INTERNATIONAL MONETARY FUND

IMF Country Report No. 20/57

MALAYSIA

February 2020

2020 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 2020 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 7, 2020 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 7, 2020, following discussions that ended on December 17, 2019, 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 23, 2020.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Malaysia.

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

Selected Issues

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February 28, 2020

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IMF Executive Board Concludes 2020 Article IV Consultation with Malaysia

On February 7, 2020, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Malaysia.

Malaysia's economy is stable despite domestic and external challenges. Growth has averaged just under 5 percent over the past 5 years, leading to higher per capita income. Economic growth has held up, and is estimated at 4.5 percent in 2019, driven by domestic demand. Headline inflation moderated from an average of 1 percent in 2018 to 0.7 percent in 2019, reflecting declining global oil prices, moderating wage growth, and the impact of replacing the GST with the smaller-base SST in 2018. Credit growth is moderating. On the external side, the current account surplus is estimated to have increased to 3.5 percent of GDP in 2019, driven by a temporary decline in capital imports and an improvement in the primary income account.

Growth is expected to remain stable in 2020 and to rebound in the medium term, with inflation slightly higher and the current account declining. Domestic demand will be the main driver of growth, with stable employment and income growth supporting private consumption. Private investment will gradually pick up as the business environment continues to improve and external uncertainties dissipate. Headline inflation is expected to increase to slightly over 2 percent as domestic demand rises, the base effect of the consumption tax regime change vanishes, and fuel subsidies become targeted. The current account surplus is expected to narrow to 2.7 percent of GDP as capital imports resume. Over the medium term, growth should converge to potential (just below 5 percent) and inflation remain under control, while the current account surplus continues to moderate.

Risks to the growth outlook are, on balance, to the downside. Malaysia's highly open economy is vulnerable to escalating trade actions and weaker-than-expected trading partners' growth. An abrupt deterioration in market sentiment towards emerging markets could lead to tighter financial conditions. However, a durable truce that may follow the recent signature of the phase-one deal

[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.

between the US and China is an upside risk. Domestically, contingent liabilities could pose fiscal risks and a sharp drop in real estate prices or a deterioration in household debt service ability could affect growth and financial stability, while domestic policy uncertainty could reduce investment.

Executive Board Assessment[2]

Executive Directors welcomed that the Malaysian economy has been stable despite internal and external challenges. Directors recognized the progress made on the reform agenda and encouraged the authorities to remain committed to governance and structural reforms. To address the risks facing the economy, Directors recommended that policy priorities ahead should continue to focus on a medium-term fiscal consolidation plan, while safeguarding growth and financial stability.

Directors welcomed the planned pace of fiscal consolidation and encouraged the authorities to identify well-defined spending and revenue measures to support this adjustment, including in the context of the upcoming medium-term revenue strategy preparation. They also encouraged the authorities to push ahead with the adoption of a Fiscal Responsibility Act, and with plans to improve debt management, public procurement, and the public investment framework.

Directors supported the broadly neutral monetary policy stance, given a closing output gap and broadly neutral financial conditions. They agreed that monetary policy should remain data dependent. Directors commended the authorities' commitment to exchange rate flexibility as well as recent initiatives to deepen the FX markets and encouraged them to explore further options in this area, as this would enhance the ability of the exchange rate to act as a shock absorber. In general, they advised the authorities to continue to review the effectiveness of FX market measures and consider gradual phasing out of such measures.

Directors agreed that the financial sector is stable, and that profitability, capitalization and asset quality of banks are sound. However, they noted that household debt is high compared to peers, with pockets of vulnerability among lower-income groups. Directors advised the authorities to closely monitor risks in the real estate and household sectors. Further enhancing the macroprudential toolkit would be helpful. Directors commended the ongoing efforts to strengthen financial literacy and manage cyber risks and climate change risks to the financial sector.

Directors commended the authorities' progress in developing and implementing governance reforms. They stressed the importance of sustaining the momentum and anchoring the reforms in legislation, particularly to help secure the independence of anti-corruption institutions, freedom

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

of information, and to establish an asset declaration system. Further strengthening the AML/CFT framework will also be important.

Directors underscored that continued structural reforms aimed at raising investment and productivity are important to safeguard macroeconomic and financial stability and help address the external imbalances over the medium term. They supported the authorities' emphasis on raising productivity as it would help achieve high-income status and inclusive growth. Directors advised that priority be given to enhancing the business environment and improving access to credit for SMEs; promoting trade openness; enhancing the quality of and access to education; encouraging innovation, including through digitalization of the economy; and boosting female labor participation.

Table 1. Malaysia: Selected Economic and Financial Indicators, 2015-21

Nominal GDP (2019): US$364 billion
Population (2018): 32.4 million
GDP per capita (2019, current prices): US$11,173
Poverty rate (2017, national poverty line): 0.4 percent
Unemployment rate (2019): 3.4 percent
Adult literacy rate (2018): 95.9 percent
Main goods exports (share in total, 2018): electrical & electronics (37.7 percent), commodities (15.6 percent), and petroleum products (7.5 percent).

	2015	2016	2017	2018	Est. 2019	Proj. 2020	Proj. 2021
Real GDP (percent change)	5.0	4.4	5.7	4.7	4.5	4.5	4.9
Total domestic demand 1/	5.8	4.8	6.5	4.3	3.4	5.6	6.3
Private consumption	5.9	5.9	6.9	8.0	7.0	6.2	5.4
Public consumption	4.5	1.1	5.5	3.3	1.7	1.9	1.9
Private investment	7.6	4.5	9.0	4.3	1.0	3.0	5.0
Public gross fixed capital formation	-2.8	-1.0	0.3	-5.0	-11.4	4.8	7.5
Net exports (contribution to growth, percentage points)	-0.3	0.0	-0.3	0.8	1.4	-0.7	-0.9
Saving and investment (in percent of GDP)							
Gross domestic investment	25.4	26.0	25.6	23.6	22.0	22.1	22.9
Gross national saving	28.4	28.4	28.4	25.7	25.5	24.8	24.8
Fiscal sector (in percent of GDP) 2/							
Federal government overall balance	-3.2	-3.1	-2.9	-3.7	-3.4	-3.2	-3.0
Revenue	18.6	17.0	16.1	16.1	17.4	15.1	15.1
Expenditure and net lending	21.8	20.1	19.0	19.8	18.3	18.3	18.1
Tax refunds (Arrears) 3/					2.4		
Federal government non-oil primary balance	-5.1	-3.4	-3.4	-5.3	-6.6	-4.1	-4.1
Consolidated public sector overall balance 4/	-7.6	-5.0	-3.6	-4.6	-6.3	-5.6	-5.2
General government debt 4/	57.0	55.8	54.4	55.6	57.1	57.0	56.5
Of which: federal government debt	53.6	51.9	50.1	51.2	52.7	52.6	52.1
Inflation and unemployment (annual average, in percent)							
CPI inflation	2.1	2.1	3.7	1.0	0.7	2.1	2.1
CPI inflation (excluding food and energy)	3.2	2.6	1.6	0.4	1.2	2.0	2.1
Unemployment rate	3.2	3.5	3.4	3.3	3.4	3.4	3.4
Macrofinancial variables (end of period)							
Broad money (percentage change) 5/	3.0	2.7	4.8	7.7	4.8	6.7	7.1
Credit to private sector (percentage change) 5/	8.6	5.3	5.4	8.3	5.4	7.1	7.1
Credit-to-GDP ratio (in percent) 6/ 7/	132.5	131.9	126.7	130.1	130.9	131.4	131.4
Credit-to-GDP gap (in percent) 6/ 7/	13.5	9.4	2.5	1.7	0.6	…	…
Overnight policy rate (in percent)	3.25	3.00	3.00	3.25	3.00	…	…
Three-month interbank rate (in percent)	3.8	3.4	3.5	3.6	3.3	…	…
Nonfinancial corporate sector debt (in percent of GDP) 8/	105.0	108.0	101.5	103.0	99.4	…	…
Nonfinancial corporate sector debt issuance (in percent of GDP)	2.6	3.1	3.3	2.0	1.4	…	…
Household debt (in percent of GDP) 8/	86.9	86.5	82.7	82.0	81.9	…	…
Household financial assets (in percent of GDP) 8/	180.1	178.6	176.5	175.8	…	…	…
House prices (percentage change)	7.4	7.1	6.5	3.3	1.5	…	…
Exchange rates (period average)							
Malaysian ringgit/U.S. dollar	3.91	4.15	4.30	4.04	4.16	…	…
Real effective exchange rate (percentage change)	-8.5	-3.4	-1.6	4.1	-2.0	…	…
Balance of payments (in billions of U.S. dollars) 6/							
Current account balance	9.0	7.2	8.9	7.5	12.7	10.3	7.9
(In percent of GDP)	3.0	2.4	2.8	2.1	3.5	2.7	1.9
Goods balance	28.0	24.6	27.2	29.5	28.5	27.1	26.0
Services balance	-5.3	-4.6	-5.3	-4.5	-2.3	-2.5	-3.2
Income balance	-13.7	-12.8	-13.0	-17.6	-13.5	-14.3	-14.9
Capital and financial account balance	-14.5	0.0	-1.1	4.6	-9.2	-7.4	-4.5
Of which: Direct investment	-0.5	3.3	3.8	2.8	4.5	4.6	4.7
Errors and omissions	-8.3	-5.8	-4.0	-10.2	-1.5	0.0	0.0
Overall balance	-13.7	1.4	3.8	1.9	2.0	2.9	3.4
Gross official reserves (US$ billions) 6/ 9/	95.3	94.5	102.4	101.4	103.4	106.4	109.8
(In months of following year's imports of goods and nonfactor services)	6.3	5.6	5.6	5.8	5.7	5.6	5.5
(In percent of short-term debt by original maturity)	116.2	112.2	117.8	103.4	104.2	112.6	118.6
(In percent of short-term debt by remaining maturity)	74.4	83.2	93.7	84.9	85.5	91.3	95.4
Total external debt (in billions of U.S. dollars) 6/ 9/	195.0	203.8	218.8	223.8	227.0	224.7	225.4
(In percent of GDP)	64.7	67.7	68.6	62.4	62.4	58.7	54.9
Of which: short-term (in percent of total, original maturity)	42.0	41.3	39.7	43.8	43.7	42.0	41.1
short-term (in percent of total, remaining maturity)	65.7	55.7	50.0	53.4	53.3	51.9	51.1
Debt service ratio 6/							
(In percent of exports of goods and services) 10/	21.5	23.4	14.0	10.6	10.9	10.7	10.4
(In percent of exports of goods and nonfactor services)	22.7	24.8	14.8	11.2	11.6	11.4	11.1
Memorandum items:							
Nominal GDP (in billions of ringgit)	1,177	1,250	1,372	1,447	1,516	1,617	1,731

Sources: Data provided by the authorities; CEIC Data Co. Ltd.; World Bank; UNESCO; and IMF, *Integrated Monetary Database* and staff estimates.
1/ Based on data provided by the authorities except for 2015 data which is estimated using splicing methodology by IMF.
2/ 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.
3/ Tax refunds in 2019 are allocated for payment of outstanding tax refunds.
4/ Consolidated public sector includes general government and nonfinancial public enterprises (NFPEs). General government includes federal government, state and local governments, and statutory bodies.
5/ Based on data provided by the authorities but follows compilation methodology used in IMF's *Integrated Monetary Database*. Credit to private sector in 2018 onwards includes data for a newly licensed commercial bank from April 2018. The impact of this bank is excluded in the calculation of credit gap.
6/ IMF staff estimates. U.S. dollar values are estimated using official data published in national currency.
7/ 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.
8/ Revisions in historical data reflect the change in base year for nominal GDP (from 2010=100 to 2015=100).
9/ The decrease in short-term debt by remaining maturity in 2017 was partly due to the implementation of an improved data compilation system that corrected previous overestimation.
10/ Includes receipts under the primary income account.

INTERNATIONAL MONETARY FUND

MALAYSIA

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION

January 23, 2020

MAIN ISSUES

Context. The Malaysian economy is stable despite domestic and external challenges. The authorities are making progress on their reform agenda including governance reforms and measures to improve the transparency and management of public finances. Policies should focus on medium-term fiscal consolidation, while safeguarding growth and financial stability. Structural reforms are needed to enshrine in law main governance measures, and to boost productivity to achieve high income status and inclusive growth.

Macroeconomic setting. Growth has held up and inflation has remained subdued. Domestic demand is expected to be the main driver of growth over the medium term. Risks to the outlook are, on balance, to the downside.

Main economic policy recommendations:

- Medium-term fiscal consolidation plans should be underpinned by well-identified revenue and spending measures. Pushing ahead with structural fiscal reforms, including the adoption of a Fiscal Responsibility Act, as well as improvement in debt management, public procurement, and the public investment framework is important.
- The current monetary policy stance is appropriate. Monetary policy should remain data dependent. The authorities should continue to develop FX markets.
- In case of negative shocks, the authorities could draw on available monetary and fiscal space, while maintaining exchange rate flexibility.
- The financial sector is sound, but risks related to high household debt and the real estate sector should be closely monitored.
- Building on initial success in launching the National Anti-Corruption Plan, governance reforms should be anchored in legislation.
- Structural reforms are needed to boost investment, growth and productivity. Priority should be given to streamlining business procedures at the state level and encouraging equity financing for SMEs; working towards further regional trade integration; improving education; and boosting female labor force participation.

Approved By
Odd Per Brekk and Maria Gonzalez

Mission dates: December 5–17, 2019
Mission Team: Nada Choueiri (Head), Giovanni Ganelli, Dan Nyberg, Xin Li (all APD), and Jochen Markus Schmittmann (Resident Representative). Han Teng Chua (Economist in Singapore office) joined part of the mission. Zaidi Mahyuddin (OED) joined the mission. Alisara Mahasandana (Executive Director) joined the concluding meeting. Claudia Marchini and Justin Flinner (both APD) assisted in the preparation of this report.

CONTENTS

APPENDICES

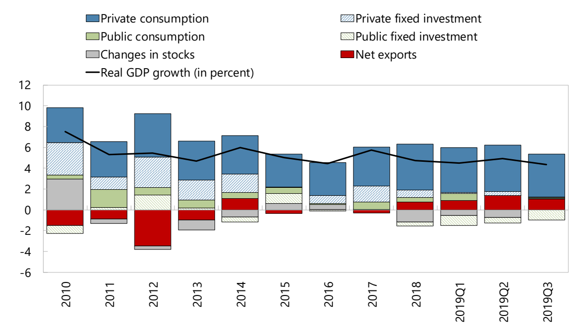
CONTEXT

1. **The authorities are making progress on their reform agenda notwithstanding external and internal challenges.** After taking power in mid-2018, the ruling coalition has initiated governance reforms and measures to improve the transparency and management of public finances. Despite difficulties, the coalition continues to focus on these reforms, while taking steps to promote growth and inclusion. While initial fiscal policy measures weakened the fiscal framework, the authorities resumed fiscal consolidation starting with the 2019 budget.

RECENT ECONOMIC DEVELOPMENTS

2. **Economic activity has held up** (Figure 1). Growth is estimated at 4.5 percent in 2019 (4.7 percent in 2018), driven by private consumption given stable labor market conditions and low inflation. Uncertainties surrounding trade tensions and domestic policies weighed on business confidence and private investment. Public investment contracted, reflecting reduced investment by public corporations given the completion of existing projects and a delay in the implementation of large infrastructure projects. Net exports contributed to growth as a decrease in exports was more than offset by a sharp decline in capital imports, largely driven by the weak investment.

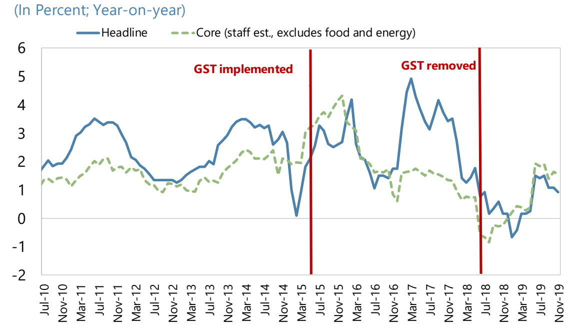
Malaysia: Contributions to Real GDP Growth
(In percentage points; year-on-year)



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

3. **Inflation remained subdued** (Figure 2). Headline inflation was 0.7 percent in 2019, reflecting declining global oil prices, moderating wage growth, extension of seasonal price controls, and the replacement of the Goods and Services Tax (GST) with the smaller-base Sales and Service Taxes (SST) in 2018. Core inflation, excluding the effect of consumption tax changes, remained stable at 1.5 percent year-on-year during January-November 2019. Credit growth moderated with the estimated credit gap closing (Figure 3).

Inflation Developments
(In Percent; Year-on-year)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.
Note: The core inflation estimated by IMF staff does not exclude effects of consumption tax changes.

4. **The 2019 budget deficit target was met** (Figures 5 and 6). The 2019 deficit declined to 3.4 percent of GDP (from 3.7 percent of GDP in 2018) as budgeted, on account of expenditure rationalization. Expenditure savings included non-fuel subsidies targeting and lower spending on goods and services following the implementation of zero-based budgeting.

5. The current account surplus increased due to temporary factors and capital flows were manageable. For 2019 the current account surplus is estimated to have increased to 3.5 percent of GDP (2.1 percent of GDP in 2018) driven by a decline in capital imports and an improvement in the primary income account deficit. Portfolio investment outflows more than offset FDI net inflows through 2019Q3 (Figure 4). Volatility of non-resident flows in the bond and equity markets declined compared to recent years. Gross official reserves are adequate at US$ 103.2 billion in November 2019—115 percent of the Assessing Reserve Adequacy (ARA) metric or, when adjusted for forward positions, 102 percent of the metric.

6. Policies have been largely in line with past Fund advice, with some exceptions (Appendix I). While eliminating the GST went against Fund advice, the authorities are working to identify concrete measures for credible medium-term fiscal consolidation and are preparing a Fiscal Responsibility Act, in line with IMF recommendations. The current broadly neutral monetary policy stance is consistent with advice to calibrate monetary policy to economic conditions. Further enhancing the FX market's functioning remains their priority, an objective that staff supports. Structural reforms are largely in line with IMF advice.

OUTLOOK AND RISKS

7. Growth is projected at 4.5 percent in 2020, with inflation rising slightly and the current account surplus declining. Domestic demand will remain the main driver of growth. Stable employment and income growth will sustain private consumption. Private investment is expected to gradually pick up as the business environment continues to improve and uncertainties dissipate. Meanwhile, public investment should begin to recover as public corporations reset their investment plans and large infrastructure projects resume. Despite signs of trade and investment diversion towards Malaysia (Appendix II), external headwinds may continue to weigh on exports in 2020. Headline inflation is expected to increase to 2.1 percent as domestic demand rises, the base effect of the consumption tax regime change vanishes, and fuel subsidies become targeted. The current account surplus will narrow to 2.7 percent of GDP as capital imports resume. Over the medium term, growth should converge to potential (4.8 percent) and inflation remain under control, while the current account surplus continues to moderate.

8. Risks are tilted to the downside. Malaysia's highly open economy is vulnerable to escalating trade actions and weaker-than-expected trading partner growth. An abrupt deterioration in market sentiment towards EMs could lead to tighter financial conditions. However, a durable truce that may follow the recent signature of the phase-one deal between the US and China is an upside risk. Domestically, contingent liabilities could pose fiscal risks, a sharp drop in real estate prices or a deterioration in household debt service ability could affect growth and financial stability, and domestic policy uncertainty could reduce investment (Appendix III).

Authorities' Views

9. **The authorities broadly agreed with staff's assessment of the outlook and risks but were more optimistic on the prospects for near-term growth.** They projected growth at 4.8 percent in 2020, primarily driven by robust private consumption underpinned by stable employment growth, a minimum wage increase in urban areas, and government assistance programs. They expected investment to pick up moderately as approved investments are realized and several large infrastructure projects are resumed. They expected inflation to rebound to about 2 percent in 2020, contingent on global oil prices and on the closing of the output gap. Over the medium term, the authorities saw growth at 4.5–5.5 percent, with risks stemming mainly from external sources and tilted to the downside.

MACROECONOMIC AND FINANCIAL POLICIES

A. Overview

10. **Policies should focus on putting in place a credible medium-term fiscal consolidation plan, while safeguarding growth and financial stability.** Medium-term fiscal consolidation is needed to boost market confidence and rebuild fiscal space. The current monetary policy stance is appropriate under the baseline scenario and monetary policy should remain data dependent. Financial policies should focus on household debt, real estate sector vulnerabilities, and challenges posed by cyber risks. External imbalances should be addressed over the medium term by creating fiscal space to expand social safety nets, and by structural reforms aimed at raising investment, labor force participation and productivity. In case of adverse shocks, the policy response could be a combination of use of available fiscal and monetary policy space and exchange rate flexibility. The effectiveness of the latter as a shock absorber would be enhanced by further deepening foreign-exchange markets.

B. Fiscal Policy

11. **The 2020 budget strikes a balance between fiscal consolidation and growth.** The budget envisages a further reduction in the deficit to 3.2 percent of GDP and incorporates efforts to support growth, improve the composition of spending, and reduce dependence on oil-related revenue. Compared to 2019, a decrease in wage spending from 5.4 to 5.1 percent of GDP, due to the expiry of one-off bonuses, will be offset by an increase in health and education expenditure. While total capital expenditure is unchanged at about 3.5 percent of GDP, the budget will prioritize infrastructure upgrading programs to support growth. Tax revenue is broadly unchanged at 11.8 percent of GDP, while non tax revenues will decline from 5.5 to 3.4 percent of GDP due to the one-off 2019 special dividend from Petronas.

12. **Continued fiscal consolidation is needed over the medium term.** Fiscal policy is anchored by a commitment to keep the federal government debt within 55 percent of GDP. However, this limit could easily be breached if downside risks materialize. Staff's debt sustainability

analysis shows that, while Malaysia's public debt is sustainable, a standard macro-fiscal shock would bring it very close to 55 percent of GDP and realization of contingent liabilities could push it above 60 percent of GDP. The authorities are targeting an average 2.8 percent of GDP deficit over 2020-2022. If gradual fiscal consolidation continues at a similar pace afterwards, debt would decline to 46 percent of GDP by 2025 (Appendix IV). This would provide welcome buffers, particularly important given that Malaysia's fiscal space is assessed to be at risk with and without fiscal rules. Indeed, an analysis based on the distribution of historical shocks faced by Malaysia suggests that reducing the debt-to-GDP ratio to 46 percent would bring the probability of breaching the 55 percent of GDP debt limit in the projection period to below 10 percent. However, under staff's unchanged-policy baseline (which does not reflect the authorities' targeted consolidation given the absence of announced policies underpinning it), the probability of breaching the 55 percent limit rises above 20 percent.

13. The planned Fiscal Responsibility Act (FRA) is an opportunity to update the public debt limit framework. In developing the FRA, with Fund technical assistance, the authorities should decide whether to enshrine in law the commitment to limit federal government debt under 55 percent of GDP. Staff analytical work suggests that Malaysia could tolerate somewhat higher debt levels while maintaining investor confidence, but debt persistently above 55 percent of GDP would likely negatively impact growth (Appendix V). This implies that the debt limit should remain at 55 percent of GDP but be applied more flexibly—for example by allowing temporary breaches of the limit in case of large shocks. This would increase fiscal policy's ability to respond to downside risks. Any change to the debt limit framework, however, should be carefully communicated and complemented by appropriate strengthening of the fiscal framework, including to define what would qualify as large shocks, requirements to bring debt back on track following a deviation from the limit.

14. Medium-term fiscal adjustment plans should rely on well-identified revenue and expenditure measures. At just below 12 percent of GDP in 2019, tax revenue in Malaysia is low compared to peers and OECD countries, and is declining. Revenue mobilization is a priority to create fiscal space to help achieve inclusive growth and high-income status. The authorities will receive technical assistance from the Fund to support their efforts in formulating and implementing a Medium-Term Revenue Strategy (MTRS) to (a) reverse declining revenue trends and (b) achieve a sustainable higher revenue level to finance priority expenditure. These efforts will build on the work of the Tax Reform Committee, which in August 2019 submitted for the government's consideration suggestions to improve tax administration, reduce tax leakages, and identify new sources of revenue. Separately, the authorities should also consider undertaking structured and targeted spending reviews to identify possible saving. Reviews could initially include overlap of social assistance programs, cost recovery in higher education, and duplication in transport and tourism programs.

15. Pushing ahead with ongoing improvements in debt management and public procurement would enhance fiscal policy credibility. Progress in this area includes the establishment in May 2019 of a high-level Debt Management Committee (DMC) chaired by the

Minister of Finance. The DMC is responsible for formulating a policy to reduce federal debt and other liabilities and, in this capacity, it evaluates and endorses all proposals which impact the fiscal and debt positions, including those related to federal government borrowing and government guarantees. Additional planned steps need to be accelerated—namely, the creation of a Debt Management Office within the Ministry of Finance to act as a secretariat for the DMC; and the preparation of a Government Procurement Act, aimed at enforcing open tender procedures and enhancing transparency of public procurement, which is expected to be submitted to Parliament in the second half of 2020.

16. Further reforms to improve the efficiency of public investment in line with the 2017 IMF Public Investment Management Assessment (PIMA) are needed. Initial progress in this area include a strengthening of the gatekeeping role of central agencies (Ministry of Finance and Ministry of Economy) that reduces fragmentation in public investment decisions and procedures. The remaining agenda includes, in line with PIMA recommendations, introducing value management exercises to evaluate projects above MYR 50 million before approval; better separating project appraisal and budgeting procedures; and updating the pipeline of approved projects. Implementing other PIMA recommendations would also be important, especially (i) developing a medium-term fiscal framework that helps reconcile the medium-term resource envelope with the funding required to complete the projects; and (ii) developing an enhanced PPP policy framework, specifying the acceptance criteria for PPPs, and establishing comprehensive reporting of PPPs and their associated risks.

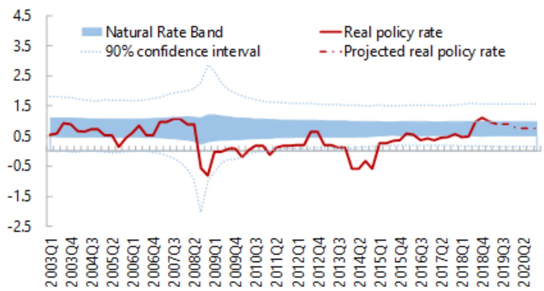
Authorities' Views

17. The authorities reaffirmed their commitment to medium-term fiscal consolidation and fiscal-structural reforms. They reiterated their commitment to achieve an average fiscal deficit of 2.8 percent of GDP over 2020-2022 and to continue fiscal consolidation in the medium term, with specific measures to be identified, including in the context of the upcoming medium-term strategy formulation. In case of negative shocks, fiscal policy would need to balance consolidation and growth objectives and would focus on high-multiplier spending. The authorities broadly agreed with staff's debt sustainability analysis and were open to considering the idea of interpreting the current debt limit more flexibly. They highlighted progress in structural reforms, including the institution of the high-level DMC, the publication for the first time of a debt sustainability analysis in budget documents, and the plans to establish a DMO within the Ministry of Finance. They also reiterated their commitment to push legislation to improve fiscal discipline and public procurement as well as plans to embed measures to improve public investment in the Twelfth Malaysia Plan currently under preparation.

C. Monetary, Exchange Rate, and Financial Market Policies

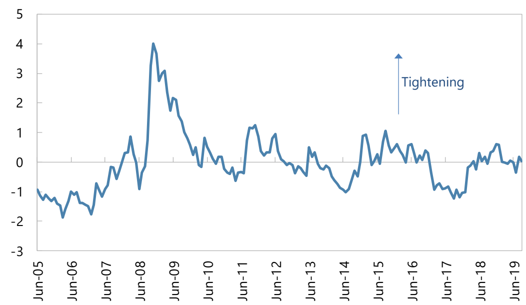
18. The broadly neutral monetary policy stance is appropriate. Malaysia's monetary policy framework has performed well, delivering price stability and robust growth in recent years.[1] After having stayed on hold since January 2018, Bank Negara Malaysia (BNM) lowered the policy rate 25 basis points to 3 percent in May 2019 and left it unchanged in subsequent policy meetings. The May rate cut helped bring the policy stance closer to neutrality following a significant drop in inflation expectations and in the context of a closing output gap and broadly neutral financial conditions. Looking forward, monetary policy should continue to be data dependent. There is space to lower the policy rate should downside risks materialize.

Real Policy Rate versus Natural Rate, 2003:Q1-2020:Q4
(Percent)



Sources: IMF staff calculations.
Note: Natural rate band derived using TV VAR with inflation expectations proxied 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 2020.

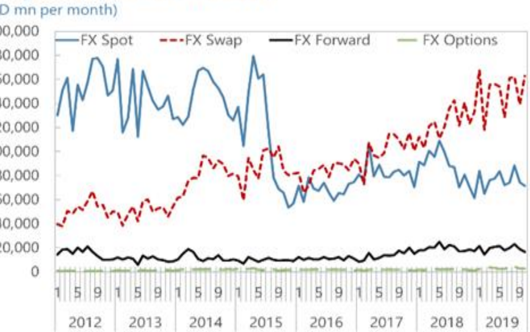
Malaysia Financial Conditions Index
(Standard deviations)



Sources: Bloomberg, CEIC, Haver, and IMF staff calculations.

19. The authorities have implemented welcome measures to deepen the domestic FX market. Recent efforts in this area include enhancing repo market liquidity and flexibility; expanding dynamic hedging of FX risks; simplifying FX transactions and documentation processes and enhancing ringgit liquidity beyond local trading hours. The authorities have also enhanced communication with foreign investors to raise awareness around the increased opportunities for onshore hedging, including through Authorized Overseas Offices. Partly as a result of these initiatives, FX market turnover has increased. Against this background, FTSE Russell decided in September to maintain Malaysian bonds in the WGBI, while retaining Malaysia on its watch list. Looking ahead, the authorities' continued efforts to deepen the domestic FX market are primarily focused on improving access to hedging markets.

Malaysia - FX Market Turnover
(USD mn per month)



Sources: BNM

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[1] Appendix VI describes Malaysia's policy framework. The frameworks followed by Malaysia and other ASEAN5 countries was the subject of a joint BNM-IMF peer-to-peer seminar held in Kuala Lumpur in July 2019. This seminar was the third in a series of annual BNM-IMF seminars to foster peer-to-peer learning and exchanges of policy views.

20. Building on the progress with the above initiatives, it would be important to further develop FX markets to enhance the exchange rate's ability to act as a shock absorber. The exchange rate has been moving within a narrow range. Recent research suggests that in some circumstances the exchange rate's shock absorber function can be impaired or a flexible exchange rate can act as a shock amplifier (Appendix VII). IMF staff will work with the authorities, upon their request, to analyze the role of the exchange rate in Malaysia's economy and explore further options to deepen FX markets. The authorities' commitment to push ahead with this agenda is welcome. In this context, they should gradually phase out existing capital flow management measures with due regard to market conditions.[2] The authorities are encouraged to consider the publication of FXI data (with appropriate lags and aggregation to guard against market sensitivities). In the event of an inflow surge, some accumulation of FX reserves would be appropriate.

21. External debt has declined from its post-GFC peak at end-2017 but remains high. At end-September 2019, external debt stood at 60.7 percent of GDP. The decline in external debt largely reflects portfolio debt outflows. At two thirds of total, the share of FX debt in external debt has remained stable. An improvement in external financing conditions and an increase in foreign assets enhance Malaysia's external debt sustainability. Nonetheless external debt remains vulnerable to exchange rate depreciation shocks (Appendix VIII).

22. For 2019, the external position is assessed to be stronger than warranted by fundamentals and desired policies (Appendix IX). A sharp decline in capital goods imports has side-tracked Malaysia's trend towards a narrowing current account surplus, resulting in a projected increase to 3.5 percent of GDP in 2019 (2.1 percent of GDP in 2018). This increase reflects a one-off decline in public investment in 2019, which is expected to recover starting 2020 with the resumption of large infrastructure projects and return to a balanced growth path over the medium-term. The 2019 surplus also reflects reduced investment amid the global trade tensions and domestic policy uncertainty, low public healthcare spending, and credit constraints likely faced by private non-financial corporations. With reference to the latter, recent IMF staff analytical work suggests that corporates in Malaysia may be facing financial constraints.[3] A separate study, however, indicates that access to financing is not a main concern among SMEs although a diversified financing ecosystem could better cater to innovative SMEs.[4] Although the current account surplus helps reassure foreign investors, it represents a gap that cannot be fully explained by fundamentals and desired policies. Going forward, policies to create fiscal space to expand social safety nets and

[2] See CR 18/61 for a full discussion of the existing capital flow management measures introduced in late 2016. With regard to the ban on offshore ringgit derivative trading, its removal would have to proceed with caution as conditions for further liberalization allow.

[3] Li (2019 forthcoming) finds that corporates in Malaysia and other ASEAN5 countries are likely facing financial constraints as, empirical analysis suggests that ASEAN5 companies with high dependence on external financing would grow faster as the financial system develops.

[4] See https://www.bnm.gov.my/files/publication/fsps/en/2018/cp02_001_box.pdf.

structural reforms to encourage investment by enhancing firms' access to credit would facilitate external rebalancing.

Authorities' Views

23. The authorities agreed with staff's assessment of monetary and financial policies, with some reservations. They viewed monetary policy as still accommodative and noted that growth and inflation remain the principal determinants of monetary policy. Exchange rate flexibility will continue to be the first line of defense against external shocks. The authorities view the narrow range of FX volatility as inherent to Malaysia's economy due to the reinforcement of rules underpinning Malaysia's long-standing policy of non-internationalization of the ringgit that aims to contain high-volatility capital flows. The authorities continue to stress that the existing capital flow measures are necessary (i) for the development of the onshore FX market; (ii) to limit speculation that causes excessive exchange rate volatility; (iii) to address foreign currency demand-supply imbalances and (iv) to streamline prudential rules to prevent excessive accumulation of domestic debt by residents to fund investment abroad. They will continue to review the measures' effectiveness and will determine the timeline and speed of the phasing out of such measures. On publication of FX intervention data, the authorities preferred to wait for the outcome of the ongoing analytical work on the Integrated Policy Framework to inform the debate on the merits of publication as a tool to enhance policy credibility and effectiveness. The authorities viewed the ARA assessment methodology as insufficiently granular to account for the characteristics of the Malaysian economy.

24. The authorities partly agreed with staff's external debt sustainability analysis but expressed reservations on the external balance assessment methodology. They noted that Malaysia's external debt has been declining since 2018 and its external borrowing conditions have improved. They viewed BNM reserves to be adequate and expected external debt to remain manageable. Besides official reserves, the authorities highlighted additional buffers against external shocks: (i) a sustained current account surplus over the medium-term; (ii) ample and growing foreign assets, three-quarters of which is held by resident banks and corporates; (iii) ringgit-denominated external debt accounting for about one-third of total external debt; (iv) about three-quarters of FX-denominated external debt subject to prudential requirements; and (v) the large share of medium/long-term external debt (over 55 percent). While the authorities took positive note of the 2018 refinement to the External Balance Assessment model, they continued to see limitations in the IMF's analytical framework given the relatively weak explanatory power of the current account regression model in the context of Malaysia. They agreed with the structural reforms advised to address policy gaps, noting that their reform plans aim to boost investment and productivity.

D. Financial Sector

25. The financial sector is stable and further enhancements to the regulatory framework are underway (Figures 7-8). Banks are well capitalized. Profitability has been maintained owing to enhancements in cost-efficiency and stable interest margins. Asset quality is sound with net impaired loans at 1 percent of total loans in October 2019. All banks record Liquidity Coverage Ratio

(LCR) levels well above the 100 percent regulatory minimum requirement, and the LCR stood at 150 percent in October 2019. In November 2019, BNM lowered the statutory reserve requirement (SRR) by 50 bps to 3 percent to support effective liquidity management across the maturity spectrum. BNM has issued the finalized Net Stable Funding Ratio (NSFR) requirements, to come into effect in July 2020. The system-wide NSFR stood at 108.5 percent in 2019H1. BNM issued a consultation paper in April 2019 on the proposed assessment methodology to identify Domestic Systemically Important Banks (DSIBs), as well as the applicable capital surcharge and reporting requirements. The DSIB framework is expected to be finalized in 2020.

26. Household debt and the real estate market require close monitoring (Figures 9-10). Household debt is high compared to peers, with pockets of vulnerability in lower-income groups. House price increases have moderated recently, but house prices remain stronger than warranted by macroeconomic fundamentals (Appendix X). A sharp decline in house prices could impact developers and investors negatively. This, combined with a household income shock, and given banks' sizeable real estate related lending, could hurt banks' financial performance and adversely impact financial stability through lower credit and broad-based confidence effects. In the 2020 Budget, the Government temporarily lowered the minimum purchase price for foreigners[5] buying completed but unsold apartments from RM1 million to RM600,000 to help reduce oversupply of high-rise apartments in urban areas. Other things equal, and assuming the existence of foreign demand at the reduced threshold, this could help avoid a sharp decline in house prices in this segment of the market and thereby moderate systemic financial risks. The measure is designed to be temporary to ensure that the supply of housing over the medium-term is better targeted to domestic housing demand conditions. This measure is a step in the right direction and, as systemic risks dissipate, the residency-based differentiation in property market measures should be gradually phased out. Should market activity in certain segments again threaten financial stability, the authorities may consider macroprudential measures that target these segments without a differentiated treatment of nonresidents.

27. The authorities are pursuing policy initiatives aimed at strengthening resilience of households and of the financial sector more broadly. A National Strategy for Financial Literacy was launched in July 2019. This five-year roadmap aims to enhance financial literacy through, inter alia, expanding financial education into school curricula and increasing access to financial management resources. The proposed Consumer Credit Act will strengthen household resilience through borrower protection, including through minimum standards on unsolicited financing, charges, credit assessments, debt collection and dispute settlements.

28. The authorities' focus on microprudential supervision could be complemented by expanding the range of macroprudential tools. Strong microprudential supervision of lending standards in individual financial institutions is critical in mitigating financial stability risks. BNM's

[5] The differentiation between non-citizens and citizens in the floor price for property purchases is classified as a CFM/MPM (see CR 10/71).

Responsible Financing Guidelines, introduced in 2012, help to ensure that borrowers have the capacity to repay a loan throughout its tenure.[6] However, in times of rapid changes in the financial cycle, the availability of macro-prudential tools that can be swiftly and transparently adjusted enhances the ability to act to mitigate financial stability risks. In this context, IMF staff sees merit in tools such as LTV and DSTI - which are among the most commonly applied macroprudential tools in advanced and emerging market countries. To ensure these tools are readily available, the authorities could introduce sector-wide LTVs on first and second properties and debt-service-to-income limits for all income groups. These tools could initially be calibrated to be non-binding, and subsequently adjusted as warranted by cyclical risks to financial stability.

29. The authorities have a well-developed strategy to mitigate cyber risks. The National Cyber Security Policy (NCSP) was established in 2006, identifying priority sectors for cyber policy. A National Cyber Crisis Management Plan (NCCMP) was developed in 2011 which sets out processes and procedures observed for detection, response, communication and coordination in the event of a cyber-attack. The authorities are in the process of updating the NCSP and will be incorporating an enhanced security incident response and digital forensic capabilities. BNM's priority areas to enhance cyber risk mitigation include (i) strengthening existing guidance around cyber security and risk management; (ii) improving information sharing on cyber threats across sectors; (iii) strengthening the collective capabilities to respond to and recover from a cyber incident; and (iv) training.

30. BNM is developing a framework for assessing climate change risks to the financial sector. BNM is actively working on this as a member of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS). In September 2019, BNM and the Securities Commission formed a Joint Committee on Climate Change with industry representation to pursue collaborative actions for building climate change resilience in the financial sector, with principal mandates including (i) building capacity in assessing and managing climate-related risk; (ii) identifying issues, challenges and priorities facing the financial sector in managing the transition to a low carbon economy; and (iii) facilitating collaboration between stakeholders.

31. Financial technology (fintech) is increasingly important in Malaysia's financial sector. Good digital infrastructure and government agencies' support have enabled growth of fintech start-ups and rising adoption from established financial institutions across major areas of fintech. Regulators have struck an appropriate balance between safeguarding financial stability and consumer protection while encouraging innovation. At present, financial stability risks from fintech appear limited given the still-small size of the sector. Continued regulatory vigilance will be important given the rapid growth of fintech and entrance of big tech firms in Malaysia. To encourage further growth of fintech, talent shortages and limited venture funding need to be addressed.

[6] These guidelines cover mortgage loan tenure, proof of income, all existing debt obligations and debt service.

Authorities' Views

32. The authorities broadly agreed with staff's assessment of the financial sector. They agreed that the financial sector has the necessary buffers to cope with sizable shocks and that household balance sheet risks require close monitoring. They viewed the risks to financial stability from a real estate price adjustment or a deterioration in households' debt service ability to be largely contained given the sound overall quality of banks' housing portfolio, supported by prudent lending and strengthened valuation and underwriting practices. The authorities noted that their stress tests also indicate that banks can withstand a 50 percent decline in property prices. The lowering of the threshold for foreigners purchasing apartments is designed to reduce housing oversupply but is temporary to avoid long-term disincentives to build in affordable price ranges. The authorities viewed sector-wide LTVs on first and second mortgages as unwarranted at this juncture given existing supervisory measures and prudent risk management practices at banks; they indicated sector-wide LTVs could easily be introduced whenever strong shifts in the financial cycle warrant them. The authorities noted their continuous focus on testing the banking system's operational resilience, including to cyber risks and climate change risks.

STRUCTURAL REFORMS

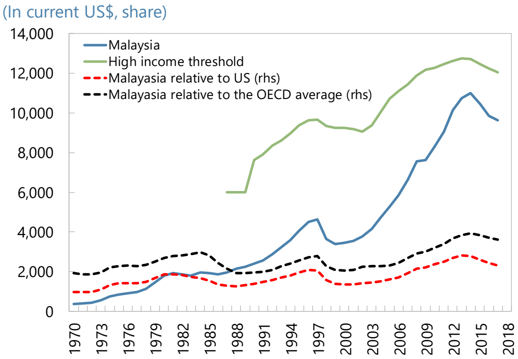
33. The authorities have made progress on governance reforms. Government priorities have been reoriented towards improving transparency and public services efficiency. The National Centre for Governance, Integrity and Anti-Corruption (GIACC) launched a National Anti-Corruption Plan (NACP) in January 2019, focusing on six priority areas: political integrity and accountability; effectiveness of public service delivery; efficiency and transparency of public procurement; enhancing the legal and judiciary system; credibility of law enforcement agencies; and corporate governance. In this regard, the authorities are moving forward with initiatives under the NACP, including the introduction of asset declaration as an administrative requirement for Administrative Members and Members of Parliament (MPs) as well as inculcating good corporate governance including in State Owned Enterprises (SOEs).

34. It would be critical to sustain the momentum in governance reforms and anchor them in legislation. Priority should be given to legislative initiatives currently underway on procurement reform, freedom of information, and independence of anti-corruption institutions, especially with regards to the appointment and tenure of the MACC Chief Commissioner and the independence of MACC officers in carrying out their investigative functions. The independence and investigative powers of the MACC should be reinforced consistent with the NACP and with international best practice. The asset declaration requirements for Administrative Members and MPs should be enshrined in law as planned under the NACP, and the asset declaration system for other high-level public officials and its verification and enforcement further enhanced. Pushing ahead with the plan to make it mandatory for public sector institutions to develop Organizational Anti-Corruption Plans (OACPs) is also important. Governance improvements would create synergies with other structural reforms discussed below, as per IMF analysis showing that the pay-off of reforms tend to be larger when governance is strong.[7]

35. Robust implementation of AML/CFT standards can support efforts to mitigate risks from corruption and virtual assets. Enhanced due diligence measures for politically exposed persons, accurate beneficial ownership information and other appropriate governance reforms can contribute to detecting, preventing and deterring large scale corruption. Some measures were taken to mitigate money laundering and terrorist financing risks related to virtual assets. In particular, Malaysia's Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001 (Act 613) applies to the exchange of virtual assets (or "digital currencies") to fiat currencies and vice versa, as well as to the exchange of one type of virtual asset for another. In 2019, the Securities Commission took over from BNM the role of AML/CFT supervisor of virtual asset exchanges. Given recent amendments to the international standards on AML/CFT, the authorities are encouraged to pursue their efforts to ensure that all virtual asset service providers listed in the standards (and not only exchanges) are regulated for AML/CFT purposes and to implement AML/CFT measures in an effective way.

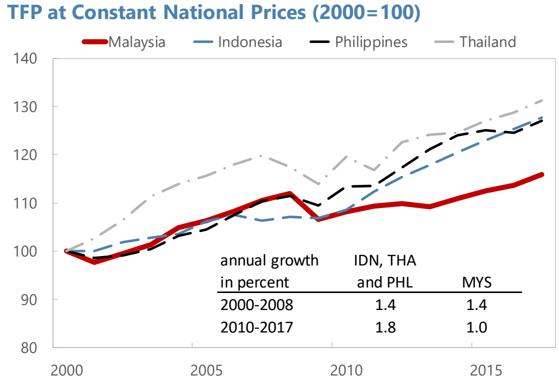
36. Boosting productivity is crucial to move up the value chain and achieve high income status. Over several decades, Malaysia has diversified its economy and improved export sophistication substantially. Nevertheless, total factor productivity (TFP) is moderating, with average growth of 1 percent during 2010–2017. The growth outlook appears to be more challenging at the current juncture, underlining the need for accelerating reforms to raise TFP growth.

Income Per Capita
(In current US$, share)



Sources: World Bank, World Development Indicators.

TFP at Constant National Prices (2000=100)



Sources: Penn World Table and IMF staff calculation.

37. The government has rolled out a comprehensive structural reform agenda aiming to reach high-income status and spurring inclusive economic development. The authorities have made progress in implementing the targets established in the Mid-Term Review (MTR) of the Eleventh Malaysia Plan and the national-level initiatives identified in the 2017 Malaysia Productivity Blueprint. Moreover, the recently released Shared Prosperity Vision 2030 outlines a long-term commitment to sustainable and inclusive growth.

[7] October 2019 World Economic Outlook, Chapter 3.

38. In this context, accelerating reforms that improve the functioning of markets and boost productivity would help unlock Malaysia's potential and ensure that the dividends are more widely shared. IMF staff calculations suggest that Malaysia's real growth rate would need to rise by about one additional percentage point per year above the baseline in order to achieve high income status by the mid-2020s. Therefore, a comprehensive package comprising both growth-enabling and growth-incentivizing reforms is essential.

39. Growth-enabling reforms could include the following:

- Continue to enhance the business environment by simplifying state-level procedures for starting a business. While the 2020 Doing Business Index ranks Malaysia 12th overall, in the area of starting a business Malaysia ranks at 126th. Moving ahead with recent proposals to work with states to speed up their procedures, such as shortening the building permit approval period to 90 days from 390 days, would help ease bottlenecks.

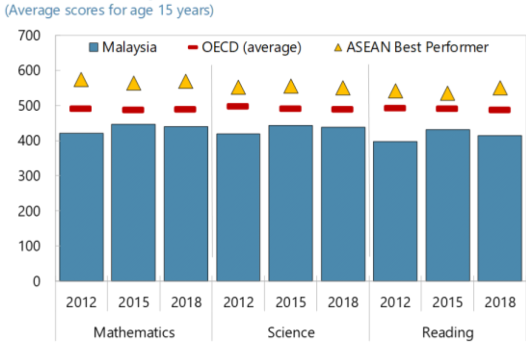
- Promote trade openness and be prepared to absorb trade and investment diversion. Efforts to speed up decisions on investment approvals, including through the revamped role of the National Committee on Investment (NCI) are welcome. It would also be important to conclude the domestic approval of the CPTPP and to work with regional partners to finalize a high-standard RCEP agreement in 2020. Malaysia should also work constructively with partners to strengthen the multilateral trading system.

- Continue to improve access to financing. Malaysia has made progress and performs relatively well compared to peers and to the OECD average. However, there remains a gap with the most competitive countries (for instance, the United States). In this context, policy priority should be given to continue to improve SMEs access to alternative sources of financing, particularly for manufacturing and innovating SMEs. Improving access to financing can also unlock and magnify the gains from labor market reforms.[8]

40. Over the medium-term, accelerating the implementation of the authorities' agenda to boost productivity is also needed. Measures that could improve TFP include:

- Enhance the quality of and access to education by improving the quality of teachers and the design of curricula; and by expanding vocational and technical training to address skills mismatches.

PISA Score Comparison
(Average scores for age 15 years)



Sources: OECD *Program for International Student Assessment* (PISA).

[8] See chapter 3 of the October 2019 WEO for a discussion of the importance of access to finance for enhancing the impact of structural reforms.

- Encourage innovation and technology adoption, including by promoting digitalization of the economy.[9]

- Boost female labor participation through promoting flexible work arrangements and returning to work initiatives. Expediting the Employment Act amendment under consideration would help in this direction.

Authorities' Views

41. The authorities reaffirmed their commitment to improving governance. They highlighted progress with implementation of the NACP and reiterated their commitment to push ahead with legislation in important areas. They also stressed that improving governance requires a change in mindsets and practices in addition to legislation. To this effect, efforts are underway to strengthen governance education at all levels and conduct outreach on the social benefits of governance reforms.

42. The authorities agreed that boosting productivity is necessary to achieve high-income status and inclusive development. They reiterated the importance of policy clarity in shoring up business confidence and have implemented measures to continue to improve the business environment and attract quality FDI. However, they noted that the effectiveness of domestic policies and reforms is blunted by intense external uncertainties. They highlighted the progress in labor market reforms, particularly in boosting female labor force participation. They noted that the implementation of a progressive multi-tiered levy system by 2021 will reduce the dependency on low-skilled foreign workers and encourage automation in the manufacturing and agriculture sectors. The authorities did not view access to financing as a main concern for SMEs but noted that a diversified financing ecosystem could better cater to innovative SMEs. They aim to finalize the RCEP negotiations with partners by 2020 and are reviewing the social and economic impact of the CPTPP to reach a decision on ratification.

STAFF APPRAISAL

43. The authorities are making progress on their reform agenda and the Malaysian economy remains stable. Activity has broadly held up and inflation has remained subdued. Risks to growth are to the downside. Developments in 2019 suggest that Malaysia's external position remains stronger than warranted by fundamentals and desired policies. Policy priorities are medium term fiscal consolidation, while safeguarding growth and financial stability, and sustaining the momentum in governance reforms by anchoring them in legislation. In case of negative shocks, the response could be a combination of use of available monetary and fiscal space, and exchange rate flexibility.

[9] According to WEF's Global Competitiveness Index (2018), compared to the OECD average, Malaysia's opportunities to improve are largest in the area of innovation capability.

44. Fiscal policy should focus on building buffers through medium-term adjustment, underpinned by specific revenue and expenditure measures. The pace of fiscal adjustment announced for 2020-2022 is appropriate and should be continued over the medium-term to build fiscal buffers, given that Malaysia's fiscal space is at risk. Specific measures need to be identified to support this adjustment, including in the context of the upcoming medium-term revenue strategy preparation. The planned Fiscal Responsibility Act is an opportunity to increase the flexibility of the current debt limit framework to enhance the capacity of fiscal policy to react to shocks, while embedding safeguards. Pushing ahead with the authorities' agenda to improve debt management, public procurement, and the public investment framework is important.

45. The 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 in the context of a closing output gap and broadly neutral financial conditions. Looking forward, monetary policy should remain data dependent. There is space to lower the policy rate should downside risks materialize.

46. Building on welcome recent initiatives, it would be important to continue to deepen domestic FX markets, which would enhance the ability of the exchange rate to act as a shock absorber. Recent actions have appropriately improved the functioning of domestic FX markets, enhanced communication with foreign investors, and expanded FX hedging instruments and liquidity at longer maturities. The authorities' commitment to explore further options to deepen FX markets is welcome and IMF staff look forward to working with the authorities in this endeavor through policy advice and technical assistance.

47. The financial sector is stable, but household debt and the real estate market require continued close monitoring. Bank profitability, capitalization and asset quality are sound. Household debt is high compared to peers. House prices remain stronger than warranted by fundamentals despite a recent price stabilization. The authorities should continue to monitor risks in this area. The recent temporary easing of a residency-based differentiation in property market policies is a step in the right direction and the differentiation should be gradually phased out as systemic risks dissipate. The authorities' focus on micro-prudential supervision of lending standards could be complemented by expanding the range of macroprudential tools to ensure they are readily available when needed to manage the financial cycle.

48. Sustaining the momentum in governance reforms and anchoring them in legislation is critical. Building on initial success in the implementation of the National Anti-Corruption plan, the authorities are encouraged to push ahead with legislative initiatives currently underway on asset declaration, procurement reform, freedom of information, and independence of anti-corruption institutions. Accelerating plans to develop Organizational Anti-Corruption Plans in public sector bodies is also important. Robust implementation of AML/CFT tools can help mitigate risks from corruption and virtual assets.

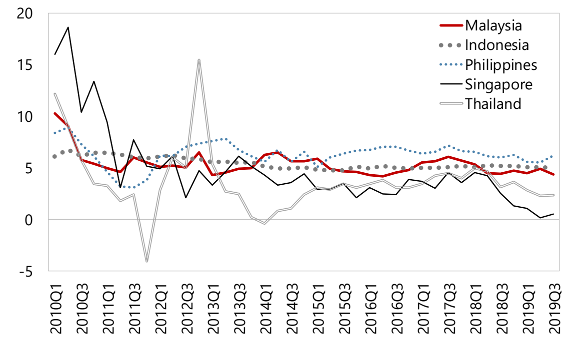
49. Structural reforms should focus on accelerating the authorities' agenda to boost productivity. Growth-enabling reforms could include simplifying procedures for starting a business at the state level; working with regional partners to promote trade openness; and improving access to alternative financing, particularly for manufacturing and innovating SMEs. Measures to boost productivity could include enhancing the quality of and access to education; encouraging innovation and technology adoption; and boosting female labor participation.

50. 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.

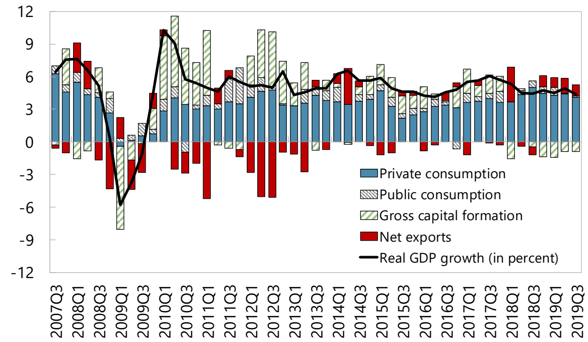
Real GDP Growth
(In Percent, Year-on-Year)



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

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

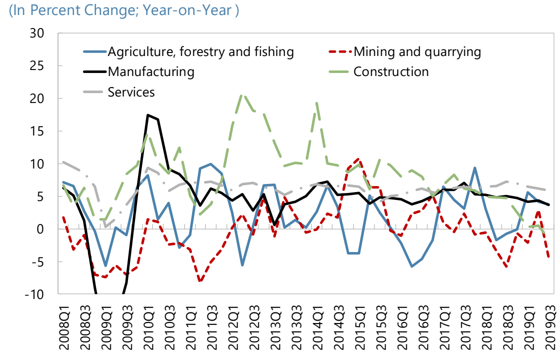
Contributions to Real GDP Growth
(In Percentage Points; Year-on-Year)



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

On the supply side, services sector growth remains robust, low oil price weighed on the mining sector, and manufacturing and construction sector growth moderated.

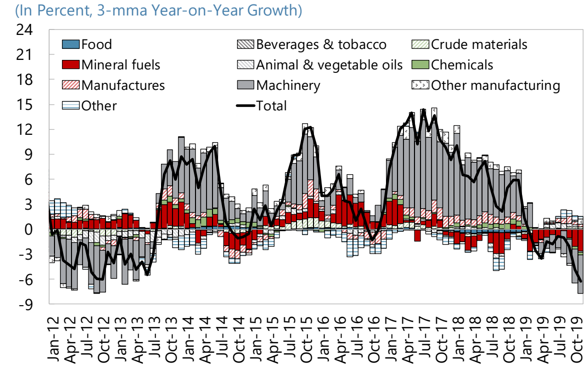
Real GDP by Industry
(In Percent Change; Year-on-Year)



Sources: Haver Analytics; and IMF staff calculations.

Manufacturing exports have contracted since 2019Q1 due to external headwinds.

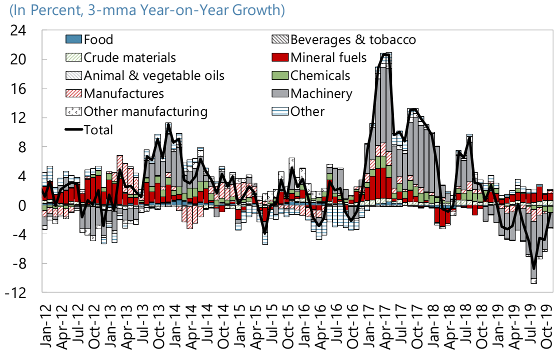
Export Volumes Growth Contribution
(In Percent, 3-mma Year-on-Year Growth)



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

Imports declined at a faster pace than exports in 2019 on account of lower capital imports, reflecting weak domestic investment…

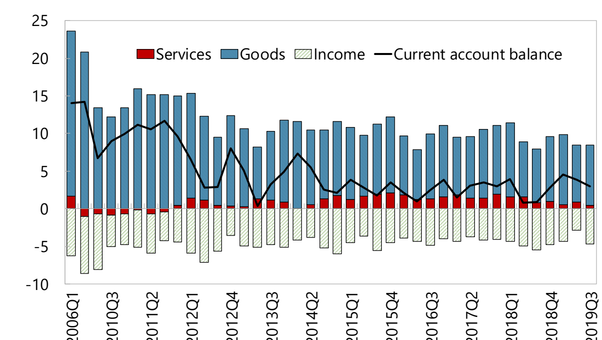
Import Volumes Growth Contribution
(In Percent, 3-mma Year-on-Year Growth)



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

… leading to an increase in the current account surplus in 2019, which was also helped by the reduction in the primary income deficit.

Current Account Balance
(In Percent of GDP)

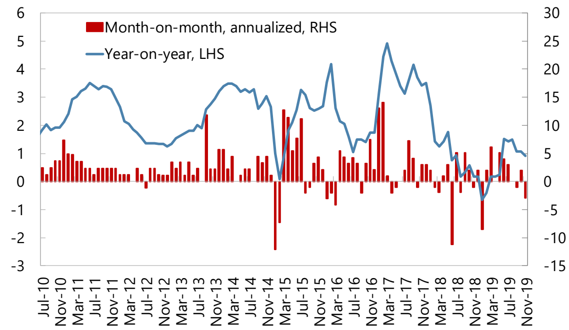


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 2. Malaysia: Inflation and Labor Markets

Headline inflation remained subdued in 2019, reflecting base effects due to changes in the consumption tax regime and low global oil price.

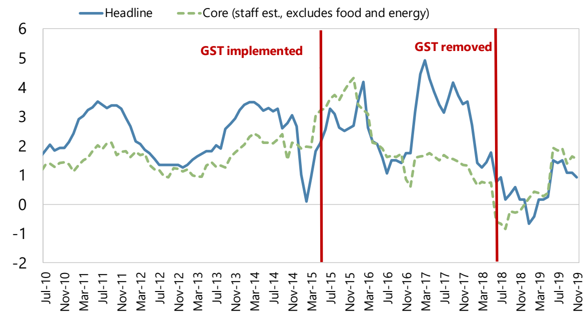
Consumer Price Index
(In Percent Change)



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

Both headline and core inflation rebounded between June and August due to a base effect, as there was no consumption tax in the same period of the preceding year.

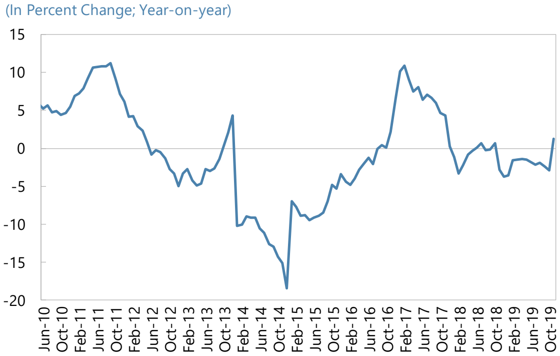
Inflation Developments
(In Percent; Year-on-year)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.
Note: The core inflation estimated by IMF staff does not exclude effects of consumption tax changes.

Producer prices continued to decline in 2019.

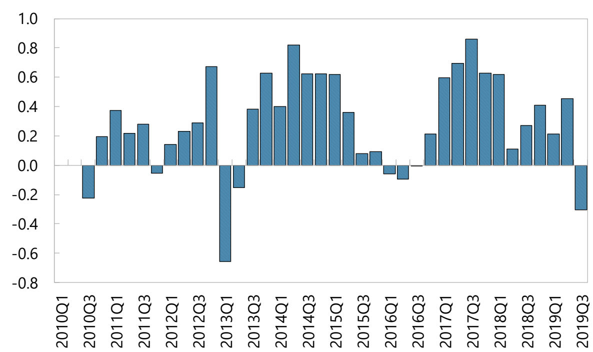
Producer Price Index
(In Percent Change; Year-on-year)



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

The output gap is closing as growth moderates.

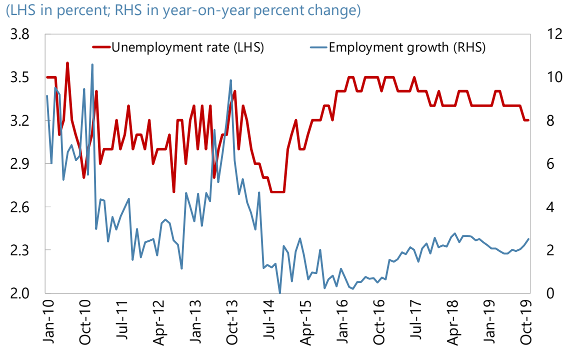
Output Gap
(In Percent of Potential GDP)



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

The unemployment rate has been stable as employment growth continues to match labor force expansion.

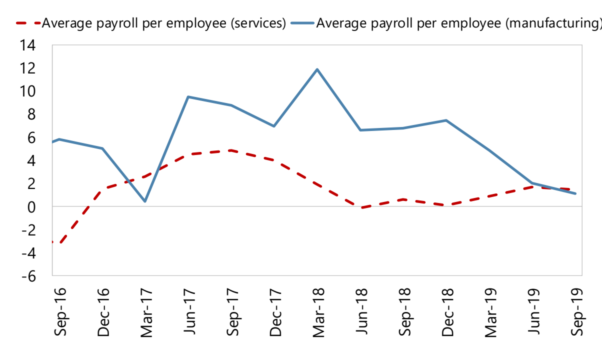
Labor Market Developments
(LHS in percent; RHS in year-on-year percent change)



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

Growth in manufacturing wages has moderated since 2018Q4; meanwhile, wage growth in the services sector remained low.

Manufacturing and Services: Payroll
(In Percent Change; Year-on-year)

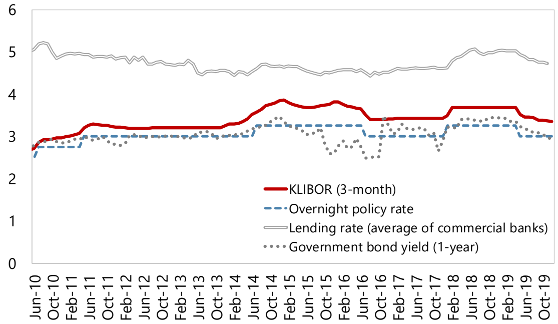


Sources: CEIC Data Co. Ltd; Haver Analytics; and IMF staff calculations.

Figure 3. Malaysia: Monetary Developments

The BNM eased monetary policy in May 2019…

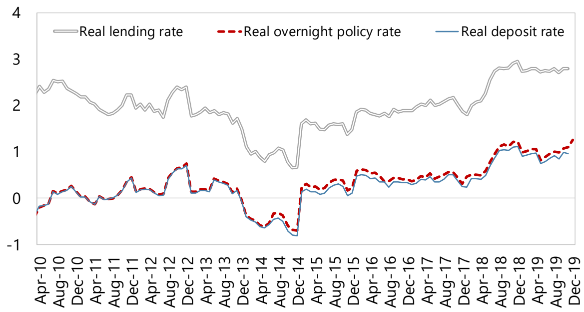
Interest Rates
(In Percent per Annum)



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

….but real interest rates remained stable due to falling inflation expectations.

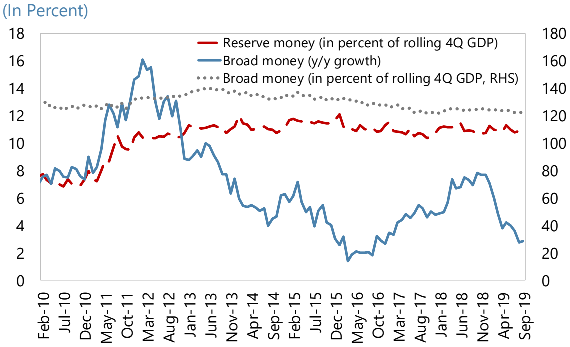
Real Interest Rates
(In Percent per Annum)



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…

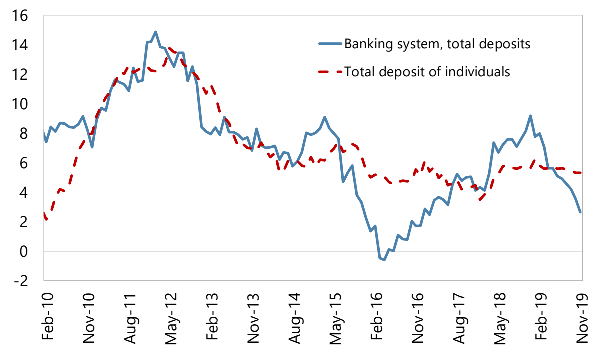
Monetary Aggregates 1/
(In Percent)



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

… supported by healthy deposit growth.

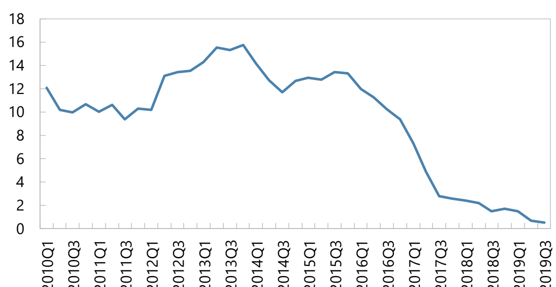
Banking System Deposit Growth
(In Percent; Year-on-year)



Sources: Bank Negara Malaysia; and IMF staff calculations.

The credit gap has nearly closed as it declined to a post-GFC low.

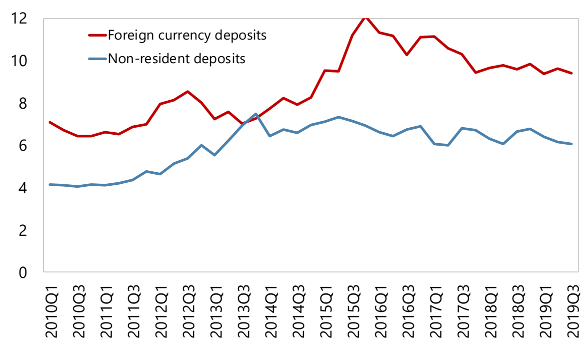
Credit Gap
(In Percent of GDP) 1/



Sources: CEIC Data Co. Ltd; and 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 2008Q2–2019Q3.

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

Foreign Currency and Non-resident Deposits
(In Percent of rolling GDP)



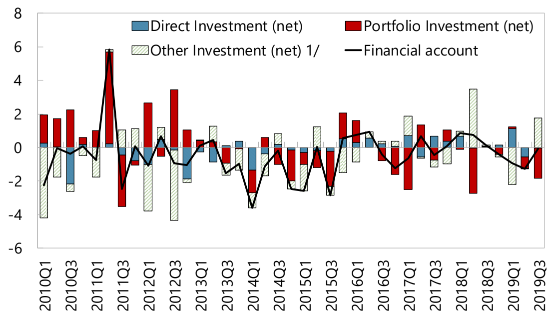
Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 4. Malaysia: Capital Flows, Foreign Exchange, and Asset Prices

The financial account deteriorated in 2019 as FDI inflows in 2019Q1 were more than offset by increased direct and portfolio investment of residents abroad in Q2-Q3.

Financial Account Balance

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

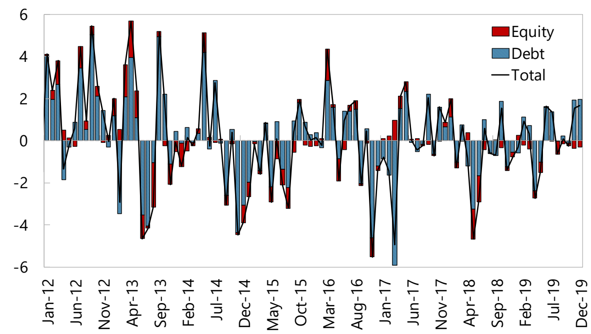


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.
1/ Includes financial derivatives.

Non-resident bond and equity portfolio flows were less volatile than in recent years.

Malaysia: Nonresident Portfolio Capital Flows 1/

(In billion U.S. dollar; as of Mar 2019)

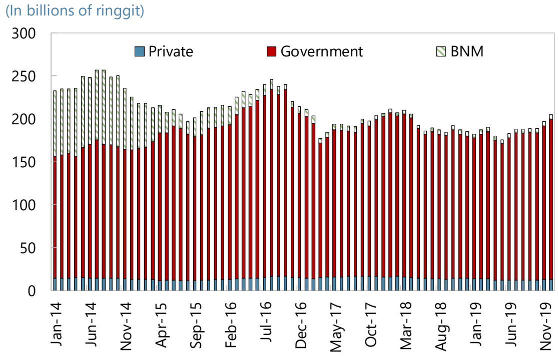


Sources: CEIC Data Co. Ltd.; and IMF staff estimates.
1/ Based on staff estimates from debt and equity markets data.

Foreign holdings of Malaysian government securities dropped in April and May but recovered since June.

Foreign Holdings of Local-Currency Debt Securities

(In billions of ringgit)

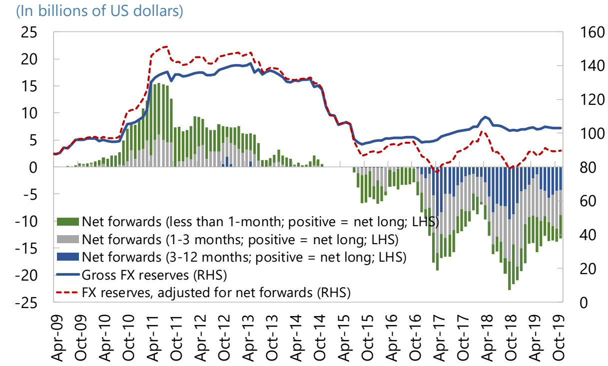


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

The BNM's gross FX reserves have stabilized since 2018Q3. Net reserves have increased due to a decreasing net short position in forwards.

Official Foreign Reserves

(In billions of US dollars)

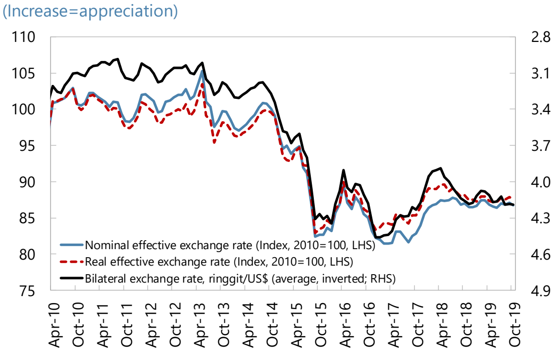


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

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

Exchange Rates

(Increase=appreciation)

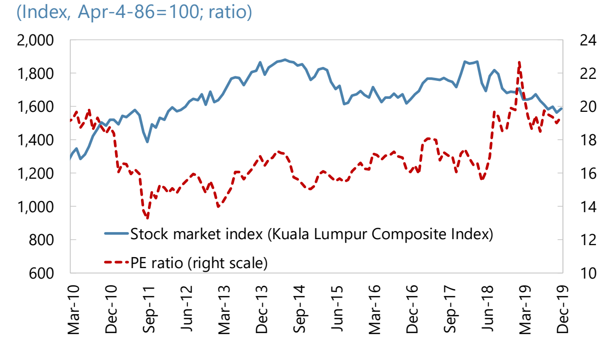


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

… and the stock market is sliding since the second half of 2018.

Stock Market Performance

(Index, Apr-4-86=100; ratio)

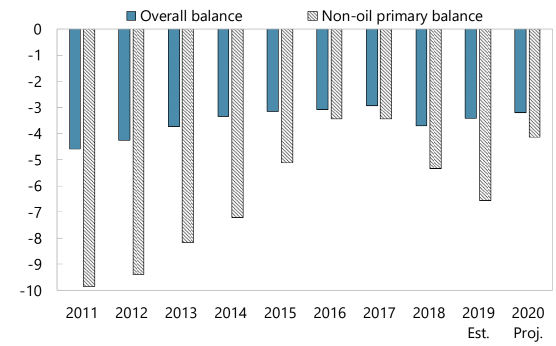


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.
Note: The blip in P/E ratio in February 2019 is due to a sharp drop in profit of the constituent AXIATA for the FY2018 and a strong market capitalization as of end February 2019.

Figure 5. Malaysia: Fiscal Policy Developments

The overall deficit started declining again from 2019.

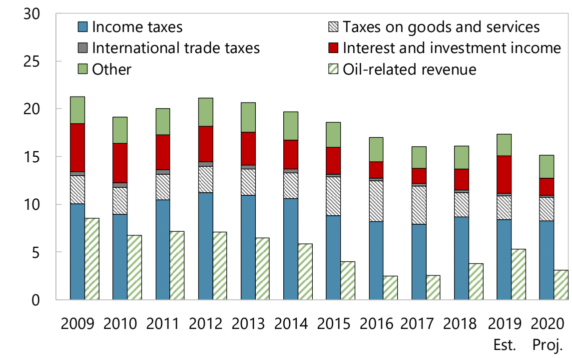
Federal Government: Overall and Non-Oil Balance
(In Percent of GDP)



Sources: Malaysian Authorities; and IMF staff calculations.

Revenue increased in 2019, mainly due to a one-off special dividend from Petronas used to finance the clearance of tax refund arrears.

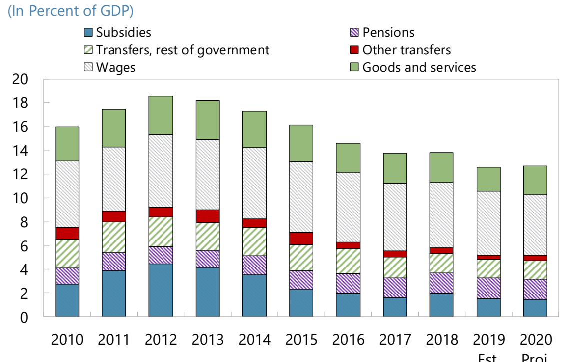
Federal Government Revenue
(In Percent of GDP)



Sources: Malaysian Authorities; and IMF staff estimates.

Current spending declined in 2019 as a ratio to GDP, driven by lower goods and services outlays.

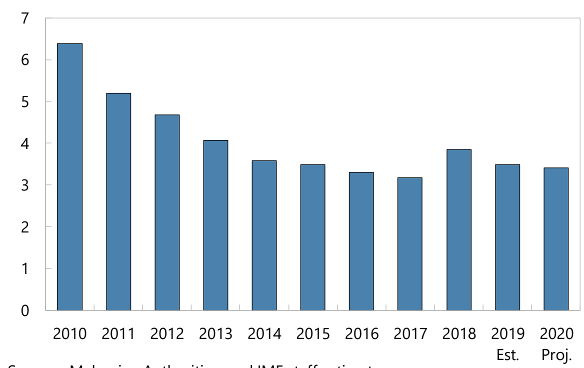
Federal Government Current Expenditures
(In Percent of GDP)



Sources: Malaysian Authorities; and IMF staff calculations.

Development spending is line with the historical trend

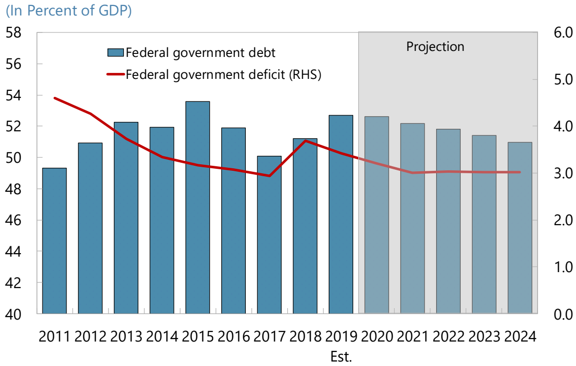
Federal Government Development Spending
(In Percent of GDP)



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)



Sources: Malaysia Authorities; and IMF staff estimates.

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

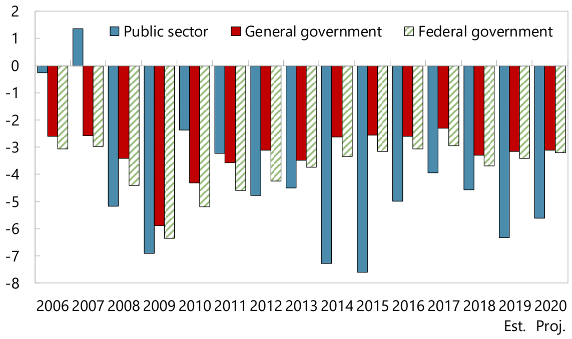
Federal Government Loan Guarantees
(In percent of 4-quarter rolling GDP)

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

Figure 6. Malaysia: Public Sector, Fiscal Stance, and Prospects

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

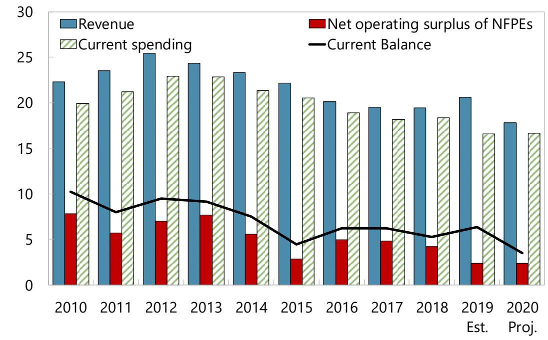
Fiscal Balance
(In Percent of GDP)



Sources: Malaysian Authorities; and IMF staff estimates.

Public companies' surpluses have been sustained.

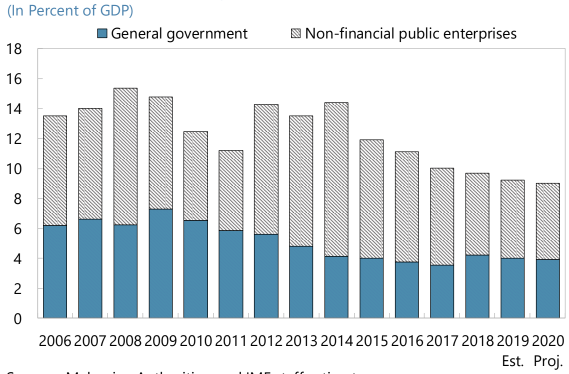
Current Balance of the Public Sector
(In Percent of GDP)



Sources: Malaysian Authorities; and IMF staff estimates.

General government development spending has declined...

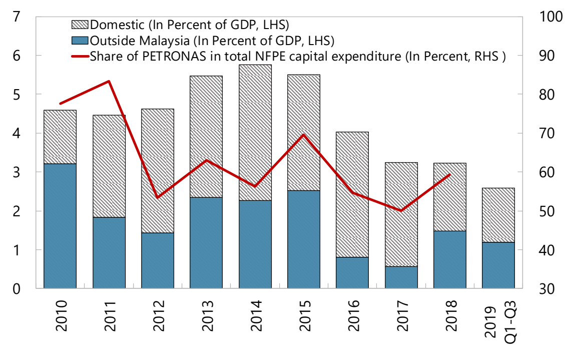
Development Spending
(In Percent of GDP)



Sources: Malaysian Authorities; and IMF staff estimates.

... with Petronas' share lower than before.

Capital Spending by PETRONAS

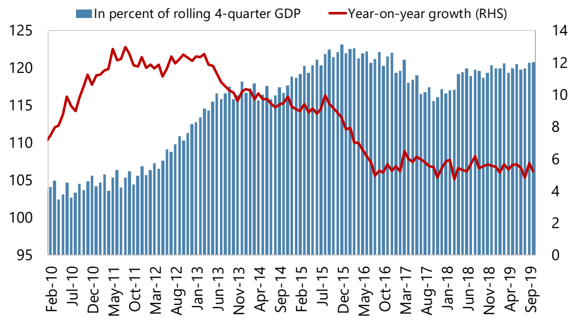


Sources: PETRONAS; Malaysian Authorities; and IMF staff calculations.

Figure 7. Malaysia: Financial Sector Developments

Credit growth is broadly in line with nominal GDP growth.

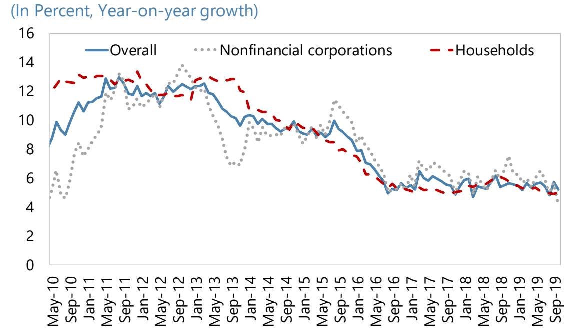
Banks' Credit to Private Sector 1/



Sources: IMF, *Integrated Monetary database*; and IMF staff calculations.
1/ The growth rates have been adjusted by staff to account for the re-classification of a non-bank to bank in April 2018.

Slowing housing and investment demand has led to lower credit growth

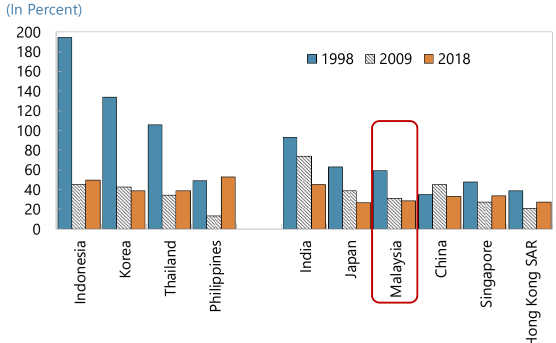
Banks' Credit to Private Sector 1/
(In Percent, Year-on-year growth)



Sources: IMF, *Integrated Monetary database*; and IMF staff calculations.
1/ The growth rates have been adjusted by staff to account for the re-classification of a non-bank to bank in April 2018.

Overall corporate sector leverage has been stable over the last 10 years and remains well below levels prior to the Asian Financial Crisis.

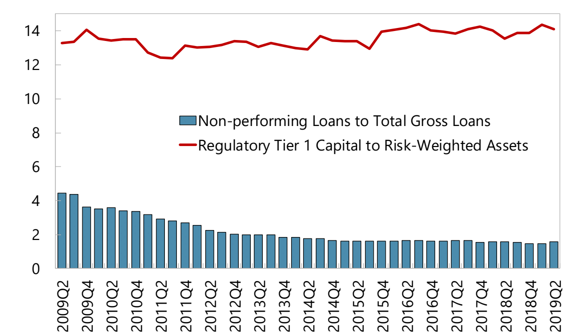
Corporate Debt-to-Equity Ratio 1/
(In Percent)



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

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

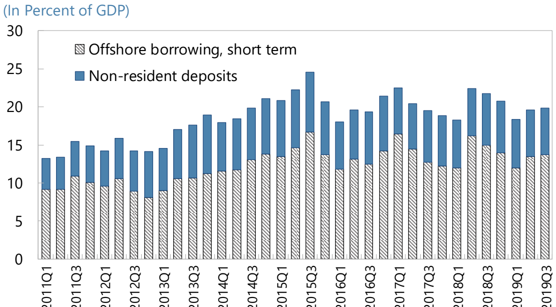
Banks' Financial Soundness Indicators
(In Percent)



Source: IMF, *Financial Soundness Indicators* database.

The banking system's reliance on short-term external debt, as a share of GDP is broadly stable…

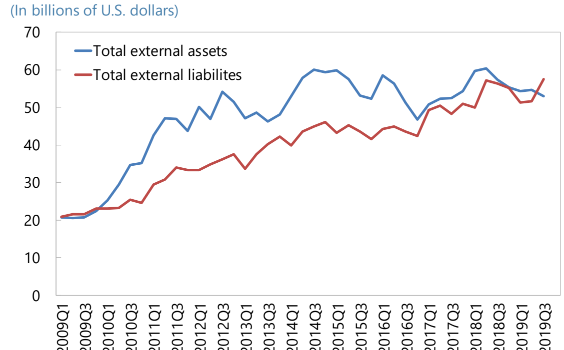
Banks' Short-Term External Debt: 2011:Q1–2019:Q3
(In Percent of GDP)



Sources: CEIC Data Co. Ltd.; and IMF staff calculations.
Note: Data as of 2017Q1 include a reclassification from medium/long-term to short-term external debt of a banking entity in Labuan.

… and banks have a broadly balanced net external asset position.

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

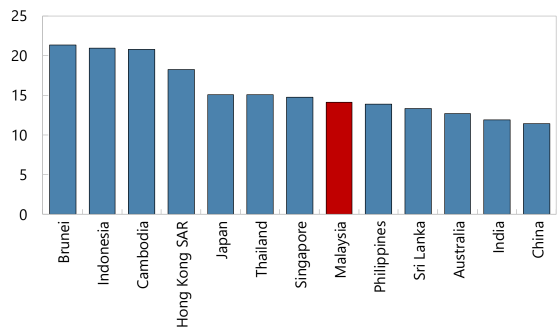


Sources: CEIC Data Co. Ltd; and IMF staff calculations.

Figure 8. Financial Soundness Indicators 1/

Malaysian banks' capital buffers are strong…

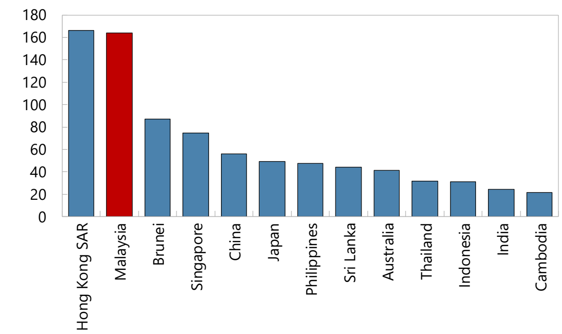
Regulatory Tier 1 Capital to Risk-Weighted Asset, 2019Q2 1/
(In Percent)



Source: IMF, *Financial Soundness Indicators* database.

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

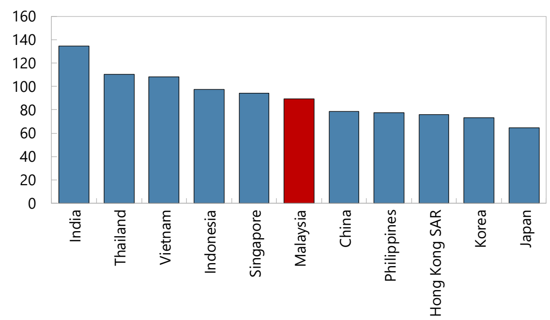
Liquid Assets to Short-Term Liabilities, 2019Q2 1/
(In Percent)



Source: IMF, *Financial Soundness Indicators* database.

Lending in proportion to deposits is in line with peers…

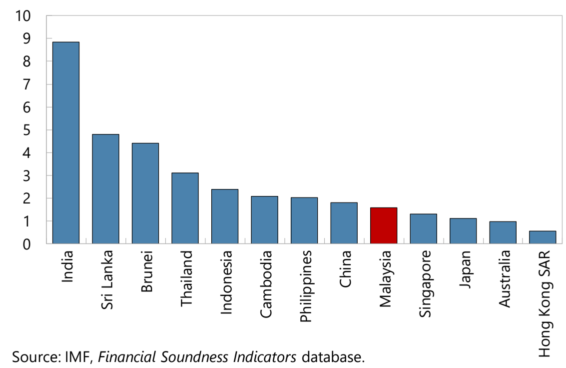
Loan to Deposit Ratio, 2019Q3 1/
(In Percent)



Sources: CEIC Data Co. Ltd.; Haver Analytics; and IMF staff calculations.
1/ Data for Vietnam are as of 2019Q1, respectively.

… and asset quality is high.

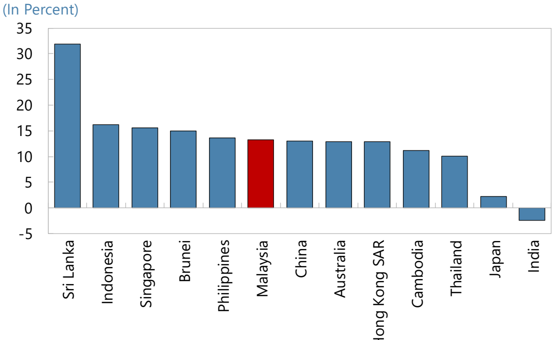
Nonperforming Loans to Total Gross Loans, 2019Q2 1/
(In Percent)



Source: IMF, *Financial Soundness Indicators* database.

Banks are profitable…

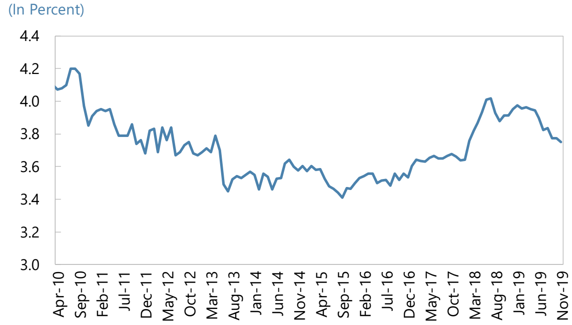
Return on Equity, 2019Q2 1/
(In Percent)



Source: IMF, *Financial Soundness Indicators* database.

… partially reflecting stable interest rate spreads.

Malaysian Commercial Banks: Interest Rate Spreads
(In Percent)



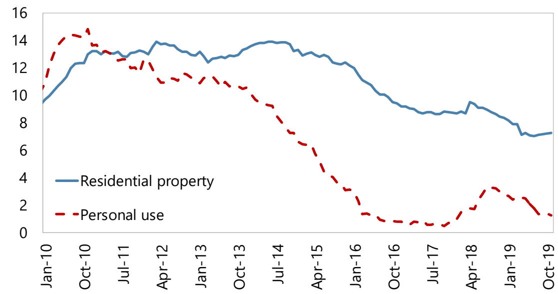
Sources: Bank Negara Malaysia; and IMF staff calculations.
Note: The interest rate spread is defined as difference between the lending rate and the rate on savings deposits.

1/ Financial Soundness Indicators for Malaysia are as indicated, while for the other countries those indicators range between 2019Q1 and 2019Q2 depending on availability.

Figure 9. Malaysia: Household Debt

Housing loan growth has moderated...

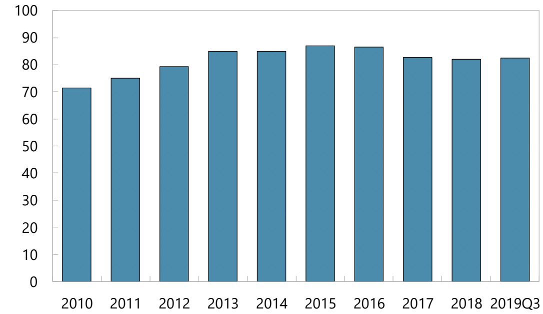
Household Loan Growth
(In Percent, Year-on-Year)



Sources: CEIC Data Co. Ltd; and IMF staff calculations.
Note: This chart is for household loan in the banking system only. The growth rate of loan for personal use has been adjusted by staff to account for the re-classification of a non-bank to bank in April 2018.

...overall household debt is stable as a share of GDP.

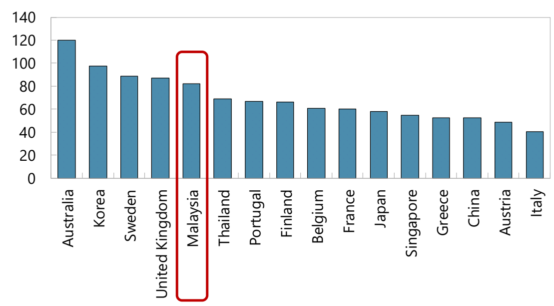
Household Debt
(In Percent of GDP)



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

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

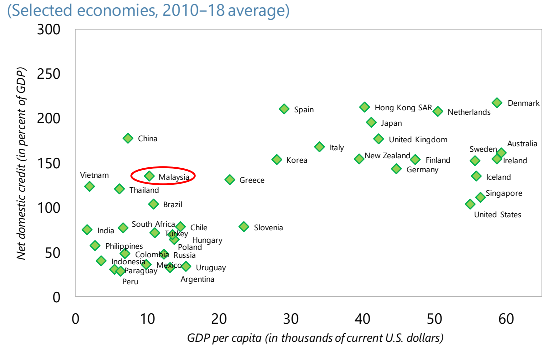
Household Debt, 2018
(In Percent of GDP; End of Period)



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

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

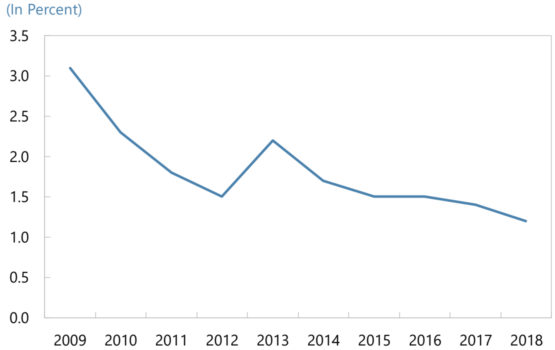
Net Domestic Credit and GDP per Capita
(Selected economies, 2010–18 average)



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

Household non-performing loans continue to decline and remain at a low level.

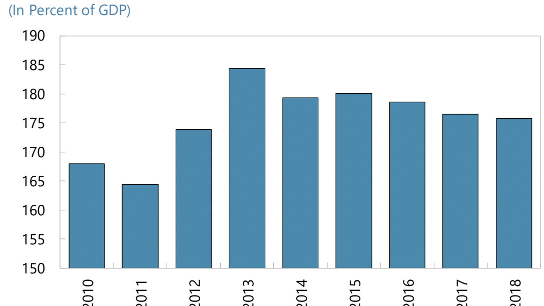
Malaysia - Household Sector NPLs
(In Percent)



Sources: Bank Negara Malaysia and Haver Analytics.

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

Household Financial Assets
(In Percent of GDP)

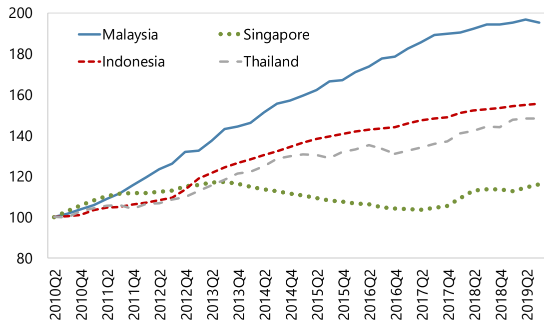


Sources: Bank Negara Malaysia; Malaysian Employee Provident Fund; CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 10. Malaysia: House Prices

House price growth has exceeded peers, but prices have recently stabilized…

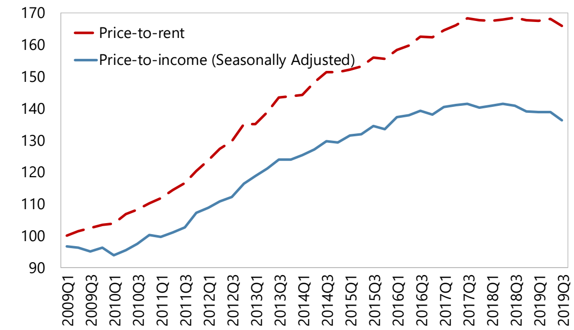
House Price Index
(2010:Q2 = 100)



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

…including relative to income and rents.

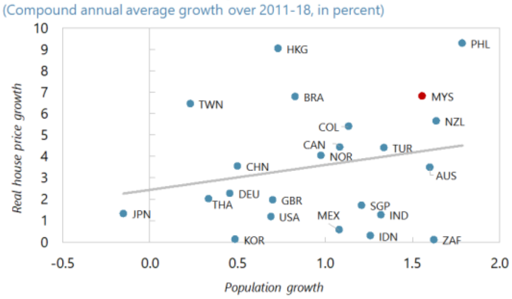
House Prices
(Ratio of indices, 2009:Q1=100)



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.

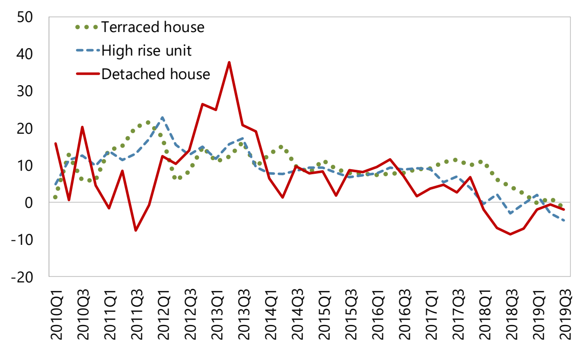
Real House Prices and Population
(Compound annual average growth over 2011-18, in percent)



Sources: CEIC Data Co. Ltd.; and IMF, Research Department database on housing prices, *World Economic Outlook* database, and IMF staff calculations.
Note: Real house prices data for 2018 are the average of 2018Q1-Q2.

The housing market in Kuala Lumpur is moderating.

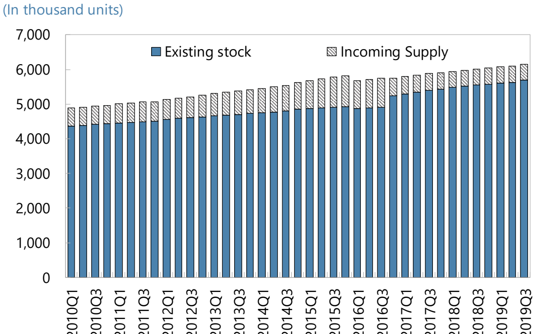
House Prices in Kuala Lumpur
(In Percentage Change; Year-on-year)



Source: CEIC Data Co. Ltd.

Residential supply has been increasing.

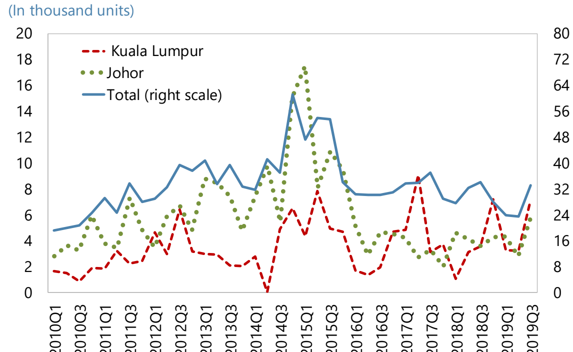
Residential Property Supply
(In thousand units)



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

Overall construction starts slowed, 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, 2015–21

Nominal GDP (2019): US$364 billion
GDP per capita (2019, current prices): US$11,173
Unemployment rate (2019): 3.4 percent

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

Main goods exports (share in total, 2018): electrical & electronics (37.7 percent), commodities (15.6 percent), and petroleum products (7.5 percent).

					Est.	Proj.	
	2015	2016	2017	2018	2019	2020	2021
Real GDP (percent change)	5.0	4.4	5.7	4.7	4.5	4.5	4.9
Total domestic demand 1/	5.8	4.8	6.5	4.3	3.4	5.6	6.3
Private consumption	5.9	5.9	6.9	8.0	7.0	6.2	5.4
Public consumption	4.5	1.1	5.5	3.3	1.7	1.9	1.9
Private investment	7.6	4.5	9.0	4.3	1.0	3.0	5.0
Public gross fixed capital formation	-2.8	-1.0	0.3	-5.0	-11.4	4.8	7.5
Net exports (contribution to growth, percentage points)	-0.3	0.0	-0.3	0.8	1.4	-0.7	-0.9
Saving and investment (in percent of GDP)							
Gross domestic investment	25.4	26.0	25.6	23.6	22.0	22.1	22.9
Gross national saving	28.4	28.4	28.4	25.7	25.5	24.8	24.8
Fiscal sector (in percent of GDP) 2/							
Federal government overall balance	-3.2	-3.1	-2.9	-3.7	-3.4	-3.2	-3.0
Revenue	18.6	17.0	16.1	16.1	17.4	15.1	15.1
Expenditure and net lending	21.8	20.1	19.0	19.8	18.3	18.3	18.1
Tax refunds (Arrears) 3/					2.4		
Federal government non-oil primary balance	-5.1	-3.4	-3.4	-5.3	-6.6	-4.1	-4.1
Consolidated public sector overall balance 4/	-7.6	-5.0	-3.6	-4.6	-6.3	-5.6	-5.2
General government debt 4/	57.0	55.8	54.4	55.6	57.1	57.0	56.5
Of which: federal government debt	53.6	51.9	50.1	51.2	52.7	52.6	52.1
Inflation and unemployment (annual average, in percent)							
CPI inflation	2.1	2.1	3.7	1.0	0.7	2.1	2.1
CPI inflation (excluding food and energy)	3.2	2.6	1.6	0.4	1.2	2.0	2.1
Unemployment rate	3.2	3.5	3.4	3.3	3.4	3.4	3.4
Macrofinancial variables (end of period)							
Broad money (percentage change) 5/	3.0	2.7	4.8	7.7	4.8	6.7	7.1
Credit to private sector (percentage change) 5/	8.6	5.3	5.4	8.3	5.4	7.1	7.1
Credit-to-GDP ratio (in percent) 6/ 7/	132.5	131.9	126.7	130.1	130.9	131.4	131.4
Credit-to-GDP gap (in percent) 6/ 7/	13.5	9.4	2.5	1.7	0.6	...	...
Overnight policy rate (in percent)	3.25	3.00	3.00	3.25	3.00	...	...
Three-month interbank rate (in percent)	3.8	3.4	3.5	3.6	3.3	...	...
Nonfinancial corporate sector debt (in percent of GDP) 8/	105.0	108.0	101.5	103.0	99.4	...	...
Nonfinancial corporate sector debt issuance (in percent of GDP)	2.6	3.1	3.3	2.0	1.4	...	...
Household debt (in percent of GDP) 8/	86.9	86.5	82.7	82.0	81.9	...	...
Household financial assets (in percent of GDP) 8/	180.1	178.6	176.5	175.8	...	...	...
House prices (percentage change)	7.4	7.1	6.5	3.3	1.5	...	...
Exchange rates (period average)							
Malaysian ringgit/U.S. dollar	3.91	4.15	4.30	4.04	4.16	...	...
Real effective exchange rate (percentage change)	-8.5	-3.4	-1.6	4.1	-2.0	...	...
Balance of payments (in billions of U.S. dollars) 6/							
Current account balance	9.0	7.2	8.9	7.5	12.7	10.3	7.9
(In percent of GDP)	3.0	2.4	2.8	2.1	3.5	2.7	1.9
Goods balance	28.0	24.6	27.2	29.5	28.5	27.1	26.0
Services balance	-5.3	-4.6	-5.3	-4.5	-2.3	-2.5	-3.2
Income balance	-13.7	-12.8	-13.0	-17.6	-13.5	-14.3	-14.9
Capital and financial account balance	-14.5	0.0	-1.1	4.6	-9.2	-7.4	-4.5
Of which: Direct investment	-0.5	3.3	3.8	2.8	4.5	4.6	4.7
Errors and omissions	-8.3	-5.8	-4.0	-10.2	-1.5	0.0	0.0
Overall balance	-13.7	1.4	3.8	1.9	2.0	2.9	3.4
Gross official reserves (US$ billions) 6/ 9/	95.3	94.5	102.4	101.4	103.4	106.4	109.8
(In months of following year's imports of goods and nonfactor services)	6.3	5.6	5.6	5.8	5.7	5.6	5.5
(In percent of short-term debt by original maturity)	116.2	112.2	117.8	103.4	104.2	112.6	118.6
(In percent of short-term debt by remaining maturity)	74.4	83.2	93.7	84.9	85.5	91.3	95.4
Total external debt (in billions of U.S. dollars) 6/ 9/	195.0	203.8	218.8	223.8	227.0	224.7	225.4
(In percent of GDP)	64.7	67.7	68.6	62.4	62.4	58.7	54.9
Of which: short-term (in percent of total, original maturity)	42.0	41.3	39.7	43.8	43.7	42.0	41.1
short-term (in percent of total, remaining maturity)	65.7	55.7	50.0	53.4	53.3	51.9	51.1
Debt service ratio 6/							
(In percent of exports of goods and services) 10/	21.5	23.4	14.0	10.6	10.9	10.7	10.4
(In percent of exports of goods and nonfactor services)	22.7	24.8	14.8	11.2	11.6	11.4	11.1
Memorandum items:							
Nominal GDP (in billions of ringgit)	1,177	1,250	1,372	1,447	1,516	1,617	1,731

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

1/ Based on data provided by the authorities except for 2015 data which is estimated using splicing methodology by IMF.

2/ 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.

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

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

5/ Based on data provided by the authorities, but follows compilation methodology used in IMF's *Integrated Monetary Database*. Credit to private sector in 2018 onwards includes data for a newly licensed commercial bank from April 2018. The impact of this bank is excluded in the calculation of credit gap.

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

7/ 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.

8/ Revisions in historical data reflect the change in base year for nominal GDP (from 2010=100 to 2015=100).

9/ The decrease in short-term debt by remaining maturity in 2017 was partly due to the implementation of an improved data compilation system that corrected previous overestimation.

10/ Includes receipts under the primary income account.

Table 2. Malaysia: Indicators of External Vulnerability, 2015–19

	2015	2016	2017	2018	2019 1/
Financial indicators					
General government debt (in percent of GDP) 2/	57.0	55.8	54.4	55.6	57.1
Broad money (end of period, year-on-year percent change) 3/	3.0	2.7	4.8	7.7	4.8
Private sector credit (end of period, year-on-year percent change) 3/	8.6	5.3	5.4	8.3	5.4
3-month interest rate (percent, 12-month average) 4/	3.7	3.6	3.4	3.7	3.5
External indicators 5/					
Goods exports, f.o.b. (percent change, 12-month basis, in U.S. dollars terms) 6/	-15.9	-5.1	12.5	10.8	-5.0
Goods imports, f.o.b. (percent change, 12-month basis, in U.S. dollars terms) 6/	-15.2	-3.7	12.9	11.1	-5.3
Current account balance (12-month basis, in billions of U.S. dollars) 6/	9.0	7.2	8.9	7.5	12.7
Current account balance (12-month basis, in percent of GDP)	3.0	2.4	2.8	2.1	3.5
Capital and financial account balance (12-month basis, in billions of U.S. dollars) 6/	-14.5	0.0	-1.1	4.6	-9.2
Gross official reserves (in billions of U.S. dollars)	95.3	94.5	102.4	101.4	103.2
In months of following year's imports of goods and nonfactor services 6/	6.3	5.6	5.6	5.8	5.7
As percent of broad money 3/ 6/	26.2	26.4	24.7	23.2	22.6
As percent of monetary base 3/ 6/	297.9	300.1	281.2	269.5	270.6
Total short-term external debt by: 6/ 7/					
Original maturity (in billions of U.S. dollars)	82.0	84.3	86.9	98.1	99.2
Remaining maturity (in billions of U.S. dollars)	128.1	113.6	109.3	119.4	120.9
Original maturity to reserves (in percent)	86.0	89.1	84.9	96.7	96.2
Original maturity to total external debt (in percent)	42.0	41.3	39.7	43.8	43.7
Remaining maturity to reserves (in percent)	134.4	120.1	106.7	117.7	117.2
Remaining maturity to total external debt (in percent)	65.7	55.7	50.0	53.4	53.3
Total external debt (in billions of U.S. dollars) 6/ 7/	195.0	203.8	218.8	223.8	227.0
Of which: public sector (medium- and long-term (MLT))	70.1	71.5	77.9	73.0	75.6
Total external debt to exports of goods and services (in percent) 6/ 8/	87.9	95.9	92.7	86.1	90.2
External amortization of MLT debt to exports of goods and services (in percent) 6/ 8/	19.9	21.7	12.4	8.6	8.5
Financial market indicators					
Kuala Lumpur Composite Index (KLCI), end of period	1,693	1,642	1,797	1,691	1,589
10-year government securities yield (percent per annum, average)	4.0	3.8	4.0	4.1	3.6

Sources: Haver Analytics; CEIC Data Co. Ltd.; data provided by the authorities; and IMF, *Integrated Monetary Database* and staff estimates.
1/ Latest available data or IMF staff estimates.
2/ Gross debt. General government includes the federal government, state and local governments, and the statutory bodies.
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, 2015–24 1/

					Est.	Proj.				
	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
	(In billions of U.S. dollars)									
Current account balance	9.0	7.2	8.9	7.5	12.7	10.3	7.9	7.5	6.8	6.1
Goods balance	28.0	24.6	27.2	29.5	28.5	27.1	26.0	27.0	27.6	28.2
Exports, f.o.b.	174.4	165.6	186.4	206.4	196.0	202.7	209.2	218.8	229.5	241.6
Imports, f.o.b.	146.5	141.0	159.1	176.9	167.5	175.6	183.2	191.9	201.9	213.4
Services balance	-5.3	-4.6	-5.3	-4.5	-2.3	-2.5	-3.2	-4.0	-4.7	-5.6
Receipts	34.8	35.6	37.1	40.1	40.5	41.0	41.4	41.9	42.5	43.0
Payments	40.1	40.1	42.4	44.6	42.9	43.5	44.6	45.9	47.2	48.6
Primary income	-8.2	-8.3	-9.0	-12.8	-8.4	-9.0	-9.2	-9.4	-9.5	-9.5
Secondary income	-5.5	-4.5	-4.0	-4.8	-5.0	-5.3	-5.7	-6.1	-6.5	-7.0
Capital and financial account balance	-14.5	0.0	-1.1	4.6	-9.2	-7.4	-4.5	-3.4	-0.8	0.7
Capital account	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-14.2	-0.1	-1.1	4.6	-9.2	-7.4	-4.5	-3.4	-0.8	0.7
Direct investment	-0.5	3.3	3.8	2.8	4.5	4.6	4.7	4.9	5.1	5.2
Portfolio investment	-6.7	-3.4	-3.6	-11.0	-8.7	-2.1	-2.0	-0.4	-0.1	0.2
Other investment	-7.0	0.0	-1.3	12.8	-5.0	-9.8	-7.2	-7.9	-5.9	-4.7
Errors and omissions	-8.3	-5.8	-4.0	-10.2	-1.5	0.0	0.0	0.0	0.0	0.0
Overall balance	-13.7	1.4	3.8	1.9	2.0	2.9	3.4	4.1	6.0	6.9
Gross official reserves	95.3	94.5	102.4	101.4	103.4	106.4	109.8	113.8	119.8	126.7
In months of following year's imports of goods and nonfactor services	6.3	5.6	5.6	5.8	5.7	5.6	5.5	5.5	5.5	5.5
In percent of short-term debt 2/ 3/	74.4	83.2	93.7	84.9	85.5	91.3	95.4	100.1	104.4	107.8
	(In percent of GDP)									
Current account balance	3.0	2.4	2.8	2.1	3.5	2.7	1.9	1.7	1.4	1.2
(Excluding crude oil and liquefied natural gas)	-1.7	-0.9	-0.9	-1.7	1.1	0.2	-0.7	-0.8	-0.9	-1.0
Goods balance	9.3	8.2	8.5	8.2	7.8	7.1	6.3	6.1	5.9	5.6
Exports, f.o.b.	57.9	55.0	58.4	57.6	53.8	52.9	51.0	49.8	48.7	47.8
Imports, f.o.b.	48.6	46.8	49.9	49.3	46.0	45.8	44.6	43.7	42.9	42.2
Services balance	-1.8	-1.5	-1.7	-1.2	-0.6	-0.7	-0.8	-0.9	-1.0	-1.1
Primary income	-2.7	-2.8	-2.8	-3.6	-2.3	-2.3	-2.2	-2.1	-2.0	-1.9
Secondary income	-1.8	-1.5	-1.3	-1.3	-1.4	-1.4	-1.4	-1.4	-1.4	-1.4
Capital and financial account balance	-4.8	0.0	-0.3	1.3	-2.5	-1.9	-1.1	-0.8	-0.2	0.1
Direct investment	-0.2	1.1	1.2	0.8	1.2	1.2	1.2	1.1	1.1	1.0
	(Annual percentage change)									
Memorandum items:										
Goods trade										
Exports, f.o.b., value growth (in U.S. dollars) 1/	-15.9	-5.1	12.5	10.8	-5.0	3.4	3.2	4.6	4.9	5.3
Export volume growth 4/	6.3	2.6	11.1	5.5	-7.6	3.2	3.1	4.1	4.1	4.1
Imports, f.o.b., value growth (in U.S. dollars) 1/	-15.2	-3.7	12.9	11.1	-5.3	4.9	4.3	4.7	5.2	5.7
Import volume growth 4/	1.1	0.6	12.9	3.1	-7.6	5.6	4.2	4.1	4.5	4.5
Terms of trade	-3.4	-3.3	1.1	-2.4	0.2	1.0	0.0	-0.1	0.0	0.0
Net international investment position 1/										
(In billions of U.S. dollars)	25.4	15.6	-7.5	-18.8	…	…	…	…	…	…
(In percent of GDP)	8.4	5.2	-2.4	-5.2	…	…	…	…	…	…

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.
3/ The decrease in short-term debt by remaining maturity in 2017 was partly due to the implementation of an improved data compilation system that corrected previous overestimation.
4/ Export and import volume growth in 2015-2018 is calculated using official export and import volume indices (2010=100).

Table 4. Malaysia: Illustrative Medium-Term Macroeconomic Framework, 2015–24 1/

	2015	2016	2017	2018	Est. 2019	Proj. 2020	2021	2022	2023	2024
Real sector (percent change)										
Real GDP growth	5.0	4.4	5.7	4.7	4.5	4.5	4.9	4.8	4.8	4.8
Total domestic demand	5.8	4.8	6.5	4.3	3.4	5.6	6.3	5.0	5.1	5.2
Of which: Private consumption	5.9	5.9	6.9	8.0	7.0	6.2	5.4	5.2	5.1	5.1
Public consumption	4.5	1.1	5.5	3.3	1.7	1.9	1.9	2.0	2.0	2.0
Private investment	7.6	4.5	9.0	4.3	1.0	3.0	5.0	5.5	5.5	5.5
Public gross fixed capital formation	-2.8	-1.0	0.3	-5.0	-11.4	4.8	7.5	8.0	7.5	7.5
Output gap (in percent) 2/	0.3	0.0	0.7	0.4	0.0	-0.3	-0.1	-0.1	0.0	0.0
Consumer prices (period average)	2.1	2.1	3.7	1.0	0.7	2.1	2.1	2.2	2.2	2.2
Consumer prices, excluding food and energy (period average) 2/	3.2	2.6	1.6	0.4	1.2	2.0	2.1	2.1	2.1	2.1
GDP deflator	-0.4	1.7	3.8	0.7	0.3	2.1	2.1	2.1	2.1	2.3
Saving and investment (in percent of GDP)										
Gross domestic investment	25.4	26.0	25.6	23.6	22.0	22.1	22.9	23.2	23.7	24.2
Private, including stocks	16.4	17.4	17.6	16.4	15.8	15.9	16.5	16.7	16.9	17.2
Of which: gross fixed capital formation	16.8	16.9	17.1	17.0	16.6	16.3	16.4	16.5	16.7	16.8
Public	9.0	8.6	8.0	7.2	6.2	6.2	6.4	6.6	6.8	7.0
Gross national saving	28.4	28.4	28.4	25.7	25.5	24.8	24.8	24.9	25.1	25.4
Private 3/	23.9	22.2	22.3	20.4	19.1	21.2	21.3	21.4	21.6	21.8
Public 3/	4.5	6.2	6.1	5.3	6.4	3.5	3.6	3.6	3.6	3.6
Fiscal sector (in percent of GDP)										
Federal government										
Revenue	18.6	17.0	16.1	16.1	17.4	15.1	15.1	15.0	14.9	14.9
Tax	14.1	13.6	13.0	12.0	11.9	11.8	11.8	11.8	11.8	11.7
Nontax	4.6	3.4	3.1	4.1	5.5	3.4	3.3	3.2	3.2	3.2
Expenditure and net lending	21.8	20.1	19.0	19.8	18.3	18.3	18.1	18.1	18.0	18.0
Current	18.3	16.8	15.8	15.9	14.9	14.9	14.9	14.8	14.6	14.6
Development	3.5	3.3	3.2	3.9	3.5	3.4	3.3	3.3	3.3	3.4
Overall balance	-3.2	-3.1	-2.9	-3.7	-3.4	-3.2	-3.0	-3.0	-3.0	-3.0
Cyclically-adjusted balance (in percent of potential GDP) 2/	-2.6	-2.6	-2.9	-4.8	-3.1	-3.2	-3.0	-3.0	-3.0	-3.0
Nonoil and gas primary balance	-5.1	-3.4	-3.4	-5.3	-6.6	-4.1	-4.1	-4.1	-4.1	-4.1
Federal government debt	53.6	51.9	50.1	51.2	52.7	52.6	52.1	51.8	51.4	51.0
Balance of payments (in billions of U.S. dollars) 2/										
Goods balance	28.0	24.6	27.2	29.5	28.5	27.1	26.0	27.0	27.6	28.2
Services balance	-5.3	-4.6	-5.3	-4.5	-2.3	-2.5	-3.2	-4.0	-4.7	-5.6
Income balance	-13.7	-12.8	-13.0	-17.6	-13.5	-14.3	-14.9	-15.5	-16.1	-16.5
Current account balance	9.0	7.2	8.9	7.5	12.7	10.3	7.9	7.5	6.8	6.1
(In percent of GDP)	3.0	2.4	2.8	2.1	3.5	2.7	1.9	1.7	1.4	1.2
Capital and financial account balance	-14.5	0.0	-1.1	4.6	-9.2	-7.4	-4.5	-3.4	-0.8	0.7
Of which: Direct investment	-0.5	3.3	3.8	2.8	4.5	4.6	4.7	4.9	5.1	5.2
Errors and omissions	-8.3	-5.8	-4.0	-10.2	-1.5	0.0	0.0	0.0	0.0	0.0
Overall balance	-13.7	1.4	3.8	1.9	2.0	2.9	3.4	4.1	6.0	6.9
International trade in goods (annual percent change) 2/										
Goods exports, f.o.b. (in U.S. dollars terms)	-15.9	-5.1	12.5	10.8	-5.0	3.4	3.2	4.6	4.9	5.3
Goods imports, f.o.b. (in U.S. dollars terms)	-15.2	-3.7	12.9	11.1	-5.3	4.9	4.3	4.7	5.2	5.7
Terms of trade	-3.4	-3.3	1.1	-2.4	0.2	1.0	0.0	-0.1	0.0	0.0
Gross official reserves (in billions of U.S. dollars) 4/	95.3	94.5	102.4	101.4	103.4	106.4	109.8	113.8	119.8	126.7
(In months of following year's imports of goods and nonfactor services)	6.3	5.6	5.6	5.8	5.7	5.6	5.5	5.5	5.5	5.5
(In percent of short-term debt by original maturity) 2/	116.2	112.2	117.8	103.4	104.2	112.6	118.6	125.9	132.0	136.6
(In percent of short-term debt by remaining maturity) 2/	74.4	83.2	93.7	84.9	85.5	91.3	95.4	100.1	104.4	107.8
Total external debt (in billions of U.S. dollars) 2/ 4/	195.0	203.8	218.8	223.8	227.0	224.7	225.4	227.4	232.1	238.9
(In percent of GDP)	64.7	67.7	68.6	62.4	62.4	58.7	54.9	51.8	49.3	47.3
Short-term external debt (percent of total, original maturity)	42.0	41.3	39.7	43.8	43.7	42.0	41.1	39.8	39.1	38.8
Short-term external debt (percent of total, remaining maturity)	65.7	55.7	50.0	53.4	53.3	51.9	51.1	50.0	49.4	49.2
Debt-service ratio 2/ 4/										
(In percent of exports of goods and nonfactor services)	22.7	24.8	14.8	11.2	11.6	11.4	11.1	10.8	10.8	10.8
Net international investment position (in billions of U.S. dollars) 2/	25.4	15.6	-7.5	-18.8	...	...	...	...	...	...
Memorandum items:										
Nominal GDP (in billions of ringgit)	1,177	1,250	1,372	1,447	1,516	1,617	1,731	1,851	1,982	2,124

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/ IMF staff estimates are used 2015 onward.

4/ The decrease in short-term debt by remaining maturity in 2017 was partly due to the implementation of an improved data compilation system that corrected previous overestimation.

Table 5. Malaysia: Summary of Federal Government Operations and Stock Positions, 2016–24

				Est.	Proj.				
	2016	2017	2018	2019	2020	2021	2022	2023	2024
I. Statement of Government Operations 1/				(In billions of ringgit)					
Revenue	212.4	220.4	232.9	263.3	244.6	261.7	278.2	296.2	317.3
Taxes	169.3	177.7	174.1	180.0	190.0	204.3	218.4	232.9	248.9
Direct taxes	109.6	116.0	130.0	135.6	142.7	154.3	165.1	176.0	188.1
Indirect taxes	59.7	61.6	44.0	44.4	47.3	50.0	53.3	56.9	60.8
Non-tax revenue	43.1	42.7	58.8	83.3	54.6	57.4	59.8	63.2	68.3
Investment income	21.4	21.6	31.9	59.5	28.6	27.6	28.0	29.4	32.2
Other revenue	21.7	21.1	26.9	23.8	26.0	29.7	31.8	33.8	36.1
Expenditure and net lending	250.8	260.7	286.3	278.1	296.4	314.0	334.4	355.5	381.1
Expense	209.5	217.2	230.5	225.3	241.1	257.4	273.2	289.9	309.3
Compensation of employees	73.1	77.0	80.0	82.0	82.6	88.4	94.6	101.3	108.5
Use of goods and services	30.1	34.7	35.3	30.2	38.5	41.3	44.1	47.2	50.6
Interest	26.5	27.9	30.5	33.0	34.9	35.5	36.4	37.2	39.3
Subsidies	24.7	22.4	27.5	23.6	24.2	26.9	28.7	30.6	32.5
Grants and transfers	33.2	31.3	30.9	28.2	32.9	33.8	36.2	38.2	40.4
Social benefits and other expense	21.9	23.8	26.3	28.3	27.9	31.4	33.1	35.4	38.0
Net acquisition of nonfinancial assets 2/	41.3	43.5	55.8	52.8	55.2	56.6	61.3	65.6	71.8
Gross operating balance	2.9	3.2	2.4	38.0	3.5	4.2	5.0	6.2	7.9
Net lending/borrowing	-38.4	-40.3	-53.4	-14.8	-51.8	-52.4	-56.2	-59.4	-63.9
Tax refunds (Arrears) 3/				-37.0					
Overall fiscal balance (authorities' definition) 1/	-38.4	-40.3	-53.4	-51.8	-51.8	-52.4	-56.2	-59.4	-63.9
				(In percent of GDP)					
Revenue	17.0	16.1	16.1	17.4	15.1	15.1	15.0	14.9	14.9
Taxes	13.6	13.0	12.0	11.9	11.8	11.8	11.8	11.8	11.7
Direct taxes	8.8	8.5	9.0	8.9	8.8	8.9	8.9	8.9	8.9
Indirect taxes	4.8	4.5	3.0	2.9	2.9	2.9	2.9	2.9	2.9
Non-tax revenue	3.4	3.1	4.1	5.5	3.4	3.3	3.2	3.2	3.2
Investment income	1.7	1.6	2.2	3.9	1.8	1.6	1.5	1.5	1.5
Other revenue	1.7	1.5	1.9	1.6	1.6	1.7	1.7	1.7	1.7
Expenditure and net lending	20.1	19.0	19.8	18.3	18.3	18.1	18.1	17.9	17.9
Expense	16.8	15.8	15.9	14.9	14.9	14.9	14.8	14.6	14.6
Compensation of employees	5.9	5.6	5.5	5.4	5.1	5.1	5.1	5.1	5.1
Use of goods and services	2.4	2.5	2.4	2.0	2.4	2.4	2.4	2.4	2.4
Interest	2.1	2.0	2.1	2.2	2.2	2.1	2.0	1.9	1.8
Subsidies	2.0	1.6	1.9	1.6	1.5	1.6	1.6	1.5	1.5
Grants and transfers	2.7	2.3	2.1	1.9	2.0	2.0	2.0	1.9	1.9
Social benefits and other expense	1.8	1.7	1.8	1.9	1.7	1.8	1.8	1.8	1.8
Net acquisition of nonfinancial assets 2/	3.3	3.2	3.9	3.5	3.4	3.3	3.3	3.3	3.4
Gross operating balance	0.2	0.2	0.2	2.5	0.2	0.2	0.3	0.3	0.4
Net lending/borrowing	-3.1	-2.9	-3.7	-1.0	-3.2	-3.0	-3.0	-3.0	-3.0
Tax refunds (Arrears) 3/				-2.4					
Overall fiscal balance (authorities' definition) 1/	-3.1	-2.9	-3.7	-3.4	-3.2	-3.0	-3.0	-3.0	-3.0
II. Stock Positions				(In billions of ringgit)					
Federal government debt	648.5	686.8	741.0	799.1	850.9	902.7	958.9	1,018.3	1,082.1
(In percent of GDP)	51.9	50.1	51.2	52.7	52.6	52.1	51.8	51.4	51.0
By instrument									
Domestic debt	624.8	665.6	719.5	769.9					
Offshore borrowing	23.7	21.3	21.5	29.2					
By holder residence									
Domestic	438.2	484.0	558.6	593.5					
Foreign	210.2	202.8	182.5	205.6					
Memorandum items:									
Structural balance (percent of potential GDP) 4/	-2.6	-3.0	-4.8	-3.1	-3.2	-3.0	-3.0	-3.0	-3.0
Structural primary balance (percent of potential GDP) 4/	-0.5	-0.9	-2.7	-0.9	-1.1	-1.0	-1.0	-1.1	-1.1
Primary balance (percent of GDP)	-1.0	-0.9	-1.5	-1.2	-1.0	-1.0	-1.1	-1.1	-1.2
Nonoil and gas primary balance (percent of GDP) 4/	-3.4	-3.4	-5.3	-6.6	-4.1	-4.1	-4.1	-4.1	-4.1
Oil and gas revenues (percent of GDP)	2.5	2.5	3.8	5.3	3.1	3.1	3.0	2.9	2.9
General government debt (percent of GDP) 5/	55.8	54.4	55.6	57.1	57.0	56.5	56.2	55.8	55.4
General government balance (percent of GDP) 5/	-2.6	-2.4	-3.3	-3.2	-3.1	-2.7	-2.7	-2.7	-2.7
Public sector balance (percent of GDP)	-5.0	-3.6	-4.6	-6.3	-5.6	-5.2	-5.3	-5.3	-5.4
Nominal GDP (in billions of ringgit)	1,250	1,372	1,447	1,516	1,617	1,731	1,851	1,982	2,124

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, 2015–21 1/

					Est.	Proj.	
	2015	2016	2017	2018	2019	2020	2021
	(In billions of ringgit; end of period)						
Net foreign assets	359.7	361.2	333.1	306.1	310.9	327.4	341.5
Foreign assets	592.8	584.6	583.4	584.0	593.9	609.9	626.1
Foreign liabilities	233.1	223.4	250.3	277.9	283.0	282.5	284.6
Net domestic assets	1,213.4	1,254.0	1,359.6	1,518.3	1,600.0	1,709.7	1,838.4
Net domestic credit	1,640.6	1,749.6	1,857.1	2,026.6	2,138.8	2,289.4	2,459.0
Net credit to nonfinancial public sector	121.8	142.2	161.7	195.0	209.1	223.3	247.0
Net credit to central government	105.0	125.3	144.4	170.9	184.9	198.9	222.5
Net credit to state & local government	1.2	1.0	1.9	1.9	2.0	2.1	2.3
Net credit to nonfinancial corporations	15.6	15.9	15.4	22.1	22.2	22.2	22.3
Credit to private sector 2/	1,448.6	1,524.9	1,607.6	1,741.7	1,835.5	1,965.7	2,104.4
Net credit to other financial corporations	70.2	82.5	87.8	89.9	94.2	100.5	107.6
Capital accounts	375.2	413.7	423.2	439.4	459.4	479.4	499.4
Other items (net)	-52.0	-81.9	-74.3	-68.9	-79.5	-100.4	-121.2
Broad money 3/	1,563.1	1,605.1	1,681.5	1,810.8	1,897.3	2,023.5	2,166.3
Narrow money	399.0	419.5	449.9	454.1	475.8	507.4	543.2
Currency in circulation	76.6	85.5	92.4	94.3	99.0	105.6	113.0
Transferable deposits	322.4	334.0	357.5	359.8	376.8	401.9	430.2
Other deposits	1,142.0	1,160.9	1,199.4	1,314.0	1,372.3	1,463.6	1,566.9
Securities other than shares	22.1	24.6	32.2	42.7	49.2	52.5	56.2
	(Contributions to 12-month growth in broad money, in percentage points)						
Net foreign assets	2.2	0.1	-1.8	-1.6	0.3	0.9	0.7
Net domestic assets	0.9	2.6	6.6	9.4	4.5	5.8	6.4
Memorandum items:							
Broad money (12-month percent change)	3.0	2.7	4.8	7.7	4.8	6.7	7.1
Currency in circulation (12-month percent change)	12.7	11.5	8.1	2.1	5.0	6.7	7.1
Credit to private sector (12-month percent change)	8.6	5.3	5.4	8.3	5.4	7.1	7.1
Money multiplier (broad money/narrow money)	3.9	3.8	3.7	4.0	4.0	4.0	4.0

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/ Actual data as provided by the Malaysian monetary authorities in the Integrated Monetary Database.
3/ 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, 2015–19Q2

	2015	2016	2017	2018	2019 Q2
	(In percent; end of period)				
Capital adequacy					
Regulatory capital to risk-weighted assets	16.7	17.0	17.8	18.1	18.0
Regulatory Tier 1 capital to risk-weighted assets	14.4	14.6	15.0	14.6	14.7
Asset quality					
Nonperforming loans net of provisions to capital 1/	6.8	6.6	6.2	5.1	5.5
Nonperforming loans to total gross loans	1.6	1.6	1.5	1.5	1.6
Earnings and profitability					
Return on assets	1.2	1.3	1.4	1.4	1.5
Return on equity	12.2	12.3	13.1	12.6	13.1
Interest margin to gross income	61.8	61.0	61.1	61.0	56.7
Non-interest expenses to gross income	46.7	44.0	43.2	42.0	41.5
Liquidity					
Liquid assets to total assets (liquid asset ratio)	21.6	20.7	22.0	23.1	23.6
Liquid assets to short-term liabilities	134.0	130.3	138.3	151.0	163.6
Loan-deposit ratio 2/	88.6	89.8	89.6	88.3	87.9
Liquidity Coverage Ratio 3/	125.1	124.3	134.9	143.2	153.0
Sensitivity to market risk					
Net open position in foreign exchange to capital	6.1	6.3	6.1	5.8	4.9
Sectoral distribution of total loans to nonbanking sector					
Residents	96.9	97.3	97.0	97.1	97.4
Other financial corporations	3.1	3.5	3.3	3.2	3.2
General government	1.4	1.6	1.9	2.0	1.9
Nonfinancial corporations	36.8	36.7	35.9	35.5	35.5
Other domestic sectors	55.5	55.5	56.0	56.3	56.8
Nonresidents	3.1	2.7	3.0	2.9	2.6

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. There is a methodology change since 2018 following the implementation of Malaysian Financial Reporting Standards (MFRS) 9.

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.

Appendix I. Staff Policy Advice from the 2018 and 2019 Article IV Consultations

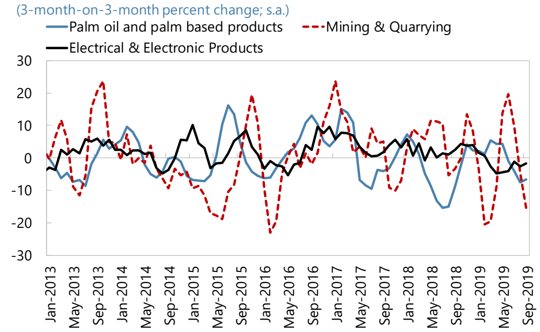
Staff Advice	Policy Actions
Fiscal Policy	
Follow a gradual consolidation path and improve the composition of fiscal adjustment by prioritizing revenue measures (2018, 2019).	The authorities have returned to a fiscal consolidation in 2019. The 2020 budget and the announced average deficit target for 2020-2022 are consistent with the medium-term fiscal consolidation advocated by staff, but specific measures need to be identified.
Broaden the tax base and reduce investment incentives (which are tax expenditures) (2018). At the current juncture, other revenue measures will be needed, such as strengthening the SST, revisiting tax incentives, increase excise taxes, broaden the PIT tax base, and introduce a capital gain tax (2019).	The authorities replaced the GST by the SST, which has narrowed the tax base and created a revenue shortfall. However, they have implemented other, albeit small, revenue measures (a special voluntary disclosure program, a sugar tax, and a departure levy). A Tax Reform Committee established in September 2018 delivered a report to the government in August 2019. Building on this report, and with IMF TA support, the authorities plan to formulate a medium-term revenue strategy.
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 (2018). Introduce targeted and strategic spending reviews on a rolling basis (2019)	After bringing back fuel subsidies in 2018 against staff advice, the authorities plan to target such subsidies to lower income groups starting in 2020. Zero-base budgeting introduced in 2019 contributed to rationalizing current spending.
Enrich the recently introduced Medium Term Fiscal Framework with more detail (2018). Fully integrate in the budget preparation process annual fiscal risks statements (2018). Improve fiscal governance (2019).	The authorities are preparing a Fiscal Responsibility Act. A recently created high-level Debt Management Committee will help enhance fiscal transparency and monitor fiscal risks. With the 2019 budget, the authorities began enhancing their reporting of federal government guarantees and possible future PPP-related payment dues. The 2020 budget included for the first time a complete debt sustainability analysis. The authorities are drafting a Government Procurement Act to enforce open tenders.
Monetary, Exchange Rate, and Financial Policies	
The broadly neutral monetary policy stance is appropriate (2019). Domestic economic and financial considerations should continue to guide monetary policy decisions (2019).	Monetary policy decisions have been data dependent. After staying on hold since January 2018, BNM lowered the policy rate 25 basis points to 3 percent in May 2019 and left it unchanged in subsequent policy meetings. The May rate cut helped bring the policy stance closer to neutrality following a significant drop in inflation expectations and in the context of a closing output gap.
The December 2016 FX measures should be gradually phased out with due regard to market conditions. (2019)	The authorities have implemented measures to deepen the domestic FX market and have requested technical assistance from the IMF to analyze the role of the exchange rate in Malaysia's economy and to deepen FX markets.
The real estate market and household debt require close monitoring (2019).	The authorities continue to closely monitor real estate market related risks. Strong micro-prudential supervision is maintained to ensure sound lending standards. The 2020 budget temporarily lowered the minimum threshold for non-resident purchases of high-rise apartments to reduce oversupply in that market.
Structural and Governance Policies	
Implement governance reforms and anchor them in legislation to secure independence of anti-corruption institutions, freedom of information, and asset declaration (2019).	The authorities have launched a National Anti-Corruption Plan (NACP) in January 2019. As of mid-December 2019, 23 of the 115 initiatives planned under the NACP have been completed and the authorities are working on legislation on asset declaration, independence of the Malaysian Anti-Corruption Authority, and freedom of information.
Raise productivity growth within the framework outlined in the 11th Malaysia Plan (2016–20) (2018), the Mid-term Review of the 11th MP (2019), 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 towards improving governance, accelerating innovation, boosting productivity, moving industries up the value chain, enhancing the wellbeing of the people, particularly the bottom 40 percent of the household income group (B40), and achieving inclusive growth.
To significantly boost productivity and long-term growth the authorities should: 1. Further raise female labor participation; 2. Improve the quality of teachers and the design of curricula, expand vocational and technical training to reduce skill mismatches, raise enrollment in higher education. 3. Encouraging R&D and address the lack of coordination in research, development, commercialization and innovation activities, and the low commercialization of R&D output (2018/19).	1. The government is amending the Employment Act 1955 to increase maternity leave in the private sector and improve working conditions (e.g. increase the penalty for the sexual harassment offences.) The government has implemented flexible working arrangements (FWA) as well as work from home and returning to work initiatives. The Budget 2020 provides cash incentives to promote FLFPR. 2. The government has (i) expanded the Dual Language Program (DLP) from 2018 and (ii) offered specialized programs in niche areas on aerospace, automotive, and furniture manufacturing and implementing National Dual Training System (NDTS) to improve the quality and delivery of TVET programs.
Promote trade openness and a move up the value chain (2019).	Malaysia supports the multilateral trading system, works closely with other countries to finalize a high-standard RCEP agreement, and the CPTPP is still under consideration.
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 (2018/19).	Per the Mid-Term Review of the Eleventh Malaysia Plan, a progressive multi-tiered levy system that is based on the proportion of foreign workers employed will be implemented to strictly reduce and regulate the number of foreign workers by 2021.
Updating public infrastructure and the regulatory framework would help further improve the business environment and support higher private investment, which would help with rebalancing (2018/19).	Following the completion of reviews and renegotiations, several large infrastructure projects will resume in 2020 with improved participation of local companies. The federal government is working with states to speed up their procedures, such as shortening the building permit approval period from 390 to 90 days.

Appendix II Trade and Investment Diversion[1]

1. **As a small open economy, Malaysia has a well-diversified export base and is deeply integrated into regional and global supply chains.** In past decades, Malaysia's trade openness index exceeded 130 percent of GDP.[2] China, Singapore, EU, and the US are its largest trading partners. Malaysia has developed a well-diversified export base and the average export-orientation rate[3] across all manufacturing industries exceeds 60 percent. (Fig. 1, Top panels) The exports of E&E products account for nearly 40 percent of total exports in 2018, a large share of which are shipped to China and regional neighbors as immediate inputs.

2. **Malaysia's exports are affected by the trade tensions between the US and China.** Exports became more volatile following the escalation of trade tensions.[4,5] In particular, since May 2018 the demand for E&E exports has experienced an initial expansion followed by a notable contraction, reflecting the net effect of the growth slowdown in main trading partners, frontloading export orders, and trade diversion. Most recently, after experiencing a 24 percent increase (m/m, seasonally adjusted) in July 2019, E&E exports fell substantially again in August. Commodity exports also recorded larger fluctuations over the past year.

Exports of electronics, mining and palm oil
(3-month-on-3-month percent change; s.a.)



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

3. **The volatile monthly export figures may have masked underlying shifts in the export landscape that could become prominent over the medium term.** Among the three factors discussed above, the China slowdown has been well-documented and the frontloaded export orders is short-lived; therefore, the remainder of this box will exclusively focus on the trade diversion effect. To do so, we make a distinction between (i) the gain from Malaysia's exports to the US where Malaysia directly competes with China (*Type-I diversion*)[6] and (ii) the gain from Malaysia's intermediate goods[7] exports to other countries integrated into global supply chain as the latter is adjusting to trade tensions (*Type-II diversion*).

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[1] Prepared by Xin Li.
[2] Trade openness is measured as the ratio of total exports and imports value to nominal GDP.
[3] Export orientation of an industry refers to the share of total domestic value added in that industry that is embodied (via exports) in foreign final demand. Export orientation is calculated based on the TiVA database (2005-16).
[4] For Malaysia, the standard deviation of monthly E&E export value increased to 8.8 percent during May 2018 to September 2019, from 7.1 percent prior to the trade tensions (Dec 2016 to April 2018).
[5] While most countries in the region experienced weaker trade performance due to the trade tensions, this appendix will focus on Malaysia only.

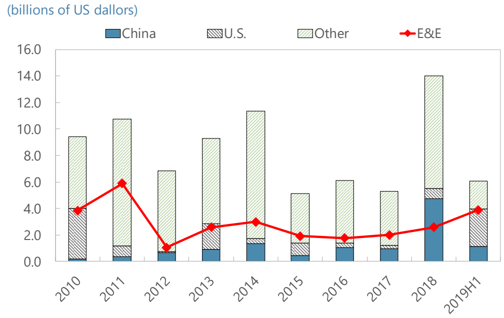
[6] it will be equally helpful to estimate the gain of Malaysia from competing with US exports in the Chinese market. However, this is more difficult due to the limited availability of granular China imports data.
[7] The classification of intermediate goods and final demand is based on the OCED TiVA database.

4. Preliminary estimates by staff show early signs of both type-I and type-II trade diversions.

- **Trade Diversion Type-I**: Malaysia's manufacturing sector has benefited mainly from an increasing share of E&E exports to the US, particularly from its exports of electronic integrated circuits (IC). The average share-effect accounts for about 0.4 percent of GDP between January and September 2019, which gradually outweighs the negative size-effect resulting from the decreasing size of total IC imports of the US.[8] (Fig. 1, center right panel) In addition, Malaysia's exports of furniture to USA grew by 29.5 percent y-o-y during January and October 2019, while its furniture exports to China decreased by 12.5 percent, following import diversion among foreign buyers.
- **Trade Diversion Type-II**: Staff estimates show that Malaysia's intermediate E&E exports to Mainland China and Hong Kong SAR combined[9] declined 6.8 percent y-o-y between January and October 2019. But this drop was compensated by the increase in exports to other markets linked to the US's E&E supply chain, such as the US (10 percent), Taiwan (45 percent), Philippines (21 percent), and Vietnam (20 percent). (Fig. 1, bottom panels)

5. Investment diversion has also emerged. While Malaysia has not yet seen a pickup in actual FDI inflows, the interest from foreign investors has increased compared with 2018, with the approved FDI in the manufacturing sector surging 60.8 percent y-o-y (or US$ 6.1 billion) in 2019H1. The lion's share has come from the US (US$2.8 billion), followed by China (US$1.2 billion) and involves both re-investments from existing US companies and new E&E players coming to Malaysia. Notably, approved FDI to the E&E sector increased to US$3.9 billion in 2019H1 (2018 full year: US$2.6 billion), fueled by high-technology manufacturing firms.

Approved FDIs in the Manufacturing Sector, 2010-2019H1
(billions of US dallors)



Sources: Haver and IMF staff calculations.

6. Coordinated policies are needed to lock in the gain from the emerging trade and investment diversion. As some businesses are relocating away from China, Malaysia is facing direct competition with other potential hosts in the region. In fact, Malaysia has gradually lost its competitiveness in labor intensive industries to neighboring countries due to more costly labor, but

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[8] Size- and share-effects are defined as follows. Let X_t and Y_t be the US imports of ICs from Malaysia and from the world (incl. Malaysia) in year t, respectively, and let α_t be Malaysia's share of total US imports of ICs in year t. That is, $X_t = \alpha_t Y_t$. The change in Malaysia's exports of ICs to the US can be break down into $X_{t+1} - X_t = \alpha_t(Y_{t+1} - Y_t) + Y_t(\alpha_{t+1} - \alpha_t)$, where the first term $\alpha_t(Y_{t+1} - Y_t)$ denotes the size-effect and the second term $Y_t(\alpha_{t+1} - \alpha_t)$ denotes the share-effect.

[9] Exports to China include those via Singapore and Hong Kong SAR.

direct investments with higher knowledge content have tended to stay. The 2020 budget lays out measures to promote digitalization and attract FDI from supply chain shifts[10].

In addition to implementing the 2020 budget measures, the Malaysian government also needs to:

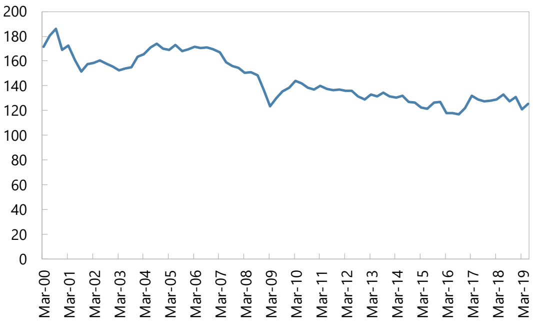
- **Enhance domestic policy clarity amid protracted external uncertainties.** Despite high approved manufacturing FDI since 2018H2, the actual FDI inflows has been lower in subsequent quarters. While it is understood that approved FDI takes about 12-18 months to translate into actual investment, the low FDI inflows in 2019Q2-Q3 could also reflect foreign investors' hesitation in investing in long-term projects in an uncertain external environment. Against this backdrop, it is important to enhance domestic policy clarity to attract high-quality FDI and encourage FDI materialization.

- **Continue to promote open trade.** Despite the benefit from trade diversion, Malaysia like other countries remains worse-off overall from the escalation of trade tensions and the negative confidence effect on the global economy. It is therefore important that Malaysia continue its support for an open and rules-based global trade system. In this vein, finalizing the RCEP negotiations (through joint effort with other nations) and accelerating the review of the CPTPP to reach a decision would help improve competitiveness, increase access to international markets, and attract quality foreign investments.

[10] Among others, these measures include (a) up to 10 year tax break for the E&E sector, (b) RM1bn (US$0.24 billion) of customized incentives annually over 5 years and special investment tax allowance to attract Fortune 500 companies that invest at least RM5bn (US$1.2 billion) each in Malaysia, (c) National Committee on Investment to overcome delays in investment approvals, with additional RM10mn for post approval monitoring and realization (d) up to RM1bn in customized incentives annually over 5 years for local export champions.

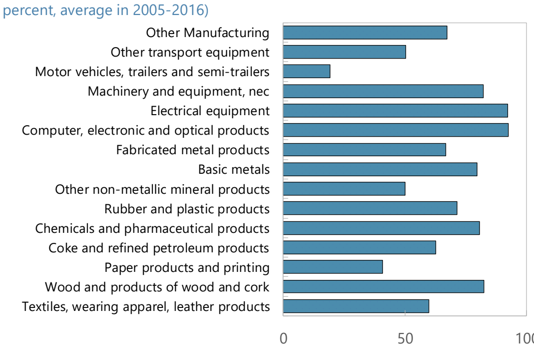
Figure 1. Malaysia: Exports and Trade Diversions

Malaysia: Trade Openness Index
(sum of exports and imports in percent of GDP)



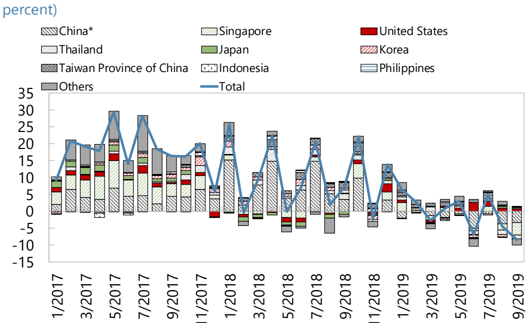
Sources: Haver and IMF staff calculations.

Malaysia: Export Orientation Rate by Industry
(in percent, average in 2005-2016)



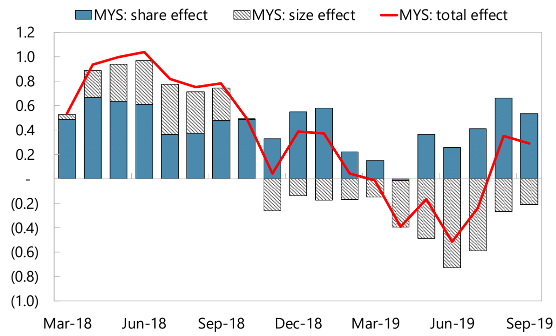
Sources: TiVA and IMF staff calculation.

Growth in Machinery and Transport Equipment Exports
(in percent)



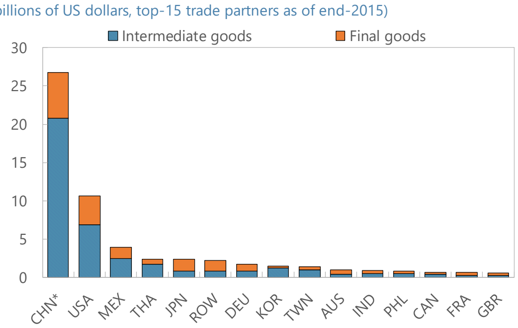
* Mainland China and Hong Kong SAR combined.
Sources: Haver and IMF staff calculation.

Malaysia: Electronic Integrated Circuits Exports to U.S.
(y-o-y change in percent of GDP, 3mma)



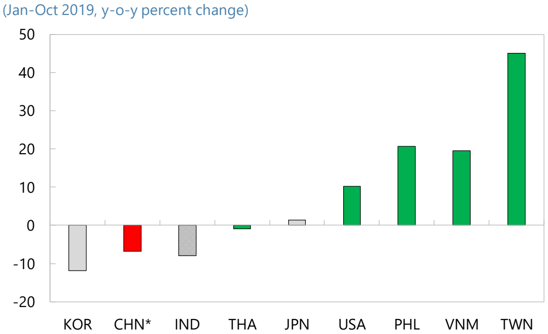
Sources: US Census Bereau and IMF staff calculation.

Malaysia: Intermediate and Final Goods Exports (E&E Sector)
(in billions of US dollars, top-15 trade partners as of end-2015)



* Exports to China include those via Singapore and Hong Kong SAR.
Sources: OCED TiVA database and IMF staff calculation.

Type-II Trade Diversion: Exports of Intermediate E&E Products
(Jan-Oct 2019, y-o-y percent change)



* Exports to China include those via Singapore and Hong Kong SAR.
Sources: OCED TiVA database, DOSM, and IMF staff calculation.

Appendix III. Risk Assessment Matrix 1/

Risks	Likelihood and Transmission	Expected Impact of Risk	Recommended Policy Responses
External			
Sharp rise in risk premia (Short-term).	**High** An abrupt deterioration in market sentiment (e.g., prompted by policy surprises, renewed stresses in emerging markets, or a disorderly Brexit) could trigger risk-off events such as recognition of underpriced risk. Higher risk premia cause higher debt service and refinancing risks; stress on leveraged firms, households, and vulnerable sovereigns; disruptive corrections to stretched asset valuations; and capital account pressures—all depressing growth.	**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 can act as a shock absorber. If capital outflows threaten domestic activity, reserve requirements could be relaxed.
Rising protectionism and retreat from multilateralism (Short- to medium-term).	**High** In the near term, escalating and unpredictable trade actions and a WTO dispute settlement system under threat imperil the global trade system and international cooperation. Additional barriers, including investment and trade restrictions in technology sectors, and the threat of new actions reduce growth both directly, and through adverse confidence effects and financial market volatility. In the medium term, geopolitical competition, protracted tensions, and fraying consensus about the benefits of globalization lead to economic fragmentation and undermine the global rules-based order, with adverse effects on investment, growth, and stability.	**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).	Support for multilateralism and the global trading system, and ongoing efforts to accelerate the ASEAN regional integration agenda, and pursue new, high-standard regional trade agreements, 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 shock absorber.
Weaker-than-expected global growth (Short to medium-term).	Idiosyncratic factors in the U.S., Europe, and China, feed off each other to result in a synchronized and prolonged growth slowdown: (Medium)	**Medium** Weaker than expected external demand would reduce exports and activity in the manufacturing sector, and therefore increasing unemployment, slowing domestic demand, 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.
Further build-up of financial vulnerabilities (Medium Term**)**	**High** Although the turn in the monetary policy cycle toward easing provides a reprieve for risky assets, it encourages risk taking through underpricing of risk and reduces financial resilience to shocks and risk-off events.	**Low/Medium** These developments could result in substantial capital inflows, increase in asset prices, FX appreciation, possibly followed by a bust cycle with resulting slowdown of growth and heightened vulnerabilities in financial and corporate sectors.	The exchange rate should be allowed to continue to act as a shock absorber, where inflow episodes would allow for a gradual FX reserve build up, and macroprudential policies applied to address financial stability risks.
Large swings in energy prices (Medium-term).	**Medium** Risks to prices are broadly balanced, reflecting offsetting—but large and uncertain—supply and demand shocks. In the near term, uncertainty surrounding the shocks translates to elevated price volatility, complicating economic management and adversely affecting investment in the energy sector. As shocks materialize, they may cause large and persistent price swings.	**Low** 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.
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 policy 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.
Stronger-than-expected growth impact of budgetary measures	**Medium** The 2020 budget strikes a balance between fiscal consolidation and growth. The authorities remain committed to medium-term fiscal consolidation which could lead to higher growth and positive confidence effects.	**Medium** Stronger growth through increased confidence, investment and domestic demand.	The exchange rate should be allowed to continue to act as a shock absorber, where inflow episodes would allow for a gradual FX reserve build up. Continue implementing structural reform priorities to increase productivity and growth.
Cyber-attacks (Short- to medium-term)	**Low** 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 should continue to 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 the 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 IV. Public Debt Sustainability Analysis

Under current policies, Malaysia's federal government debt is projected to decline slightly but to 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 easily be breached if downside risks materialize. Sizable external financing needs and high contingent liabilities exacerbate debt sustainability risk. A gradual fiscal consolidation is needed to build fiscal buffers and improve market confidence.

1. Macro-fiscal assumptions. Macroeconomic projections and policy assumptions are consistent with the baseline macro-framework. Economic growth is projected to remain stable at 4.5 percent in 2020, then to gradually recover and stabilize at just below 5 percent over the medium-term. The federal government fiscal deficit is projected to decline to 3.2 percent of GDP in 2020 (from 3.4 percent of GDP in 2019). The fiscal deficit is projected to remain at around 3 percent over the medium-term in the absence of explicit policies that would underpin the authorities' announced consolidation path.

2. Financing Needs. Under the baseline, Malaysia's gross financing needs (defined as the sum of the fiscal deficit and maturing debt) are expected to decline slightly but to remain above 7 percent of GDP over the medium-term.

3. Debt Profile. The debt profile in the DSA is based on the federal government budget, consistent with the data on government debt reported by the authorities. This definition of debt covers 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. The authorities have announced that federal government's guarantees and PPP lease payment obligations risk bringing the federal government debt to about 75 percent of GDP, should they materialize. These contingent liabilities pose significant risks to long-term debt sustainability and constrain fiscal space. The external financing requirement is high at 29 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 primary balance are neither too optimistic nor pessimistic. The median forecast error for the GDP deflator is -1.8 percent, suggesting that the staff forecasts have been relatively optimistic. 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 41 percent compared to the historical experience for high-debt market access countries. The CAPB level is in a percent rank of 71 percent.

5. Stress Tests, Reform Scenario and Risks. Under the baseline scenario, 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 the 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 2025, exceeding the authorities' debt anchor.

- *Macro-fiscal stress tests.* Under the primary balance shock, real GDP growth shock, and interest rate shock, the debt-to-GDP ratio is not expected to breach the authorities' debt anchor of 55 percent during the projection period. However, the combined macro-fiscal shock would bring debt to 54.2 percent of GDP, very close to breaching the debt anchor.

- *Contingent liability shock.* The federal government is exposed to sizeable contingent liabilities. This shock assumes that the government is obliged to absorb all guarantees, totaling 12 percent of GDP, over 5 years. This shock also assumes negative feedback effect on the interest rate. The debt-to-GDP ratio would rise above 60 percent of GDP under this scenario.

- *Illustrative 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. In this respect, the authorities have announced a target of an average deficit of 2.8 percent of GDP over 2020-2022. Continuing with a similar pace of consolidation after 2022 would lower debt-to-GDP ratio to around 46 percent by 2025, providing a comfortable buffer 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 24 percent, exceeding the lower threshold of early warning benchmarks. Nevertheless, the existence of large domestic institutional investors who tend to make opportunistic investments is a mitigating factor of this risk.

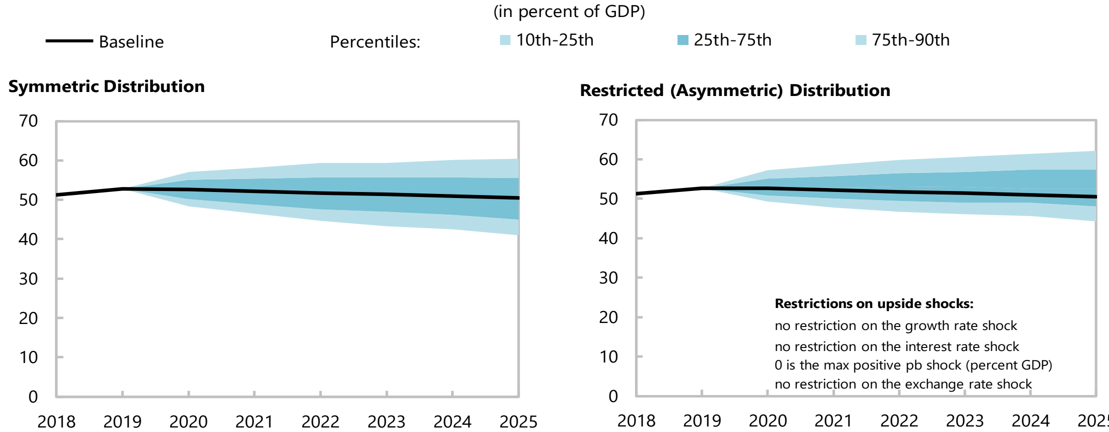
Figure 1. Malaysia—Public DSA Risk Assessment

Heat Map

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

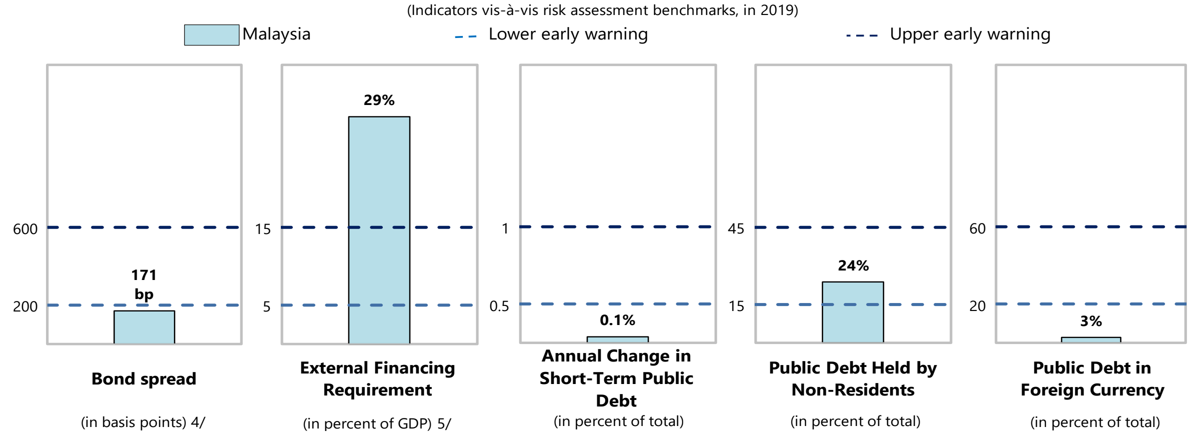
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2019)



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.

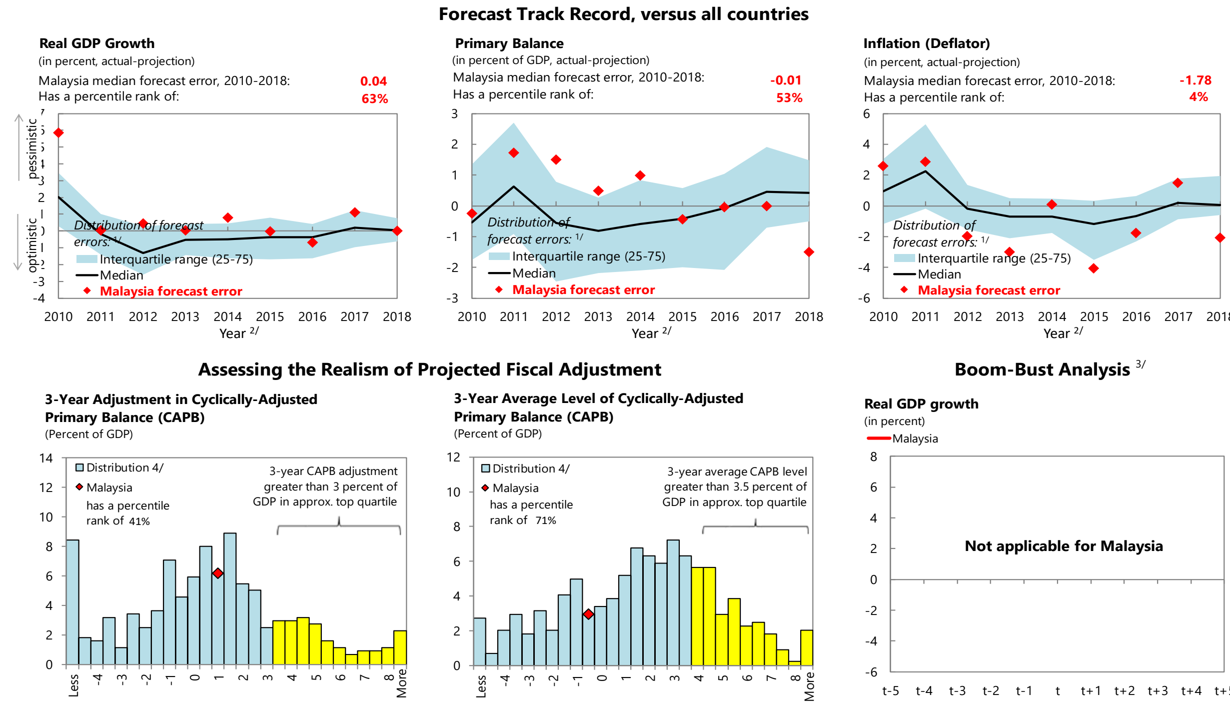
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, 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, 12-Jul-19 through 10-Oct-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



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/]

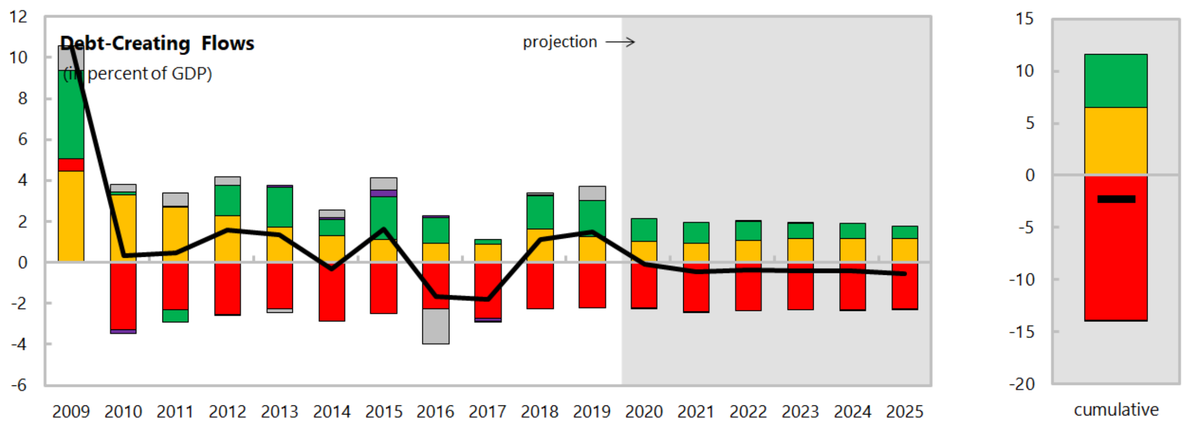
	Actual			Projections					
	2009-2017 [2/]	2018	2019	2020	2021	2022	2023	2024	2025
Nominal gross public debt	50.8	51.2	52.7	52.6	52.1	51.8	51.4	51.0	50.4
Public gross financing needs	9.3	7.8	10.2	8.3	8.0	7.6	7.0	7.5	7.1
Real GDP growth (in percent)	4.7	4.7	4.5	4.5	4.9	4.8	4.8	4.8	4.8
Inflation (GDP deflator, in percent)	1.4	0.7	0.3	2.1	2.1	2.1	2.2	2.2	2.5
Nominal GDP growth (in percent)	6.2	5.5	4.8	6.7	7.1	7.0	7.1	7.2	7.4
Effective interest rate (in percent) [4/]	4.3	4.4	4.5	4.4	4.2	4.0	3.9	3.9	3.8

As of October 10, 2019

Sovereign Spreads		
EMBIG (bp) 3/	171	
5Y CDS (bp)	52	
Ratings	Foreign	Local
Moody's	A3	A3
S&Ps	A-	A
Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2009-2017	2018	2019	2020	2021	2022	2023	2024	2025	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.3	1.1	1.5	-0.1	-0.5	-0.4	-0.4	-0.4	-0.5	-2.3	
Identified debt-creating flows	1.2	1.0	0.8	-0.1	-0.5	-0.4	-0.4	-0.4	-0.5	-2.3	
Primary deficit	2.1	1.6	1.2	1.0	0.9	1.1	1.1	1.2	1.2	6.5	-1.7
Primary (noninterest) revenue and grants	19.3	16.1	14.9	15.1	15.1	15.0	15.0	15.0	15.0	90.2	
Primary (noninterest) expenditure	21.4	17.7	16.2	16.2	16.1	16.1	16.1	16.2	16.1	96.8	
Automatic debt dynamics [5/]	-0.9	-0.6	-0.4	-1.1	-1.4	-1.4	-1.5	-1.6	-1.7	-8.8	
Interest rate/growth differential [6/]	-0.9	-0.6	-0.4	-1.1	-1.4	-1.4	-1.5	-1.6	-1.7	-8.8	
Of which: real interest rate	1.3	1.6	1.8	1.1	1.0	0.9	0.8	0.7	0.6	5.1	
Of which: real GDP growth	-2.2	-2.3	-2.2	-2.2	-2.4	-2.3	-2.3	-2.3	-2.3	-13.9	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
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/]	0.2	0.1	0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



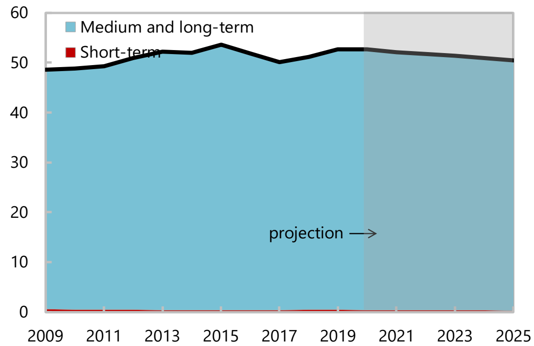
Source: IMF staff.
1/ Public sector is defined as central government.
2/ Based on available data.
3/ Long-term bond spread over U.S. bonds.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times 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 - π (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

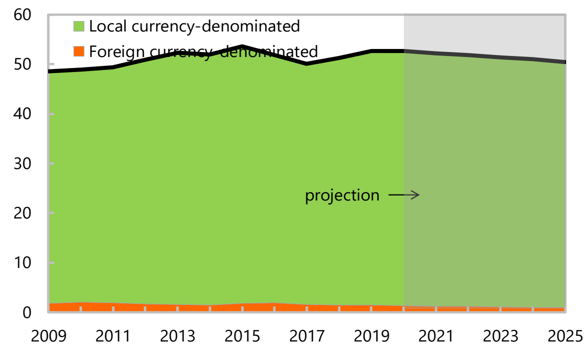
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

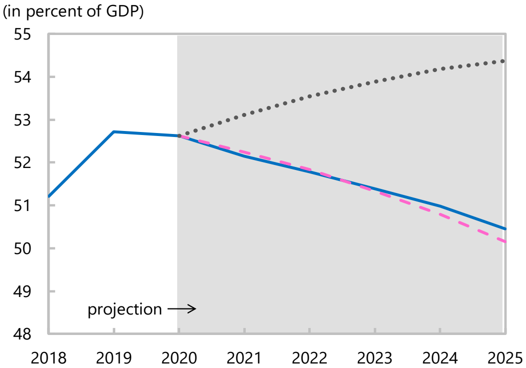


Alternative Scenarios

Baseline Historical Constant Primary Balance

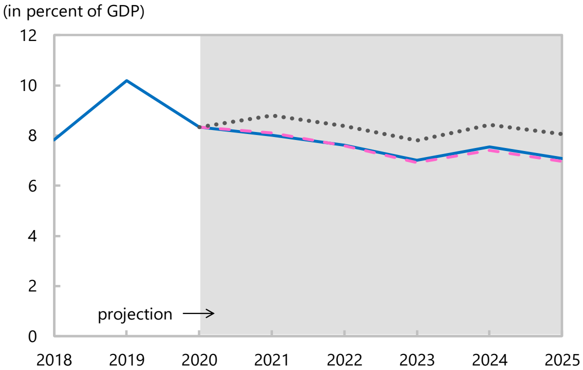
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

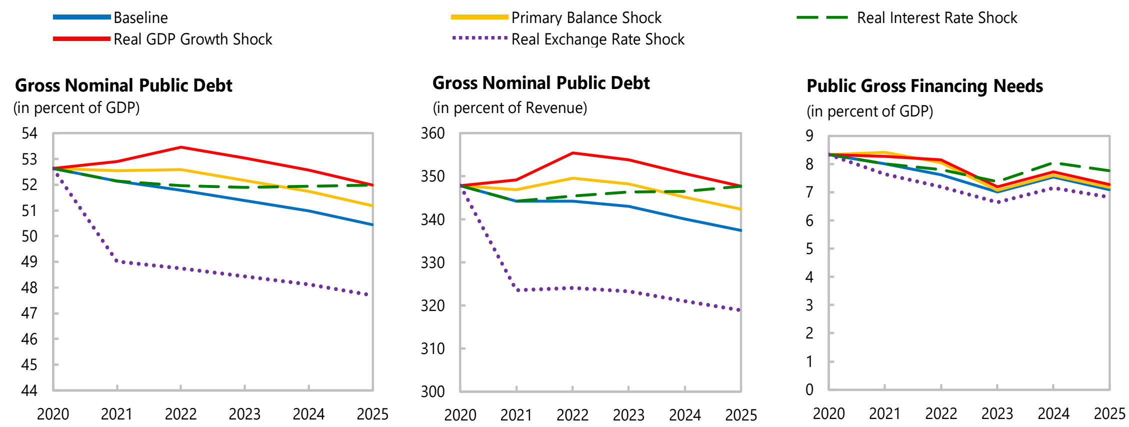
Baseline Scenario	2020	2021	2022	2023	2024	2025
Real GDP growth	4.5	4.9	4.8	4.8	4.8	4.8
Inflation	2.1	2.1	2.1	2.2	2.2	2.5
Primary Balance	-1.0	-0.9	-1.1	-1.1	-1.2	-1.2
Effective interest rate	4.4	4.2	4.0	3.9	3.9	3.8
Constant Primary Balance Scenario						
Real GDP growth	4.5	4.9	4.8	4.8	4.8	4.8
Inflation	2.1	2.1	2.1	2.2	2.2	2.5
Primary Balance	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Effective interest rate	4.4	4.2	4.0	3.9	3.9	3.8

Historical Scenario	2020	2021	2022	2023	2024	2025
Real GDP growth	4.5	4.5	4.5	4.5	4.5	4.5
Inflation	2.1	2.1	2.1	2.2	2.2	2.5
Primary Balance	-1.0	-1.7	-1.7	-1.7	-1.7	-1.7
Effective interest rate	4.4	4.2	4.1	4.0	4.0	4.1

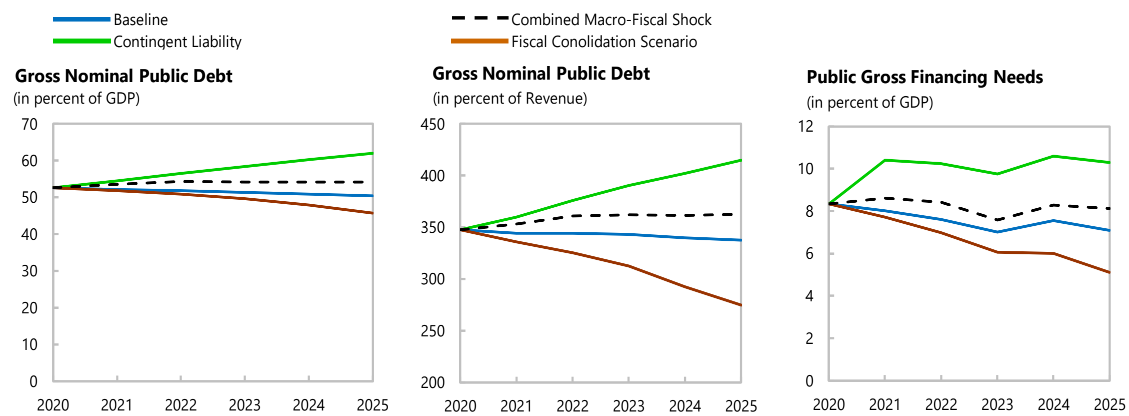
Source: IMF staff.

Figure 5. Malaysia—Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2020	2021	2022	2023	2024	2025
Real GDP growth	4.5	4.9	4.8	4.8	4.8	4.8
Inflation	2.1	2.1	2.1	2.2	2.2	2.5
Primary balance	-1.0	-1.4	-1.5	-1.1	-1.2	-1.2
Effective interest rate	4.4	4.2	4.0	3.9	3.9	3.8
Real Interest Rate Shock						
Real GDP growth	4.5	4.9	4.8	4.8	4.8	4.8
Inflation	2.1	2.1	2.1	2.2	2.2	2.5
Primary balance	-1.0	-0.9	-1.1	-1.1	-1.2	-1.2
Effective interest rate	4.4	4.2	4.4	4.6	4.8	5.1
Combined Shock						
Real GDP growth	4.5	4.0	3.9	4.8	4.8	4.8
Inflation	2.1	1.8	1.8	2.2	2.2	2.5
Primary balance	-1.0	-1.4	-1.5	-1.1	-1.2	-1.2
Effective interest rate	4.4	4.2	4.4	4.6	4.8	5.1

Real GDP Growth Shock	2020	2021	2022	2023	2024	2025
Real GDP growth	4.5	4.0	3.9	4.8	4.8	4.8
Inflation	2.1	1.8	1.8	2.2	2.2	2.5
Primary balance	-1.0	-1.1	-1.4	-1.1	-1.2	-1.2
Effective interest rate	4.4	4.2	4.0	3.9	3.9	3.8
Real Exchange Rate Shock						
Real GDP growth	4.5	4.9	4.8	4.8	4.8	4.8
Inflation	2.1	9.6	2.1	2.2	2.2	2.5
Primary balance	-1.0	-0.9	-1.1	-1.1	-1.2	-1.2
Effective interest rate	4.4	4.2	4.0	3.9	3.9	3.8

Source: IMF staff.

Appendix V. Considerations in Reviewing Malaysia's Public Debt Limit Framework[1]

A. Background and Main Takeaways

1. **The preparation of a Fiscal Responsibility Act (FRA) by the Malaysian authorities is an opportunity to review the public debt limit framework.** The federal government debt is currently subject to a self-imposed policy limit of 55 percent of GDP. While the current debt level is below this limit, it is projected at about 52 percent of GDP at end 2019, meaning that the policy limit could easily be breached if downside shocks materialize. As they prepare the FRA, the authorities need to consider whether to maintain the existing framework or update it, either by changing the limit itself or by introducing safety valves in its application, and whether to enshrine the new framework in law.

2. **Looking at this issue from various perspectives, the analysis presented in this appendix suggests that the debt limit itself should remain at 55 percent of GDP but should be treated more flexibly in case of negative shocks.** An application of the "debt intolerance" methodology suggests that Malaysia could tolerate a somewhat higher level of debt while maintaining investor creditworthiness. At the same time, assessing the sustainability of debt based on a realistic projected pattern of fiscal surpluses and future debt dynamics, as well as an international comparison, suggest that there would be some limited scope to increase the debt limit in Malaysia. However, a review of the empirical literature on the impact of debt on growth suggests that Malaysia's growth would be negatively affected, on average, if its public debt were to increase above 55 percent of GDP. Taken together, these results suggest that Malaysia should leave its debt-to-GDP limit at 55 percent but should treat it more flexibly. For example, when the limit is enshrined in law, appropriate caveats would need to be included to allow for temporarily exceeding it in case of large negative shocks. Any change to the current debt limit framework should be complemented by appropriate changes to the institutional framework, and the rationale for the changes would need to be carefully communicated.

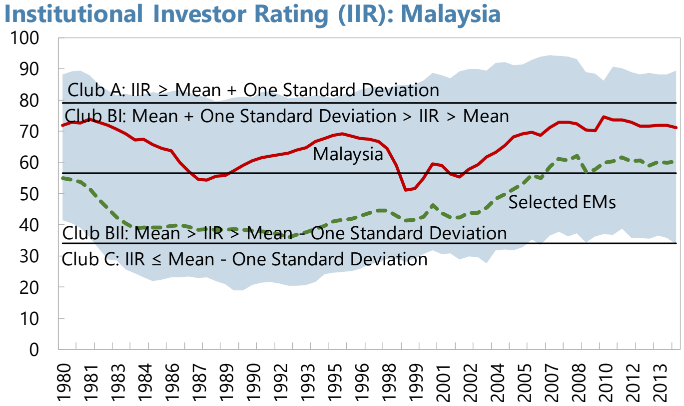
B. Debt Intolerance

3. **The "debt intolerance" methodology measures the level of a country's credit-worthiness using the Institutional Investor Rating (IIR).** The IIR, which has been published biannually until 2014 by the Institutional Investor magazine, measures economists' and sovereign risk analysts' perception of a country's default risk. The IIR grades each country on a scale from 0 to 100, where a rating of 100 corresponds to the lowest default risk. As standard in the debt intolerance literature, countries can be divided in four creditworthiness clubs: club A (IIR>IIR average plus one standard deviation in the sample); club BI (IIR<IIR average plus one standard deviation in the sample and IIR >IIR average in the sample); club BII (IIR<IIR average in the sample and IIR>IIR average minus one standard deviation in the sample); club C (IIR<IIR average minus one standard deviation in the sample). Malaysia's IIR has performed better than peers over time (text chart).

[1] Prepared by Giovanni Ganelli and Claudia Marchini.

Malaysia has remained within Club BI since 1980, besides a couple of episodes in which its IIR slightly deteriorated into Club BII (1987-1989 and 1998-2000). Malaysia's IIR average was 67.3 during 2000-2014, compared to a sample average of 56.5.

Institutional Investor Rating (IIR): Malaysia



Sources: Institutional Investor, Inc; and IMF staff calculations.
Notes: Error bands show the 10th and 90th percentile of rankings among MAC countries. EM peers include Argentina, Brazil, Chile, China, Colombia, Hungary, India, Indonesia, Mexico, Peru, Philippines, Poland, Romania, Russia, Thailand, Turkey, Ukraine, and Vietnam.

4. **We regressed the IIR on a set of country characteristics.** Following Reinhart, Rogoff and Savastano (*Brookings Papers on Economic Activity,* 2003), our regressors include the level of public debt, interacted with dummies for country clubs to capture club-specific effects, and variables capturing the history of high inflation and defaults. We also include the level of GDP-per-capita to capture the impact of the level of development.[2] Table 1 presents the results of our regressions, which are in line with the debt intolerance literature and show that a history of default and high inflation reduces the IIR.

5. **The "debt intolerance" methodology suggests that Malaysia has some limited room to increase its debt limit while maintaining its current level of investor credit-worthiness.** Tables 2 and 3 show the simulated IIR for Malaysia as a function of different levels of debt, using the parameters estimated in the regressions presented in Table 1. The tables also report the thresholds at Malaysia's simulated IIR would move from creditworthiness club BI to BII depending on the assumed level of debt. Two different approaches have been followed in the literature to calculate these thresholds. The first one is to calculate the thresholds with reference to the whole sample of countries for which the IIR is available (namely 114 countries). Using this whole-sample thresholds (Table 2), the simulations taken at face value would suggest that Malaysia could reach very high levels of debt (above 100 percent of GDP) while remaining in the same creditworthiness club. The second approach is to calculate the thresholds with reference only to the countries included in the regressions, which can be less than the full sample due to availability of regressors —the relevant number in our estimations is 61 countries. Using the regression-specific thresholds (Table 3) provides a different story: for two of our regression specifications the change in creditworthiness club would happen for levels of debt-to-GDP as low as in the 50-65 percent range. Overall, the

[2] Our sample of 114 countries includes all countries in the MAC DSA (IMF's market-access debt sustainability analysis) with exclusion of a few countries for which the IIR is not available.

results of the debt intolerance methodology suggest that Malaysia's debt limit framework could be relaxed to some extent, but they should not be taken as evidence that Malaysia can reset its debt-to-GDP limit to significantly higher level than the current 55 percent.

Table 1. Malaysia: Regression Results 1/

	Model 1	Model 2	Model 3	Model 4
Debt x Club A	0.216 ***	0.007	0.222***	0.032
	[0.079]	[0.060]	[0.069]	[0.051]
Debt x Not Club A	-0.167 **	-0.0892*		
	[0.075]	[0.053]		
Debt x Club B			-0.108	-0.051
			[0.067]	[0.045]
Debt x Club C			-0.536***	-0.382***
			[0.107]	[0.074]
Inflation (%years inflation >20%)	-0.507**	-0.348**	-0.543***	-0.390***
	[0.230]	[0.161]	[0.200]	[0.135]
Crisis 1950 (% years in default since 1950)	-0.485***	-0.253**	-0.394***	-0.205**
	[0.132]	[0.096]	[0.117]	[0.081]
GDPPC_PPP		0.0008***		0.0008***
		[0.0001]		[0.0001]
Constant	74.243***	50.957***	73.705***	52.730***
	[4.405]	[4.251]	[3.836]	[3.572]
R^2	0.624	0.823	0.720	0.879
Adjusted R^2	0.597	0.807	0.695	0.865
N	61	61	61	61

1/ Numbers in square brackets are standard errors. *** indicates significance at the 1 percent level, ** at the 5 percent level, and * at the 10 percent level.

Table 2. Malaysia: Institutional Investor Rating (General) and Central Government Debt

	Model 1		Model 2		Model 3		Model 4	
Debt ratio	Predicted IIR	Club	Predicted IIR	Club	Predicted IIR	Club	Predicted IIR	Club
20	70.9	BI	66.1	BI	71.5	BI	67.0	BI
25	70.1	BI	65.6	BI	71.0	BI	66.8	BI
30	69.2	BI	65.2	BI	70.5	BI	66.5	BI
35	68.4	BI	64.7	BI	69.9	BI	66.3	BI
40	67.6	BI	64.3	BI	69.4	BI	66.0	BI
45	66.7	BI	63.8	BI	68.8	BI	65.7	BI
50	65.9	BI	63.4	BI	68.3	BI	65.5	BI
55	65.1	BI	63.0	BI	67.8	BI	65.2	BI
60	64.2	BI	62.5	BI	67.2	BI	65.0	BI
65	63.4	BI	62.1	BI	66.7	BI	64.7	BI
70	62.6	BI	61.6	BI	66.1	BI	64.5	BI
75	61.7	BI	61.2	BI	65.6	BI	64.2	BI
80	60.9	BI	60.7	BI	65.1	BI	64.0	BI
85	60.1	BI	60.3	BI	64.5	BI	63.7	BI
90	59.2	BI	59.8	BI	64.0	BI	63.4	BI
95	58.4	BI	59.4	BI	63.5	BI	63.2	BI
100	57.6	BI	58.9	BI	62.9	BI	62.9	BI
105	56.7	BI	58.5	BI	62.4	BI	62.7	BI
110	55.9	BII	58.0	BI	61.8	BI	62.4	BI
115	55.1	BII	57.6	BI	61.3	BI	62.2	BI
120	54.2	BII	57.2	BI	60.8	BI	61.9	BI
125	53.4	BII	56.7	BI	60.2	BI	61.7	BI
130	52.6	BII	56.3	BII	59.7	BI	61.4	BI

Table 3. Malaysia: Institutional Investor Rating (Sample Specific) and Central Government Debt

	Model 1		Model 2		Model 3		Model 4	
Debt ratio	Predicted IIR	Club	Predicted IIR	Club	Predicted IIR	Club	Predicted IIR	Club
20	70.9	BI	66.1	BI	71.5	BI	67.0	BI
25	70.1	BI	65.6	BI	71.0	BI	66.8	BI
30	69.2	BI	65.2	BI	70.5	BI	66.5	BI
35	68.4	BI	64.7	BI	69.9	BI	66.3	BI
40	67.6	BI	64.3	BI	69.4	BI	66.0	BI
45	66.7	BI	63.8	BI	68.8	BI	65.7	BI
50	65.9	BI	63.4	BII	68.3	BI	65.5	BI
55	65.1	BI	63.0	BII	67.8	BI	65.2	BI
60	64.2	BI	62.5	BII	67.2	BI	65.0	BI
65	63.4	BII	62.1	BII	66.7	BI	64.7	BI
70	62.6	BII	61.6	BII	66.1	BI	64.5	BI
75	61.7	BII	61.2	BII	65.6	BI	64.2	BI
80	60.9	BII	60.7	BII	65.1	BI	64.0	BI
85	60.1	BII	60.3	BII	64.5	BI	63.7	BI
90	59.2	BII	59.8	BII	64.0	BI	63.4	BII
95	58.4	BII	59.4	BII	63.5	BII	63.2	BII
100	57.6	BII	58.9	BII	62.9	BII	62.9	BII
105	56.7	BII	58.5	BII	62.4	BII	62.7	BII
110	55.9	BII	58.0	BII	61.8	BII	62.4	BII
115	55.1	BII	57.6	BII	61.3	BII	62.2	BII
120	54.2	BII	57.2	BII	60.8	BII	61.9	BII
125	53.4	BII	56.7	BII	60.2	BII	61.7	BII
130	52.6	BII	56.3	BII	59.7	BII	61.4	BII

C. Sustainability of Debt Limit

6. **A different approach is aimed at assessing the sustainability of a given debt level based on a realistic projected pattern of future primary surpluses.** Following the methodology outlined in IMF (2003) and Abiad and Ostry (*IMF Policy Discussion Paper,* 2005), one way to assess whether a certain level of debt is sustainable is based on a simple relationship between the current debt ratio and expected future primary surpluses. A sustainable level of debt-to-GDP ratio d* should be less than or equal to the present discounted value of future surpluses: d*=pb/(r-g), where pb is the primary balance-to-GDP ratio, r the real interest rate, and g the rate of growth of the economy.

7. **In this approach, the value of (r-g) plays a critical role.** While Malaysia has been enjoying a negative real interest rate-growth differential in recent years, a negative (r-g) is not compatible with a long run equilibrium. Furthermore, a number of factors are likely to push (r-g) into positive territory for Malaysia in coming decades. Even if real interest rates remain low for a long time, more moderate growth rates after achieving high income status might push (r-g) into positive territory. Furthermore, other factors are likely to affect (r-g), including a more limited role of domestic "deep pocketed" institutional investors going forward, which might push up the cost of borrowing for the government. For these reasons, in Table 4 we report simulations of the primary balance levels needed to make a certain level of debt sustainable, given positive levels of (r-g).

8. **This approach also suggests that there is some limited room to relax the current debt limit.** Table 4 shows that for a moderate level (1 percent) of the (r-g) differential, the level of primary

balance needed to keep debt at the current limit (55 percent of GDP) is a primary surplus of 0.55 percent of GDP. Such a primary surplus should be the medium-term goal of fiscal consolidation under the current debt limit framework. It is important to stress that, while such level of the primary surplus is not unattainable, it would require a substantial fiscal effort in a historical perspective, given that Malaysia has not run a primary surplus since 1998 but has been able to stabilize its debt while running primary deficits thanks to the favorable (r-g) dynamics.[3] This shows the importance of putting in place a credible and well-specified medium term consolidation plan, which would reduce the cost of borrowing, implying a more favorable (r-g) dynamics and making a higher level of debt more sustainable. Table 4 also suggests that there is some limited room to relax the current debt limit framework, because the needed fiscal adjustment to keep debt at 60 percent of GDP, compared to that implied by strict adherence to the current debt limit, would be minimal: the primary surplus would need to go from 0.55 to 0.6 percent of GDP.

Table 4. Malaysia: Public Debt-to-GDP Ratio: Sensitivity to Primary Surplus and Interest-Growth Rate Differential

pb	r-g		
	1.0	**1.5**	**2.0**
1	100%	66.7%	50%
0.8	80%	53.3%	40%
0.6	60%	40.0%	30%
0.55	55%	36.7%	28%
0.4	40%	26.7%	20%
0.2	20%	13.3%	10%
0.1	10%	6.7%	5%

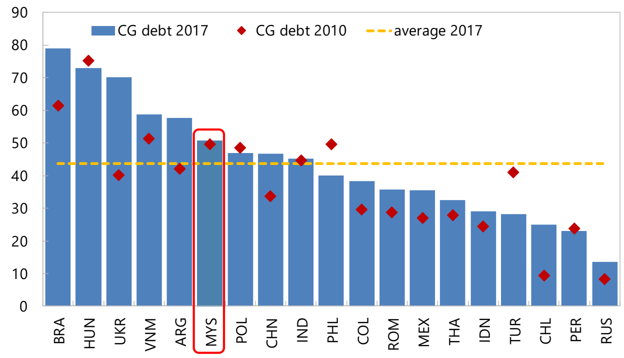
Source: IMF staff calculations.

D. Cross Country Comparison

9. A cross-country comparison shows that Malaysia's debt-to-GDP ratio is already relatively high compared to peers. While Malaysia's public debt to GDP ratio remained stable at about 50 percent of GDP in the last decade, Figure 1 shows that its debt is higher than several peers. Figure 2 also shows that Malaysia's debt to GDP ratio is higher than the level warranted by its GDP-per-capita based on a simple bivariate correlation. This suggests that a level of debt substantially above 60 percent of GDP would bring Malaysia out of line with peers.

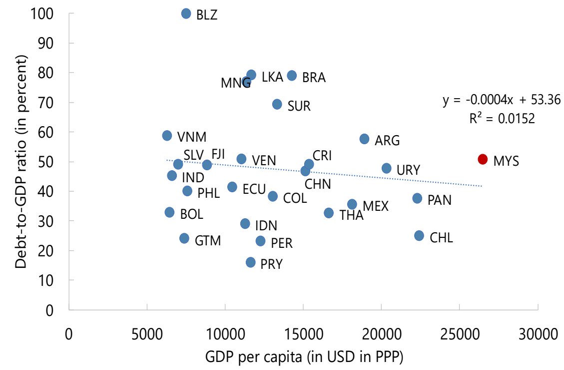
[3] The average primary balance during 1998-2018 was a deficit of -1.8 percent of GDP.

Figure 1. Debt-to-GDP Ration in Selected Emerging Markets
(Percent of GDP)



Sources: IMF *Global Debt Database*; and IMF staff calculations.

Figure 2. Selected Emerging Markets in Asia and Latin America, 2017



Sources: IMF *Global Debt Database*; and IMF staff calculations.

E. Impact of Public Debt on Growth

10. The literature has emphasized the existence of "tipping points" in the debt-growth nexus. While for reasonable levels of public debt-to-GDP a further increase in debt can stimulate growth, for example by financing productive spending such as education and infrastructure, the literature has stressed the existence of "tipping points" above which the impact of debt on growth is likely to turn negative. Using descriptive statistics for both advanced economies and emerging markets, Reinhart and Rogoff (*American Economic Review*, 2010) have argued that on average debt levels above 90 percent of GDP tend to have a detrimental effect on growth. Using a panel threshold regression approach, Caner, Grennes and Koehler-Geib (*World Bank Policy Research Working Paper*, 2010) conclude that for emerging markets the tipping point is likely to be at 64 percent of GDP.

11. The existing debt-growth nexus literature suggests that Malaysia should not significantly increase its public debt-to-GDP level above 55 percent. Applying the threshold regression approach specifically to Malaysia, Baharumshah, Soon, and Lau (*Journal of Policy Modeling*, 2016) find the tipping point to be at 54.7 percent of GDP. According to their estimations, for levels below this threshold an additional percentage point of GDP of debt would increase growth by about 0.2 percent, while for levels above the threshold an additional percentage point of GDP of debt would lower growth by about 0.15 percent. Since their results are based on data for 1980-2014, they summarize the average impact over a long period and do not necessarily imply that the impact of debt on growth would be negative in case of a temporary increase above 55 percent following a negative shock. At the same time, these results suggest that the debt limit for Malaysia should broadly remain at 55 percent of GDP.

F. Conclusions

12. The analysis presented in this Annex suggests that, in the context of the forthcoming FRA, Malaysia has some limited room to relax its debt limit framework, but caution is warranted. The "debt intolerance" methodology suggests that Malaysia has some limited room to tolerate a higher level of debt (compared to the current limit) while maintaining its current level of investor creditworthiness. A "debt sustainability" approach in the spirit of Abiad and Ostry (2005) and an international comparison also suggest some limited scope to relax the current debt limit framework. The existing literature on the debt-growth nexus suggests that Malaysia's growth would be negatively affected, on average, if its debt limit were to be increased. Overall, the analysis presented in this appendix suggests that Malaysia should leave its debt-to-GDP limit at 55 percent but should treat it more flexibly. A less stringent approach to its debt limit framework would allow temporary breaches of the current limit in case of large negative shocks. Any change to the current debt limit policy should be complemented by appropriate changes in the institutional framework, to be discussed in the context of the TA from FAD on the FRA, and the rationale for the changes would need to be carefully communicated.

Appendix VI. Policy Framework to Address Macroeconomic and Financial Shocks[1]

This Appendix summarizes the authorities' main policy considerations in addressing shocks including the role of monetary, exchange rate, macroprudential, and capital flow management policies.

1. **The BNM's principal objectives are to preserve monetary and financial stability, with the ultimate objective to promote sustainable growth.** Monetary stability rests on maintaining price stability while giving due regard to economic developments. Financial stability rests on addressing emerging risks that could disrupt financial intermediation, including those presented by a disorderly functioning of the foreign exchange market. To meet the dual objectives, the BNM has developed a broad policy toolkit. The policy reaction function to macroeconomic and financial shocks can be described as "a multi-instrument reaction function responding to multiple-indicator variables, including the exchange rate."[2]

BNM Dual Principal Objectives: Monetary and financial stability conducive to sustainable growth					
Monetary stability			**Financial stability**		
Maintaining price stability giving due regard to the developments in the economy			Maintaining orderly financial sector intermediation, functioning and public confidence.		
Policy Tools					
Monetary policy	**Exchange rate**	**Prudential**	**CFMs**	**Structural**	**Fiscal**
OPR, SRR and liquidity tools	FX flexibility, intervention and reserves management	Micro and macroprudential	Inflow, outflow	Financial market development	Advisory role to the Government
Source: BNM and Fund Staff					

2. **The BNM has a range of policy tools available to address shocks**. Operationally, the principal tool for monetary policy in Malaysia is the Overnight Policy Rate (OPR) with the Statutory Reserve Requirement (SRR) and open market operations also used to manage liquidity. Financial stability tools are primarily micro and macroprudential measures as well as BNM's supervisory function. The main instrument to ensure external stability is exchange rate flexibility, with FX intervention used to avoid excessive volatility in the exchange rate and to maintain orderly markets. BNM views CFMs as part of its broader policy toolkit in managing risks, although not frequently used. Depending on its assessment of risks, BNM can use any tool to support the primary tool in delivering on a particular objective. BNM views such discretion as critical to help it achieve its mandate without overburdening any one tool. BNM also emphasizes communications and engagement with key stakeholders as an important tool to provide clarity regarding its policy objectives and tools deployed.

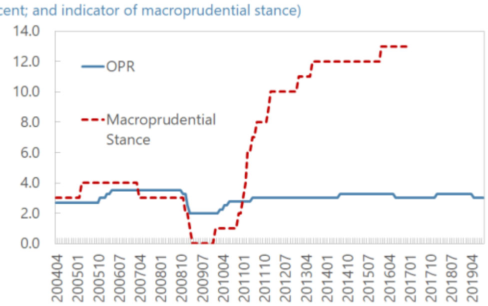
[1] Prepared by Dan Nyberg.

[2] Omar (2019), "Remarks at IMF Seminar on Comprehensive Approaches to Monetary and Financial Policy Making in ASEAN-5 Countries", http://www.bnm.gov.my/index.php?ch=en_speech&pg=en_speech&ac=831&lang=en

3. The openness of Malaysia's economy and balance sheet vulnerabilities are important characteristics in shaping BNM's policy response. While Malaysia's integration in the global economy and international financial markets has yielded substantial benefits, it has also made Malaysia more susceptible to external shocks and spillover effects from global developments, including through volatile capital flows in the post GFC period of accommodative monetary policy in advanced economies.[3] In small open economies, these flows can overwhelm the domestic financial markets, causing large movements in asset prices (including in the real estate market), liquidity conditions and exchange rates and leading to a build-up of vulnerabilities. In this context, balance sheet characteristics such as corporate external debt and government and household debt are important considerations.

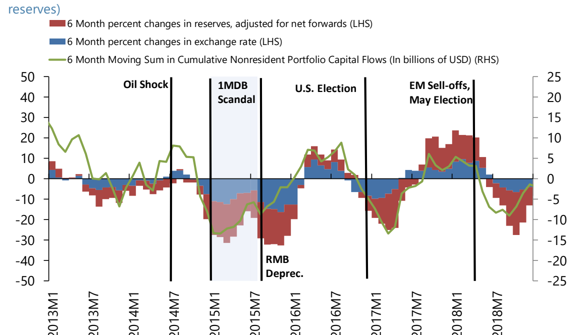
4. In practice, the authorities have used a combination of policy tools in response to shocks. In the post-GFC period, the authorities' policy responses to external shocks such as the 2014-15 oil price decline, the 1MDB scandal, and episodes of EM selloffs have differed. The policy response has typically included a tailored combination of policy tools such as (i) FXI to reduce excess exchange rate volatility; (ii) exchange rate adjustment; (iii) monetary policy recalibration; (iv) macroprudential policy tightening to mitigate systemic risks, including those stemming from capital flows and credit growth; as well as (v) CFMs.[4] In the case of the 2014-15 oil price decline, the policy response mainly included exchange rate depreciation, whereas the response to shocks in the offshore financial market in 2016 included FX intervention to contain excessive volatility. On the domestic side, the authorities have actively used macroprudential policy to mitigate financial stability risks relating to elevated household debt.

Monetary and Macroprudential Policies 1/
(Percent; and indicator of macroprudential stance)



Sources: Haver and IMF iMaPP Database (2019).
1/ The indicator for macroprudential policy stance shows the number of net tightenings of macroprudential policies.

Capital Flows and Exchange Market Pressure Index
(EMPI = percent change in U.S. dollar/local currency exchange rate plus percent change in reserves)



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

5. The BNM also serves an advisory role to the Government on fiscal and structural issues. The BNM Governor is a member of the Fiscal Policy Committee and the Debt Management Committee. On the structural side, the authorities' policy efforts have focused on deepening domestic financial markets. The authorities have in recent years introduced a sequence of reforms to deepen the liquidity of domestic markets by simplifying market regulation, enhancing FX hedging instruments and extending trading hours.

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[3] See, for instance, Figure 7 of the IMF Asia and Pacific Regional Outlook, October 2019, page 10. https://www.imf.org/en/Publications/REO/APAC/Issues/2019/10/03/areo1023

[4] Some of the CFMs used in Malaysia have also been classified as macroprudential measures to reduce financial stability risks (i.e. CFM/MPMs). See IMF Taxonomy of CFMs (2019).

Appendix VII. Exchange Rate Flexibility: Shock Absorber or Amplifier?[1]

1. Exchange rate flexibility can have two opposite effects on the domestic economy. Traditional analysis sees a floating exchange rate as a shock absorber that dampens the effect on the domestic economy from external shocks by affecting the competitiveness of exporters and import-competing industries. A flexible exchange rate can also help reduce the probability of speculative attacks.[2] Nevertheless, the possibility of overshooting cannot be ruled out under a freely floating regime; and recent research has cast doubt on the effectiveness of the competitiveness channel at least in the short term.[3] Moreover, a large depreciation may depress corporate activity by exacerbating the debt burden of firms with FX liabilities. When such liabilities are large and unhedged, the negative balance sheet effect could dominate the competitiveness effect.

2. Macro-level evidence shows that Asian EMEs make extensive use of FXI to moderate exchange rate fluctuations in response to volatile capital flows, on average absorbing about 70 percent of net capital flows. FXI is more pronounced in countries where corporate FX liabilities are larger, suggesting that currency mismatches on corporate balance sheets are an important factor for the use of FXI. On the other hand, Asian countries with greater financial depth rely less on FXI, reflecting better hedging opportunities which reduce the need for central bank intervention. Empirical estimates at the macro level suggest that a one percent real depreciation permanently lowers the investment ratio by ½ percent when markets are less-developed, while the effect is not statistically-significant otherwise. A similar effect is observed for GDP growth, although the impact is more short-lived. (IMF APD-REO, October 2019)

3. Consistent with macro-level evidence, recent firm-level studies find that while exchange rate fluctuations may play a shock-absorbing role, in some cases they can exacerbate corporate vulnerabilities and discourage investment/encourage precautionary saving. This is especially true for firms with large FX liabilities, high dependence on external financing, or operating in shallow financial markets. Li (2019 forthcoming) finds that in ASEAN5, currency depreciation disproportionately increases the net saving rate of firms in industries with low export-orientation rate[4] or high dependence on external funds.[5] Jiang and Sedik (2018) finds that a

[1] Prepared by Xin Li.

[2] By definition, a speculative attack on a currency occurs when market participants, believing that a currency is overvalued, sell that currency in large amounts in anticipation of its value falling. A flexible exchange rate reduces such occurrences because, in well-functioning markets, a flexible exchange rate's value is more likely to be close to equilibrium and hence less subject to a speculative attack.

[3] Recent work find that the competitiveness channel is less effective for countries/regions that are (i) invoicing in dominant currency (Casas et al., 2016; IMF 2019 External Sector Report, Chapter 2) or (ii) heavily integrated into the global supply chain (Amiti et al., 2014).

[4] Following OCED's methodology, export orientation is defined as the value-added originating from an industry of a country that is embodied (via exporting activities) in foreign final demand—as a share of the total domestic value added generated by that industry. In this context, export orientation is used as a proxy for natural hedging opportunities.

[5] Following Rajan and Zingales (1998), external financing refers to a firm's use of external finance, including borrowings and equity issues, which by definition equals total capital expenditure less cash flows from operations.

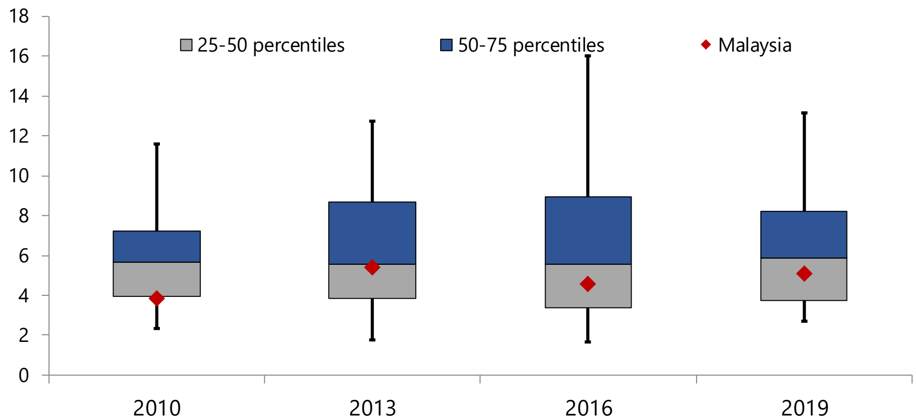
30 percent currency depreciation shifts 7 percent of firms across Asia into a high probability of default category, with stronger effects when the share of FX debt is high. This discourages investment in firms with FX liabilities accounting for over 20 percent of total debt. IMF APD-REO (2019) finds that the degree of financial development influences how exchange rate shocks impact firms' investment decisions—higher FX liabilities tend to hurt the balance sheets of companies operating in countries with relatively less-developed financial markets, with fewer or costlier hedging opportunities.

4. Preliminary modeling work supports the evidence for the possibility of the exchange rate acting as a shock amplifier. Exploiting a small open DSGE model, a forthcoming paper by Chen, Nadeem, and Peiris demonstrates that in an average Asian emerging economy, exchange rate flexibility helps absorb the negative impact of a productivity shock on the real economy via the competitiveness channel. However, exchange rate fluctuations may amplify the impact of financial shocks (e.g., foreign interest rate shock or capital flow shock) via banks' balance sheet effects due to frictions associated with foreign currency denominated liabilities. When balance sheet exposures are high, the balance sheet effect may dominate; by reducing excess exchange rate fluctuations, FX intervention could therefore help mitigate the negative real impact of financial shocks given the imperfect substitutability between foreign and domestic assets. CFMs could in some cases help stabilize the exchange rate but they are more costly in terms of inflation and output costs than FXI in responding to the financial shocks.

5. Against this background, further study is needed to determine whether the exchange rate plays a shock absorber or shock amplifier role in Malaysia. Indeed, at the aggregate level, while risks from corporate sector FX liabilities are likely contained, Malaysia's FX market still has room for greater depth given the country's high trade openness and cross-border capital flows. Malaysia's corporate sector accounts for close to half of FX external debt (about 20 percent of total corporate sector debt or 20 percent of GDP) as of 2019Q3. A large share of corporate external borrowing is subject to the central bank's approval framework to ascertain that they are utilized for productive purposes and supported by foreign currency earnings. As for the FX market, the authorities have implemented over the past few years a number of measures to develop the onshore market, and transactions have indeed increased. However, the FX turnover-to-gross trade and capital flow ratio suggests that the depth of Malaysia's FX market remains below the median of its peers, implying that further FX market development would be beneficial to enhance the market's resilience and ability to meet the economy's hedging needs at all times.[6]

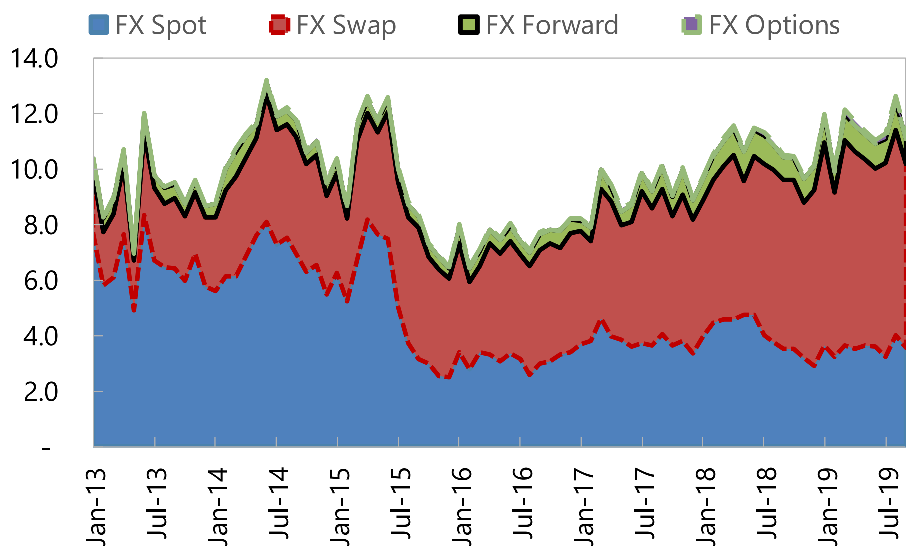
[6] Malaysia is a highly export-oriented economy with total exports and imports account for over 130 percent of GDP in the past decade.

Figure 1. Malaysia: Ratio of FX Turnover to Gross Trade and Capital Flows
(Ratio, daily average)



Notes: Comparators include Argentina, Brazil, Chile, Colombia, Hungary, India, Indonesia, Mexico, Philippines, Poland, Russia, Thailand, and Turkey. Daily FX turnover is defined as the total value of FX spot, forward, swap, and option transactions executed in a given day. Gross trade flows are defined as the sum of exports and imports of goods and services. Gross capital flows are approximated by the sum of quarterly (absolute) changes in financial assets and liabilities; it tends to underestimate gross capital transactions as capital inflows and outflows within the same quarter offset each other.
Sources: BIS and IMF staff calculations.

Figure 2. Malaysia: Daily Average FX Turnover by Instrument
(In billions of U.S. dollars)



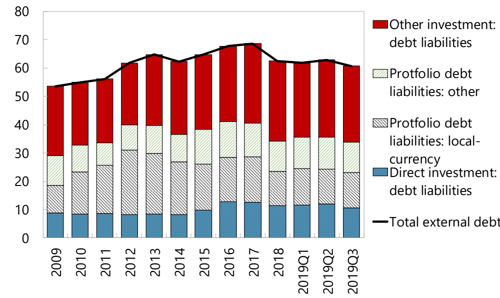
Sources: BNM and IMF staff calculations.

Appendix VIII. External Debt Sustainability Analysis

1. Malaysia's external debt has declined over the past two years, primarily reflected in an outflow of portfolio debt. Malaysia's external debt-to-GDP ratio stands at 60.7 percent of GDP as of 2019Q3, down from 68.6 percent of GDP at end-2017 (end-2018: 62.4 percent of GDP). Non-resident holdings of local-currency debt securities declined by 3.6 percent of GDP, accounting for about half of the total decline in the debt ratio, followed by a decrease in FDI debt liabilities (2.0 percent).

Malaysia: External Debt

(In percent of GDP; based on U.S. dollar values)



Sources: Bank Negara Malaysia; and IMF staff calculations.

2. The currency profile of external debt is stable. As of 2019Q3, close to one-third of external debt (about 20 percent of GDP) is denominated in ringgit, mainly in the form of nonresident holdings of domestic debt securities (63 percent of ringgit-denominated external debt) and ringgit deposits (18 percent) in domestic banking institutions. The remaining two-thirds of external debt (about 40 percent of GDP) is denominated in foreign currency (FC). The non-financial corporate sector accounted for close to half of FC-denominated external debt, which is largely subject to prudential and hedging requirements.[1] Another 40 percent of FC-denominated external debt is accounted by interbank borrowings and FC deposits in the domestic banking system, three quarters of which are in the form of intragroup borrowings from related offices abroad. This reflects banks' centralized liquidity and funding management practices. (Text Table)

3. From a maturity perspective, the share of short-term external debt by original maturity has remained stable over the past years. Short-term debt by original maturity accounted for 43 percent of total external debt (about 25 percent of GDP) as of 2019Q3. Close to half of the short-term external debt are intragroup borrowings among banks and corporations which are generally stable, while another 12 percent are accounted by trade credits, largely backed by export earnings. Nevertheless, short-term external debt by remaining maturity was significantly revised down by RM70 billion (about 5 percent of GDP) in 2017, following the implementation of a new data compilation system: as more disaggregated data became available under the new system, the statistical authorities were able to separate the interbank borrowing of a banking entity in Labuan from long-term loans and reclassify it as short-term external debt.[2] As a result, the amortization of medium- and long-term debt in 2017 was significantly revised down after eliminating the cumulative repayments of short-term interbank borrowings associated with that banking entity in Labuan.

[1] The central bank uses an approval framework to ascertain that corporate external borrowings are utilized for productive purposes and that they are supported by foreign currency earnings.

[2] The reclassifications also involved some FDI-related external debt of private corporations from short-term to medium- and long-term external debt. In aggregate, these reclassifications were RM27 billion larger relative to the reclassification of interbank borrowing of the bank in Labuan to short-term external debt, resulting in higher MLT external debt and lower ST external debt in 2017.

4. Over the medium term, the external debt-to-GDP ratio is projected to remain on a steady downward path, falling to about 48 percent by 2024. This baseline path reflects the net effect of sustained current account (CA) surpluses (excluding interest payments), robust growth supported by domestic demand, continued non-debt generating capital inflows, and low external financing rates. The share of short-term debt, by original maturity, is projected to stabilize at about 46 percent of total external debt by the end of the medium term. With a sharp decline in 2017 due to the reclassification of external debt, gross external financing need will continue to moderate to about 25 percent of GDP by 2024. (Table 1)

5. The sizable external debt would keep Malaysia's external vulnerabilities elevated, albeit manageable. Standard stress tests under the external DSA indicate that external debt is most vulnerable to exchange rate and current account shocks. A 30 percent real exchange rate depreciation in 2020 could push external debt over 61 percent of GDP by 2024. Moreover, a permanent drop in CA balance (excluding interest payments) could lead to an external debt level over 58 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: (i) the high share of ringgit-denominated external debt (more than 30 percent of total external debt) and (ii) largely stable intercompany loans (12 percent of external debt) and interbank borrowings (21 percent of external debt, about three quarters of which are in the term of intragroup borrowings from related offices abroad).

6. Risks to Malaysia's external debt sustainability arising from the above vulnerabilities would be managed via a variety of mitigation measures. As of September 2019, gross official reserves stood at $103 billion, or about 72 percent of short-term external debt by remaining maturity. Gross official reserves are adequate under the IMF reserve adequacy metric (ARA) (about 115 percent of the metric)[3]. Exchange rate flexibility, a moderate CA surplus, and the relatively large share of ringgit-denominated external debt will continue to serve as important buffers against potential external shocks. Moreover, banks' exposure in the form of interbank borrowings, NR deposits and debt issuances are subject to prudential and supervisory requirements on liquidity and funding risk management, while corporations are subject to an approval framework to ascertain that external borrowings are utilized for productive purposes and that they are supported by foreign currency earnings.

[3] Net reserves adjusted for net forwards positions are about 102 percent of the ARA metric.

Table 1. Malaysia: Profile of External Debt

(Percent of GDP unless otherwise mentioned; original maturity)

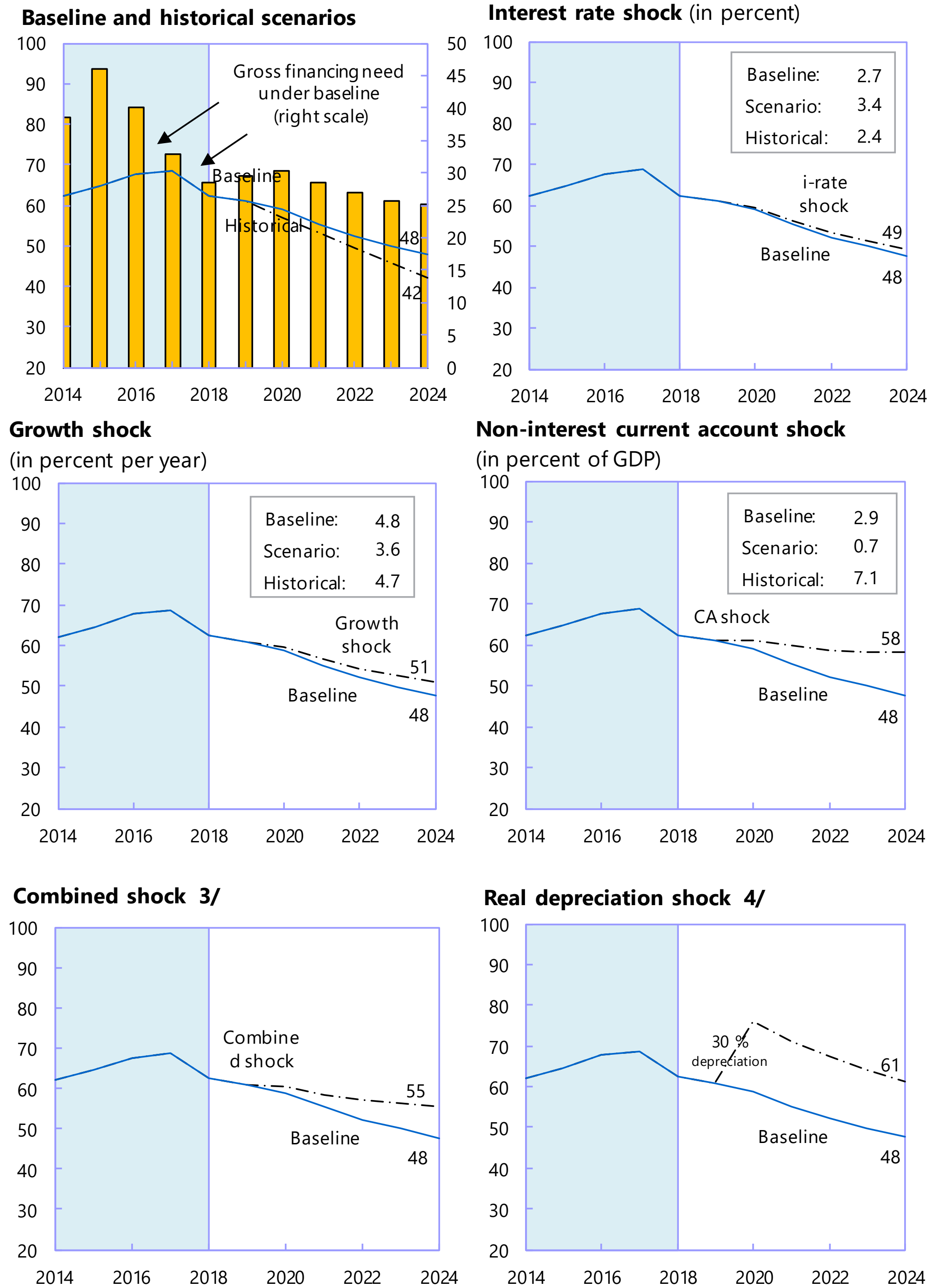
	2015	2016	2017	2018	2019Q1	2019Q2	2019Q3
Total external debt (staff estimate) 1/	64.7	67.7	68.6	62.4	61.7	62.8	60.7
Medium- and long-term	*37.5*	*39.7*	*41.3*	*35.1*	*36.6*	*36.6*	*34.6*
Offshore borrowing	22.3	23.9	24.9	22.5	23.3	23.7	21.6
Public sector	9.9	9.7	10.3	9.7	10.0	10.0	8.6
Federal government	1.7	1.4	1.3	1.1	1.6	1.6	1.6
Public enterprises	8.3	8.3	9.0	8.5	8.4	8.3	7.0
Private sector	12.4	14.2	14.6	12.8	13.2	13.7	13.0
Banks	3.9	3.9	3.6	3.2	3.2	3.4	3.5
Nonbanks	8.5	10.3	11.0	9.7	10.0	10.3	9.5
Nonresident holdings of ringgit-denominated debt instruments	14.2	14.9	15.2	11.4	12.1	11.8	11.9
Government securities	13.3	14.1	14.2	10.7	11.4	11.0	11.2
Other securities	0.9	0.9	1.0	0.7	0.8	0.7	0.7
Other	0.9	0.9	1.3	1.1	1.2	1.2	1.1
Short-term	*27.2*	*28.0*	*27.3*	*27.3*	*25.2*	*26.2*	*26.1*
Offshore borrowing	13.7	15.4	14.5	15.7	14.1	15.5	15.5
Public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	13.7	15.4	14.5	15.7	14.1	15.5	15.5
Banks	12.5	12.7	13.3	13.8	12.0	13.4	13.5
Nonbanks	1.3	2.7	1.2	2.0	2.1	2.1	2.0
Nonresident holdings of ringgit-denominated debt instruments	2.1	0.8	0.9	0.7	0.6	0.5	0.6
Government securities	0.3	0.1	0.3	0.3	0.1	0.1	0.2
Other securities	1.8	0.7	0.6	0.5	0.5	0.4	0.4
Nonresident deposits	6.3	6.4	7.1	6.6	6.4	6.2	6.0
Other	5.1	5.4	4.7	4.2	4.0	4.0	4.0
Memorandum items:							
	(In percent of total external debt unless otherwise mentioned)						
By original maturity:							
Short-term	42.0	41.3	39.7	43.8	40.8	41.7	43.0
Medium- and long-term	58.0	58.7	60.3	56.2	59.2	58.3	57.0
By currency:							
Local currency denominated	36.0	34.0	34.4	31.1	32.7	31.7	32.9
Foreign currency denominated	64.0	66.0	65.6	68.9	67.3	68.3	67.1
By instrument:							
Nonresident holdings of ringgit-denominated debt instruments	25.3	23.3	23.4	19.5	20.7	19.5	20.5
Interbank borrowing	19.3	18.7	19.2	21.8	19.2	21.1	22.2
as share of GDP	12.5	12.6	13.2	13.6	11.9	13.3	13.5
Bonds and notes	19.1	18.5	17.4	16.5	17.4	17.4	17.0
Intercompany loans	11.1	15.0	11.3	11.2	11.7	11.9	10.0
as share of GDP	7.2	10.2	7.7	7.0	7.2	7.5	6.1
Nonresident deposits	9.8	9.4	10.4	10.6	10.4	9.8	9.9
Loans	6.3	5.9	5.8	7.6	7.7	7.3	7.4
Gross official foreign exchange reserves (US$ billion)	95.3	94.5	102.4	101.4	103.0	102.7	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/

(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 2020.

Table 2. Malaysia: External Debt Sustainability Framework, 2014–2024

(Percent of GDP, unless otherwise indicated)

	Actual							Est.	Proj.					
	2014	2015	2016	2017	2018			2019	2020	2021	2022	2023	2024	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	62.2	64.7	67.7	68.6	62.4			**61.0**	**58.9**	**55.3**	**52.2**	**49.9**	**47.7**	**-2.8**
2 Change in external debt	-2.5	2.5	3.0	0.9	-6.2			-1.4	-2.1	-3.6	-3.0	-2.4	-2.2	
3 Identified external debt-creating flows (4+8+9)	-5.9	3.2	-4.5	-9.3	-8.4			-6.5	-5.8	-5.9	-5.4	-4.8	-4.3	
4 Current account deficit, excluding interest payments	-5.4	-4.1	-3.6	-4.0	-3.5			-4.8	-3.5	-3.2	-3.0	-2.7	-2.3	
5 Deficit in balance of goods and services	-9.1	-7.5	-6.7	-6.9	-7.0			-7.8	-6.3	-6.3	-6.0	-5.4	-4.9	
6 Exports	72.8	69.4	66.8	70.0	68.7			67.7	65.0	63.5	61.8	60.0	58.4	
7 Imports	63.6	61.9	60.1	63.2	61.7			59.9	58.6	57.2	55.8	54.6	53.5	
8 Net non-debt creating capital inflows (negative)	2.2	1.8	-0.9	-2.0	0.0			-0.6	-1.3	-1.3	-1.2	-1.2	-1.1	
9 Automatic debt dynamics 1/	-2.7	5.5	0.0	-3.4	-4.9			-1.1	-1.0	-1.3	-1.1	-0.9	-0.9	
10 Contribution from nominal interest rate	1.1	1.1	1.2	1.2	1.5			1.6	1.6	1.4	1.4	1.4	1.4	
11 Contribution from real GDP growth	-3.7	-3.5	-2.9	-3.7	-2.9			-2.8	-2.6	-2.7	-2.5	-2.4	-2.3	
12 Contribution from price and exchange rate changes 2/	-0.1	7.9	1.6	-0.9	-3.4			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	3.4	-0.7	7.5	10.2	2.2			5.1	3.7	2.2	2.4	2.5	2.2	
External debt-to-exports ratio (in percent)	85.5	93.2	101.3	97.9	90.8			90.1	90.6	87.0	84.6	83.1	81.7	
Gross external financing need (in billions of US dollars) 4/	132.2	139.0	120.8	104.7	101.8			107.9	115.9	116.2	118.0	121.0	126.7	
in percent of GDP	38.5	46.1	40.1	32.8	28.4	10-Year	10-Year	29.5	30.4	28.4	26.9	25.7	25.1	
Scenario with key variables at their historical averages 5/								**61.0**	**57.1**	**53.2**	**49.4**	**45.9**	**42.2**	**-0.2**
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
Real GDP growth (in percent)	6.0	5.0	4.4	5.7	4.7	4.7	2.4	4.5	4.4	4.9	4.8	4.8	4.9	
GDP deflator in US dollars (change in percent)	-1.4	-16.3	-4.3	0.1	7.3	-0.3	9.2	-2.5	0.0	2.3	2.2	2.2	2.4	
Nominal external interest rate (in percent)	1.8	1.6	1.9	1.8	2.4	2.4	1.3	2.7	2.7	2.5	2.6	2.9	3.0	
Growth of exports (US dollar terms, in percent)	2.0	-16.1	-3.9	11.1	10.3	1.5	12.8	0.3	0.3	4.9	4.2	4.1	4.5	
Growth of imports (US dollar terms, in percent)	0.6	-14.4	-2.9	11.2	9.9	3.0	13.4	-1.2	2.3	4.7	4.6	4.8	5.3	
Current account balance, excluding interest payments	5.4	4.1	3.6	4.0	3.5	7.1	4.5	4.8	3.5	3.2	3.0	2.7	2.3	
Net non-debt creating capital inflows	-2.2	-1.8	0.9	2.0	0.0	-0.6	1.5	0.6	1.3	1.3	1.2	1.2	1.1	

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

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in 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 $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in 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. External Sector Assessment

Overall Assessment: *The external position in 2019 was stronger than implied by fundamentals and medium-term desirable policies.* Over the past few years Malaysia's growth model has become increasingly driven by private domestic demand, and its CA surplus has narrowed significantly. Further decline in the surplus is projected over the medium term on the back of policies supporting continued robust domestic private demand.

Potential Policy Responses: The planned medium-term fiscal consolidation should be accompanied by policies to strengthen the social safety net and continue to encourage private investment. Fiscal spending should be reoriented to accommodate further improvements in social protection and public health care. At the same time, continued efforts are needed to improve the quality of public infrastructure (supported by enhanced public finance management) and to address structural impediments holding back private investment and productivity growth, including measures to improve SMEs' access to credit, promote the quality of education, reduce skills mismatch, and encourage female labor participation. Continued exchange rate flexibility is necessary to facilitate external adjustment, with intervention limited to addressing disorderly market conditions.

Foreign Asset and Liability Position and Trajectory	**Background.** Malaysia's NIIP has averaged about 1 percent of GDP since 2010, with changes in recent years reflecting both CA surplus and valuation effects. As of 2019Q3, the NIIP improved to about –0.9 percent of GDP (compared with –5.4 percent of GDP at end-2018), with higher net direct investment and other investment liabilities more than offsetting the reduction in net portfolio capital liabilities.[1] Direct investment abroad and official reserves contribute most to net assets, whereas net portfolio liabilities contribute most to net liabilities. Total external debt, measured in US dollars, was about 60.7 percent of GDP in September 2019 (end-2018: 62.3 percent), of which about two-thirds was in foreign currency and 43 percent in short-term debt, by original maturity. **Assessment.** The NIIP should rise gradually over the medium term reflecting projected moderate 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]					
Sept 2019 (Percent of GDP)	NIIP: –0.9	Gross Assets: 118.2	Res. Assets: 28.9	Gross Liab.: 119.0	Debt Liab.: 61.3	
Current Account	**Background.** Malaysia's CA surplus declined by about 8 percentage points of GDP between 2010 and 2018, primarily driven by lower national savings and a modest rise in investment till 2017. In the first half of 2019, the CA surplus recorded a temporary increase to 4.2 percent of GDP, driven by the sharp decline in capital imports. The goods balance remained in surplus, whereas the services account and income accounts registered lower deficits. **Assessment.** The EBA CA regression estimates a cyclically adjusted CA of 3.6 percent of GDP and a CA norm at –0.3 percent of GDP for 2019. After factoring in the effect of the postponement of large infrastructure projects (which have relatively high import content) on capital imports (0.4 percent of GDP), which represents a temporary yet protracted shock that would gradually taper off, the preliminary estimate of the staff CA gap is about 3.5 percent of GDP (±about 1 percent of GDP). Over half of the CA gap is attributed to policy distortions. Low domestic public health care spending contributes 0.7 ppt to the CA gap, while looser fiscal policy in the rest of the world, relative to Malaysia, also contributes 0.7 ppt to the excess surplus. Unidentified residuals potentially reflect structural impediments and country-specific factors not included in the model. The CA balance is expected to remain in surplus, albeit a lower one, over the medium term, driven by lower private sector saving and higher investment.					
2019 (Percent GDP)	Actual CA: 3.5	Cycl. Adj. CA: 3.6	EBA CA Norm: –0.3	EBA CA Gap: 3.9	Staff Adj.: -0.4	Staff CA Gap: 3.5
Real Exchange Rate	**Background.** Through September 2019, the REER has depreciated by 1.5 percent relative to the 2018 average. The REER is about 12 percent lower than its 2013 level, reflecting the impact on the NEER from capital outflows and terms-of-trade shocks, with the latter contributing to a decline in the CA surplus. **Assessment.** The EBA REER Index and Level models estimate Malaysia's REER to be undervalued by about 26 and 39 percent, respectively. However, the usual macroeconomic stresses associated with such undervaluation are absent (for example, high core inflation, sustained wage pressure, or significant FX reserve buildup). Consistent with the assessed CA gap, staff assesses the REER gap in 2019 to be –7.6 percent (± about 2 percent).[3]					
Capital and Financial Accounts: Flows and Policy Measures	**Background.** Since the global financial crisis, Malaysia has experienced periods of significant capital flow volatility, largely driven by portfolio flows in and out of the local-currency debt market, in response to both the change in global financial conditions and domestic factors. Since late 2016, the Financial Markets Committee has implemented measures to develop the onshore FX market.[4] **Assessment.** Continued exchange rate flexibility and macroeconomic policy adjustments are necessary to manage capital flow volatility. CFM measures should be gradually phased out, with due regard for market conditions.					
FX Intervention and Reserves Level	**Background.** Malaysia's official reserves fell by US$8.1 billion since May 2018 and stabilized at US$101.4 billion as of end-2018. Reverses level began to gradually pick up in 2019H1 and stands at US$103.0 billion as of September 2019. **Assessment.** Under the IMF's composite reserve adequacy metric (ARA),[5] reserves remain broadly adequate. Gross and net official reserves are about 115 percent and 102 percent of the ARA metric as of September 2019. respectively. Given limited reserves and the increased hedging opportunities since 2017, FX interventions should be limited to preventing disorderly market conditions. In case of an inflow surge, some reserve accumulation would be appropriate to increase the reserve coverage ratio.					

[1] The ratios to GDP are based on staff estimates using US dollar values.

[2] Close to one-third of external debt is denominated in local currency and is largely of medium-term maturity, helping reduce FX and rollover risks. Malaysia's local currency external debt reflects holdings of domestically issued debt (mainly Malaysian government securities) by nonresident investors (about 12 percent of GDP as of 2019:Q3). Short-term FX-denominated debt largely belongs to the banking system, and a good portion is matched by short-term foreign currency assets, which are being closely supervised by Bank Negara Malaysia. Stress test analysis by staff suggests that the Malaysian economy would be resilient to a large capital flow reversal due to the depth of the domestic financial markets and the role of institutional investors.

[3] The REER gap is based on the estimated semi-elasticity of CA to REER at 0.46.

[4] On December 2, 2016, the Financial Markets Committee 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 CFMs under the IMF's institutional view on capital flows. In addition, the authorities' strengthened enforcement of regulations on resident banks' noninvolvement in offshore ringgit transactions was considered enhanced enforcement of an existing capital flow management measure. Over the course of 2017-2019, additional measures were announced to help deepen the onshore financial market and facilitate currency risk management.

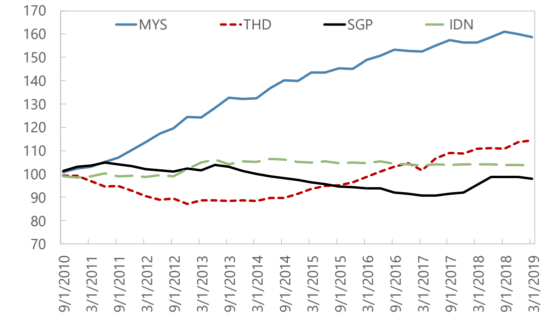
[5] The IMF's composite reserve adequacy metric classifies Malaysia's regime as "floating" since 2016.

Appendix X. The Real Estate Market and Financial Stability Risks[1]

House prices rose faster than incomes in the aftermath of the GFC…

1. Over the past decade, real house prices rose faster than income. House prices in Malaysia increased faster than in many regional comparators in the wake of the GFC (text chart). On average real house prices rose by 6 percent in Malaysia annually since 2010, compared with below one percent in regional comparators. At the same time, per capita income in Malaysia grew by around 4 percent annually leading to a deterioration in affordability over this time period (text chart).

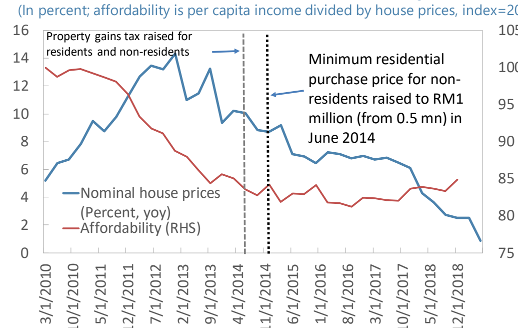
Real House Prices
(Index, 2010=100)



Sources: BIS

2. From 2015 onwards, house price growth has moderated from high levels. The average annual nominal house price increase during 2010-14 was 10 percent, but it has declined to an average of 5.5 percent during 2015-19. Most recently, preliminary data indicate that house prices increased by 0.4 percent in 2019Q3 (year-on-year) (text chart). The moderation in house price growth is broad-based across regions, including Kuala Lumpur (text chart).

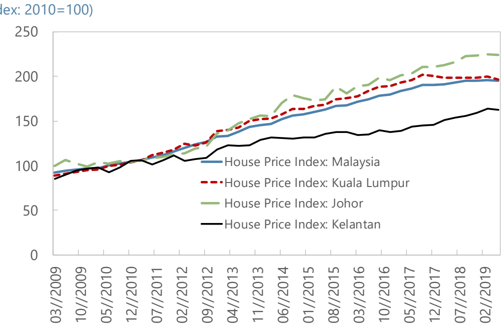
Annual House Price Growth and Affordability
(In percent; affordability is per capita income divided by house prices, index=2010)



Sources: CEIC and Fund staff calculations

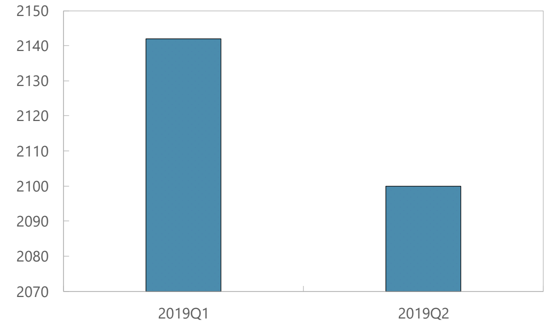
3. Residential housing supply has responded to higher prices with a lag. Supply factors are important determinants of housing market dynamics, especially considering that residential housing has long planning-to-production lags which can produce temporary supply and demand mismatches. In the aftermath of the GFC, residential property launches plummeted from a peak of nearly 350,000 units before the GFC to a lowest point of 173,000 in 2012 (text chart). The increase in house prices during 2010-15 triggered a strong supply response from 2015 onwards and currently housing starts are well above 300,000.

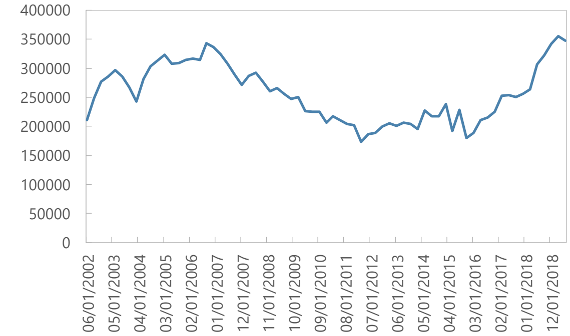
Malaysia - House Prices By Region
(Index: 2010=100)

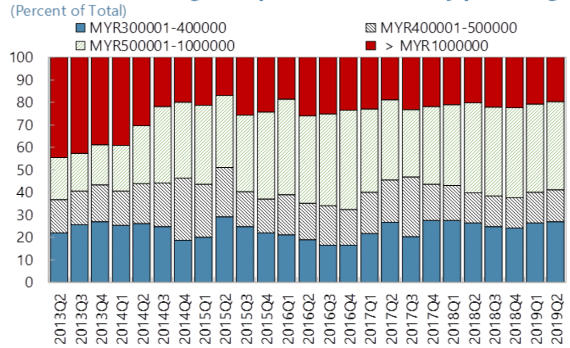


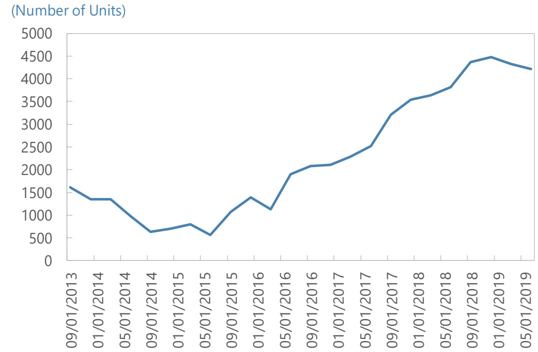
Sources: CEIC Data

[1] Prepared by Dan Nyberg.









4. The strong supply response has led to overproduction in some segments of the market. Affordable housing in Malaysia is usually considered to be below RM300,000.[2] Unsold properties in the upper segment (above RM500,000) has increased sharply in 2018-19, particularly in the high-rise apartment segments, whereas recent housing demand has been strong in the lower segments of the market as evidenced by the lower inventory of unsold housing units; unsold units above RM 1 million remain at a high level.

5. In contrast, there is an undersupply of housing at affordable levels, especially in urban areas. The deterioration of housing affordability can be illustrated in the house price-to-income ratio, which has increased from 4.1 in 2002 to 5.0 in 2016 (see Khazanah Research Institute, 2019). In addition, urban migration has increased housing demand in urban areas. The World Bank (2019) finds that households in Kuala Lumpur and Petaling District with monthly incomes below RM5,000 experience severe unaffordability, and can experience difficulty finding finance given low and often volatile income. Households with incomes from RM6,000-10,000 have moderate difficulty in

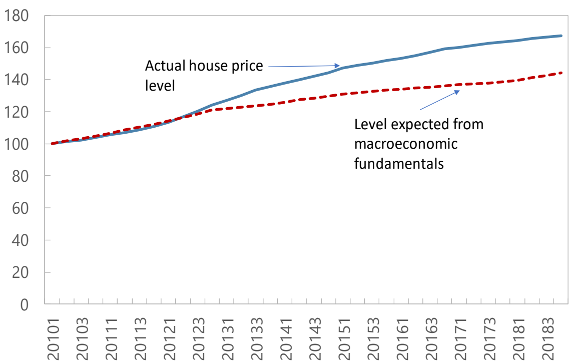
[2] A common rule of thumb is that house prices should be below 3x median income, which would put an affordable housing threshold in the range of RM280,000-300,000. BNM's program for affordable housing allows for house prices up to RM300,000 to assist first-time home buyers in lower-income groups where eligible home buyers can access financing at a concessionary rate. See Table 1 for additional details.

purchasing a home, while those with incomes above RM10,000 find ample supply within their capacity-to-pay.

…leading to a moderate overvaluation of house prices.

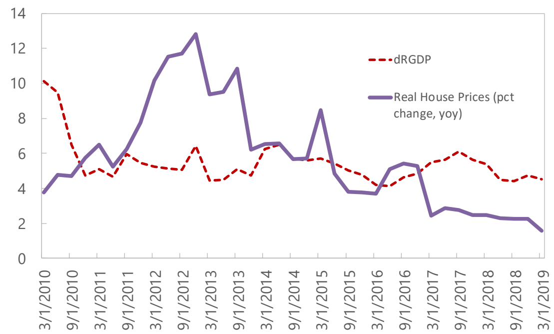
6. **House prices are estimated to be moderately overvalued.** Using an econometric model with fundamental determinants of house prices such as affordability, per capita income, interest rates, credit growth, working age population and equity share prices, suggest that real house prices remain about 15 percent above what fundamental macroeconomic variables would indicate (Box 1), although the overvaluation has slightly narrowed in recent years as house price increases have moderated.

House Prices and Macroeconomic Fundamentals
(Index, 2010=100)



Sources: Haver, CEIC, FRED, and Fund Staff calculations.

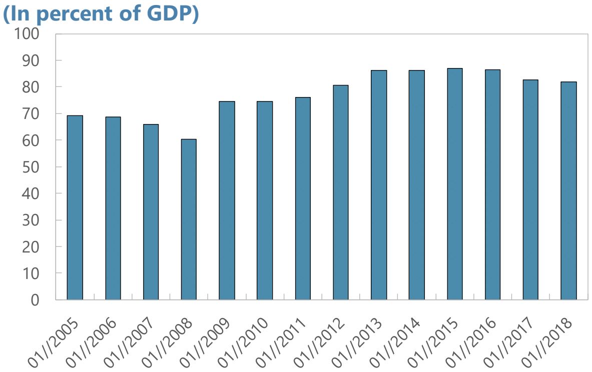
Malaysia - Real House Price and Income Growth
(In percent)



Sources: Haver Analytics, CEIC, FRED Database, and Fund staff calculations

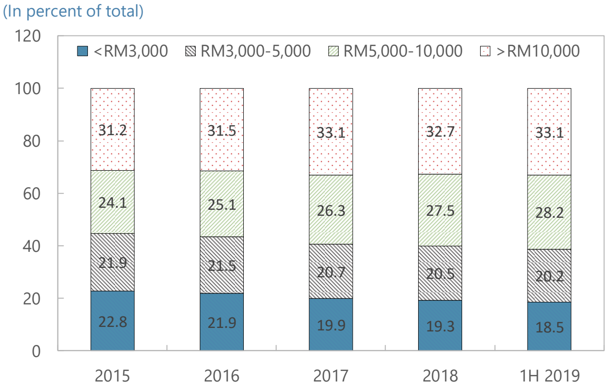
Household debt also increased rapidly along with rising house prices…

Malaysia - Household Debt
(In percent of GDP)



Sources: CEIC Data

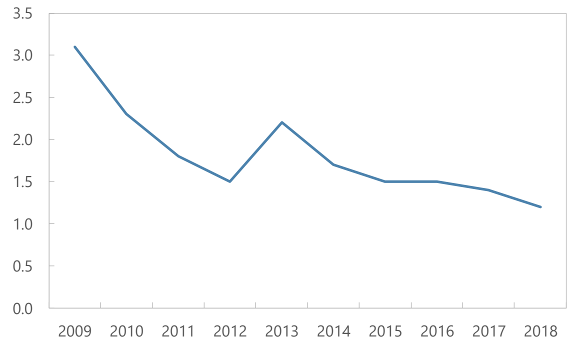
Malaysia - Household Debt By Monthly Income
(In percent of total)



Sources: BNM Financial Stability Report, September 2019.

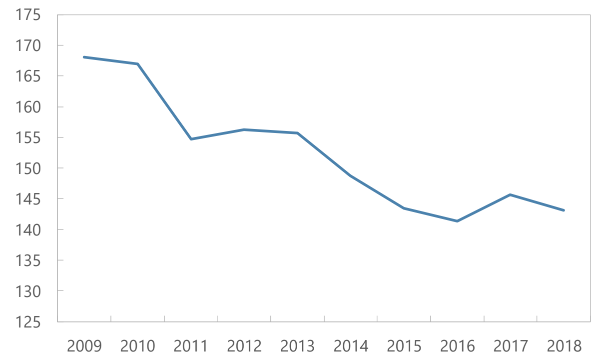
7. **Along with the increase in house prices, household debt has risen sharply over the past decade.** Household debt increased from 60.4 percent of GDP in 2008 to 86.5 percent in 2016. Household debt has stabilized around 82 percent in 2019. Nevertheless, the level of household debt in Malaysia is relatively high by regional standards. Of the total household debt, around 54.5 percent is residential mortgages in 2019. Household debt by monthly income (as a share of total) has decreased for households making less than RM3,000, from 22.8 to 18.5 percent perhaps partly as a result of loan affordability assessments following the introduction of BNM's Responsible Financing Guidelines in 2012.

Malaysia - Household Sector NPLs
(Percent share of total household sector loans)



Sources: Haver Analytics

Malaysia - Household liquid financial assets to debt
(Percent)



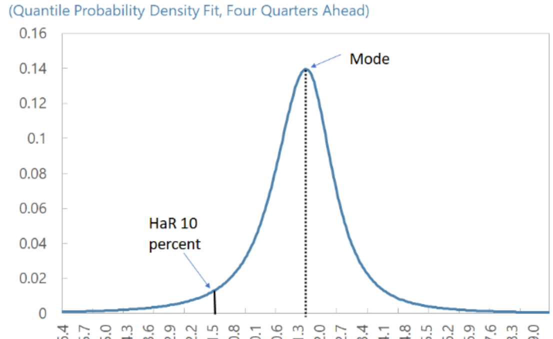
Sources: Haver Analytics

...and high household debt heightens financial stability risks.

8. **High household debt raises financial stability risks, although households also hold substantial assets and non-performing loans are low**. Although growth in household debt has moderated in recent years, some households could face increasing stress, particularly if they are over-extended from easier lending conditions in the past and severe income shocks could erode household financial buffers and impact spending (see Nordin et al 2018). Financial stability concerns relating to household debt are cushioned by high household assets (more than twice the debt) of which 2/3 are considered liquid. Moreover, household non-performing loans have declined and are somewhat below the banking sector average of 1.6 percent of total lending.

9. **The concept of "House price at Risk" (HaR) can be used to obtain a measure of worst possible outcome for house prices over a given horizon**. Following the approach in IMF (2019), a housing-at-risk approach quantifies the risk of negative house price growth 4-quarters ahead. Specifically, we use the explanatory variables in the econometric model discussed in the appendix to derive a distribution of projected real house price increases four quarters ahead. Using this approach

House Price-at-Risk
(Quantile Probability Density Fit, Four Quarters Ahead)



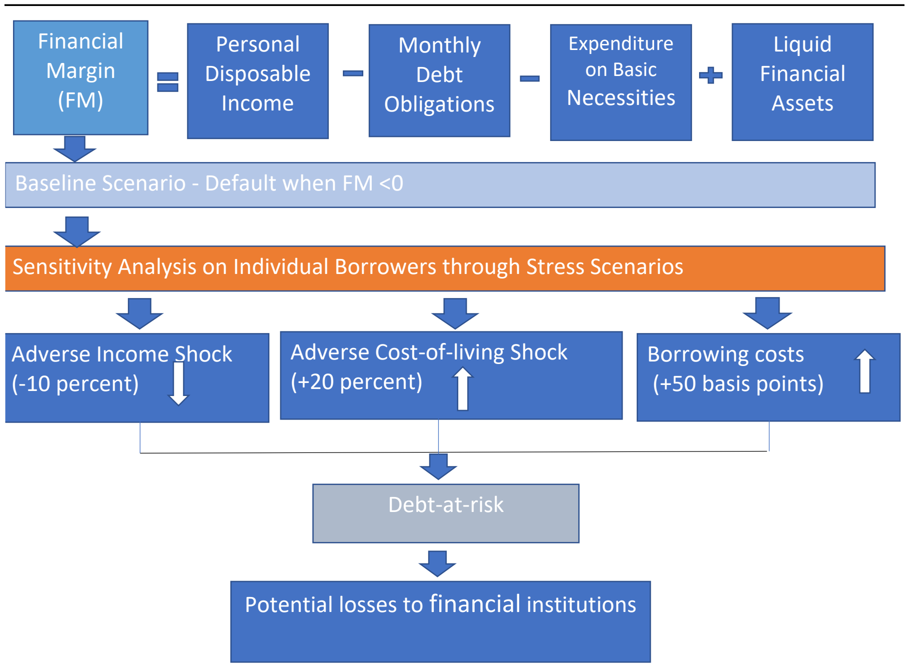
Sources: CEIC, Haver Analytics, and Fund staff calculations.

suggests that the mode of house price increase will stabilize around 1.5 percent four quarters ahead (see text chart).

The authorities have taken steps to manage risk and enhance affordability.

10. In view of elevated risks related to high household debt, the BNM has enhanced its stress testing of banks and household finance. The BNM uses a net “Financial Margin” approach to stress test household finances (see Text illustration below). This entails establishing a baseline for financial disposable income that remains after subtracting debt obligations and expenditures on necessities, while considering the household’s liquid financial assets. The latest stress test assumed that borrowing costs increase by 50 basis points, cost of living increases by 20 percent, and incomes decline by 10 percent.[3] Borrowers’ debt repayment capacity was most affected under income and cost of living shocks, with a smaller impact from an increase in borrowing costs. The associated increase in potential losses to the banking system under stress scenarios remained within banks’ excess capital buffers as at end-June 2019. Based on the BNM’s sensitivity analysis, banks continue to maintain capital buffers to absorb 1.5 times the potential losses under severe stress scenarios.[4]

BNM Household Financial Margin Stress Testing



Source: BNM, Financial Stability Review First Half 2019, Diagram 2 of the Box Article "An Enhanced Financial Margin Framework for the Household Sector".

[3] These shocks are calibrated to match or exceed the worst possible shocks experienced since the Asian Financial Crisis. Internally, the BNM also models house price shocks within the Financial Margin stress testing framework discussed above.

[4] Refers to a 50 percent earnings shock on large corporate borrowers in the property sector and 50 percent decline in property prices. A significant share – 83 percent – of residential property loans is extended to owner-occupiers who are viewed to have a stronger incentive to maintain loan repayments (compared to investors). Almost 70 percent of outstanding housing loans have a loan-to-value ratio of less than 80 percent, thus providing a buffer against potential losses.

11. The authorities have introduced housing market initiatives to reduce housing oversupply and enhance affordability.[5] (Tables 1 and 2). The Government has introduced several policy measures to enhance affordability. For instance, the authorities have introduced stamp duty exemptions, youth housing schemes, and mortgage guarantees, and have established a BNM Fund for Affordable Homes. Initiatives to enhance financial literacy have also been introduced (Table 1). While it is too early to fully evaluate the affordability measures, they have been welcomed by the industry and some initiatives have been extended and/or expanded. The BNM Fund for Affordable Homes has met a strong uptake and the program was recently enhanced by raising the maximum purchase price to RM300,000. The Home Ownership campaign was also extended to end-2019.

12. The macroprudential measures adopted by the authorities have likely contributed to a slowdown in activity in the housing market, including by non-residents. The share of nonresident transactions in the real estate market have declined following the introduction of the macroprudential measures and represent a relatively small share of total (less than 5 percent). 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. The 2020 budget announced a lower limit for non-resident purchases (from RM1 million to RM0.6 million) of completed but unsold apartments. This measure is expected to remain valid for one year to stimulate apartment demand and reduce the stock of unsold units at the upper end of the market. The authorities have also introduced several macroprudential measures such as limits on amortization periods and restrictions on unsecured loans to reduce the financial stability risks stemming from the household sector (see Table 2).

Summary and Conclusions

13. Although house price growth has moderated and household debt stabilized, the real estate sector requires continued close monitoring and affordability challenges remain. House prices rose faster than incomes in the post GFC period leading to house price overvaluation and a deterioration in affordability. There is a current oversupply of apartments in upper-price segments, while demand for affordable housing (below RM300,000) remains relatively stronger. Household debt has stabilized at a high level but continues to pose vulnerabilities in a potential economic downturn. The systemic financial sector risks from the real estate sector are partly mitigated by high household assets and strong banking sector capital and profitability.

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[5] See Khazanah Research Institute (2019) for an overview of considerations for the new National Housing Policy.(See http://www.krinstitute.org/Publications-@-Rethinking_Housing-;_Between_State,_Market_and_Society.aspx)

Table 1. Malaysia—Recent Housing Market Initiatives

Target	Measure	Description
Targeted to first-time home buyers	Stamp duty exemption	Stamp duty exemption on memorandum of transfer and loan agreement for the first RM300,000. Applicable for properties up to RM500,000 (primary and secondary market). The exemption is valid for a period of two years until December 2020.
	BNM Fund for Affordable Homes	In 2019, the BNM established a fund with a total allocation of RM1 bn to assist first-time home buyers in lower-income groups. Eligible first-time home buyers with monthly household income of up to RM4,360 will be able to access home financing at a concessionary financing rate of up to 3.5 percent per annum to purchase houses up to RM300,000. The Fund is available for two years starting in 2019, or until the RM1 bn is fully utilized.
	Youth Housing Scheme	To assist first home purchases, the government will extend the Youth Housing Scheme administered by Bank Simpanan Nasional to December 2021. Originally announced in the 2015 Budget, the scheme offers a 10 percent loan guarantee through Cagamas to enable borrowers of full financing and RM200 monthly installment assistance for the first two years.
	Rent-to-Own financing scheme	Financing up to RM10 bn will be provided by the financial institutions with the support from the Government via a 30 percent of RM3 bn guarantee. Announced in the 2020 Budget, this rent-to-own scheme is for purchase of first home up to RM500,000 property price. Under this scheme, the applicant will rent the property for up to 5 years and after the first year, the tenant will have the option to purchase the home based on the price fixed at the time the tenancy agreement is signed. The government will provide stamp duty exemptions on the instruments of transfer between the developer and the financial institution.
	Mortgage guarantees	Higher margin of financing supported by guarantees from Cagamas Berhad and Syarikat Jaminan Kredit Perumahan Berhad under various schemes.
Targeted to all buyers	Home ownership campaign	Stamp duty exemption on memorandum of transfer for residential properties up to RM1 million and for loan agreement up to RM2.5 million. Campaign extended to December 2019.
	Advisory assistance	MyKNP has been established to assist applicants who have been unsuccessful in securing home financing to obtain advisory services. RUMAHKU Financial Education program has been launched to help potential borrowers understand their financial commitments prior to purchasing a home.
	Real property gain tax	Announced in the 2020 Budget, the government will enhance real property gains tax treatment by revising the base year for asset acquisition at January 1, 2013 for assets acquired before 2013 (previous base year was January 1, 2000).
Targeted to foreign buyers	Lower limit for non-resident purchases of property	The 2020 Budget announced the Government's decision to lower the property threshold for foreign property buyers from RM1 million to RM600,000 on completed but unsold high-rise property units in urban areas. This measure is valid for one year.

Source: BNM Financial Stability Review, First Half 2019; and the 2020 Budget.

Table 2. Malaysia—Household Sector Macroprudential Tools

Measure	Description
Household sector capital requirements	Effective February 2011, residential mortgages with LTV ratio over 90% and personal financing with tenure of more than five years are risk-weighted at 100%. This framework is applicable to all licensed banking institutions and approved financial holding companies (FHC) under FSA 2013 and IFSA 2013.
Cap on loan-to-value ratio	Effective November 2010, the maximum LTV ratio for third and subsequent mortgages is 70%. The measure was introduced to curb speculative activities and promote a sustainable property market. Effective December 2011, the maximum LTV ratio for all housing loans taken by non-individuals is 60%. Both frameworks are applicable to financial institutions under FSA 2013 and IFSA 2013, and prescribed institutions under the Development Financial Institutions Act 2002 (DFIA 2002).
Limit on amortization periods	Effective November 2011, the maximum tenure for loans for the purchase of motor vehicles is 9 years. Effective July 2013, the maximum tenure for purchase of properties is 35 years, while the maximum tenure for personal financing is 10 years. These measures are applicable to all banking institutions under FSA 2013 and IFSA 2013, prescribed institutions under DFIA 2002, credit cooperatives regulated by the Suruhanjaya Koperasi Malaysia (SKM), and two large retail credit providers.
Restrictions on unsecured loans	Effective July 2013, preapproved unsolicited personal financing products are prohibited, while new personal financing products or variations to existing products must receive approval from the BNM.
Other	Effective November 2013, financial institutions are prohibited from granting any end financing facility to any individuals for the purpose of financing the purchase of a property that is offered under an interest capitalization scheme (ICS) or any other permutation thereof, including the developer interest bearing scheme (DIBS). Financial institutions are also prohibited from granting any bridging financing facility for the purposes of financing a property development that offers ICS or any permutation thereof, including DIBS. The prohibition is applicable to financial institutions under FSA 2013 and IFSA 2013, and prescribed institutions under DFIA 2002.
Fiscal measures to contain systemic risks	Effective January 1, 2014, the real property gains tax (RPGT) for Resident individuals, for disposal of property is: 30% within 3 years after date of property acquisition, 20% in the 4th year, 15% in the 5th year, and 0% thereafter. Effective January 1, 2014, the real property gains tax (RPGT) for Non-resident individuals, for disposal of property is: 30% within 5 years after date of property acquisition, and 5% thereafter. Effective January 1, 2014, the real property gains tax (RPGT) for Non-resident individuals, for disposal of property is: 30% within 5 years after date of property acquisition, and 5% thereafter. Effective January 1, 2014, the real property gains tax (RPGT) for Companies, for disposal of property is: 30% within 3 years after date of property acquisition, 20% in the 4th year, 15% in the 5th year, and 5% thereafter. Previous changes to the RPGT for Residents, Non-Residents, and Companies apply similarly across all three groups and are as follows: Effective January 1, 2010, RPGT for disposal within 5 years was 5% and 0% thereafter. Effective January 1, 2012, RPGT was 10% within 2 years, 5% in the 3rd, 4th, and 5th years, and 0% thereafter. Effective January 1 2013, RPGT was 15% within 2 years, 10% in the 3rd, 4th, and 5th years, and 0% thereafter. Effective November 2013, developers are prohibited from implementing projects with elements of the ICS, including DIBS or any permutation thereof. Introduced in the 2014 Budget, the floor price for properties that can be purchased by non-residents is RM 1 million, an increase from the previous RM 500,000 floor. Effective July 1, 2012, in Penang, the floor price for properties that can be purchased by non-residents is RM 2 million on the island and RM 1 million on the mainland for all types of property. The 2020 Budget lowered the floor price for completed but unsold high-rise property in urban areas that can be purchased by non-residents to RM 600,000 for one year.

Source: IMF Macroprudential Database and Fund staff.

Box 1. Estimating an Equilibrium Level of House Prices

Building on the approach in Igan and Loungani (2012), one way of looking at the equilibrium level of house prices is to model and estimate the main drivers of house prices and calculate the gap between the actual house prices and their predicted values based on this model. Real house price changes are modeled as a function of changes in disposable income, working-age population, equity prices, credit, and the level of interest rates. The following regression is estimated:

$$\Delta HPI_t = \alpha + \beta_1 A_{t-1} + \beta_2 \Delta YPC_t + \beta_3 \Delta WAP_t + \beta_4 \Delta SP_t + \beta_5 \Delta Cr_t + \beta_6 i_t + e_t$$

where ΔHPI is the change in real house prices; A is affordability level of housing in the previous period, measured by the ratio of house prices to income per capita; ΔYPC is the change in real income per capita; Δ WAP is the change in working-age population over the past year; ΔSP is the change in stock prices over the year before last; ΔCr_t is the credit growth (credit to the private non-financial sector by domestic banks) over the last year; and i_t is the real interest rate (base lending rate). The model is estimated using quarterly data from 1988 to 2018, with a reference year of 2010 for calculating house price misalignment. In the absence of sufficiently long data on working age population, total population data are used. The regression equation is estimated using ordinary least squares (OLS), with the following coefficients on the explanatory variables:

Fundamental Determinants of House Prices - Regression Results

Explanatory Variable	Coefficients	
Affordability	-41.4	***
Per Capita Income	0.69	***
Credit	0.4	***
Population	-1.75	**
Equity Prices	0.05	***
Interest Rate	-0.16	
Constant	17.7	***
Observations	120	
R2	0.48	

Note: *p<0.1; **p<0.05; ***p<0.01

References

Igan, D. and P. Loungani (2012), "Global Housing Cycles", IMF Working Paper 12/217, August.

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INTERNATIONAL MONETARY FUND

MALAYSIA

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 23, 2020

Prepared By: Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of December 31, 2019)

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)	2,830.44	77.89
Reserve tranche position	803.38	22.11
Lending to the Fund New Arrangement to Borrow	22.13	

III. SDR Department

	SDR Millions	Percent of Allocation
Net cumulative allocation	1,346.14	100.00
Holdings	822.85	61.135

Exchange Arrangement:

The de jure and de facto exchange rate arrangements are floating.

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

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 2019 Article IV Consultation Report (IMF Country Report No. 19/71) lists exchange rate measures that have been taken between December 2016 and December 2018.

In March and August 2019, the BNM announced further liberalization of the FEA policy aimed at providing greater flexibility and efficiency for businesses to better manage their foreign exchange risk and conduct their daily operations.

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 of 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. Staff discussions for the 2019 Article IV consultation took place during November 28–December 12, 2018. The consultation was concluded by the Executive Board on February 15, 2019 (IMF Country Report No. 19/71). Staff discussions for the 2020 Article IV consultation were conducted on a mission to Kuala Lumpur during December 5–December 17, 2019. In addition, a staff visit took place during July 18–24, 2019.

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. Technical Assistance on the Medium-Term Revenue Strategy and on the Fiscal Responsibility Act is planned for early 2020.

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. The authorities have requested technical assistance on further options to deepen FX markets and on analyzing the role of the exchange rate in Malaysia's economy.

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 follow-up GFS technical assistance missions were conducted in March and December 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 FATF 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. In the Third Enhanced Follow-up Report (October 2018), Malaysia made progress in addressing the technical compliance deficiencies, but remained under the FATF's enhanced follow-up process and will report back on progress made to strengthen its implementation of AML/CFT measures.

Resident Representative/Advisor: None.

STATISTICAL ISSUES

(As of December 2019)

I. Assessment of Data Adequacy for Surveillance
General: Data provision is broadly adequate for surveillance.
National accounts: Currently, the Department of Statistics Malaysia (DOSM) publishes annual and quarterly estimates of GDP, compiled by the production, expenditure, and (annual only) income approaches, at current and constant 2015 prices, based on the *2008 SNA*. The DOSM also disseminates annual estimates for gross disposable income, saving, and net lending for the economy, as well as supply and use tables. Quarterly GDP estimates are released about one and a half months after the reference quarter. **Price statistics**: The monthly CPI and the PPI are available on a timely and comprehensive basis. A quarterly Services PPI and monthly building cost index are also published 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 agencies, including the Ministry of Finance, 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. 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 only 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. **Financial Access Survey:** BNM reports data on several key series and indicators of the Financial Access Survey (FAS), including mobile money and the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).
Balance of payments: Department of Statistics Malaysia compiles and publishes quarterly balance of payments and international investment position (IIP) estimates in accordance with the sixth edition of the Balance of Payments and International Investment Position Manual. 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. The persistent large negative net errors and omissions up to 2018 has been addressed in 2019 following the implementation of a new data compilation system. The IIP data are reported without a breakdown by institutional sector and 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 15, 2020)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	01/14/2020	01/14/2020	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	11/30/2019	01/01/2020	M	M	M
Reserve/base money	11/2019	01/2020	M	M	M
Broad money	11/2019	01/2020	M	M	M
Central bank balance sheet	11/2019	01/2020	M	M	M
Consolidated balance sheet of the banking system	11/2019	01/20209	M	M	M
Interest rates[2]	01/14/2020	01/14/2020	D	D	D
Consumer price index	11/2019	12/26/2019	M	M	M
Revenue, expenditure, balance and composition of financing[3]—general government[4]	2018	2019	A	A	A
Revenue, expenditure, balance and composition of financing[3]—federal government	2019:Q3	11/2019	Q	Q	Q
Stocks of central government and central government guaranteed debt[5]	2019:Q3	11/2019	Q	Q	Q
External current account balance	2019:Q3	11/2019	Q	Q	Q
Exports and imports of goods	11/2019	01/2020	M	M	M
Exports and imports of services	2019:Q3	11/2019	Q	Q	Q
GDP/GNP	2019:Q3	11/2019	Q	Q	Q
Gross external debt	2019:Q3	11/2019	Q	Q	Q
International Investment Position	2019:Q3	11/2019	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 the Staff Representative on Malaysia
February 7, 2020

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

On January 22, 2020, Bank Negara Malaysia (BNM) reduced the Overnight Policy Rate (OPR) by 25 basis points to 2.75 percent. In its monetary policy statement, the BNM stated that "the adjustment to the OPR is a pre-emptive measure to secure the improving growth trajectory amid price stability." The statement also indicates that BNM continues to expect growth to be within its projected range of 4.3-4.8 percent in 2019 and to gradually improve in 2020. Nonetheless, the statement mentions downside risks to growth including trade-related uncertainty, geopolitical risks, weaker-than-expected growth in major trade partners, heightened volatility in financial markets, and domestic factors such as weakness in commodity-related sectors and delays in the implementation of projects. Analysts have portrayed the main motivation for the rate cut as buying insurance against the downside risks.

Staff Assessment: Staff support the rate cut in view of the recent drop in inflation expectations seen in the January consensus forecasts. The cut is consistent with staff advice that monetary policy should remain data dependent. With the recent drop in inflation expectations, the cut implies that monetary policy remains appropriately broadly neutral according to staff's assessment. The rate cut also helps bring risks to the outlook, assessed in the staff report to be to the downside, closer to balance.

Implications for the Staff Report: The rate cut does not alter the thrust of the staff appraisal.

Statement by Alisara Mahasandana, Executive Director for Malaysia, and Zaidi Mahyuddin, Senior Advisor to the Executive Director
February 7, 2020

Introduction

On behalf of the Malaysian authorities, we wish to express our appreciation to the IMF team for the comprehensive report and constructive dialogue during the 2020 Article IV consultation. We are encouraged by staff's positive assessment on Malaysia's economic and financial outlook, as well as acknowledging the appropriateness of the current macroeconomic policy setting and the progress in Malaysia's reform agenda.

Amidst heightened uncertainty and considerable downside risks in the global economy, the Malaysian economy moderated in 2019. Growth was underpinned by a diversified economy, the flexibility accorded by a floating exchange rate and healthy external balance. The Malaysian authorities continue to be vigilant over near-term risks and remain committed towards medium-term governance and structural reforms to ensure sustainable and inclusive growth.

Given its highly open economy with a financial system that is integrated with the international financial system, Malaysia remains susceptible to external developments and cross-border spillovers. In managing these risks, the necessary policy frameworks that enable timely and targeted policy responses and adequate buffers are in place to cushion the impact of these external spillovers and address specific risks confronting the economy and the financial system. As risks and challenges become more complex, especially under the "low for long" interest rate environment in a number of advanced economies, we welcome the Fund's greater recognition of the need for an expanded policy toolkit and an integrated approach to policy formulation, and urge the Fund to expedite its ongoing work on the integrated policy framework.

Latest economic development and outlook

Authorities broadly agree with the IMF's near-term assessment of the Malaysian economic growth and risks. The Malaysian economy grew by 4.6% in the first 3 quarters of 2019, supported by firm private consumption spending and positive net exports. Investment activity, however, remained modest, due to weak capital spending by both the private and public sectors. In 4Q 2019, unanticipated supply disruptions in the commodities sector and a contraction in net exports are expected to weigh on growth. Headline inflation averaged lower (2019: 0.7%; 2018: 1.0%), mainly reflecting the extension of domestic retail fuel price ceilings and the lapsed effect of the changes in the consumption tax policy[1]. Meanwhile, core inflation was broadly stable (2019: 1.5%; 2018: 1.6%).

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[1] Refers to the combined impact of the zeroization of the Goods and Services Tax (GST) rate and the implementation of the Sales and Services Tax (SST) in 2018.

In 2020, the authorities expect gradual improvement in growth, supported by continued household spending amid stable labor market conditions. Key Government initiatives from the 2020 Budget such as the higher minimum wage in urban areas, targeted fuel subsidy and cash transfers are also expected to lift disposable income. Investment activity is expected to record a modest recovery, underpinned by the realization of approved investment projects and resumption of large infrastructure projects. In line with the expected improvement in global growth and trade, Malaysia's exports are expected to experience a broad-based recovery. E&E exports (37.8% share of Malaysia's total exports), in particular, is poised to benefit from the pickup in the current global technology cycle given Malaysia's position as the 6th largest semiconductor exporter globally. Headline inflation is expected to average higher than in 2019 but remain modest. The trajectory of headline inflation will be dependent on global oil and commodity price developments and the timing of the lifting of the domestic retail fuel price ceilings. Underlying inflation is expected to remain broadly stable, reflecting the continued expansion in economic activity and the absence of strong demand pressures.

Our authorities concur that risks to the growth outlook are tilted to the downside. These include the uncertainty surrounding trade tensions, slower-than-expected growth in major trading partners, potential tightening of global financial conditions as a result of heightened risk aversion towards emerging markets and implications from prolonged Coronavirus outbreak. On the domestic front, weakness in commodity-related sectors and delays in the implementation of projects may pose further risks to growth.

However, several factors will help mitigate these risks. Exchange rate flexibility with adequate levels of international reserves will continue to buffer against external shocks. Malaysia's diversified export base reduces reliance on any single product or market. Deep financial markets, supported by demand from large domestic institutional investors and a sound banking system, will continue to intermediate capital flows during risk-off periods. The Malaysian Government's commitment to ensure timely implementation of public projects and continued efforts to provide policy clarity will help cushion the downside risks to growth.

Fiscal Policy

The authorities embarked on a holistic fiscal reform program that focuses on strengthening of the governance and fiscal policy management while continuing to remain supportive of sustainable and inclusive economic growth.

The authorities continue to promote greater transparency and accountability through its second annual publication of the Fiscal Outlook and Federal Government Revenue Estimates. The report, among others, highlights the Medium-Term Fiscal Framework for the next 3 years and includes a comprehensive reporting of fiscal risks and liability exposures, including Government Guarantees and other liabilities such as those related to public-private- partnerships. A comprehensive assessment of debt management and an internal Debt Sustainability Analysis suggest that Malaysia has relatively manageable level of debt and financing needs. This is consistent with staff's findings that the debt level is expected to gradually decline to a debt-to-GDP ratio of below 50% in the medium term. The authorities are establishing a Debt Management Office, for a more holistic assessment of total debt and liabilities and more prudent debt management. The Government Procurement Act will likewise further promote the credibility and efficiency of public finance while the enactment of the Fiscal Responsibility Act in 2021 will further enhance fiscal discipline.

The authorities have remained steadfast in their commitment towards fiscal consolidation and are confident in achieving further deficit reduction over the medium term. The authorities undertook a rigorous exercise to minimize fiscal leakages by improving spending efficiency, strengthening the procurement processes and ceasing low priority projects with low multiplier effects. The authorities will also gradually reduce the broad- based fuel subsidy and move towards more targeted assistance through the implementation of the Targeted Fuel Subsidy Program. The better spending efficiency created the required space for higher expenditures in health and education as well as other spending to support longer-term structural reforms.

The authorities are committed to enhancing its revenue base by reducing the tax gap and improving tax efficiency through various initiatives. This includes rationalizing tax incentives, minimizing tax leakages and enhancing tax compliance through effective auditing. Excluding the one-off PETRONAS special dividend payout in 2019, higher revenue collection is expected in 2020. More progressive personal income tax structure, higher chargeable income criteria for corporates to benefit from the reduced tax rate for SMEs and new Digital Services Tax are among the key measures expected to enhance the revenue base in 2020. The Tax Reform Committee (TRC) undertook a holistic review of the national tax system to broaden the tax base while supporting sustainable and inclusive growth. Recommendations from the TRC will be incorporated in the Medium-Term Revenue Strategy (MTRS). Support from the Fund in formulating and implementing the MTRS and other fiscal initiatives are most welcomed.

Monetary policy

Our authorities welcome staff's view that Malaysia's monetary policy framework has performed well in delivering its objective of price stability and growth. The authorities concur with staff's assessment that the monetary policy stance is appropriate. The Monetary Policy Committee (MPC) lowered the Overnight Policy Rate by 25 basis points to 2.75% in January 2020. The adjustment was a pre-emptive measure to secure the improving growth trajectory amid price stability. The MPC will continue to assess the balance of risks surrounding the outlook for domestic growth and inflation.

Exchange rate policy and reserves adequacy

Our authorities wish to emphasize that Malaysia is committed to exchange rate flexibility to enhance Malaysia's resilience against volatile capital flows and external shocks. Two-way foreign exchange market operations are undertaken to ensure orderly market conditions, particularly during periods of large and volatile capital flows. This ensures that the domestic financial markets continue to effectively play its role in intermediating funds and supporting economic activity. This is complemented by wider efforts to strengthen the underlying fundamentals of the Malaysian economy and further deepen and strengthen the domestic financial markets.

While Malaysia remains committed to exchange rate flexibility, staff's view that in some cases the exchange rate can act as a shock amplifier rather than a shock absorber is also in line with that of our authorities. Efforts are being undertaken to better understand conditions under which exchange rate can be a shock amplifier. In this regard, the authorities welcome the analyses and insights provided by the IMF, including through future collaborative work. Lessons from these efforts can help further refine the IMF's view and policy advice on managing external spillovers.

At the current juncture, the authorities believe that existing foreign exchange market operations are sufficiently transparent and effective. International reserves data is published every fortnight and is deemed as adequate. The publication of foreign exchange intervention data would be assessed once the work on integrated policy framework is completed.

The authorities concur with the IMF's assessment of Malaysia's international reserves adequacy. International reserves remain adequate across a wide range of indicators, including the ARA metric. Reserves adequacy assessments must evolve to take into account other forms of liquidity avenues available. In particular, liquid external assets held by resident entities and the availability and use of wide-ranging financial instruments, including hedging instruments, allow resident entities to manage and mitigate external exposures more effectively. Going forward, declining external indebtedness and continued healthy current account surplus will further enhance Malaysia's reserves adequacy.

The authorities welcome the IMF's acknowledgement of the improvement of Malaysia's external debt sustainability and its manageability under a variety of shocks. A holistic and dynamic assessment is critical in simulating exogenous shocks on external debt sustainability. While the external debt will rise most under the simulated exchange rate shock, this does not necessarily imply Malaysia's healthy external debt servicing capacity will deteriorate. Given Malaysia's sizeable net foreign currency asset position, exchange rate depreciation will result in a larger increase in external assets compared to the increase in external liabilities or external debt, in domestic currency terms, thus improving Malaysia's net international investment position (IIP). This stabilizing mechanism arising from the composition of Malaysia's IIP and trade and economic structures will provide some cushion for the country against potential external shocks.

The authorities welcome the 2018 refinement to the External Balance Assessment model but note that the model's explanatory power remains weak in the Malaysian context. Malaysia's current account surplus has narrowed significantly over the last decade, reflecting both structural and cyclical factors. Nevertheless, the authorities recognize that the current account surplus reflects partly the high savings and low investment in Malaysia. In this regard, the authorities have and remain committed to implementing reforms to promote investments and ensure a more comprehensive social safety net, particularly for the vulnerable groups. We are encouraged by the IMF's acknowledgement that signs of significant undervaluation are currently not present in the economy, despite the model estimating Malaysia's real effective exchange rate (REER) to be undervalued.

Financial market development policies

Our authorities welcome the Fund's acknowledgement of the effectiveness of the domestic FX market deepening initiatives, and will continue to emphasize accessibility and liquidity as financial market development objectives. Regular engagements with investors will continue to play a pivotal role in ongoing policy communication and in informing appropriate policy responses by the authorities. In 2019, the expansion of the Appointed Overseas Office (AOO) pilot programme received positive feedback from investors, both in terms of improved ringgit liquidity and price discovery beyond trading hours. The dynamic hedging programme has also progressively gained traction onshore, with an increase from 84 investors managing an aggregate of USD30 billion registered in 2018 to 104 investors managing USD37 billion in 2019. The growing demand for investor hedging in the onshore markets will continue to support the development of domestic FX swaps and forward markets, which have seen an increase in average daily FX transactions from USD11.5 billion in 2018 to USD12.2 billion in 2019.

The existing FX market measures are prudential in nature and form part of a broader policy toolkit. The authorities will continuously review the measures' effectiveness and will determine the timeline and speed of phasing out of such measures. To this end, our authorities appreciate the ongoing dialogue with the Fund, including possible discourse to further enhance Malaysia's hedging market as well as alternative measures that are in line with our authorities' policy objectives.

Financial sector resilience and prudential measures

Our authorities welcome staff's assessment that the Malaysian financial sector remains resilient and stable. We appreciate the recognition of the authorities' policy initiatives aimed at reducing the build-up of financial imbalances from exposures to households and real estate sector, and strengthening the soundness and stability of the financial sector more broadly. We are also encouraged by staff's recognition of the efforts undertaken to better manage risks posed by climate change to the financial system to enhance operational resilience of the industry and efforts to safeguard against cyber risks.

The authorities continue to closely monitor household debt given the high level of indebtedness but affirm that potential risks to financial stability emanating from the household sector remain manageable. Asset quality remains sound with low and stable ratio of aggregate impaired loans to total outstanding household debt for both banks and non- banks. Households' debt-servicing capacity continued to be supported by income and employment growth, coupled with ample aggregate financial buffers. Internal simulations suggest that under stressed scenarios, potential losses to the banking system from exposures to the overall household sector are estimated to be manageable.

Our authorities concur that borrowings by the vulnerable household group (individual borrowers with monthly earnings of below RM3,000) warrant close vigilance. Nonetheless, exposures to this group continue to exhibit low impairment ratios and improved vintage analysis. The proportion of exposures to this segment is also on a declining trend. Most of the new loans approved to the vulnerable segment continued to be within prudent debt service ratios in line with sound underwriting practices.

Our authorities broadly agree with the need for continued vigilance on the property market. However, the effect of a sharp deterioration in house prices to the banking system are mitigated by the fact that the majority of the outstanding housing loans carry a loan-to-value (LTV) of below 80%. Moreover, the bulk of housing loans are to owner-occupants, who are more likely to maintain loan repayments in the event of negative equity compared to investors. Banks also have sufficient capital buffers to absorb potential losses arising from up to a 50% decline in property prices and the associated spillover to business sectors that are highly dependent on the performance of the property sector.

The authorities reiterate the continued appropriateness of macroprudential and fiscal measures put in place since 2010. These measures have effectively contained risks from household indebtedness and credit-fueled speculative activities in the property market. They have also been complemented by the authorities' efforts to increase the supply of affordable houses as well as several policy measures to enhance affordability (e.g. Home Ownership Campaign, stamp duty exemptions, etc.) in line with sustained demand for affordable properties. With these measures in place, coupled with continued household formation as well as continued employment and income growth, risks associated with a sharp and generalized downward correction in house prices are assessed to be low.

While the authorities take note of staff's recommendation to impose sector-wide standardized LTV limits on first and second properties in the medium term as well as imposing a debt-to-service ratio limit on all individual borrowers, the authorities maintain that current macroprudential measures remain appropriate to contain risks from household indebtedness and rising property prices. Further, in practice, the LTV levels reflect banks' affordability assessments, which are carried out in line with the Responsible Financing Guidelines that must be observed by financial institutions. Differentiated capital charges for loans with higher LTV ratios and provisioning practices provide further support to mitigate banks' credit risk. While the authorities view current policies to be sufficient at present, they have noted that should developments warrant additional limits to be introduced for LTV and DSR, such measures can be readily implemented under existing policy frameworks that have already been put in place.

Efforts to strengthen safeguards against threats of money laundering and terrorism financing (ML/TF) continue to be a key priority for our authorities. The revised policy documents on Anti-

Money Laundering, Countering Financing of Terrorism and Targeted Financial Sanctions for Financial Institutions (AML/CFT and TFS for FIs) which came into effect on 1 January 2020 emphasizes the adoption of a risk-based approach when conducting customer due diligence (CDD) in accordance to the ML/TF risk levels. The new policy document has also consolidated requirements for TFS to ensure consistency and clearer guidance for institutions to implement sanctions screening regime across all sectors.

Governance and Structural Reform for Sustainable and Inclusive Growth

The authorities welcome staff's assessment of the progress made on governance reform. The implementation of the ambitious National Anti-Corruption Plan 2019-2023 (NACP) has shown significant progress, where 22 out of 115 initiatives in the plan have been implemented in 2019, including asset declaration by members of the administration. The remaining initiatives, including those which involve amending the Federal Constitution are on track. The authorities also underscore the importance of ensuring operational independence of the Malaysia Anti-Corruption Commission (MACC). The Special Cabinet Committee on Anti-Corruption, in January 2020, has agreed on the proposal for the termination of service of the chief commissioner be made through a constitutional process by amending the relevant law. A study will be carried out on the possibility for a chief commissioner's appointment procedures to be made through a constitutional process. Furthermore, other anti-corruption legislations such as the MACC Act, Witness Protection Act and the Whistle Blower Protection Act will be continuously reviewed and strengthened to ensure its relevance with current developments. Malaysia in the latest Transparency International's Corruption Perceptions Index (CPI) 2019, has jumped 10 spots in world ranking, reflecting the significant progress made in recent years.

The remaining 11th Malaysia Plan (11MP) period will also focus 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. The focus will be on strengthening sectoral growth, particularly services and manufacturing sectors, and promoting private investment. Meanwhile, further efforts will be taken to improve the business climate through enhancing the delivery of public services, reducing bureaucratic red tape and provision of quality infrastructure. Efforts to accelerate improvement in education and human capital development will continue to be prioritized.

More recently, the Government released the Shared Prosperity Vision 2030, which outlines the longer-term policy direction that continues to focus on creating a high-value, high-technology economy as well as diversifying resources and growth potential, while ensuring an inclusive, sustainable and meaningful socioeconomic development.

The Government continued to accelerate its structural reform agenda with growth- enabling reforms as well as boosting productivity and competitiveness. Approved foreign direct investment, particularly in the manufacturing sector hit an all-time-high in 2018 and continued to record a significant increase in 2019. The establishment of the National Committee Investment in

August 2019 has been successful in expediting large investment approvals. A comprehensive review and a revamp of the existing incentive framework is also expected to be ready by January 2021 to facilitate more FDIs. The authorities remain committed to continuously improve the business climate, with greater emphasis on well- functioning ports and logistics system and infrastructure support for higher investment in regional development activities. To improve SMEs' access to alternative sources of financing, the authorities are encouraging new digital financial innovation such as Equity CrowdFunding and Peer-to-peer funding through My Co-Investment Fund and provide tax incentives to attract venture capital and angel investors.

In January 2020, an exposure draft on the Corporate Strategic Plan for the development financial institutions (DFIs) was also issued. This sets out the enhanced expectations for developing robust and forward-looking business strategies and funding plans to further enhance the development impact of DFIs in meeting the financing needs of the economy. In addition, DFIs are required to measure the effectiveness and efficiency of discharging their mandates through an enhanced performance measurement framework.

As part of measures to spur innovation and technology adoption in the financial sector while also fostering financial inclusion, the authorities issued an Exposure Draft on Licensing Framework for Digital Banks in December 2019. Up to five licenses may be issued to qualified applicants to establish digital banks in Malaysia. Such digital banks are expected to offer meaningful access to and promote responsible usage of suitable and affordable financial solutions to financial consumers, especially those in the underserved and unserved segments.

The recent 2020 Budget announcement had also highlighted the capital development spending for digital infrastructure, incentivized digital application by businesses and levelled up of human capital. Education continues to receive the largest allocation in 2020, emphasizing on quality, equity, access, unity, efficiency and inclusiveness. Meanwhile, the progress on labor market reforms, particularly in boosting female labor force participation remains on track.

Concluding remarks

The Malaysian authorities will continue to remain vigilant in facing any adverse developments and potential risks to the Malaysian economy and financial system. Our diversified economy, the flexibility accorded by a floating exchange rate, healthy external balance and strong financial sector will continue to support the economy's resilience to withstand shocks. Adequate policy tools and buffers also allow the authorities to respond effectively in a timely manner to preserve macroeconomic and financial stability. The authorities are committed to undertake key governance and structural reforms to achieve sustainable and inclusive growth. As the global environment becomes more challenging, the Fund has a greater role to play in reducing the risks from disruptive cross-border spillovers that can be destabilizing for small and open economies like Malaysia.