



MALAYSIA

2011 ARTICLE IV CONSULTATION

February 2012

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 2011 Article IV consultation with Malaysia, the following documents have been released and are included in this package:

- **Staff Report** for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 9, 2011, 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 December 23, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice (PIN)** summarizing the views of the Executive Board as expressed during its February 6, 2012 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Malaysia.

The document listed below has been or will be separately released.

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: <http://www.imf.org>

International Monetary Fund
Washington, D.C.



MALAYSIA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

December 23, 2011

KEY ISSUES

Near-term outlook. Economic activity is expected to moderate as the weaker external environment tempers exports, private investment and consumption growth. This is expected to lower inflation, but will make the 2012 budget deficit target difficult to achieve. General elections, expected by analysts in early 2012, may add to market volatility.

Managing the spillovers from downside external risks. Given its integration with the rest of the world, the economy is vulnerable to a prolonged downturn in advanced economies or a sharp escalation in global financial stress. Weaker exports and terms of trade would spill over into domestic demand. Financial spillovers could include a reversal of cross-border bank and portfolio flows. Healthy financial and corporate balance sheets, ample foreign exchange reserves, and room to further loosen monetary policy would help contain the impact of an external shock on the financial sector and the economy. The room for fiscal policy to respond is, however, more limited given elevated federal government debt levels.

Ensuring sustained and more inclusive growth. Raising potential growth will require sustained efforts to raise the skills of the workforce, facilitate greater competition in product markets, and implement structural fiscal reforms. To make growth more inclusive, this will need to be complemented with investments in social safety nets. Given the limited fiscal room over the medium term, social spending will need to be better targeted to the needy, although an unemployment insurance scheme and expanded pension provision could be designed without a large fiscal cost.

Approved By
**Nigel Chalk and
 David Marston**

Discussions took place in Kuala Lumpur during October 27–November 9, 2011. The staff team comprised Messrs. Lall (head), Abdel-Rahman, Balakrishnan, Cubero, Dodzin, and Ms. Nowak (all APD). Ms. Ridzam (OED) attended key policy meetings.

CONTENTS

INTRODUCTION	3
THE ECONOMIC CONTEXT	3
A. Growth is Easing on a Weaker External Environment	3
B. Outlook and Policies under the Baseline	6
POLICY THEME #1—MANAGING THE SPILLOVERS FROM EXTERNAL RISKS	10
POLICY THEME #2—ENSURING INCLUSIVE AND SUSTAINABLE GROWTH	16
STAFF APPRAISAL	20
BOXES	
1. Impact of the 2008–09 Global Financial Crisis and Policy Response	12
2. Asia: Exposure to European Banks	13
FIGURES	
1. Growth is Slowing Against a Weakening External Environment	23
2. Domestic Demand However Remains Supported	24
3. Financial Spillovers from the Global Turmoil Have Had a Modest Impact So Far	25
4. Malaysia’s Exposure to European Banks is Relatively Contained	26
TABLES	
1. Selected Economic and Financial Indicators, 2007–12	27
2. Indicators of External Vulnerability, 2007–11	28
3. Balance of Payments, 2007–12	29
4. Illustrative Medium-Term Macroeconomic Framework, 2007–16	30
5. Summary of Federal Government Operations and Stock Positions, 2007–12	31
6. Monetary Survey, 2009–11	32
7. Banks’ Financial Soundness Indicators, 2007–11	33

INTRODUCTION

1. Following a strong recovery from the downturn of 2008–09, economic momentum in Malaysia is beginning to ease against the backdrop of a weakening external environment.

As the recovery took hold, macroeconomic policies moved towards a less accommodative stance from early 2010. As a result, inflation remains contained and the rapid post-crisis buildup in public debt has leveled off. More recently, the growth of manufacturing exports has begun to ease, while commodity exports have thus far remained resilient.

2. The downside risks to growth are elevated. While a softening in activity is envisaged under the baseline, the risks of a sharper slowdown are substantial. Monetary policy can be eased if the growth outlook

weakens substantially, but fiscal space is more limited. If downside risks materialize, temporary expenditure measures could be put in place but would need to be solidly framed within a credible medium-term consolidation plan.

3. Raising potential growth and reducing income disparities is the key challenge over the medium term. High and stable growth requires sustained structural reforms anchored around medium-term fiscal consolidation. This would help raise productivity and target public assistance to the most needy. To further raise the inclusiveness of growth, consideration could be given to increasing pension benefits and introducing an unemployment insurance scheme.

THE ECONOMIC CONTEXT

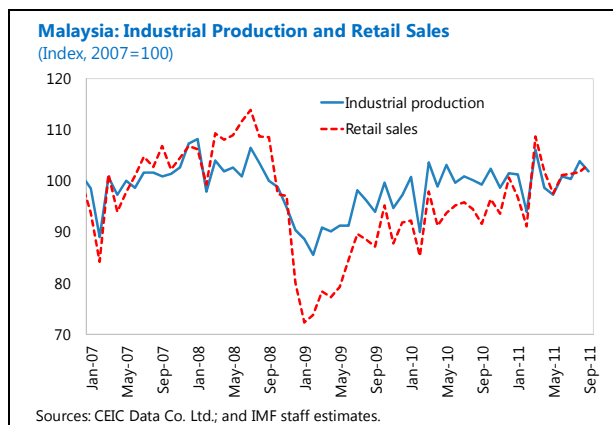
A. Growth is Easing on a Weaker External Environment

4. Economic activity is easing. Following the rebound in 2010, private consumption growth remained strong through the third quarter of 2011 given robust employment and wage growth. Manufacturing export growth has weakened, although commodity exports have nevertheless continued to grow at a healthy pace. Forward-looking sentiment

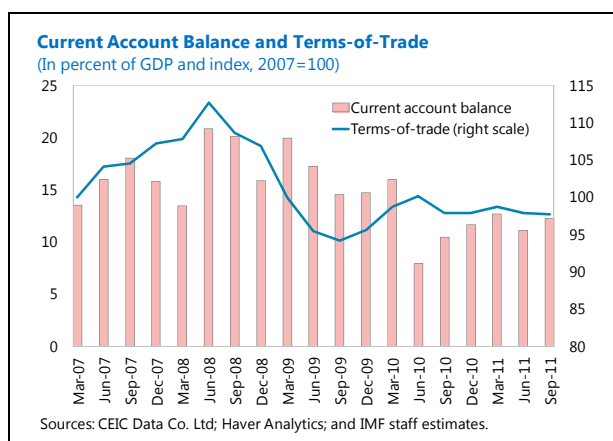
indicators suggest less optimistic near-term prospects (Figures 1 and 2).

5. While the output gap has closed, inflation remains contained. This reflects the timely monetary policy tightening that began in 2010 and the easing of temporary supply side factors which had nudged headline inflation up in the middle of 2011. Core

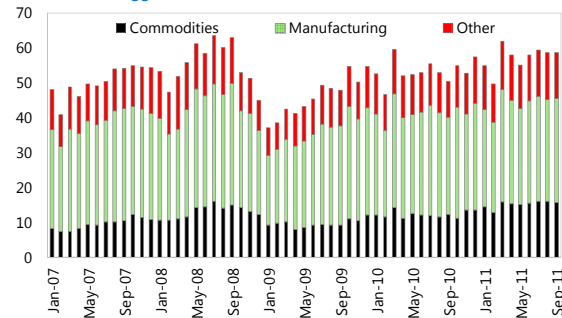
inflation rose modestly, reflecting the recovery in domestic demand, but remains low at 2.5 percent.



6. Notwithstanding the weakening environment, Malaysia's external position remains strong. The real effective exchange rate (REER) remained broadly stable in the year through July 2011 before the recent episode of market volatility, and the current account surplus is expected to have remained roughly constant in 2011. This reflects stronger commodity exports being offset by robust consumption and capital goods imports.

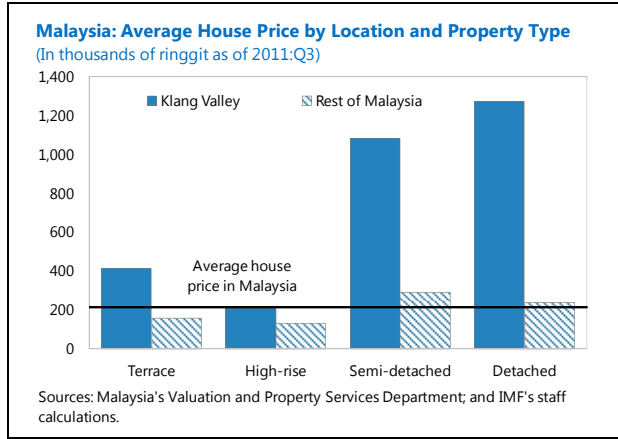
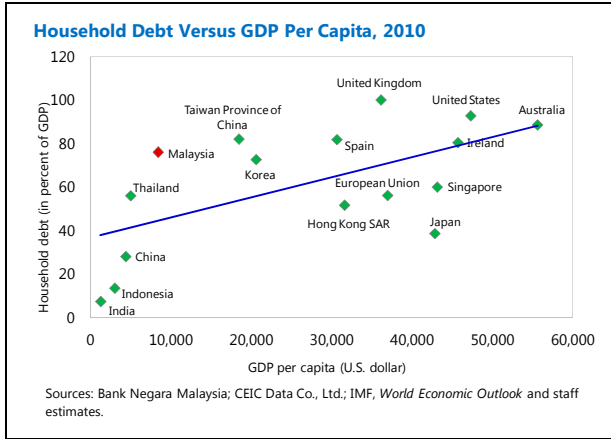


Exports by Sector 1/
(In billions of ringgit)



Sources: CEIC Data Co. Ltd.; and IMF staff estimates.
1/ Based on major and selected commodities classifications.

7. A strong rebound in credit to households has further increased household indebtedness. Gross household debt has risen by 12.3 percentage points to 76 percent of GDP during 2008–2011. To curb the rise in mortgage lending (around half of total household debt), Bank Negara Malaysia (BNM) in November 2010 introduced loan-to-value (LTV) restrictions on third and further residential mortgages, where speculative demand is likely to be concentrated. The rise in credit card debt prompted the issuance of guidelines to banks on credit card debt in March 2011, including on income eligibility criteria and the total number of cards. Other borrowing, including through unsecured personal loans (16 percent of household debt) is subject to few restrictions and has continued to grow.



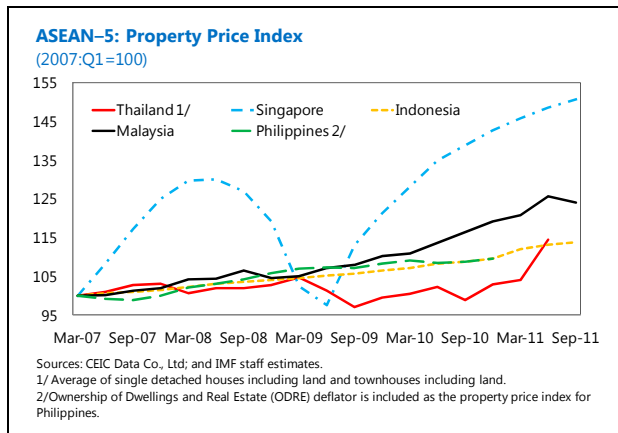
Heat Map: Signs of Asset Price and Corporate Imbalances 1/

	Peak pre-1998	Peak pre-2009	Recent
Equity forward-looking P/E ratios	27.5	15.1	13.7
House price index deflated by CPI 2/	...	104.6	109.5
House price-to-income ratio 2/	...	122.2	102.6
House price-to-rent ratio 2/	...	107.7	105.8
Credit-to-GDP ratio	165.0	145.5	124.5
Corporate debt to equity	59.3	45.7	33.6
Corporate debt to assets	31.0	25.4	21.4

Sources: CEIC Data Company Ltd.; Haver Analytics; Thomson Reuters I/B/E/S database; Organization for Economic Co-operation and Development; Worldscope; and IMF, *International Financial Statistics*; and staff estimates.

1/ Colors represent the extent of the deviation from long-term averages expressed in number of standard deviations. Green denotes less than 1.5 standard deviations above long-term averages, orange between 1.5 and 2 standard deviations, and red greater than 2 standard deviations.

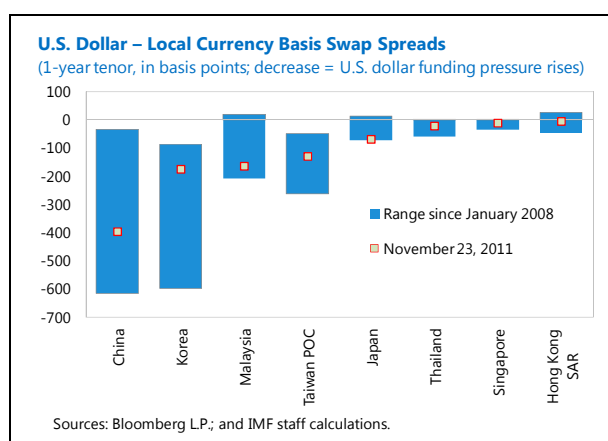
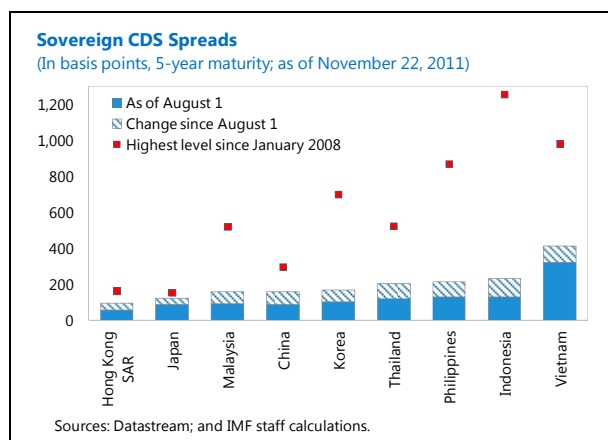
2/ Index, 2008:Q4=100.



8. Despite the recent growth of credit, the banking system remains sound. Overall credit growth has accelerated since the second half of 2009, but there are no evident signs of overheating or asset price pressures (heat map). Against an average capital adequacy ratio (CAR) of 14.6 percent and core capital of 12.5 percent, nonperforming loans (NPLs) have declined to around 2 percent. Housing prices rose 17 percent nationwide during 2008–10, but have eased more recently and remain in line with fundamentals, although certain areas have seen sharp rises.

9. Fiscal policy is on track to meet the deficit target of 5.4 percent for 2011. While federal government spending on subsidies was higher than budgeted due to elevated oil prices, this was more than offset by strong commodity-related revenues. The overall revenue growth rate is estimated to be 11 percentage points higher than projected in the budget, due to higher petroleum prices and stronger tax revenues.

10. Financial market volatility has risen since August alongside higher global risk aversion. Capital flows were robust through the first half of 2011, led by portfolio bond inflows. However, foreign investors subsequently scaled back their exposures, mainly in equity markets and BNM bills, prompting a depreciation of around 8 percent against the U.S. dollar since the beginning of August (Figure 3). The depreciation was less severe than in some other open economies in part due to foreign exchange intervention. Cross-currency basis swap spreads have also widened sharply to about post-Lehman levels. This appears to reflect the illiquidity of the Malaysian foreign exchange market, generalized dollar funding pressures, and hedging demand by exporters. There is no evidence, however, of a pullback in cross-border lending by banks.



B. Outlook and Policies under the Baseline

Staff's Views

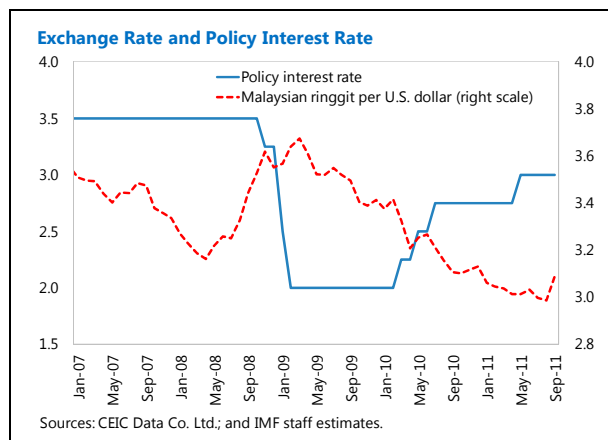
11. The pace of activity is expected to ease in the first half of 2012 before gradually picking up strength. Under the baseline, the demand for Malaysian exports is expected to remain soft in coming quarters, leading to sluggish private investment and industrial production. The impact of floods in Thailand is expected to be limited, as supply chain disruptions, mainly in the automotive sector, are expected to be offset by a temporary shift in production to Malaysia. While robust labor market conditions and

fiscal transfers to households are expected to support consumption, the high indebtedness of households would limit debt-financed increases in consumption spending. Growth for 2012 is projected at 4 percent before strengthening to 4.5 percent in 2013. Weaker exports are expected to narrow the current account surplus to 10.8 percent of GDP.

12. Risks to the outlook are tilted to the downside. A slower recovery in the key advanced economies would further subdue exports and domestic demand. A more serious impact on growth would come from the

combination of a protracted recovery in advanced economies and a sharp escalation of global financial stress. Longer than expected supply chain disruptions related to the floods in Thailand pose additional downside risks. Domestic downside risks include the potential that households will be unable to sustain their consumption growth due to high levels of indebtedness, and that credit quality may decline with income. This could be exacerbated by a tightening of financing conditions. On the upside, a swift and decisive resolution of the crisis in Europe as well as faster growth in other major advanced economies would increase Malaysian exports.

13. Under the baseline, inflation is expected to continue to moderate, and the current monetary policy remains appropriate. The output gap is projected to turn mildly negative, driving core inflation down to below 2 percent in 2012. With easing food and transportation costs, headline inflation is expected to average around 2.5 percent. While Malaysia is a large importer of rice, the disruption to production in Thailand is not expected to have a material impact as import contracts through 2012 have been signed with Vietnam.



14. The exchange rate should continue to move flexibly while guarding against excessive volatility. Given the prospects for continued capital flow volatility in the near term, smoothing disorderly movements in the exchange rate through two-sided intervention, as observed in the past, remains appropriate. Based on standard or risk-weighted metrics, the level of foreign exchange reserves is assessed as comfortable.¹ There is also no evident need for capital controls to dampen the volatility of flows.

15. The recent increase in personal unsecured credit needs continued monitoring. While overall credit growth is expected to moderate as banks continue to tighten lending standards, the rise in personal loans calls for continued vigilance by lenders. The bulk of unsecured lending is reportedly to

¹ The risk-weighted metric is 166 percent. The benchmark range considered adequate for this metric is 100–150 percent. See IMF Policy Paper, *Assessing Reserve Adequacy* (<http://www.imf.org/external/np/pp/eng/2011/021411b.pdf>).

civil servants with relative job security, but banks need to remain alert to the creditworthiness of households. Some studies suggest that the median household's financial assets are relatively low, with most financial assets held by the top 20 percent of households. BNM has stepped up its monitoring and supervision on household debt. Since 2008, these are principally focused on banks' underwriting and valuation practices, risk management standards and infrastructure. In November 2011, BNM issued guidelines that require financial institutions to apply a consistent approach to measure and assess retail borrowers' debt service-to-income ratios (DTI). Similar guidelines were issued for credit cooperatives by the Cooperatives Commission. If the need arises, the authorities should consider introducing additional measures to limit growth in unsecured lending. There is little information on informal lending, although this is reported to be a small share of total credit. With nationwide house prices cooling and slower growth in mortgage lending, there is no evident need for additional restrictions on mortgage lending.

16. The deficit target envisaged in the 2012 budget will be difficult to achieve in light of the projected growth slowdown.

In the staff's view, the authorities should abide by their budget expenditure ceiling but allow automatic stabilizers to operate on the revenue side. Under these assumptions, the federal government's budget deficit is projected by staff at 5.1 percent of GDP,

against the budget target of 4.7 percent, implying marginal consolidation over 2011. While federal government debt would rise above 55 percent of GDP, this more modest fiscal adjustment would help cushion the downturn. Keeping to the budget target would add a significant drag on growth. Efforts, however, should be made to better target budgeted expenditures to the most needy, as well as to rationalize subsidies and channel the realized savings to items with high fiscal multipliers.

Authorities' Views

17. The authorities concurred that growth is likely to ease. They agreed that weaker exports would feed through to domestic demand, but underscored that if the downdraft from external sources remains contained, employment would remain well supported and prevent a more substantial downturn. While acknowledging that the growth projections underlying the 2012 budget may now be somewhat optimistic, they noted that the drag from external sources would be mitigated by higher private investment under Economic Transformation Programme (ETP) projects, fiscal transfers contained in the 2012 budget of 0.3 percent of GDP, and rising intraregional trade. In addition, the authorities noted that investment will be boosted in 2012 by a special off-budget stimulus package of RM 6 billion.

18. The authorities agreed that inflation will likely ease and monetary policy has

room to respond flexibly. They agreed with staff that the early move towards policy normalization helped keep inflation expectations well anchored, affording them greater room to maintain the current policy stance while preserving flexibility to respond to downside risks.

19. The authorities noted that foreign exchange intervention is limited to smoothing excessive volatility and to prevent exchange rate overshooting. They emphasized the challenges to small open economies posed by rapid shifts in capital flows, and the destabilizing effects of sharp movements in the exchange rate. They also underscored that their approach had been effective thus far without the use of additional macroprudential measures.

20. The authorities underscored that overall credit growth does not pose any immediate macroeconomic or financial stability concerns, but agreed the growth in personal loans needs to be monitored. The LTV limits on third mortgages appear to be effective and overall mortgage lending is cooling, requiring no additional LTV

restrictions. They also noted that banks monitor credit exposures to households closely. Nevertheless, the authorities issued new guidelines in November 2011 to promote responsible retail lending practices by financial institutions, including requirements to standardize the computation of income in assessing DTI ratios. DTI regulations on overall household debt are seen as too blunt an instrument to address the growth in the personal loan category, which comprises around 15 percent of overall household debt.

21. The authorities were confident of meeting the 2012 deficit target even if growth is lower than expected. Given conservative revenue assumptions, they remain optimistic that federal government debt can be kept below 55 percent of GDP in 2012 and over the medium term, based on a deficit path targeting a 3 percent of GDP deficit by 2015. Nevertheless, they would view a temporary rise in federal government debt above this threshold as acceptable to support growth under exceptional circumstances if downside risks to growth materialize. Otherwise, they will ensure that the debt-to-GDP ratio does not exceed 55 percent.

POLICY THEME #1—MANAGING THE SPILLOVERS FROM EXTERNAL RISKS

Malaysia faces considerable downside risks from protracted low growth in the major advanced economies and/or a sharp escalation in global financial stress. While being well positioned to withstand financial spillovers, given monetary policy space and financial policy tools, the limited fiscal space would not allow the headwinds to growth to be fully offset.

Staff's Views

22. Real spillovers from an extended downturn would affect both external and domestic demand.

- If global growth were to be sharply lower than assumed, Malaysia would experience a slowdown in both commodity and manufacturing exports and a deterioration in the terms of trade.² Indeed, Malaysia remains among the Asian economies most highly exposed to demand outside the region, with non-Asian final demand contributing around 38 percent of value added to GDP.³
- Weaker exports would act as a drag on industrial production and investment in both manufacturing and the commodity

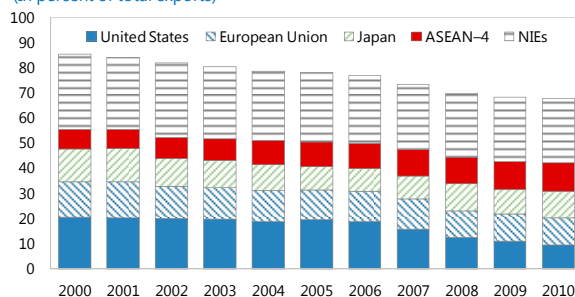
² While Malaysia's direct exports to the European Union (EU) constitute 9 percent of total exports, and the share has declined over the past decade, overall exposure is higher (around 13 percent of GDP) taking into account Malaysian intermediate goods exports that are used in final exports to Europe by Malaysia's trading partners.

³ See Chapter 1 of *Regional Economic Outlook: Asia and Pacific*, October 2011.

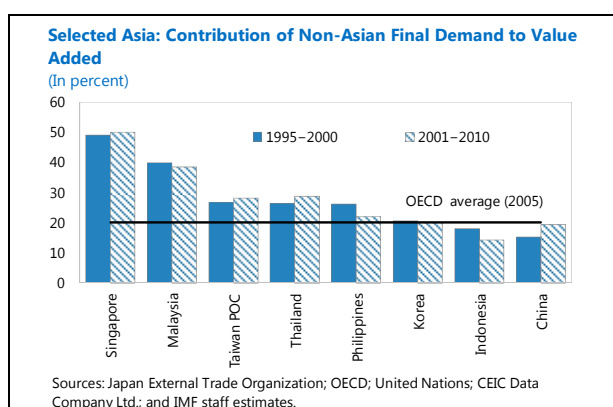
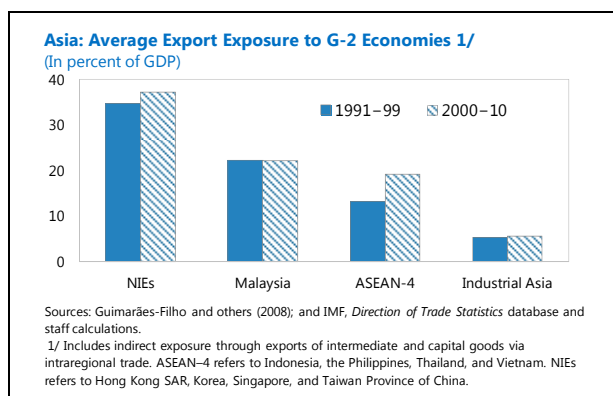
related sectors. Consumption would be curtailed by the impact on confidence and lower disposable incomes in commodity intensive sectors such as palm oil and sectors linked to the manufacturing supply chain, including small and medium enterprises (SMEs).

- Overall, estimates suggest that a 1 percent decline in global growth below the baseline would reduce Malaysian GDP growth by 1.2 percentage points. However, should unemployment rise or wages fall significantly more than has been typical in previous slowdowns, the short-term spillover effects of global growth on domestic aggregate demand would rise disproportionately more.

Share of Exports by Selected Destinations 1/
(In percent of total exports)



Sources: CEIC Data Co. Ltd; and IMF staff estimates.
1/ ASEAN-4 refers to Indonesia, the Philippines, Thailand, and Vietnam. NIEs refers to Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.



23. The alternative scenario of extreme global financial stress would feed through swiftly.

As in 2008–09 (Box 1), the initial impact is likely to be through a reversal in portfolio equity and debt inflows, and a pullback in lending by international banks, particularly those with large exposures in the euro area.

- Foreign investor holdings comprise some 20 percent of the domestic bond market and 22 percent of the equity market. A sharp decline in foreign holdings would have a tangible wealth effect given that retail participation through direct holdings and unit trusts is around

45 percent of equity market capitalization. Foreign holdings of bonds have risen markedly to around RM 160 billion from RM 126 billion in April 2008, and amount to around 45 percent of reserves.⁴

- The consolidated claims of euro area banks on Malaysia are estimated at 6 percent of GDP with the nonfinancial public and private sectors as the main recipients (see Box 2 and Figure 4). Banks from the United Kingdom are the major foreign providers of household credit, although much of this is funded by the local ringgit deposit base. Overall, foreign banks account for around 21 percent of total credit.
- While euro area banks have been active in providing trade finance in Asia, private contacts suggest that the big foreign players in Malaysia are Singapore and U.K. banks. Moreover, most financing seems to be directly provided rather than intermediated through Singapore. A significant deleveraging by European banks would reduce the supply of trade finance, but local and other foreign banks should be able to step in and offset some of this.⁵

⁴ In the aftermath of the collapse of Lehman Brothers, bond holdings fell peak-to-trough from 36 percent to 10 percent.

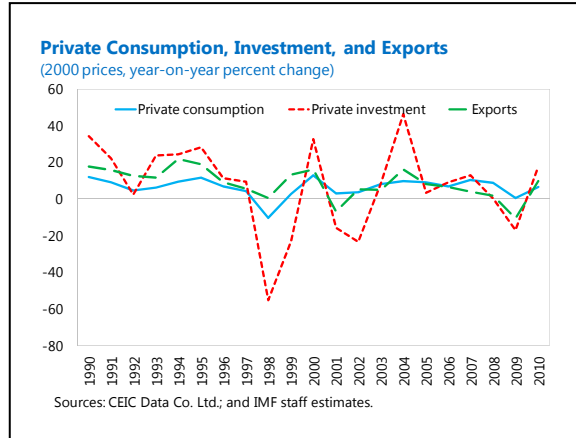
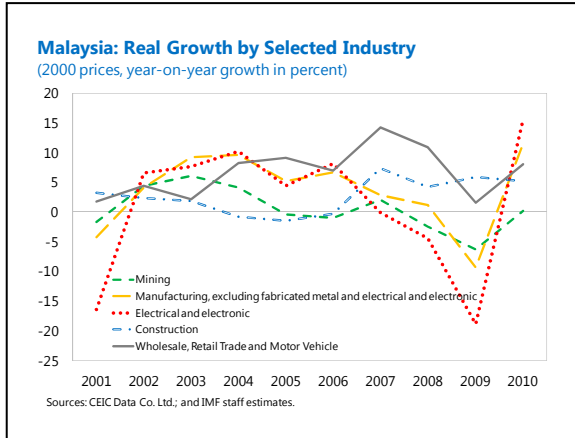
⁵ As noted in Box 2, the scope for substitution by other foreign banks depends on the extent of contagion from the euro zone. U.K. banks, in particular, have high exposures to the euro area.

Box 1. Malaysia: Impact of the 2008–09 Global Financial Crisis and Policy Response

As a highly open economy, Malaysia was affected through both real and financial channels during the 2008–09 global financial crisis.

Real channels

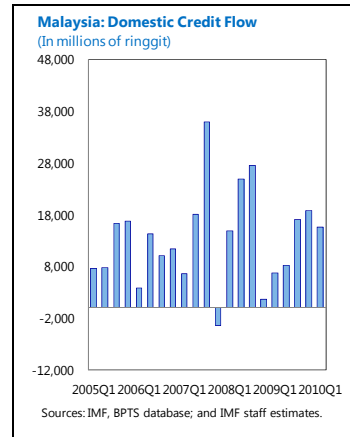
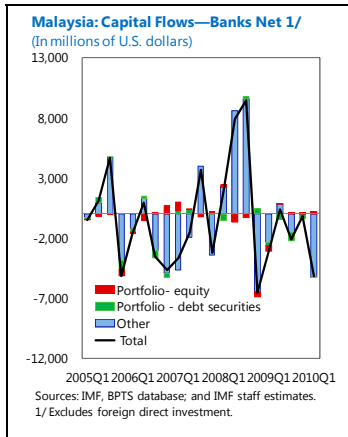
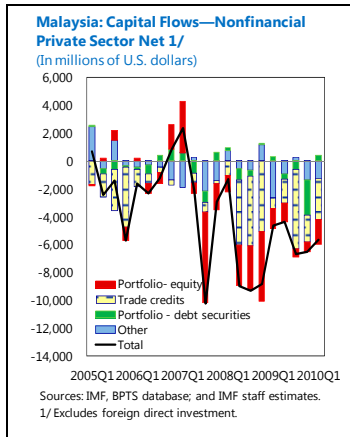
A sharp decline in exports led to a downturn in production and investment, particularly in manufacturing. Private consumption slowed but remained positive, in part due to the authorities' support measures.



Financial channels

External financing. There were large reversals in portfolio equity flows and trade credits, while loans to the private sector and private debt securities were much less affected. The banking system also experienced large net outflows in 2008:Q4. Foreign holdings of BNM bills declined sharply, while outflows from government bills were more moderate.

Domestic financing. However, the decline in foreign holdings of government securities was offset by domestic residents. Indeed, yields fell, in line with the decline in global interest rates. Despite large external bank outflows, domestic credit slowed but remained positive. The banking system also remained financially sound, with NPL ratios steady.



The authorities response was multipronged. The main measures included:

- Loosening monetary policy: the policy rate was cut by 150 basis points to 2 percent and reserve requirements were reduced.
- A combination of exchange rate depreciation and reserves drawdown: between August 2008 and March 2009 the ringgit depreciated by 9.5 percent against the U.S. dollar while reserves fell by 28 percent.
- Providing U.S. dollar liquidity to the markets by drawing down reserves.
- Announcing that Bank Negara Malaysia would back interbank lending.
- Extending a blanket guarantee on all ringgit and foreign currency deposits through December 2010.
- Introducing new financing and guarantee facilities for SMEs.
- Introducing two fiscal stimulus packages.

Box 2. Asia: Exposure to European Banks

Like many emerging economies that are highly integrated, Malaysia's exposure to European banks is also high. According to BIS data as of end-June 2011, foreign banks had total consolidated claims on the Malaysian economy of about 60 percent of GDP on an ultimate risk basis, with European banks accounting for around 40 percent of claims (Figure 4).

While such a high exposure suggests Asia faces a significant vulnerability to deleveraging by European banks, there are some key factors which mitigate this risk for Malaysia:

- *Local deposits.* Total European banks' claims include credit extended by European banks subsidiaries in Malaysia, which are funded largely by local deposits. In that sense, the consolidated claims may somewhat overstate the vulnerability to deleveraging by European banks.
- *Substitution.* U.K. banks account for almost 80 percent of European banks claims. Given this, local and other banks (e.g., from the United Kingdom, United States, and the region) may have the capacity to offset euro area bank withdrawals, using it as an opportunity to gain market share and increase margins, especially if financial stress remains confined to the euro area. Local banks appear well placed given low reliance on wholesale funding (less than 11 percent of total funding) and external assets significantly above 100 percent of external liabilities. There may be limits to their ability to substitute for euro area banks, however, given the latter's expertise in specialized areas such as project, mining, shipping and aircraft finance.
- *Reserves.* The large stock of foreign reserves (over 200 percent of total European banks' claims) enhances Bank Negara's ability to mitigate any serious foreign currency liquidity shortages that may arise from European banks deleveraging.

- Total foreign bank claims on domestic banks are low at 7.4 percent of 2010 GDP and 3.3 percent of total liabilities of the latter. Moreover, domestic banks' external assets are 137 percent of liabilities. Against a loan to deposit ratio of 82.5 percent, overall wholesale funding of domestic banks is relatively low, at 11 percent of liabilities. Cross-border funding comprises only 3.7 percent of bank liabilities.
- The burgeoning Islamic financial segment is unlikely to be spared from global financial shocks. Staff research⁶ indicates that Islamic banks, which hold about 20 percent of total banking assets, respond to economic and financial shocks in much the same way as conventional banks. Likewise, Islamic and conventional security prices are driven by the same macrofinancial factors. However, given a wider investor base, Islamic bonds have continued to attract strong demand despite increased global financial turbulence, including for Malaysia's US\$2 billion global *sukuk* issuance in July 2011.

24. The domestic financial sector would be able to withstand a significant shock

⁶ Krasicka, Olga, and Sylwia Nowak, "What's in It for Me? A Primer on Islamic Finance in Malaysia," IMF Working Paper, forthcoming (Washington: International Monetary Fund).

from external funding sources.⁷ In addition to the specific factors cited above, given the high CAR of around 14.6 percent of the banking system as of end-September 2011, and liquid assets as a share of total assets at around 13.8 percent (higher than before the collapse of Lehman Brothers), domestic banks are not expected to face major funding strains or deleveraging, and may indeed help offset any pullback in lending by foreign banks. Moreover, the corporate sector has strong cash positions (11.5 percent of liabilities for listed companies) providing a buffer if financing conditions tighten.

25. Monetary, exchange rate and financial policies can help prevent abrupt financial deleveraging and provide a cushion against a downturn. There is room to cut policy rates, provide both foreign exchange and domestic currency liquidity, and allow the exchange rate to act as a shock absorber. In addition, other financial policies that were deployed in 2008–09 could be reactivated in order to ensure orderly financial market conditions and to stabilize confidence.

26. In the event of a severe downturn, there is only limited room for countercyclical fiscal stimulus. Given

⁷ The Financial Sector Assessment Program scheduled for 2012 will examine financial stability in the context of high household indebtedness and the risk of cross-border financial spillovers in detail.

Malaysia's still high fiscal deficit and federal government debt, any limited discretionary measures would need to be accompanied by credible medium-term fiscal consolidation plans to ensure debt can return to a declining path over the medium term. Fiscal measures should aim at supporting low-income households and in areas with high multipliers, and could be augmented with guarantees and credit lines to small and medium enterprises to support employment and incomes.

Authorities' Views

27. The authorities agreed that under a slow global recovery and/or a financial stress scenario, growth could be substantially lower. They noted that should intraregional demand remain well supported, the overall impact would be mitigated, particularly since the demand for Malaysia's commodity exports is well diversified beyond the advanced western economies.

28. The authorities agreed that the financial sector is well positioned to withstand global financial stress. They noted that the experience of 2008–09 had demonstrated the resilience of the financial system to a severe global liquidity squeeze. Moreover, the experience has informed new policy initiatives including recent changes to allow deposit insurance to be expanded quickly in a crisis. They also noted that some preemptive measures put in place at the time, including the corporate debt restructuring facility and some SME support schemes,

remain in place, although they have remained largely unutilized. The authorities also noted that euro area banks' lending to Malaysia is smaller than in many other Asian economies, and the size of wholesale financing is minimal. Given the robust capital and liquidity positions of domestic banks, they would be able to avoid deleveraging pressures and may even be able to garner market share from foreign banks.

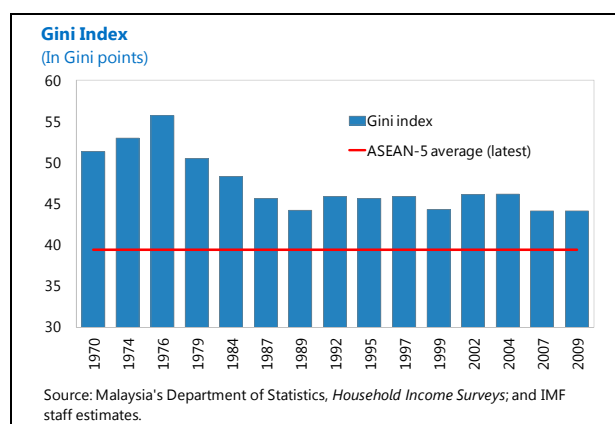
29. The authorities pointed out that the macrofinancial sector feedback loop would be an important channel, particularly in a more extended downturn. They noted that if employment and incomes were to fall, bank lending would likely be scaled back as fears of rising NPLs grew, acting as a further drag on domestic demand. Monetary policy could be used to cushion the downturn given the anticipated further easing in inflation. While acknowledging that fiscal room is more limited, the authorities were of the view that a temporary rise in federal government debt beyond the indicative ceiling of 55 percent of GDP would be acceptable under exceptional circumstances in order to provide support to economic activity. Otherwise, they remain committed to the debt-to-GDP ratio not exceeding 55 percent.

POLICY THEME #2—ENSURING INCLUSIVE AND SUSTAINABLE GROWTH

Raising Malaysia's potential growth over the medium term will require sustained efforts to improve human capital, facilitate greater competition in product markets, and undertake structural fiscal reforms. Exchange rate appreciation will be an essential element of rebalancing the sources of growth. To make growth more inclusive, there is scope to enhance the social safety net.

Background

30. Malaysia's potential growth has slowed over the last decade. Considerable efforts will be needed to meet the authorities' goal of raising per capita income to at least US\$15,000 by the end of the decade. Moreover, while inequality fell considerably until the late-1980s, it has largely flat lined since then, suggesting that making growth more inclusive remains an important policy challenge.



31. The authorities have diagnosed the key constraints to raising potential growth and recognize the need for deep-rooted structural reforms. The broad aim of reforms is to raise the share of private investment and

improve the level of education and skills in order to raise productivity levels closer to those of more advanced Asian economies. Towards this end, reforms envisage improvements in governance and inclusiveness, promoting catalytic investment projects, focusing on high value-added manufacturing and services sectors, as well as broader economic reforms to raise incomes of the poorest households and reform public finances to ensure their sustainability and remove distortions.⁸

32. Considerable attention is focused on projects under the ETP as a catalyst for sustained investment growth. Since its initiation in October 2010, 113 projects with a total value of RM 177 billion have been announced, concentrated mainly in infrastructure, commodity related investments and construction. RM 10 billion of investment was realized through October 2011,

⁸ The diagnoses and key medium-term priorities are articulated under the 10th Malaysia Plan, the New Economic Model, the Government Transformation Programme, and the Economic Transformation Programme.

constituting only 64 percent of investments committed for 2011.

33. A minimum wage is being considered to make growth more inclusive.

An Act was passed in July 2011 to set up the National Minimum Wage Consultative Council, charged with making a recommendation to the cabinet on the minimum wage rate and coverage.

Staff's Views

34. The economy's medium-term growth outlook is conditioned on the pace and implementation of broad-based reforms.

Under the staff's baseline scenario, medium-term growth is estimated at about 5 percent, with a gradual rebalancing of demand from the tradable to the nontradables sector. Raising potential growth above 5 percent would require sustained efforts to boost the productivity of both human and physical capital.⁹

35. Investments under the ETP would need to be accompanied by broad based reforms to sustainably raise productivity and investment. Kick starting investment projects by contributing a share of risk capital and removing impediments to investment is likely to boost investment in the short term. However, to generate a virtuous circle of

higher investment, productivity and incomes would need broader reforms to address the underlying fundamentals identified by the government. More progress is needed in a number of critical areas, including education and training, governance, and creating equal opportunities for all segments of the population.

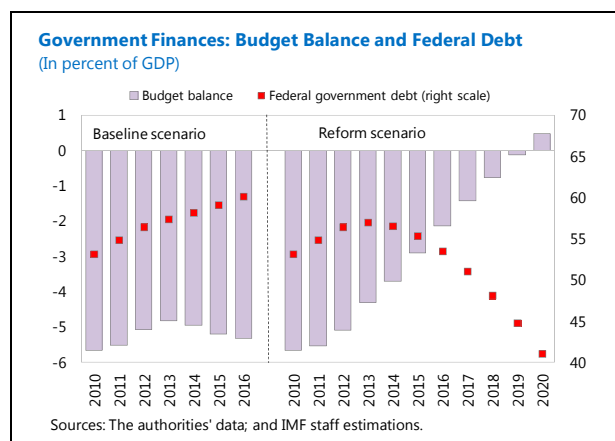
36. Structural measures need to be accompanied by fiscal reforms.

Efforts should concentrate on increasing fiscal space to allow room for countercyclical fiscal policies, putting federal government debt on a declining trajectory, and removing distortions in the tax and subsidy system. Broadening the tax base through the proposed goods and services tax would help reduce reliance on procyclical oil-related revenues. Resource allocation would be improved by the streamlining of subsidies and wasteful tax incentives, and replacing them with targeted assistance to the needy.

37. To achieve the authorities' projected deficit path and generate sufficient fiscal space, consolidation needs to be faster than under the staff's baseline. Committing to a medium term anchor accompanied by well-articulated revenue and expenditure measures, while allowing room for automatic stabilizers to operate and some discretionary spending to counter cyclical downturns, would help cement credibility. The staff's medium-term illustrative reform scenario envisages a reduction in federal government

⁹ See *Malaysia—Staff Report for the 2010 Article IV Consultation* (IMF Country Report No. 10/265) for details of the reform scenario.

debt to the pre-crisis level of 42 percent of GDP as a benchmark. This is consistent with the authorities' fiscal deficit path, and could be achieved by broadening the tax base, reducing subsidies and rationalizing both operating and development expenditure.



38. The formulation of fiscal policies would be enhanced by further improvements to fiscal transparency.

Malaysia's fiscal transparency is supported most importantly by a comprehensive legal framework that governs public finances and the budget process. In some areas, further efforts to increase transparency in line with the 2011 fiscal ROSC are recommended, including: expanding the coverage of the budget to include pension funds and all autonomous entities; gradually moving from discretionary to rules-based tax incentives; reporting comprehensively on public-private partnerships with a focus on fiscal risks; including in the budget clear information on new revenue and expenditure initiatives, contingent liabilities and quasi-fiscal activities;

and preparing a comprehensive fiscal risk assessment.

39. Making growth more inclusive will likely require a multi-pronged approach to enhancing safety nets. Fiscal policy can play a role through making access to good education and healthcare more equal, including via further use of conditional cash transfers that have proved successful in Brazil and Mexico and not too costly.¹⁰ Consideration could also be given to introducing an unemployment insurance scheme that could be mainly funded by employers and employees to avoid burdening the public purse. Relatively low pension replacement ratios point to a need to press ahead with the development of private defined contribution plans to supplement the compulsory Employees Provident Fund (EPF); to increase the age that one can withdraw income from EPF accounts from 55; and to raise the rate of return on EPF investments.¹¹ Regarding the latter, the October 2010 measure to increase the overseas investment limit of the EPF to 20 percent is a welcome first step.

40. The overall efficacy of a minimum wage remains subject to debate in theory

¹⁰ The Bolsa Familia program in Brazil covers about 25 percent of the population and costs around 0.4 percent of GDP.

¹¹ Organisation for Economic Co-operation and Development (OECD), 2009, *Pensions at a Glance, Special Edition: Asia/Pacific* (Paris).

and practice.¹² The key question is whether its role in supporting wages of low-skilled workers is offset by disemployment effects, and will depend on the rate that is set.¹³ Moreover, implementation will be challenging in an economy with porous borders and where workers can easily migrate from the formal to informal sector. A minimum wage policy would have to be carefully designed to address these concerns.

41. Appreciation of the real effective exchange rate over the medium term will be a key element of rebalancing the sources of growth. The current account surplus has declined quite significantly from its recent peak of just under 18 percent of GDP in 2008. However, the staff's Consultative Group on Exchange Rates (CGER) estimates suggest that the ringgit is still weaker than the level implied by medium-term fundamentals. Going forward, the policy of two-way flexibility with intervention limited to smoothing excessive volatility should allow for the appreciation of the currency over the medium term, and would facilitate the allocation of resources towards the nontradables sector, particularly if accompanied by ambitious structural reforms.

¹² Boeri, Tito, and Jan van Ours, 2008, *The Economics of Imperfect Labor Markets* (Princeton: Princeton University Press).

¹³ Minimum wage levels in most countries cluster around 40 percent of the average wage, with a range of 27 percent to 52 percent in OECD countries.

Authorities' Views

42. The authorities shared the view that enhancing human capital, improving governance, and ensuring broad-based access to opportunities are critical to the success of the reform. They underscored their commitment to decisive implementation of wide ranging reforms. The authorities were also somewhat more optimistic regarding the role of the ETP program as a catalyst for sustained, private sector investment.

43. The authorities agreed with the need for consolidation and streamlining inefficient subsidies. They said that work is ongoing on plans to streamline subsidies and other public expenditures, and on a goods and services tax. They also noted that adhering to the deficit target of 3 percent of GDP by 2015 and budget balance by 2020 will reduce federal government debt, but cyclical considerations may warrant flexibility in individual years.

44. The authorities argued that the real effective exchange rate would appreciate in line with fundamentals over the medium term. However, they emphasized the need to smooth excessive volatility arising from short-term capital flows. They noted that they

do not target a level for the exchange rate or foreign exchange reserves, and that the

two-sided nature of intervention is evident from recent experience.

STAFF APPRAISAL

45. Growth is projected to slow against the backdrop of a weakening external environment. Despite resilient employment conditions and fiscal transfers to households under the 2012 budget, the deteriorating global outlook is expected to weigh on private domestic demand. Under the baseline scenario, activity is expected to pick up in the latter half of 2012 with overall growth projected at 4 percent in 2012 and 4½ percent in 2013.

46. The monetary policy stance has correctly balanced the risks to growth and inflation. Headline inflation is projected to ease in 2012 as domestic demand moderates. As a result, policy rates should be maintained around current levels, but should be eased if growth prospects worsen significantly. The authorities should continue to allow two-way flexibility of the exchange rate to allow the currency to move in line with fundamentals, while limiting intervention to smooth out excess volatility.

47. High household debt levels need continued monitoring. While the financial system remains adequately capitalized with low nonperforming loans, banks should be

vigilant to the risks from rapidly-growing unsecured personal loans. The recently issued guidance to standardize banks' assessment of debt service to income ratios is welcome. There is no evidence of excessive house price increases; indeed prices have begun to ease since the implementation of LTV limits on third mortgages. Therefore, there is little need for additional prudential restrictions on mortgage lending at this juncture.

48. In 2012, the authorities should keep to the expenditure envelope in the 2012 federal government budget, but allow automatic stabilizers to work on the revenue side. Given the growth slowdown projected under the baseline, this would lead to more modest consolidation than envisaged in the 2012 budget, helping cushion the downturn. As a result, federal government debt would rise above 55 percent in the near term. Subsidy rationalization and more targeted help for the needy would facilitate an increased multiplier effect from fiscal spending.

49. Risks to the outlook are mostly external and tilted to the downside. The two key risks are protracted slow growth in the

major advanced economies and a sharp escalation of financial stress in global markets. In both cases, Malaysia's growth would be adversely affected through trade and its spillover to domestic demand. However, in the financial stress scenario, the domestic downturn would be compounded by financial-real linkages.

50. Malaysia is well positioned to withstand adverse shocks. There is room to cut policy rates, ensure an adequate supply of liquidity in foreign and domestic currency, and let the exchange rate act as a shock absorber. Domestic banks and corporates would likely not face enduring funding strains. There is also scope for additional financial sector policies similar to those deployed in 2008–09 to prevent deleveraging. Given the need for fiscal consolidation, there is more limited room for a countercyclical fiscal response. Any temporary fiscal expansion should be well targeted and anchored by a credible medium-term consolidation plan.

51. Over the medium term, ambitious implementation of structural reforms is needed to raise potential growth as the authorities recognize. The comprehensive diagnosis of constraints to growth needs to be followed up with action on multiple fronts. The Economic Transformation Programme is likely to help jump-start investment in the short term and would be helped by tackling underlying impediments further. Efforts should focus on improving the business climate; reducing

distortions to enhance competition and economic flexibility; improving education and upgrading skills to meet the needs of dynamic sectors; improving governance, and creating equal opportunities for all segments of society.

52. Structural measures need to be complemented by fiscal reforms to reduce distortions and boost countercyclical fiscal space. Streamlining subsidies and incentives would help improve resource allocation. Broadening the tax base would reduce reliance on oil and reduce revenue procyclicality. A clear medium-term fiscal consolidation plan to put federal government debt on a sustained downward trend, anchored on a debt target, would increase the space to implement countercyclical fiscal policies. Finally, implementing the recommendations from the fiscal ROSC would help improve fiscal transparency and manage fiscal risks, including those from contingent liabilities.

53. Ensuring inclusive growth is a key medium term priority. Reducing inequality requires a multi-pronged approach. Fiscal reforms can help, for example, by replacing broad-based subsidies with targeted assistance to vulnerable groups. Other measures could include conditional cash transfers, unemployment insurance, and an expanded pension provision designed to minimize the fiscal cost, and a well-designed minimum wage.

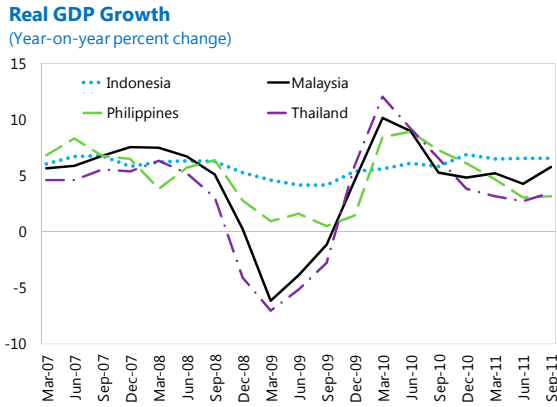
54. Appreciation of the real exchange rate over the medium term can complement these measures. Current model-based estimates suggest that the ringgit is somewhat undervalued relative to medium-term fundamentals. A gradual strengthening of the real exchange rate would

support the reform efforts to rebalance the sources of growth.

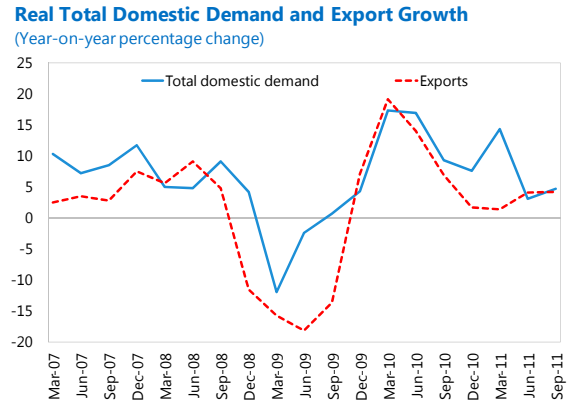
55. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Growth is Slowing Against a Weakening External Environment

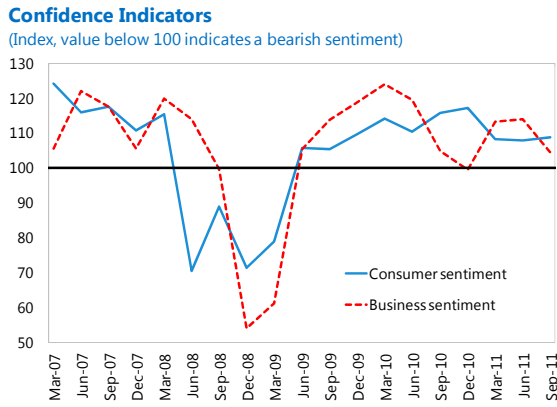
As in other export oriented economies, growth is slowing...



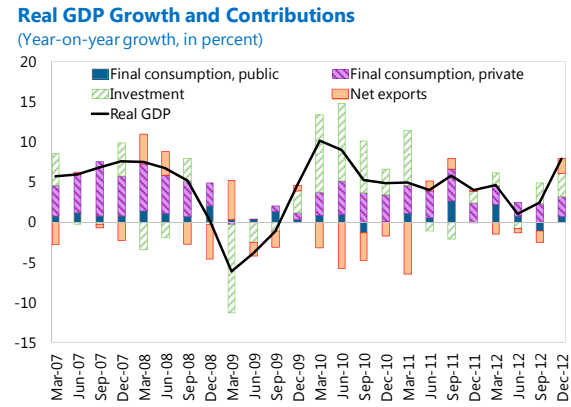
...with weaker exports driving down domestic demand.



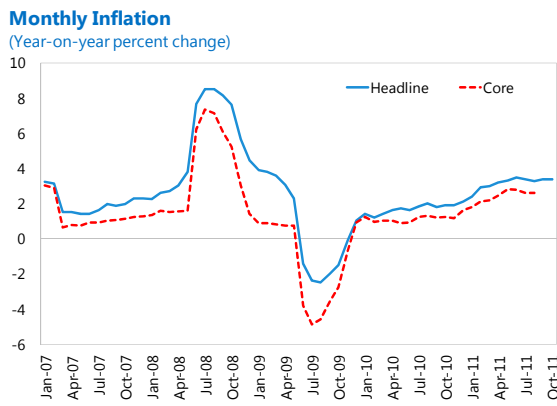
Forward looking sentiment indicators point to a weakening outlook for investment...



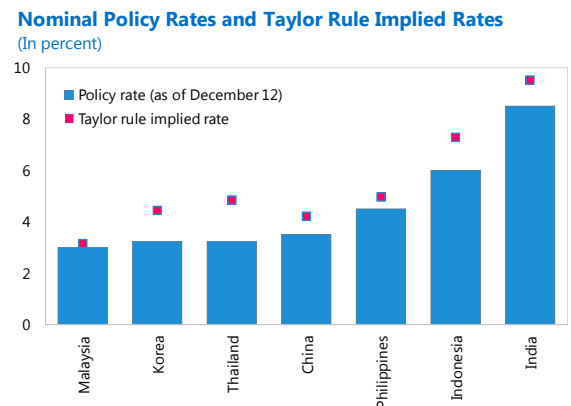
...but private consumption has held strong, and is expected to remain relatively resilient.



Inflation had been rising but is peaking...



...in part reflecting BNM's preemptive policy tightening since 2010.

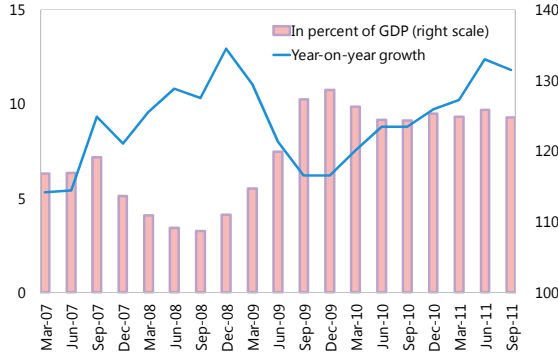


Sources: CEIC Data Co. Ltd; Haver Analytics; IMF, *World Economic Outlook*; and IMF staff estimates.

Figure 2. Domestic Demand However Remains Supported

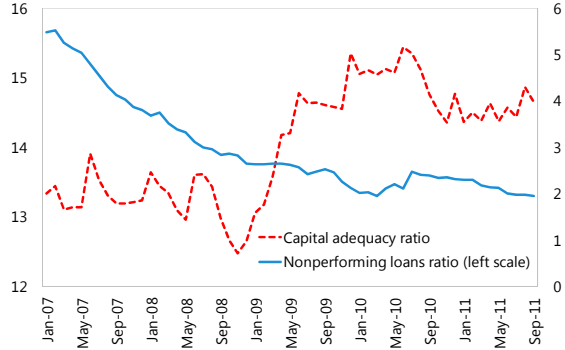
Credit growth remains robust...

Credit to Private Sector
(In percent)



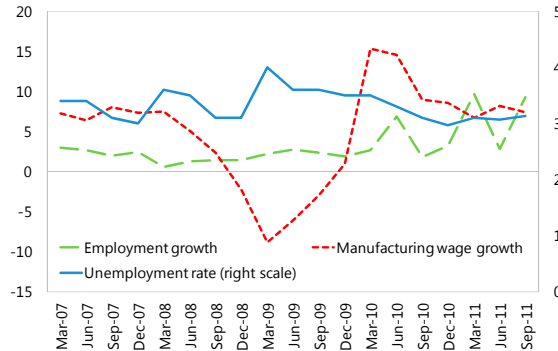
...buttressed by a sound financial system.

Financial Soundness Indicators
(In percent)



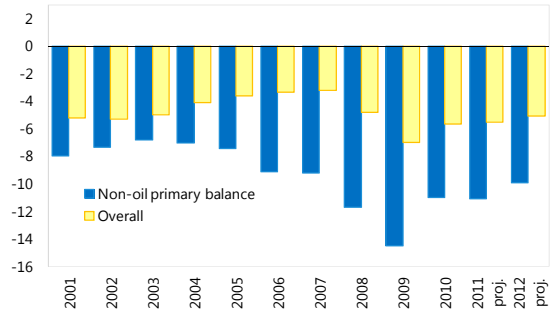
The labor market also remains strong.

Employment, Unemployment, and Wages
(In percent, with year-on-year growth rates)



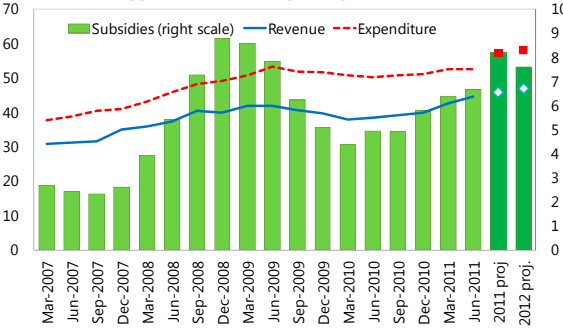
And the slow pace of fiscal consolidation will also help maintain domestic demand...

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



...as revenue growth is mostly offset by rising expenditures, including on subsidies.

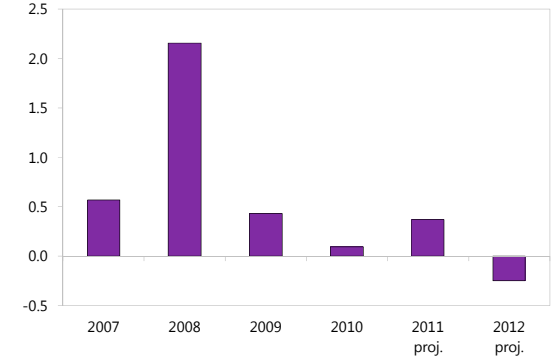
Central Government Finances 1/
(In billions of ringgit, 4-quarter moving average)



1/ Projections for 2011 and 2012 include one-fourth of the annual projection.

As a result, the fiscal impulse will be positive in 2011 and only mildly negative in 2012.

Fiscal Impulse
(In percent of GDP)



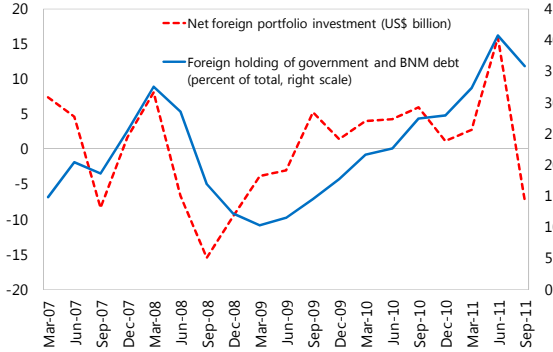
Sources: CEIC Data Co. Ltd; Haver Analytics; Bank Negara Malaysia; IMF, *World Economic Outlook*; and IMF staff estimates.

Figure 3. Financial Spillovers from the Global Turmoil Have Had a Modest Impact So Far

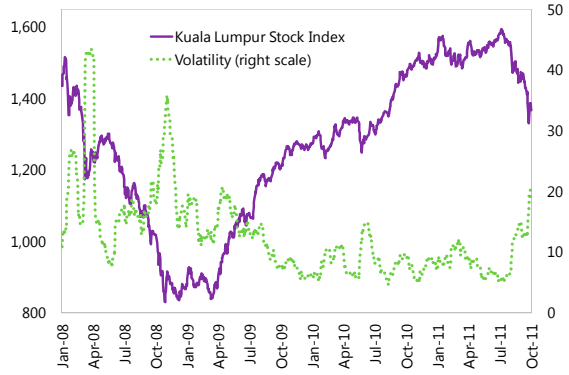
In line with the regional sell off, Malaysia experienced sizeable net portfolio outflows in August-September 2011...

...leading to a decline in equity markets...

Portfolio Outflows and Foreign Holding of Government and BNM Debt



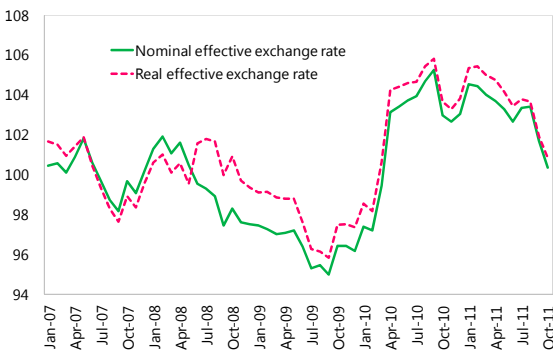
Stock Market Index with Volatility



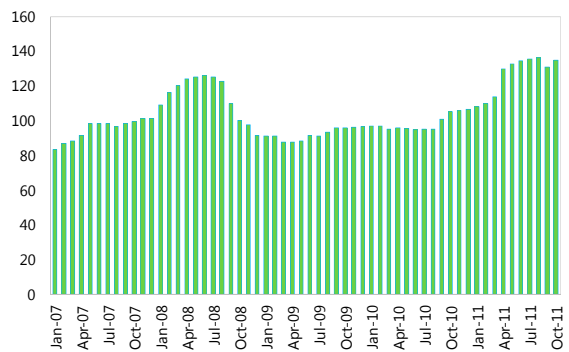
...a weakening of the exchange rate...

...but no significant reserve losses.

Effective Exchange Rate
(2007=100, increase=appreciation)



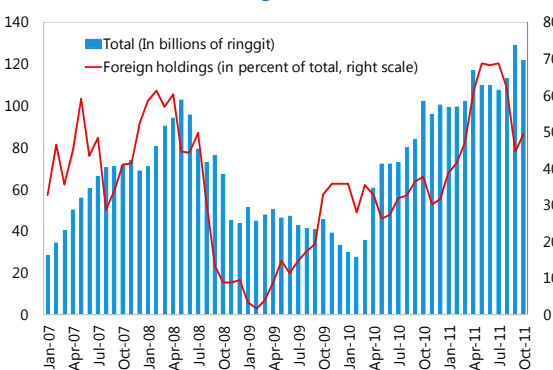
Foreign Reserves
(In billions of U.S. dollars)



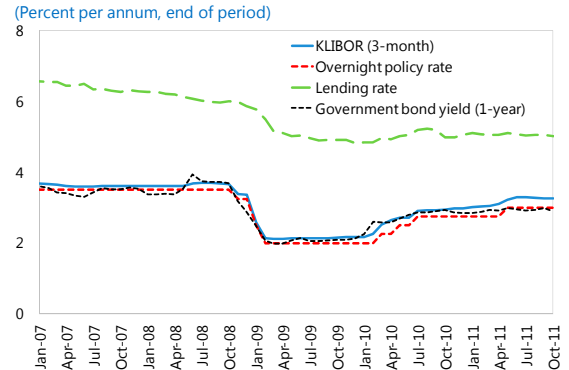
The decline in foreign holdings of BNM bills was more than offset by local investors.

This isolated the impact of the outflows on domestic liquidity conditions and helped keep interest rates stable.

BNM Securities Outstanding



Interest Rates
(Percent per annum, end of period)

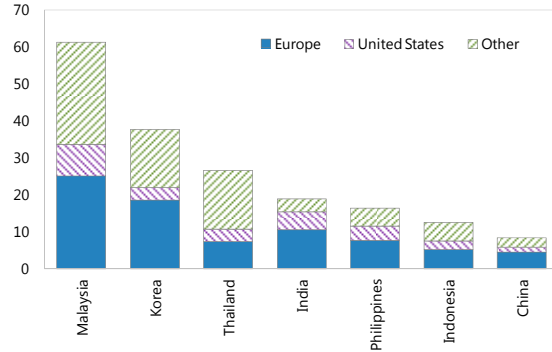


Sources: CEIC Data Co. Ltd; Haver Analytics; IMF, *World Economic Outlook*; and IMF staff estimates.

Figure 4. Malaysia's Exposure to European Banks is Relatively Contained

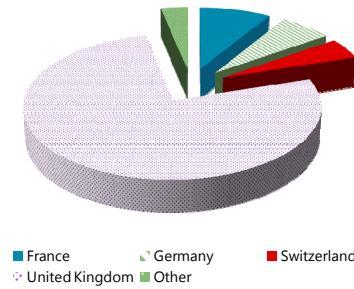
While European bank claims as a share of GDP are among the highest regionally...

Foreign Banks' Claims on Selected Asian Countries
(As of June 2011, in percent of 2010 GDP)



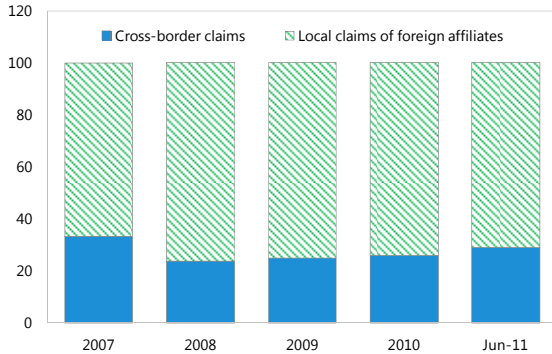
...the majority of European banks' claims are from non euro area banks.

Composition of European Banks' Claims by Nationality
(As of June 2011)



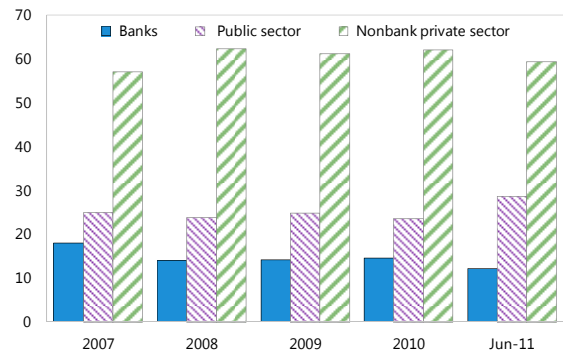
Moreover, over two thirds of total foreign bank claims are accounted for by local affiliates, which are largely domestically funded.

Cross Border Claims
(In percent of total)



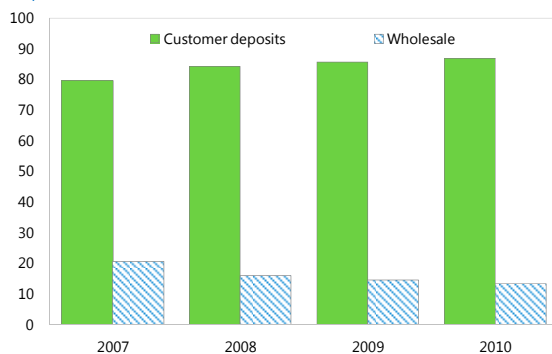
Most of foreign bank claims are with the non financial public and private sectors.

Foreign Claims by Sector
(In percent of total)



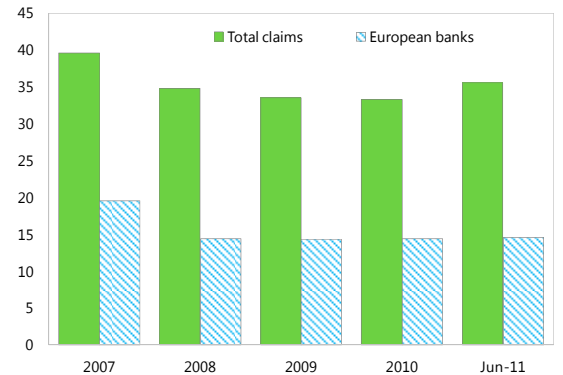
Indeed, the share of wholesale funding of banks is low and declining.

Structure of Domestic Banks Funding
(In percent of total)



Also, European bank claims are small compared with domestic banks' assets, so local banks may be able to offset any moderate deleveraging by European banks.

Foreign Claims in Percent of Domestic Commercial Banks' Assets



Sources: Bank for International Settlements; Bankscope database; and IMF staff estimates.

Table 1. Malaysia: Selected Economic and Financial Indicators, 2007–12

Nominal GDP (2010): US\$238 billion
 Main export (percent of total): electrical & electronic products (39%), commodities (23%)
 GDP per capita (2010): US\$8,423
 Population (2010): 28.3 million
 Unemployment rate (2010): 3.3 percent

	2007	2008	2009	2010	Proj.	
					2011	2012
Real GDP (percent change)	6.5	4.8	-1.6	7.2	4.7	4.0
Total domestic demand	9.4	5.8	-2.4	12.4	5.9	4.5
Consumption	9.7	9.0	1.3	5.2	6.3	3.8
Private consumption	10.5	8.7	0.7	6.5	6.0	3.7
Gross capital formation	8.4	-2.9	-13.8	38.3	4.8	6.6
GDP deflator	5.0	10.3	-6.9	2.5	2.9	2.7
Saving and investment (in percent of GDP)						
Gross domestic investment	21.6	19.3	14.4	21.4	21.8	21.8
Gross national saving	37.5	37.0	30.9	32.9	33.3	32.6
Fiscal sector (in percent of GDP)						
Federal government overall balance	-3.2	-4.8	-7.0	-5.6	-5.5	-5.1
Revenue	21.8	21.5	23.3	20.8	22.2	21.3
Expenditure and net lending	25.0	26.3	30.3	26.5	27.7	26.4
Federal government non-oil primary balance	-9.2	-11.7	-14.5	-11.0	-11.1	-9.9
Consolidated public sector overall balance 1/	1.5	-5.6	-7.6	-2.1	-8.4	-8.8
General government debt	42.7	42.8	55.4	55.4	56.6	57.5
Inflation and unemployment (period average, in percent)						
CPI inflation	2.0	5.4	0.6	1.7	3.2	2.5
Unemployment rate	3.2	3.3	3.7	3.4	3.2	3.1
Money and credit (end of period, percentage change)						
Broad money (M3) 2/	7.9	10.5	7.7	7.3	11.4	...
Credit to private sector 2/	7.9	12.9	6.2	9.7	9.8	...
Three-month interbank rate (in percent) 3/	3.6	3.4	2.2	3.0	3.2	...
Balance of payments (in billions of U.S. dollars)						
Current account balance	29.8	39.4	31.8	27.4	31.5	31.7
(In percent of GDP)	15.9	17.7	16.5	11.5	11.5	10.8
Trade balance	37.7	51.5	40.2	41.9	47.4	47.8
Exports, f.o.b.	176.3	199.2	157.3	198.8	226.9	241.7
Imports, f.o.b.	138.5	147.6	117.1	157.0	179.6	193.9
Services and income account balance	-3.3	-6.9	-2.8	-7.7	-9.0	-9.2
Capital and financial account balance	-11.3	-35.7	-22.8	-6.2	-19.1	-19.6
Errors and omissions	-5.2	-9.2	-5.1	-11.5	0.0	0.0
Overall balance	13.2	-5.5	3.9	9.7	12.5	12.1
Gross official reserves (US\$ billions)	101.3	91.6	96.8	106.5	119.0	131.1
(In months of following year's imports)	6.8	7.6	6.1	6.0	6.2	6.4
(In percent of short-term debt) 4/	495.4	274.9	362.1	347.0	389.6	436.0
Total external debt (US\$ billions)	56.7	68.2	68.0	73.7	73.3	72.2
(In percent of GDP)	30.3	30.6	35.2	31.0	26.6	24.6
Of which: short-term (in percent of total) 4/	36.1	48.9	39.3	41.7	41.7	41.6
Debt service ratio						
(In percent of exports of goods and services)	3.6	2.8	6.6	2.7	2.7	2.6

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

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

2/ As of October 2011.

3/ As of November 2011.

4/ By remaining maturity.

Table 2. Malaysia: Indicators of External Vulnerability, 2007–11

	2007	2008	2009	2010	Proj. 2011
Financial indicators					
General government debt (in percent of GDP) 1/	42.7	42.8	55.4	55.4	56.6
Total liquidity (M3: percent change, 12-month basis)	7.9	10.5	7.7	7.3	11.4
Private sector credit (percent change, 12-month basis)	7.9	12.9	6.2	9.7	9.8
Treasury bill interest rate (percent, 12-month average) 2/	3.4	3.4	2.1	2.6	2.9
External indicators					
Exports (percent change, 12-month basis in U.S. dollars)	10.0	13.0	-21.0	26.4	14.1
Imports (percent change, 12-month basis in U.S. dollars)	12.7	6.5	-20.7	34.1	14.4
Current account balance (in billions of U.S. dollars)	29.8	39.4	31.8	27.4	31.5
Current account balance (in percent of GDP)	15.9	17.7	16.5	11.5	11.5
Capital and financial account balance (in billions of U.S. dollars)	-11.3	-35.7	-22.8	-6.2	-19.1
Gross official reserves (in billions of U.S. dollars)	101.3	91.6	96.8	106.5	119.0
In months of following year's imports of goods and nonfactor services	6.8	7.6	6.1	6.0	6.2
As percent of total liquidity (M3)	40.3	34.0	32.6	30.0	31.9
As percent of monetary base	524.5	461.8	604.3	532.6	426.5
Total short-term external debt by:					
Original maturity (in billions of U.S. dollars)	16.5	23.0	22.6	25.8	25.5
Remaining maturity (in billions of U.S. dollars)	20.5	33.3	26.7	30.7	30.5
Original maturity to reserves (in percent)	16.3	25.1	23.4	24.2	21.4
Original maturity to total external debt (in percent)	29.1	33.7	33.3	35.0	34.8
Remaining maturity to reserves (in percent)	20.2	36.4	27.6	28.8	25.7
Remaining maturity to total external debt (in percent)	36.1	48.9	39.3	41.7	41.7
Total external debt (in billions of U.S. dollars)	56.7	68.2	68.0	73.7	73.3
<i>Of which</i> : public and publicly guaranteed debt	18.6	24.1	24.9	27.0	27.2
Total external debt to exports of goods and services (in percent)	26.1	28.2	34.5	30.3	26.6
External amortization payments to exports of goods and services (in percent)	2.6	1.6	5.2	1.7	1.8
Financial market indicators					
Kuala Lumpur Composite Index (KLCI), end of period 3/	1,445	877	1,273	1,519	1,472
10 years government securities yield (percent per annum, average)	3.7	4.1	4.1	4.0	3.9

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

1/ Gross debt

2/ Discount rate on 3-month treasury bills.

3/ The last observation is for November 2011.

Table 3. Malaysia: Balance of Payments, 2007–12

	2007	2008	2009	2010	Proj.	
					2011	2012
(In billions of U.S. dollars)						
Current account balance	29.8	39.4	31.8	27.4	31.5	31.7
Trade balance	37.7	51.5	40.2	41.9	47.4	47.8
Exports, f.o.b.	176.3	199.2	157.3	198.8	226.9	241.7
Imports, f.o.b.	138.5	147.6	117.1	157.0	179.6	193.9
Services and income account balance	-3.3	-6.9	-2.8	-7.7	-9.0	-9.2
Receipts	40.9	42.8	39.9	44.6	48.0	50.3
<i>Of which: income</i>	11.4	12.1	11.2	11.9	12.1	12.3
Payments	44.1	49.6	42.8	52.3	57.0	59.5
<i>Of which: income</i>	15.5	19.0	15.3	20.1	23.0	24.5
Net transfers	-4.7	-5.2	-5.6	-6.8	-6.9	-6.9
Capital and financial account balance	-11.3	-35.7	-22.8	-6.2	-19.1	-19.6
Capital account	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-11.3	-35.7	-22.8	-6.2	-19.1	-19.6
Net foreign direct investment	-2.7	-7.8	-6.5	-4.2	-4.9	-3.4
Portfolio investment	5.4	-25.0	-0.5	15.1	7.0	5.9
Other investment	-14.0	-3.0	-15.8	-17.0	-21.2	-22.1
Errors and omissions	-5.2	-9.2	-5.1	-11.5	0.0	0.0
Overall balance	13.2	-5.5	3.9	9.7	12.5	12.1
Gross official reserves	101.3	91.6	96.8	106.5	119.0	131.1
In months of following year's imports of goods and nonfactor services	6.8	7.6	6.1	6.0	6.2	6.4
In percent of short-term debt 1/	495.4	274.9	362.1	347.0	389.6	436.0
(In percent of GDP)						
Current account balance	15.9	17.7	16.5	11.5	11.5	10.8
(Excluding oil)	13.4	14.8	14.3	9.3	8.9	8.5
Trade balance	20.2	23.1	20.8	17.6	17.2	16.3
Exports	94.3	89.4	81.5	83.6	82.5	82.3
Imports	74.1	66.3	60.6	66.0	65.3	66.0
Services and income account balance	-1.8	-3.1	-1.5	-3.2	-3.3	-3.1
Capital and financial account balance	-6.1	-16.0	-11.8	-2.6	-6.9	-6.7
Net foreign direct investment	-1.5	-3.5	-3.4	-1.8	-1.8	-1.2
(Annual percentage change)						
Memorandum items:						
Export value growth (in U.S. dollars)	10.0	13.0	-21.0	26.4	14.1	6.5
Export volume growth	1.2	2.9	-12.7	11.6	2.8	6.6
Import value growth (in U.S. dollars)	12.7	6.5	-20.7	34.1	14.4	8.0
Import volume growth	4.5	2.0	-18.5	18.3	7.4	7.9
Terms of trade	0.9	1.1	0.3	-2.1	-0.4	-0.2
Net international investment position						
(In billions of U.S. dollars)	-4.5	30.4	30.9	4.3	...	...
(In percent of GDP)	-2.4	13.6	16.0	1.8	...	...

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

1/ By remaining maturity.

Table 4. Malaysia: Illustrative Medium-Term Macroeconomic Framework, 2007–16 1/

	2007	2008	2009	2010	Proj.					
					2011	2012	2013	2014	2015	2016
Real sector (percent change)										
Real GDP growth	6.5	4.8	-1.6	7.2	4.7	4.0	4.5	5.0	5.0	5.0
Total domestic demand	9.4	5.8	-2.4	12.4	5.9	4.5	5.6	5.8	5.9	6.0
CPI inflation (period average)	2.0	5.4	0.6	1.7	3.2	2.5	2.5	2.5	2.5	2.5
Saving and investment (in percent of GDP)										
Gross domestic investment	21.6	19.3	14.4	21.4	21.8	21.8	21.9	22.0	22.1	22.2
Private, including stocks	11.9	10.2	3.7	13.1	12.6	11.6	12.7	13.2	13.8	14.3
Public	9.6	9.1	10.7	8.3	9.2	10.2	9.2	8.8	8.3	7.9
Gross national saving	37.5	37.0	30.9	32.9	33.3	32.6	31.9	31.5	31.2	30.8
Private	21.2	26.1	22.0	21.5	25.2	23.3	23.0	22.9	23.0	23.0
Public	16.2	11.0	8.9	11.5	8.1	9.3	9.0	8.6	8.2	7.9
Fiscal sector (in percent of GDP)										
Federal government overall balance	-3.2	-4.8	-7.0	-5.6	-5.5	-5.1	-4.8	-5.0	-5.2	-5.3
Revenue	21.8	21.5	23.3	20.8	22.2	21.3	21.0	20.6	20.2	19.9
Expenditure and net lending	25.0	26.3	30.3	26.5	27.7	26.4	25.8	25.5	25.4	25.2
Federal government non-oil primary balance	-9.2	-11.7	-14.5	-11.0	-11.1	-9.9	-9.1	-8.6	-8.2	-7.3
Consolidated public sector overall balance 2/	1.5	-5.6	-7.6	-2.1	-8.4	-8.8	-7.5	-7.1	-6.7	-6.4
General government debt	42.7	42.8	55.4	55.4	56.6	57.5	58.6	59.5	60.2	61.0
Of which: federal government debt	41.5	41.3	53.3	53.1	54.9	56.4	57.4	58.2	59.1	60.1
Balance of payments (in billions of U.S. dollars)										
Trade balance	37.7	51.5	40.2	41.9	47.4	47.8	48.0	49.4	50.5	52.4
Services and income account balance	-3.3	-6.9	-2.8	-7.7	-9.0	-9.2	-9.5	-10.1	-10.8	-11.6
Current account balance	29.8	39.4	31.8	27.4	31.5	31.7	31.6	32.3	33.5	34.2
(In percent of GDP)	15.9	17.7	16.5	11.5	11.5	10.8	10.0	9.5	9.1	8.6
Capital and financial account balance	-11.3	-35.7	-22.8	-6.2	-19.1	-19.6	-19.5	-19.4	-20.0	-19.7
Errors and omissions	-5.2	-9.2	-5.1	-11.5	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	13.2	-5.5	3.9	9.7	12.5	12.1	12.1	12.9	13.5	14.5
International trade (annual percent change)										
Export value	10.0	13.0	-21.0	26.4	14.1	6.5	6.6	7.8	7.7	8.8
Import value	12.7	6.5	-20.7	34.1	14.4	8.0	8.2	8.9	8.9	9.8
Terms of trade	0.9	1.1	0.3	-2.1	-0.4	-0.2	0.1	-0.1	-0.3	-0.1
Gross official reserves (in billions of U.S. dollars)										
(In months of following year's imports)	6.8	7.6	6.1	6.0	6.2	6.4	6.5	6.5	6.5	6.5
(In percent of short-term debt) 3/	495.4	274.9	362.1	347.0	389.6	436.0	489.0	553.6	632.6	732.3
Total external debt (in billions of U.S. dollars)										
(In percent of GDP)	30.3	30.6	35.2	31.0	26.6	24.6	22.4	20.3	18.3	16.3
Short-term external debt (percent of total) 3/										
Debt-service ratio	36.1	48.9	39.3	41.7	41.7	41.6	41.4	40.8	40.0	38.9
(In percent of exports of goods and services)	3.6	2.8	6.6	2.7	2.7	2.6	2.4	2.3	2.2	2.1
Net international investment position (in billions of U.S. dollars)										
	-4.5	30.4	30.9	4.3	...	...	...	...	...	...
Memorandum item										
Nominal GDP (in billions of ringgit)	642	742	680	766	825	881	946	1,020	1,101	1,187

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

1/ Period ending December 31.

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

3/ By remaining maturity.

Table 5. Malaysia: Summary of Federal Government Operations and Stock Positions, 2007–12

	2007	2008	2009	2010	2011 Proj.	2012	
						Budget	Proj.
I. Statement of Government Operations							
(In millions of ringgit)							
Revenue	139,886	159,794	158,640	159,654	183,375	186,907	187,785
Taxes	95,168	112,900	106,504	109,515	129,182	135,618	136,555
Other revenue	44,718	46,895	52,135	50,139	54,193	51,289	51,230
Expenditure	160,543	195,387	206,063	202,928	228,886	229,927	232,483
Expense	124,654	154,784	157,148	152,429	182,268	184,022	186,578
Compensation of employees	32,587	41,011	42,778	46,663	49,913	52,017	53,321
Use of goods and services	27,724	29,317	29,035	26,507	33,038	34,042	35,294
Interest	12,911	12,797	14,221	15,621	18,517	20,453	20,453
Subsidies	13,581	35,166	20,345	23,106	32,798	30,408	30,408
Grants	14,611	16,949	16,919	17,096	18,879	20,297	20,297
Social benefits and other expense	23,240	19,544	33,850	23,436	29,123	26,805	26,805
Net acquisition of nonfinancial assets	35,889	40,603	48,915	50,499	46,618	45,905	45,905
Gross operating balance	15,232	5,010	1,492	7,225	1,107	2,885	1,207
Net lending/borrowing	-20,657	-35,593	-47,423	-43,274	-45,511	-43,020	-44,698
Net acquisition of financial assets	364	1,234	6,871	-957	...	...	...
By financial instrument							
Currency and deposits	827	-414	3,168	-3,156	...	...	...
Loans	-463	1,648	3,702	2,199	...	...	...
By holder residence							
Domestic	364	1,234	6,871	-957	...	...	...
Foreign	0	0	0	0	...	...	...
Net incurrence of liabilities	21,486	35,180	50,593	40,120	...	...	...
By financial instrument							
Debt securities	25,800	35,654	56,879	36,456	...	...	...
Loans	-4,314	-474	-6,286	3,664	...	...	...
By holder residence							
Domestic	10,697	37,799	44,365	3,567	...	...	...
Foreign	10,789	-2,619	6,227	36,553	...	...	...
Statistical discrepancy 1/	465	-1,647	-3,701	-2,198	...	...	...
(In percent of GDP)							
Revenue	21.8	21.5	23.3	20.8	22.2	21.2	21.3
Taxes	14.8	15.2	15.7	14.3	15.7	15.4	15.5
Other revenue	7.0	6.3	7.7	6.5	6.6	5.8	5.8
Expenditure	25.0	26.3	30.3	26.5	27.7	26.1	26.4
Expense	19.4	20.8	23.1	19.9	22.1	20.9	21.2
Net acquisition of nonfinancial assets	5.6	5.5	7.2	6.6	5.7	5.2	5.2
Gross operating balance	2.4	0.7	0.2	0.9	0.1	0.3	0.1
Net lending/borrowing	-3.2	-4.8	-7.0	-5.6	-5.5	-4.9	-5.1
II. Stock Positions							
(In millions of ringgit)							
Liabilities (nominal value)	266,722	306,437	362,386	407,101	452,612	...	497,310
By financial instrument							
Debt securities	224,020	260,621	312,590	346,813	...	...	...
Loans	42,702	45,816	49,796	60,289	...	...	...
By holder residence							
Domestic	215,365	256,512	306,477	315,344	...	...	...
Foreign	51,357	49,925	55,909	91,757	...	...	...
Memorandum items:							
Cyclically adjusted balance (percent of GDP)	-3.6	-5.3	-6.2	-5.6	-5.6	-4.8	-5.0
Nominal GDP (in millions of ringgit)	642,049	742,470	679,938	765,966	825,053	881,386	881,386

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

1/ Statistical discrepancy between the net lending/borrowing, net acquisition of financial assets, and net incurrence of liabilities, due to inconsistency between different sources of data used.

Table 6. Malaysia: Monetary Survey, 2009–11

	2009	2010				2011		
		Mar	Jun	Sep	Dec	Mar	Jun	Sep
(In millions of ringgit; end of period)								
Net foreign assets	295,397	278,047	272,821	275,579	290,583	294,225	335,215	347,785
Foreign assets	396,650	382,571	392,293	402,671	420,705	455,864	529,741	544,188
Foreign liabilities	101,253	104,524	119,472	127,093	130,122	161,639	194,527	196,403
Net domestic assets	696,655	729,557	736,515	758,783	774,363	796,544	803,316	819,699
Net domestic credit	929,831	947,086	955,695	984,808	1,005,859	1,031,050	1,058,794	1,079,787
Net credit to nonfinancial public sector	55,865	55,844	55,668	60,899	56,766	53,323	47,210	45,987
Credit to private sector	795,598	811,269	834,649	852,935	879,943	904,756	936,132	960,321
Net credit to other financial corporations	78,369	79,974	65,378	70,973	69,151	72,971	75,453	73,479
Capital accounts	189,941	170,758	168,817	169,456	170,956	173,199	183,662	195,667
Other items (net)	-43,235	-46,771	-50,362	-56,569	-60,540	-61,307	-71,817	-64,421
Broad money	992,052	1,007,604	1,009,336	1,034,362	1,064,945	1,090,769	1,138,531	1,167,484
Narrow money	213,869	214,592	221,916	228,486	239,784	242,900	254,420	263,025
Currency in circulation	43,438	44,685	44,362	45,585	47,685	48,816	49,767	51,393
Transferable deposits	170,431	169,907	177,554	182,901	192,100	194,084	204,652	211,632
Other deposits	749,555	765,780	762,479	780,118	798,978	820,714	855,011	874,813
Securities other than shares	28,628	27,233	24,941	25,757	26,183	27,124	29,100	29,564
Repurchase agreements	0	0	0	0	0	30	0	83
(Contribution to 12-month growth in broad money)								
Net foreign assets	4.1	1.0	0.4	-1.1	-0.5	1.6	6.2	7.0
Net domestic assets	3.7	6.7	7.6	9.3	7.8	6.6	6.6	5.9
Memorandum items:								
Broad money (12-month percent change)	7.7	7.7	8.0	8.3	7.3	8.3	12.8	12.9
Currency in circulation (12-month percent change)	7.4	9.5	8.5	7.3	9.8	9.2	12.2	12.7
Money Multiplier (broad money/narrow money)	4.6	4.7	4.5	4.5	4.4	4.5	4.5	4.4

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

Table 7. Malaysia: Banks' Financial Soundness Indicators, 2007–11

	2007	2008	2009	2010	2011 June
	(In percent)				
Capital adequacy					
Regulatory capital to risk-weighted assets	14.8	16.1	18.2	17.5	16.6
Regulatory Tier 1 capital to risk-weighted assets	10.6	11.7	14.1	13.5	12.4
Asset quality					
Nonperforming loans net of provisions to capital 1/	27.0	17.7	11.8	13.9	12.4
Nonperforming loans to total gross loans	6.5	4.8	3.6	3.4	2.9
Total provisions to nonperforming loans	63.2	74.7	82.5	88.4	94.8
Earnings and profitability					
Return on assets	1.5	1.5	1.2	1.5	1.7
Return on equity	19.2	17.6	13.4	16.3	18.5
Interest margin to gross income	55.5	58.2	57.7	59.8	56.2
Non-interest expenses to gross income	37.4	39.8	45.2	41.5	41.0
Liquidity					
Liquid assets to total assets (liquid asset ratio)	14.6	14.8	14.3	15.7	13.8
Liquid assets to short term liabilities	38.7	42.1	43.0	48.1	39.9
Loan-deposit ratio 2/	74.1	74.7	77.9	81.3	81.8
Sensitivity to market risk					
Net open position in foreign exchange to capital	5.7	5.1	3.9	9.3	12.6
Sectoral distribution of total loans to nonbanking sector					
Residents	99.0	98.3	98.1	98.0	97.6
Other financial corporations	2.9	3.2	3.4	3.1	3.3
General government	0.2	0.9	2.0	2.7	2.7
Nonfinancial corporations	40.5	40.6	38.4	37.6	37.3
Other domestic sectors	55.3	53.6	54.4	54.6	54.2
Nonresidents	1.0	1.7	1.9	2.0	2.4

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

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

2/ Deposits include repos and negotiable instruments of deposit. Loans exclude loans sold to Cagamas Berhad.



MALAYSIA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

December 23, 2011

Prepared By

Asia and Pacific Department

CONTENTS

I. MEDIUM TERM DEBT SUSTAINABILITY ANALYSIS	2
II. FUND RELATIONS	7
III. STATISTICAL ISSUES	9

ANNEX I: MALAYSIA—MEDIUM TERM DEBT SUSTAINABILITY ANALYSIS

1. Malaysia's external debt is expected to remain on a steady downward trend over the medium term, falling to just over

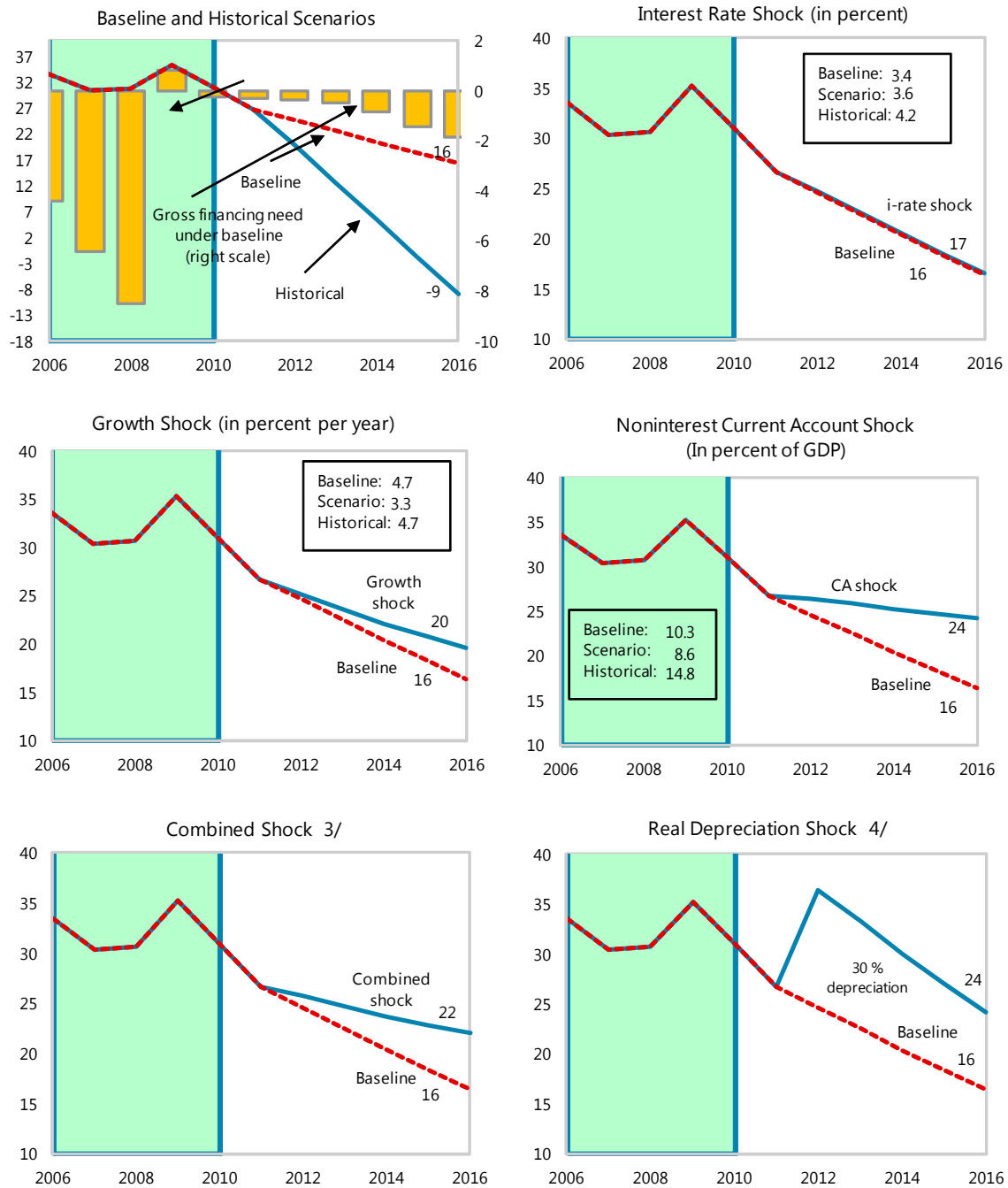
16 percent of GDP by 2016. The

10 percentage point decline in the external debt to GDP ratio from 2011 to 2016 mostly reflects sustained current account surpluses and some shift towards domestic debt. Stress tests indicate that external debt would remain manageable under a variety of shocks, including weaker GDP growth, a lower current account deficit, and a one time 30 percent depreciation of the ringgit. Under these scenarios, the external debt to GDP ratio rises above the baseline over the projection period by only modest margins to about 24 percent of GDP in 2016. In the case of the exchange rate depreciation scenario, the debt ratio would rise sharply to 36 percent of GDP in 2012, but would subsequently fall to 24 percent of GDP by 2016.

2. The gross debt to GDP ratio for the general government is expected to increase over the medium term. Under the baseline

scenario, debt is expected to rise steadily relative to GDP over the next five years, reaching about 61 percent of GDP by 2016. Bound tests indicate that the debt path is highly vulnerable to growth and interest rate shocks. For instance, a decline in real GDP growth of about 1½ percentage point relative to the baseline would increase the debt to GDP ratio to above 70 percent in 2016. Further budget consolidation efforts are needed to put the debt to GDP ratio on a declining trajectory over the medium term through clearly articulated revenue and expenditure measures, including a phased reduction of subsidies, broadening of the tax base, and more targeted and efficient social spending.

Figure I.1. Malaysia: External Debt Sustainability: Bound Tests 1/ 2/
(External debt, in percent of GDP)



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

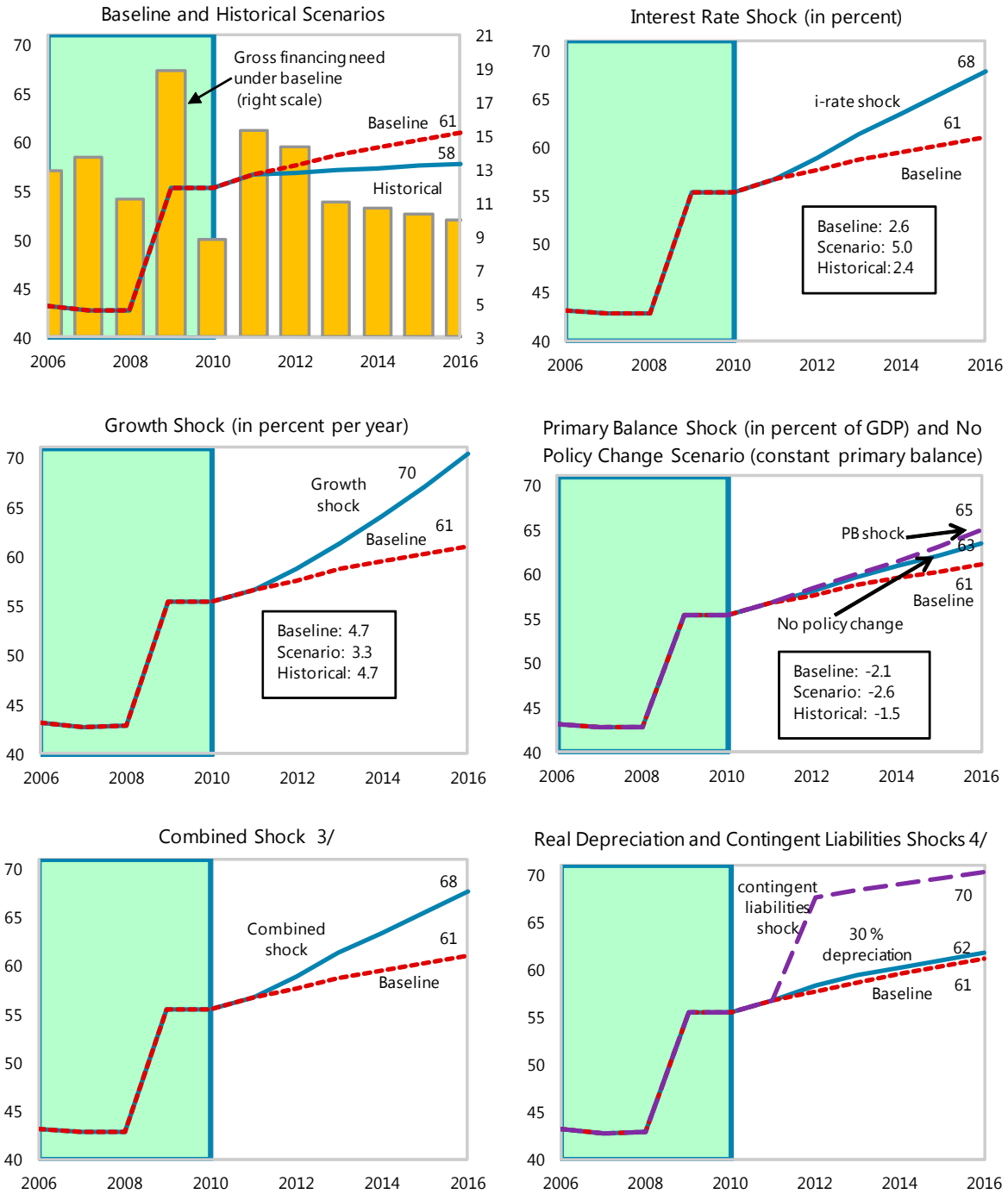
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

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

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

4/ One-time real depreciation of 30 percent occurs in 2010.

Figure I.2. Malaysia: Public Debt Sustainability: Bound Tests 1/ 2/
(Public debt, in percent of GDP)



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

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

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

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

4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table I.1. Malaysia: External Debt Sustainability Framework, 2006–2016
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Debt-stabilizing no-interest current account 6/
Baseline: external debt	33.5	30.3	30.6	35.2	31.0	26.6	24.6	22.4	20.3	18.3	16.3	-0.5
Change in external debt	-4.5	-3.2	0.3	4.6	-4.3	-4.3	-2.1	-2.1	-2.1	-2.0	-1.9	
Identified external debt-creating flows (4+8+9)	-21.2	-19.8	-19.1	-8.4	-16.4	-10.9	-10.6	-10.1	-9.9	-9.7	-9.3	
Current account deficit, excluding interest payments	-18.1	-17.2	-19.0	-17.9	-12.5	-12.3	-11.6	-10.8	-10.2	-9.8	-9.2	
Deficit in balance of goods and services	-22.5	-20.6	-23.2	-21.5	-17.8	-17.9	-17.3	-16.6	-16.1	-15.5	-15.2	
Exports	116.5	110.0	103.2	96.4	97.3	95.6	95.2	94.5	94.3	94.0	94.6	
Imports	94.1	89.4	80.0	74.8	79.5	77.7	77.9	77.9	78.2	78.5	79.4	
Net nondebt creating capital inflows (negative)	0.0	1.5	3.5	3.4	1.8	1.8	1.2	0.9	0.7	0.4	0.2	
Automatic debt dynamics 1/	-3.1	-4.1	-3.6	6.1	-5.6	-0.4	-0.2	-0.3	-0.3	-0.3	-0.2	
Contribution from nominal interest rate	1.5	1.2	1.3	1.4	1.0	0.9	0.8	0.8	0.7	0.7	0.6	
Contribution from real GDP growth	-2.0	-1.8	-1.2	0.6	-2.1	-1.2	-1.0	-1.0	-1.0	-0.9	-0.8	
Contribution from price and exchange rate changes 2/	-2.7	-3.5	-3.6	4.1	-4.6	...	...	...	...	...	...
Residual, including change in gross foreign assets (2-3) 3/	16.7	16.6	19.4	13.0	12.1	6.6	8.6	8.0	7.7	7.7	7.4	
External debt-to-exports ratio (in percent)	28.7	27.6	29.7	36.5	31.8	27.9	25.8	23.8	21.5	19.4	17.3	
Gross external financing need (in billions of U.S. dollars) 4/	-6.9	-12.1	-19.0	1.5	-0.6	-0.9	-1.2	-1.6	-3.0	-5.3	-7.4	
In percent of GDP	-4.5	-6.5	-8.5	0.8	-0.3	-0.3	-0.4	-0.5	-0.9	-1.4	-1.9	
Scenario with key variables at their historical averages 5/						26.6	19.8	12.6	5.3	-1.9	-9.1	1.0
Key macroeconomic assumptions underlying baseline												
Real GDP growth (in percent)	5.8	6.5	4.8	-1.6	7.2	4.7	4.0	4.5	5.0	5.0	5.0	
GDP deflator in U.S. dollars (change in percent)	7.5	11.8	13.6	-11.9	15.0	5.2	7.9	2.7	2.7	2.7	2.7	
Nominal external interest rate (in percent)	4.5	4.4	5.0	4.0	3.6	4.2	3.3	3.3	3.4	3.5	3.6	
Growth of exports (U.S. dollar terms, in percent)	12.1	13.2	11.7	-19.1	24.5	8.3	13.5	6.4	6.5	7.6	7.5	
Growth of imports (U.S. dollar terms, in percent)	12.3	14.0	6.6	-18.9	30.9	8.1	12.9	7.2	7.4	8.2	8.3	
Current account balance, excluding interest payments	18.1	17.2	19.0	17.9	12.5	14.8	12.3	11.6	10.8	10.2	9.8	
Net nondebt creating capital inflows	0.0	-1.5	-3.5	-3.4	-1.8	-0.5	-1.8	-1.2	-0.9	-0.7	-0.4	

1/ Derived as $[r - g - r(1+g) + ea(1+r)]/(1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

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

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.

Table I.2. Malaysia: Public Sector Debt Sustainability Framework, 2006–2016
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					Debt-stabilizing primary balance 9/	
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015		2016
1 Baseline: public sector debt 1/ Of which: foreign-currency denominated	43.2	42.7	42.8	55.4	55.4	56.6	57.5	58.6	59.5	60.2	61.0	-1.0
2 Change in public sector debt	4.4	3.1	2.7	2.0	2.2	1.6	1.4	1.2	1.1	1.0	0.9	
3 Identified debt-creating flows (4+7+12)	-1.3	-0.4	0.0	12.6	0.0	1.3	0.9	1.1	0.8	0.8	0.8	
4 Primary deficit	-2.3	-2.2	-2.4	9.2	-2.6	1.3	0.9	1.1	0.8	0.8	0.8	
5 Revenue and grants	-0.1	0.5	1.5	3.2	1.6	2.9	2.2	2.4	2.2	1.9	1.8	
6 Primary (noninterest) expenditure	25.0	25.3	25.5	27.1	24.8	25.5	24.4	24.1	23.7	23.3	23.0	
7 Automatic debt dynamics 2/	24.9	25.8	27.0	30.2	26.4	28.4	26.6	26.5	25.9	25.3	24.8	
8 Contribution from interest rate/growth differential 3/ Of which: contribution from real interest rate	-2.2	-2.7	-3.9	6.1	-4.3	-1.6	-1.3	-1.3	-1.4	-1.2	-1.0	
9 Of which: contribution from real GDP growth	-1.8	-2.5	-4.0	6.1	-4.1	-1.6	-1.3	-1.3	-1.4	-1.2	-1.0	
10 Of which: contribution from real interest rate	0.6	0.0	-2.2	5.3	-0.6	0.7	0.9	1.1	1.3	1.6	1.8	
11 Contribution from exchange rate depreciation 4/	-2.4	-2.5	-1.8	0.8	-3.5	-2.4	-2.1	-2.4	-2.7	-2.8	-2.8	
12 Other identified debt-creating flows	-0.4	-0.3	0.1	0.0	-0.2	...	...	...	...	...	...
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2–3) 5/	1.0	1.8	2.5	3.4	2.6	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	172.6	168.7	167.4	204.5	223.4	222.0	235.7	243.6	251.2	258.4	265.5	
Gross financing need 6/ In billions of U.S. dollars	12.9	13.7	11.3	18.8	8.8	15.3	14.3	11.1	10.7	10.3	10.0	
Scenario with key variables at their historical averages 7/ Scenario with no policy change (constant primary balance) in 2011–2016	20.2	25.5	25.1	36.4	21.0	41.7	41.5	34.4	35.9	37.3	39.0	
Key macroeconomic and fiscal assumptions underlying baseline												
Real GDP growth (in percent)	5.8	6.5	4.8	-1.6	7.2	4.7	4.0	4.5	5.0	5.0	5.0	
Average nominal interest rate on public debt (in percent) 8/	5.5	5.4	4.8	4.7	4.3	4.5	4.5	4.9	5.3	5.8	6.0	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.6	0.4	-5.5	11.6	-0.8	1.6	1.7	2.2	2.5	3.0	3.3	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	7.0	6.8	-4.5	1.2	9.8	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.9	5.0	10.3	-6.9	5.1	2.9	2.7	2.7	2.7	2.7	2.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	8.0	10.5	9.6	10.2	-6.4	12.6	-2.7	4.0	2.8	2.4	3.1	
Primary deficit	-0.1	0.5	1.5	3.2	1.6	2.9	2.2	2.4	2.2	1.9	1.8	

1/ General government gross debt.

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

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

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

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

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

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

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

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

ANNEX II: MALAYSIA—FUND RELATIONS

(As of November 30, 2011)

I. Membership Status: Joined March 7, 1958;

Article VIII

II. General Resources Account

	SDR Millions	Percent of Quota
Quota	1,773.90	100.00
Fund holdings of currency	1,283.47	72.35
Reserve position in Fund	490.43	27.65

III. SDR Department

	SDR Millions	Percent of Allocation
Net cumulative allocation	1,346.14	100.00
Holdings	1,285.31	95.48

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to the Fund: None.

VII. Exchange Arrangement:

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

Malaysia maintains bilateral payments arrangements with 23 countries. The authorities have indicated that these arrangements do not have restrictive features.

Capital control measures imposed in early 1994 and in 1998 in the wake of the Asian crisis have mostly been lifted, except for the internationalization of the ringgit. In particular, since May 2001, nonresident portfolio investors are freely allowed to repatriate their principal sums and profits out of the country at any time. Malaysia further liberalized exchange control regulations during 2002–10. The main measures were a relaxation of regulations on investment abroad by domestic institutions, an easing of regulations on domestic credit facilities extended to nonresidents, abolition of overnight limits on all foreign currency accounts maintained by residents and of the net open position limit imposed on a licensed onshore bank, allowing residents to open and maintain foreign currency accounts for any purpose, easing requirements on foreign currency and ringgit credit facilities from nonresidents, relaxation of rules on the provision of financial guarantees, abolition of several reporting requirements, and a relaxation of the conditions on residents and nonresidents to enter into foreign exchange forward contracts to hedge capital account transactions with licensed onshore banks. Further measures were also taken to ease rules on residents’ borrowing in foreign currency, and borrowing in ringgit by residents from nonresidents as well as lending in ringgit by residents to nonresidents for use in Malaysia.

The Malaysian authorities view remaining exchange control regulations as prudential in nature and necessary to ensure the availability of adequate information on the settlement of payments and receipts as part of the monitoring mechanism on capital flows. These controls do not contravene Malaysia's obligations under Article VIII.

Malaysia, in accordance with the UN Security Council resolutions, maintains restrictions on payments and transfers for current international transactions with respect to some designated individuals and entities. These measures are maintained for the reasons of national and international security and have been notified to the Fund pursuant to the IMF Executive Board Decision No. 144 (52/51). Malaysia also restricts current international transactions between Malaysian residents and Israeli companies and individuals; however, since these restrictions affect the underlying transactions themselves, they are not subject to Fund jurisdiction under Article VIII, Section 2(b).

VIII. Article IV Consultation:

Malaysia is on the standard 12-month consultation cycle. Discussions for the 2010 Article IV consultation took place during May 21-June 2, 2010 (IMF Country Report No. 10/265). Staff discussions for the 2011 Article IV consultation were conducted on a mission to Kuala Lumpur during October 27-November 9, 2011. In addition, a staff visit took place during April 27-May 3, 2011.

IX. FSAP Participation:

Malaysia will participate in the FSAP in 2012.

X. Technical Assistance:

FAD: Mission in October 2008 to analyze the distributional impact of social safety net programs. A fiscal ROSC mission was fielded in May-June 2011.

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

MCM: Workshop in November 2008 on stress testing. Workshop in October 2009 on assessing the systemic implications of financial linkages and developing early warning indicators for the insurance and corporate sectors at BNM. Mission in October 2009 on macrofinancial risk analysis and vulnerability analysis for corporate and financial institutions. Workshop in May 2010 on monitoring financial risks.

XI. AML/CFT:

Malaysia (including the Labuan International Offshore Financial Center) underwent its second Mutual Evaluation in February 2007 that was conducted by the Asia/Pacific Group on Money Laundering (APG). The full report was adopted by APG members in July 2007 (<http://www.apgml.org/documents/docs/17/Malaysia%20MER%20FINAL%20August%202007.pdf>).

XII. Resident Representative/Advisor: None.

ANNEX III: MALAYSIA—STATISTICAL ISSUES

(As of November 22, 2011)

I. Assessment of Data Adequacy for Surveillance
<p>General: Data provision is broadly adequate for surveillance. However, further efforts to improve statistics for the consolidated public sector are necessary.</p>
<p>National accounts: Currently, the Department of Statistics Malaysia (DOSM) compiles and publishes annual and quarterly estimates of GDP by activity and by expenditure at current and constant prices, and annual estimates for gross disposable income, saving, and net lending for the economy based on the 1993 SNA. The quarterly data are released about two months after the reference quarter.</p> <p>Price statistics: The CPI and the PPI are available on a timely and comprehensive basis. A revised CPI was introduced in January 2011; it covers all 14 states and features a more disaggregated measure of the consumption basket and updated expenditure weights based on a 2009/10 comprehensive household income and expenditure survey.</p>
<p>Government finance statistics: There is a need to improve the timeliness, detail, and availability of data on NFPEs and the state and local governments. Dissemination of more detailed data on nonlisted NFPEs' assets and liabilities and domestic and foreign financing by type of debt instrument and holder would be desirable; efforts in this direction will require continued close collaboration among the Economic Planning Unit (EPU), the Treasury, and Bank Negara Malaysia (BNM). There is also a need to disseminate more information on public private partnerships.</p>
<p>Monetary statistics: The monetary and financial statistics (MFS) are reported on a timely and regular basis and are broadly in conformity with the Fund's data needs. There is a need to improve the institutional coverage of the financial corporations, sectorization of the domestic economy, and classification and valuation of financial instruments to ensure full adherence to the IMF's <i>Monetary and Financial Statistics Manual</i>. In addition, due to the growing importance of insurance corporations, pension funds, and other financial intermediaries in Malaysia, coverage of MFS should be expanded to include these institutions. The MFS missions of January 2004 and 2005 developed an integrated monetary database to be used for publication and operational needs of the BNM, STA, and APD. The Bank Negara Malaysia reports data in STA's standardized report forms (SRFs) which provide more detailed classification of certain items, fuller sectoral and instrument breakdown, and currency aggregation. MFS based on the SRFs are published in the quarterly <i>IFS Supplement on Monetary and Financial Statistics</i>.</p>
<p>Balance of payments: Department of Statistics Malaysia compiles and publishes quarterly balance of payments estimates in accordance with the fifth edition of the Balance of Payments Manual and the SDDS. The quarterly data are released three months after the reference quarter. No data are shown for the capital transfers or acquisition/sale of nonproduced nonfinancial assets, and transactions in reserve assets are computed as differences in amounts outstanding and thus include valuation changes. The international investment position data on other investment—assets and liabilities—are reported only in an aggregate form.</p>
II. Data Standards and Quality
<p>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).</p>

Malaysia: Table of Common Indicators Required for Surveillance
(As of November 22, 2011)

	Date of Latest Observation	Date Received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of Publication ⁶
Exchange rates	11/22/11	11/22/11	D	D	D
International reserve assets and reserve liabilities of the monetary authorities ¹	11/15/11	11/22/11	Bi W	Bi W	Bi W
Reserve/base money	11/15/11	11/22/11	Bi W	Bi W	Bi W
Broad money	09/11	10/11	M	M	M
Central bank balance sheet	11/15/11	11/22/11	Bi W	Bi W	Bi W
Consolidated balance sheet of the banking system	09/11	10/11	M	M	M
Interest rates ²	11/22/11	11/22/11	D	D	M
Consumer price index	09/11	10/11	M	M	M
Revenue, expenditure, balance and composition of financing ³ —general government ⁴	2010	2011	A	A	A
Revenue, expenditure, balance and composition of financing ³ —federal government	2011:Q2	11/22/11	Q	Q	Q
Stocks of central government and central government guaranteed debt ⁵	2011:Q2	11/22/11	Q	Q	Q
External current account balance	2011:Q3	11/11	Q	Q	Q
Exports and imports of goods and services	09/11	11/11	M	M	M
GDP/GNP	2011:Q3	11/11	Q	Q	Q
Gross external debt	2011:Q2	08/11	Q	Q	Q

¹Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

²Both market based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.

³Foreign, domestic bank, and domestic nonbank financing is only available on an annual basis.

⁴The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵Including currency and maturity composition.

⁶Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A).



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 12/16
FOR IMMEDIATE RELEASE
February 10, 2012

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

IMF Executive Board Concludes 2011 Article IV Consultation with Malaysia

On February 6, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Malaysia.¹

Background

Following a strong recovery in 2010, the Malaysian economy is moderating in the face of a challenging external environment. While growth remains supported by robust consumption and investment, export growth has slowed relatively to 2010. In the near term, external demand is expected to soften further, driving down domestic economic activity. GDP growth is projected to slow to 4 percent in 2012. Inflation rose through mid-2011, but has since eased and remains contained.

Global financial market volatility has not spared Malaysia. While capital inflows remained strong through the first half of 2011, there was a significant retrenchment in the third quarter as global uncertainty increased, leading to a decline in equity markets, a depreciation of the exchange rate, and a pause in reserve accumulation.

The financial system, however, remains sound, with strong capital and liquidity positions and still declining nonperforming loans. Credit growth has accelerated in line with the economic recovery, but there are no signs of overheating or asset price excesses. Household debt, however, has continued to climb, with growth in unsecured personal lending particularly strong.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

The fiscal deficit in 2011 is expected to be roughly in line with, or even below, budget projections. Higher petroleum prices and strong tax collections led to a better-than-budgeted revenue performance, more than offsetting the increase in energy-related subsidies.

Executive Board Assessment

Executive Directors commended the authorities for Malaysia's strong macroeconomic performance in the aftermath of the global downturn. Underpinned by robust fundamentals and policy frameworks, Malaysia is well positioned to face the challenging external environment in the period ahead. Consolidating public finances remains a high priority, while structural reforms continue to be crucial to raise the economy's growth potential and achieve a more balanced and inclusive growth.

Directors supported the current stance of monetary policy. They saw room for lowering the policy rate if growth prospects worsen significantly. Directors noted that letting the exchange rate move flexibly in line with fundamentals while limiting excessive volatility would allow the real exchange rate to appreciate over the medium term. This would support the structural reforms to rebalance the sources of growth and a reallocation of resources toward dynamic, high productivity industries.

Directors noted that Malaysia's financial system remains sound, well capitalized, and resilient. In case downside risks materialize, extraordinary support measures similar to those deployed in 2008–09 could be reinstated. The significant increase in household indebtedness warrants close monitoring. In this context, Directors welcomed the prudential measures taken recently, including the introduction of guidelines to ensure that borrowers' debt is in line with their incomes. They looked forward to the upcoming Financial Sector Assessment Program (FSAP) report.

Directors welcomed the authorities' commitment to put debt on a downward trajectory. Given the projected slowdown in growth and the relatively high public debt, scope for discretionary fiscal support appears limited. Nonetheless, Directors encouraged the authorities to allow automatic stabilizers to operate, while anchoring any temporary stimulus around a medium term consolidation path. They also recommended further efforts to better target expenditure, broaden the tax base, and enhance fiscal transparency as recommended in the fiscal Report on the Observance of Standard and Codes (ROSCs).

Directors welcomed the ambitious reform agenda to boost potential growth, based on comprehensive diagnoses of the bottlenecks that hinder investment and productivity. In particular, they stressed the need to improve the business climate, enhance competition, upgrade workers' skills, and create economic opportunities for all Malaysians. Reforms in these areas, combined with measures to enhance social safety nets, including a well designed minimum wage, would strengthen the foundations for more inclusive growth.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2011 Article IV Consultation with Malaysia is also available.

Malaysia: Selected Economic and Financial Indicators, 2007–12

	2007	2008	2009	2010	Proj.	
					2011	2012
Growth (percent change)						
Real GDP	6.5	4.8	-1.6	7.2	4.7	4.0
Total domestic demand	9.4	5.8	-2.4	12.4	5.9	4.5
Consumption	9.7	9.0	1.3	5.2	6.3	3.8
Private consumption	10.5	8.7	0.7	6.5	6.0	3.7
Gross capital formation	8.4	-2.9	-13.8	38.3	4.8	6.6
Saving and investment (percent of GDP)						
Gross domestic investment	21.6	19.3	14.4	21.4	21.8	21.8
Gross national saving	37.5	37.0	30.9	32.9	33.3	32.6
Fiscal sector (percent of GDP)						
Federal government overall balance	-3.2	-4.8	-7.0	-5.6	-5.5	-5.1
Revenue	21.8	21.5	23.3	20.8	22.2	21.3
Expenditure and net lending	25.0	26.3	30.3	26.5	27.7	26.4
Federal government non-oil primary balance	-9.2	-11.7	-14.5	-11.0	-11.1	-9.9
Consolidated public sector overall balance 1/	1.5	-5.6	-7.6	-2.1	-8.4	-8.8
General government gross debt	42.7	42.8	55.4	55.4	56.6	57.5
Inflation and unemployment (period average, percent)						
CPI inflation	2.0	5.4	0.6	1.7	3.2	2.5
Unemployment rate	3.2	3.3	3.7	3.4	3.2	3.1
Money and credit (end of period, percentage change)						
Broad money (M3)	7.9	10.5	7.7	7.3	14.4	...
Credit to private sector	7.9	12.9	6.2	9.7	12.2	...
Three-month interbank rate (percent)	3.6	3.4	2.2	3.0	3.2	...
Balance of payments (US\$ billions)						
Trade balance	37.7	51.5	40.2	41.9	47.4	47.8
Exports, f.o.b.	176.3	199.2	157.3	198.8	226.9	241.7
Imports, f.o.b.	138.5	147.6	117.1	157.0	179.6	193.9
Services and income account	-3.3	-6.9	-2.8	-7.7	-9.0	-9.2
Current account balance	29.8	39.4	31.8	27.4	31.5	31.7
(In percent of GDP)	15.9	17.7	16.5	11.5	11.5	10.8
Capital and financial account balance	-11.3	-35.7	-22.8	-6.2	-19.1	-19.6
Overall balance	13.2	-5.5	3.9	9.7	12.5	12.1
Gross official reserves (US\$ billions)	101.3	91.6	96.8	106.5	119.0	131.1
(In months of following year's imports)	6.8	7.6	6.1	6.0	6.2	6.4
(In percent of short-term debt) 2/	495.4	274.9	362.1	347.0	389.6	436.0
Total external debt (US\$ billions)	56.7	68.2	68.0	73.7	73.3	72.2
(In percent of GDP)	30.3	30.6	35.2	31.0	26.6	24.6
Short-term external debt (percent of total) 2/	36.1	48.9	39.3	41.7	41.7	41.6
Debt-service ratio						
(In percent of exports of goods and services)	3.6	2.8	6.6	2.7	2.7	2.6

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

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

2/ By remaining maturity.

**Statement by Der Jiun Chia, Executive Director for Malaysia
and Shasha Ridzam, Advisor to Executive Director
February 6, 2012**

1. On behalf of our Malaysian authorities, we would like to thank the IMF team for the focused and constructive discussions on macroeconomic developments and policy issues in Malaysia. For the most part, there is broad agreement on almost all of the major policy thrusts. As such, this statement will provide an update on the latest developments in Malaysia and elaborate on selected policy issues mainly for emphasis and clarification.

Outlook for 2012

2. In October 2011, the authorities projected that the economy will expand between 5 – 6 percent in 2012. This outlook was premised on several key assumptions at that time, namely lower but still positive world growth, resilience in regional trade, and firm commodity prices. While Malaysia's domestic fundamentals are strong and resilient, the deterioration in global conditions will affect external demand. Nevertheless, domestic demand is expected to continue to be the anchor of growth. Private consumption will be supported by stable employment outlook, continued income growth and firm commodity prices. The additional factors that will support private consumption in 2012 are the one-off financial assistance to low- and middle-income groups, civil service pension adjustments and improved remuneration scheme for civil servants. Private investment is also expected to continue to record strong growth, supported by the implementation of the Economic Transformation Programme projects and projects approved by the Malaysian Industrial Development Authority, still high capacity utilisation rate in the manufacturing sector and sustained domestic demand, which in turn will support capital spending in the services sector. The public sector is expected to remain supportive of growth, driven by the higher capital expenditure of the non-financial public enterprises.

**Navigating a Challenging Global Environment: Policy Challenges and Responses
in 2011 – 2012**

3. As a highly open economy, Malaysia would be affected by the increased uncertainty in the international environment. Nevertheless, the economy is expected to be supported by internal sources of demand. Furthermore, the more diversified economic and trade structures, the strong financial system as well as favourable macroeconomic fundamentals have increased the resilience of Malaysian economy and its capacity to cope with such external challenges. In addition, there remains sufficient policy flexibility to support the domestic economy should conditions warrant it.

Monetary Policy

4. Bank Negara Malaysia (BNM) normalised the Overnight Policy Rate (OPR) cumulatively by 100 basis points between March 2010 and May 2011. The assessment then was that the economy was firmly on a steady growth path and there was the risk that keeping

interest rates too low for too long could result in the accumulation of financial imbalances that could undermine growth in the long run. The Statutory Reserve Requirement was also raised as a pre-emptive measure to manage the risks of the build-up of liquidity from resulting in macroeconomic and financial imbalances. Since the second half of 2011, the OPR has been left unchanged as the deteriorating external environment tilted the balance of risks towards growth. Going forward, BNM will assess carefully the evolving developments and adjust monetary conditions accordingly to ensure the sustainability of economic growth in an environment of price stability.

Financial Sector

5. Financial stability remained intact in 2011 amid more challenging external conditions and greater domestic competition. This was underpinned by well-capitalised financial institutions which provided continued support for financial intermediation activities in the domestic economy. As at end-November 2011, the banking system continued to maintain a high level of capitalisation with the core capital ratio and risk-weighted capital ratio remaining strong at 12.8 percent and 14.8 percent respectively. Approximately 85 percent of total capital comprised high quality Tier-1 capital primarily in the form of paid-up capital and reserves. Capital in excess of the minimum 8 percent regulatory requirement remained high at USD 21.9 billion, hence providing the banking system with the strong capacity to absorb any unexpected losses from adverse market and economic conditions.

Limited exposure to European banks

6. Public confidence in the financial system was also preserved. The financial market demonstrated the capacity to absorb the increased volatility arising from concerns about sovereign risk in the US and Euro area. Malaysian banks' (including Labuan banks) exposure to the Euro area account for less than one fifth of total external exposures. More than half of these direct European exposure were with the EU-3 countries. As mentioned in Box 2, there are several key factors that mitigate the risk for Malaysia. European banks in Malaysia fund their operations domestically, with the bulk of these being in the form of domestic deposits which account for more than 80% of their total funding. Furthermore, European banks in Malaysia are locally incorporated subsidiaries. Thus, the risks emanating from their parent companies are somewhat "isolated".

Household indebtedness level remains manageable

7. The overall household indebtedness to GDP ratio was relatively stable at 77.6 percent in the third quarter of 2011. The bulk of household debts continued to be directed towards asset accumulation through the purchase of residential properties and vehicles. Banks' credit to households through personal financing and credit cards increased at a faster pace but continued to represent less than 10 percent of overall banking system loans, unchanged from 2010. The rising trend in household indebtedness level has been supported by strong household fundamentals and financial capacity.

- On aggregate, the debt servicing capacity of households continued to be well-supported by financial assets that amount to 2.3 times of total household debts.
- Given sustained growth in income levels and a low unemployment rate, the capacity to undertake borrowings have been strengthened.
- Moreover, a high savings rate has been supported by continued growth in deposits of households¹. This should provide sufficient cushion to households when faced with income shocks.

Financial institutions, on their part, have continued to maintain underwriting standards, supported by information obtained from the Central Credit Reference Information System. As a result, the net impaired loan ratio for the household sector has remained low at 1.8% at end-2011.

8. While the level of overall household indebtedness in Malaysia remains manageable at this juncture, as part of the ongoing initiatives to ensure sustainability in the household sector, BNM has put in place the necessary infrastructure and introduced several pre-emptive measures to manage the possible risks emanating from expansion in household debts. Among others, these include:

- Revised credit card guidelines.
- Intensified supervisory focus.
- Implemented a maximum loan-to-value (LTV) ratio of 70 percent on the third and subsequent financing facility for the purchase of houses.
- Higher risk weights of 100 percent (from 75 percent) for capital charge on housing loans with LTV exceeding 90 percent and personal financing with tenure of more than five years.

9. On 18 November 2011, BNM issued the Guidelines on Responsible Finance to promote responsible behaviours and practices by both the lenders and households. The Guidelines will subject financial institutions to a set of minimum standards in lending practices with a focus on strengthening the rigour of affordability assessments and ensuring more consistent practices in the conduct of such assessments across the industry. Similar guidelines have also been issued to cooperatives by the Co-operative Commission of Malaysia.

Financial Sector Blueprint 2011 – 2020

10. As Malaysia transitions towards a high value-added and high-income economy, the role of the financial sector is envisioned to grow beyond its role as an enabler of growth to being a driver and catalyst of economic growth. The aim is for the financial sector to be more

¹ Household deposit accounts for 32 percent of financial assets and 75 percent of debt of households

competitive, dynamic, inclusive, diversified and integrated, with the ability to offer world class financial services to serve the needs of Malaysia. To chart the future direction of the financial system over the next ten years, BNM unveiled the new Financial Sector Blueprint in December 2011. The Blueprint builds on the strong foundation laid out by the Financial Sector Masterplan (2001 - 2010), of which, all the recommendations have been successfully completed or are being implemented on an ongoing basis.

11. Meanwhile, the Islamic finance industry continues to demonstrate sustainable growth as Malaysia enhances its interlinkages with other financial centres and further strengthens the country's position as an international Islamic financial centre. Over the recent year, the authorities have undertaken measures to strengthen the prudential and regulatory framework, strategic collaboration with global partners and operationalisation of the International Islamic Liquidity Management Corporation for more efficient cross-border liquidity management.

Fiscal Policy

12. The Government is expected to register a better-than-expected lower fiscal deficit of 5.4 percent of GDP in 2011. This is a result of favourable revenue collection due to firm commodity prices and concerted efforts to widen the revenue base. In line with the commitment to further strengthen public finances over the medium term, Malaysia expects to achieve a lower fiscal deficit of 4.7 percent of GDP in 2012.

13. With regard to debt management, Malaysia has embraced a broader rule to ensure fiscal sustainability. Although legal debt limits vary for domestic and external debt, the Government is fully committed to ensuring a total debt level (domestic and external) not exceeding 55 percent of GDP. Given the increasing uncertainty in the external environment and if growth deteriorates, the authorities view a temporary rise in Federal Government debt level (above the 55 percent to GDP threshold) as acceptable to support aggregate demand.

14. The authorities are committed to improving their fiscal position while remaining supportive of growth. More importantly, the authorities are mindful that strict adherence to fiscal discipline as well as medium-term fiscal targets will ensure fiscal sustainability and promote macroeconomic stability.

Exchange rate

15. The managed float exchange rate policy continued to serve the economy well in balancing between stability and flexibility. The policy focus of authorities has been to maintain orderly foreign exchange market conditions in the short term while ensuring that the ringgit is not misaligned against the country's fundamentals over the medium to longer term. It is important to note that the ringgit's exchange rate is determined by market forces and the authorities have no particular target for the exchange rate level. As staff have also noted, intervention operations have been two-way and have been limited to ensuring orderly market conditions and to prevent extremes in currency volatility.

16. The ringgit reached a new high in July 2011, an appreciation of 29% since the adoption of the managed float in July 2005. This appreciating trend, however, was interrupted in the second half of 2011 due to mounting concerns in the global economy. The modest depreciation in 2011 only partially reversed the cumulative appreciation of 9% appreciation in 2009 and 2010. Nevertheless, the authorities believed that as global financial market normalise, fundamental factors will continue to support the ringgit in the medium to long term. While a strengthening of the exchange rate could complement the structural reforms needed to rebalance sources of growth and raise the potential growth of the economy, it is important to caution against excessive reliance on the exchange rate alone to facilitate such adjustments. An over-reliance on the exchange rate could result in other imbalances in the economy.

17. With regard to the valuation assessment by the IMF, the authorities remain unconvinced with the capacity of the model-based estimates to capture country-specific features of the economic structure, including the significant contribution of non-renewable commodities such as oil to the trade balance. The IMF assessment on the potential undervaluation of the ringgit also is not corroborated with qualitative evidence, given the fact that inflation remains low and there has been no evidence of persistent imbalances in the economy.

Structural Reforms: Enhancing Growth Potential

18. The Government has put in place comprehensive structural reform plans to address the structural issues in the economy and to create a globally competitive enabling environment for the private sector. This is to accelerate Malaysia's transformation into a high-income economy by 2020. Most of the initiatives to transform Malaysia are set forth in the Government Transformation Programme and the Economic Transformation Programme (ETP). Since the last Board meeting in July 2010, significant progress has been achieved since the launch of the ETP in October 2010. Thus far, total committed investments (up to the year 2020) amount to around USD58 billion.

Final Remarks

19. Malaysia has embarked on a far-reaching reform agenda that would elevate it to the next stage of growth and development. At the same time, the authorities are mindful of the significant downside risks posed by the current challenging global environment. The authorities will closely monitor developments in the external environment and will respond as appropriate.