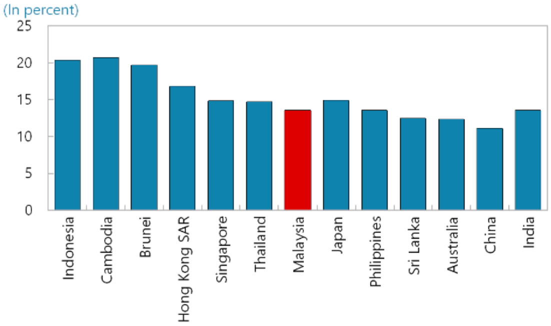


Sources: CEIC Data Co. Ltd; and IMF staff calculations.

Figure 8. Financial Soundness Indicators 1/

Malaysian banks' capital buffers are strong…

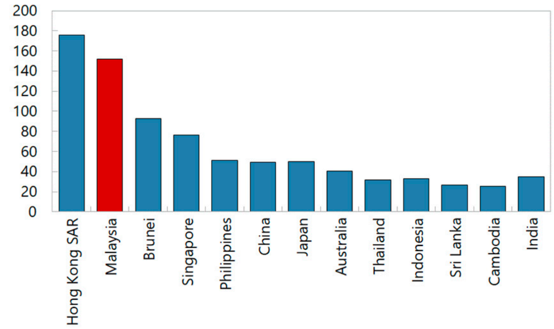
Regulatory Tier 1 Capital to Risk-Weighted Asset, 2018Q2 1/
(In percent)



Source: IMF, *Financial Soundness Indicators* database.

… while liquidity provides stronger cover for short-term liabilities relative to peers.

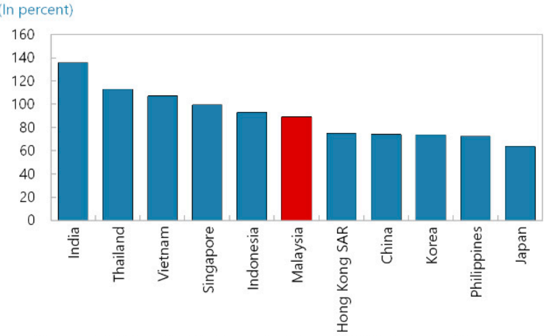
Liquid Assets to Short-Term Liabilities, 2018Q2 1/
(In percent)



Source: IMF, *Financial Soundness Indicators* database.

Lending in proportion to deposits is in line with peers…

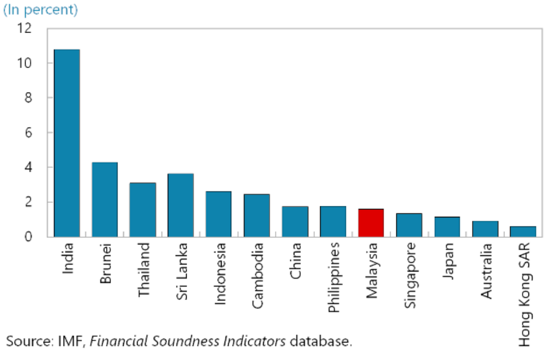
Loan to Deposit Ratio, 2018Q3 1/
(In percent)



Sources: CEIC Data Co. Ltd.; Haver Analytics; and IMF staff calculations.
1/ Data for Vietnam are as of 2017Q4.

… and asset quality is high.

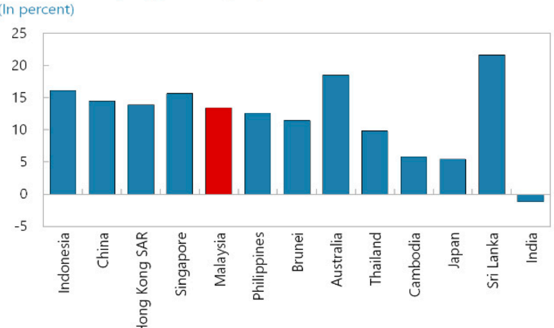
Nonperforming Loans to Total Gross Loans, 2018Q2 1/
(In percent)



Source: IMF, *Financial Soundness Indicators* database.

Banks are profitable…

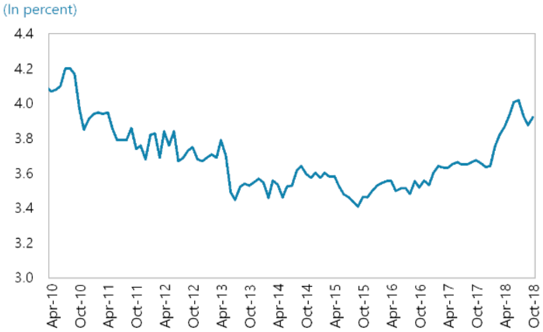
Return on Equity, 2018Q2 2/
(In percent)



Source: IMF, *Financial Soundness Indicators* database.

… partially reflecting high and rising interest rate spreads.

Malaysian Commercial Banks: Interest Rate Spreads
(In percent)



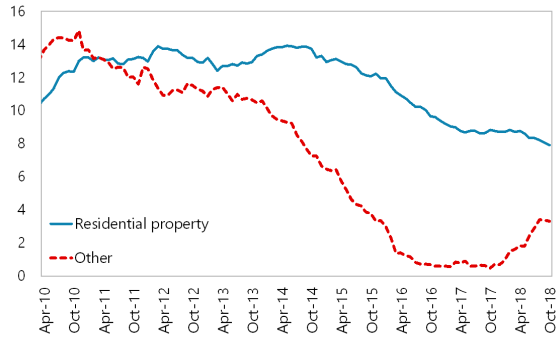
Sources: Bank Negara Malaysia; and IMF staff calculations.

1/ Financial Soundness Indicators for Malaysia are as indicated, while for the other countries those indicators range between 2017Q2 and 2018Q3 depending on availability.

Figure 9. Malaysia: Household Debt

Housing loan growth has moderated, while personal loans growth has accelerated slightly in 2018…

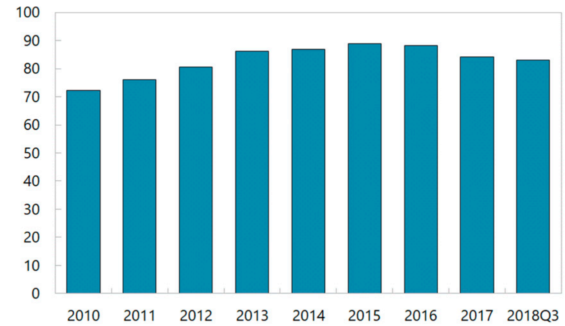
Household Loan Growth
(In percent, year-on-year)



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

… but overall household debt has declined as a share of GDP.

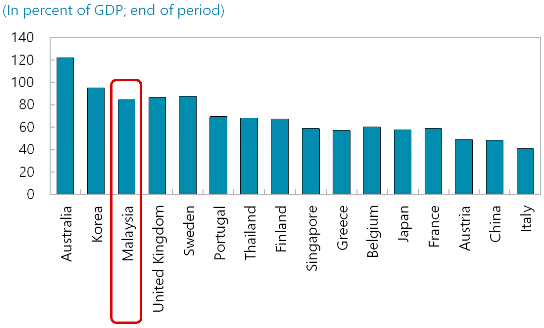
Household Debt
(In percent of GDP)



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

Household debt-to-GDP ratio remains high compared to other countries…

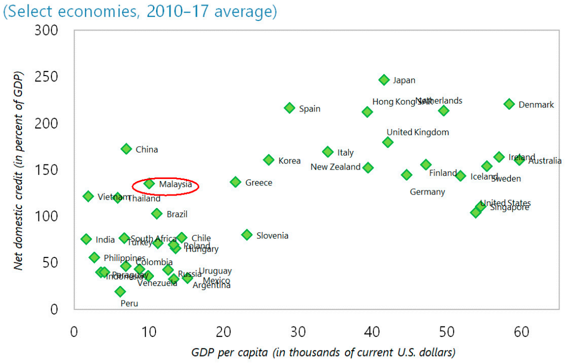
Household Debt, 2017
(In percent of GDP; end of period)



Sources: Bank Negara Malaysia; Bank for Internaitonal Settlements; and IMF, *World Economic Outlook* and staff calculations.

… and is above the levels observed in countries with similar GDP per capita.

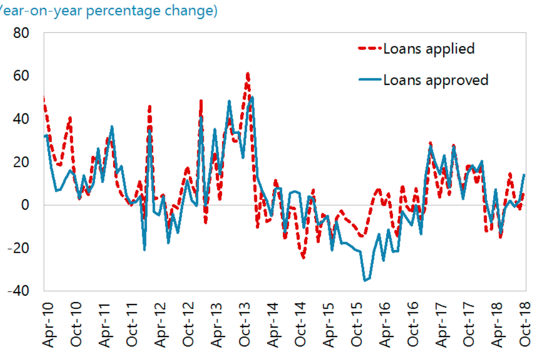
Net Domestic Credit and GDP per Capita
(Select economies, 2010–17 average)



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

Loan approvals and applications have been on a decline in early 2018, but later showed signs of improvement, reflecting stronger private sector confidence.

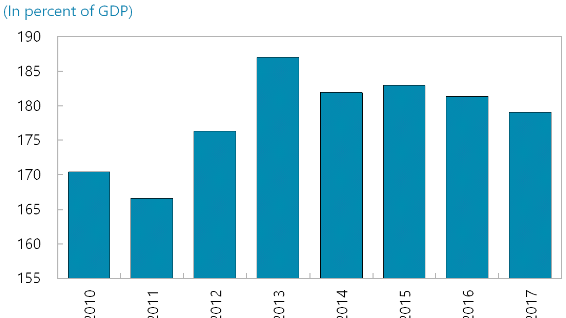
Loan Applications and Approvals
(Year-on-year percentage change)



Source: CEIC Data Co. Ltd.

High household financial assets help mitigate the vulnerability from growing household debt.

Household Financial Assets
(In percent of GDP)

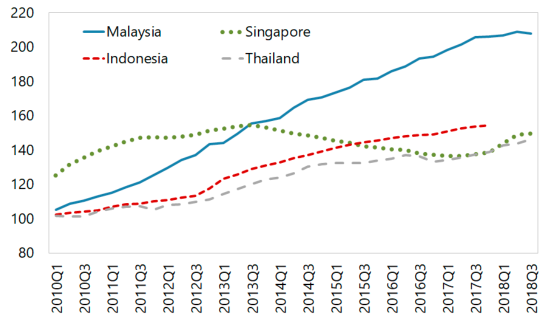


Sources: Bank Negara Malaysia; Malaysian Employee Provident Fund; CEIC Data Co. Ltd.; and IMF

Figure 10. Malaysia: House Prices

House prices appear to have stabilized…

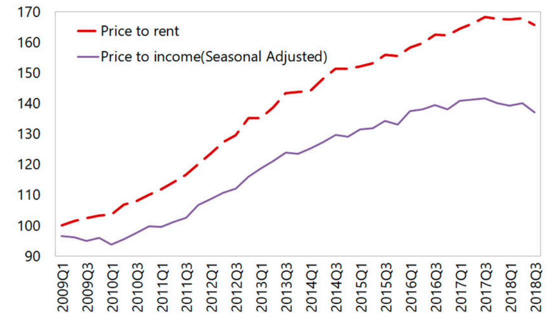
House Price Index
(2009:Q1 = 100)



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

…resulting in a slower increase relative to income and rents.

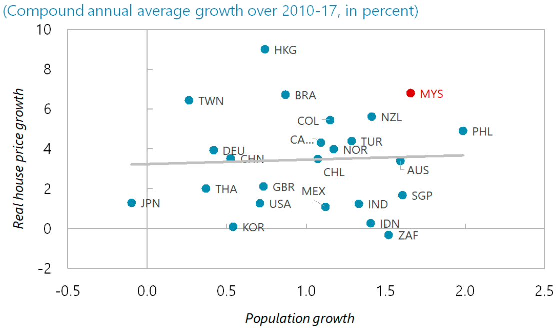
House Prices
(Ratio of indices, 2009:Q1=100)



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

Although population growth is strong, this alone cannot explain the rise in house prices relative to other countries.

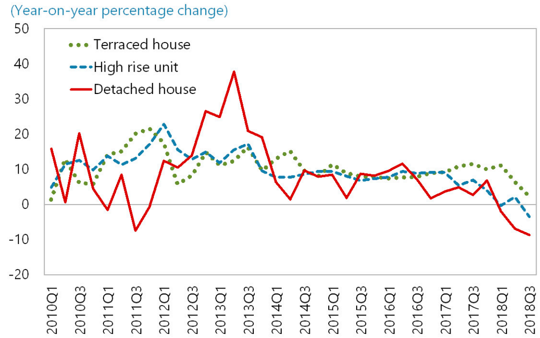
Real House Prices and Population
(Compound annual average growth over 2010-17, in percent)



Sources: CEIC Data Co. Ltd.; and IMF, Research Department database on housing prices, *World Economic Outlook* database, and staff calculations.

The housing market in Kuala Lumpur is moderating.

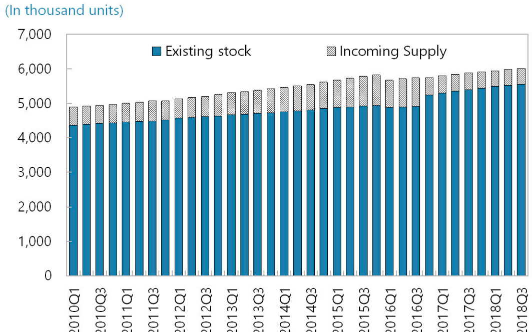
Malaysia: House Prices in Kuala Lumpur
(Year-on-year percentage change)



Source: CEIC Data Co. Ltd.

Residential supply has been increasing.

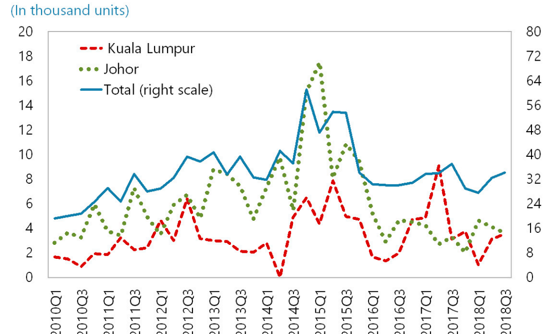
Residential Property Supply
(In thousand units)



Source: CEIC Data Co. Ltd.

Construction starts slowed since 2017Q3, which helps alleviate concerns of growing oversupply.

Residential Property: Construction Started
(In thousand units)



Source: CEIC Data Co. Ltd.

Table 1. Malaysia: Selected Economic and Financial Indicators, 2014–20

Nominal GDP (2018, est.): US$353.6 billion
GDP per capita (2018, current prices, est.): US$10,919
Unemployment rate (August 2018): 3.4 percent

Population (2018, mid-year): 32.4 million
Poverty rate (2016, national poverty line): 0.4 percent
Adult literacy rate (2017): 95.9 percent

Main goods exports (share in total, 2017): electrical & electronics (36.7 percent), commodities (13.6 percent), and petroleum products (7.7 percent).

					Est.	Proj.	
	2014	2015	2016	2017	2018	2019	2020
Real GDP (percent change)	6.0	5.1	4.2	5.9	4.7	4.7	4.8
Total domestic demand	5.3	6.0	4.5	6.6	4.6	5.1	4.8
Private consumption	7.0	6.0	6.0	7.0	7.3	6.8	5.8
Public consumption	4.4	4.5	0.9	5.4	0.8	0.2	0.6
Private investment	11.1	6.3	4.3	9.3	4.4	5.5	6.0
Public gross fixed capital formation	-4.7	-1.1	-0.5	0.1	-1.6	-2.5	1.1
Net exports (contribution to growth, percentage points)	1.2	-0.3	0.1	-0.2	0.5	0.0	0.3
Saving and investment (in percent of GDP)							
Gross domestic investment	25.0	25.1	25.8	25.6	24.5	24.2	24.2
Gross national saving	29.4	28.2	28.3	28.5	26.7	26.0	25.8
Fiscal sector (in percent of GDP) 1/							
Federal government overall balance	-3.4	-3.2	-3.1	-3.0	-3.7	-3.4	-3.0
Revenue	19.9	18.9	17.3	16.3	16.6	17.2	15.0
Expenditure and net lending	23.3	22.1	20.4	19.3	20.3	18.2	18.0
Tax refunds (Arrears) 2/						2.4	
Federal government non-oil primary balance	-7.3	-5.2	-3.5	-3.5	-5.2	-6.6	-4.1
Consolidated public sector overall balance 3/	-7.4	-7.7	-5.1	-3.2	-5.5	-5.8	-5.1
General government debt 3/	56.2	57.9	56.6	55.2	56.3	56.5	56.0
Of which: federal government debt	52.7	54.4	52.7	50.7	51.9	52.1	51.5
Inflation and unemployment (annual average, in percent)							
CPI inflation	3.2	2.1	2.1	3.7	1.0	2.2	2.6
CPI inflation (excluding food and energy) 4/	2.1	3.2	2.6	1.6	0.4	1.2	2.4
Unemployment rate	2.9	3.2	3.5	3.4	3.4	3.4	3.4
Macrofinancial variables (end of period)							
Broad money (percentage change) 5/	6.3	3.0	2.7	4.8	5.5	…	…
Credit to private sector (percentage change) 5/	9.2	8.6	5.3	5.4	6.0	…	…
Credit-to-GDP ratio (in percent) 4/ 6/	130.1	134.6	133.9	128.3	129.1	…	…
Credit-to-GDP gap (in percent) 4/ 6/	12.7	13.5	9.4	2.5	2.6	…	…
Overnight policy rate (in percent)	3.25	3.25	3.00	3.00	3.25	…	…
Three-month interbank rate (in percent)	3.9	3.8	3.4	3.5	3.7	…	…
Nonfinancial corporate sector debt (in percent of GDP)	98.6	106.7	109.5	102.8	104.3	…	…
Nonfinancial corporate sector debt issuance (in percent of GDP)	3.2	2.6	3.2	3.4	3.7	…	…
Household debt (in percent of GDP)	86.1	88.4	87.8	83.8	83.0	…	…
Household financial assets (in percent of GDP)	182.1	183.1	181.5	177.6	…	…	…
House prices (percentage change)	9.4	7.4	7.1	6.5	…	…	…
Exchange rates (period average)							
Malaysian ringgit/U.S. dollar	3.27	3.91	4.15	4.30	4.04	…	…
Real effective exchange rate (percentage change)	-0.7	-7.9	-4.3	-1.7	4.1	…	…
Balance of payments (in billions of U.S. dollars) 4/							
Current account balance	14.8	9.0	7.2	9.4	7.7	6.5	6.4
(In percent of GDP)	4.4	3.0	2.4	3.0	2.2	1.8	1.6
Goods balance	34.6	28.0	24.6	27.2	30.7	29.8	31.3
Services balance	-3.3	-5.3	-4.6	-5.3	-6.6	-6.5	-6.9
Income balance	-16.5	-13.7	-12.8	-12.5	-16.5	-16.9	-18.0
Capital and financial account balance	-24.3	-14.5	0.0	0.9	2.3	5.5	7.0
Of which: Direct investment	-5.5	-0.5	3.3	3.8	4.1	4.3	4.6
Errors and omissions	-1.7	6.4	-5.8	-6.4	-11.0	0.0	0.0
Overall balance	-11.2	1.0	1.4	3.8	-1.0	12.0	13.4
Gross official reserves (US$ billions) 4/	115.9	95.3	94.5	102.4	101.4	113.4	126.8
(In months of following year's imports of goods and nonfactor services)	7.5	6.3	5.6	5.8	5.5	5.9	6.2
(In percent of short-term debt by original maturity)	111.6	116.2	112.5	109.9	105.8	112.1	121.1
(In percent of short-term debt by remaining maturity)	78.3	74.4	72.6	72.5	70.4	76.1	82.3
Total external debt (in billions of U.S. dollars) 4/	213.4	195.0	204.2	218.3	221.1	225.9	233.2
(In percent of GDP)	63.1	65.7	68.8	69.4	62.5	61.0	58.7
Of which: short-term (in percent of total, original maturity)	48.7	42.0	41.2	42.7	43.4	44.8	44.9
short-term (in percent of total, remaining maturity)	69.4	65.7	63.7	64.7	65.1	66.0	66.0
Debt service ratio 4/							
(In percent of exports of goods and services) 7/	17.9	21.5	23.4	21.0	21.3	21.1	20.5
(In percent of exports of goods and nonfactor services)	19.1	22.7	24.8	22.2	22.5	22.3	21.7
Memorandum items:							
Nominal GDP (in billions of ringgit)	1,106	1,159	1,231	1,353	1,427	1,522	1,633

Sources: Data provided by the authorities; CEIC Data Co. Ltd.; World Bank; UNESCO; and IMF, *Integrated Monetary Database* and staff estimates.

1/ Cash basis. The authorities plan to adopt accrual basis by 2021. For 2019, overall and primary balance includes the payment of outstanding tax refund (arrears) amounting to RM37 billion.

2/ Tax refunds in 2019 are allocated for payment of outstanding tax refunds.

3/ Consolidated public sector includes general government and nonfinancial public enterprises (NFPEs). General government includes federal government, state and local governments, and statutory bodies.

4/ IMF staff estimates. U.S. dollar values are estimated using official data published in national currency.

5/ Based on data provided by the authorities, but follows compilation methodology used in IMF's *Integrated Monetary Database.*

6/ Based on a broader measure of liquidity. Credit gap is estimated on quarterly data from 2000, using one-sided Hodrick-Prescott filter with a large parameter.

7/ Includes receipts under the primary income account.

Table 2. Malaysia: Indicators of External Vulnerability, 2014–18

	2014	2015	2016	2017	2018 2/
Financial indicators					
General government debt (in percent of GDP) 1/	56.2	57.9	56.6	55.2	56.2
Broad money (end of period, year-on-year percent change) 3/	6.3	3.0	2.7	4.8	5.7
Private sector credit (end of period, year-on-year percent change) 3/	9.2	8.6	5.3	5.4	6.3
3-month interest rate (percent, 12-month average) 4/	3.5	3.7	3.6	3.4	3.7
External indicators 5/					
Goods exports, f.o.b. (percent change, 12-month basis, in U.S. dollars terms) 6/	2.5	-15.9	-5.1	13.3	10.5
Goods imports, f.o.b. (percent change, 12-month basis, in U.S. dollars terms) 6/	0.6	-15.2	-3.7	13.8	10.4
Current account balance (12-month basis, in billions of U.S. dollars) 6/	14.8	9.0	7.2	9.4	8.3
Current account balance (12-month basis, in percent of GDP)	4.4	3.0	2.4	3.0	2.3
Capital and financial account balance (12-month basis, in billions of U.S. dollars) 6/	-24.3	-14.5	0.0	-1.1	4.6
Gross official reserves (in billions of U.S. dollars)	115.9	95.3	94.5	102.4	101.4
In months of following year's imports of goods and nonfactor services 6/	7.5	6.3	5.6	5.5	5.3
As percent of broad money 3/ 6/	26.8	26.2	26.4	24.7	23.6
As percent of monetary base 3/ 6/	325.7	297.9	300.1	281.2	268.1
Total short-term external debt by: 6/ 7/					
Original maturity (in billions of U.S. dollars)	103.9	82.0	84.0	93.2	95.5
Remaining maturity (in billions of U.S. dollars)	148.0	128.1	130.2	141.2	142.8
Original maturity to reserves (in percent)	89.6	86.0	88.9	91.0	94.2
Original maturity to total external debt (in percent)	48.7	42.0	41.2	42.7	43.7
Remaining maturity to reserves (in percent)	127.7	134.4	137.7	137.9	140.8
Remaining maturity to total external debt (in percent)	69.4	65.7	63.7	64.7	65.3
Total external debt (in billions of U.S. dollars) 6/ 7/	213.4	195.0	204.2	218.3	218.6
Of which: public sector (medium- and long-term (MLT))	69.7	70.1	72.2	74.8	70.3
Total external debt to exports of goods and services (in percent) 6/ 8/	80.4	87.9	96.1	92.1	84.0
External amortization of MLT debt to exports of goods and services (in percent) 6/ 8/	16.5	19.9	21.7	19.5	18.5
Financial market indicators					
Kuala Lumpur Composite Index (KLCI), end of period	1,761	1,693	1,642	1,797	1,691
10-year government securities yield (percent per annum, average)	4.0	4.0	3.8	4.0	4.1

Sources: Haver Analytics; CEIC Data Co. Ltd.; data provided by the authorities; and IMF, *Integrated Monetary Database* and staff estimates.

1/ Gross debt. General government includes the federal government, state and local governments, and the statutory bodies.

2/ Latest available data or IMF staff estimates.

3/ Based on data provided by the authorities, but follows compilation methodology used in IMF's *Integrated Monetary Database.*

4/ Kuala Lumpur interbank offer rate.

5/ Based on balance of payments.

6/ IMF staff estimates. U.S. dollar values are estimated using official data published in national currency.

7/ Includes offshore borrowing, nonresident holdings of ringgit-denominated securities, nonresident deposits, and other short-term debt.

8/ Includes receipts under the primary income account.

Table 3. Malaysia: Balance of Payments, 2014–23 1/

	2014	2015	2016	2017	Est. 2018	Proj. 2019	2020	2021	2022	2023
	(In billions of U.S. dollars)									
Current account balance	14.8	9.0	7.2	9.4	7.7	6.5	6.4	5.4	4.0	3.0
Goods balance	34.6	28.0	24.6	27.2	30.7	29.8	31.3	32.3	32.4	32.6
Exports, f.o.b.	207.4	174.4	165.6	187.7	197.9	204.3	215.1	226.5	237.3	248.0
Imports, f.o.b.	172.8	146.5	141.0	160.5	167.2	174.5	183.8	194.2	204.9	215.3
Services balance	-3.3	-5.3	-4.6	-5.3	-6.6	-6.5	-6.9	-7.7	-8.5	-9.3
Receipts	42.0	34.8	35.6	37.0	38.4	39.8	41.3	42.9	44.6	46.4
Payments	45.3	40.1	40.1	42.3	44.9	46.2	48.2	50.6	53.1	55.7
Primary income	-11.2	-8.2	-8.3	-8.5	-12.0	-12.1	-13.0	-13.7	-14.0	-14.0
Secondary income	-5.3	-5.5	-4.5	-4.0	-4.5	-4.7	-5.1	-5.5	-5.9	-6.3
Capital and financial account balance	-24.3	-14.5	0.0	0.9	2.3	5.5	7.0	8.9	10.9	12.7
Capital account	0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-24.4	-14.2	-0.1	0.9	2.3	5.5	7.0	8.9	10.9	12.7
Direct investment	-5.5	-0.5	3.3	3.8	4.1	4.3	4.6	5.0	5.4	5.7
Portfolio investment	-12.0	-6.7	-3.4	-2.9	-7.5	0.8	1.7	2.4	3.6	3.9
Other investment	-6.9	-7.0	0.0	0.0	5.7	0.4	0.6	1.5	1.9	3.1
Errors and omissions	-1.7	6.4	-5.8	-6.4	-11.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-11.2	1.0	1.4	3.8	-1.0	12.0	13.4	14.3	14.9	15.7
Gross official reserves	115.9	95.3	94.5	102.4	101.4	113.4	126.8	141.1	156.0	171.7
In months of following year's imports of goods and nonfactor services	7.5	6.3	5.6	5.8	5.5	5.9	6.2	6.6	6.9	7.2
In percent of short-term debt 2/	78.3	74.4	72.6	72.5	70.4	76.1	82.3	87.9	92.4	96.2
	(In percent of GDP)									
Current account balance	4.4	3.0	2.4	3.0	2.2	1.8	1.6	1.3	0.9	0.6
(Excluding crude oil and liquefied natural gas)	-1.7	-1.7	-1.0	-0.7	-1.2	-1.6	-1.9	-2.1	-2.4	-2.5
Goods balance	10.2	9.4	8.3	8.6	8.7	8.1	7.9	7.6	7.1	6.6
Exports, f.o.b.	61.4	58.8	55.8	59.6	56.0	55.2	54.2	53.1	51.7	50.3
Imports, f.o.b.	51.1	49.4	47.5	51.0	47.3	47.2	46.3	45.5	44.7	43.7
Services balance	-1.0	-1.8	-1.5	-1.7	-1.9	-1.8	-1.7	-1.8	-1.9	-1.9
Primary income	-3.3	-2.8	-2.8	-2.7	-3.4	-3.3	-3.3	-3.2	-3.0	-2.8
Secondary income	-1.6	-1.8	-1.5	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Capital and financial account balance	-7.2	-4.9	0.0	0.3	0.6	1.5	1.8	2.1	2.4	2.6
Direct investment	-1.6	-0.2	1.1	1.2	1.1	1.2	1.2	1.2	1.2	1.2
	(Annual percentage change)									
Memorandum items:										
Goods trade										
Exports, f.o.b., value growth (in U.S. dollars) 1/	2.5	-15.9	-5.1	13.3	5.5	3.3	5.3	5.3	4.8	4.5
Export volume growth	6.6	6.0	3.3	10.8	2.1	3.9	4.8	4.5	4.1	3.9
Imports, f.o.b., value growth (in U.S. dollars) 1/	0.6	-15.2	-3.7	13.8	4.2	4.4	5.3	5.7	5.5	5.1
Import volume growth	4.1	1.3	0.5	12.8	0.6	4.9	4.8	4.9	4.8	4.5
Terms of trade	-1.4	-3.4	-3.3	1.1	-0.2	-0.2	0.0	-0.1	-0.1	-0.1
Net international investment position 1/										
(In billions of U.S. dollars)	-5.0	25.4	15.6	-6.2	...	...	...	...	...	...
(In percent of GDP)	-1.5	8.6	5.3	-2.0	...	...	...	...	...	...

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

1/ Information presented in this table is based on staff estimates using official data published in national currency.
2/ Based on IMF staff estimates of short-term external debt by remaining maturity.

Table 4. Malaysia: Illustrative Medium-Term Macroeconomic Framework, 2014–23 1/

					Est.	Proj.				
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Real sector (percent change)										
Real GDP growth	6.0	5.1	4.2	5.9	4.7	4.7	4.8	4.8	4.8	4.8
Total domestic demand	5.3	6.0	4.5	6.6	4.6	5.1	4.8	5.2	5.4	5.3
Output gap (in percent) 2/	0.1	0.3	-0.2	0.6	0.4	0.2	0.1	0.1	0.1	0.0
Consumer prices (period average)	3.1	2.1	2.1	3.8	1.0	2.2	2.6	2.5	2.4	2.3
Consumer prices, excluding food and energy (period average) 2/	2.1	3.2	2.6	1.6	0.4	1.2	2.4	2.3	2.1	1.9
GDP deflator	2.5	-0.4	2.0	3.8	0.7	1.9	2.4	2.4	2.3	2.3
Saving and investment (in percent of GDP)										
Gross domestic investment	25.0	25.1	25.8	25.6	24.5	24.2	24.2	24.2	24.3	24.3
Private, including stocks	15.6	16.2	17.3	17.6	17.0	17.3	17.4	17.7	17.9	18.1
Of which: gross fixed capital formation	16.6	17.1	17.2	17.4	17.4	17.5	17.8	18.0	18.2	18.4
Public	9.4	9.0	8.6	7.9	7.5	7.0	6.7	6.6	6.4	6.2
Gross national saving	29.4	28.2	28.3	28.5	26.7	26.0	25.8	25.5	25.1	24.9
Private 3/	24.9	23.6	21.9	21.3	21.8	20.1	22.1	21.9	21.5	21.3
Public 3/	4.5	4.6	6.3	7.2	4.9	5.9	3.6	3.6	3.7	3.6
Fiscal sector (in percent of GDP)										
Federal government										
Revenue	19.9	18.9	17.3	16.3	16.6	17.2	15.0	14.9	14.8	14.7
Tax	14.8	14.3	13.8	13.1	12.2	11.6	11.6	11.5	11.5	11.4
Nontax	5.1	4.6	3.5	3.2	4.3	5.6	3.4	3.4	3.3	3.3
Expenditure and net lending	23.3	22.1	20.4	19.3	20.3	18.2	18.0	17.8	17.7	17.6
Current	19.7	18.6	17.0	16.0	16.5	14.6	14.6	14.5	14.4	14.3
Development	3.6	3.5	3.4	3.2	3.8	3.6	3.4	3.4	3.4	3.4
Overall balance	-3.4	-3.2	-3.1	-3.0	-3.7	-3.4	-3.0	-3.0	-2.9	-2.9
Cyclically-adjusted balance (in percent of potential GDP) 2/	-3.7	-2.7	-2.6	-3.0	-4.9	-2.9	-2.9	-3.0	-2.9	-3.0
Nonoil and gas primary balance	-7.3	-5.2	-3.5	-3.5	-5.2	-6.6	-4.1	-4.0	-3.8	-3.7
Federal government debt	52.7	54.4	52.7	50.7	51.9	52.1	51.5	51.0	50.4	50.0
General government and consolidated public sector										
Consolidated public sector overall balance 4/	-7.4	-7.7	-5.1	-3.2	-5.5	-5.8	-5.1	-5.1	-5.1	-5.1
General government debt 5/	56.2	57.9	56.6	55.2	56.3	56.5	56.0	55.4	54.8	54.4
Balance of payments (in billions of U.S. dollars) 2/										
Goods balance	34.6	28.0	24.6	27.2	30.7	29.8	31.3	32.3	32.4	32.6
Services balance	-3.3	-5.3	-4.6	-5.3	-6.6	-6.5	-6.9	-7.7	-8.5	-9.3
Income balance	-16.5	-13.7	-12.8	-12.5	-16.5	-16.9	-18.0	-19.1	-19.8	-20.3
Current account balance	14.8	9.0	7.2	9.4	7.7	6.5	6.4	5.4	4.0	3.0
(In percent of GDP)	4.4	3.0	2.4	3.0	2.2	1.8	1.6	1.3	0.9	0.6
Capital and financial account balance	-24.3	-14.5	0.0	0.9	2.3	5.5	7.0	8.9	10.9	12.7
Of which : Direct investment	-5.5	-0.5	3.3	3.8	4.1	4.3	4.6	5.0	5.4	5.7
Errors and omissions	-1.7	6.4	-5.8	-6.4	-11.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-11.2	1.0	1.4	3.8	-1.0	12.0	13.4	14.3	14.9	15.7
International trade in goods (annual percent change) 2/										
Goods exports, f.o.b. (in U.S. dollars terms)	2.5	-15.9	-5.1	13.3	5.5	3.3	5.3	5.3	4.8	4.5
Goods imports, f.o.b. (in U.S. dollars terms)	0.6	-15.2	-3.7	13.8	4.2	4.4	5.3	5.7	5.5	5.1
Terms of trade	-1.4	-3.4	-3.3	1.1	-0.2	-0.2	0.0	-0.1	-0.1	-0.1
Gross official reserves (in billions of U.S. dollars)	115.9	95.3	94.5	102.4	101.4	113.4	126.8	141.1	156.0	171.7
(In months of following year's imports of goods and nonfactor services)	7.5	6.3	5.6	5.8	5.5	5.9	6.2	6.6	6.9	7.2
(In percent of short-term debt by original maturity) 2/	111.6	116.2	112.5	109.9	105.8	112.1	121.1	128.9	135.1	139.5
(In percent of short-term debt by remaining maturity) 2/	78.3	74.4	72.6	72.5	70.4	76.1	82.3	87.9	92.4	96.2
Total external debt (in billions of U.S. dollars) 2/	213.4	195.0	204.2	218.3	221.1	225.9	233.2	242.4	254.6	267.3
(In percent of GDP) 2/	63.1	65.7	68.8	69.4	62.5	61.0	58.7	56.8	55.5	54.2
Short-term external debt (percent of total, original maturity) 2/	48.7	42.0	41.2	42.7	43.4	44.8	44.9	45.1	45.3	46.0
Short-term external debt (percent of total, remaining maturity) 2/	69.4	65.7	63.7	64.7	65.1	66.0	66.0	66.2	66.3	66.8
Debt-service ratio 2/										
(In percent of exports of goods and nonfactor services)	19.1	22.7	24.8	22.2	22.5	22.3	21.7	21.7	21.4	21.3
Net international investment position (in billions of U.S. dollars) 2/	-5.0	25.4	15.6	-6.2	…	…	…	…	…	…
Memorandum items:										
Nominal GDP (in billions of ringgit)	1,106	1,159	1,231	1,353	1,427	1,522	1,633	1,753	1,881	2,016

Sources: Data provided by the authorities; and IMF staff estimates.
1/ Period ending December 31.
2/ IMF staff estimates. U.S. dollar values are estimated using the official data published in national currency.
3/ For 2013 and 2014, based on data published by Department of Statistics, Malaysia. IMF staff estimates are used 2015 onward.
4/ 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.
5/ General government includes the federal government, state and local governments, and the statutory bodies.

Table 5. Malaysia: Summary of Federal Government Operations and Stock Positions, 2014–23

						Est.			Proj.		
	2014	2015	2016	2017	2018bdgt	2018	2019	2020	2021	2022	2023
I. Statement of Government Operations 1/					(In billions of ringgit)						
Revenue	220.6	219.1	212.4	220.4	239.9	236.5	261.8	244.4	260.6	278.4	296.0
Taxes	164.2	165.4	169.3	177.7	191.6	174.7	176.2	188.9	201.5	215.6	229.3
Direct taxes	126.7	111.8	109.6	116.0	127.7	133.5	135.1	144.8	154.1	164.6	174.4
Indirect taxes	37.5	53.7	59.7	61.6	63.9	41.2	41.1	44.1	47.4	51.0	54.9
Non-tax revenue	56.4	53.6	43.1	42.7	48.3	61.8	85.7	55.5	59.1	62.8	66.7
Investment income	33.8	32.8	21.4	21.6	24.6	36.9	59.5	30.7	32.7	34.9	37.2
Other revenue	22.7	20.8	21.7	21.1	23.7	24.8	26.1	24.8	26.4	27.9	29.5
Expenditure and net lending	258.0	256.3	250.8	260.7	279.7	289.8	276.9	293.2	312.7	333.3	355.4
Expense	217.8	215.3	209.5	217.2	233.7	234.9	222.2	238.2	253.6	269.9	287.4
Compensation of employees	66.9	70.1	73.1	77.0	79.1	81.3	82.0	86.7	91.2	95.8	100.7
Use of goods and services	34.3	36.4	30.1	34.7	33.6	36.5	29.1	31.2	33.5	35.9	38.5
Interest	22.6	24.3	26.5	27.9	30.9	30.9	33.0	33.7	36.9	40.3	44.2
Subsidies	39.7	27.3	24.7	22.4	26.5	28.1	22.3	23.6	25.1	26.6	28.2
Grants and transfers	34.6	37.3	33.2	31.3	37.8	31.2	27.5	31.8	33.8	36.3	38.3
Social benefits and other expense	19.7	20.0	21.9	23.8	25.6	26.9	28.3	31.0	33.1	35.0	37.5
Net acquisition of nonfinancial assets 2/	40.3	41.0	41.3	43.5	46.0	54.9	54.7	55.1	59.1	63.4	68.0
Gross operating balance	2.8	3.8	2.9	3.2	6.2	1.6	39.6	6.2	7.0	8.5	8.6
Net lending/borrowing	-37.4	-37.2	-38.4	-40.3	-39.8	-53.3	-15.1	-48.8	-52.2	-54.9	-59.4
Tax refunds (Arrears) 3/							-37.0				
Overall fiscal balance (authorities' definition) 1/	-37.4	-37.2	-38.4	-40.3	-39.8	-53.3	-52.1	-48.8	-52.2	-54.9	-59.4
					(In percent of GDP)						
Revenue	19.9	18.9	17.3	16.3	16.6	16.6	17.2	15.0	14.9	14.8	14.7
Taxes	14.8	14.3	13.8	13.1	13.2	12.2	11.6	11.6	11.5	11.5	11.4
Direct taxes	11.5	9.6	8.9	8.6	8.8	9.4	8.9	8.9	8.8	8.8	8.7
Indirect taxes	3.4	4.6	4.9	4.6	4.4	2.9	2.7	2.7	2.7	2.7	2.7
Non-tax revenue	5.1	4.6	3.5	3.2	3.3	4.3	5.6	3.4	3.4	3.3	3.3
Investment income	3.1	2.8	1.7	1.6	1.7	2.6	3.9	1.9	1.9	1.9	1.8
Other revenue	2.0	1.8	1.8	1.6	1.6	1.7	1.7	1.5	1.5	1.5	1.5
Expenditure and net lending	23.3	22.1	20.4	19.3	19.3	20.3	18.2	18.0	17.8	17.7	17.6
Expense	19.7	18.6	17.0	16.0	16.2	16.5	14.6	14.6	14.5	14.4	14.3
Compensation of employees	6.1	6.0	5.9	5.7	5.5	5.7	5.4	5.3	5.2	5.1	5.0
Use of goods and services	3.1	3.1	2.4	2.6	2.3	2.6	1.9	1.9	1.9	1.9	1.9
Interest	2.0	2.1	2.2	2.1	2.1	2.2	2.2	2.1	2.1	2.1	2.2
Subsidies	3.6	2.4	2.0	1.7	1.8	2.0	1.5	1.4	1.4	1.4	1.4
Grants and transfers	3.1	3.2	2.7	2.3	2.6	2.2	1.8	1.9	1.9	1.9	1.9
Social benefits and other expense	1.8	1.7	1.8	1.8	1.8	1.9	1.9	1.9	1.9	1.9	1.9
Net acquisition of nonfinancial assets 2/	3.6	3.5	3.4	3.2	3.2	3.8	3.6	3.4	3.4	3.4	3.4
Gross operating balance	0.3	0.3	0.2	0.2	0.4	0.1	2.6	0.4	0.4	0.5	0.4
Net lending/borrowing	-3.4	-3.2	-3.1	-3.0	-2.8	-3.7	-1.0	-3.0	-3.0	-2.9	-2.9
Tax refunds (Arrears) 3/							-2.4				
Overall fiscal balance (authorities' definition) 1/	-3.4	-3.2	-3.1	-3.0	-2.8	-3.7	-3.4	-3.0	-3.0	-2.9	-2.9
II. Stock Positions					(In billions of ringgit)						
Federal government debt	582.8	630.5	648.5	686.8		741.1	793.0	841.7	893.8	948.6	1,008.0
(In percent of GDP)	52.7	54.4	52.7	50.7		51.9	52.1	51.5	51.0	50.4	50.0
By instrument											
Domestic debt	566.1	609.1	624.8	665.6		719.5					
Offshore borrowing	16.8	21.5	23.7	21.3		21.6					
By holder residence											
Domestic	415.3	436.9	438.2	484.0		535.9					
Foreign	167.5	193.6	210.2	202.8		205.2					
Memorandum items:											
Structural balance (percent of potential GDP) 4/	-3.7	-2.7	-2.6	-3.0		-4.9	-2.9	-2.9	-3.0	-2.9	-3.0
Structural primary balance (percent of potential GDP) 4/	-1.6	-0.6	-0.5	-1.0		-2.7	-0.7	-0.9	-0.9	-0.8	-0.8
Primary balance (percent of GDP)	-1.3	-1.1	-1.0	-0.9		-1.6	-1.3	-0.9	-0.9	-0.8	-0.8
Nonoil and gas primary balance (percent of GDP) 4/	-7.3	-5.2	-3.5	-3.5		-5.2	-6.6	-4.1	-4.0	-3.8	-3.7
Oil and gas revenues (percent of GDP)	6.0	4.1	2.5	2.6		3.6	5.3	3.2	3.1	3.0	2.9
General government revenue (percent of GDP) 5/	23.7	22.5	20.4	19.4		19.4	20.0	17.8	17.7	17.6	17.5
General government expenditure (percent of GDP) 5/	26.3	25.1	23.0	21.9		23.0	20.6	20.3	20.2	20.1	20.1
General government balance (percent of GDP) 5/	-2.7	-2.6	-2.6	-2.4		-3.6	-3.0	-2.6	-2.6	-2.5	-2.6
Public sector balance (percent of GDP)	-7.4	-7.7	-5.1	-3.2		-5.5	-5.8	-5.1	-5.1	-5.1	-5.1
Nominal GDP (in billions of ringgit)	1,106	1,159	1,231	1,353	1,447	1,427	1,522	1,633	1,753	1,881	2,016

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

1/ Cash basis. The authorities plan to adopt accrual basis by 2021.
2/ Net acquisition of nonfinancial assets include lending and loan repayment to and from other government related entities.
3/ Tax refunds in 2019 are allocated for payment of outstanding tax refunds.
4/ Structural (primary) balance removes one-off revenues and tax refunds in 2019, while nonoil and gas primary balance does not exclude tax refunds in 2019.
5/ General government includes federal government, state and local governments, and statutory bodies. Public sector includes general government and nonfinancial public enterprises (NFPEs).

Table 6. Malaysia: Monetary Survey, 2014–20 1/

	2014	2015	2016	2017	Est. 2018	Proj. 2019	2020
	(In billions of ringgit; end of period)						
Net foreign assets	326.0	359.7	361.2	347.3	348.3	395.1	442.3
Foreign assets	579.3	592.8	584.6	583.3	595.9	645.3	699.3
Foreign liabilities	253.3	233.1	223.4	236.0	247.6	250.2	257.0
Net domestic assets	1,200.2	1,213.7	1,254.2	1,380.0	1,470.7	1,542.3	1,632.8
Net domestic credit	1,521.8	1,640.9	1,749.9	1,857.2	1,973.3	2,102.7	2,250.1
Net credit to nonfinancial public sector	121.1	121.8	142.2	161.7	176.1	190.3	203.7
Net credit to central government	101.0	105.0	125.3	144.4	158.8	172.8	186.0
Net credit to state & local government	1.4	1.2	1.0	1.9	2.0	2.2	2.3
Net credit to nonfinancial corporations	18.8	15.6	15.9	15.4	15.3	15.3	15.3
Credit to private sector	1,334.1	1,448.9	1,525.2	1,607.4	1,704.4	1,813.3	1,940.1
Net credit to other financial corporations	66.5	70.2	82.5	88.1	92.9	99.1	106.3
Capital accounts	293.0	375.2	413.7	423.2	443.2	463.2	483.2
Other items (net)	-28.7	-52.0	-81.9	-53.9	-59.4	-97.2	-134.0
Broad money 2/	1,517.0	1,563.1	1,605.1	1,681.5	1,773.2	1,891.6	2,029.3
Narrow money	374.5	399.0	419.5	449.9	474.4	506.1	543.0
Currency in circulation	68.0	76.6	85.5	92.3	98.7	105.3	112.9
Transferable deposits	306.4	322.4	334.0	357.5	375.7	400.8	430.0
Other deposits	1,111.6	1,142.0	1,160.9	1,199.4	1,281.9	1,367.5	1,467.0
Securities other than shares	30.9	22.1	24.6	32.2	16.9	18.0	19.3
	(Contributions to 12-month growth in broad money, in percentage points)						
Net foreign assets	-0.8	2.2	0.1	-0.9	0.1	2.6	2.5
Net domestic assets	7.0	0.9	2.6	7.8	5.4	4.0	4.8
Memorandum items:							
Broad money (12-month percent change)	6.3	3.0	2.7	4.8	5.5	6.7	7.3
Currency in circulation (12-month percent change)	8.5	12.7	11.5	8.1	6.9	6.7	7.3
Credit to private sector (12-month percent change)	9.2	8.6	5.3	5.4	6.0	6.4	7.0
Money multiplier (broad money/narrow money)	4.1	3.9	3.8	3.7	3.7	3.7	3.7

Sources: Data provided by the Malaysian authorities; and IMF, *Integrated Monetary Database* and staff calculations.
1/ Based on data provided by the authorities, but follows compilation methodology used in IMF's *Integrated Monetary Database.*
2/ Broad money does not equal the sum of net foreign assets and net domestic assets due to non-liquid liabilities, primarily at the other depository corporations.

Table 7. Malaysia: Banks' Financial Soundness Indicators, 2014–18

	2014	2015	2016	2017	2018 Q2
		(In percent; end of period)			
Capital adequacy					
Regulatory capital to risk-weighted assets	15.4	16.3	16.5	17.1	17.0
Regulatory Tier 1 capital to risk-weighted assets	13.4	13.9	14.0	14.3	13.5
Asset quality					
Nonperforming loans net of provisions to capital 1/	7.0	6.8	6.7	6.2	5.7
Nonperforming loans to total gross loans	1.6	1.6	1.6	1.5	1.6
Total provisions to nonperforming loans	95.5	88.8	84.6	84.6	84.6
Earnings and profitability					
Return on assets	1.5	1.2	1.3	1.4	1.5
Return on equity	15.0	12.3	12.3	13.1	13.4
Interest margin to gross income	61.0	61.8	61.0	61.1	58.6
Non-interest expenses to gross income	43.0	46.7	44.0	43.1	41.3
Liquidity					
Liquid assets to total assets (liquid asset ratio)	13.3	22.1	21.2	22.5	23.9
Liquid assets to short-term liabilities	43.2	141.8	134.5	142.0	151.7
Loan-deposit ratio 2/	86.7	88.6	89.8	89.6	89.2
Liquidity Coverage Ratio 3/	…	125.1	124.3	134.9	139.3
Sensitivity to market risk					
Net open position in foreign exchange to capital	13.2	12.5	13.1	10.3	10.2
Sectoral distribution of total loans to nonbanking sector					
Residents	96.9	96.9	97.3	97.0	97.0
Other financial corporations	2.8	3.1	3.4	3.3	3.0
General government	1.7	1.4	1.6	1.9	2.0
Nonfinancial corporations	36.8	36.9	36.7	35.9	36.0
Other domestic sectors	55.6	55.5	55.5	56.0	55.9
Nonresidents	3.1	3.1	2.7	3.0	3.0

Sources: Bank Negara Malaysia; 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 nonperforming loans exclude interest-in-suspense and specific provisions.

2/ Deposits exclude those accepted from banking institutions and Bank Negara Malaysia. Loans exclude loans sold to Cagamas Berhad and loans extended to banking institutions. Beginning July 2015, loans exclude financing funded by Islamic Investment Accounts.

3/ Introduced in July 2015.

	Malaysia
Foreign asset and liability position and trajectory	**Background**. Malaysia's net international investment position (NIIP), as a percent of GDP, averaged 1.2 percent of GDP since 2010, with changes in recent years reflecting both capital flows and valuation effects. In 2018Q3, the NIIP was at about -7.9 percent of GDP (end-2017: about -2.0 percent of GDP), with higher net direct investment and other investment liabilities more than offsetting the reduction of net portfolio capital liabilities.1/ Official reserves contribute most to net assets, while net portfolio liabilities contribute most to net liabilities. Total external debt, measured in U.S. dollars, was at about 65.4 percent of GDP in 2018: Q3 (end-2017: about 70 percent of GDP), of which about two-thirds was in foreign currency and 46 percent in short-term debt. **Assessment**. The NIIP should rise gradually over the medium term reflecting projected moderate current account (CA) surpluses. Malaysia's balance sheet strength, along with exchange rate flexibility and increased domestic investor participation, would help support resilience to a variety of shocks, including outflows associated with external liabilities. 2/
Current account	**Background**. Malaysia's CA surplus has declined by about 7 percentage points of GDP between 2010 and 2017, driven mainly by a decline in national saving, while investment also rose. In the first three quarters of 2018 the CA surplus narrowed to 2.2 percent of GDP, down from 3 percent of GDP in 2017. Trade balance remains the main contributor to Malaysia's overall CA surplus, with export growth supported by continued demands from Malaysia's major trade partners in the region and import growth by re-export activities. Services and income accounts register larger deficits. In 2018, the CA surplus is estimated at 2.1 percent of GDP. **Assessment**. The EBA CA regression (November 2018 vintage) estimates the 2018 CA norm at 0.0 percent of GDP after cyclical and multilateral consistency adjustments. The 2018 cyclically adjusted CA is estimated at about 2.2 percent of GDP. This leads to an estimated 2018 CA gap of 2.2 percent of GDP (±about 1 percent of GDP). Unidentified residuals explain the entire CA gap, potentially reflecting structural distortions and country-specific factors not included in the model. Identified domestic policy gaps have offsetting effect. While low public healthcare spending contributes to the excess surplus, FX intervention that helped to prevent further currency depreciation reduces the surplus. The CA balance is expected to remain in surplus, albeit a lower one, over the medium term, driven by smaller private sector net saving.3/
	Actual CA 2.2 | Cycl. Adj. CA 2.2 | EBA CA Norm 0.0 | EBA CA Gap 2.2 | Staff Adj. 0.0 | Staff CA Gap 2.2
Real exchange rate	**Background**. In 2018, average real effective exchange rate (REER) was appreciated by 4.1 percent. However, it had depreciated nearly 3.5 percent since April 2018. The REER is about 10 percent lower than its 2013 level, reflecting impact on the NEER from capital outflows and terms of trade shocks, with the latter contributing to a decline in the CA surplus. 4/ **Assessment**. The EBA REER models estimate Malaysia's REER to be about 26-29 percent below what is warranted by fundamentals and desirable policies. However, the usual macroeconomic stresses associated with such undervaluation are absent, for example, high core inflation, sustained wage pressure, or significant FX reserve build up. Consistent with the assessed CA gap, staff assesses the REER gap in 2018 was close to -4.8 percent (± about 2 percent).5/
Capital and financial accounts: flows and policy measures	**Background**. Since the Global Financial Crisis, Malaysia experienced significant capital flow volatility, largely driven by portfolio flows in and out of the local-currency debt market. In 2017, the annual financial account balance was in a small surplus for the first time since 2011. Following the tightening of global financial conditions and general elections in spring 2018, Malaysia experienced intensified portfolio outflows from the Malaysian government debt market and equity market in the second quarter of 2018. Since late 2016, the Financial Markets Committee has implemented measures to develop the onshore FX market.6/ **Assessment**. Exchange rate flexibility and macroeconomic policy adjustments should continue to play the central role in response to capital flow volatility. The capital flow management measures should be gradually phased out, with due regard to market conditions.
FX intervention and reserves level	**Background**. During the first four months of 2018, gross official reserves increased by US$7.1 billion to US$109.5 billion as of end-April 2018. However, reserves have dropped by US$8.1 billion since then and stood at US$101.4 billion as of end-2018. In the past years, Malaysia faced significant reserve losses in 2014 and 2015 and a slight decrease in 2016 and witnessed an increase of nearly US$8 billion in 2017. **Assessment**. Under the IMF's composite reserve adequacy metric (ARA) 7/, reserves remain broadly adequate. Gross official reserves are about 108 percent of the ARA metric as of end 2018, but reserves adjusted for net forwards positions are below 100 percent of the ARA metric. Given limited reserves and the increased hedging opportunities since 2017, FX interventions should be limited to preventing disorderly market conditions.

Overall Assessment
Overall Assessment *The external position in 2018 is assessed to remain stronger than the level consistent with fundamentals and medium-term desirable policies*. The current account surplus, as a ratio to GDP, is projected to be lower than its 2017 level, following an increase in income account deficit and strong domestic private demand. **Potential Policy Responses** Over the past few years Malaysia's growth model has become increasingly driven by domestic demand, and its current account surplus has narrowed significantly. Going forward, continued exchange rate flexibility, improved government spending, and structural policies should address the existing policy gaps. Spending needs should accommodate further improvements in social protection and public healthcare. At the same time, addressing structural bottlenecks (for example, labor market frictions in terms of skills mismatch; low female labor participation; and weak education quality) and improving the quality of infrastructure, supported by enhanced public finance management, would help support higher private investment and productivity growth.

Appendix I. External Sector Assessment

Appendix I. External Sector Assessment (concluded)

	Malaysia (concluded)
Technical Background Notes	1/ The ratios to GDP are based on staff estimates using U.S. dollar values and may vary with the authorities' data mainly due to different exchange rate assumptions for converting the nominal GDP in U.S. dollar terms. 2/ Close to one-third of external debt is denominated in local currency and largely of medium-term maturity, helping to reduce FX and rollover risks. Malaysia's local currency external debt reflects holdings of domestically-issued debt (mainly Malaysian Government Securities-MGS) by nonresident investors (about 13 percent of GDP as of 2018Q3). Short-term FX-denominated debt largely belongs to the banking system and a good portion is matched by short-term foreign currency assets, which is being closely supervised by Bank Negara Malaysia, including through frequent liquidity stress tests. Stress test analysis by staff suggests that the Malaysian economy could be resilient to a large reversal due to the depth of the domestic financial markets and the role of institutional investors. 3/ Preliminary assessment, given the reliance on staff estimates of the 2018 CA balance and explanatory variables. The estimated 2018 EBA norm is 0.6 percentage point lower than the 2017 norm, largely reflecting a decrease in the net foreign assets (NFA) and a larger debt stabilizing fiscal deficit. 4/ Since 2000, movements in the REER have been driven largely by the nominal exchange rate rather than inflation differentials. In 2018, the average NEER was about 5.2 percent appreciated. 5/ The REER gap is based on the estimated semi-elasticity of CA to REER at -0.46. The elasticity estimate has been updated from the last assessment. It is based on cross-country estimates of exports and imports elasticities obtained from the IMF's Consultative Group on Exchange Rates (CGER), adjusting for updates to Malaysia's trade openness and share of commodity exports. 6/ On December 2, 2016, the Financial Markets Committee (FMC) announced a package of measures aimed at facilitating onshore FX risk management and enhancing the depth and liquidity of onshore financial markets. Two of these measures were classified as capital flow management measures under the IMF's Institutional View on capital flows. In addition, the authorities' strengthened enforcement of regulations on resident banks' non-involvement in offshore ringgit transactions was considered as enhanced enforcement of an existing capital flow management measure. In April, September, and November 2017, additional measures were announced to help deepen the onshore financial market and facilitate currency risk management. 7/ The IMF's composite reserve adequacy metric uses a binary classification of the exchange rate regime and classifies Malaysia's regime as "floating" since 2016.

Appendix II. Corporate Savings in Malaysia[1]

A. Introduction

1. IMF analysis suggests that Malaysia's current account (CA) surplus is higher than warranted by medium-term fundamentals and desired policies. National income account data up to 2015 suggest that private nonfinancial corporations could be a significant contributor to the CA surplus, followed by private financial firms. Given the importance of private nonfinancial corporations in Malaysia's national savings, staff undertook an analysis of these savings to understand their history and identify their drivers.

2. Leveraging firm-level data for listed firms, we focus on the contribution to the CA surplus of private nonfinancial corporations. Specifically, we aim to understand:

- Which categories of corporations are contributing most to national savings? How do corporate savings evolve over time?
- From an accounting perspective, what factors explain saving behavior? What are the economic drivers of corporate savings?
- Are those savings excessive in light of the underlying determinants?

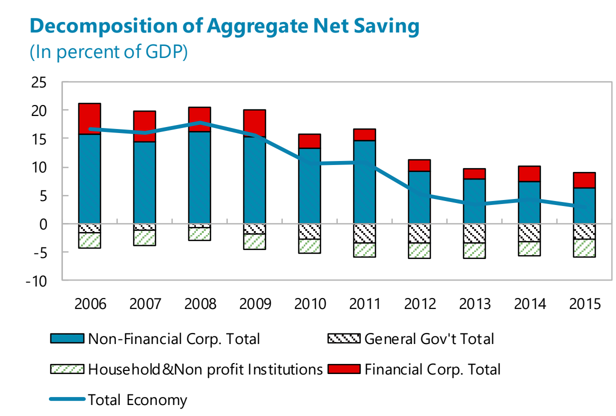
B. Stylized Facts Based on National Income Account Data

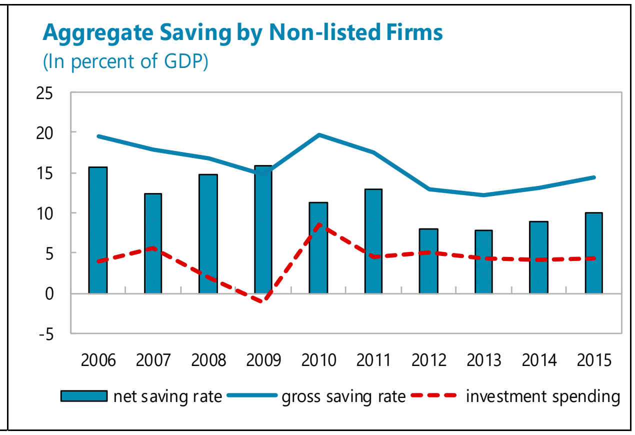
3. From a global perspective, the corporate sector has shifted from a net borrower to a net saver (Chen et al., 2017 JME). This rise in gross savings does not seem to have led to an increase in capital investment, but a larger holding of liquid financial assets (cash).

4. In Malaysia, aggregate net savings have been on a declining trend since 2006, with non-financial corporates being the largest contributor. The contributions of the corporate sector to the CA surplus are partially offset by dissaving by the public sector and households[2] & non-profit institutions. Listed firms tend to invest more than non-listed firms, possibly reflecting their easier access to external finance.

[1] Prepared by Xin Li.

[2] Nonetheless, it is important to note that households in Malaysia hold significant net financial assets (about 95 percent of GDP as of 2017), part of which may reflect precautionary motives.





C. Firm Level Analysis

5. **We employ balance sheet and income statement data for 1400 publicly listed firms in Malaysia over the period of 2000–2017** (currently about 940 active, total assets about 170 percent of GDP), drawing from the Thompson WorldScope Database. As the interpretation of saving and investment flows for financial firms is different from that for non-financial corporations, this study focuses only on the financing decisions of non-financial corporations (see Fama and French, 2001; and DeAngelo et al., 2004). An important drawback is that the WorldScope database does not include information on non-listed firms, which might have different motivations for saving than listed-firms. Key variables of interest are defined as follows:

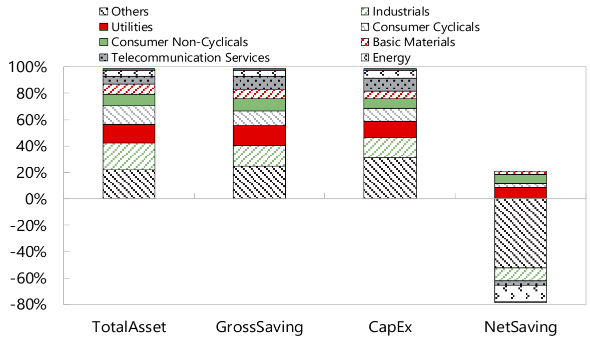
- $Profit = Gross\ Operating\ Surplus - Taxes\ on\ Profits - Interest;$
- $Gross\ Saving = Profit - Net\ Dividends;$
- $Net\ Saving = Gross\ Saving - Investment.$

6. **In the study period of 2000–2017, the following overall patterns are worth noting:**

- **Most sectors were dissaving[3] over the period of 2000–2017.** Among all non-financial corporations, industrials, utilities, and consumer cyclicals are the largest net savers and they share similar saving/investment behaviors. Energy sector, Telecommunications, and other non-categorized firms show significant negative net savings rates as gross savings are more than offset by large scale investments.
- **Gross savings exhibit cyclical fluctuations and investment was positively correlated with gross savings up to 2012.** Capital expenditure surged during 2013 and 2014, becoming a main engine of GDP growth, and began to decline thereafter. As a result, net corporate savings rate remained largely stable around zero up to 2012 and entered the negative domain since 2013. It began to pick up since 2015 due to a cyclical upswing of gross savings and the continued decline of investment.

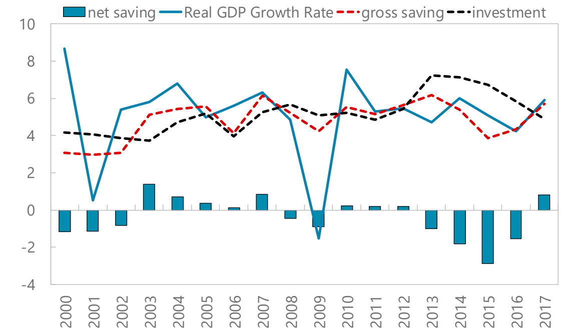
[3] Gross or and net savings rates are defined as shares of total asset, as opposed to profit, because profit can be either positive or negative.

Sectoral Composition of Listed Firms, 2000–2017
(In percent, excluding financial sector)



Sources: WorldScope and IMF staff calculation.

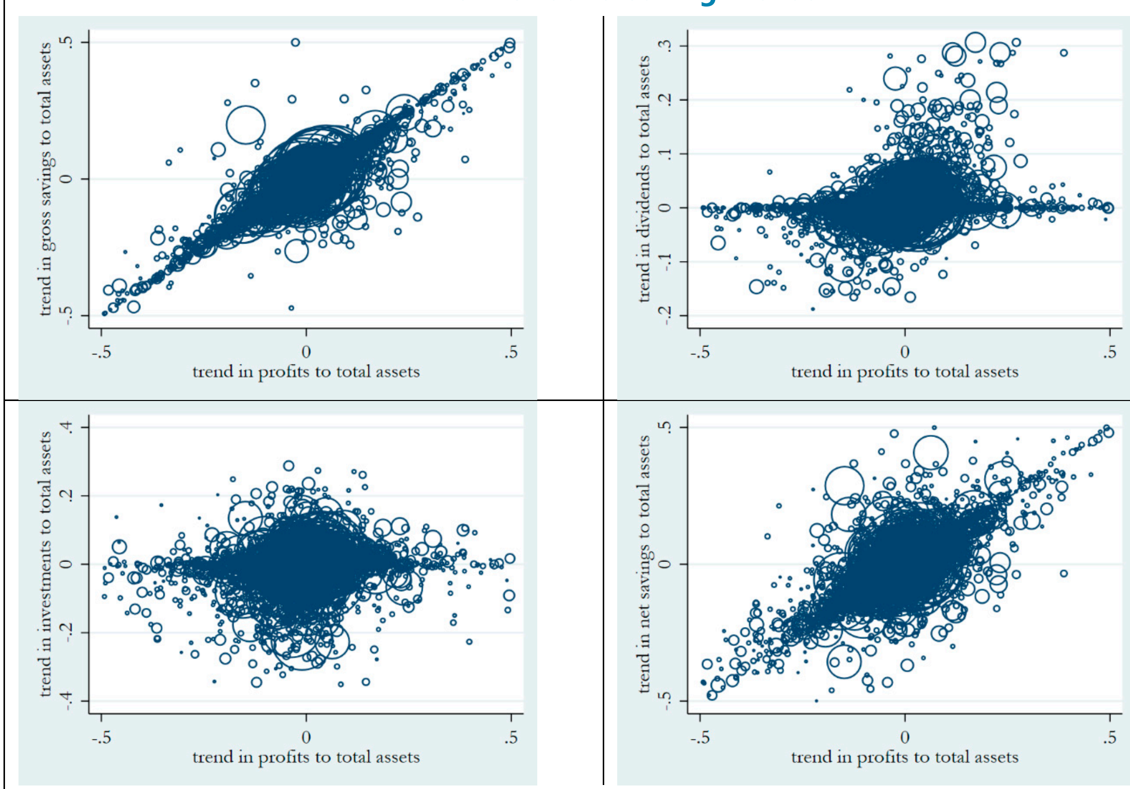
Corporate Net Saving, 2000-2017
(in percent of total asset, excluding financial sector)



Sources: WorldScope and IMF staff calculation.

7. Individual firm-level data confirm that in case of large profits (or, equivalently, cash flows), Malaysian non-financial firms tend to increase their net savings (in the form of cash), as opposed to paying more dividends or increasing investment. The four panels below plot the 10-year trend in percentage point in firm profit against the trends in the main components of it. The area of each circle corresponds to a firm's average size over the sample period. The top panels show a strong cross-sectional relationship between trends in gross savings rate and trends in profit relative to total asset, partly because of a weak correlation between profit and dividends. The bottom panels show that trends in investment are uncorrelated with trends in profit, leading to a meaningful positive relationship between profit and net savings rate. These conclusions are robust if the 10-year trend is replaced with a 5-year trend.

Firm's Profit and Saving Trends



Sources: WorldScope and IMF staff calculation.

D. External Financing Dependence—A Proxy for Excess Savings by Corporates

8. **Various industries have different dependence on external funds, depending on the technological characteristics of the industry.** We define the external financing dependence (EFD) at the industrial level following a two-step process developed by Rajan and Zingales (1998). First, we derive a firm's EFD by summing the firm's use of external finance (borrowings and equity issues) over a 10-year period and then divide it by the sum of capital expenditure over the same period, i.e., $(CapEx - Opt.CashFlow)/CapEx$.[4] Then, to summarize the EFDs across all firms in an industry, we use the industry median.[5]

9. **While an industry's actual dependence on external financing may differ significantly across countries, its desired dependence on external funds is identified using the data on U.S. firms and applied to other countries.** This approach is reasonable because: (i) the production functions[6] of the same industry are similar across different countries—particularly, an industry in the manufacturing sector is more likely to use similar technologies across different countries than the services sector does; and (ii) capital markets in the United States are relatively frictionless—as a result, the actual amount of external funds raised by a U.S. firm reflects the technological demand for financing, as opposed to supply constraints.

10. **The trend analysis above indicates a high dependence of listed firms in Malaysia on internal funds (savings) to finance their investments or, equivalently, a lower dependence on external funds.** This is particularly true when we compare the external financing dependence of firms in Malaysia with those firms of the same industries in the U.S. The top panels in figure below show that across a variety of industries, there are significant gaps, in terms of use of external funds, between Malaysia and U.S.,[7] particularly among young firms (i.e., less than ten years from listing).[8] This is perhaps because firms tend to depend more on external funds at early stage. In addition, as is shown in the bottom panels below, the EFD gaps are largely attributable to the industries with high desired EFDs.[9]

[4] The sum of cash flows over a period of 10 years could be a good approximation of cumulative cash stock, unless the firm had a large initial cash stock in the beginning of the period (i.e., mature firms).

[5] Similar to Rajan and Zingales (1998), we treat large and small firms equally, which allows us to prevent large, mature firms from swamping the information of small firms (e.g., Apple's large free cash flow should mask the possible constraint faced by smaller IT firms).

[6] Production function is used to represent the investment cycle of an industry driven by the technological characteristics associated with the industry, such as size of initial investment, implementation period, cash harvest period, and follow-up investment.

[7] The 45-degree line (red solid line) represents industries with identical EFD in Malaysia as in United States. The size of each bubble is proportional to the total asset size of the corresponding industry. The bubbles below the 45-degree line designate industries that depict lower external financial dependence in Malaysia compared to the US. In addition, the chart does not show industries with large X-values and small Y-values (i.e., industries with large EFD in the United States). These outliers include transportation by air, chemicals and allied products, etc.

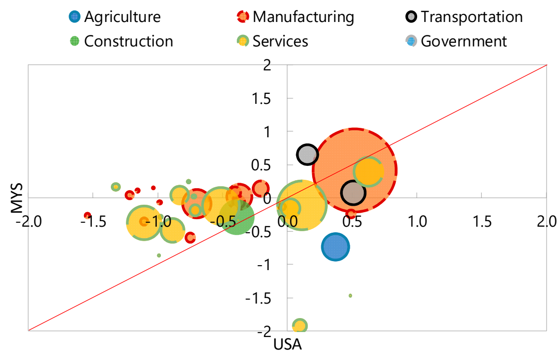
[8] The interquartile range of Malaysian industries' EFDs is 1.1 (75th percentile: 0.7; 25th percentile: -0.4); whereas it is 2.1 (75th percentile: 1.4; 25th percentile: -0.7) for American industries.

[9] We define an industry is of high EFD if its desired EFD is above the median EFD across all industries.

External Financial Dependence by Industry

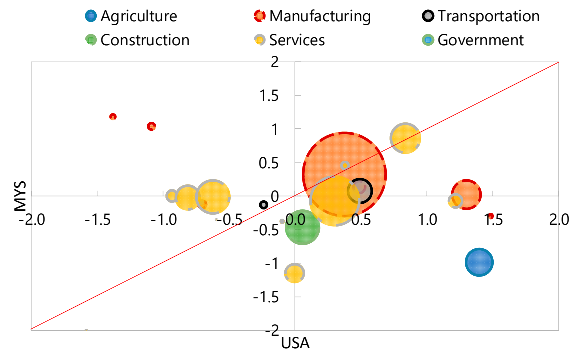
(Comparison between Malaysia and United States)

All Firms



Sources: WorldScope and IMF staff calculation.

Young Firms

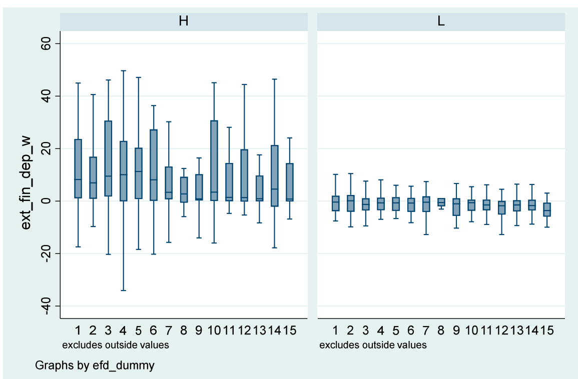


Sources: WorldScope and IMF staff calcuation.

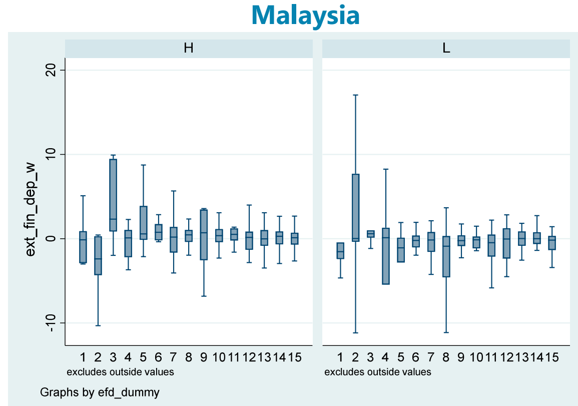
External Financial Dependence by Maturity

(Number of years since IPO)

United States



Malaysia

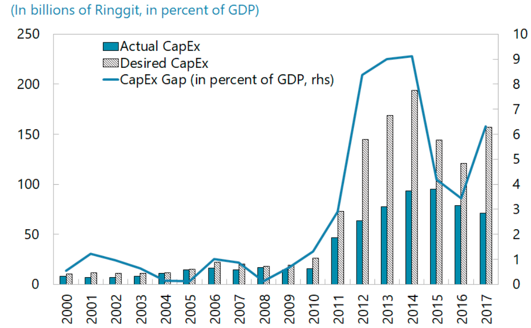


Sources: WorldScope and IMF staff calculations.

11. **Capital expenditure (CapEx) shortfall could be used as a proxy for excess savings by corporates.** Taking the cash flow of a firm as given, the firm can generate excess net savings through under-investment. While paying less dividends could lead to over-saving (gross), it is more reasonable to assume that the investment channel plays a more significant role in understanding corporate's excess savings. Specifically, the *CapEx gap* of a firm j in industry i, $CapEx\ Gap_{ij}$, is defined as the amount of investment required to restore its actual capital expenditure, over a 10-year period, to the desired dependence of external financing of industry i, $EFD_i^{desired}$. That is,

Capital Expenditure Gap (excl. Service Sectors, 2000–2017

(In billions of Ringgit, in percent of GDP)



Sources: IMF and WorldScope.

$$CapEx\ Gap_{ij} = CapEx_{ij}^{desired} - CapEx_{ij}^{actual},$$

where $CapEx_{ij}^{desired} = Opt.CashFlow_{ij}/(1 - EFD_i^{desired})$. [10] To make this approach more plausible, we also make a distinction between the $EFD_i^{desired}$ for young and old firms in industry i, respectively. Preliminarily calculation shows that the total CapEx gap of all listed firms (excluding the services sector) accounts for 2.8 percent of GDP on average in the period between 2000–2017.

12. Many drivers could help explain why firms raise less funds externally than the desired level. It could reflect either the external financing constraints faced by firms (particularly SMEs) in countries with less developed financial markets, the lack of profitable investment opportunities due to slow productivity growth, weak governance, or policy distortions. A companion selected issues paper explores these possible economic drivers.[11]

E. Conclusions

13. In the past two decades, Malaysian companies have maintained high net savings rates, contributing to national savings. Micro firm level data suggest that corporate gross savings are procyclical due to procyclical profits and acyclical dividend payments. Increases in gross savings do not lead to higher investment, but rather to a larger holding of liquid financial assets (net savings). In external-financing dependent industries, there is evidence of gaps between the actual and desired level of external financing, particularly among young firms. Using CapEx gap as a proxy, our calculation suggests that industrial firms contribute positively to the current account surplus. A selected issues paper explores possible economic drivers of corporate net savings and CapEx gap.

[10] Some caveats are worth mentioning. First, the identification of the desired EFDs for Malaysian firms hinges on the assumption that firms in the same industry share similar technologies and investment cycles across countries. This assumption would be challenged, for example, by the distinct roles that firms in different countries play in the global value chain. Second, this is only a partial equilibrium result, in the sense that it does not consider the counterfactual effect of increased capital expenditure on future cash flows (i.e., operational cash flows are taken as given).

[11] See the companion Selected Issues Paper, Chapter 1—Corporate Savings in Malaysia.

Appendix III. Staff Policy Advice from the 2017 and 2018 Article IV Consultations

Staff Advice	Policy Actions
Fiscal Policy	
Anchor fiscal policy to the medium-term consolidation objective, with the annual pace of consolidation reflecting evolving economic conditions (2017). Follow a gradual consolidation path and improve the composition of fiscal adjustment by prioritizing revenue measures (2018).	The authorities have reset their fiscal consolidation path in the 2019 budget, given a higher deficit outcome in 2018. The path implies gradual consolidation, in line with staff's advice, and the authorities continue to express commitment to medium-term fiscal consolidation to respect the self-imposed limit of 55 percent of GDP for federal government debt.
Increase tax compliance through increased information sharing between agencies. Improve the international taxation framework to strengthen anti-avoidance rules (2017). Broaden the tax base, including by eliminating GST exemptions. Raise the GST rate (2017, 2018). Reduce investment incentives (which are tax expenditures) (2018).	The authorities replaced the GST by the SST, which has narrowed the tax base and created a revenue shortfall. However, they have announced other, albeit small, revenue measures (e.g. increases in excise and property taxes). Also, a Tax Reform Committee was established in September 2018, tasked to carry out a comprehensive review of the Malaysian tax system including tax incentives and will explore new sources of sustainable revenues.
Implement spending reviews. Improve efficiency of public spending through better targeting of social spending, cost recovery in higher education, user fees for health care services, and limiting duplications in transport and tourism programs (2017, 2018). Improve the quality of fiscal adjustment to facilitate external rebalancing (2018)	While the authorities have brought back subsidies for lower-grade petroleum in 2018 against staff advice, they have announced the reintroduction of a managed-float fuel price mechanism with targeted subsidies for the low-income group effective 2019. In the 2019 budget, the authorities have also announced a plan to restructure cash assistance (Living Aid Assistance) through better targeting.
Enrich the recently introduced Medium Term Fiscal Framework with more detail (2017, 2018). Fully integrate in the budget preparation process annual fiscal risks statements. Complete the implementation of accrual fiscal accounting (2018)	The authorities have announced plans to draft a Fiscal Responsibility Act and move to accrual accounting by 2021 and recognize the need to further improve risk monitoring and enhance fiscal transparency. In the 2019 budget, the authorities enhanced their reporting on federal government guarantees and possible future payment obligations related to PPPs.
Monetary, Exchange Rate, and Financial Policies	
The current bias towards reduced monetary policy accommodation is appropriate (2018). Domestic economic and financial considerations should continue to guide monetary policy decisions (2017/18).	The BNM has maintained its policy rate at 3.0 percent since July 2016 but appropriately signaled a bias towards reduced monetary policy accommodation in November 2017. After a 25 bps in January 2018, the rate has been maintained at 3.25 percent (through November 2018).
Use exchange rate flexibility as a key absorber of external shocks. Deploy reserves in the event of disorderly market conditions. (2017). A more holistic approach towards onshore market development—which would address existing gaps and phase out recent FX market measures—would have potential benefits (2018).	The Ringgit has depreciated following the capital outflow pressures in late 2016 and early 2017, but regained value through April 2018 beyond which it started to depreciate again. In the 12 months since November 2016, the Financial Markets Committee introduced measures to deepen domestic FX markets and bolster resilience to external shocks. However, while limiting FX volatility, some of the measures also limited capital flows. The authorities notified the Fund of the change in their *de jure* exchange rate regime, effective September 2016, following which the *de facto* regime is currently classified as floating.
To contain risks from a possible real estate price correction, consider measures that would further strengthen the prudential framework and encourage the development of a rental market (2018).	The authorities maintain macroprudential measures to curb household indebtedness (amid declining aggregate debt-to-GDP ratio) and an enhanced framework for monitoring (still high) household indebtedness. The BNM, MOF, and Ministry of Housing and Local Government have introduced new measures with the objective to strengthen the demand for housing and facilitate leasing.
Structural Policies	
Steadfast implementation of the domestic reform agenda will be necessary in realizing the long-term development objectives (2017). Raise productivity growth within the framework outlined in the Eleventh Malaysia Plan (2016–20) and Malaysia Productivity Blueprint to support longer-term economic potential (2018).	As the first policy document of Malaysia's new government, the Mid-Term Review of the Eleventh Malaysia Plan (October 2018) reoriented government priorities. Reforms will aim at improving governance, accelerating innovation, boosting productivity, moving industries up the value chain, enhancing the wellbeing of the people, particularly the bottom 40% of the household income group (B40), and achieving inclusive growth.
To significantly boost long-term growth the authorities should: further raise female labor participation; improve the quality of education; lower skill mismatches, boost productivity growth by encouraging R&D; and uphold high standards of governance (2017/18). Expand vocational and technical training to reduce skill mismatches; raise enrollment in higher education (2018).	In May 2017, the authorities launched the Malaysia Productivity Blueprint which describes the strategy to reach productivity targets under the Eleventh Malaysia Plan. In October 2018, the Mid-Term Review of the Eleventh Malaysia Plan continued to prioritize human capital development. Intended reforms will focus on improving labor efficiency and productivity, enhancing access to quality education and training as well as fostering stronger industry-academia linkages.
Facilitate trade integration and encourage foreign investment (2017).	Malaysia is participating in multilateral trade agreement discussions such as the RCEP. Ratification of the CPTPP is still under consideration. The authorities plan to rationalize existing tax incentives to better steer investment towards high value-added, high productivity industries and less developed regions.
Any reform to foreign labor policies, to induce firms to raise productivity, should be market-based, clearly communicated, and gradually phased-in to allow sectors that rely on foreign workers to adjust (2018).	Per the Mid-Term Review of the Eleventh Malaysia Plan, efforts will also be undertaken to reduce dependency on foreign workers by promoting greater automation and strictly regulate the number of foreign workers by introducing progressive multi-tiered charges on foreign labor employment.
Updating public infrastructure and the regulatory framework would help further improve the business environment and support higher private investment, which would help with rebalancing (2018).	The authorities have initiated a review of all major infrastructure projects and are taking steps to improve public investment management. They are committed to providing quality infrastructure and efficient utilities to boost economic development.

Appendix IV. Risk Assessment Matrix[1]

Risks	Likelihood and Transmission	Expected Impact of Risk	Recommended Policy Responses
External			
Sharp tightening of global financial conditions. (Short-term).	**High** Tighter financial conditions could be triggered by a sharper-than-expected increase in U.S. interest rates or the materialization of other risks.	**Medium** This could cause higher debt service and refinancing risks; stress on leveraged firms and households; capital account pressures; and a broad-based downturn.	Liquidity support (including in FX) could be provided, while the exchange rate is allowed to adjust to discourage capital outflows. If capital outflows threaten domestic activity, reserve requirements could be relaxed.
Rising protectionism and retreat from multilateralism (Short- to medium-term).	**High** Global imbalances and fraying consensus about the benefits of globalization could lead to sustained trade actions and spreading isolationism. This threatens the global trade system, labor mobility, as well as global and regional policy and regulatory collaboration.	**Medium** With a highly open economy, Malaysia is vulnerable to measures aimed at curtailing global trade. The impact would be felt both directly and indirectly (via trading partner exposures).	Ongoing efforts to accelerate the ASEAN regional integration agenda, and pursue new, high-standard regional trade agreements, including through completing the approval and initiating implementation of the CPTPP, which are important in their own right, would also help mitigate the impact of this shock. In the absence of adequate automatic stabilizers, discretionary fiscal policy should only be deployed temporarily and if the shock is perceived as temporary. The exchange rate should continue to act as a key shock absorber.
Weaker-than-expected growth in advanced economies (Medium-term).	**Medium** In the **Euro Area**, progress on fiscal adjustment, on addressing legacy banking-sector problems, and on other structural reforms slows or reverses, raising debt sustainability concerns. In **the US**, as the economy pushes further through full employment, the risks of a sharper-than-expected slowdown increase.	**Medium** Weaker than expected external demand would reduce exports and activity in the manufacturing sector, and therefore dampen domestic demand, increasing unemployment, dampening housing and asset prices, weakening bank, corporate, and sovereign balance sheets, in a negative feedback loop	The ability of macroeconomic policies to provide a cushion against a protracted slump is limited. Policymakers would need to adjust to slower medium-term growth although carefully selected infrastructure projects and structural reforms could increase productivity and growth.
Unsustainable macroeconomic policies (Short- to medium-term).	**Medium** Policies in systemically important countries to boost near-term activity beyond sustainable levels may exacerbate underlying vulnerabilities and, in some cases, backfire by hurting confidence and global growth.	**Low/Medium** These developments could weigh on global growth and reduce the demand for Malaysian exports, with resulting slowdown of growth and emergence of vulnerabilities of financial and corporate sectors.	In the absence of adequate automatic stabilizers, discretionary fiscal policy should only be deployed temporarily and if the shock is perceived as temporary, and the exchange rate should be allowed to continue to act as a key shock absorber.
Sizable decline in energy prices from the baseline (Short- to medium-term).	**Medium** Prices could drop significantly if downside global growth risks materialize or supply exceeds expectations, possibly due to faster-than-expected U.S. shale production growth, or, over the medium term, higher OPEC/Russia production.	**Low** Lower growth along with reduced oil revenues could cause a set-back in fiscal consolidation efforts. Substantial declines in commodity prices could also push Malaysia to a twin deficit and trigger an adverse feedback loop of higher interest costs and undermine investor confidence.	Fiscal reforms to reduce the reliance on oil revenues, such as broad-based taxes, are critical. Investment in infrastructure and other productivity-boosting structural reforms could continue to reduce reliance on the energy sector. Since fiscal and structural reforms will take time, the exchange rate can provide the first line of defense in the short term.
Weaker-than-expected growth in China (Short- to medium-term).	**Low/Medium** Disorderly deleveraging may adversely affect near-term growth. In the medium term, insufficient progress in deleveraging and rebalancing reduces growth, with additional credit stimulus postponing the slowdown, but making it sharper.	**Medium** The resulting weaker domestic demand in China would roil global financial markets and reduce global growth, resulting in an external demand shock for Malaysia.	The exchange rate should be allowed to act as a key shock absorber, intervening only to prevent disorderly market conditions. A more accommodative monetary policy stance could be appropriate, if risks of fueling financial imbalances are low.
Domestic			
Fiscal risks from public debt and contingent liabilities (Short- to medium-term).	**Medium** Realization of risks would have adverse consequences for fiscal policy, raising the sovereign's financing cost and requiring even stronger fiscal adjustment to restore fiscal sustainability.	**Medium/High** Higher financing costs for the sovereign; a relatively high public debt; and realization of contingent liabilities would exacerbate concerns about public debt sustainability and could lead to an adverse feedback loop of spikes in domestic interest rates and exit of foreign investors.	The authorities' ability to mount countercyclical responses would be boosted by medium-term fiscal consolidation. Continued progress in reforming fiscal institutions can mitigate the impact, including adopting a fiscal risks management framework and publication of an annual fiscal risks statement, along with increased transparency of GLC operations.
Cyber-attacks (Short- to medium-term)	**Medium** Attacks on critical global financial, or communication infrastructure and broader private and public institutions trigger systemic financial instability or widespread disruptions in socio-economic activities.	**Medium/High** Theft of personal information, SWIFT fraud, hacked crypto-asset exchanges, and business disruptions across the supply chain could materialize. Larger attacks could be highly disruptive to the global economy.	Existing IT security frameworks could be strengthened, and new lines of defense could be built to eliminate the risk of such attacks and minimize their impact.
Sharp adjustment in housing market prices or ability to service debt (Short- to medium-term).	**Low/Medium** A large stock of unsold (luxury) residential and commercial properties may result in a sharp drop in real estate prices. A deterioration of households' ability to service debt may trigger defaults and increase bank NPLs.	**Medium** Despite existing buffers, a large housing price adjustment could adversely affect real estate developers, with implications for downstream sectors and aggregate demand and may have implications for banks' balance sheets.	Vigilant micro- and macro-prudential oversight would be required to mitigate the risks and ensure financial stability. Specific measures could include risk weights and credit limits targeting construction sector, and measures encouraging developers to lease the unsold housing stock to prevent sizable price adjustments.

[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 V. Public Debt Sustainability Analysis[1]

Under the baseline scenario, Malaysia's federal government debt is projected to remain below the authorities' debt anchor of 55 percent of GDP as well as the DSA's debt burden benchmark of 70 percent. Nevertheless, the debt will remain high at around 50 percent of GDP over the medium-term, implying that the federal government debt limit of 55 percent of GDP could be breached if downside risks materialize and there is no fiscal consolidation. Sizable external financing needs and high contingent liabilities exacerbate debt sustainability risk. A gradual fiscal consolidation is needed to build fiscal buffers, improve market confidence, and lower debt sustainability risks.

1. Macro-fiscal assumptions. Macroeconomic projections and policy assumptions are consistent with the macro-framework:

- *Growth*. Economic growth is moderating to 4.7 percent in 2018 and 2019 from 5.9 percent in 2017. Growth will remain stable over the medium-term.
- *Fiscal policy*. The federal government fiscal deficit is estimated at 3.7 percent of GDP in 2018 relative to the 2018 budget target of 2.8 percent. The deficit is projected to decline to 3.4 percent in 2019, and then remain at around 3 percent over the medium-term if there is no additional fiscal consolidation.
- *Interest rate*. Nominal interest rates are assumed to increase by 1 percentage points by 2024. This reflects that pressure from higher global interest rates will be largely mitigated by robust demand for government bonds from domestic institutional investors. In addition, the effective interest rate on government debt will increase only modestly by 0.3 percentage points, helped by an extended maturity of federal government bonds (above 7 years as of 2018).

2. Financing Needs. Malaysia's gross financing needs (defined as the sum of the fiscal deficit and maturing debt) are expected to be stable at around 8 percent of GDP, showing a moderate decline trend over the medium-term.

3. Debt Profile. The debt profile is based on the federal government budget, consistent with the government debt data reported by the authorities. This definition of debt accounts for more than 90 percent of general government debt. However, it does not include local and state governments and statutory bodies which typically receive explicit government guarantees. Federal government guarantees (18 percent of GDP as of June 2018) and possible future payment obligations related to Public-Private-Partnerships (PPP) projects (13 percent of GDP on an undiscounted cash basis over next 30 years, also as of June 2018) could pose an upside risk to public debt and constrain fiscal space. The external financing requirement is high at 38 percent of GDP, while the share of foreign currency denominated debt is low at 3 percent of total debt.

4. Realism of Baseline Assumptions. Past assumptions on real growth and the primary balance are neither too optimistic nor pessimistic. On the other hand, the median forecast error for the GDP

[1] Prepared by Kazuaki Miyachi.

deflator is -1.8 percent, suggesting that staff forecasts for nominal GDP have been relatively optimistic. Nevertheless, the forecast bias has improved in the past few years

- Under the baseline scenario, the projected 3-year adjustment in the cyclically adjusted primary balance (CAPB) is relatively small, with a percentile rank of 31 percent compared to the historical experience for high-debt market access countries. The CAPB level is in a percent rank of 70 percent.

5. Stress Tests, Reform Scenario and Risks. Under the baseline scenario, the federal government debt will remain below the authorities' debt anchor of 55 percent of GDP as well as the DSA's debt burden benchmark of 70 percent. However, stress tests illustrate that Malaysia's public debt position is exposed to various risks:

- *Fan chart.* The fan chart, which incorporates feedback effects between macroeconomic variables and relies on historical data to calibrate shocks, illustrates uncertainty around the baseline. For example, under the worst quartile case, the debt-to-GDP ratio could reach 60 percent of GDP by 2024—exceeding the authorities' debt anchor.
- *Macro-fiscal stress tests.* Under a primary balance shock (equivalent to half of the 10-year historical standard deviation), the debt-to-GDP ratio is not expected to breach the authorities' debt anchor of 55 percent throughout the projection period. However, a real GDP shock (based on the 10-year historical standard deviation) or interest rate shock (based on the historical maximum real interest rate) would bring the debt-to-GDP ratio to 55 percent, hitting the debt anchor. In particular, the effect of an interest rate shock would become larger over a longer time horizon. This risk is particularly relevant amid the expected monetary policy normalization in major advanced economies and highlights the importance of maintaining market confidence. More importantly, the combined macro-fiscal shock will bring debt to above 60 percent of GDP, easily breaching the debt anchor.
- *Contingent liability shock.* As mentioned earlier, the federal government is exposed to sizeable contingent liabilities. This shock assumes that the government is obliged to absorb all government guarantees that mature within 5 years, totaling 6 percent of GDP, over 5 years. This shock also assumes a negative feedback effect on the interest rate. The debt-to-GDP ratio could reach 55 percent of GDP under this scenario.
- *Authorities' fiscal consolidation scenario.* In order to make the authorities' debt anchor of 55 percent of GDP resilient to various shocks, a gradual fiscal consolidation is essential to build fiscal buffers. In this respect, the authorities aim at bringing down fiscal deficit to about 2 percent of GDP over the medium-term. This gradual consolidation would lower debt-to-GDP ratio to 47 percent by 2024, which would provide comfortable buffers based on historical volatility in macroeconomic variables.
- *Heat map.* Malaysia faces risks arising from its large external financing requirement, which is above the upper threshold of early warning benchmarks. The share of debt held by foreigners is also high at 26 percent, exceeding the lower threshold of early warning benchmarks. Nevertheless, the existence of a large domestic institutional investor base mitigates this risk.

Figure 1. Malaysia Published DSA Risk Assessment

Heat Map

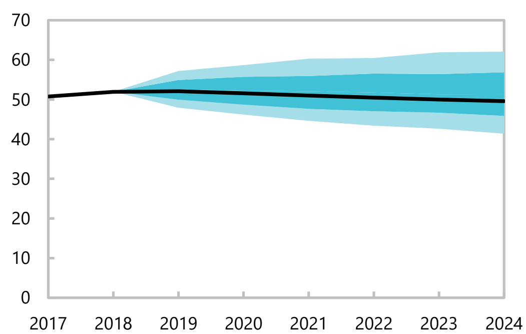
Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	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

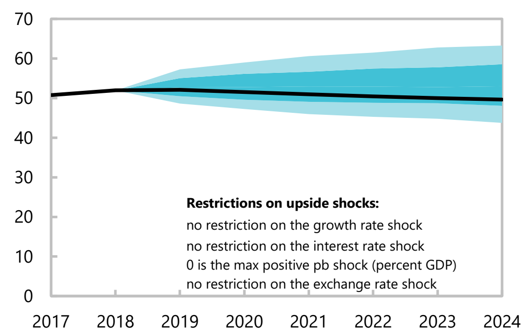
(in percent of GDP)

Baseline   Percentiles: 10th-25th   25th-75th   75th-90th

Symmetric Distribution



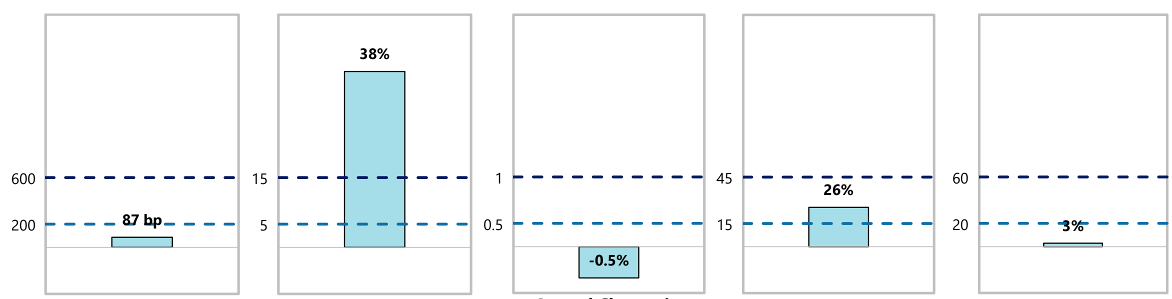
Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2018)

Malaysia   Lower early warning   Upper early warning



Bond spread	External Financing Requirement	Annual Change in Short-Term Public Debt	Public Debt Held by Non-Residents	Public Debt in Foreign Currency
(in basis points) 4/	(in percent of GDP) 5/	(in percent of total)	(in percent of total)	(in percent of total)

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.

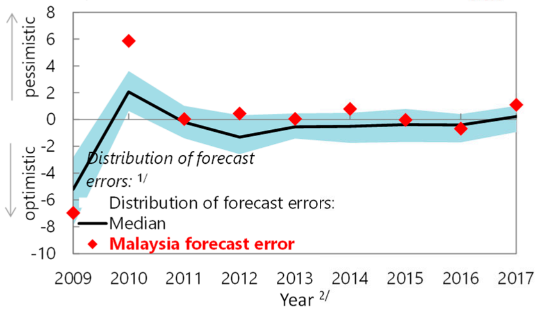
4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 06-Oct-18 through 04-Jan-19.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

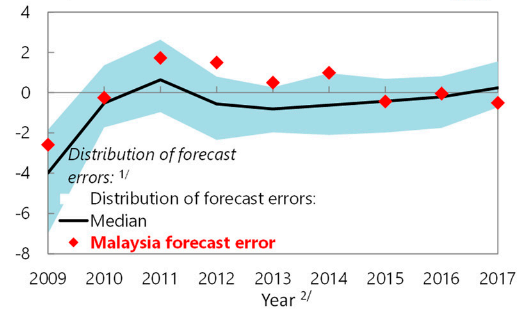
Figure 2. Malaysia Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus all countries

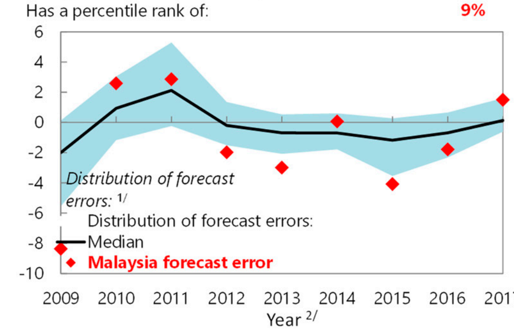
Real GDP Growth
(in percent, actual-projection)
Malaysia median forecast error, 2009-2017: 0.04
Has a percentile rank of: 74%



Primary Balance
(in percent of GDP, actual-projection)
Malaysia median forecast error, 2009-2017: -0.05
Has a percentile rank of: 60%

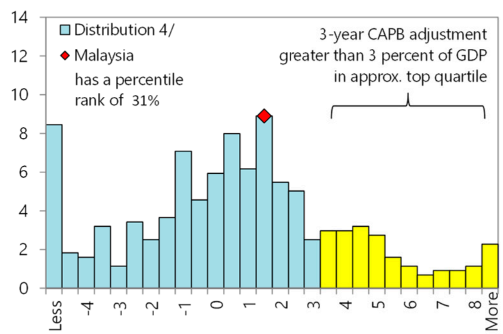


Inflation (Deflator)
(in percent, actual-projection)
Malaysia median forecast error, 2009-2017: -1.78
Has a percentile rank of: 9%

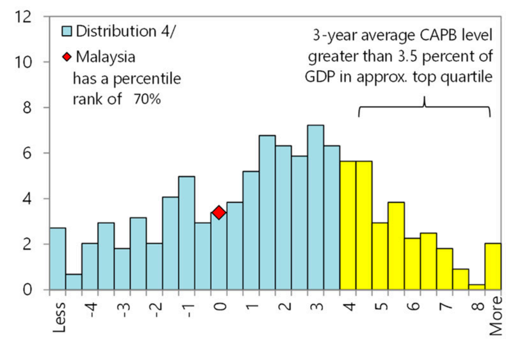


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

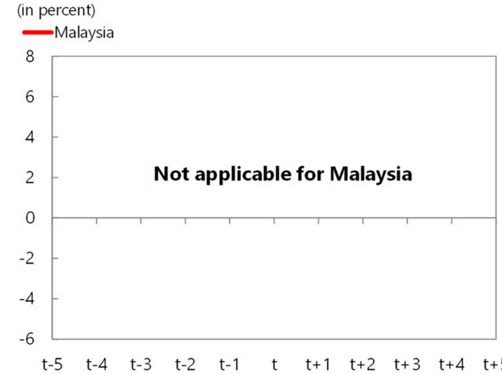


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Malaysia, as it meets neither the positive output gap criterion nor the private credit growth criterion.
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.

Figure 3. Malaysia Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

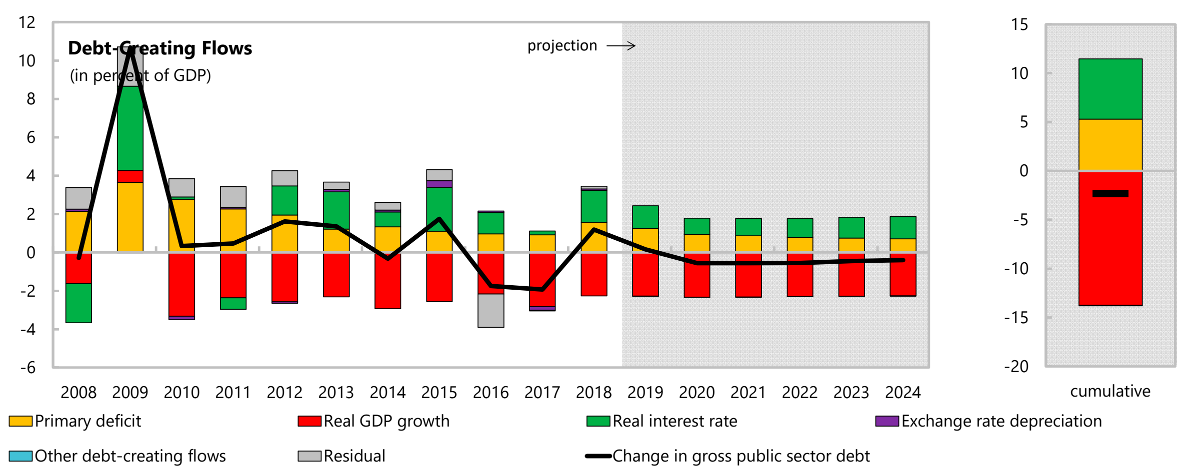
(In percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of January 04, 2019		
	2008-2016 [2/]	2017	2018	2019	2020	2021	2022	2023	2024	Sovereign Spreads		
Nominal gross public debt	50.2	50.7	51.9	52.1	51.5	51.0	50.4	50.0	49.6	EMBIG (bp) 3/	124	
Public gross financing needs	9.0	8.5	7.9	8.5	7.9	7.9	7.7	6.6	7.1	5Y CDS (bp)	108	
Real GDP growth (in percent)	4.6	5.9	4.7	4.7	4.8	4.8	4.8	4.8	4.8	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	2.1	3.8	0.7	1.9	2.4	2.4	2.3	2.3	2.2	Moody's	A3	A3
Nominal GDP growth (in percent)	6.9	9.9	5.4	6.7	7.3	7.3	7.3	7.2	7.2	S&Ps	A-	A
Effective interest rate (in percent) [4/]	4.3	4.3	4.5	4.5	4.3	4.4	4.5	4.7	4.8	Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.5	-1.9	1.2	0.2	-0.6	-0.6	-0.5	-0.4	-0.4	-2.3	
Identified debt-creating flows	0.9	-1.9	1.0	0.2	-0.5	-0.6	-0.5	-0.4	-0.4	-2.3	
Primary deficit	1.9	0.9	1.6	1.3	0.9	0.9	0.8	0.8	0.7	5.3	-1.1
Primary (noninterest) revenue and grants	20.0	16.3	16.6	14.8	15.0	14.9	14.8	14.7	14.7	88.8	
Primary (noninterest) expenditure	21.9	17.2	18.1	16.0	15.9	15.7	15.6	15.4	15.4	94.1	
Automatic debt dynamics [5/]	-1.0	-2.8	-0.5	-1.1	-1.5	-1.4	-1.3	-1.2	-1.1	-7.6	
Interest rate/growth differential [6/]	-1.1	-2.6	-0.6	-1.1	-1.5	-1.4	-1.3	-1.2	-1.1	-7.6	
Of which: real interest rate	1.1	0.2	1.7	1.2	0.9	0.9	1.0	1.1	1.2	6.2	
Of which: real GDP growth	-2.1	-2.8	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-13.8	
Exchange rate depreciation [7/]	0.1	-0.2	0.1	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.6	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

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

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; 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 numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

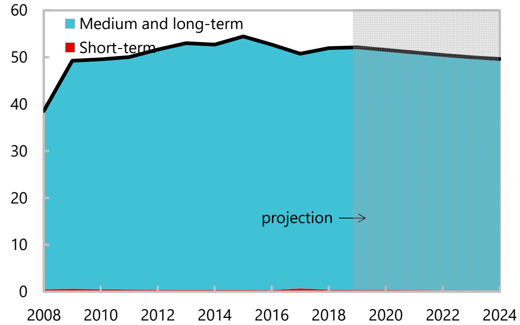
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

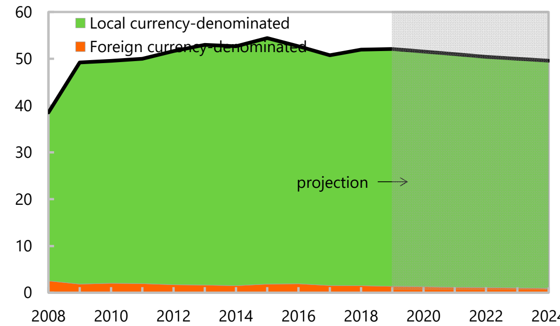
Figure 4. Malaysia Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)

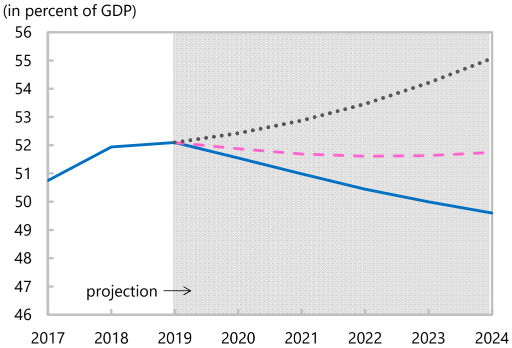


By Currency
(in percent of GDP)

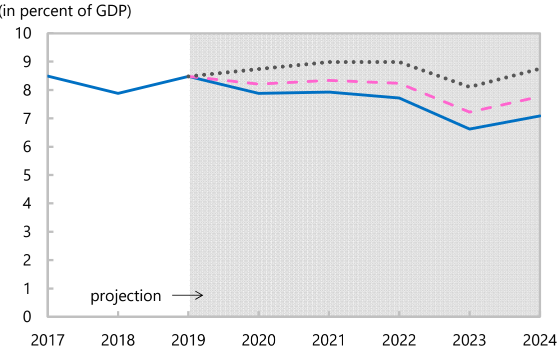


Alternative Scenarios

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

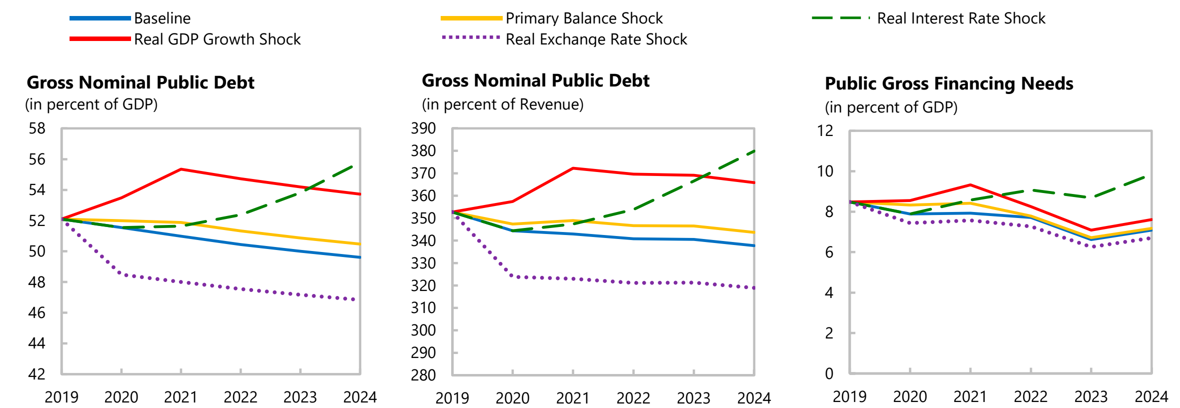
Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	4.7	4.8	4.8	4.8	4.8	4.8
Inflation	1.9	2.4	2.4	2.3	2.3	2.2
Primary Balance	-1.3	-0.9	-0.9	-0.8	-0.8	-0.7
Effective interest rate	4.5	4.3	4.4	4.5	4.7	4.8
Constant Primary Balance Scenario						
Real GDP growth	4.7	4.8	4.8	4.8	4.8	4.8
Inflation	1.9	2.4	2.4	2.3	2.3	2.2
Primary Balance	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Effective interest rate	4.5	4.3	4.4	4.5	4.7	4.8

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	4.7	4.7	4.7	4.7	4.7	4.7
Inflation	1.9	2.4	2.4	2.3	2.3	2.2
Primary Balance	-1.3	-1.8	-1.8	-1.8	-1.8	-1.8
Effective interest rate	4.5	4.3	4.5	4.8	5.0	5.3

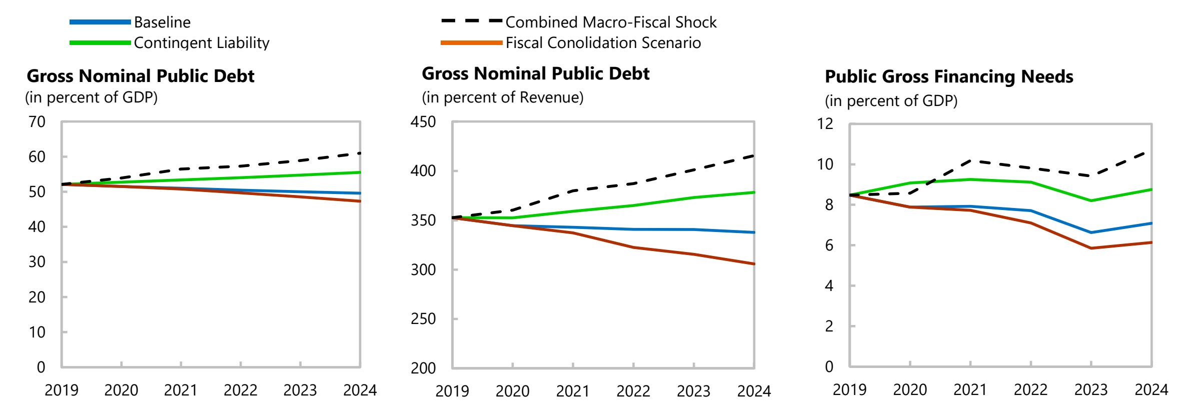
Source: IMF staff.

Figure 5. Malaysia Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2019	2020	2021	2022	2023	2024
Primary Balance Shock						
Real GDP growth	4.7	4.8	4.8	4.8	4.8	4.8
Inflation	1.9	2.4	2.4	2.3	2.3	2.2
Primary balance	-1.3	-1.4	-1.3	-0.8	-0.8	-0.7
Effective interest rate	4.5	4.3	4.4	4.5	4.7	4.8
Real Interest Rate Shock						
Real GDP growth	4.7	4.8	4.8	4.8	4.8	4.8
Inflation	1.9	2.4	2.4	2.3	2.3	2.2
Primary balance	-1.3	-0.9	-0.9	-0.8	-0.8	-0.7
Effective interest rate	4.5	4.3	5.7	7.2	8.6	9.7
Combined Shock						
Real GDP growth	4.7	2.4	2.5	4.8	4.8	4.8
Inflation	1.9	1.8	1.8	2.3	2.3	2.2
Primary balance	-1.3	-1.4	-1.8	-0.8	-0.8	-0.7
Effective interest rate	4.5	4.3	5.8	7.4	8.7	9.8

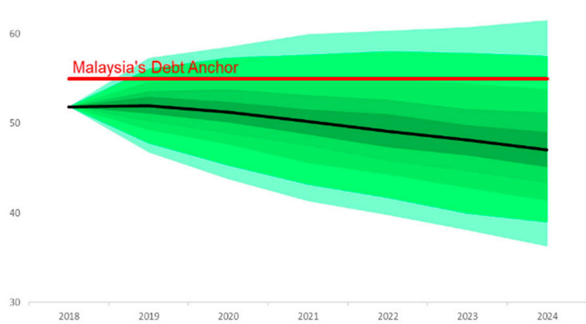
	2019	2020	2021	2022	2023	2024
Real GDP Growth Shock						
Real GDP growth	4.7	2.4	2.5	4.8	4.8	4.8
Inflation	1.9	1.8	1.8	2.3	2.3	2.2
Primary balance	-1.3	-1.4	-1.8	-0.8	-0.8	-0.7
Effective interest rate	4.5	4.3	4.4	4.6	4.7	4.8
Real Exchange Rate Shock						
Real GDP growth	4.7	4.8	4.8	4.8	4.8	4.8
Inflation	1.9	9.9	2.4	2.3	2.3	2.2
Primary balance	-1.3	-0.9	-0.9	-0.8	-0.8	-0.7
Effective interest rate	4.5	4.3	4.4	4.5	4.7	4.8

Source: IMF staff.

Appendix VI. Medium-Term Fiscal Framework[1]

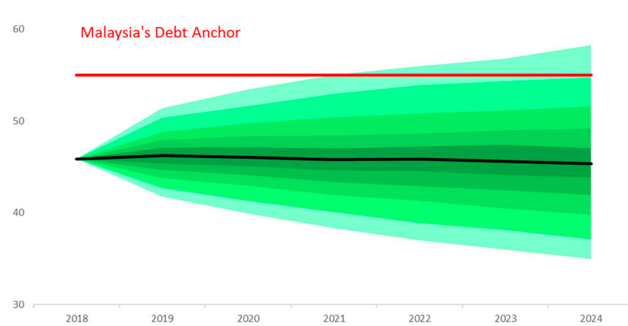
1. Malaysia's fiscal policy is currently anchored by a commitment to keep the total federal government debt within 55 percent of GDP. However, staff simulations suggest that, under the status quo scenario without fiscal consolidation, there is a 15–20 percent probability that the debt trajectory will exceed the debt-to-GDP ceiling of 55 percent. To contain the probability breaching the anchor at a prudent level—within 10 percent, the debt level in normal time should be lowered to 46 percent of GDP (See text charts). In this respect, the authorities' fiscal consolidation path is appropriate, reducing the debt-to-GDP ratio to 47 percent of GDP by 2024 (Appendix V).

Status Quo Scenario



Source: IMF staff calculations.

Debt-to-GDP Reduced to 46 Percent



Source: IMF staff calculations.

2. The authorities' consolidation path should be embedded in a strengthened framework being mindful of the procyclical nature of a nominal fiscal deficit target. The authorities' fiscal deficit target is simple, closely linked to debt dynamics, easy to communicate to the public, and therefore has played an important role in building market confidence. Nevertheless, the medium-term target is not fully operationalized in the annual budget process, which could undermine its enforceability. Clearer operational rules embedded in a medium-term fiscal framework are necessary. Moreover, the fiscal deficit target does not consider the cyclical position of the economy. Hence, in bad times, meeting the target could require undesirable expenditure cuts to offset the decline in tax revenue. In addition, the overall fiscal balance could be affected by debt service payments, which cannot be fully controlled by the government. The procyclical nature of a nominal fiscal balance is further exacerbated by the dependence of oil-related revenues on the economic cycle. The authorities could calibrate the fiscal stance by being mindful of the underlying economic conditions. However, under the current framework, there is no clear guidance regarding modalities and timing of such calibration.

[1] Prepared by Kazuaki Miyachi. For details, see 2019 Malaysia Selected Issues Paper "Medium-Term Fiscal Framework in Malaysia."

3. Introducing an expenditure rule could be considered as an option to strengthen the fiscal framework. Expenditure rules can help avoid procyclicality and are generally easy to communicate and implement, and compliance can be relatively easily monitored.[2] Specifically, an expenditure rule would include the following key features:

- *The expenditure rule would cap the growth rate of primary expenditure.* This allows automatic stabilizers to operate by helping contain expenditure growth in an economic upturn while preventing large expenditure cuts in a downturn. Expenditure rules in percent of GDP should be avoided as they tend to be procyclical.

- *The growth rate of expenditure would need to be consistent with the authorities' debt anchor.* The expenditure rule should achieve the debt anchor under realistic assumptions on GDP growth and financing cost and be resilient to cyclical fluctuations. Nonetheless, since primary expenditure has only partial implications on debt dynamics, there is a risk that the implementation of an expenditure rule would not deliver intended debt dynamics due to, for example, a permanent shift of trend growth. To address this concern, a feedback mechanism is warranted to adjust the growth rate of expenditure when the projected debt trajectory deviates from the anchor.

- *The growth rate of expenditure would be calibrated to meet the government's strategic objectives.* Given Malaysia's relatively low tax revenue and the need to raise spending to meet social and development objectives, revenue mobilization is a priority, as the expenditure rule also needs to be based on realistic and achievable revenue projections. Therefore, the growth rate of expenditure should not be constrained by current revenue mobilization capacity. Rather, specific revenue mobilization measures would need to be developed to meet the needs specified by the spending rule and ensure its consistency with planned revenues.[3]

- *Illustrative scenarios based on staff's macro-fiscal projection (trend nominal GDP growth at 7 percent):* The text table below shows that without additional revenue mobilization, the growth rate of expenditure would need to be 5 percent—below the trend nominal GDP growth—to achieve a fiscal deficit of 2 percent of GDP by 2024 (in line with the authorities' consolidation plan). However, this would lower the non-interest expenditure in percent GDP from 15.9 percent in 2020 to 14.5 percent in 2024 and undermine the authorities' ability to meet its social and development objectives. On the other hand, as shown in text chart (main text, paragraph 14), staff recommends that the primary expenditure should broadly remain at the same level in percent of GDP to accommodate additional spending needs. In this case, revenue mobilization measures need to be specified to allow the non-interest expenditure to grow at the trend nominal GDP growth rate while achieving fiscal deficit of 2 percent by 2024. To this end, revenue in percent of GDP should increase from 15.0 percent in 2020 to 16.1 percent in 2024.

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[2] One potential alternative could be targeting the structural balance, taking into account the business cycle and one-off factors. However, the structural balance could be difficult to compute, monitor, and communicate.

[3] For example, the European expenditure benchmark takes into account the revenue side by capping the growth rate of expenditure net of new revenue mobilization measures.

Table 1. Illustrative Scenarios

Assumptions
Trend nominal GDP growth: 7 percent
Consolidation path: Achieving fiscal deficit of 2 percent of GDP by 2024 (in line with the authorities' plan)

Scenarios

		2020	2021	2022	2023	2024
Status quo (without consolidation)	Revenue	15.0%	14.9%	14.8%	14.7%	14.7%
	Non-interest expenditure	15.9%	15.7%	15.6%	15.4%	15.4%
	Fiscal balance	-3.0%	-3.0%	-2.9%	-2.9%	-2.9%
Consolidation without revenue mobilization	Revenue	15.0%	14.9%	14.8%	14.7%	14.7%
(Expenditure growth: 5 percent every year)	Non-interest expenditure	15.9%	15.5%	15.2%	14.8%	14.5%
	Fiscal balance	-3.0%	-2.8%	-2.5%	-2.3%	-2.0%
Consolidation with revenue mobilization	Revenue	15.0%	15.2%	15.5%	15.7%	16.1%
(Expenditure growth in line with trend nominal	Non-interest expenditure	15.9%	15.9%	15.9%	15.9%	15.9%
GDP growth)	Fiscal balance	-3.0%	-2.8%	-2.5%	-2.3%	-2.0%

Sources: IMF staff calculations based on Public Debt Sustainability Analysis.

4. **Well-defined escape clauses and a formal accountability mechanism will support the effectiveness of the rule-based framework.** To make a fiscal framework credible and resilient, it should include well-defined escape clauses allowing flexibility to adjust to tail events. An escape clause should define: (i) a limited set of events triggering the operation of the clause, (ii) for how long fiscal policy can deviate from the targets, and (iii) a correction mechanism to the targets after the operation of the escape clause. Also, effectiveness of fiscal rules hinges on strong compliance. Greater fiscal transparency (e.g., obligations to publicly explain deviations from the fiscal rule) can increase political incentives for compliance by raising the reputational costs associated with noncompliance. An independent fiscal institution could be useful to analyze fiscal policy developments and alert to the risk of breaching fiscal rules.

Appendix VII. Financial Conditions Index[1]

Background

1. **Early research on financial conditions was narrowly focused on the slope of the public yield curve, while more recently additional variables were included.** The yield curve has been found to outperform other financial variables in terms of predicting recessions (Estrella and Mishkin, 1996). Stock market variables had been included in indexes of leading indicators since the 1950s (Zarnowitz, 1992). The Bank of Canada (BOC) pioneered work on broader financial condition measures in the mid-1990s, when it introduced its monetary conditions index (MCI, Freedman, 1994). For the BOC, the exchange rate was the most important additional variable. Its MCI, therefore, consisted of a weighted average of its refinancing rate and the exchange rate.[2]

2. **In the late-1990s, MCIs along the lines constructed by BOC became a widely used tool to assess the stance of monetary policy in many countries.** Moreover, the scope of variables augmenting the effects of policy rates was broadened to include long-term interest rates, equity prices, and house prices (since rising house prices increased the borrowing capacity of households). These broader measures became known as financial condition indexes (FCIs) to distinguish them from MCIs.

3. **A variety of methodologies for constructing FCIs have been developed over time and tend to fall into two broad categories: a weighted-sum approach and a principal-components approach.** In the *weighted-sum approach*, the weights on each financial variable are generally assigned based on estimates of the relative impacts of changes in the variables on real GDP. The *principal components methodology* extracts a common factor (from a group of several financial variables), which captures the greatest common variation in the variables and is either used as the FCI or is added to the central bank policy rate to make up the FCI.

4. **In most cases, financial condition indexes are based on the current value of financial variables, but some take into account lagged financial variables as well.** Some FCIs can be interpreted as summarizing the impact of financial conditions on growth, others can be interpreted as measuring whether financial conditions have tightened or loosened.

5. **The FCIs offer a useful addition to the macro-financial surveillance toolkit by providing consolidated information from a broad array of widely observable financial variables.** Absent significant structural improvements/deepening in the financial system during the observed period (e.g. which may suggest either shifts in relative importance of sub-components of the index or increased tolerance of the financial system toward a particular type of imbalance), the FCIs provide a good measure of changes in financial conditions over time (i.e., indicate whether overall financial conditions are tightening or loosening relative to a base period).[3]

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[1] Prepared by David Grigorian.

[2] The weights were determined via simulations with macroeconomic models designed to quantify the relative effect of a given percentage change in each variable on GDP or final demand.

[3] Indeed, major investment banks (e.g., Citi, Deutsche Bank, Goldman Sachs, etc.) and Bloomberg have built their own FCIs. In addition, various Fund teams have created their own country FCIs, including those for the US, France, South Africa, Greece, Russia, and Poland. Finally, BNM has created own FCI for Malaysia, made public in the 2017 Financial Stability Report.

Financial Conditions Index for Malaysia

6. The FCI used by staff[4] is based on MCM's FCI published in 2017 GFSR, with subsequent updates for 2017–2018Q2. The approach is based on Koop and Korobilis (2014) with time-varying parameter vector autoregression (Primiceri, 2005) and dynamic factors (Doz, Giannone, and Reichlin, 2011). Essentially, it handles the following three issues: (i) selection of financial variables to enter into the FCI, (ii) the weights used to average these financial variables into an index and (iii) the relationship between the FCI and the macroeconomy.[5] The model parameters are estimated based on 20 financial indicators covering credit, foreign exchange, debt, and equity markets for 43 advanced and emerging market economies for 1990–2016, where data are available, transformed to stationarity (Hatzius *et al.* 2010). Increase in the index means tightening financial conditions.

7. The model used for estimating the FCI for Malaysia can be presented as:

$$x_t = \lambda_t^y Y_t + \lambda_t^f f_t + u_t,$$

$$\begin{bmatrix} Y_t \\ f_t \end{bmatrix} = B_{1,t}\begin{bmatrix} Y_{t-1} \\ f_{t-1} \end{bmatrix} + B_{2,t}\begin{bmatrix} Y_{t-2} \\ f_{t-2} \end{bmatrix} + \ldots + \varepsilon_t,$$

in which x is a vector of financial variables, Y_t is a vector of macroeconomic variables of interest (including growth in industrial production and inflation), $\lambda^t{}_y$ are regression coefficients, $\lambda^f{}_t$ are the factor loadings, and f_t is the latent factor, interpreted as the FCI.

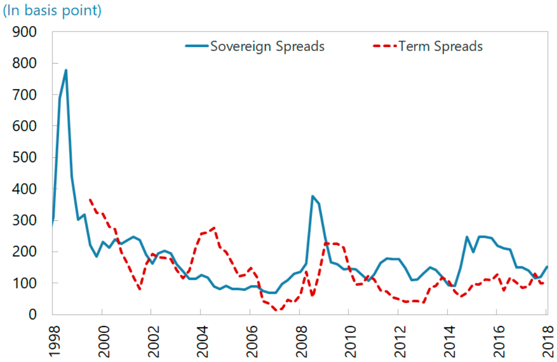
8. Some subcomponents of Malaysian FCI, representing all four markets, are shown in Figure 1 below. Both the FCI and its components seem to reflect Malaysia's financial histories well, showing periods of both tight and lose conditions consistent with anecdotal evidence and historic developments. From the early 2000s through the global financial crisis, financial conditions had been easing and, following a sharp tightening in the wake of the GFC, financial conditions eased again. While forecasting power (and therefore policy relevance) of FCIs may be limited (since financial systems evolve and variables most relevant for tracking financial conditions may change), looking at FCIs in conjunction with its key components (representing various markets) may prove useful for policy conduct. Significant easing in 2016–17, as portrayed by the estimated FCI, justified the tightening monetary policy bias in 2017, and the policy rate increase in January 2018; likewise, the recent tightening would justify monetary policy remaining on hold.

[4] See paragraph 18 of the staff report's main text.

[5] It does so by implementing model selection or model averaging in a dynamic manner (i.e., choosing different financial variables to make up the FCI at different points in time) and constructing an FCI by averaging over many individual FCIs built using different financial variables and time-varying weights.

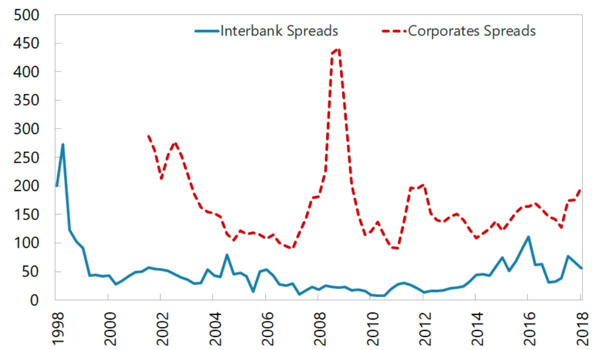
Figure 1. Components of Financial Conditions Index

Sovereign Debt Market
(In basis point)



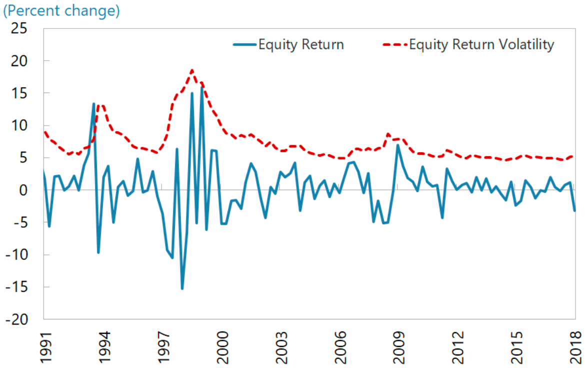
Sources: Bloomberg L.P. ; and IMF staff calculations.

Interbank and Credit Markets
(In basis point)



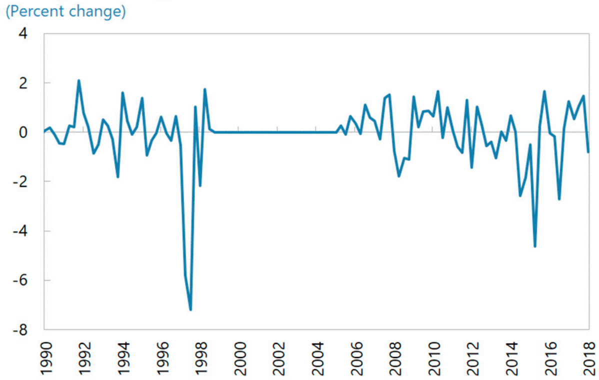
Sources: Bloomberg L.P. ;Thomson Reuters Datastream; and IMF staff calculations.

Equity Markets
(Percent change)



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

Foreign Exchange Market
(Percent change)



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

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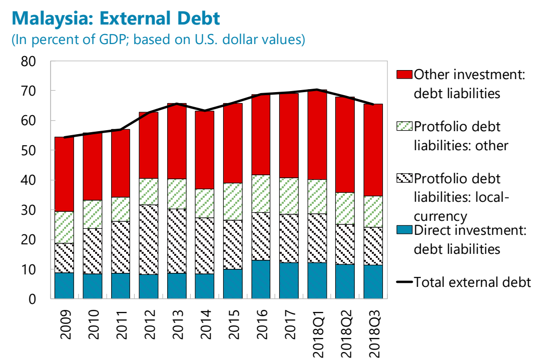
Appendix VIII. External Debt Sustainability Analysis[1]

1. **Malaysia's external debt has trended upward post the Global Financial Crisis, driven by a surge in the inflows of portfolio debt and other debt liabilities.** Malaysia's external debt-to-GDP ratio has risen by more than 16 percentage points of GDP between 2009 and 2018Q1, to about 70 percent of GDP (2009: 54¼ percent of GDP). About one-half of this increase in the debt ratio was due to the rise in portfolio debt liabilities between 2009 and 2013, particularly nonresident investment in Malaysia's local-currency debt securities. While portfolio debt liabilities as a share of GDP have declined since 2014, increases in other debt liabilities (interbank borrowings and intercompany loans) contributed to an increase in the overall debt ratio by about 7.2 ppts of GDP.[2]



Sources: Bank Negara Malaysia; and IMF staff calculations.

2. **The composition of external debt changed in the face of a general EM risk-off sentiment and post-election policy uncertainty.** As of 2018Q3, Malaysia's external debt, valued in U.S. dollars, stood at 65.4 percent of GDP, down from 70.3 percent of GDP in 2018Q1. This is primarily driven by the reduction of nonresident holding of local currency-denominated government debt (portfolio debt liabilities: local-currency) since May 2018, which was partly offset by the increased interbank borrowings[3] (other investment: debt liabilities) for liquidity management purposes and intercompany loans. These changes lead to two compositional effects: (i) foreign currency-denominated debt increased both in nominal value and as a share of total external debt; and (ii) the share of short-term debt reached 48 percent of total external debt in 2018Q2, approaching its peak level in 2014 (see Text Table below), and dropped slightly to 46 percent in 2018Q3. The reduction in nonresident holding of ringgit-denominated government debt was compensated by an increase in domestic investor holdings.

3. **Over the medium term, the external debt-to-GDP ratio is projected to remain on a steady downward path, falling to about 53 percent by 2023.** Under staff's baseline, this path reflects the net effect of sustained current account (CA) surpluses (excluding interest payments), robust growth, continued non-debt generating capital inflows, and an expected increase in external financing rates. Share of short-term debt, by original maturity, is assumed to gradually decline to about 45 percent of total external debt by the end of the medium term.

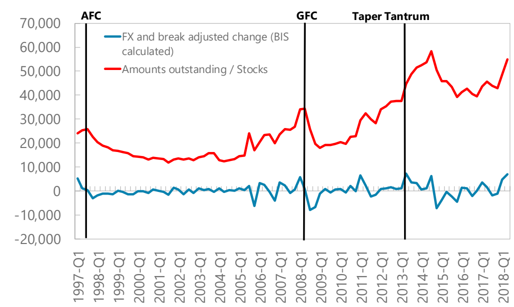
[1] Prepared by Xin Li.

[2] As a share of GDP, interbank borrowings increased from 12.6 to 16.2 percent, and intercompany loans increased from 5.9 to 9.5 percent since 2014.

[3] That is, through higher placements of foreign currency and deposits with domestic financial institutions.

4. **Sizable external debt would keep Malaysia's external vulnerabilities elevated.** Standard stress tests under the external DSA indicate that external debt is most vulnerable to exchange rate depreciation. A 30 percent real exchange rate depreciation could push external debt above 71 percent of GDP over the medium-term. Moreover, a permanent drop in the CA balance (excluding interest payments) could raise the external debt level above 66 percent of GDP in the outer years. Other scenarios—such as a deceleration in real GDP growth and a rise in the interest rate—would lead to moderate increases in external debt. The impact of these shocks would be mitigated by the high share of ringgit-denominated external debt (more than 30 percent). The large net inflows of interbank borrowings, which experienced reversals following the GFC and AFC, are less likely to pose a risk in case of adverse external shock, as three-quarters of short-term interbank borrowings today are accounted for by stable intragroup placements among banks as of 2018Q3.

Interbank Borrowing: Malaysia
(millions of U.S. dollars)



Sources: BIS International Locational Banking Statistics.

5. **Risks to Malaysia's external debt sustainability arising from the above vulnerabilities would be managed via a variety of mitigation measures.** As of December 2018, gross official reserves stood at $101.4 billion, or about 70 percent of short-term external debt by remaining maturity. Gross official reserves are adequate under the IMF reserve adequacy metric (ARA) (about 108 percent of the ARA metric).[4] Exchange rate flexibility, a moderate CA surplus, and the relatively large share of ringgit-denominated external debt[5], will continue to serve as important buffers against potential external shocks. Moreover, banks' foreign currency debt is subject to robust internal controls and policies, and the authorities indicated that intercompany FX loans are usually available on concessional terms.

[4] However, net reserves adjusted for net forwards positions are below 100 percent coverage of the ARA metric.

[5] As of 2018Q2, local currency-denominated debt accounted for close to one-third of total external debt.

Malaysia: Profile of External Debt

(In percent of GDP unless otherwise mentioned; original maturity)

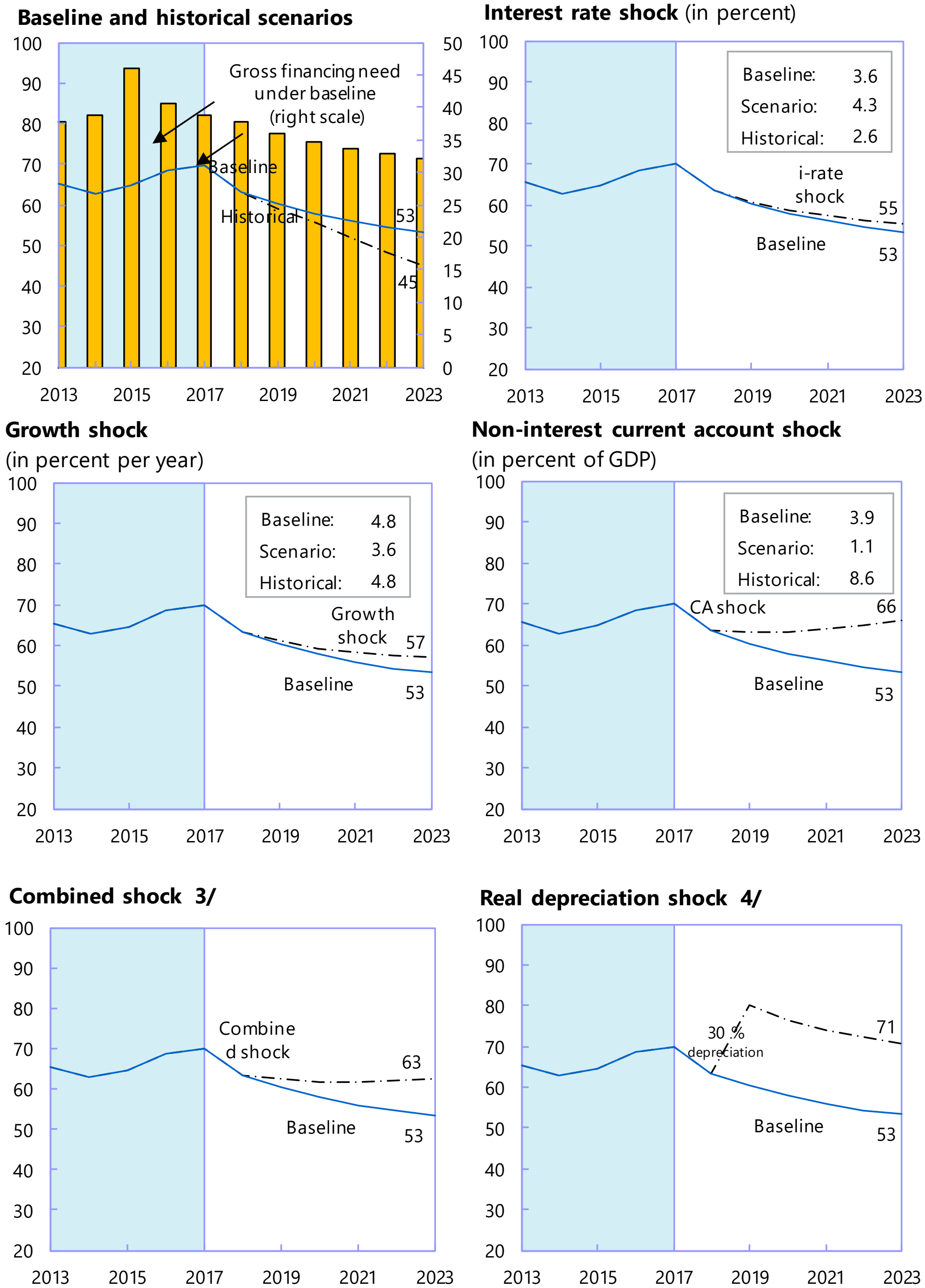
	2014	2015	2016	2017	2018Q1	2018Q2	2018Q3
Total external debt (staff estimate) 1/	63.1	65.7	68.7	69.1	70.3	67.9	65.4
Medium- and long-term	*32.4*	*38.1*	*40.3*	*39.3*	*39.0*	*35.3*	*35.3*
Offshore borrowing	17.8	22.7	24.3	22.9	22.3	21.3	22.2
Public sector	7.9	10.1	9.8	9.4	9.0	10.1	9.6
Federal government	1.4	1.7	1.4	1.3	1.3	1.2	1.1
Public enterprises	6.4	8.4	8.4	8.1	7.7	8.9	8.5
Private sector	9.9	12.6	14.4	13.4	13.3	11.2	12.6
Banks	3.1	3.9	4.0	3.3	3.3	3.0	3.0
Nonbanks	6.8	8.7	10.5	10.1	10.0	8.2	9.6
Nonresident holdings of ringgit-denominated debt instruments	13.7	14.5	15.2	15.4	15.6	12.8	12.0
Government securities	12.8	13.6	14.3	14.4	14.5	12.0	11.2
Other securities	1.0	0.9	0.9	1.0	1.0	0.8	0.8
Other	0.9	0.9	0.9	1.1	1.2	1.2	1.1
Short-term	*30.7*	*27.6*	*28.4*	*29.8*	*31.3*	*32.6*	*30.1*
Offshore borrowing	14.3	14.0	15.6	16.5	18.5	21.2	18.2
Public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	14.3	14.0	15.6	16.5	18.5	21.2	18.2
Banks	12.6	12.7	12.8	13.6	13.2	16.1	14.6
Nonbanks	1.7	1.3	2.8	2.9	5.2	5.1	3.6
Nonresident holdings of ringgit-denominated debt instruments	5.1	2.1	0.8	0.9	1.0	0.6	0.7
Government securities	0.0	0.3	0.1	0.3	0.4	0.2	0.3
Other securities	5.1	1.9	0.7	0.6	0.6	0.4	0.4
Nonresident deposits	6.6	6.4	6.5	7.2	6.9	6.2	6.6
Other	4.7	5.1	5.5	5.3	4.9	4.6	4.7
Memorandum items:							
	(In percent of total external debt unless otherwise mentioned)						
By original maturity:							
Short-term	48.7	42.0	41.2	43.1	44.5	48.0	46.0
Medium- and long-term	51.3	58.0	58.8	56.9	55.5	52.0	54.0
By currency:							
Local currency denominated	41.0	36.0	34.0	34.4	34.8	31.2	30.6
Foreign currency denominated	59.0	64.0	66.0	65.6	65.2	68.8	69.4
By instrument:							
Nonresident holdings of ringgit-denominated debt instruments	29.9	25.3	23.4	23.5	23.5	19.8	19.4
Interbank borrowing	20.0	19.3	18.7	19.2	18.8	23.7	22.2
as share of GDP	12.6	12.7	12.8	13.3	13.2	16.1	14.5
Bonds and notes	15.7	19.1	18.5	17.4	15.9	15.6	15.8
Intercompany loans	9.4	11.1	15.0	11.3	14.1	13.9	13.9
as share of GDP	5.9	7.3	10.3	7.8	9.9	9.4	9.1
Nonresident deposits	10.4	9.8	9.4	10.3	9.8	9.1	10.0
Loans	5.8	6.3	5.9	5.8	9.1	9.5	9.7
Gross official foreign exchange reserves (US$ billion)	115.9	95.3	94.5	102.4	107.8	104.8	103.0

Sources: Bank Negara Malaysia; and IMF staff calculations.

1/ Based on staff's estimate of external debt and nominal GDP in U.S. dollar. Authorities' data are in ringgit terms. Differences with the authorities' debt-to-GDP ratio may occur on account of the exchange rate assumptions.

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

(In percent of GDP)



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

Table 1. Malaysia: External Debt Sustainability Framework, 2013–2023

(In percent of GDP, unless otherwise indicated)

Table 1. Country: External Debt Sustainability Framework, 2013-2023

(In percent of GDP, unless otherwise indicated)

	Actual 2013	2014	2015	2016	2017	10-Year Historical Average	10-Year Standard Deviation	Est. 2018	Proj. 2019	2020	2021	2022	2023	For debt stabilization	Debt-stabilizing non-interest current account 6/
Baseline: External debt	65.7	63.1	65.7	68.8	69.4			**62.7**	**59.6**	**57.1**	**55.1**	**53.7**	**52.5**		**-2.4**
Change in external debt	3.1	-2.6	2.6	3.1	0.6			-6.7	-3.1	-2.5	-1.9	-1.5	-1.2	0.0	
Identified external debt-creating flows (4+8+9)	-5.0	-6.6	1.1	-5.0	-8.9			-6.7	-6.1	-6.0	-5.3	-4.5	-4.4	0.0	
Current account deficit, excluding interest payments	-4.6	-5.5	-4.2	-3.7	-4.1			-4.1	-4.2	-4.3	-4.0	-3.3	-3.2	2.4	
Deficit in balance of goods and services	-8.5	-9.3	-7.6	-6.8	-6.9			-6.5	-6.2	-6.2	-5.6	-4.8	-4.6		
Exports	75.6	73.8	70.6	67.8	71.4			66.8	65.2	63.9	62.1	59.8	57.7		
Imports	67.1	64.5	62.9	61.0	64.4			60.3	59.0	57.7	56.5	55.0	53.1		
Net non-debt creating capital inflows (negative)	0.6	1.6	0.2	-1.1	-1.2			-1.1	-1.0	-0.9	-0.8	-0.7	-0.7	-0.7	
Automatic debt dynamics 1/	-1.1	-2.7	5.1	-0.2	-3.6			-1.5	-1.0	-0.7	-0.5	-0.5	-0.6	-1.8	
Contribution from nominal interest rate	1.1	1.1	1.2	1.3	1.2			1.4	1.7	1.9	2.1	2.0	1.8	1.8	
Contribution from real GDP growth	-2.9	-3.8	-3.7	-2.8	-3.8			-2.9	-2.7	-2.7	-2.6	-2.5	-2.4	-2.4	
Contribution from price and exchange rate changes 2/	0.7	-0.1	7.6	1.3	-0.9			...	...	...	...	...	...	-1.2	
Residual, incl. change in gross foreign assets (2-3) 3/	8.1	4.0	1.5	8.1	9.4			0.0	3.0	3.5	3.3	3.1	3.3	0.0	
External debt-to-exports ratio (in percent)	86.8	85.5	93.2	101.5	97.2			93.9	91.4	89.3	88.8	89.7	90.9		
Gross external financing need (in billions of US dollars) 4/	122.9	132.2	139.0	120.8	120.8			131.8	134.2	138.3	144.4	152.4	159.7		
in percent of GDP	38.0	39.1	46.9	40.7	38.4			37.4	35.6	34.1	33.1	32.4	31.7		
Scenario with key variables at their historical averages 5/								**62.7**	**58.4**	**54.8**	**51.1**	**47.4**	**43.8**		**0.1**
Key Macroeconomic Assumptions Underlying Baseline															
Real GDP growth (in percent)	4.7	6.0	5.1	4.2	5.9	4.8	2.4	4.7	4.6	4.8	4.8	4.8	4.8	4.8	
GDP deflator in US dollars (change in percent)	-1.8	-1.4	-16.5	-4.0	0.1	0.4	10.1	6.8	2.5	2.7	2.5	2.8	2.3	2.3	
Nominal external interest rate (in percent)	1.8	1.8	1.6	1.9	1.8	2.6	1.5	2.3	2.9	3.5	3.9	3.8	3.7	3.7	
Growth of exports (US dollar terms, in percent)	-2.0	2.0	-16.1	-3.9	11.7	1.7	13.0	4.6	4.7	5.4	4.4	3.8	3.5		
Growth of imports (US dollar terms, in percent)	0.6	0.6	-14.4	-2.9	12.0	2.8	13.3	4.6	4.9	5.3	5.2	4.9	3.6		
Current account balance, excluding interest payments	4.6	5.5	4.2	3.7	4.1	8.6	5.4	4.1	4.2	4.3	4.0	3.3	3.2		
Net non-debt creating capital inflows	-0.6	-1.6	-0.2	1.1	1.2	-1.2	1.6	1.1	1.0	0.9	0.8	0.7	0.7		

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

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

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

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

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

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

Appendix IX. Foreign Exchange Market Considerations[1]

A. Introduction

1. The authorities have taken several steps to develop the onshore financial markets over recent years while seeking to curtail ringgit activity in offshore markets. Underpinning this approach is a desire to closely monitor activity in foreign exchange markets, while seeking to dissuade activity which they consider to be of a short-term or speculative nature. Such activity is seen to increase risks to market stability, upon which the authorities place a greater weight than they do on the potential costs of limiting capital flows, including from the loss of market liquidity in the offshore market arising from limiting participation.

2. This appendix assesses developments in the foreign exchange market incorporating feedback received during a July 2018 staff visit to Malaysia. The focus is on Capital Flow Management Measures and activity in the foreign exchange market while broader issues of the monetary policy framework and prudential policy are not covered. A summary of the feedback from the meetings held during the mission is contained in Box 1.

B. BNM Market Development Initiatives

3. The BNM's approach to financial markets development is guided by the Financial Sector Blueprint 2011–2020, which covers a broad range of financial sector issues. At the core is a belief that the financial markets should serve the participants in the real economy, which calls for ringgit-based activity to be closely monitored and regulated, thereby favoring onshore market activity over activity conducted offshore. With regard to the foreign exchange market, the Financial Sector Blueprint contained four specific recommendations; i) allow corporations to actively manage foreign currency exposures arising from overseas operations, ii) permit institutional funds and retail investors to trade in foreign currencies subject to suitable safeguards, iii) allow financial institutions to offer internet and electronic trading platforms for corporations and retail investors, and iv) permit participation by non-residents in the onshore foreign exchange derivatives market without underlying trades or investments, subject to safeguards.

[1] Prepared by Darryl King with contributions from Nada Choueiri, Kelly Eckhold, Tjoervi Olafsson, Asad Qureshi and Jochen Schmittmann.

Box 1: Summary of Financial Market Participants' Views[1]

The mission held meetings with a cross-section of onshore and offshore banks, asset managers, importers/exporters to discuss the functioning of the foreign exchange market in the context of the BNM's objective to improve foreign currency liquidity in onshore markets. Onshore participants were supportive of this objective while parties offshore were critical of some of the 2016 measures introduced by BNM, reflecting the relative impact on activity in the respective segments. Three themes were prominent throughout the discussions: 1) The changes made in late 2016 were implemented without giving market participants a chance to adequately prepare (not enough advance warning and clarity about modalities of implementation) but they have now adjusted, and compliance is not an issue; 2) the administrative burden and costs of complying with the regulations are not negligible but are manageable; and 3) the domestic markets are functioning reasonably well.

Offshore players tended to be more negative about the tightening of regulations in late-2016, some noting the impact on offshore activity. Large fixed income investors attributed the fall in the weighting of Malaysian bonds in the JPMorgan EMBI from over 10 percent to 5.6 percent partially to the December 2016 measures.

Local banks were generally happy with the functioning of the domestic foreign exchange markets noting a decline in 'speculative' trading, with good liquidity and tight bid/offer spreads. They noted a clear sign of improvement in the onshore market following the introduction of the measures in late 2016. Almost all interbank activity is reported to be undertaken through three voice-brokers with only moderate support expressed for moving to an electronic matching platform. BNM interventions were seen as building confidence as they provided liquidity when market conditions were thin or when a large transaction was being dealt. BNM was not seen as defending an exchange rate level or seeking to change the trend. Local banks noted the benefit of the extended onshore trading hours while trading could also happen outside of these hours through Appointed Overseas Offices (AOOs); it seems little business is conducted outside of Malaysia hours. The views about the functioning of the MGS market were positive with traders able to take short positions, facilitated by the broadening of short-selling eligibility to include non-bank resident entities and supported by the BNM securities-driven repo facility.

Corporates reported that liquidity and the cost of doing business (i.e. bid/offer spreads) in the foreign exchange market were generally acceptable. There was some support for regulatory measures to the extent that they lowered volatility. However, the strict interpretation of domestic borrowings (which captured corporate credit cards) activated limits on foreign currency investment and has resulted in regional treasury units being based outside of Malaysia. Noted also was the inability to manage foreign exchange risks across companies within a group, where one company may earn the bulk of the export proceeds while others may import.[2] In such cases the mandatory conversion requirement may be more binding than intended.

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[1] These views were gathered in meetings held during the July 2018 staff visit.

[2] Regarding this concern, BNM indicated that it welcomes applications to seek approval for foreign currency intragroup payments especially for cases where the exporting arm and importing arm are two separate entities within the same group of companies.

4. **Progress has been made on implementing measures to deepen the onshore foreign exchange market, including:** i) improving credibility of the foreign exchange reference rate by using traded rates covering most of the day, ii) allowing residents to hedge foreign currency exposures up to net MYR position of RM6 million per bank against 5 major currencies (i.e. USD, CNH, GBP, EUR and JPY) without documentary evidence, subject to declaration of hedging intent to the licensed onshore bank,, iii), allowing dynamic hedging (where registered foreign institutional investors are able to actively manage their FX exposure to hedge up to 100 percent of their underlying MYR assets as well as manage an additional 25 percent of FX exposure, where settlements of forward transactions can be undertaken on gross or net basis), iv) extending official trading hours by one hour to 6pm, and v) allowing short-selling of MGS and MGII. Further, to enhance monitoring of the domestic securities market, the BNM implemented the "RENTAS Segregated Securities Account (SSA) Initiative" up to fund manager level, replacing the practice of having securities block reported in omnibus accounts. All custodians have complied except Euroclear, which has agreed to do so and has been given an extension to comply Complementing RENTAS SSA implementation is the adoption of Legal Entity Identifier (LEI) as a unique identifier, in line with global practices, to promote greater transparency. The adoption of LEI is similar to EU's MIFID II requirements for the use of LEI to report financial market transactions.

C. The Regulatory Environment

4. **The foreign exchange regulatory regime is quite complex.** Changes in the regulatory regime are motivated by the authorities' desire to curtail offshore ringgit activity, and other activity they see as 'speculative', which they assess as activity that is not based on real underlying economic transactions or investments with a medium-term horizon. The offshore ringgit non-deliverable forwards (NDF) market falls into this category. This market arose from impediments some participants (e.g. portfolio investors) faced when dealing onshore and from capital account restrictions. In late 2016, the authorities introduced three measures that were assessed as capital flow management measures under the Fund's Institutional View (IV).[2] The three measures are as follows[3]:

- The BNM tightened the enforcement (November 2016) of an existing measure by requiring attestations about banks' activities to the effect that they do not engage or facilitate transactions in the offshore ringgit NDF market. The long-standing measure which predates the IV, limits capital outflows by not allowing onshore banks to engage in or facilitate offshore activities.[4]

- The BNM introduced a requirement for conversion of 75 percent of export proceeds (December 2016) which increases the cost of investment abroad in FX and thus limits capital flows.

[2] IMF 2012: The Liberalization and Management of Capital Flows: An Institutional View.

[3] See IMF Malaysia Staff Report January 2018 for further discussion of the measures taken in late-2016.

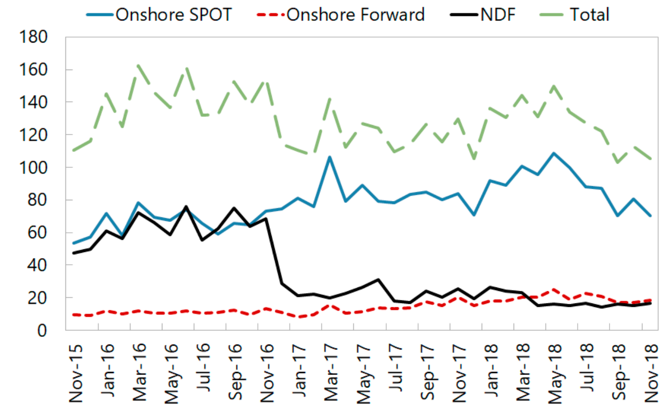
[4] IMF 2018 Taxonomy of Capital Flow Management Measures.

- A measure limiting investment in FX assets by residents with domestic ringgit borrowing (which predates the IV) was extended to exporters in December 2016; they were previously exempted.

5. In April 2017, steps were taken to ease the restrictions on capital movements, including:

- Simplified and streamlined procedures for registered non-resident investors to hedge up to 100 percent of their ringgit exposures, up from 25 percent, and take additional 25 percent MYR exposure on top of their underlying asset.

Figure 1: Foreign Exchange Market Turnover
(In billion U.S. dollar)



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

- Residents are allowed to hedge foreign currency exposures up to net MYR position of RM6 million per bank against 5 major currencies (i.e. USD, CNH, GBP, EUR and JPY) without documentary evidence, subject to declaration of hedging intent to the licensed onshore bank.

- Since August 2018, exporters are allowed to retain their export proceeds in a Trade Foreign Currency Account (Trade FCA) to meet their 6 months foreign currency obligations (including import and foreign currency loan repayment). This improvement was welcomed by market participants as it allows them to avoid the practice of conversion-reconversion.

D. Market Developments

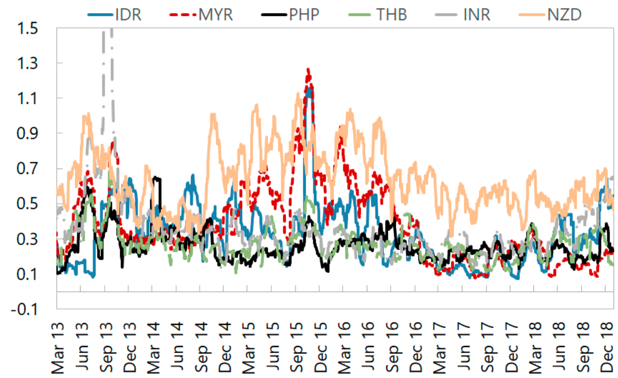
6. The measures taken during late 2016 markedly reduced the turnover in the NDF market with limited activity moving onshore (Figure 1). Total spot and hedging activity—defined as spot, forward and NDFs activity—fell from around US$150 billion per month to US$105 billion per month, and since then has been steadily increasing on account of an increase in onshore spot activity.[5] Onshore forward activity has similarly been increasing, but only marginally, even though some requirements were relaxed and offshore participants were permitted to hedge up to 100 percent of their underlying MYR assets as well as manage an additional 25 percent of FX exposure

[5] The complete picture on NDFs activity is difficult to ascertain because much of the trading is OTC, some of which may be unreported. However, it is estimated that around 80 percent of trade is captured from reporting in the major trading centers of London, New York and Singapore.

from early-2017. Overall, activity in longer-dated risk markets (NDF and onshore forwards) has declined while spot activity has increased.

7. Ringgit volatility has remained near the middle of the pack of comparator countries (Figure 2). After spiking in mid-2015, volatility has returned close to the levels of neighboring countries while there is evidence that movements in both the price and volatility of the USD/MYR, are correlated with oil. For example, pre-December 2016 the correlation between USD/MYR and oil was -0.94, which since has fallen to -0.79. It is noted that the stated objective of BNM intervention is to limit what they see as excessive volatility.

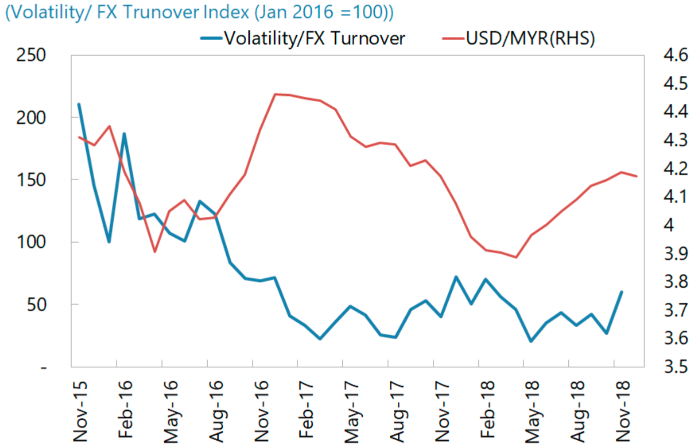
Figure 2: Currency Volatilites
(Rolling 1-month standard deviation)



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

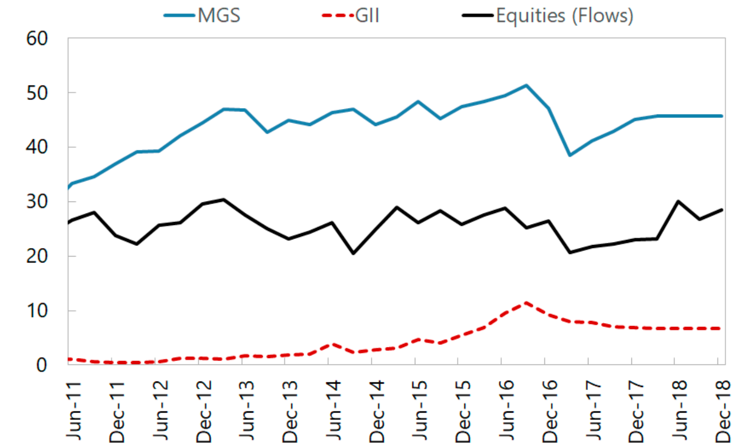
8. Market resilience is important from both price and financial stability viewpoints. Resilience can be proxied as volatility per unit of currency traded. That is, for a given volume, how much does the currency move – the lesser the movement, the greater the resilience. On this measure, resilience has generally improved from end-2015, with a notable dip after the introduction of the measures at end-2016 which has since been recovered (Figure 3). However, the caveat when assessing the resilience here is the extent of central bank intervention, given its impact of lowering volatility and increasing traded volumes, which would overstate market resilience. Further analysis is constrained by the lack of intervention data.

Figure 3: Foreign Exchange Market Resillience
(Volatility/ FX Trunover Index (Jan 2016 =100))



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

Figure 4: Non-resident Holdings
(In percent of Total Holdings)



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

9. Financial market turbulence after the 2016 US election lead to capital outflows from Malaysia and the authorities responded initially by tightening some regulations. The outflows were most pronounced in MGS, while also noticeable in MGII (Figure 4). A rebound in non-resident holdings appears to coincide with a relaxation of some of the measures through the further liberalization of dynamic hedging, in April 2017, allowing non-resident investors to hedge up to 100 percent of their underlying MYR assets as well as manage an additional 25 percent of FX exposure.

10. The onshore financial markets have grown recently and fare well against other like countries.

- **BNM's annual report on the financial markets reveals a 20 percent increase in onshore foreign exchange activity** to US$2.4 trillion, the majority of which is swaps (51 percent), and spot (41 percent).[6] The share of the top ten banks has fallen from 81 percent in 2016 to 77 percent in 2017.

- **The markets generally fare well against comparable countries.**[7] In terms of foreign exchange spot turnover as a percentage of GDP, Malaysia is at the median (0.5 percent) of a group of emerging market countries. And for forward, swaps and options, is materially above the median (2.3 percent versus a median of 1.0 percent for the group).[8]

E. BNM Intervention and Reserve Coverage

11. BNM characterizes its objectives in the foreign exchange market as smoothing volatility and supporting market liquidity. Market participants agreed with this characterization, with none believing that the BNM sought to defend a level of the exchange rate. Without

[6] BNM: 2017 League Table

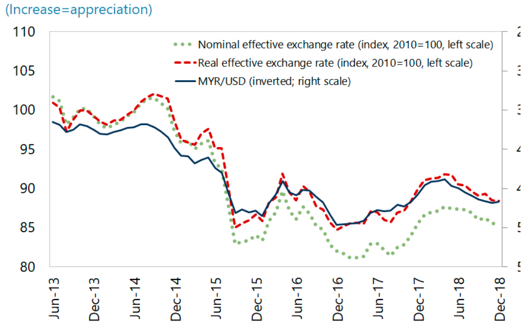
[7] See Appendix 3: Foreign Investors, Domestic Investor Base, and Market Liquidity Measures.

[8] IMF Global Financial Stability Report October 2018. Note that this figure includes foreign exchange swaps while the earlier reference (paragraph 7) excludes swaps.

intervention data, it is however difficult to deduce the BNM's reaction function, however the USD/MYR has moved in a wide range over recent years (Figure 5).

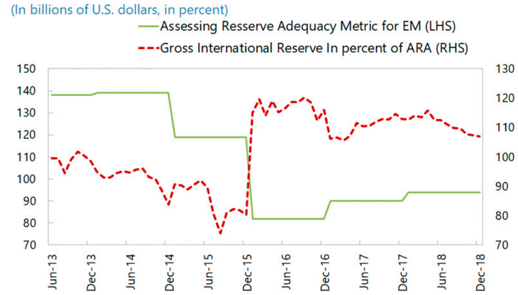
12. The BNM holds reserves that are in the lower part of the range considered to be broadly adequate. Assessed against the Fund's reserve adequacy framework (ARA), BNM reserves were about 108 percent of the relevant metric in December 2018 (Figure 6). The improvement in the ARA coverage (September 2016) stemmed from a substantial fall in the metric after the exchange rate regime was reclassified to 'floating'.[9] It is worth noting that the ARA is a gross metric and the unencumbered reserves level is lower given BNM's net USD short forward position which stood at $21.7 billion in November 2018.[10]

Figure 5: Exchange Rates
(Increase=appreciation)



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

Figure 6: Assessing Resserve Adequacy and Gross International Reserves
(In billions of U.S. dollars, in percent)



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

F. Concluding Observations

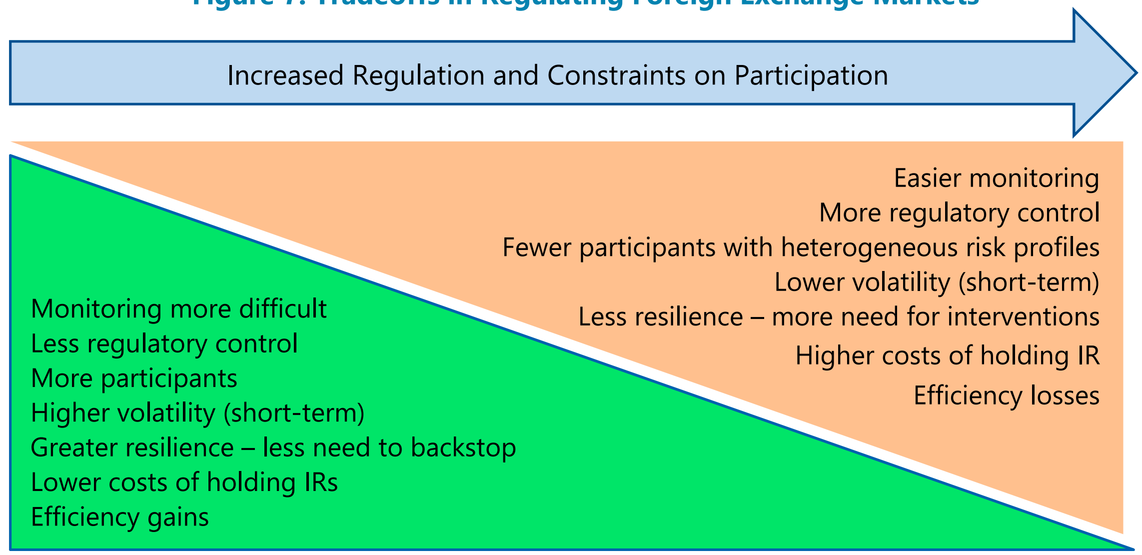
13. The BNM has made important progress in developing onshore financial markets, including the foreign exchange market. Good progress has been made with respect to establishing an appropriate market micro-structure, along with a code of conduct, and market infrastructure. Some further steps could be taken to improve market functioning with potential benefits of lower transaction costs, increased liquidity and greater resilience.

14. The authorities have decided to limit participation from entities with short-term trading horizons while opting for measures that allow for closer monitoring and stronger regulation. Excluding a segment of participants (i.e. those involved in the NDF segment) with heterogenous risks profiles reduces liquidity in good times, and resilience when shocks hit. Indeed, when shocks do hit, the presence of the NDF market ensures that while some but not all, short-term traders may exit, others enter seeking profit opportunities.

[9] As result the weights on exports, broad money and other liabilities were reduced by five percent

[10] BNM publishes data on its forward book monthly with a one-month lag.

Figure 7: Tradeoffs in Regulating Foreign Exchange Markets



16. For a given institutional and financial setting, the impact of regulation may be viewed along a continuum (Figure 7). The authorities would seem to have assessed the trade-offs, and placed themselves at a point to the right, along this continuum; a point where they consider their actions to be of benefit to the *'real'* users of the foreign exchange market – those being, importers, exporters, medium-term investors. This being the case, the markets do appear to be functioning reasonably well – with narrow bid/offer spreads – based on a preliminary assessment of resilience, general feedback from the domestic players that the mission met, and when compared with peer countries.

Appendix X. Malaysia Housing Market Measures[1]

1. The housing market is an important part of Malaysia's economy with significant linkages to the financial sector. Sixty percent of Malaysian households' high total debt (83 percent of GDP in 2Q 2018) is in mortgages held by banks and NBFIs. In addition to mortgages, financial institutions are also exposed to (residential and commercial) real estate developers—together constituting 12 percent of outstanding credit to the economy—making them vulnerable to large real estate price adjustments.

2. Prior to 2014, the housing market in Malaysia experienced significant price increases, largely believed to be triggered by speculative activity, including by non-resident investors.[2] The Malaysian House Price Index (MHPI) grew by a cumulative 24 percent in 2012-13 (or above 11 percent per annum), well above its long-run average of 6 percent. In 2014, amid significant price increases, transactions by non-residents surged as well, reaching 2,406 (or 1 percent of total residential property transaction by volume, Table 1).[3]

Table 1: Residential Property Transactions by Non-residents

	2012	2013	2014	2015	2016	2017
No. of transaction *(Annual growth, %)*	1,934 *(+1.3)*	1,846 *(-4.6)*	2,406 *(+30.3)*	1,156 *(-52.0)*	706 *(-38.9)*	792 *(+12.2)*
As % of total residential property transactions	*0.7%*	*0.7%*	*1.0%*	*0.5%*	*0.3%*	*0.4%*

Source: NAPIC

3. In response to the growing concerns about the aggregate household balance sheet and property market risks, the government has since 2010 introduced a series of policy measures to cool down the residential property market, preserve financial stability, and address deteriorating housing affordability. These measures included the introduction of 70 percent LTV for third property, reintroduction of the RPGT (both in 2010), an increase of capital risk-weights to 100 percent for mortgages with LTVs exceeding 90 percent, introduction of an LTV cap of 60 percent on housing loans for corporates (both in 2011), prohibition of the Developer Interest Bearing Schemes, and limiting mortgage loans to 35 years (both in 2013). Subsequently, in 2014, the real property gains tax (RPGT) was increased to 30 percent (with higher rates for non-residents for

[1] Prepared by David Grigorian.

[2] BOP data do not allow differentiation of inflows by purpose to help draw inferences regarding non-resident property purchases in Malaysia.

[3] About 64 percent of purchases by non-residents in 2010-13 were for properties priced between RM250,000 to RM1 million and 70 percent for properties priced above RM500,000.

holding 4 years and beyond, bringing the rate structure essentially to the one that existed prior to April 1, 2007; Table 2), and a minimum price of property that can be purchased by foreigners was increased to RM1 million.[4] Given that land matters are under the purview of each State government, several states have imposed their own buying restrictions and enforcement date, and four out of sixteen states have maintained a minimum price for property purchases by foreigners at 0.4 or 0.5 million ringgits.[5] These measures are complemented by wider efforts by the government to increase the supply of affordable housing nationwide and promote the rental market as an alternative to home ownership.[6]

4. The macroprudential measures adopted by the authorities have contributed to a slowdown in activity in the housing market, including by non-residents. The number of nonresident transactions in the real estate market more than halved in 2015, and dropped by another 38.9 percent in 2016, before picking up again in 2017. Housing price growth decelerated—at 3 percent in 2018Q1, growth of the MHPI is now below its long-term average (6 percent during 2001-17). By 2017, nonresidents only accounted for 792 transactions in the property market. While this is a small share of the total, the authorities continue to view the role of nonresidents as destabilizing the market and are watching carefully the resurgence of nonresident activity in the property market (by 12.2 percent in 2017 and 8.5 percent in 2018H1). The authorities also view macroprudential measures aimed at nonresidents as a necessary signal to property developers to encourage a rebalancing of supply towards the more affordable range, thus reducing the probability of large price adjustment (and financial stability implications) in the future.

[4] These measures are assessed as CFM/MPMs under the Fund's Institutional View on capital flows. A minimum price for the acquisition of property by foreigners was first enforced on June 30, 2009, with a floor at RM250,000 per unit. Subsequently, the threshold was raised to RM500,000 per unit effective January 1, 2010, and thereafter to RM1 million effective January 1, 2014.

[5] For example, since July 1, 2012, the Penang State Government had restricted foreign interests to property purchase above RM1 million in Penang and RM2 million for the landed property on the island. In 2015, to curb property speculative activity by foreigners, non-citizens were limited to properties above RM2 million for landed properties and RM1 million for strata-titled properties on the island. For the mainland of Penang, the floor price is maintained at RM1 million for landed properties and reduced to RM500,000 for strata-title properties. The Penang State government also introduced a 3 percent approval fee for all foreign purchase of properties in the state at that time. The share of residential property transactions in Penang was 7.4 percent of the national real estate transactions.

[6] These measures include the establishment of a single entity for affordable housing (announced in July 2018) and the enactment of a Residential Tenancy Act (announced in the Federal Budget 2018).

Table 2. Real Property Gain Tax Historical Rates

Period	Type of seller	Disposal in 1st year	Disposal in 2nd year	Disposal in 3rd year	Disposal in 4th year	Disposal in 5th year	Disposal in 6th year & above
Prior to 1 April 2007	Individual	30%	30%	20%	15%	5%	0%
	Non citizen & non PR	30%	30%	30%	30%	30%	5%
	Company	30%	30%	20%	15%	5%	5%
1 Apr 2007 - 31 Dec 2009	Individual	0%	0%	0%	0%	0%	0%
1 Jan 2010 - 31 Dec 2011	Individual	5%	5%	5%	5%	5%	0%
	Non citizen & non PR	5%	5%	5%	5%	5%	0%
1 Jan 2012 - 31 Dec 2012	Individual	10%	10%	5%	5%	5%	0%
	Non citizen & non PR	10%	10%	5%	5%	5%	0%
	Company	10%	10%	5%	5%	5%	0%
1 Jan 2013 - 31 Dec 2013	Individual	15%	15%	10%	10%	10%	0%
	Non citizen & non PR	15%	15%	10%	10%	10%	0%
	Company	15%	15%	10%	10%	10%	0%
Effective 1 Jan 2014	Individual	30%	30%	30%	20%	15%	0%
	Non citizen & non PR	30%	30%	30%	30%	30%	5%
	Company	30%	30%	30%	20%	15%	5%
Effective 1 Jan 2019	Individual	30%	30%	30%	20%	15%	5%
	Non citizen & non PR	30%	30%	30%	30%	30%	10%
	Company	30%	30%	30%	20%	15%	10%

Table 3: Breakdown of Property Transactions by Nonresidents

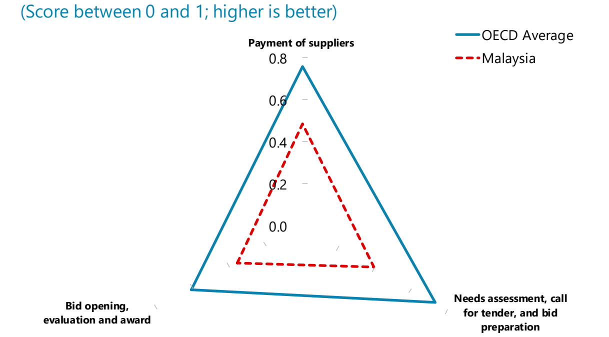
	2009	2010	2011	2012	2013	2014	2015	2016	2017	1H 2018
	As % of total non-residents' residential property transactions									
<RM250,000	4.4	10.0	10.5	9.7	3.8	2.7	4.2	5.7	3.4	2.6
RM250,001-RM500,000	56.3	39.2	22.8	16.1	6.4	5.4	5.3	6.2	5.7	6.8
RM500,001-RM1 million	25.4	30.4	43.3	44.1	50.6	47.9	28.7	18.3	16.2	15.5
>RM1 million	13.9	20.4	23.3	30.1	39.2	44.0	61.9	69.8	74.7	75.1

Source: NAPIC

Appendix XI. Fiscal Governance and Anti-Corruption Measures[1]

1. Fiscal governance vulnerabilities include the reliance on off budget spending, weaknesses in managing large infrastructure projects and in procurement systems, and a budget process that could be more transparent. Significant reliance on off budget initiatives, including government guarantees and public-private partnerships (PPPs), make it difficult to form a comprehensive assessment of the government fiscal position. The governance of large infrastructure projects in terms of project appraisal and approval, costing, and extension of government guarantees presents further challenges. Malaysia ranks low compared to the OECD average in the 2017 World Bank Benchmarking PPP Procurement (text chart), especially on (i) needs assessment, call for tender, and bid preparation; (ii) bid opening, evaluation and award; and (iii) payments to suppliers. The Open Budget Survey 2017, which assesses the transparency of central government budget processes, suggested that Malaysia provides the public with limited budget information, there are few opportunities for the public to engage in the budget process, and the legislature and supreme audit institution provide weak oversight of the budget.

Strength of Procurement Systems, 2017
(Score between 0 and 1; higher is better)

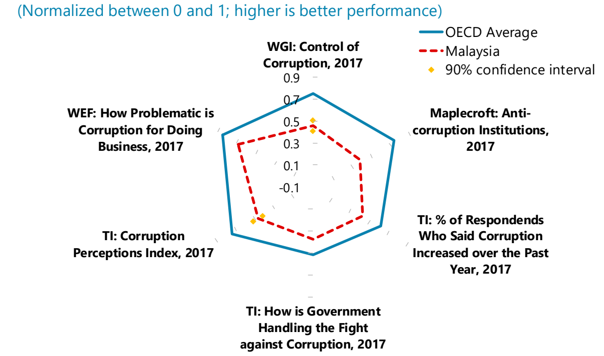


Sources: World Bank Benchmarking PPP Procurement (BPP); and IMF Staff calculations.

BPP provides expert assessment of PPP frameworks around the world in terms of PPP preparation, PPP procurement, treatment of unsolicited proposals, and PPP contract management.

2. Governance weaknesses have also led to corruption in Malaysia. Available indicators show that, as of end 2017 (text chart), Malaysia performed worse than the OECD average in terms of control of corruption (WB World Governance Indicators) and the strength of anti-corruption institutions (Maplecroft). Inefficient bureaucracy and corruption were among the six most problematic factors in doing business in Malaysia according to the 2017 executives survey by the World Economic Forum. According to Transparency International, in 2017 perception of corruption was high in Malaysia, and 60 percent of respondents perceived corruption to be on the rise and gave poor ratings on the previous government's efforts to fight corruption.

Corruption Perception Indicators, 2017
(Normalized between 0 and 1; higher is better performance)



Sources: Worldwide Governance Indicators (WGI); Maplecroft; World Economic Forum (WEF); Transparency International (TI) Corruption Perceptions Index and Global Corruption Barometer; and IMF staff calculations.

3. The new government has launched initiatives on multiple fronts to address governance weaknesses and corruption:

- In terms of the overall framework, the Mid-Term Review of the Eleventh Malaysia Plan reoriented government priorities towards improving transparency and public services efficiency.

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[1] Prepared by Katsiaryna Svirydzenka.

The National Centre for Governance, Integrity and Anti-Corruption (GIACC) was established to develop a national anti-corruption plan (expected launch in the first quarter of 2019) and to coordinate all government initiatives and activities related to governance. A Special Cabinet Committee against Corruption (JKKMAR) chaired by the Prime Minister was formed and meets monthly to mobilize government efforts to formulate appropriate governance policies. The intention is to move forward with important legislation to anchor governance reforms, as well as take firm steps towards ensuring public participation and key institutional reforms. Public participation seems to be working well; policy advocacy groups seem to be openly engaging with the general public, Parliament, and governance committees, which helps improve checks and balances.

- Special committees were established to tackle specific governance weaknesses. A Special Investigation Committee on Governance, Procurement, and Finance was formed to audit existing procurement contracts in line ministries. Pre-qualified open tender has been enforced in procurement, and single-sourced tenders have been prohibited. A Special Task Force on 1MDB was formed to track asset recovery and criminal investigations.
- Existing institutions are being strengthened: (i) the current Prime Minister no longer holds the Minister of Finance portfolio; (ii) consideration is being given to vesting with a parliamentary committee the responsibility for high level appointments (such as Attorney General and head of the MACC and judges), which had been resting with the PM – this would help minimize the risks of political influence; (iii) the Economic Planning Unit was moved from the PM office to a new Ministry of Economic Affairs (MEA), which constitutes a first step in strengthening its gatekeeper role for public investment; (iv) the PPP unit was moved under MOF control and the existing PPP framework is currently under review by MOF and MEA; (v) the government is working on strengthening the legal framework and SOEs' structure to improve their fiscal management and governance.

4. Anchoring governance reforms in appropriate legislation is needed to make them sustainable. Several important reforms – such as ensuring the independence of the MACC (appointment of the Chief Commissioner, securing its own yearly operational budget, and wider reporting of findings) and separating prosecution powers from legal advisory powers (both currently embodied in the person of the Attorney General) – require constitutional changes and a 2/3 approval in Parliament. Legislative reforms will be needed on freedom of information, political financing, and declaration of assets.

5. Improving fiscal governance will also require significant institutional reforms. Improvements in public investment management would require: (i) establishing an independent appeals panel for procurement and publish an annual report from this panel; (ii) updating regulations to establish a rigorous process for appraisal, pre-approval and approval of projects to avoid premature funding decisions, (iii) establishing comprehensive reporting of PPPs and their associated risks; and (iv) developing a medium-term fiscal framework that helps reconcile the medium-term resource envelope with medium-term estimates of operational and development expenditure, including required funding to complete the projects. It is important to avoid future tax refund arrears, improve financial oversight of SOEs and publish a more detailed set of accounts, and of a fiscal risks statement.

INTERNATIONAL MONETARY FUND

MALAYSIA

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 30, 2019

Prepared By

Asia and Pacific Department

CONTENTS

FUND RELATIONS ____ 2

STATISTICAL ISSUES ____ 5

FUND RELATIONS

(As of December 31, 2018)

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

II. **General Resources Account**

	SDR Millions	Percent of Quota
Quota	3,633.80	100.00
Fund holdings of currency (exchange rate)	3,001.78	82.61
Reserve tranche position	632.06	17.39
Lending to the Fund New Arrangement to Borrow	28.83	

III. **SDR Department**

	SDR Millions	Percent of Allocation
Net cumulative allocation	1,346.14	100.00
Holdings	821.83	61.05

Exchange Arrangement:

On September 7, 2017, Bank Negara Malaysia notified the Fund that since the unpegging of the ringgit in July 2005, Malaysia's exchange rate policy has gradually evolved, and the ringgit has been highly flexible, mainly driven by market force. Based on information on the exchange rate behavior, the de facto exchange rate regime is classified as floating, in line with the de jure classification.

Malaysia maintains bilateral payments arrangements with 7 countries. The authorities have indicated that these arrangements do not have restrictive features.

Malaysia continues to maintain a liberal foreign exchange administration policy. The current foreign exchange administration (FEA) rules include prudential measures to promote monetary and financial stability while safeguarding the balance of payments position and value of the ringgit. The FEA rules are continuously reviewed to ensure comprehensive policies conducive to the sustainable growth of the economy.

On December 2, 2016, the Financial Markets Committee (FMC) announced measures requiring the conversion of 75 percent of export proceeds into ringgits and extending to exporters the limit on foreign currency investment that applies to residents with ringgit borrowing. However, exporters can hold their export proceeds into foreign currency to meet projected loans, imports and other currency account obligations for up to six months ahead. Prior to these measures, the BNM also enhanced the enforcement of regulations, existing since 1998, on banks' non-involvement in offshore ringgit transactions. In April 2017, FMC announced a second series of measures which came into effect May 2 and which increased flexibility and streamlined FX hedging facilities onshore. Additional measures were announced in September and November 2017 to help deepen the onshore financial market.

The Malaysian authorities view remaining FEA rules 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 has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains a system free of restrictions on the making of payments and transfers for current international transactions except for restrictions in place for security reasons notified to the Fund pursuant to Decision No. 144-(52/51).

Malaysia, in accordance with the UN Security Council resolutions implements the freezing without delay funds and other financial resources, including funds derived or generated from property owned or controlled directly or indirectly by the 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 any dealings or transactions with Israeli/Israel-related entities/individuals as well as in Israeli Shekel; 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 2018 Article IV consultation took place during November 28–December 18, 2017 (IMF Country Report No. 18/61). Staff discussions for the 2019 Article IV consultation were conducted on a mission to Kuala Lumpur during November 28–December 12, 2018. In addition, a staff visit took place during July 12–18, 2018.

Financial Sector Assessment Program (FSAP) Participation:

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

Technical Assistance:

Fiscal Affairs Department (FAD): A joint workshop on tax policy with MOF was held in July 2016. A mission on expenditure review was conducted in December 2016. A Public Investment Management Assessment (PIMA) mission took place in May 2017. A seminar on treasury modernization was held in July 2017.

Legal Department (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.

Monetary and Capital Markets Department (MCM): A mission on macrofinancial risk analysis and vulnerability analysis for corporate and financial institutions was conducted in October 2009. A workshop on monitoring financial risks was held in in May 2010. Technical assistance missions on stress testing capital markets was conducted in 2013.

Statistics Department (STA): A mission to assist with implementing the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*) was conducted during May–June 2013. Technical assistance and training missions on Government Financial Statistics (GFS) were conducted in March 2017 and March 2018, respectively, and a follow-up GFS technical assistance mission is scheduled for March 2019.

Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT):

In November 2014, Malaysia's AML/CFT regime was subject of an on-site assessment by the Asia Pacific Group on Money Laundering (APG) under the new methodology of the Financial Action Task Force (FATF), the global standard setter for AML/CFT. The Mutual Evaluation Report was published in September 2015. It concluded that overall Malaysia has a broadly robust legal AML/CFT framework with generally well-developed and implemented policies, but with a moderate level of effectiveness. The country developed an action plan to address the key deficiencies identified in the report. In February 2016, the FAFT granted full membership to Malaysia based on its commitments to continue improving its AML/CFT regime. The FATF will continue to monitor the country's progress through its enhanced follow-up process.

Resident Representative/Advisor: None.

STATISTICAL ISSUES

(As of January 2019)

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) publishes annual and quarterly estimates of GDP, compiled by the production and by the expenditure approach, at current and constant prices, with base year 2010, based on the *2008 SNA*. The DOSM also disseminates annual estimates for gross disposable income, saving, and net lending for the economy. The quarterly data are released about one and a half month after the reference quarter. **Price statistics**: The CPI and the PPI are available on a timely and comprehensive basis. From January 2016, the CPI basket of goods and services has been updated based on the *Household Expenditure Survey* 2014.
Government finance statistics: Adoption of accrual reporting is necessary to capture a consolidated view of both assets and liabilities. There is a need to improve the timeliness, detail, and availability of data on nonfinancial public enterprises (NFPEs) and the state and local governments. Dissemination of more detailed data on non-listed 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, the Department of Statistics Malaysia (DOSM), 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. The Bank Negara Malaysia (BNM) reports the standardized report forms (SRFs) 1SR for central bank and 2SR for other depository corporations for publication in the *International Financial Statistics* with a lag of about one month. 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 and Compilation Guide*. 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.
Financial Soundness Indicators: The BNM reports the 12 core financial soundness indicators (FSIs) and one of the 13 encouraged FSIs for deposit taking institutions for posting on the IMF's FSI website. FSIs are reported with a lag of one quarter.
Balance of payments: Department of Statistics Malaysia compiles and publishes quarterly balance of payments estimates in accordance with the sixth edition of the Balance of Payments Manual and the SDDS. The quarterly data are released about one and a half month after the reference quarter. The authorities improved reporting of BOP with much more detailed items in 2018. However, persisting large negative net errors and omissions need to be addressed. 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 24, 2019)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	1/24/2019	1/24/2019	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	1/15/2019	1/22/2019	Bi W	Bi W	Bi W
Reserve/base money	11/2018	1/2019	M	M	M
Broad money	11/2018	1/2019	M	M	M
Central bank balance sheet	11/2018	1/2019	M	M	M
Consolidated balance sheet of the banking system	11/2018	1/2019	M	M	M
Interest rates[2]	1/24/2019	1/24/2019	D	D	D
Consumer price index	12/2018	1/24/2019	M	M	M
Revenue, expenditure, balance and composition of financing[3]—general government[4]	2017	2018	A	A	A
Revenue, expenditure, balance and composition of financing[3]—federal government	2018:Q2	12/2018	Q	Q	Q
Stocks of central government and central government guaranteed debt[5]	2018:Q2	12/2018	Q	Q	Q
External current account balance	2018:Q3	11/2018	Q	Q	Q
Exports and imports of goods	11/2018	1/2019	M	M	M
Exports and imports of services	2018:Q3	11/2018	Q	Q	Q
GDP/GNP	2018:Q3	11/2018	Q	Q	Q
Gross external debt	2018:Q3	11/2018	Q	Q	Q
International Investment Position	2018:Q3	11/2018	Q	Q	Q

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

Statement by Juda Agung, Executive Director for Malaysia, and Mohamad Hasni Shaari, Senior Advisor to the Executive Director
February 15, 2019

Introduction

On behalf of the Malaysian authorities, we would like to express our appreciation to the IMF team for the comprehensive and constructive dialogue during the 2019 Article IV consultation. We are encouraged by staff's positive assessment on Malaysia's economic and financial outlook as well as the appropriateness of the current macroeconomic policy setting.

In an environment of heightened uncertainty and downside risks in the global economy, resilience of the Malaysian economy is underpinned by strong macroeconomic fundamentals and a robust financial system. Appropriate policy frameworks, timely policy responses and ample buffers are in place to further reinforce the economy's resilience. Our authorities continue to be vigilant over the near-term risks while remaining committed towards medium-term structural reforms to ensure inclusive and sustainable growth.

As a highly open economy with a financial system that is integrated with the international financial system, Malaysia is susceptible to external influences and spillovers from abroad. Given this environment, our authorities remain committed to exchange rate flexibility as a first line of defense against shocks. A broad suite of policies remain available to ensure the instruments deployed are the most effective for the specific risks being managed. As conditions evolve and new challenges emerge, the effectiveness of our policies are continuously assessed to ensure overall macroeconomic conditions are conducive to growth with price stability.

Our authorities welcome staff's efforts to understand the domestic economy and country specific challenges. We are encouraged by staff's recognition of the positive outcomes from the foreign exchange measures implemented by the authorities. Greater understanding of authorities' policies and their intended outcomes are imperative for effective and balanced policy advice by the Fund. In this regard, we encourage staff to offer more constructive policy advice, such as alternative measures to better address the key challenges faced by the authorities, and to move away from rigid adherence to the Fund's prescriptive set of policy advice. Policies have to be designed in the context of the situation.

Latest economic developments and outlook

Authorities agree with IMF's assessment that the Malaysian economy continued to show resilience. In the first three quarters of 2018, the economy recorded growth of 4.7%. While a moderation from the 5.9% growth in 2017 had been expected, growth in 2018 was also marked by commodity-specific production disruptions. While there was a smooth political transition to a new Government, transitory policy uncertainty weighed down on growth in the few months after the May General Election. In 4Q 2018, growth is expected to rebound (3Q: 4.4%), supported partly by the on-going recovery in commodity output. Based on this development, for 2018 as a whole, the Malaysian economy is on track to expand at around the official forecast of 4.8%. At close to 5%, and amid global trade tensions and tighter financial conditions during the year, growth remains highly respectable. Headline inflation averaged at 1.0% in 2018, mainly reflecting the impact of the zerorisation of the Goods and Services Tax (GST) and the fixing of retail fuel prices. Labour market conditions were favourable, underpinned by firm employment and steady income growth. Importantly, the higher net employment gains were mainly driven by high- and mid-skilled workers. Malaysia's external sector remained resilient, amid a challenging external environment during the year. Malaysia's current account is expected to continue to register a surplus in 2018 (1Q-3Q 2018: 2.1% of GDP; 2017: 3.0% of GDP), with positive exports growth. As highlighted by staff, highly volatile short-term capital flows, which were driven mainly by global uncertainties, were ably intermediated by deep capital markets and broad base of domestic institutional investors.

For 2019, growth is projected to remain on a steady growth path and driven by the gradual recovery in commodities output, which would also support growth in the manufacturing sector and trade performance. In addition, the new production facilities particularly in the petrochemicals industry will lend further support to growth. On the demand side, private sector spending will remain the anchor of growth amid continued rationalisation of public sector expenditure. Private consumption is expected to normalise following the lapse of one-off factors in 2018, but remain firm underpinned by continued income and employment growth. Government measures such as the minimum wage increment, cash transfers and targeted fuel subsidy will support household spending among the lower-income household. Investment activities will remain supported by the on-going multi-year infrastructure projects and sustained capital spending by both domestic- and export-oriented firms. Inflation in 2019 is expected to average moderately higher, with the impact of the consumption tax policy on headline inflation lapsing towards the end of the year. However, the trajectory of headline inflation will be dependent on global oil prices given the resumption of the managed float fuel pricing mechanism. Nevertheless, underlying inflation is expected to remain contained in the absence of strong demand pressures. On the external front, exports is expected to record a more moderate but positive growth, in line with the expectations of slower global growth and trade momentum.

Going forward, Malaysia's economic fundamentals are expected to remain strong. The diversified export base in terms of products and markets would partially mitigate the impact from slower global growth and trade. The current account is expected to remain in surplus, driven by a sizeable goods surplus, which will be more than sufficient to offset the services and income deficits. Malaysia's deep and diversified financial markets and strong economic fundamentals will continue to intermediate capital flows. In addition, the broad base of domestic institutional investors, including banks, insurance companies, and provident and pension funds will mitigate excessive volatility in the domestic financial markets. Exchange rate flexibility with adequate levels of international reserves remain an important tool against external shocks.

Our authorities concur that risks to the growth outlook are tilted to the downside and stem mainly from external sources. As a small open economy, Malaysia will be affected particularly by the intensification of the trade conflict and slower-than-expected growth in trading partners. Notwithstanding this, the strong fundamentals and the diversified nature of the economy will enable Malaysia to continue to weather these downside risks. Macro- and micro- level stress tests conducted by the authorities and individual banking institutions affirm Malaysian banks' strong capacity to withstand extreme macroeconomic and financial shocks, hence, presenting low downside risks to growth. Vulnerabilities associated with banks' and corporates' external debt are largely contained considering the risk profile and activities underpinning such exposures. While staff assessed the household debt as elevated, authorities view that risks to financial stability emanating from household indebtedness have receded amid sound underwriting standards, risk management practices and loan affordability assessments. Household debt growth has moderated towards a more sustainable rate, lower than that of income. Consequently, the household debt-to-GDP ratio has also been declining, a trend sustained since 2015, and the increase in house prices have moderated in recent years to be in line with domestic fundamentals.

Fiscal Policy

The conduct of fiscal policy centers on strengthening the public finance position while supportive for a sustainable and inclusive economic growth. In this regard, the Malaysian authorities adopted prudent fiscal management approach that aims to build healthy fiscal buffer and to ensure debt remain at sustainable level. The authorities is also committed to instill efficient and good governance in the fiscal policy management. Towards this end, several measures have been initiated to strengthen transparency and governance aspects of the fiscal management, as well as efforts to achieve greater expenditure optimization and revenue enhancement.

The inaugural publication of the Fiscal Outlook and Federal Government Revenue Estimates in November 2018, signified the ongoing effort to promote better transparency and accountability in Malaysia's public finance management. This is complemented with the introduction of the Medium-Term Fiscal Framework (MTFF) which outlines the 3-year fiscal consolidation plan and the indicative expenditure ceiling for the 2019-2021. Work is currently underway to introduce the Fiscal Responsibility Act (FRA), by 2021 to strengthen the current fiscal governance framework. Among others, the FRA will strengthen the conduct of fiscal policy by enhancing fiscal rules and principles, transparency and accountability while ensuring macro stability in the medium and long term. In addition, the Government Procurement Act will also be introduced to enhance fiscal governance and improve efficiency of public spending. The authority also took initiative to establish Debt Management Office to enhance debt management operation as well as intensify fiscal risk assessment.

The authorities is currently undertaking a rigorous expenditure optimization exercise with the emphasis to minimize fiscal leakages while at the same time ensure public programs and projects continue to support growth. Among the key priority measures to improve spending efficiencies are streamlining the structure and functions of ministries and agencies; ceasing of low priority programs and projects with low multiplier effect to the economy; and improving Government procurement policy through strengthening the procurement processes and implementing wider use of open tender. The Public Finance Committee has been established to monitor the progress and ensure effective implementation of these measures.

On the revenue enhancement, the Tax Reform Committee has been set up to carry out a comprehensive review of the Malaysian tax system including reviewing tax incentives and exploring new sources of sustainable revenue. The main task of the Committee is to narrow the tax gap and improve tax efficiency to increase tax buoyancy. The Committee is expected to provide its recommendations to the Government for its further consideration and onwards implementation.

Monetary Policy

Our authorities welcome the staff's view that monetary policy should continue to be geared towards domestic stability and that the monetary policy framework has performed well. The Monetary Policy Committee (MPC) normalised the degree of monetary accommodation by raising the Overnight Policy Rate (OPR) by 25 basis point to 3.25% in January 2018. The OPR was maintained for the remainder of the year, as the MPC assessed that at the prevailing level of the OPR, the degree of monetary accommodativeness is consistent with the intended policy stance. The MPC will continue to monitor and assess the balance of risks surrounding the outlook for domestic growth and inflation.

Adjusting to external shocks

In 2018, similar to other emerging market economies, Malaysia experienced large non-resident portfolio outflows and exchange rate depreciation pressure, driven primarily by external developments. Ongoing external uncertainties suggest that this could potentially continue going into 2019. For a small and open economy with liberalised financial markets, external developments will continue to affect non-resident investment behaviour, and periods of heightened capital flows and exchange rate volatility are inevitable. If not appropriately managed, prolonged periods of exchange rate volatility could disrupt orderly financial market activity and eventually spill over to the real economy. A key consideration therefore is to ensure that levels of volatility are not excessive to preserve orderly market conditions, public confidence and overall financial stability.

Our authorities concur with staff on the importance of exchange rate flexibility and wish to reiterate that exchange rate flexibility remains a key policy in enhancing Malaysia's resilience to capital outflows and helping the economy adjust to external shocks. Foreign exchange market operations are limited to ensuring orderly market conditions particularly during periods of large and volatile capital flows. This is complemented by a sustained focus to enhance the depth and liquidity of the onshore market, and wider efforts to strengthen the underlying fundamentals of the Malaysian economy and financial system. Better hedging flexibilities ensure that domestic financial markets players are better equipped to manage currency risks.

International reserves of USD101.7 billion remain adequate, sufficient to finance 7.3 months of retained imports and 1.0 times short term external debt as at 15 January 2019. Beyond these headline numbers, the assessment of reserve level as a measure of external resilience should however, take into account the context within which reserves are held, in this case the high degree of reserves decentralisation, including liquid external assets held by the private sector. Domestic corporates and banks account for about three-quarters of Malaysia's external assets. Our authorities welcome staff's acknowledgment that sizable external assets held by private sector entities would allow banks and corporates to manage their own external liabilities. Potential claims on reserves to meet the external obligations are therefore assessed to remain limited as the large holdings of foreign currency external assets by resident entities can be drawn upon to meet their foreign currency external debt obligations.

Authorities concur that, Malaysia's external debt remains manageable. The external debt-to-GDP ratio has declined considerably from 70.3% in 1Q 2018 to 65.4% in 3Q 2018. Despite higher external debt-to-GDP ratio than peer median countries, a set of mitigating factors accord Malaysia with resilience against external shocks. First, about one third of external debt is denominated in ringgit, lowering the exposure to currency fluctuations. Second, three-quarters of the foreign-currency external debt are subject to Bank Negara Malaysia's prudential requirements and approval framework, ensuring credible repayment capacity of Malaysian borrowers. These include requirements on liquidity and funding risk management for banks' external debt (i.e. interbank borrowings, non-resident deposits and bonds and notes), while corporate external borrowings in the form of loans and bonds and notes are subject to an approval framework to ensure that they are supported by foreign currency earnings or sufficiently hedged. Third, intercompany loans which are mostly accounted by FDI companies are generally on flexible and concessionary terms, including no fixed repayment schedules and zero or much lower interest rates charged compared to the prevailing market interest rates.

Our authorities welcome the Fund's acknowledgement of the effectiveness of the December 2016 measures in reducing volatility in the onshore market. Prior to December 2016, the negative spillover impact from the offshore NDF market resulted in heightened USDMYR 1-month implied volatility of 12.0%, raising the risks of market dysfunction and financial instability. The volatility has since then moderated to an average of 4.6% along with other regional currencies (SGD, THB, IDR, PHP, CNY) at 5.5%. The spillover impact of the MYR NDF market has also remained contained as observed in the subdued daily volume of USD0.6 – 0.7 billion per day, from an average of USD2.9 billion in 2016 (High: USD6.9 billion). Ringgit has also traded in line with the performance and expectations of other regional currencies. Onshore foreign exchange trading volume has risen with better balance of demand and supply. The market recorded a healthy daily average foreign exchange transaction volume of USD10.6 billion since December 2016. Domestic liquidity also improved, as reflected in the narrowed USDMYR bid-ask spread while net inflows from resident trade contributed to a more balanced foreign currency supply and demand. The measures thus succeeded in providing stability to the onshore market.

Our authorities concur with staff's view that the December 2016 measures should be gradually reviewed in line with evolving market conditions. Our authorities have indeed been proactive, as evident in the recent enhancement to the export conversion measure in August 2018. Exporters are now allowed to automatically retain export proceeds with onshore banks to meet up to 6 months' foreign currency obligations without the need to first convert proceeds into ringgit. Our authorities wish to emphasise that the streamlining of investment abroad rules is prudential in nature and not distortive, as assessed by staff. The authorities continue to support productive investment abroad, as reflected in the high-level of approvals, while being mindful of the need to ensure safeguards are in place to prevent excessive build- up of corporate debt.

While our authorities remain committed to an open environment, the review of the December 2016 measures needs to be balanced with the risks that are being addressed. Subject to on-going assessment, these measures, which are prudential in nature, may be retained for an extended period of time as long as they are effective in managing the risks to the financial system and overall macroeconomic stability. When the intermediation capacity of the domestic market reaches a mature stage in terms of its ability to absorb and counter the effect of large and volatile capital flows, further relaxation or gradual phasing out of current rules can be considered. Therefore, staff needs to view the policies in place as part of a broader toolkit, alongside foreign exchange operations to ensure orderly market conditions. In this context, it would be helpful if staff could suggest policy alternatives to meet our objectives, rather than just advising the authorities to remove these measures.

Financial Sector

Our authorities welcome the staff's assessment that the Malaysian financial sector is resilient and that risks to financial stability remain broadly contained.

We are also encouraged by the staff's recognition of the efforts undertaken to enhance operational resilience and crisis preparedness of the domestic financial system. We wish to highlight that efforts are already ongoing to strengthen the resolution framework and related facilities, including contingent resolution funding facilities, to ensure alignment with the principles set out in the Financial Stability Board's Key Attributes for Effective Resolution Regimes.

While non-bank financial institutions (NBFIs) intermediate about 50% of financial system assets, contagion risks, as staff noted, from the activities of NBFIs remain contained. Most of the NBFIs are regulated by BNM, Securities Commission Malaysia, Malaysia Co-operative Societies Commission, or subjected to some form of oversight by government ministries. Institutional arrangements to support inter-agency cooperation are in place to facilitate information sharing across regulators and to enhance inter-agency responses and coordination. The surveillance of more systemic NBFIs by BNM is additionally supported by strengthened reporting frameworks applied to these NBFIs. The commitment by the new Malaysian Government to institutionalise greater transparency, governance and integrity across all NBFIs will also help promote the sustainability and long-term viability of these entities.

Businesses continue to maintain healthy debt servicing capacity and liquidity positions. This has supported the expansion in overall corporate debt, which grew in line with domestic economic expansion. The overall quality of business borrowings also remains high. While some sectors, such as the oil and gas and real estate sectors continue to face persistent headwinds, risks to domestic financial stability remain limited, with losses sufficiently provisioned by banks and the quality of borrowings remaining broadly stable. Bank exposures in these sectors (excluding end-financing for property) also remain small.

The authorities affirm that credit exposures to the household sector remained manageable. Debt servicing capacity of households continued to remain intact supported by healthy financial buffers with financial assets and liquid financial assets of 2.1 times and 1.4 times of debt, respectively. Asset quality remained sound with the ratio of aggregate impaired loans to total outstanding household debt for both banks and non-banks remaining low and stable.

While we note staff's assessment on the vulnerability of the vulnerable household group (individual borrowers with monthly earnings of below RM3,000), authorities view that potential risks to financial stability emanating from credit exposures to this group are mitigated given a declining proportion of exposures to this segment to 18.3% of total exposures of the banking system as at end-June 2018 (2013: 25.1%). Underwriting practices remain sound, with the bulk of new loans approved to the vulnerable segment with prudent debt service ratios of below 60%. The authorities agree that significant income, interest rate or cost of living shocks could affect the ability of some households to service their debt. However, internal simulations as published in the Financial Stability and Payment Systems Report 2017[1], suggest that under stressed scenarios, potential losses to the banking system from exposures to the household sector of between RM66 billion and RM104 billion will be manageable given the high excess capital buffers of banks (RM124.5 billion).

Our authorities continue to be vigilant against risks emanating from the property market. While mortgages account for a significant portion of household debt as highlighted by staff, risks to the banking system from a sharp deterioration in house prices are mitigated by prudent loan-to-value (LTV) measures observed by banks (generally below 80%), and low and

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[1] As per the Box Article on page 39 entitled '*Indebted to Debt: An Assessment of Debt Levels and Financial Buffers of Households'*

reducing share of investment borrowers. Sensitivity analysis further indicate that banks have sufficient capital buffers to absorb potential losses arising from up to a 50% decline in property prices and its spillover to business sectors that are highly dependent on the performance of the property sector.

A comprehensive set of macroprudential and fiscal measures put in place since 2010 have effectively contained risks from household indebtedness and rising property prices. These demand management measures were also complemented by the authorities' efforts to increase the supply of affordable houses, which has also helped ease upward pressure on house prices. With these measures in place, credit risks from a more generalised downward correction in house prices are assessed to be low. As such, while the authorities take note of staff's recommendation to impose sector-wide standardised LTV limits on first and second properties in the medium term, they remain of the view that current macro-prudential measures continue to be sufficient. This is supported by existing regulatory and supervisory measures such as the differentiated capital charges for loans with higher LTV, and the review of provisioning practices of banks which also consider LTV levels as a risk driver for setting provisions. Banks' mortgage underwriting standards have also continued to strengthen as evidenced by vintage analysis for housing loans over recent years. While the authorities have not imposed a higher risk weight on the construction sector, BNM has introduced strengthened requirements on credit risk management in January 2018, which set out expectations of banks to conduct more robust assessments of financing proposals for new property development on construction prospects. Compliance with these expectations is reviewed through BNM's supervisory activities.

Finally, the authorities disagreed with staff's recommendation to phase out the differentiated RPGT and floor price for non-residents' purchase of properties, and view that the measures remain relevant to ensure that growth in house prices are reflective of domestic fundamentals. Recent data from 2017 and the first half of 2018 has indicated some resurgence in the growth of investment property purchases by non-residents. In this regard, these measures are still considered appropriate to manage risks arising from the build-up of financial imbalances in the property market, which could spill over to the domestic financial system.

Efforts to strengthen safeguards against threats of money laundering and terrorism financing (ML/TF) continue to be a key priority for our authorities. In regard to efforts to support anti-corruption, our authorities have reduced the reporting threshold amount for Cash Threshold Reporting (CTR) from transactions amounting to RM50,000 (approximately USD12,000) and above, to RM25,000 and above in a day. These new measures were made based on the 2017 National Risk Assessment (NRA) and recent enforcement cases that found cash is still widely used by criminals to launder illegal proceeds. In addition, Malaysia continue to remain committed towards meeting its five-year National AML/CFT Strategic Plan objectives. As at 2018, 82% of the 74 action and sub-action plans have been reported as either completed or currently in progress within the stipulated timeline.

Reforms for sustainable and inclusive growth

The report of Mid-Term Review of the 11th Malaysia Plan (MTR 11MP), tabled and approved by the Parliament in October 2018, outlines the medium-term strategies and reform measures of the new government, with greater emphasis on strengthening the economy, public institutions and governance.

The MTR 11MP focuses on strengthening Malaysia's economic fundamentals, premised on innovation, creativity and improving productivity, in line with the aspiration to become a developed and inclusive nation. Focus will be on strengthening sectoral growth - particularly services and manufacturing sectors - and promoting private investment, while efforts to accelerate improvement in education and human capital development will continue to be prioritised to increase productivity. The transformation of the education system will emphasise quality, equity, access, unity, efficiency and inclusivity of education. Enhancing science, technology, engineering and mathematics education, and higher order thinking skills will be the focus for basic education. Meanwhile, governance of Institutions of Higher Education and stronger industry-academia linkages will be further enhanced to improve the quality of graduates. In addition, existing programmes of Technical and Vocational Education will be continuously reviewed in collaboration with industry players to meet industry demand. Further efforts will also be taken to improve the business climate through enhancing the delivery of public services, reducing bureaucratic red tape and provision of quality infrastructure. In particular, the adoption of Good Regulatory Practices will be intensified to improve the processes and procedures in increasing productivity and competitiveness, and will be expanded to the sub-national or state level.

To ensure sustained and better enforcement of prudent public finance management, a comprehensive reform on fiscal and public finance management framework will also be implemented. Strategies to be implemented include improving the budgeting system, enhancing procurement management as well as strengthening performance management, monitoring and evaluation framework. The implementation of the accrual accounting system will also be expedited to further enhance transparency and full disclosure of government's assets and liabilities. In addition, the Fiscal Responsibility Act (FRA) and Government Procurement Act will be introduced to enhance fiscal governance and improve efficiency of public spending. The authority also took initiative to establish the Debt Management Office to enhance debt management operations as well as intensify fiscal risk assessment.

Reform initiatives are also being undertaken to improve governance and strengthen public institutions. Among the key priorities is to strengthen the check and balance mechanism at all levels. For instance, the MTR 11MP outlines the commitment to establish a select committee in Parliament. To ensure operational independence of the institutions, the select committee will endorse the appointment of key positions, among others including in the Malaysia Anti-Corruption Commission (MACC), Election Commission (EC), National Audit Department and Judicial Appointments Commission. In addition, the MACC and EC will also be made answerable directly to Parliament. The Government is also committed to execute efforts in fighting corruption effectively and efficiently at all levels. In this regard, the MACC will be transformed into a fully independent body. Furthermore, the anti- corruption legislation such as the MACC Act, Witness Protection Act and the Whistleblower Protection Act will be continuously reviewed and strengthened to ensure its relevance with current development. The Government has also launched the National Anti-Corruption Plan (NACP) 2019-2023 that covers 6 strategies, including increasing the efficiency and transparency in public procurement, institutionalise the credibility of law enforcement agencies and inculcate good governance in corporate entities.

Concluding Remark

Malaysia's diversified economy, sound fundamentals and strong financial system have considerably strengthened the economy's resilience to withstand shocks. A robust policy framework, underpinned by a pre-emptive and pragmatic policy approach have also minimised risks and vulnerabilities. As the external economic and financial conditions evolve, our authorities remain vigilant to adverse developments and potential risks to the Malaysian economy and financial system. In the event of adverse shocks, our authorities have adequate policy buffers to respond in a timely and effective manner to preserve macroeconomic and financial stability, and achieve sustainable and inclusive growth.

Looking ahead, the challenging global environment also necessitates the Fund, as the multilateral institution responsible to safeguard the global financial system, to play greater role in reducing the risks from disruptive cross-border spillovers that can be detrimental to member economies, including Malaysia.