INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/61

MALAYSIA

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MALAYSIA

March 2018

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 2018 Article IV consultation with Malaysia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 9, 2018 consideration of the staff report that concluded the Article IV consultation with Malaysia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 9, 2018, following discussions that ended on December 8, 2017, with the officials of Malaysia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 24, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Malaysia.

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

Selected Issues

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

Press Release No. 18/73
FOR IMMEDIATE RELEASE
March 7, 2018

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

IMF Executive Board Concludes 2018 Article IV Consultation with Malaysia

On February 9, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Malaysia.

Background

The Malaysian economy has shown resilience in recent years despite external shocks and has continued to perform well. Progress was made toward achieving high income status and improving inclusion. Median household income has risen further and the already-low national poverty ratio declined. Real GDP growth has surprised on the upside in 2017, and is estimated at 5.8 percent for the year, driven by domestic demand and robust exports. While headline consumer price inflation went up to 3.8 percent in 2017 due to higher oil prices, core inflation and credit growth are contained. On the external side, the current account surplus is estimated to increase to 2.8 percent of GDP, helped by strong exports.

Growth is projected to start to decelerate from its 2017 peak, remaining above potential at 5.3 percent in 2018, and converging to its potential rate of close to 5 percent in the medium term. In 2018, headline inflation is expected to moderate to 3.2 percent, as the response of core inflation to a positive output gap is partly offset by lower contribution from oil prices. The current account surplus is expected to soften to 2.4 percent of GDP in 2018, as export growth normalizes.

Risks to the growth outlook are balanced. On the external side, downside risks include a global retreat from cross-border integration, structurally weak growth in advanced economies, and a significant China slowdown, while a speedy approval and implementation of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and possibly lingering strong global demand for electronics are upside risks. Domestically, the confidence effects related to the cyclical upturn could be stronger than anticipated, while exposures in the real estate sector pose a downside risk.

[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.

Executive Board Assessment[2]

Executive Directors commended the authorities for the strong and resilient performance of the Malaysian economy, underpinned by accommodative monetary policy and gradual fiscal consolidation. While growth will likely remain above potential in 2018, inflationary pressures appear contained, and risks to the outlook are balanced. Going forward, Directors emphasized the importance of supporting economic growth while maintaining stability, as well as raising productivity through structural reform.

Directors agreed with the planned pace of fiscal consolidation in 2018, noting that it will help build buffers while maintaining financial market confidence. Going forward, they supported a gradual consolidation path consistent with the authorities' fiscal anchor, which would help build additional fiscal space. Directors advised that fiscal consolidation should prioritize higher revenue, to facilitate the adoption of fiscal measures to support external rebalancing. They encouraged further progress on the fiscal structural agenda, including efforts to strengthen fiscal transparency and risk management.

Directors supported the January increase in the monetary policy rate, and agreed that the current policy stance is appropriately biased toward less accommodation while remaining supportive of demand. Noting that Bank Negara Malaysia's monetary policy framework has served the country well, Directors recommended that monetary policy and exchange rate flexibility remain the first line of defense against shocks.

Directors welcomed improvements in the depth and liquidity of onshore financial markets during 2017 following the Financial Markets Committee (FMC) measures that liberalized and increased the flexibility of onshore hedging instruments, as well as a general rebound of capital inflows to emerging markets. They supported the consultative and inclusive approach adopted by the FMC in developing these measures, and encouraged the authorities to build on these successes to address any further gaps in financial market development. Some Directors urged the authorities to phase out—in a manner that preserves financial stability—the measures assessed by staff as capital flow management measures. A few other Directors, however, were of the view that there should be a greater openness to other approaches to promoting the authorities' development objectives. Directors urged the authorities to continue a constructive dialogue with staff on these issues.

Directors agreed that financial sector risks appear contained, with sound bank profitability and liquidity, and low nonperforming loans. Nonetheless, they noted that vulnerabilities in household mortgages and the property development sector require vigilance, and recommended taking any necessary steps to mitigate risks. They encouraged the development of a rental real estate market. Directors welcomed the authorities' commitment to take further actions to address deficiencies in Malaysia's AML/CFT framework.

---

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

Directors commended the authorities' emphasis on raising productivity and investment and encouraged further labor market reforms. Priority should be given to measures that encourage female labor force participation, improve the quality of education, reduce skills mismatches, and bolster public infrastructure and the regulatory framework to further encourage private investment.

Table 1. Malaysia: Selected Economic and Financial Indicators, 2013–19

Nominal GDP (2017, est.): US$314.4 billion
GDP per capita (2017, current prices, est.): US$9,808
Unemployment rate (November 2017): 3.3 percent
Population (2017, mid-year): 32 million
Poverty rate (2016, national poverty line): 0.4 percent
Adult literacy rate (2015): 94.6 percent
Main exports (share in total goods exports, 2016): electrical & electronic products (36.5 percent), and commodities (13.5 percent)

					Est.	Proj.	
	2013	2014	2015	2016	2017	2018	2019
Real GDP (percent change)	4.7	6.0	5.0	4.2	5.8	5.3	5.0
Total domestic demand	6.3	5.3	5.9	4.5	6.4	5.8	5.3
Private consumption	7.2	7.0	6.0	6.0	7.0	6.2	5.6
Public consumption	5.8	4.4	4.4	0.9	4.0	5.0	2.0
Private investment	12.8	11.1	6.3	4.3	9.2	8.0	8.0
Public gross fixed capital formation	1.8	-4.7	-1.1	-0.5	-0.6	-0.2	1.9
Net exports (contribution to growth)	-1.0	1.2	-0.3	0.1	-0.1	-0.1	0.1
Saving and investment (in percent of GDP)							
Gross domestic investment	25.9	25.0	25.1	25.9	25.4	25.4	25.7
Gross national saving	29.4	29.4	28.1	28.2	28.2	27.8	27.9
Fiscal sector (in percent of GDP)							
Federal government overall balance 1/	-4.2	-3.4	-3.2	-3.1	-3.0	-2.8	-2.5
Revenue	20.4	19.9	18.9	17.3	16.7	16.6	16.6
Expenditure and net lending	24.6	23.3	22.1	20.4	19.8	19.3	19.1
Federal government non-oil primary balance	-8.7	-7.3	-5.2	-3.6	-3.6	-3.5	-3.0
Consolidated public sector overall balance 2/	-6.0	-7.4	-7.7	-5.2	-5.0	-3.5	-3.0
General government debt 3/	56.4	56.2	57.9	56.2	54.2	53.6	52.4
Of which: federal government debt	53.0	52.7	54.5	52.7	50.7	50.1	48.9
Inflation and unemployment (annual average, in percent)							
CPI inflation	2.1	3.1	2.1	2.1	3.8	3.2	2.8
CPI inflation (excluding food and energy) 4/	1.3	2.1	3.2	2.6	1.6	2.2	2.6
Unemployment rate	3.3	2.9	3.2	3.5	3.4	3.2	3.0
Macrofinancial variables (end of period)							
Broad money (percentage change)	7.4	6.3	3.0	2.7	4.9	8.5	8.0
Credit to private sector (percentage change) 5/	10.2	9.2	8.6	5.3	6.4	5.8	5.6
Credit-to-GDP ratio (in percent) 4/ 6/	129.7	130.1	134.7	134.0	129.7	126.4	123.7
Credit-to-GDP gap (in percent) 4/ 6/	15.7	12.7	13.5	9.4	3.2	…	…
Overnight policy rate (in percent)	3.00	3.25	3.25	3.00	3.00	…	…
Three-month interbank rate (in percent)	3.3	3.9	3.8	3.4	3.3	…	…
Nonfinancial corporate sector debt (in percent of GDP)	99.8	98.6	106.7	109.5	104.2	103.1	102.1
Nonfinancial corporate sector debt issuance (in percent of GDP)	3.5	3.2	2.6	3.2	3.2	…	…
Household debt (in percent of GDP)	86.1	86.8	89.0	88.3	84.6	82.5	80.7
Household financial assets (in percent of GDP)	187.0	182.1	183.1	181.5	177.6	…	…
House prices (percentage change)	10.9	8.5	7.4	6.9	5.1	5.0	5.2
Exchange rates (period average)							
Malaysian ringgit/U.S. dollar	3.15	3.27	3.91	4.15	4.31	…	…
Real effective exchange rate (percentage change)	0.5	-0.7	-7.9	-4.3	-1.5	…	…
Balance of payments (in billions of U.S. dollars) 4/							
Current account balance	11.3	14.8	9.0	7.0	8.9	8.3	8.5
(In percent of GDP)	3.5	4.4	3.0	2.4	2.8	2.4	2.2
Goods balance	30.6	34.6	28.0	24.4	27.1	28.6	30.7
Services balance	-3.0	-3.3	-5.3	-4.6	-5.0	-5.8	-6.4
Income balance	-16.3	-16.5	-13.7	-12.8	-13.3	-14.4	-15.8
Capital and financial account balance	-6.4	-24.3	-14.5	-0.2	3.6	2.7	3.2
Of which: Direct investment	-2.0	-5.5	-0.5	3.4	2.1	1.0	0.3
Errors and omissions	-0.2	-1.7	6.4	-3.2	-4.9	0.0	0.0
Overall balance	4.6	-11.2	1.0	3.6	7.7	11.1	11.7
Gross official reserves (US$ billions)	134.9	115.9	95.3	94.6	102.4	113.3	125.0
(In months of following year's imports of goods and nonfactor services)	7.4	7.5	6.3	5.6	5.8	6.0	6.3
(In percent of short-term debt by original maturity) 4/	130.7	111.6	116.2	112.5	111.7	123.9	143.6
(In percent of short-term debt by remaining maturity) 4/	91.8	78.3	74.4	71.5	72.1	79.0	87.2
Total external debt (in billions of U.S. dollars) 4/	212.3	213.4	195.0	204.2	217.3	221.2	227.5
(In percent of GDP) 4/	65.7	63.1	65.8	68.9	69.1	63.0	58.6
Of which: short-term (in percent of total, original maturity) 4/	48.6	48.7	42.0	41.2	42.2	41.3	38.3
short-term (in percent of total, remaining maturity) 4/	69.3	69.4	65.7	64.7	65.4	64.9	63.0
Debt service ratio 4/							
(In percent of exports of goods and services) 7/	17.3	17.9	21.4	23.5	22.7	23.0	23.1
(In percent of exports of goods and nonfactor services)	18.4	19.1	22.7	24.9	24.1	24.4	24.5
Memorandum items:							
Nominal GDP (in billions of ringgit)	1,019	1,106	1,158	1,230	1,352	1,467	1,584

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

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

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

3/ General government includes the federal government, state and local governments, and the statutory bodies.

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

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

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

7/ Includes receipts under the primary income account.

INTERNATIONAL MONETARY FUND

MALAYSIA

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

January 24, 2018

KEY ISSUES

Context. In recent years, the economy has shown resilience and continued to perform well despite external shocks, while fiscal consolidation proceeded. Progress was made toward achieving high income status and improving inclusion. Going forward, striking the right balance in macroeconomic policies is key. There is room for improving forward guidance on economic and financial policies, while implementing the comprehensive structural reforms agenda.

Near-Term Outlook. After surprising on the upside (at an estimated 5.8 percent) in 2017, real GDP growth is projected to remain above potential at 5.3 percent in 2018. Despite a small positive output gap, there are no signs of inflationary pressures. Risks to the outlook are balanced.

Main policy recommendations:

- Fiscal policy should follow a gradual consolidation path as envisaged under staff's baseline. This would be consistent with the authorities' public debt anchor. However, fiscal consolidation should be more revenue based, which would also facilitate the adoption of measures that are important for external rebalancing.
- The current bias toward reduced monetary policy accommodation is appropriate. Should leading indicators suggest the emergence of inflationary pressures, the policy rate should be increased.
- The authorities should communicate to the public their strategy on onshore FX market development. The strategy needs to address existing gaps and phase out recent capital flow management measures while maintaining financial stability.
- While the banking sector is overall sound, risks related to exposures in household mortgages and in the property development sectors should be closely monitored. The authorities should consider macroprudential measures to mitigate these risks.
- Structural reforms should focus on improving labor market outcomes and encouraging productivity and investment within the context of the authorities' 11th Malaysia Plan. Priority should be given to measures to encourage female labor force participation, improve the quality of education, reduce skill mismatches, encourage R&D, and update public infrastructure and the regulatory framework to make the business environment more conducive to private investment.

Approved By
Odd Per Brekk and Zeine Zeidane

Mission dates: November 28–December 8, 2017
Mission Team: Nada Choueiri (Head), Giovanni Ganelli, David Grigorian, Juan Manuel Jauregui, Souvik Gupta (all APD), and Jochen Markus Schmittmann (Resident Representative). Mohamad Hasni Shaari (OED) and Odd Per Brekk (APD Reviewer) joined the mission, and Juda Agung (Executive Director) joined the concluding meetings. Adeline Yeo, Simon Paroutzoglou, Christina He, Justin Flinner, and Ross Rattanasena (all APD) assisted in the preparation of this report. Data used in this report for staff analyses are as of January 24, 2018.

CONTENTS

TABLES

APPENDICES

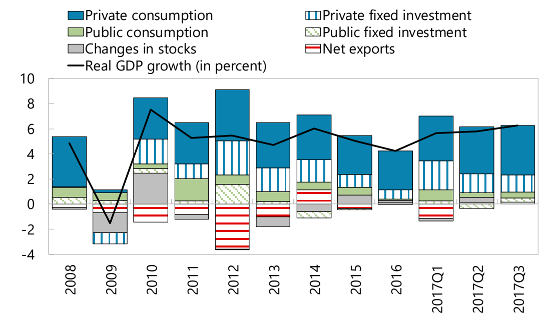
Glossary

11MP	11th Malaysia Plan, the
AML	Anti-money laundering
BA	Bankers Acceptance
BNIB	Bank Negara Interbank Bills
BNM	Bank Negara Malaysia
CA	Current account
CFM	Capital flow management measures
CFT	Combatting the financing of terrorism
CPTPP	Comprehensive and Progressive Agreement for Trans-Pacific Partnership
DSA	Debt Sustainability Analysis
EBA	External Balance Assessment
EPF	Employees Provident Fund
FDI	Foreign direct investment
FMC	Financial Markets Committee
FX	Foreign exchange
GBI	J.P. Morgan Government Bond Index
GDP	Gross domestic product
GFC	Global financial crisis
GST	Goods and Services Tax
IV	The Liberalization and Management of Capital Flows: An Institutional View
LTV	Loan-to-value ratio
MGS	Malaysian Government Securities
MGII	Malaysian Government Investment Issues
NDF	Non-deliverable forwards
NFPS	Nonfinancial public sector
NID	Negotiable Instruments of Deposit
NPL	Non-performing loans
OECD	Organization for Economic Co-operation and Development, the
R&D	Research and development
US	United States, the
WEO	World Economic Outlook, the
y/y	Year-on-year

ECONOMIC OUTLOOK: CONTINUED FAVORABLE PERFORMANCE WITH BALANCED RISKS

1. **The Malaysian economy has shown resilience and continues to perform strongly.** In recent years, the economy has grown at a sustained pace despite external shocks. Fiscal consolidation has proceeded, with the government pushing through important initiatives (subsidy reform and the Goods and Services Tax (GST)). Progress was made toward achieving high income status and improving inclusion. Median household income has risen further and the already-low national poverty rate has declined. General elections are due by August 2018.

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

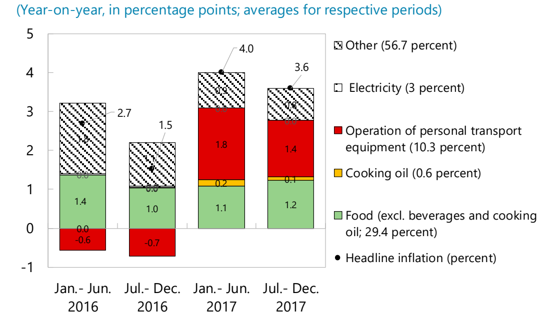


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

2. **Growth surprised on the upside in 2017, driven by domestic demand.** Real GDP growth exceeded potential, and is estimated at 5.8 percent for the year (4.2 percent in 2016), implying a small positive output gap. Employment and wage gains, spurred by a broad-based recovery, boosted private consumption, with private investment and public consumption also contributing to growth. On the external side, Malaysia benefitted from a stronger-than-expected global demand uplift for electronics and improved commodity terms of trade. However, growth in both final and intermediate goods imports lowered the contribution of net exports to growth.

3. **There are no signs of inflationary pressures at present.** Average headline inflation was 3.8 percent in 2017 (2.1 percent in 2016), with the increase mainly reflecting the impact of higher oil prices. Average core inflation (headline excluding food and energy) fell to 1.6 percent (2.6 percent in 2016), driven by lower services and durable goods inflation. Real wage growth over 2017Q1-Q3 in the manufacturing and services sectors, which account for the bulk of employment, did not exceed labor productivity gains. Private sector credit growth has moderated, implying a further decline in the credit gap to an estimated 3.2 percent of GDP (9.4 percent of GDP in 2016) and housing price growth has declined.

Malaysia: Contributions to CPI Inflation
(Year-on-year, in percentage points; averages for respective periods)



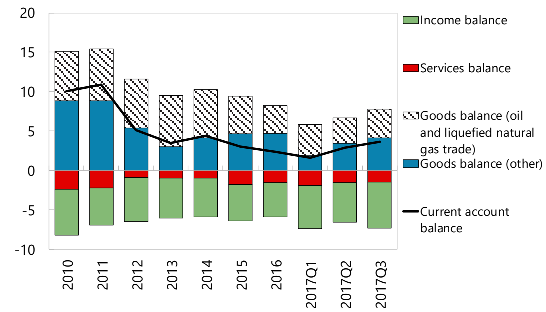
Sources: Haver Analytics; and IMF staff calculations.
1/ Weights, in percent, for the CPI components are shown in the chart legend.

4. **Fiscal consolidation continued in 2017, albeit at a slower pace.** The 2017 federal budget deficit edged lower to 3 percent of GDP (3.1 percent of GDP in 2016), in line with budget plans. A decline in revenue of 0.5 percent of GDP, mostly due to low GST buoyancy, was more than

compensated by cuts in subsidies and transfers totaling 0.7 percent of GDP, while protecting social and development spending. The consolidated public sector deficit is estimated to have fallen by 0.2 percent of GDP in 2017, after a sharp drop of 2.5 percentage points of GDP in 2016.

5. The external position remains stronger than the level consistent with fundamentals and desirable policies, unchanged from the July 2017 External Sector Report (Appendix I).[1] The current account (CA) surplus is estimated at 2.8 percent of GDP in 2017, compared to 2.4 percent of GDP in 2016. The current account gap, estimated based on the IMF's External Balance Assessment (EBA), is 2.4 percent of GDP, implying a real exchange rate undervaluation of about 5 percent. Malaysia recorded a small net financial outflow in the first three quarters of 2017, reflecting lower net FDI inflows relative to a year ago, and large nonresident portfolio debt outflows in 2017Q1. Nonresident portfolio debt inflows have resumed since 2017Q2. Relative to end-2016 levels, the bilateral and real effective exchange rates have appreciated, Treasury yields have stabilized, and the stock market has registered gains. However, the real effective exchange rate remains about 14 percent depreciated from its 2013 level, reflecting in part the impact of negative terms-of-trade shocks.

Malaysia: Current Account Balance
(In percent of GDP)



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

6. Policies have been largely in line with past Fund advice (Appendix II)**.** As recommended by staff, the authorities are anchoring fiscal policy to their medium-term consolidation objective, while considering economic conditions in deciding the year-to-year pace of consolidation. Similarly, the current monetary policy stance, including the bias towards reduced accommodation, is consistent with staff advice to carefully calibrate monetary policy in response to economic conditions. In line with staff's advice of maintaining a flexible exchange rate as a shock absorber, the authorities have notified the Fund of the change in their *de jure* exchange rate regime effective September 2016, following which the *de facto* regime is currently classified as floating. In relation to staff's advice of reviewing the December 2016 FX market measures, the authorities see them as appropriate, helpful, and not entailing undue cost. Structural reforms are largely in line with staff's advice.

7. Looking ahead, inflation should moderate in 2018 and growth should decelerate from its 2017 peak, converging to its potential rate of close to 5 percent in the medium term. While the ongoing cyclical upturn should begin to normalize, momentum in activity is expected to remain strong in the first half of 2018, supported by domestic demand and continued strength in global trade. Projected at 5.3 percent, growth in 2018 should remain above potential. Core inflation should edge up to 1.9 percent in response to a positive output gap. However, this would be more than

[1] Preliminary assessment, given ongoing refinements to the IMF's EBA methodology and reliance on staff estimate of the 2017 CA balance.

offset by lower contribution from global oil prices. Thus, headline inflation is expected to moderate to 3.2 percent in 2018. The current account surplus is expected to decline to 2.4 percent of GDP in 2018, as export growth normalizes. Over the medium term, both growth and inflation should converge to their long-term trend. The capital/labor ratio should continue to rise over the medium term, as firms respond to labor's rising share in income. This capital accumulation, together with improvement in total factor productivity and gains in female labor force participation, should help offset the impact from decelerating working-age population growth on real GDP growth.

8. **Risks to the outlook are balanced** (Appendix III)**.** In the near term, strong global demand for electronics lasting longer than expected is the main external upside risk. Downside external risks include policy uncertainty and tighter global financial conditions in advanced economies, which could spill over to domestic financial markets and cause financial stress for indebted Malaysian households and corporations. Domestically, the confidence effects related to the cyclical upturn could be stronger than anticipated, but an abrupt adjustment in real estate prices could have macro-financial spillovers through private sector balance sheet effects. Over the medium term, a global retreat from cross-border integration, structurally weak growth in advanced economies, and a significant China slowdown are the main downside risks, while a speedy approval and implementation of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) represents an upside risk.

Authorities' Views

9. **The authorities broadly agreed with staff's assessment of the economic outlook and risks.** They expected growth to remain strong at 5–5.5 percent in 2018, mainly driven by domestic demand. Sustained demand from trading partners would help maintain the resilience of the external sector, despite a projected narrowing of the current account surplus. They expect inflation to moderate to 2.5–3.5 percent in 2018, with core inflation largely stable, helped in part by productivity gains. Over the medium term, they saw growth at 5–6 percent with risks stemming mainly from external sources, both regional and global. On staff's external sector assessment, the authorities continued to see limitations in the IMF's analytical framework given the relatively weak explanatory power of the current account regression model in the Malaysian context.

MACROECONOMIC AND FINANCIAL POLICIES: STRIKING THE RIGHT BALANCE

10. **Striking the right balance in policies is key, and there is room for improving forward guidance on economic and financial policies.** Macroeconomic policies should support growth while pursuing revenue-based fiscal consolidation. Medium-term fiscal targets should be better communicated. A comprehensive policy framework to develop onshore FX markets should also be appropriately communicated. Structural reforms should boost medium-term growth, while also helping external rebalancing.

A. Fiscal Policy

11. Staff expects the authorities' federal budget deficit target of 2.8 percent of GDP for 2018 to be met. Revenue is budgeted to fall by 0.2 percent of GDP, largely due to a conservative estimate of GST collection, considering the early stage of implementation. Expenditure is budgeted to fall by 0.4 percent of GDP, driven by both lower development expenditure and a lower wage bill. The consolidated public sector deficit is projected to fall by 1.5 percent of GDP in 2018, reflecting an improved operating surplus of Petronas and lower development spending as some large projects come onstream.

12. Fiscal consolidation should proceed gradually over the medium term. The IMF staff's baseline projection envisages a fiscal consolidation of 1.3 percent of GDP evenly spread across 2018-22. Under continued expenditure reduction in line with recent years, but unchanged policies otherwise, this baseline path for the federal government budget balance would be feasible. Such a path would deliver debt reduction, as the federal government debt would remain below 55 percent of GDP in the near term and fall below 45 percent of GDP by 2022 (Appendix IV). Fiscal consolidation is also appropriate given Malaysia's limited fiscal space, due to large external financing needs (about 39 percent of GDP, see Appendix IV, Fig. 5) and high contingent liabilities. Moreover, the importance of fiscal consolidation is borne out by staff analysis showing that, if fiscal policy continues to react to shocks as in the past, the public debt could exceed the authorities' self-imposed debt ceiling in a shock scenario (Appendix V).

13. However, the composition of fiscal adjustment could be improved by shifting the emphasis towards revenue measures. During 2016–17, fiscal consolidation has been largely driven by expenditure reduction. Going forward, this consolidation should be more revenue based, starting by broadening the tax base, including by eliminating GST exemptions, and subsequently raising the GST rate (text table). Tax expenditure in the form of investment incentives should also be reduced. These tax measures would be consistent with the authorities' commitment to have a fair and efficient tax system. There is scope for further cuts in subsidies (including for liquefied petroleum gas, and fuel for fisheries and public transportation) and better targeting of social spending, for example in health and

Malaysia: Illustrative Medium-Term Fiscal Consolidation Measures 1/

Fiscal measures	Impact on overall balance 2/ (percent of GDP)
Deficit reduction captured in the baseline 3/	**1.3**
Higher projected revenue	0.1
Expenditure growth restraint 4/	1.2
Alternative measures	
Revenues (A)	**1.5**
GST	1.1
removal of exemptions	0.35
increase in rate 5/	0.75
Income tax 6/	0.3
Service fees	0.1
Expenditure (B)	**-0.2**
Subsidy rationalization	0.3
Extra social and development spending	-0.5
Total balance improvement (=A+B)	**1.3**

Source: IMF staff estimates.
1/ This table provides examples of alternative combinations of revenue and spending measures that would yield the same overall balance as in Fund staff's baseline scenario.
2/ A positive sign indicates an improvement in the overall balance.
3/ The changes in the baseline between 2018 and 2022 are taken as a reference.
4/ Reduction in spending on the wage bill and supplies.
5/ Assumes a 1.5 percentage point increase in the rate from 6.0 percent to 7.5 percent.
6/ Streamlining investment incentives.

education. Also, cost recovery in health and higher education can be increased, and duplications in public programs, for example in transportation and tourism, should be minimized. Improving the quality of fiscal adjustment would also facilitate the adoption of measures that are important for external rebalancing, such as further improvements in social protection, increases in healthcare spending, and higher public investment in physical and human capital.

14. Fiscal transparency and fiscal risks management could be further enhanced. Following the formulation of key projections under the Medium-Term Fiscal Framework, started in 2015, the yearly communication of a more detailed set of accounts, underpinning the authorities' medium-term objectives, and of annual fiscal risks statements, should be fully integrated in the budget preparation process. An explicit medium-term framework would help in identifying risks and developing risk mitigation strategies, and would contribute to anchoring market expectations regarding the course of fiscal policy. A medium-term framework would also facilitate the work of the recently established Fiscal and Financial Committee on Risks and Liabilities, which aims at monitoring and mitigating fiscal risks. This is especially important given the high level of contingent liabilities. Loan guarantees by the federal government, which stand at 16 percent of GDP, are issued mostly to support infrastructure investment, frequently under public-private partnerships.[2] While the authorities have taken some helpful mitigating actions,[3] contingent liabilities exceed loan guarantees, however, as other fiscal risks could materialize (e.g. unfunded pensions for public employees).

15. Progress in other areas of the fiscal structural agenda could be accelerated. The authorities are encouraged to complete the implementation of accrual fiscal accounting, which is at an advanced stage. Undertaking targeted spending reviews would help eliminate duplication and raise efficiency in social programs, which would help fiscal consolidation. While Malaysia's public investment management institutions are already quite strong, there is scope to further improve project appraisal processes and strengthen the gatekeeping role of central agencies in project selection.

Authorities' Views

16. The authorities noted that fiscal policy must be countercyclical, business friendly and inclusive. They reiterated their commitment to fiscal sustainability and fiscal consolidation, indicating that the balanced budget objective would be delayed by 2-3 years beyond 2020 to support growth. Regarding the composition of fiscal adjustment, they prioritize improving revenue collections first, then broadening the tax base, including by reviewing tax expenditures. They also stressed their plans of maintaining expenditure restraint by increasing expenditure efficiency. They agreed on the need to strengthen fiscal risks monitoring, but stressed that, although contingent liabilities are sizable, the steps taken to mitigate associated risks are appropriate. Government loan

---

[2] Other guarantees are issued to companies in the services sector and to public holding companies.

[3] Mitigating actions include charging a guarantee fee and favoring long-term domestic-currency loans backed with assets. Guaranteed non-performing student loans have diminished significantly after specific actions that included public listing of debtors in arrears and travel restrictions.

guarantees have a low probability of being called in their view, as they are granted to entities with healthy balance sheets.

B. Monetary, Exchange Rate, and Financial Market Policies

17. Monetary policy remains supportive with a bias towards reduced accommodation. Domestic economic and financial considerations continue to guide monetary policy decisions, within a policy framework that has been delivering broad price and output stability despite economic shocks. Bank Negara Malaysia (BNM) has maintained an accommodative stance with its policy rate kept unchanged at 3 percent since July 2016. However, in its November 2017 policy meeting, the BNM signaled a bias toward reduced accommodation, justified by above-potential growth but stable core inflation and no signs of financial sector stress. Should leading indicators suggest the emergence of inflationary pressures, the policy rate should be increased.

18. Monetary policy and exchange rate flexibility should be the first line of defense against shocks. Domestic private sector balance sheet strength will help mitigate the impact of exchange rate fluctuations under the current floating regime. At about US$102 billion as of end-2017, BNM's gross official reserves are adequate as per the IMF's Adequacy of Reserves metric (still adequate, but closer to the lower bound, if adjusted for BNM's forward book), and could be deployed at times of disorderly market conditions. In the face of a capital inflow surge, a combination of further reserve accumulation and some exchange rate appreciation would be appropriate.

19. Malaysia's external debt remains manageable, although external financing vulnerabilities are higher than in the median peer country. Since end-2016, Malaysia's external debt-to-GDP ratio has stabilized after rising by about 13½ percentage points in the previous seven years. About one-half of the increase in external debt was driven by a rise in nonresident investment in Malaysia's local-currency debt market. External borrowing by nonfinancial corporations has also increased in recent years. Standard stress tests under the IMF's External Debt Sustainability Analysis indicate that the external debt-to-GDP ratio would remain close to the baseline level under a variety of shocks over the medium term, except under an exchange rate depreciation shock (Appendix VI). However, about one-third of external debt is denominated in ringgit, which provides some cushion against exchange rate risks. Nonetheless, relative to the median peer country, Malaysia's external financing vulnerabilities are higher, due to, for example, high amortization-to-GDP ratio, lower share of FDI liabilities in gross external liabilities, and slightly above-average potential claims on FX reserves from non-FDI liabilities.

Authorities' Views

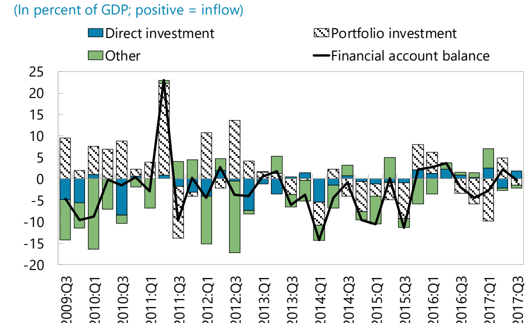
20. The authorities agreed with staff's assessment of the current monetary policy stance. They noted that, since growth has become more entrenched, future monetary policy decisions may entail reduction of the degree of monetary policy accommodation, while also ensuring sustained growth. The exchange rate will continue to play an important role in responding to external shocks. Reserves are adequate and external debt is manageable. The authorities highlighted several factors which provide resilience against external shocks and exchange rate movements: the international assets position is diversified and mitigates financing vulnerabilities, as BNM's reserves account for only about a quarter of total foreign assets, with the remaining three quarters held by resident banks and corporates, which can be drawn upon to meet external debt obligations without creating a claim on official reserves; the domestic financial sector is strong; about two-fifths of external debt is ringgit-denominated; foreign currency debt is subject to prudent management practices; and medium/long-term debt exceeds 50 percent of total external debt.

21. Financial markets development remained at the forefront of the authorities' agenda with the Financial Markets Committee (FMC) taking measures to improve the functioning of foreign exchange (FX) markets. The methodology for calculating the reference USD/MYR exchange rate was revised in July 2016 and the credibility of the rate fixing mechanism was enhanced by using transacted rates over longer intra-day trading hours. Trading hours on the onshore market were extended. A revision of the Code of Conduct for market participants was initiated in the fall of 2016, with the final policy document issued in April 2017.

22. As other emerging market economies, Malaysia experienced a bout of capital outflows after the November 2016 US presidential election. Malaysia has experienced higher capital flow volatility than its median peer since the Global Financial Crisis, amid a global capital flow surge in the wake of quantitative monetary easing in advanced countries. A significant share of portfolio inflows to Malaysia target the conventional Malaysian Government Securities (MGS) market, which is the most liquid of local government debt markets and which functions well (Appendix VII). By October 2016, the share of nonresident holdings in conventional MGS was at an all-time high (52 percent of the outstanding stock; 17 percent of GDP). However, a significant portion of the inflows into MGS reversed after the US presidential election.[4]

Malaysia: Net Capital Flows

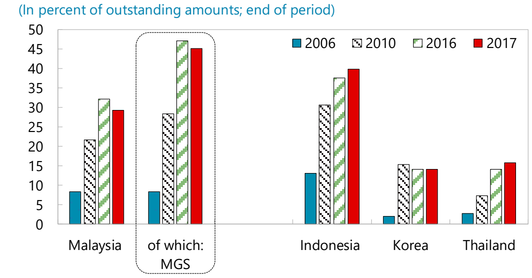
(In percent of GDP; positive = inflow)



Sources: Haver Analytics; and IMF staff calculations.

Selected Asia: Nonresident Holdings of Local-Currency Government Securities

(In percent of outstanding amounts; end of period)



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

1/ 2017 data for Korea and Thailand are as of November.

---

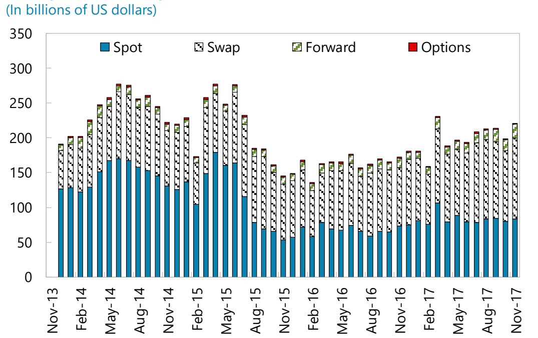
[4] A comparable movement out of T-bills was observed at end 2016, as the share of nonresident holdings dropped from 78 percent of total in 2016Q3 to 39 percent in 2016Q4. Nonresident holdings of Malaysian Government Investment Issues (MGII) were more stable declining only from 11 percent in 2016Q3 to 9 percent in 2016Q4.

23. In December 2016, the FMC announced additional FX market measures that have entailed both costs and benefits.

- Some of the measures helped enhance onshore FX risk management by liberalizing hedging (Appendix VIII). Two measures, classified as capital flow management measures under the IMF's Institutional View on Capital Flows (IV), aimed at (i) increasing FX liquidity onshore by requiring the conversion into ringgits of export proceeds; and (ii) extending prudential limits on foreign currency investments by residents with domestic ringgit borrowing to exporters, who were previously exempted. The BNM also strengthened in late 2016 the enforcement of regulations, in place since 1998, on banks' non-involvement in offshore ringgit transactions. This measure is considered an enhanced enforcement of an existing capital flow management measure under the IV.

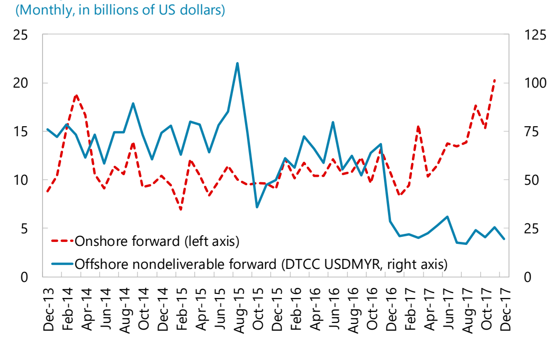
- Following the introduction of these measures, hedging opportunities and the supply of foreign exchange onshore both increased; turnover in the onshore spot, forward, and swap FX markets improved, bid-ask spreads narrowed and ringgit volatility declined. Some of these developments could be also linked to the rebound of capital inflows to emerging markets in early 2017. Meanwhile, most banks stopped quoting non-deliverable ringgit forwards (NDF) offshore and liquidity in the NDF market fell sharply. In the bond market, foreign positioning has become less concentrated in very short maturities. However, some of the measures have imposed compliance costs on market participants.

Malaysia: Monthly Onshore FX Market Turnover
(In billions of US dollars)



Source: Bank Negara Malaysia.

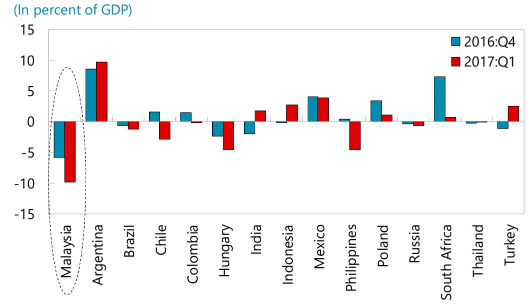
Malaysia: FX Forward Volumes
(Monthly, in billions of US dollars)



Sources: Bank Negara Malaysia; Bloomberg L.P.; and IMF staff calculations.

- While causality is difficult to establish and foreign investor sentiment could have been also weakened by other factors, some of the measures may have temporarily protracted the portfolio capital outflow episode. During 2017Q1, nonresidents' share in MGS holdings kept falling, reaching 38.5 percent by March 2017, while portfolio flows returned to other major emerging markets. Asset managers accounted for most of the reduction in

Selected Emerging Markets: Net Portfolio Flows during 2016:Q4 and 2017:Q1
(In percent of GDP)



Sources: Haver Analytics; IMF, *Balance of Payments Statistics* and staff calculations.

nonresident holdings in 2017Q1. Malaysia's weight in the JP Morgan GBI EM global diversified index, one of the main benchmarks for local-currency emerging market fixed-income investors, was reduced from 9 percent at end 2016 to 7½ percent at end March 2017 (and further to 5.6 percent as of December 2017), whereas the weight of neighboring Thailand and Indonesia changed only marginally. This likely reflects, in part, reduced interest by international investors in exposure to Malaysia government bonds. Domestic institutional investors and banks helped cushion the impact on yields.

24. Nonresident inflows into the MGS market resumed in the second quarter of 2017, driven by both global and domestic factors, including new FMC policy measures. Malaysia's rapid economic growth and the recovery in global sentiment toward emerging market securities likely helped. In May 2017, partly in response to feedback from market participants, new measures were implemented that increased flexibility and ease of FX hedging facilities onshore. These measures likely also reassured international investors. By December 2017, nonresidents' share in the MGS market had risen to about 45 percent of the outstanding stock. Meanwhile, the equity market has received net capital inflows, although much smaller than the debt markets, in most months of 2017. The FMC continues to monitor financial market developments and, in consultation with market participants, propose adjustments, such as the most recent measures in November 2017 to deepen the onshore financial market (Appendix VIII).

25. Building on the recent steps, a comprehensive approach towards onshore market development would have potential benefits. The FMC is a welcome and appropriate forum because it allows the BNM to consult with market participants and the private sector on steps to develop onshore markets. In accordance with its mandate, the FMC should help articulate a high-level strategy based on broad market consultation and communicate it to the public to enhance predictability and build confidence. It would be important for the strategy to ensure that continued reliance on exchange rate flexibility and macroeconomic policy adjustments remain the first line of defense against capital flow shocks. The strategy to develop financial markets needs to address existing gaps in market development and phase out the recent capital flow management measures while preserving financial stability. Market participants pointed to the following gaps: transaction costs associated with extensive documentation requirements; and lack of liquidity in the forward market beyond very short-term (3-6 months) instruments. Meanwhile, to contain financial stability risks associated with exporters' possible unhedged ringgit borrowing, the authorities could consider alternative measures that directly address the risk such as higher risk-weighting for loans to unhedged borrowers by banks.

Authorities' Views

26. The authorities viewed their current approach towards development of onshore FX markets as appropriate and effective. They argued that the measures introduced by the FMC have been successful in achieving their objective to ensure an orderly and efficient functioning of the onshore FX markets by addressing foreign currency imbalances arising from speculative activities. The authorities did not see the recent measures as imposing excessive costs. They highlighted that continued healthy and improving onshore transactions volume throughout 2017 indicates that the

FMC measures represented a balanced approach in terms of fostering the above objectives and addressing the impact from external spillovers. The authorities do not believe the late 2016 measures should have been seen as capital flow management measures because they were not targeted to limit capital flows, or that they had a sustained negative impact on market sentiment and attributed the decline in the MGS weight in JP Morgan 's GBI EM Global Diversified Index mainly to a broadening of the index's country coverage. They disagreed with staff's recommendation to phase out these measures and stressed the importance of preserving policy flexibility and indicated that they will remain vigilant in implementing necessary policies to ensure an efficient functioning of FX markets.

C. Financial Sector

27. The financial sector is robust, and overall risks appear contained. Bank profitability and liquidity are sound, and nonperforming loans (NPLs) are low. Corporate access to credit remains healthy and the sector is moderately leveraged. Overall corporate sector NPLs are at a manageable 2.7 percent. While the sector's FX borrowing has been on the rise (currently at 26 percent of total debt), a large share of this increase consists of intercompany loans and trade credits, which are subject to lower rollover risk and more favorable terms. Household debt declined slightly but remains high at 84.6 percent of GDP in 2017Q3; internal bank credit underwriting standards have been effective in curbing household NPLs, which declined slightly to reach 1.4 percent of gross loans to households.

28. Despite low impairment ratios, households' mortgage exposures require close monitoring. These exposures represent nearly half of households' total indebtedness, one of the largest in the region. Direct risks to the mortgage portfolio are mitigated by: (i) a very large share (about 85 percent) of primary homeowners; (ii) a small share (3 percent of total) of investment property mortgages; (iii) with the latter subject to conservative LTV ratios (70 percent for individual owners of 3 properties or more and 60 percent for all legal entities); (iv) households' sizable total asset and liquid asset buffers (two times and 1.5 times total liabilities, respectively); and (v) very low levels of foreign ownership (1-2 percent of transactions only, in the 1 million ringgit and up segment where foreigners are allowed to buy). However, at end 2017Q3, the overhang of unsold houses was at a 10-year high and growing, exposing the housing market to a potential price adjustment. In addition, most mortgages in Malaysia carry variable interest rates (that can adjust monthly), exposing their holders to interest rate risk.

29. Financial risks associated with residential and commercial property developers should also be monitored closely. In addition to the oversupply of residential properties, the supply of commercial retail space is expected to reach historic highs in the coming years. Despite relatively low leverage and healthy margins, the economic footprint of the property development sector (measured by links to other sectors and share of employment) could expose other sectors—including banks and nonbank creditors—to indirect risks. To reduce the flow of housing supply, the authorities recently announced that high-rise luxury property projects with units with sale value above 1 million ringgits in selected locations will require special permission. Banks' direct exposure to developers remains low and is closely monitored by the BNM.

30. Measures could be considered to mitigate risks to financial stability. For the housing development market, possible measures could include risk weights and lending limits targeting the construction sector, and measures encouraging developers to lease the housing stock that remains unsold for an extended period. To encourage the rental market, the authorities could look into reforming the regulations pertaining to rents and tenant-landlord relationships or granting developers tax exemptions for rental income on leasing units, within the context of the approved government budget envelope. On mortgage lending, sector-wide LTVs (on the second and first properties) and debt service to income limits could supplement the ones that are presently self-imposed by the banks, complementing the existing limit for borrowers with income under 3,000 ringgits per month. Strong economic conditions offer a good window of opportunity for the above policy adjustments.

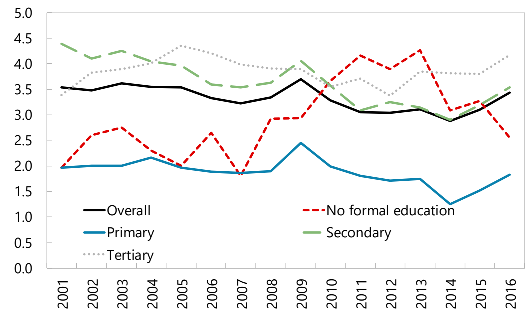
31. The authorities should also continue to implement AML/CFT and anti-corruption measures, consistent with past policies and commitments. Eradication of corruption and improving the perception of integrity in the public service were identified as goals in the 11th Malaysia Plan. Strengthening anti-corruption institutions, publication and robust verification of asset declarations (especially of high-level public officials) in line with international best practices would contribute to these goals. Effective use of AML tools could further support the authorities' anti-corruption efforts.

Authorities' Views

32. The authorities largely agreed with staff's view on prevailing financial sector conditions. They stated that risks are being monitored closely via stress-testing, and other analyses which indicate that domestic financial stability remains preserved even under extreme scenarios, supported by well-capitalized financial institutions. They indicated that the housing market exhibited signs of recovery, while the oversupply in the commercial property segment is being closely monitored. The authorities assess that banks can manage the potential risks to the property market, given the small size and sound quality of direct exposures to the segments with acute oversupply. The authorities are developing a holistic solution to promote a sustainable property market, including a legislation for the residential rental market and the second National Housing Policy to drive a medium-term strategy for the housing market development. Given that risks to domestic financial stability are well-contained amid a favorable economic outlook, the authorities view that no further macroprudential or other policy measures are needed at this point. Regarding AML/CFT issues, the Malaysia Anti-Corruption Commission is constantly and periodically reviewing the efficacy of the Malaysian Anti-Corruption Commission Act 2009 to remain in line with Malaysia's obligations to the UN Convention against Corruption, and taking steps to strengthen its measures following the recommendations coming out of these reviews.

MEDIUM-TERM CHALLENGES: RAISING LIVING STANDARDS WHILE HELPING EXTERNAL REBALANCING

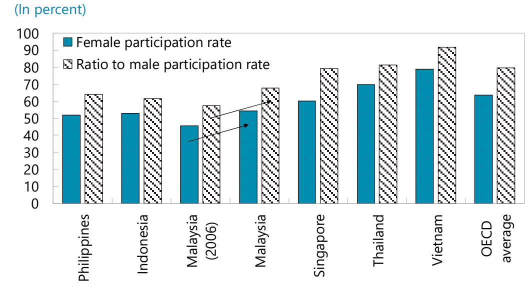
Malaysia: Unemployment Rate by Educational Attainment
(In percent)



Sources: Department of Statistics, Malaysia; and IMF staff calculations.

33. Labor market improvements have helped raise living standards (Appendix IX and Selected Issues Paper)**.** Malaysia has recorded employment gains in every year for the past three decades and the overall unemployment rate has remained largely stable. More recently, despite a slowdown in working-age population growth, higher female labor force participation and foreign worker inflows since 2010 have expanded the labor force, contributing to economic growth. The share of lower-skilled or less-educated workers in total unemployed workers has continued to decline. Moreover, the wage gap between lower and higher skilled/educated workers has declined, helped in part by the minimum wage legislation that came into effect in 2013. Meanwhile, the process of capital deepening has continued, with the capital/labor ratio growing at a faster average pace over 2010–16 compared to 2001–08, although the manufacturing sector has seen a slowdown in such growth. However, unlike in most OECD member countries, the unemployment rate for tertiary-educated workers has been consistently higher than the national unemployment rate for over a decade, suggesting potential skill mismatches at the higher end of the labor market.

Selected ASEAN Countries and OECD: Female Labor Force, 2016
(In percent)



Sources: Department of Statistics, Malaysia; OECD.Stat; World Economic Forum, *the Global Gender Gap Report*, 2016; CEIC Data Co. Ltd.; and IMF staff calculations.

34. There is scope to further improve labor market outcomes and raise productivity and investment within the context of the authorities' comprehensive structural reform agenda. Raising productivity growth within the framework outlined in the 11th Malaysia Plan (11MP, 2016–20) and in the recently-launched Malaysia Productivity Blueprint (MPB) would support longer–term economic potential and strengthen resilience to shocks (Box 1). However, achieving some of the labor market targets by 2020 will require additional efforts. Priority should be given to policies to: encourage female labor force participation, particularly for married or less educated women; improve the quality of education and skills; expand vocational and technical training to reduce skill mismatches; raise enrollment in higher education, which is low relative to the OECD average; and encourage R&D. Some of the 2018 Budget measures aim to support higher female labor participation. Any reform to foreign labor policies, to induce firms to switch to more capital intensive technology, should be market-based, clearly communicated, and gradually phased-in to allow sectors that rely on foreign workers to adjust. Improved labor market outcomes, along with updates of public infrastructure and the regulatory framework, would help further improve the business environment and support higher private investment, which would help with rebalancing. The recently passed Employment Insurance System Act, applicable to all industries and aiming to support eligible employees in the event of loss of employment, including with re-employment training opportunities, could help lower private precautionary saving.

Authorities' Views

35. The authorities reiterated their commitment to achieving high-income status, while acknowledging that the timing of realization of this goal depends on prevailing macroeconomic conditions and economic performance. They remain committed to structural reforms and aspire to place Malaysia among the top twenty nations in economic development, social advancement, and innovation by 2050 (as laid out in a new National Transformation Plan 2050). To achieve these goals and guided by the 11MP, the authorities agreed on the need to address skill mismatches, further improve the female labor force participation rate, and improve education quality, with an emphasis on technical and vocational training. The authorities stressed that, while foreign workers have contributed to economic growth, there is also a need to reassess the costs of the high presence of low-skilled foreign workers and the overreliance of certain economic sectors on these workers. The authorities emphasized the need to invest in and attract higher-skilled workers. Public investment projects will continue to improve soft and hard infrastructure. Malaysia remains committed to trade openness.

STAFF APPRAISAL

36. The Malaysian economy is performing strongly. Real GDP growth is likely to grow above potential in 2018 before reverting to the potential rate in the medium term. Despite a small positive output gap, there are no signs of inflationary pressures at present. Risks to the growth outlook are balanced. Developments in 2017 suggest that Malaysia's external position remains stronger than warranted by fundamentals and desired policies. Going forward, macroeconomic policies should strike the right balance between stability and growth, and forward guidance on fiscal and financial policies would need to be enhanced.

37. Fiscal policy should follow a gradual consolidation path, and the composition of fiscal adjustment could be improved. The planned pace of consolidation for 2018 is appropriate, and will help build buffers and maintain financial market confidence. A gradual consolidation path as envisaged under staff's baseline would be consistent with the authorities' fiscal anchor and would help build additional fiscal space. However, fiscal consolidation should prioritize revenue measures: The tax base should be broadened, and the GST rate could be raised (for example, in line with staff's illustrative consolidation measures). A predominantly revenue-based fiscal adjustment would also facilitate the adoption of measures that are important for external rebalancing, such as higher social and health spending, and higher public investment. Finally, there is scope for improvements in fiscal transparency and fiscal risk management, and for making further progress on other areas of the fiscal structural agenda.

38. The current bias towards reduced monetary policy accommodation is appropriate. Malaysia's monetary policy framework has performed well, delivering both price and output stability in a context of domestic transformation and external shocks. Given above-potential growth combined with stable core inflation, the bias toward reduced accommodation signaled by the BNM at the November 2017 policy meeting is appropriate. Should leading indicators suggest the emergence of inflationary pressures, the policy rate should be increased. Monetary policy and exchange rate flexibility should be the first line of defense against temporary shocks, given limited fiscal space.

39. A more holistic approach towards onshore market development would have potential benefits. The authorities should formulate and communicate to the public a high-level strategy to enhance predictability, build confidence, and help markets understand how the measures taken by the BNM since late 2016 support the overarching objective of developing onshore markets. The strategy needs to address existing gaps in market development and phase out recent capital flow management measures. The IMF stands ready to help with the preparation of both the strategy and a roadmap to implement it.

40. Financial sector risks appear contained, but exposures in household mortgages and the property development sector need to be kept under review. Bank profitability and liquidity are sound, and NPLs low. Corporate access to credit remains healthy and the sector is moderately leveraged. Household mortgages represent a large share in household total indebtedness, and there is a large supply of both residential and commercial properties. To contain risks from a possible real estate price correction, the authorities should consider measures that would further strengthen the prudential framework and encourage the development of a rental market.

41. The authorities' emphasis on raising productivity and investment is appropriate, and should prioritize further improving labor market outcomes. Malaysia should step up efforts to achieve the productivity targets and related labor market reforms outlined in the 11MP and in the MPB. In this context, priority should be given to measures to encourage female labor force participation, improve the quality of education, reduce skill mismatches, encourage R&D, and update public infrastructure and the regulatory framework (including continued implementation of AML/CFT and anti-corruption measures) to make the business environment more conducive to private investment.

42. The staff recommends that the Article IV consultation with Malaysia be held on the standard 12-month cycle.

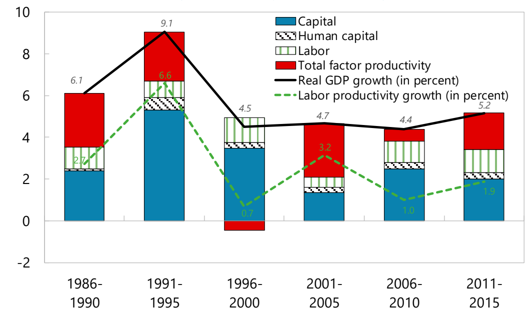
Box 1. The Malaysia Productivity Blueprint

Malaysia aspires to become a high-income nation. To pursue this aspiration, the 11th Malaysia Plan (11MP, 2016–20) focuses on inclusive and sustainable development, with productivity and innovation as the main pillars. Launched in May 2017, the Malaysia Productivity Blueprint (MPB) describes the strategy to reach productivity targets under the 11MP.

The 11MP and the MPB recognize that long-term growth should rely primarily on higher labor productivity. Since the 1980s, Malaysia's growth was largely driven by investments in industries and infrastructure. More recently, contributions from productivity declined, a pattern also observed globally. Against this backdrop, the 11MP targets a 3.7 percent annual growth in national labor productivity and an increase in labor's income share, supported by higher female labor participation; higher skilled labor employment; improvements in education quality; and better alignment of labor skills to industry needs.

Malaysia: Growth Accounting

(Contributions in percentage points; five-year simple averages)



Source: IMF staff estimates.

The Blueprint identifies five thrust areas in which national, sectoral, and enterprise level initiatives would be implemented to improve labor productivity:

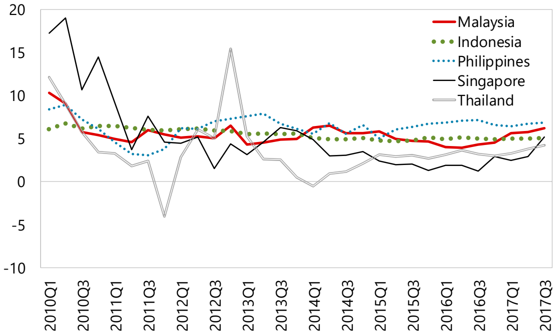
- *Building workforce of the future*— through national strategic workforce planning, with reduced reliance on low-skill workers.
- *Driving digitalization and innovation*—through technology improvements and digitalization of the economy, including the small and medium enterprises.
- *Making industry accountable for productivity*—reducing reliance on subsidies and linking liberalization efforts and funding mechanisms (including grants and soft loans) to productivity outcomes.
- *Forging a robust ecosystem*—addressing regulatory constraints; building a robust accountability system for effective implementation of regulatory reviews. Immediate priorities include removing non-tariff barriers and improving efficiency in the logistics sector.
- *Securing a strong implementation mechanism*—create a culture that values productivity; strong coordination and an effective governance mechanism.

Nine subsectors have been identified for productivity improvement given their economic importance and readiness. These include retail and food & beverages; agro-food; and chemicals and chemical products.

Figure 1. Malaysia: Growth and Exports

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

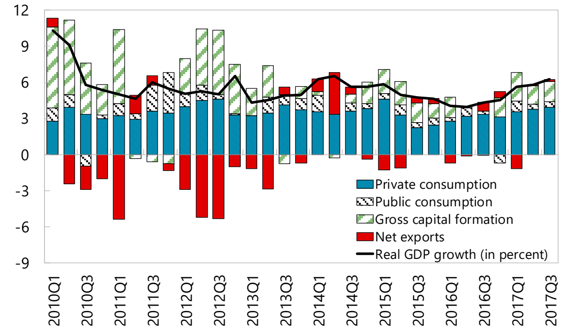
Real GDP Growth
(In percent)



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

In 2017, real GDP growth accelerated, supported by robust private domestic demand and stronger exports.

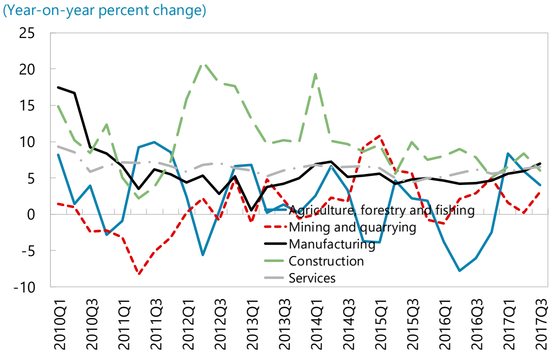
Contributions to Real GDP Growth
(Year-on-year; in percentage points)



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

On the supply side, agricultural productions recovered, while other major sectors sustained growth from last year.

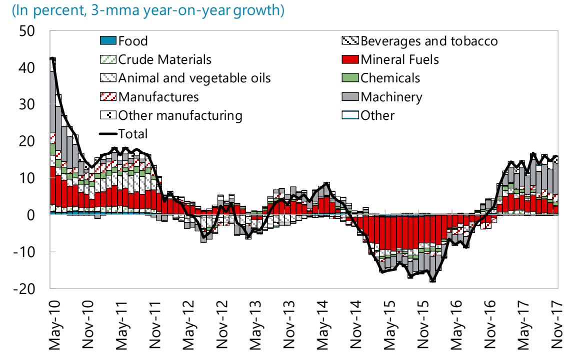
Malaysia: Real GDP by Industy
(Year-on-year percent change)



Sources: Haver Analytics; and IMF staff calculations.

Electrical and electronic products and commodities were the main drivers of export growth.

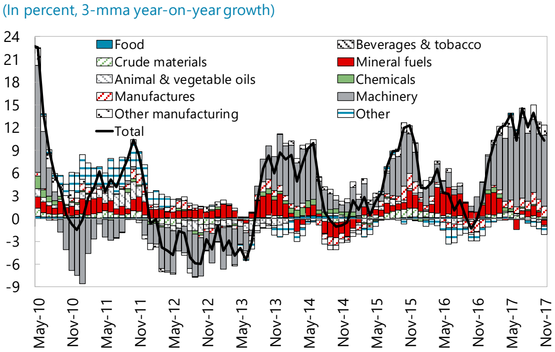
Export Values Growth Contribution
(In percent, 3-mma year-on-year growth)



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

Exports recovery is driven by improvements in both volumes and terms of trade.

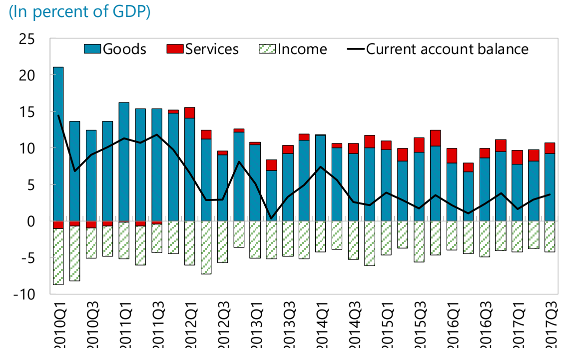
Export Volumes Growth Contribution
(In percent, 3-mma year-on-year growth)



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

Imports have also risen, but the current account surplus, as a share of GDP, is slightly higher than a year ago.

Current Account Balance
(In percent of GDP)

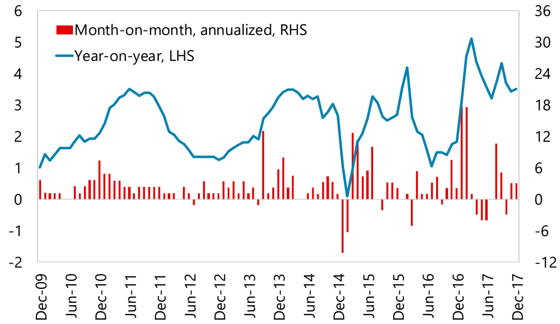


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 2. Malaysia: Inflation and Domestic Resource Constraints

Headline inflation has moderated from its peak in early 2017, as base effects from higher oil prices waned.

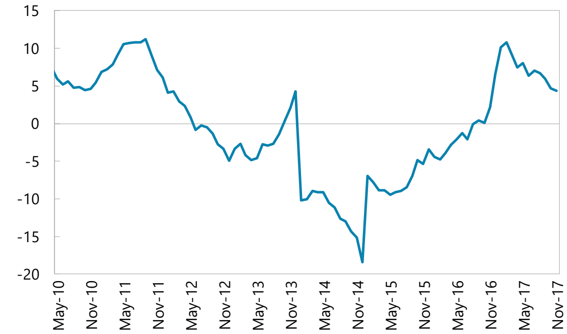
Consumer Price Index
(Percent change)



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

Producer prices have also moderated from their early-2017 peak.

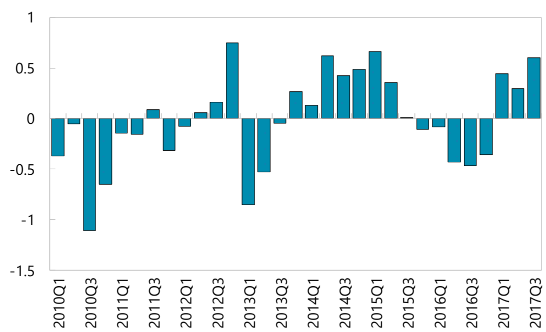
Producer Price Index
(Year-on-year percent change)



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

On the back of a strong economic performance, the output gap has turned slightly positive.

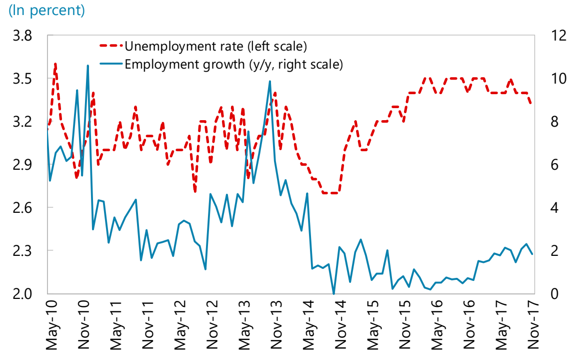
Output Gap
(In percent)



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

The unemployment rate has stabilized as employment growth has picked up…

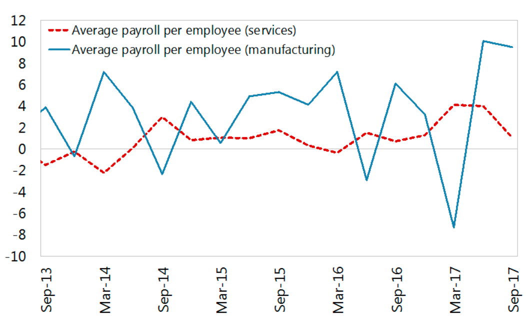
Labor Market Developments
(In percent)



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

…and payrolls have been rising, especially in the manufacturing sector.

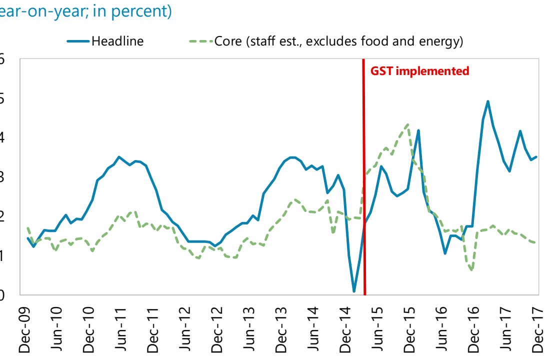
Manufacturing and Services: Payroll
(Year-on-year change in percent)



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

Despite the strength in the domestic economy, core inflation has remained low.

Inflation Developments
(Year-on-year; in percent)

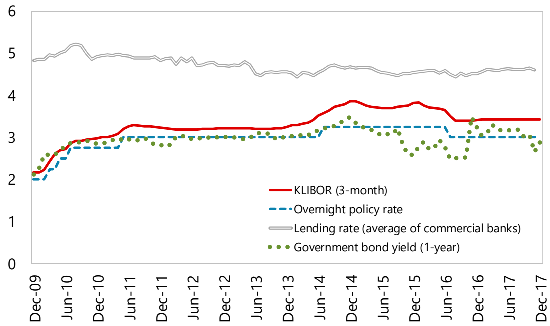


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 3. Malaysia: Monetary Developments

The BNM has kept its policy rate unchanged since July 2016 and market interest rates have largely stabilized.

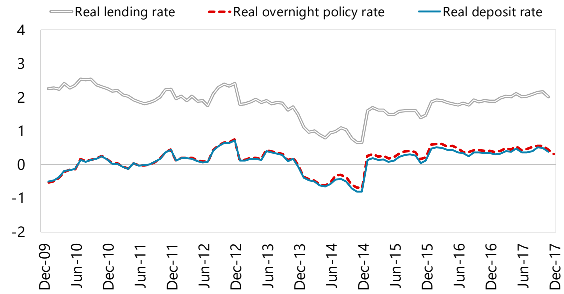
Interest Rates
(In percent per annum)



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

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

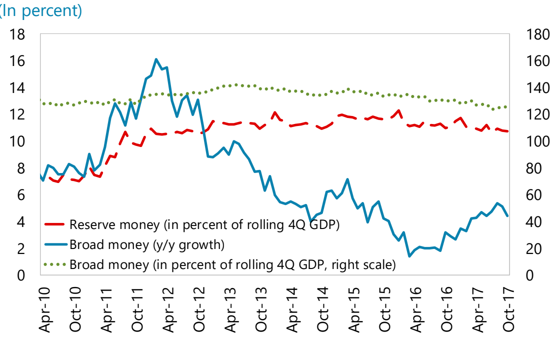
Real Interest Rates
(In percent per annum)



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

Broad money growth has bottomed out...

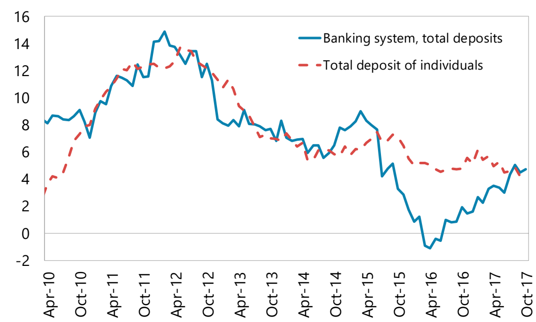
Monetary Aggregates 1/
(In percent)



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

... along with a pickup in deposit growth.

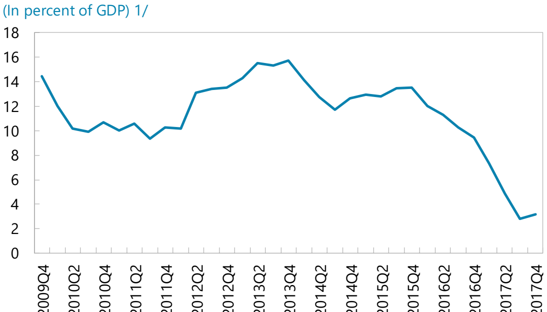
Banking System Deposit Growth
(In percent, y-o-y)



Source: Bank Negara Malaysia; and IMF staff calculations.

Credit gap has declined to a post-GFC low.

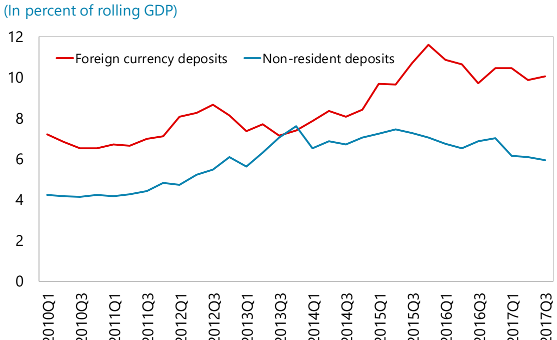
Credit Gap
(In percent of GDP) 1/



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

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

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

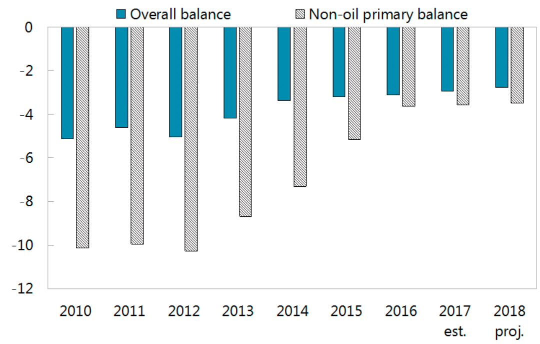


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 4. Malaysia: Fiscal Policy Developments

The federal deficit continues to fall gradually…

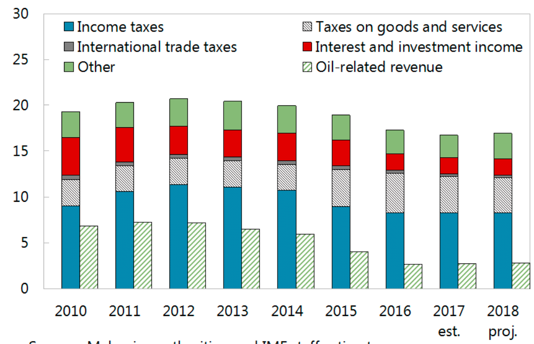
Federal Government: Overall and Non-Oil Balance
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff calculations.

… even with oil revenue lower than in boom years.

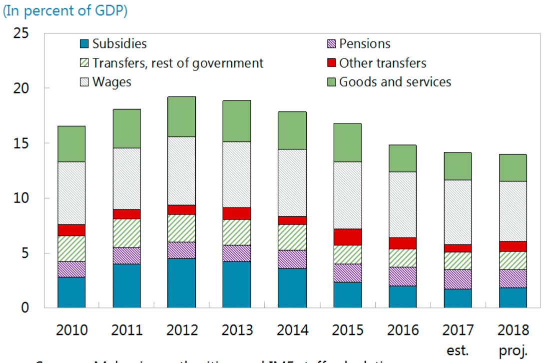
Federal Government Revenue
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

As the authorities adjusted subsidies and transfers…

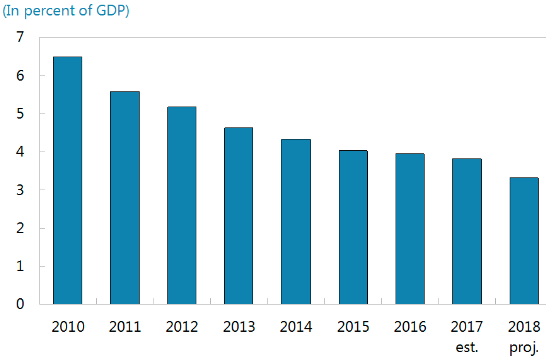
Federal Government Current Expenditures
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff calculations.

… development spending was significantly reduced and is now stable.

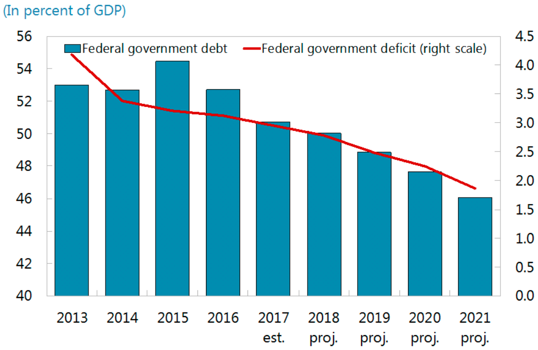
Federal Government Development Spending
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

The federal debt is in a downward trajectory at projected deficit levels.

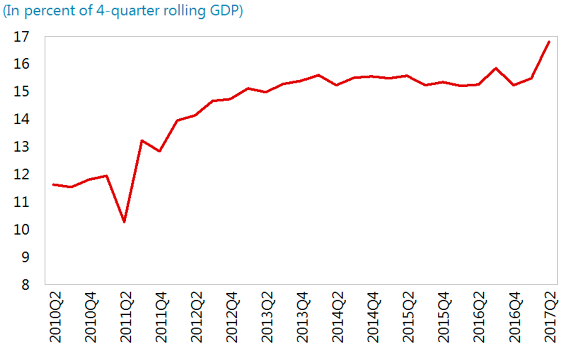
Medium–Term Fiscal Outlook
(In percent of GDP)



Source: IMF staff estimates.

Guarantees, as a share of GDP, have increased recently after remaining stable for several years.

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

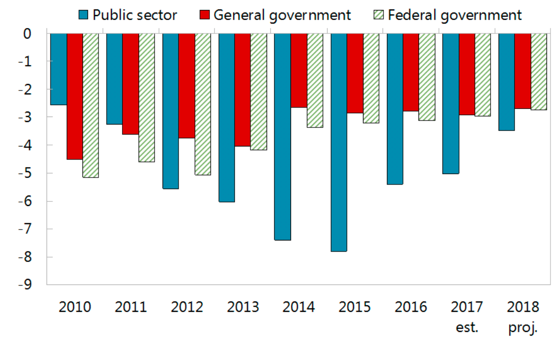


Source: CEIC Data Co. Ltd.

Figure 5. Malaysia: Public Sector Fiscal Stance and Prospects

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

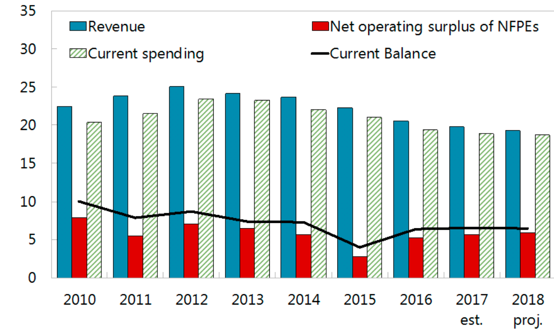
Fiscal Balance
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

… as public companies' surpluses have recovered.

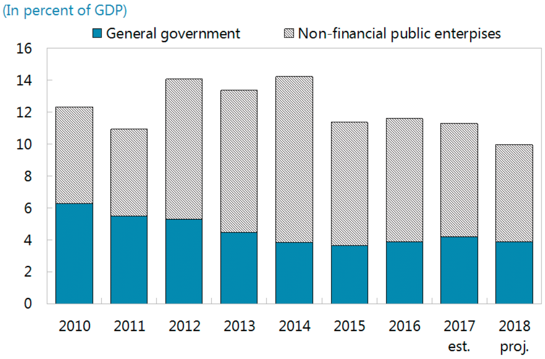
Current Balance of the Public Sector
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

However, development spending is lower…

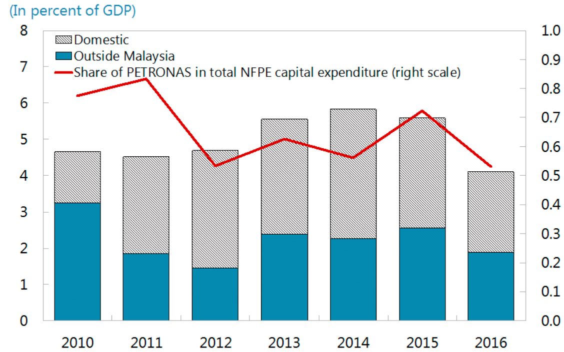
Development Spending
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

… with PETRONAS adjusting investment to lower oil prices.

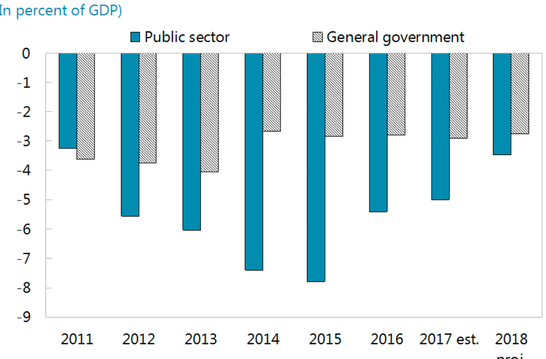
Capital Spending by PETRONAS
(In percent of GDP)



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

The deficits for both general government and NFPS are projected to fall gradually…

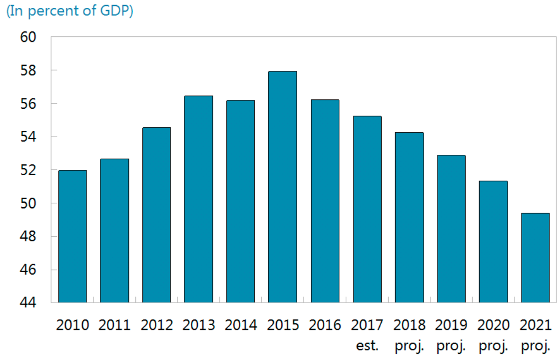
Fiscal Balance
(In percent of GDP)



Sources: Malaysian authorities; and IMF staff estimates.

… with general government debt also declining.

General Government Debt
(In percent of GDP)

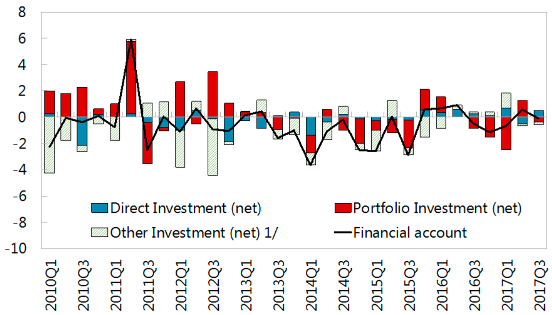


Sources: Malaysian authorities; and IMF staff estimates.

Figure 6. Malaysia: Capital Flows

Nonresident portfolio inflows have recovered after the outflows in 2016Q4 and 2017Q1, leading to an improvement in the financial account.

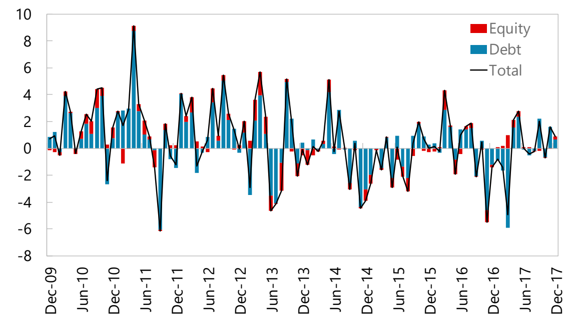
Financial Account Balance
(In percent of 4-quarter rolling GDP; positive = net inflows)



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

Nonresident portfolio flows have been dominated by debt market flows...

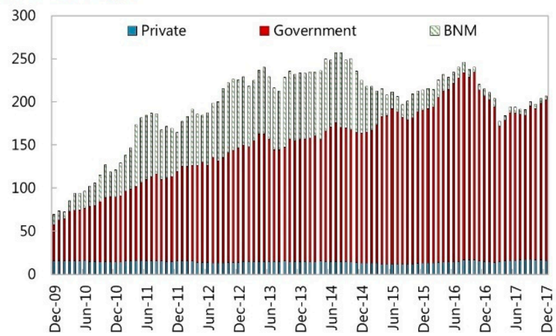
Malaysia: Nonresident Portfolio Capital Flows 1/
(In billion U.S. dollar; as of November 2017)



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

...especially, flows into the Malaysian government securities.

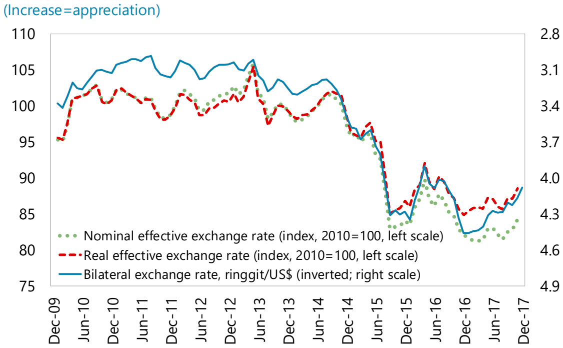
Foreign Holdings of Local-Currency Debt Securities
(In billions of ringgit)



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

The currency appreciated in 2017 but remained below its 2013 peak.

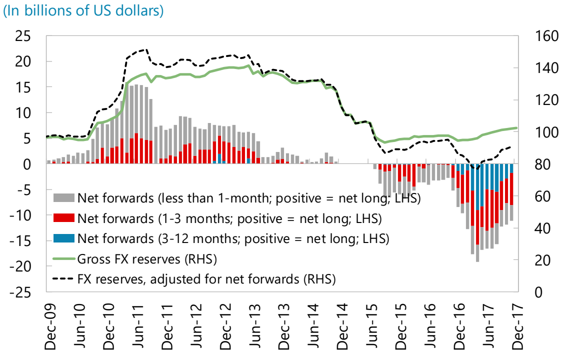
Exchange Rates
(Increase=appreciation)



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

BNM's FX reserves have stabilized.

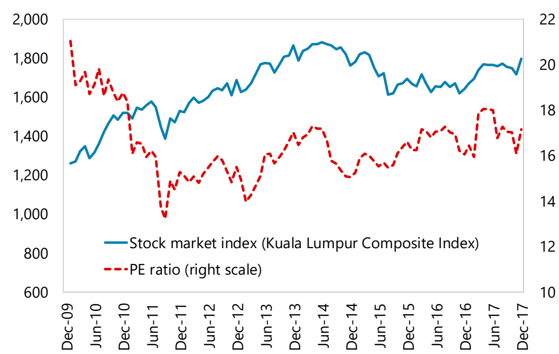
Official Foreign Reserves
(In billions of US dollars)



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

The stock market has gained since late 2016, reflecting both global and domestic developments.

Stock Market Performance

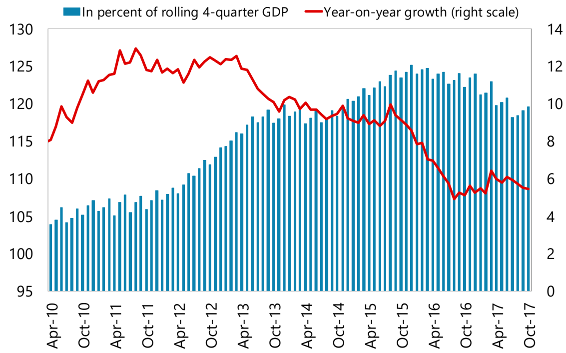


Source: Bloomberg L.P.

Figure 7. Malaysia: Financial Sector Developments

Credit growth has slowed down considerably, lowering the credit-to-GDP ratio.

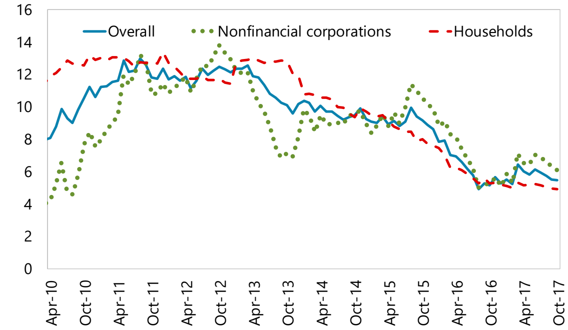
Banks' Claims on Private Sector



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

Credit growth has slowed across the board.

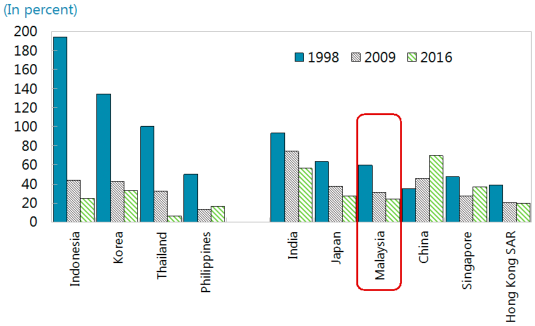
Banks' Claims on Private Sector
(Year-on-year growth)



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

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

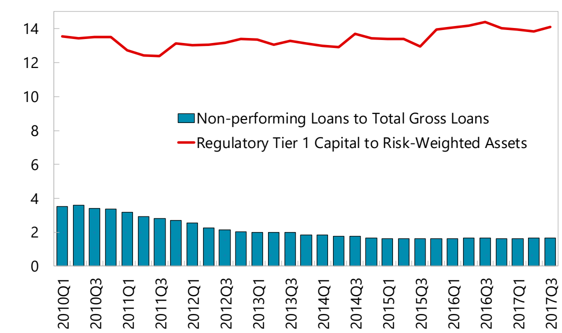
Corporate Debt-to-Equity Ratio 1/
(In percent)



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

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

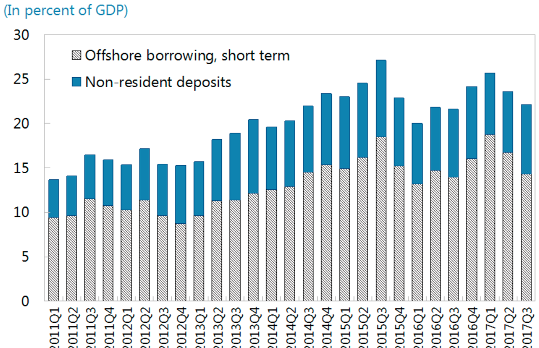
Banks' Financial Soundness Indicators
(In percent)



Source: IMF, *Financial Soundness Indicators* database.

The banking system's reliance on short-term external debt, as a share of GDP, has declined …

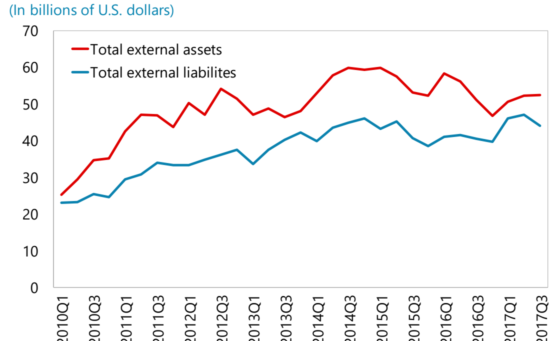
Banks' Short-Term External Debt: 2011:Q1–2017:Q3
(In percent of GDP)



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

… and banks' net external asset positions narrowed between 2016 and early 2017.

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

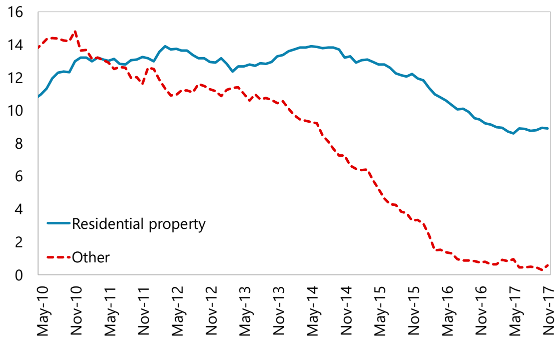


Sources: CEIC Data Co. Ltd; and IMF staff calculations.

Figure 8. Malaysia: Household Debt

Housing and personal loan growth have moderated…

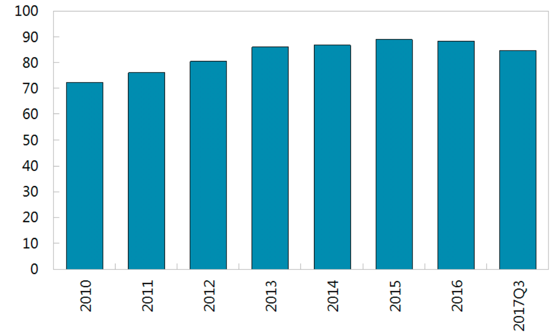
Household Loan Growth
(In percent, year-on-year)



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

… helping lower household debt as a share of GDP.

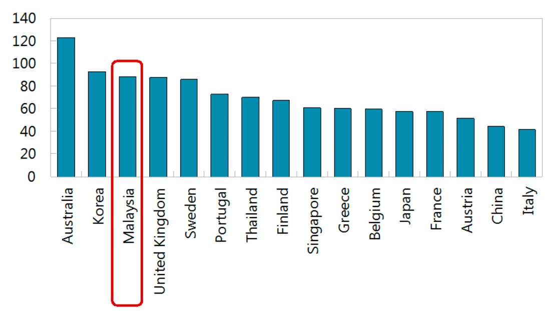
Household Debt
(In percent of GDP)



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

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

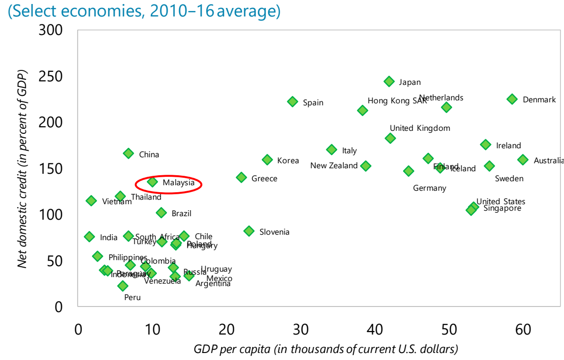
Household Debt, 2016
(In percent of GDP; end of period)



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

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

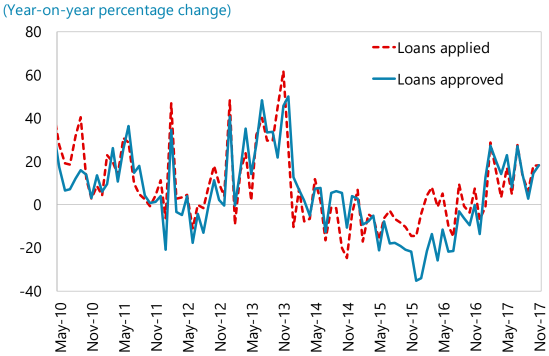
Net Domestic Credit and GDP per Capita
(Select economies, 2010–16 average)



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

Loan approvals and applications have been trending upward, reflecting stronger private sector confidence.

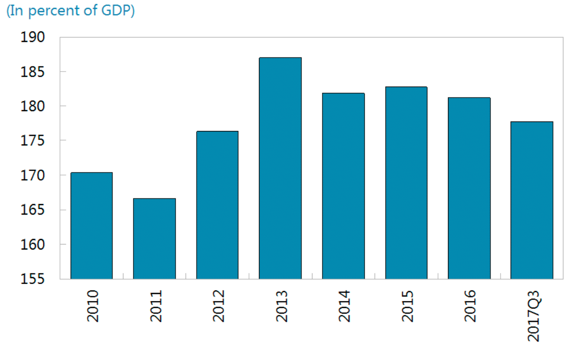
Loan Applications and Approvals
(Year-on-year percentage change)



Source: CEIC Data Co. Ltd.

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

Household Financial Assets
(In percent of GDP)

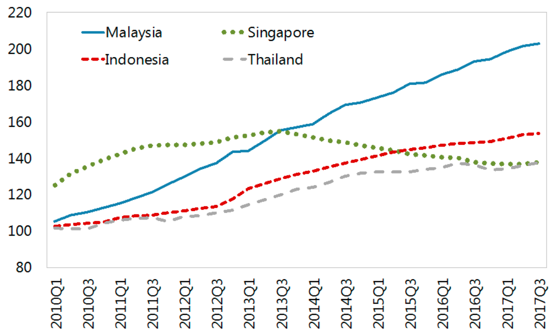


Sources: Bank Negara Malaysia; Malaysian Employee Provident Fund; CEIC Data C staff calculations.

Figure 9. Malaysia: House Prices

House prices continue to rise, but the rate of growth has moderated recently…

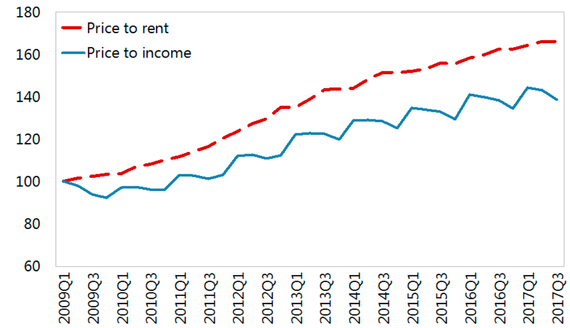
House Price Index
(2009:Q1 = 100)



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

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

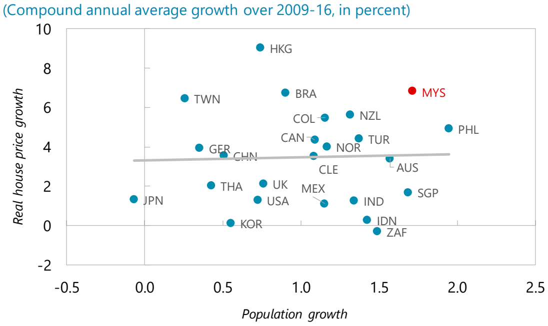
House Prices
(Ratio of indices, 2009:Q1=100)



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

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

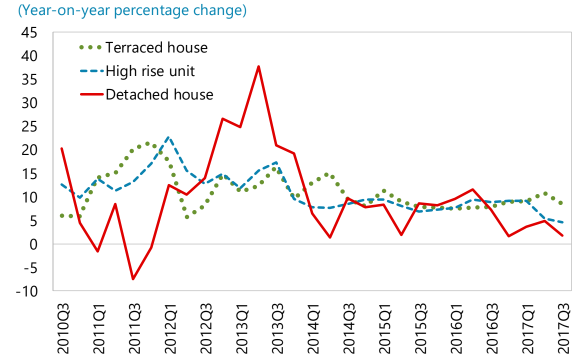
Real House Prices and Population
(Compound annual average growth over 2009-16, in percent)



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

The housing market in Kuala Lumpur is moderating.

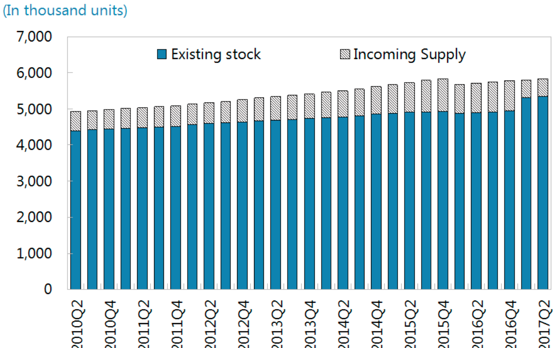
Malaysia: House Prices in Kuala Lumpur
(Year-on-year percentage change)



Source: CEIC Data Co. Ltd.

Residential supply has been increasing.

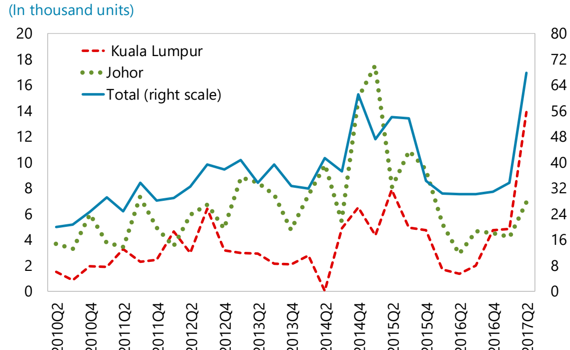
Residential Property Supply
(In thousand units)



Source: CEIC Data Co. Ltd.

Construction starts picked up in 2017, creating some concerns of oversupply.

Residential Property: Construction Started
(In thousand units)

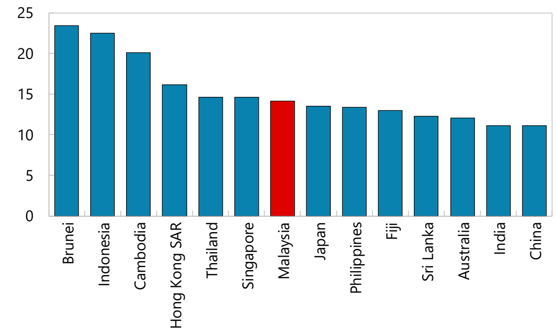


Source: CEIC Data Co. Ltd.

Figure 10. Malaysia: Financial Soundness Indicators 1/

Malaysian banks' capital buffers are strong…

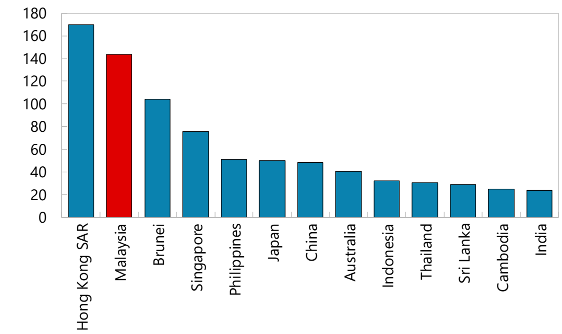
Regulatory Tier 1 Capital to Risk-Weighted Assets
(In percent)



Source: IMF, *Financial Soundness Indicators.*

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

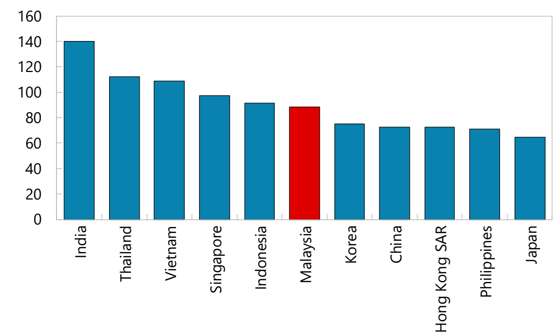
Liquid Assets to Short-Term Liabilities
(In percent)



Source: IMF, *Financial Soundness Indicators.*

Lending in proportion to deposits is in line with peers…

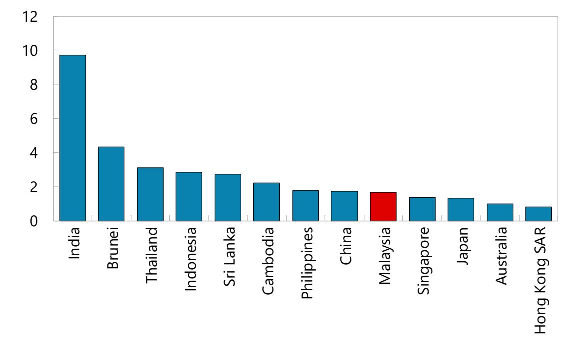
Loan to Deposit Ratio
(In percent)



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

… and asset quality is high.

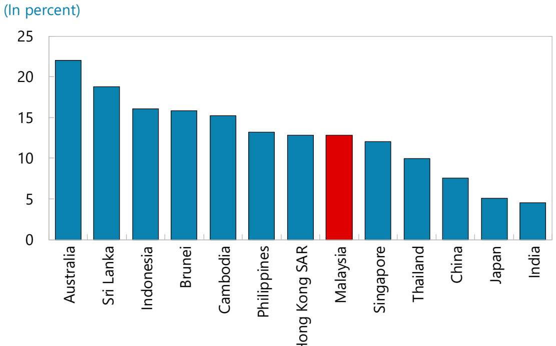
Nonperforming Loans to Total Gross Loans
(In percent)



Source: IMF, *Financial Soundness Indicators.*

Banks are profitable…

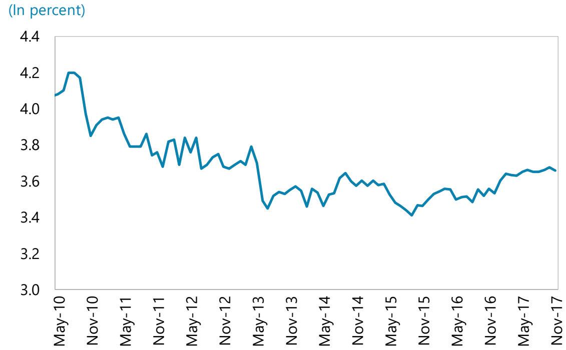
Return on Equity
(In percent)



Source: IMF, *Financial Soundness Indicators.*

… partially reflecting healthy and stable interest rate spreads.

Malaysian Commercial Banks: Interest Rate Spreads
(In percent)



Sources: Bank Negara Malaysia; and IMF staff calculations.

1/ Data for Malaysia are as of 2017:Q3, while data for the other economies range between 2016:Q2 and 2017:Q3 depending on availability.

Table 1. Malaysia: Selected Economic and Financial Indicators, 2013–19

Nominal GDP (2017, est.): US$314.4 billion
GDP per capita (2017, current prices, est.): US$9,808
Unemployment rate (November 2017): 3.3 percent

Population (2017, mid-year): 32 million
Poverty rate (2016, national poverty line): 0.4 percent
Adult literacy rate (2015): 94.6 percent

Main exports (share in total goods exports, 2016): electrical & electronic products (36.5 percent), and commodities (13.5 percent)

	2013	2014	2015	2016	Est. 2017	Proj. 2018	2019
Real GDP (percent change)	4.7	6.0	5.0	4.2	5.8	5.3	5.0
Total domestic demand	6.3	5.3	5.9	4.5	6.4	5.8	5.2
Private consumption	7.2	7.0	6.0	6.0	7.0	6.2	5.6
Public consumption	5.8	4.4	4.4	0.9	4.0	5.0	2.0
Private investment	12.8	11.1	6.3	4.3	9.2	8.0	8.0
Public gross fixed capital formation	1.8	-4.7	-1.1	-0.5	0.6	-0.2	1.9
Net exports (contribution to growth, percentage points)	-1.0	1.2	-0.3	0.1	-0.1	-0.1	0.1
Saving and investment (in percent of GDP)							
Gross domestic investment	25.9	25.0	25.1	25.9	25.4	25.4	25.7
Gross national saving	29.4	29.4	28.1	28.2	28.2	27.8	27.9
Fiscal sector (in percent of GDP)							
Federal government overall balance 1/	-4.2	-3.4	-3.2	-3.1	-3.0	-2.8	-2.5
Revenue	20.4	19.9	18.9	17.3	16.7	16.6	16.6
Expenditure and net lending	24.6	23.3	22.1	20.4	19.8	19.3	19.1
Federal government non-oil primary balance	-8.7	-7.3	-5.2	-3.6	-3.6	-3.5	-3.0
Consolidated public sector overall balance 2/	-6.0	-7.4	-7.7	-5.2	-5.0	-3.5	-3.0
General government debt 3/	56.4	56.2	57.9	56.2	54.2	53.6	52.4
Of which: federal government debt	53.0	52.7	54.5	52.7	50.7	50.1	48.9
Inflation and unemployment (annual average, in percent)							
CPI inflation	2.1	3.1	2.1	2.1	3.8	3.2	2.8
CPI inflation (excluding food and energy) 4/	1.3	2.1	3.2	2.6	1.6	2.2	2.6
Unemployment rate	3.3	2.9	3.1	3.4	3.4	3.2	3.0
Macrofinancial variables (end of period)							
Broad money (percentage change) 5/	7.4	6.3	3.0	2.7	4.9	8.5	8.0
Credit to private sector (percentage change) 5/	10.2	9.2	8.6	5.3	6.4	5.8	5.6
Credit-to-GDP ratio (in percent) 4/ 6/	129.7	130.1	134.7	134.0	129.7	126.4	123.7
Credit-to-GDP gap (in percent) 4/ 6/	15.7	12.7	13.5	9.4	3.2	...	...
Overnight policy rate (in percent)	3.00	3.25	3.25	3.00	3.00	...	...
Three-month interbank rate (in percent)	3.3	3.9	3.8	3.4	3.3	...	...
Nonfinancial corporate sector debt (in percent of GDP)	99.8	98.6	106.7	109.5	104.2	103.1	102.1
Nonfinancial corporate sector debt issuance (in percent of GDP)	3.5	3.2	2.6	3.2	3.2	...	...
Household debt (in percent of GDP)	86.1	86.8	89.0	88.3	84.6	82.5	80.7
Household financial assets (in percent of GDP)	187.0	182.1	183.1	181.5	177.6	...	...
House prices (percentage change)	10.9	8.5	7.4	6.9	5.1	5.0	5.2
Exchange rates (period average)							
Malaysian ringgit/U.S. dollar	3.15	3.27	3.91	4.15	4.30	...	...
Real effective exchange rate (percentage change)	0.5	-0.7	-7.9	-4.3	-1.5	...	...
Balance of payments (in billions of U.S. dollars) 4/							
Current account balance	11.3	14.8	9.0	7.0	8.9	8.3	8.5
(In percent of GDP)	3.5	4.4	3.0	2.4	2.8	2.4	2.2
Goods balance	30.6	34.6	28.0	24.4	27.1	28.6	30.7
Services balance	-3.0	-3.3	-5.3	-4.6	-5.0	-5.8	-6.4
Income balance	-16.3	-16.5	-13.7	-12.8	-13.3	-14.4	-15.8
Capital and financial account balance	-6.4	-24.3	-14.5	-0.2	3.6	2.7	3.2
Of which: Direct investment	-2.0	-5.5	-0.5	3.4	2.1	1.0	0.3
Errors and omissions	-0.2	-1.7	6.4	-3.2	-4.9	0.0	0.0
Overall balance	4.6	-11.2	1.0	3.6	7.7	11.1	11.7
Gross official reserves (US$ billions)	134.9	115.9	95.3	94.6	102.4	113.3	125.0
(In months of following year's imports of goods and nonfactor services)	7.4	7.5	6.3	5.6	5.8	6.0	6.3
(In percent of short-term debt by original maturity) 4/	130.7	111.6	116.2	112.5	111.7	123.9	143.6
(In percent of short-term debt by remaining maturity) 4/	91.8	78.3	74.4	71.5	72.1	79.0	87.2
Total external debt (in billions of U.S. dollars) 4/	212.3	213.4	195.0	204.2	217.3	221.2	227.5
(In percent of GDP) 4/	65.7	63.1	65.8	68.9	69.1	63.0	58.6
Of which: short-term (in percent of total, original maturity) 4/	48.6	48.7	42.0	41.2	42.2	41.3	38.3
short-term (in percent of total, remaining maturity) 4/	69.3	69.4	65.7	64.7	65.4	64.9	63.0
Debt service ratio 4/							
(In percent of exports of goods and services) 7/	17.3	17.9	21.4	23.5	22.7	23.0	23.1
(In percent of exports of goods and nonfactor services)	18.4	19.1	22.7	24.9	24.1	24.4	24.5
Memorandum items:							
Nominal GDP (in billions of ringgit)	1,019	1,106	1,158	1,230	1,352	1,467	1,584

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

1/ Based on staff's estimate of the federal government fiscal balance using GFSM 2001, which differs from the authorities' cash-based measure of the fiscal deficit.
2/ Capital expenditure in the budget includes foreign fixed assets and other items, such as purchase of shares and land, which are excluded from public investment in the national accounts.
3/ General government includes the federal government, state and local governments, and the statutory bodies.
4/ IMF staff estimates. U.S. dollar values are estimated using official data published in national currency.
5/ Based on data provided by the authorities, but follows compilation methodology used in IMF's *Integrated Monetary Database.*
6/ Based on a broader measure of liquidity. Credit gap is estimated on quarterly data from 2000, using one-sided Hodrick-Prescott filter with a large parameter.
7/ Includes receipts under the primary income account.

Table 2. Malaysia: Indicators of External Vulnerability, 2013–17

	2013	2014	2015	2016	2017 2/
Financial indicators					
General government debt (in percent of GDP) 1/	56.4	56.2	57.9	56.2	...
Broad money (end of period, year-on-year percent change) 3/	7.4	6.3	3.0	2.7	4.4
Private sector credit (end of period, year-on-year percent change) 3/	10.2	9.2	8.6	5.3	5.5
3-month interest rate (percent, 12-month average) 4/	3.2	3.5	3.7	3.5	3.4
External indicators 5/					
Goods exports, f.o.b. (percent change, 12-month basis, in U.S. dollars terms) 6/	-3.1	2.5	-15.9	-5.2	10.3
Goods imports, f.o.b. (percent change, 12-month basis, in U.S. dollars terms) 6/	-0.3	0.6	-15.2	-3.8	10.7
Current account balance (12-month basis, in billions of U.S. dollars) 6/	11.3	14.8	9.0	7.0	9.2
Current account balance (12-month basis, in percent of GDP)	3.5	4.4	3.0	2.4	3.0
Capital and financial account balance (12-month basis, in billions of U.S. dollars) 6/	-6.4	-24.3	-14.5	-0.2	-3.9
Gross official reserves (in billions of U.S. dollars)	134.9	115.9	95.3	94.6	102.4
In months of following year's imports of goods and nonfactor services 6/	7.4	7.5	6.3	5.6	5.8
As percent of broad money 3/ 6/	31.0	26.8	26.2	26.4	26.0
As percent of monetary base 3/ 6/	382.2	325.7	297.9	300.2	305.1
Total short-term external debt by: 6/ 7/					
Original maturity (in billions of U.S. dollars)	103.3	103.9	82.0	84.0	91.1
Remaining maturity (in billions of U.S. dollars)	147.0	148.0	128.2	132.2	...
Original maturity to reserves (in percent)	76.5	89.6	86.0	88.9	88.9
Original maturity to total external debt (in percent)	48.6	48.7	42.0	41.2	44.0
Remaining maturity to reserves (in percent)	109.0	127.7	134.5	139.8	...
Remaining maturity to total external debt (in percent)	69.3	69.4	65.7	64.7	...
Total external debt (in billions of U.S. dollars) 6/ 7/	212.3	213.4	195.0	204.2	207.0
Of which: public sector (medium- and long-term (MLT))	72.9	69.7	70.1	72.2	71.2
Total external debt to exports of goods and services (in percent) 6/ 8/	81.8	80.4	87.9	96.3	90.3
External amortization of MLT debt to exports of goods and services (in percent) 6/ 8/	16.0	16.5	19.9	21.8	...
Financial market indicators					
Kuala Lumpur Composite Index (KLCI), end of period	1,867	1,761	1,693	1,642	1,797
10-year government securities yield (percent per annum, average)	3.7	4.0	4.0	3.8	4.0

Sources: Haver Analytics; CEIC Data Co. Ltd.; data provided by the authorities; and IMF, *Integrated Monetary Database* and staff estimates.
1/ Gross debt. General government includes the federal government, state and local governments, and the statutory bodies.
2/ Latest available data.
3/ Based on data provided by the authorities, but follows compilation methodology used in IMF's *Integrated Monetary Database.*
4/ Kuala Lumpur interbank offer rate.
5/ Based on balance of payments.
4/ IMF staff estimates. U.S. dollar values are estimated using official data published in national currency.
7/ Includes offshore borrowing, nonresident holdings of ringgit-denominated securities, nonresident deposits, and other short-term debt.
8/ Includes receipts under the primary income account.

Table 3. Malaysia: Balance of Payments, 2013–22 1/

					Est.	Proj.				
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
	(In billions of U.S. dollars)									
Current account balance	11.3	14.8	9.0	7.0	8.9	8.3	8.5	7.7	8.5	9.2
Goods balance	30.6	34.6	28.0	24.4	27.4	28.6	30.7	32.0	34.1	35.9
Exports, f.o.b.	202.4	207.4	174.4	165.4	187.5	197.3	209.8	220.9	232.3	241.4
Imports, f.o.b.	171.7	172.8	146.5	140.9	160.1	168.7	179.1	188.9	198.1	205.5
Services balance	-3.0	-3.3	-5.3	-4.6	-5.0	-5.8	-6.4	-6.9	-7.6	-7.9
Receipts	42.1	42.0	34.8	35.3	36.8	38.1	39.6	41.0	42.5	43.3
Payments	45.2	45.3	40.1	39.9	41.8	43.9	46.0	47.9	50.1	51.2
Primary income	-10.8	-11.2	-8.2	-8.4	-8.5	-9.1	-9.9	-11.0	-11.1	-11.2
Secondary income	-5.6	-5.3	-5.5	-4.5	-4.8	-5.3	-5.9	-6.4	-7.0	-7.6
Capital and financial account balance	-6.4	-24.3	-14.5	-0.2	3.8	2.5	3.2	4.5	4.9	4.9
Capital account	0.0	0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-6.4	-24.4	-14.2	-0.3	3.8	2.5	3.2	4.5	4.9	4.9
Direct investment	-2.0	-5.5	-0.5	3.4	2.1	1.0	0.3	0.8	-0.6	-1.4
Portfolio investment	-1.0	-12.0	-6.7	-3.7	-1.1	0.5	1.7	2.8	4.4	5.3
Other investment	-3.5	-6.9	-7.0	0.0	2.8	1.0	1.2	1.0	1.0	1.0
Errors and omissions	-0.2	-1.7	6.4	-3.2	-4.9	0.0	0.0	0.0	0.0	0.0
Overall balance	4.6	-11.2	1.0	3.6	7.8	10.9	11.7	12.2	13.4	14.2
Gross official reserves	134.9	115.9	95.3	94.6	102.4	113.3	125.0	137.2	150.5	164.7
In months of following year's imports of goods and nonfactor services	7.4	7.5	6.3	5.6	5.8	6.0	6.3	6.6	7.0	7.3
In percent of short-term debt 2/	91.8	78.3	74.4	71.5	72.1	79.0	87.2	93.8	100.3	101.1
	(In percent of GDP)									
Current account balance	3.5	4.4	3.0	2.4	2.8	2.4	2.2	1.8	1.8	1.8
(Excluding crude oil and liquefied natural gas)	-3.0	-1.7	-1.7	-1.2	-1.4	-1.7	-1.7	-1.9	-1.7	-1.5
Goods balance	9.5	10.2	9.4	8.2	8.7	8.1	7.9	7.5	7.4	7.2
Exports, f.o.b.	62.6	61.4	58.8	55.8	59.6	56.2	54.0	52.0	50.1	48.1
Imports, f.o.b.	53.1	51.1	49.4	47.5	50.9	48.1	46.1	44.5	42.8	41.0
Services balance	-0.9	-1.0	-1.8	-1.6	-1.6	-1.7	-1.7	-1.6	-1.6	-1.6
Primary income	-3.3	-3.3	-2.8	-2.8	-2.7	-2.6	-2.5	-2.6	-2.4	-2.2
Secondary income	-1.7	-1.6	-1.8	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5
Capital and financial account balance	-2.0	-7.2	-4.9	-0.1	1.2	0.7	0.8	1.1	1.0	1.0
Direct investment	-0.6	-1.6	-0.2	1.1	0.7	0.3	0.1	0.2	-0.1	-0.3
	(Annual percentage change)									
Memorandum items:										
Goods trade										
Exports, f.o.b., value growth (in U.S. dollars) 1/	-3.1	2.5	-15.9	-5.2	13.2	5.4	6.3	5.3	5.1	3.9
Export volume growth	1.9	6.6	6.0	3.3	12.2	3.6	5.1	4.5	3.8	3.5
Imports, f.o.b., value growth (in U.S. dollars) 1/	-0.3	0.6	-15.2	-3.8	13.6	5.4	6.1	5.5	4.9	3.7
Import volume growth	5.9	4.1	1.3	0.5	12.2	3.5	4.9	4.5	3.5	3.2
Terms of trade	-0.4	-1.4	-3.4	-3.3	-0.4	-0.2	0.0	-0.2	0.0	-0.1
Net international investment position 1/										
(In billions of U.S. dollars)	-14.3	-5.0	25.4	15.6	…	…	…	…	…	…
(In percent of GDP)	-4.4	-1.5	8.6	5.3	…	…	…	…	…	…

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

1/ Information presented in this table is based on staff estimates using official data published in national currency.

2/ Based on IMF staff estimates of short-term external debt by remaining maturity.

Table 4. Malaysia: Illustrative Medium-Term Macroeconomic Framework, 2013–22 1/

	2013	2014	2015	2016	Est. 2017	Proj. 2018	2019	2020	2021	2022
Real sector (percent change)										
Real GDP growth	4.7	6.0	5.0	4.2	5.8	5.3	5.0	4.9	4.7	4.9
Total domestic demand	6.3	5.3	5.9	4.5	6.4	5.8	5.2	5.2	5.0	5.2
Output gap (in percent) 2/	-1.0	0.1	0.3	-0.3	0.4	0.6	0.6	0.4	0.1	0.0
Consumer prices (period average)	2.1	3.1	2.1	2.1	3.8	3.2	2.8	2.6	2.6	2.5
Consumer prices, excluding food and energy (period average) 2/	1.3	2.1	3.2	2.6	1.6	2.2	2.6	2.5	2.3	1.9
GDP deflator	0.2	2.5	-0.4	2.0	3.9	3.1	2.8	2.5	2.7	2.6
Saving and investment (in percent of GDP)										
Gross domestic investment	25.9	25.0	25.1	25.9	25.4	25.4	25.7	25.8	25.8	25.9
Private, including stocks	15.4	15.6	16.1	17.3	17.4	17.9	18.4	18.7	18.9	19.0
Of which: gross fixed capital formation	15.9	16.6	17.2	17.2	17.4	17.9	18.4	18.7	18.9	19.0
Public	10.5	9.4	9.0	8.6	8.0	7.6	7.3	7.1	7.0	6.8
Gross national saving	29.4	29.4	28.1	28.2	28.2	27.8	27.9	27.6	27.7	27.7
Private 3/	25.3	24.9	26.7	24.9	25.1	24.6	24.3	23.9	23.9	20.9
Public 3/	4.1	4.5	1.4	3.3	3.1	3.2	3.6	3.7	3.8	4.0
Fiscal sector (in percent of GDP)										
Federal government										
Revenue	20.4	19.9	18.9	17.3	16.7	16.6	16.6	16.6	16.6	16.7
Tax	15.3	14.8	14.3	13.8	13.4	13.3	13.3	13.4	13.4	13.5
Nontax	5.1	5.1	4.6	3.5	3.3	3.3	3.3	3.2	3.2	3.2
Expenditure	24.6	23.3	22.1	20.4	19.8	19.3	19.1	18.8	18.5	18.1
Current	21.0	20.0	18.9	17.4	16.4	16.1	15.9	15.6	15.3	14.9
Development	3.6	3.3	3.2	3.0	3.4	3.2	3.2	3.2	3.2	3.2
Overall balance	-4.2	-3.4	-3.2	-3.1	-3.0	-2.8	-2.5	-2.2	-1.9	-1.5
Cyclically-adjusted balance (in percent of potential GDP) 2/	-4.2	-3.6	-2.9	-2.8	-3.1	-2.9	-2.6	-2.2	-1.9	-1.5
Nonoil and gas primary balance	-8.7	-7.3	-5.2	-3.6	-3.6	-3.5	-3.0	-2.5	-2.2	-1.7
Federal government debt	53.0	52.7	54.5	52.7	50.7	50.1	48.9	47.6	46.1	44.3
General government and consolidated public sector										
Consolidated public sector overall balance 4/	-6.0	-7.4	-7.7	-5.2	-5.0	-3.5	-3.0	-2.7	-2.5	-2.2
General government debt 5/	56.4	56.2	57.9	56.2	54.2	53.6	52.4	51.1	49.6	47.8
Balance of payments (in billions of U.S. dollars) 2/										
Goods balance	30.6	34.6	28.0	24.4	27.1	28.6	30.7	32.0	34.1	35.9
Services balance	-3.0	-3.3	-5.3	-4.6	-5.0	-5.8	-6.4	-6.9	-7.6	-19.1
Income balance	-16.3	-16.5	-13.7	-12.8	-13.3	-14.4	-15.8	-17.4	-18.1	-18.8
Current account balance	11.3	14.8	9.0	7.0	8.9	8.3	8.5	7.7	8.5	9.2
(In percent of GDP)	3.5	4.4	3.0	2.4	2.8	2.4	2.2	1.8	1.8	1.8
Capital and financial account balance	-6.4	-24.3	-14.5	-0.2	3.6	2.7	3.2	4.5	4.9	4.9
Of which : Direct investment	-2.0	-5.5	-0.5	3.4	2.1	1.0	0.3	0.8	-0.6	-1.4
Errors and omissions	-0.2	-1.7	6.4	-3.2	-4.9	0.0	0.0	0.0	0.0	0.0
Overall balance	4.6	-11.2	1.0	3.6	7.7	11.1	11.7	12.2	13.4	14.2
International trade in goods (annual percent change) 2/										
Goods exports, f.o.b. (in U.S. dollars terms)	-3.1	2.5	-15.9	-5.2	13.2	5.4	6.3	5.3	5.1	3.9
Goods imports, f.o.b. (in U.S. dollars terms)	-0.3	0.6	-15.2	-3.8	13.6	5.4	6.1	5.5	4.9	3.7
Terms of trade	-0.4	-1.4	-3.4	-3.3	-0.4	-0.2	0.0	-0.2	0.0	-0.1
Gross official reserves (in billions of U.S. dollars)	134.9	115.9	95.3	94.6	102.4	113.3	125.0	137.2	150.5	164.7
(In months of following year's imports of goods and nonfactor services)	7.4	7.5	6.3	5.6	5.8	6.0	6.3	6.6	7.0	7.3
(In percent of short-term debt by original maturity) 2/	130.7	111.6	116.2	112.5	111.7	123.9	143.6	161.0	180.8	182.1
(In percent of short-term debt by remaining maturity) 2/	91.8	78.3	74.4	71.5	72.0	79.0	87.2	93.8	100.3	101.1
Total external debt (in billions of U.S. dollars) 2/	212.3	213.4	195.0	204.2	217.3	221.2	227.5	237.4	249.8	271.4
(In percent of GDP) 2/	65.7	63.1	65.8	68.9	69.1	63.0	58.6	55.9	53.9	54.1
Short-term external debt (percent of total, original maturity) 2/	48.6	48.7	42.0	41.2	42.2	41.3	38.3	35.9	33.3	33.3
Short-term external debt (percent of total, remaining maturity) 2/	69.3	69.4	65.7	64.7	65.4	64.9	63.0	61.6	60.1	60.1
Debt-service ratio 2/										
(In percent of exports of goods and nonfactor services)	18.4	19.1	22.7	24.9	24.1	24.4	24.5	25.2	25.5	26.8
Net international investment position (in billions of U.S. dollars) 2/	-14.3	-5.0	25.4	15.6	...	...	...	...	...	...
Memorandum items:										
Nominal GDP (in billions of ringgit)	1,019	1,106	1,158	1,230	1,352	1,467	1,584	1,703	1,832	1,972

Sources: Data provided by the authorities; and IMF staff estimates.
1/ Period ending December 31.
2/ IMF staff estimates. U.S. dollar values are estimated using the official data published in national currency.
3/ For 2013 and 2014, based on data published by Department of Statistics, Malaysia. IMF staff estimates are used 2015 onward.
4/ Capital expenditure in the budget includes foreign fixed assets and other items, such as purchases of shares and land, which are excluded from public investment in the national accounts.
5/ General government includes the federal government, state and local governments, and the statutory bodies.

Table 5. Malaysia: Summary of Federal Government Operations and Stock Positions, 2013–19

	2013	2014	2015	2016	Est. 2017	Proj. 2018	2019
I. Statement of Government Operations			(In billions of ringgit)				
Revenue	208.0	220.6	219.1	212.4	226.3	242.9	262.6
Taxes	156.0	164.2	165.4	169.3	181.2	194.6	210.9
Direct taxes	120.5	126.7	111.8	109.6	120.7	130.7	142.2
Indirect taxes	35.4	37.5	53.7	59.7	60.5	63.9	68.7
Non-tax revenue	52.0	56.4	53.6	43.1	45.1	48.3	51.7
Investment income	29.9	33.8	32.8	21.4	22.7	24.6	26.8
Other revenue	22.1	22.7	20.8	21.7	22.5	23.7	24.9
Expenditure	250.6	258.0	256.3	250.9	267.2	283.7	301.9
Expense	213.9	221.5	219.4	213.4	221.2	236.7	251.2
Compensation of employees	61.0	66.9	70.1	73.1	78.8	79.1	82.3
Use of goods and services	37.9	38.0	40.5	34.0	34.6	36.6	38.1
Interest	20.8	22.6	24.3	26.5	28.9	30.9	35.7
Subsidies	43.3	39.7	27.3	24.7	23.1	26.5	27.3
Grants	34.8	34.6	37.3	33.3	31.4	38.0	40.3
Social benefits and other expense	16.1	19.7	20.0	21.8	24.5	25.4	27.5
Net acquisition of nonfinancial assets	36.7	36.5	36.9	37.4	46.0	47.0	50.7
Gross operating balance	-5.9	-0.9	-0.3	-1.0	5.1	6.2	11.4
Net lending/borrowing	-42.6	-37.4	-37.2	-38.4	-40.9	-40.8	-39.3
Overall fiscal balance (authorities' definition) 1/	-38.6	-37.4	-37.2	-38.4	-40.9	-40.8	-39.3
Net incurrence of liabilities	39.1	36.8	38.2	38.4	36.6	50.0	39.3
By financial instrument							
Debt securities	39.3	37.2	38.6	38.7	37.5	50.9	39.9
Loans	-0.2	-0.4	-0.4	-0.4	-1.0	-0.9	-0.6
By holder residence							
Domestic	30.0	28.1	27.1	32.9	58.0	43.8	29.5
Foreign	9.0	8.7	11.1	5.5	-21.4	6.2	9.8
			(In percent of GDP)				
Revenue	20.4	19.9	18.9	17.3	16.7	16.6	16.6
Taxes	15.3	14.8	14.3	13.8	13.4	13.3	13.3
Direct taxes	11.8	11.5	9.7	8.9	8.9	8.9	9.0
Indirect taxes	3.5	3.4	4.6	4.9	4.5	4.4	4.3
Non-tax revenue	5.1	5.1	4.6	3.5	3.3	3.3	3.3
Investment income	2.9	3.1	2.8	1.7	1.7	1.7	1.7
Other revenue	2.2	2.0	1.8	1.8	1.7	1.6	1.6
Expenditure	24.6	23.3	22.1	20.4	19.8	19.3	19.1
Expense	21.0	20.0	18.9	17.4	16.4	16.1	15.9
Compensation of employees	6.0	6.1	6.1	5.9	5.8	5.4	5.2
Use of goods and services	3.7	3.4	3.5	2.8	2.6	2.5	2.4
Interest	2.0	2.0	2.1	2.2	2.1	2.1	2.3
Subsidies	4.3	3.6	2.4	2.0	1.7	1.8	1.7
Grants	3.4	3.1	3.2	2.7	2.3	2.6	2.5
Social benefits and other expense	1.6	1.8	1.7	1.8	1.8	1.7	1.7
Net acquisition of nonfinancial assets	3.6	3.3	3.2	3.0	3.4	3.2	3.2
Gross operating balance	-0.6	-0.1	0.0	-0.1	0.4	0.4	0.7
Net lending/borrowing	-4.2	-3.4	-3.2	-3.1	-3.0	-2.8	-2.5
Overall fiscal balance (authorities' definition) 1/	-3.8	-3.4	-3.2	-3.1	-3.0	-2.8	-2.5
II. Stock Positions			(In billions of ringgit)				
Liabilities (nominal value)	539.9	582.8	630.5	648.5	685.1	735.1	774.3
By financial instrument							
Debt securities	481.9	530.9	573.9	624.8	662.4	713.2	753.1
Loans	58.0	51.9	56.6	23.7	22.7	21.8	21.2
By holder residence							
Domestic	381.4	414.6	431.9	438.2	496.3	540.0	569.5
Foreign	158.4	168.2	198.6	210.2	188.8	195.0	204.8
Memorandum items:							
Cyclically- adjusted balance (percent of potential GDP)	-4.2	-3.6	-2.9	-2.8	-3.1	-2.9	-2.6
Structural primary balance (percent of potential GDP)	-2.1	-1.6	-0.8	-0.7	-1.0	-0.8	-0.3
Primary balance (percent of GDP)	-2.1	-1.3	-1.1	-1.0	-0.9	-0.7	-0.2
Nonoil and gas primary balance (percent of GDP)	-8.7	-7.3	-5.2	-3.6	-3.6	-3.5	-3.0
Oil and gas revenues (percent of GDP)	6.5	6.0	4.0	2.7	2.8	2.8	2.7
General government revenue (percent of GDP) 2/	24.1	23.7	22.5	20.7	19.6	19.0	19.3
General government expenditure (percent of GDP) 2/	28.2	26.3	25.1	23.3	22.5	21.7	21.8
General government balance (percent of GDP) 2/	-4.1	-2.7	-2.6	-2.6	-2.9	-2.7	-2.5
Public sector balance (percent of GDP) 2/	-6.0	-7.4	-7.7	-5.2	-5.0	-3.5	-3.0
Nominal GDP (in billions of ringgit)	1,019	1,106	1,158	1,230	1,352	1,467	1,584

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

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

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

Table 6. Malaysia: Monetary Survey, 2013–19 1/

	2013	2014	2015	2016	Est. 2017	Proj. 2018	2019
	(In billions of ringgit; end of period)						
Net foreign assets	337.4	326.0	359.7	361.2	362.4	406.0	445.7
Foreign assets	576.4	579.3	592.8	584.6	613.5	665.7	711.8
Foreign liabilities	239.0	253.3	233.1	223.4	251.1	259.8	266.1
Net domestic assets	1,100.9	1,200.2	1,213.7	1,254.2	1,355.9	1,431.7	1,537.3
Net domestic credit	1,384.1	1,521.8	1,640.9	1,749.9	1,875.9	1,988.9	2,103.8
Net credit to nonfinancial public sector	92.9	121.1	121.8	142.2	169.3	180.9	191.7
Net credit to central government	72.3	101.0	105.0	125.3	151.4	162.4	173.0
Net credit to state & local government	1.6	1.4	1.2	1.0	1.6	1.8	1.9
Net credit to nonfinancial corporations	19.0	18.8	15.6	15.9	16.3	16.7	16.7
Credit to private sector	1,221.3	1,334.1	1,448.9	1,525.2	1,622.1	1,716.3	1,813.1
Net credit to other financial corporations	69.8	66.5	70.2	82.5	84.6	91.8	99.1
Capital accounts	250.5	293.0	375.2	413.7	429.7	449.7	469.7
Other items (net)	-32.7	-28.7	-52.0	-81.9	-90.3	-107.5	-96.9
Broad money 2/	1,427.0	1,517.0	1,563.1	1,605.1	1,683.8	1,827.3	1,972.6
Narrow money	347.6	374.5	399.0	419.5	436.0	473.2	510.8
Currency in circulation	62.7	68.0	76.6	85.5	91.6	98.4	106.3
Transferable deposits	284.9	306.4	322.4	334.0	344.4	374.8	404.6
Other deposits	1,053.3	1,111.6	1,142.0	1,160.9	1,217.3	1,320.9	1,426.0
Securities other than shares	26.1	30.9	22.1	24.6	30.5	33.1	35.8
	(Contributions to 12-month growth in broad money, in percentage points)						
Net foreign assets	-0.8	-0.8	2.2	0.1	0.1	2.6	2.2
Net domestic assets	6.7	7.0	0.9	2.6	6.3	4.5	5.8
Memorandum items:							
Broad money (12-month percent change)	7.4	6.3	3.0	2.7	4.9	8.5	8.0
Currency in circulation (12-month percent change)	10.4	8.5	12.7	11.5	7.2	7.4	8.0
Credit to private sector (12-month percent change)	10.2	9.2	8.6	5.3	6.4	5.8	5.6
Money multiplier (broad money/narrow money)	4.1	4.1	3.9	3.8	3.9	3.9	3.9

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

Table 7. Malaysia: Banks' Financial Soundness Indicators, 2013–17

	2013	2014	2015	2016	2017 Q3
	(In percent; end of period)				
Capital adequacy					
Regulatory capital to risk-weighted assets	14.6	15.4	16.3	16.5	17.1
Regulatory Tier 1 capital to risk-weighted assets	13.1	13.4	13.9	14.0	14.1
Asset quality					
Nonperforming loans net of provisions to capital 1/	8.1	7.0	6.8	6.7	6.8
Nonperforming loans to total gross loans	1.8	1.6	1.6	1.6	1.7
Total provisions to nonperforming loans	99.6	95.5	88.8	84.6	84.6
Earnings and profitability					
Return on assets	1.5	1.5	1.2	1.3	1.4
Return on equity	15.8	15.0	12.3	12.3	12.8
Interest margin to gross income	59.6	61.0	61.8	61.0	62.7
Non-interest expenses to gross income	42.6	43.0	46.7	44.0	43.6
Liquidity					
Liquid assets to total assets (liquid asset ratio)	13.2	13.3	22.1	21.2	23.1
Liquid assets to short-term liabilities	41.0	43.2	141.8	134.5	143.3
Loan-deposit ratio 2/	84.8	86.8	88.7	89.8	88.7
Liquidity Coverage Ratio 3/	…	…	125.1	124.3	135.8
Sensitivity to market risk					
Net open position in foreign exchange to capital	13.8	13.2	12.5	13.1	11.3
Sectoral distribution of total loans to nonbanking sector					
Residents	97.2	96.9	96.9	97.3	97.0
Other financial corporations	2.8	2.8	3.1	3.4	3.2
General government	2.1	1.7	1.4	1.6	1.6
Nonfinancial corporations	36.9	36.8	36.9	36.7	36.5
Other domestic sectors	55.4	55.6	55.5	55.5	55.7
Nonresidents	2.8	3.1	3.1	2.7	3.0

Sources: Bank Negara Malaysia; and IMF, *Financial Soundness Indicators* database.

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

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

3/ Introduced in July 2015.

Appendix I. External Sector Assessment

	Malaysia	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Malaysia's net international investment position (NIIP), as a percent of GDP, averaged around 1¾ percent of GDP since 2010, rising in recent years mainly on valuation effects. In 2017Q3, the NIIP was at about 1.7 percent of GDP (2016: about 5¼ percent of GDP), consisting largely of official reserve assets, and net portfolio and other investment liabilities. Total external debt was at about 67¾ percent of GDP in 2017Q3 (2016: 69 percent of GDP), of which about two-thirds was in foreign currency and 44 percent in short-term debt. 1/ **Assessment**. The NIIP is expected to rise gradually over the medium term reflecting projected moderate current account (CA) surpluses. Malaysia's balance sheet strength along with exchange rate flexibility would help support resilience to a variety of shocks, including potential outflows associated with external liabilities. 2/	**Overall Assessment** *The external position in 2017 is assessed to remain stronger than the level consistent with fundamentals and medium-term desirable policies*. The current account surplus in 2017, as a ratio to GDP, is estimated to be slightly higher than a year ago, following recovery in external demand and improvement in terms of trade. **Potential Policy Responses** Over the past few years Malaysia's growth model has become increasingly driven by domestic demand, and its current account surplus and current account gap have narrowed significantly. Going forward, macroeconomic policy adjustments, including exchange rate flexibility, and structural policies should address the existing policy gaps. The planned fiscal consolidation should be accompanied by further improvements in social protection and higher public healthcare spending. At the same time, addressing the structural bottlenecks (for example, labor market frictions in terms of skills mismatch; low female participation; and weak education quality) and further improving the physical infrastructure will help support a rise in private investment and productivity, helping with rebalancing.
Current account	**Background**. Malaysia's CA surplus has declined by about 7½ percentage points of GDP between 2010 and 2016, driven mainly by a decline in national saving, while investment also rose. In the first three quarters of 2017, the CA surplus, as a share of GDP, was higher at 2.8 percent relative to a year ago. Surpluses in goods balance are the main contributor to Malaysia's overall CA surplus. Services and income accounts are in deficits. In 2017, the CA surplus is estimated at 2.8 percent of GDP, with a recovery in exports partly offset by stronger imports owing to a resilient domestic demand. **Assessment**. The EBA CA model implies a 2017 CA norm at 1.2 percent of GDP after cyclical and multilateral consistency adjustments. The 2017 cyclically-adjusted CA is estimated at about 3.6 percent of GDP, including staff adjustments of 0.1 percent of GDP to cyclical factors arising from changes in the share of commodity exports in Malaysia's total exports. This leads to a staff estimated 2017 CA gap of 2.4 percent of GDP (±1.2 percent of GDP), close to 2.3 percent of GDP 2016 CA gap reported in the July 2017 External Sector Report. The identified policy gaps account for two-fifths of this CA gap, most of which are from external sources. 3/	
Real exchange rate	**Background**. As of November 2017, year-to-date average real effective exchange rate (REER) was depreciated by nearly 2 percent relative to its 2016 annual average. However, it had appreciated nearly 4 percent since August 2017. The REER remains depreciated by about 14 percent from its 2013 level, reflecting impact on the NEER from capital outflows and terms of trade shocks, with the latter contributing to a decline in the CA surplus. 4/ **Assessment**. The EBA REER models (index and level based) estimate Malaysia's REER to be about 28–37 percent below what is warranted by fundamentals and desirable policies. However, the usual macroeconomic stresses associated with such undervaluation are absent, for example, high core inflation, sustained wage pressure, or significant FX reserve build up. Consistent with the assessed CA gap, the REER gap for 2016 was close to -5 percent (± about 2½ percent). 5/	
Capital and financial accounts: flows and policy measures	**Background**. Since the Global Financial Crisis, Malaysia experienced significant capital flow volatilities, largely driven by portfolio flows in and out of the local-currency debt market. After the U.S. presidential election in November 2016, Malaysia experienced intensified portfolio outflows from the government debt market that continued through 2017Q1. These flows have returned since then. Since late 2016, the Financial Markets Committee and Bank Negara Malaysia have been implementing a series of measures aimed at developing the onshore FX market. 6/ **Assessment**. In line with the IMF's *Institutional View* on capital flows, exchange rate flexibility and macroeconomic policy adjustments should continue to play the central role in response to capital flow volatility.	
FX intervention and reserves level	**Background**. Foreign reserves stood at US$102.4 billion in 2017, an increase of nearly US$8 billion since end-2016. Malaysia faced significant reserve losses in 2014 and 2015, while in 2016 reserves declined slightly. **Assessment**. Under the IMF's composite reserve adequacy metric, which uses a binary classification of the exchange rate regime and classifies Malaysia's regime as "floating", official reserves, at about 118 percent of the metric, are currently within the adequacy range. Additionally, not all short-term external debt creates a claim on reserves. In case of disorderly market conditions reserves could be deployed. In the face of a capital inflow surge, a combination of further reserve accumulation and some exchange rate appreciation would be appropriate.	

	Malaysia (concluded)
Technical Background Notes	1/ The ratios to GDP are based on staff estimates using U.S. dollar values and may vary with the authorities' data mainly due to different exchange rate assumptions for converting the nominal GDP in U.S. dollar terms. As of 2017Q3, gross external assets were close to 132 percent of GDP. 2/ Close to one-third of external debt is denominated in local currency and largely of medium-term maturity, helping to reduce FX and rollover risks. Malaysia's local currency external debt reflects holdings of domestically-issued debt (mainly Malaysian Government Securities-MGS) by nonresident investors (about 12 percent of GDP as of 2017Q3). Short-term FX-denominated debt largely belongs to the banking system and a good portion is matched by short-term foreign currency assets, which is being closely supervised by Bank Negara Malaysia, including through frequent liquidity stress tests. Stress test analysis by staff suggests that the Malaysian economy could be resilient to a large reversal due to the depth of the domestic financial markets and the role of institutional investors. 3/ Preliminary assessment, given ongoing refinements to the IMF's EBA methodology and reliance on staff estimate of the 2017 CA balance. 4/ Since 2000, movements in the REER have been driven almost entirely by the nominal exchange rate rather than inflation differentials. 5/ The REER gap is based on the estimated semi-elasticity of CA to REER at –0.47. The elasticity estimate has been updated from the last assessment. It is based on cross-country estimates of exports and imports elasticities, obtained from the IMF's Consultative Group on Exchange Rates (CGER), and adjusted for updates to Malaysia's trade openness and share of commodity export 6/ On December 2, 2016, the Financial Markets Committee (FMC) announced a package of measures aimed at facilitating onshore FX risk management and enhancing the depth and liquidity of onshore financial markets. They include relaxing documentation requirements in onshore hedging market trading, conversion requirement for exporters, and extension of the prudential limits on outward investments for exporters. On April 13, 2017, additional liberalization measures on short-selling of government securities and onshore hedging activities were announced. In September and November 2017, additional measures were announced to help deepen the onshore financial market.

Appendix II. Staff Policy Advice from the 2016 and 2017 Article IV Consultations

Staff Advice	Policy Actions
Fiscal Policy	
Allow the fiscal stabilizers to work if the economy is weaker than expected (2016). Anchor fiscal policy to the medium-term consolidation objective, with the year-to-year pace of consolidation reflecting evolving economic conditions (2017)	The authorities promptly revised the 2016 federal budgets (in January 2016) in response to sharp declines in oil and gas prices. These timely actions have maintained the federal budget deficit ceiling close to original targets and were well received by markets and analysts. The 2018 budget is consistent with balancing growth and consolidation objectives.
Narrow the list of GST-exempt and zero-rated items. Increase GST rate (2016). Increase tax compliance through increased information sharing between agencies. Reduce the number of exempt and zero-rated items under the GST. Increase GST rate. Improve the international taxation framework to strengthen anti-avoidance rules (2017).	The authorities have not broadened the base of the GST since its introduction in April 2015, but seem open to do so in the future. They are planning a study on the effectiveness and costs of tax incentives.
Implement continuous expenditure reviews. Improve efficiency of public spending through better targeting of social spending, cost recovery in higher education, user fees for health care services, and limiting duplications in transport and tourism programs (2017).	Fuel and some other subsidies were removed starting in December 2014. The authorities have since increased the frequency of in their mechanism from monthly to weekly adjustment of fuel prices. Adjustments of toll, electricity, and other utility tariffs are ongoing.
Publish an annual statement of fiscal risk (2016). Enrich the recently introduced Medium Term Fiscal Framework with more detail (2017).	The authorities have formed a Fiscal and Financial Committee on Risks and Liabilities, but have not yet published a statement of risk. Their medium-term fiscal framework is still too broadly defined.
Monetary, Exchange Rate, and Financial Policies	
Tighten interest rates if signs emerge of second-round inflation pressures (2016). The current monetary policy is appropriate. Continue to carefully calibrate monetary policy to support growth while being mindful of financial conditions (2017).	In July 2016, the BNM cut the policy rate by 25 basis points to 3.0 percent, citing weaker global growth, the uncertain global environment, and receding risks from financial imbalances. The BNM has maintained its policy rate at 3.0 percent since July 2016 but appropriately signaled a bias towards reduced monetary policy accommodation in November 2017.
Given low level of reserves, a greater reliance of FX rate flexibility is recommended (2016). Use exchange rate flexibility as a key absorber of external shocks. Deploy reserves in the event of disorderly market conditions. Accumulate reserves during more normal market conditions. Review the December 2016 FX market measures, recognizing their costs and benefits (2017).	Over 2014–15, the exchange rate depreciated in the face of multiple external shocks while reserves were also deployed. Following the capital outflow pressures in late 2016 and early 2017, the exchange rate depreciated further. In the 12 months since November 2016, the Financial Markets Committee introduced measures to deepen domestic FX markets and bolster resilience to external shocks. Some of the measures however limited capital flows. The authorities notified the Fund of the change in their *de jure* exchange rate regime, effective September 2016, following which the *de facto* regime is currently classified as floating.
Provide liquidity through open market operations and/or further lower the statutory reserve requirement (2016). Closely monitor private sector vulnerabilities. Increase loss absorbing capacity of banks using Pillar II measures. Strengthen the investigative capacity of the Anti-Corruption commission in conjunction with enhanced use of AML/CFT tools (2017).	The authorities maintain macroprudential measures to curb household indebtedness and an enhanced framework for risk-based pricing of loans to deal with rising household indebtedness. The BNM is collecting granular data on household debt. These efforts have reduced risk from credit growth and increased the resilience of banks. Corporate borrowing in foreign currency is closely monitored to ensure borrowers are naturally or otherwise hedged.
Structural Policies	
Boost growth and productivity through implementation of structural reforms, including reforms of government-linked companies; liberalization of labor and product markets; and enhanced education and training (2014). Uphold high standards of governance and communication in public financial management (2016). Steadfast implementation of the domestic reform agenda will be necessary in realizing the long-term development objectives (2017).	Many of these recommendations also form part of the authorities' Economic Transformation Program and the Government Transformation Program. Some progress has been made on the strategic reform initiatives and the authorities' further plans to boost growth and improve governance are discussed in this Staff Report.
To achieve high income status, continue to: (i) prioritize infrastructure investment; (ii) further improve public financial management; (iii) boost spending on Research and Development; and (iv) improve the quality of education with a view to reducing skills mismatches and raising productivity (2016). To significantly boost long-term growth the authorities should: further raise female labor participation; improve the quality of education; lower skill mismatches, boost productivity growth by encouraging R&D; and uphold high standards of governance (2017).	In May 2015, the authorities unveiled their 11th Malaysia Plan (11MP), spanning 2016–20. The Plan continues the authorities' efforts to boost public capital through major infrastructure projects and seeks to promote home-grown innovation and a knowledge-based society through increased cooperation between government, education, and industry in harnessing research and development and raising the quality of human capital. In May 2017, the authorities launched the Malaysia Productivity Blueprint (MPB), which describes the strategy to reach productivity targets under the 11MP.
Maintain an economic system that is highly open to trade and investment. (2016). Facilitate trade integration and encourage foreign investment (2017).	Malaysia remains an open economy. The ASEAN Economic Community came into being at the start of 2016 following efforts of Malaysia during its ASEAN chairmanship in 2015. Malaysia is participating in the discussions on other multilateral trade agreements such as the CPTPP.

Appendix III. Risk Assessment Matrix 1/

Risks	Likelihood and Transmission	Expected Impact of Risk	Recommended Policy Responses
External			
Structurally weak growth in key advanced economies (Medium-term).	**High** Low productivity growth, a failure to fully address crisis legacies and undertake structural reforms, and persistently low inflation in some advanced economies may undermine medium-term growth in those economies.	**Medium** Prolonged weakness in external demand would likely dampen domestic demand, lowering growth, increasing unemployment, dampening housing and asset prices, weakening bank, corporate, and sovereign balance sheets, in a negative feedback loop.	The ability of macroeconomic policies to provide a long-lived cushion against a protracted slump is limited. Policymakers would need to adjust to slower medium-term growth although carefully selected infrastructure projects and structural reforms could increase productivity.
Significant slowdown in China and its spillovers (Short- to medium-term).	**Low/Medium** Efforts to rein in financial sector risks may expose vulnerabilities of indebted entities and reduce near-term growth. Overly ambitious growth targets may reduce fiscal space and further increase financial imbalances.	**Medium** The resulting weaker domestic demand in China would lower commodity prices, roil global financial markets, and reduce global growth, resulting in an external demand shock for Malaysia.	The exchange rate should be allowed to act as a key shock absorber, intervening only to prevent disorderly market condition. A more accommodative monetary policy stance could be appropriate, if risks of fueling financial imbalances are low.
Tighter global financial conditions. (Short-term).	**High** Fed normalization and tapering by ECB may increase global rates and term premia, strengthen the U.S. dollar and the euro vis-à-vis the other currencies, and correct market valuations.	**Medium** Higher debt service and refinancing risks could stress leveraged firms, households, and the sovereign, including through capital account pressures in some cases. Adjustments could be disruptive if there are policy surprises.	Monetary policy could tighten to avoid capital outflows. Liquidity support (including in FX) could be provided. If capital outflows threaten domestic activity, reserve requirements could be relaxed.
Policy uncertainty (Short- to medium-term).	**High** Two-sided risks to U.S. growth with difficult-to-predict policies; uncertainty associated with negotiating post-Brexit arrangements; and evolving political processes, including elections in several large advanced and emerging market economies may weigh on global growth.	**Medium** These developments could weigh on global growth and reduce the demand for Malaysian exports, with resulting slowdown of growth and emergence of vulnerabilities of financial and corporate sectors.	The exchange rate should be allowed to continue to act as a key shock absorber. In the absence of adequate automatic stabilizers, discretionary fiscal policy should only be deployed temporarily and if the shock is perceived as temporary.
Retreat from cross-border integration. (Short- to medium-term).	**High** A fraying consensus about the benefits of globalization could lead to protectionism and economic isolationism, leading to reduced global and regional policy collaboration with negative consequences for trade, capital and labor flows, sentiment, and growth.	**Low** With a highly open economy, Malaysia is vulnerable to measures aimed at curtailing global trade. The impact would be felt both directly and indirectly (via trading partner exposures). The ongoing negotiations on CPTPP may help mitigate these challenges.	The exchange rate should be allowed to continue to act as a key shock absorber. In the absence of adequate automatic stabilizers, discretionary fiscal policy should only be deployed temporarily and if the shock is perceived as temporary. New, high-standard regional trade agreements could help.
Lower energy prices (Short- to medium-term).	**Low** Production cuts by OPEC and other major producers may not materialize as agreed while other suppliers could increase production. Lower commodity prices could affect future investment activities, leading to lower potential growth.	**Low** Lower growth along with reduced oil revenues could stymie fiscal consolidation efforts. Further declines in commodity prices could also push Malaysia to a twin deficit and trigger an adverse feedback loop of higher interest costs and/or a run by foreign investors.	The exchange rate can provide the first line of defense. Fiscal reforms to reduce the reliance on oil revenues, such as broad-based taxes, are critical. Investment in infrastructure and other productivity-boosting structural reforms could further reduce reliance on the energy sector.
Domestic			
Fiscal risks from public debt and contingent liabilities (Short- to medium-term).	**Low** Realization of risks would have adverse consequences for the credibility of fiscal policies, raising the sovereign's financing cost.	**Medium/High** Higher financing costs for the sovereign; a relatively high public debt; and realization of contingent liabilities would exacerbate concerns about public debt sustainability and could lead to an adverse feedback loop of spikes in domestic interest rates and exit of foreign investors.	The authorities' ability to mount countercyclical responses would be boosted by medium-term fiscal consolidation. Continued progress in reforming fiscal institutions can mitigate the impact, including adopting a fiscal risks management framework and publication of an annual fiscal risks statement, along with increased transparency of GLC operations.
Sharp housing market price adjustment (Short- to medium-term).	**Low/Medium** A large and growing stock of unsold residential (especially in the luxury segment) and commercial properties may result in a sharp drop in real estate prices.	**Medium** Despite existing buffers, a large housing price adjustment could adversely affect real estate developers, with implications for downstream sectors and aggregate demand and may have implications for borrowers' ability to service loans across all sectors.	Vigilant micro- and macro-prudential oversight would be required to mitigate the risks and ensure financial stability. Specific measures could include risk weights and credit limits targeting construction sector, and measures encouraging developers to lease the unsold housing stock to prevent sizable price adjustments.

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

Appendix IV. Public Debt Sustainability Analysis

The public DSA suggests that Malaysia's public debt remains manageable at under 70 percent of GDP (with gross financing needs below 15 percent of GDP) under different macro-fiscal shocks.

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

2. Macro-fiscal assumptions. Growth is estimated at 5.8 percent in 2017, converging to 4.9 percent in the medium term. In staff's baseline projections, federal government deficit is reduced in the near term from 3.0 percent of GDP in 2017 to 1.5 percent in 2022. The projected fiscal consolidation is consistent with the authorities' targets and is supported by structural reforms announced in recent budgets. The projected consolidation is lower than what is expected under policy commitments.

3. Data coverage. Consistent with the data on government debt reported by the authorities, the fiscal assumptions in the DSA are based on the federal government budget. This coverage excludes local and state governments and statutory bodies which typically borrow from the federal government or receive explicit government guarantees. The liabilities of these entities are therefore captured in the federal government's gross debt and stock of loan guarantees.[1] Borrowing by state owned enterprises, which are in some cases under federal government guarantees, has increased in recent years and is projected to continue to increase in the medium term.

4. Choice of framework. Malaysia's high level of government debt and gross financing requirement calls for using the higher scrutiny framework. Government's gross debt increased sharply in 2009, reflecting sizable discretionary fiscal stimulus, declining real and nominal growth and a large fall in oil prices. Although growth has recovered since then, the primary deficit has remained high, pushing the debt to GDP ratio to about the authorities' debt ceiling of 55 percent. Gross financing needs (GFN) peaked at 10.2 percent of GDP in 2013 and are expected to fall and remain below 8 percent in the medium term.

5. Realism of baseline assumptions. The median forecast error for real GDP growth during 2008–16 is zero, suggesting that there is no evidence of a systemic projection bias that would undermine the assessment. The median forecast error for GDP deflator is -1.8 percent, suggesting that the staff forecasts have been more optimistic. The median forecast error for primary balance suggests that staff projections have been slightly optimistic (a forecast bias of –0.25 percent of GDP), but the forecast bias has improved in the later years.

---

[1] Gross debt of consolidated general government is not published by the authorities.

6. Cross-country experience suggests the projected fiscal adjustment is feasible. The maximum three-year adjustment in the cyclically-adjusted primary balance (CAPB) over the projection period (1.5 percent of GDP) is ambitious but realistic. As highlighted earlier, staff does not rule out the existence of implementation risks and therefore considering a no adjustment scenario, as done in this DSA, is necessary to take that into account. Finally, the maximum level of the primary balance (0.1 percent of GDP) that is assumed in the projections is reasonable when compared to the experience in other market-access countries.

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

- Under the baseline, the debt-to-GDP ratio is projected to decrease to below 45 percent by 2022, but if the projected consolidation does not take place, captured under the constant primary balance simulation, it remains broadly constant at about 50 percent of GDP. Under most macro-fiscal stress tests, debt-to-GDP ratio remains below 60 percent of GDP. If there is a one standard deviation shock to real GDP growth, the debt-to-GDP ratio initially increases about 2 percent by 2020 and declines thereafter. A similar path results in a combined macro-fiscal shock that includes higher interest rates and a lower primary balance and would keep debt at about 50 percent of GDP.

- A permanent oil price shock implies a growing debt-to-GDP profile to about 70 percent in the medium term. The oil price shock in analysis is very large. It assumes a 1 percent of GDP permanent reduction in the oil income. Such a shock would be commensurate with a 33 percent decline in oil price, with an amplifying effect that reduces oil companies' profits by 66 percent.

- A contingent liability shock, whereby the government would have to absorb all government guaranteed loans, totaling 15 percent of GDP, over two years, would increase risks significantly. This shock also includes a persistent shock to growth and interest rate increases. The debt-to-GDP ratio would rise above 55 percent of GDP. Although this is a low probability scenario, the simulations underscore the growing vulnerability posed by contingent liabilities.

- Gross financing needs under all scenarios remain below 10 percent, except for the oil shock scenario in which they grow to almost 15 percent by the end of the projection horizon.

- Stochastic simulations based on historical volatilities in Malaysia's macroeconomic variables also show that the 90th percentile of the debt-to-GDP simulations is below 60 percent.

8. Heat map. Despite the low share of foreign currency and short-term debt in public debt, Malaysia faces risks arising from its external financing requirement and relatively large share of public debt held by foreigners. At 39 percent, the external financing requirement is above the upper threshold of early warning benchmarks and the share of debt held by foreigners is relatively high at about 30 percent of total. As discussed earlier, the existence of large domestic institutional investors who tend to make opportunistic investments is a mitigating factor.

Figure 1. Malaysia: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(In percent of GDP unless otherwise indicated)

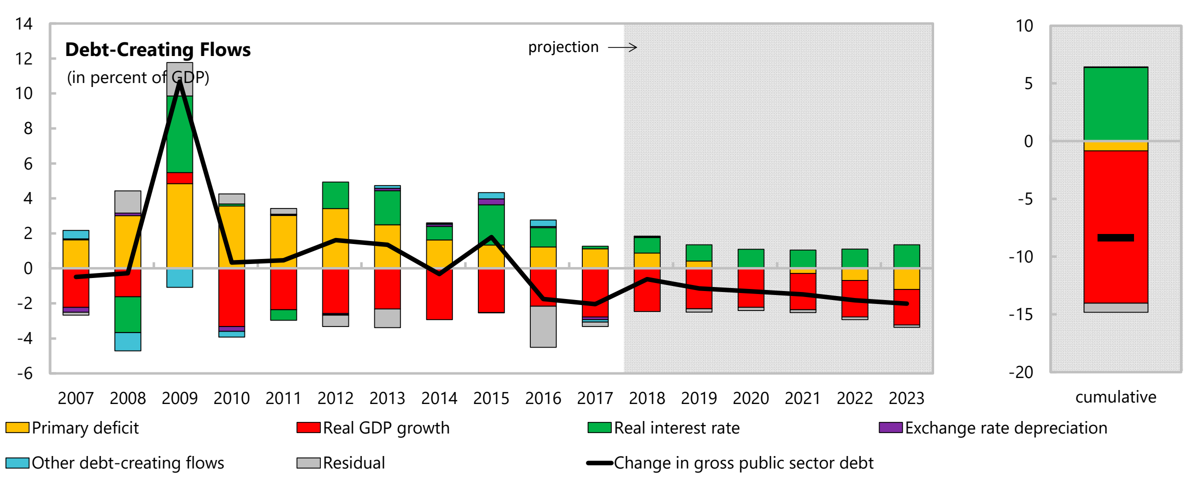
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2007-2015 [2/]	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	48.7	52.7	50.7	50.1	48.9	47.6	46.1	44.3	42.3
Public gross financing needs	9.5	9.9	10.7	7.7	7.0	7.0	7.1	7.1	7.0
Real GDP growth (in percent)	4.8	4.2	5.8	5.3	5.0	4.9	4.7	4.9	4.9
Inflation (GDP deflator, in percent)	2.4	2.0	3.9	3.1	2.8	2.5	2.7	2.6	2.4
Nominal GDP growth (in percent)	7.4	6.3	9.9	8.5	8.0	7.6	7.6	7.6	7.4
Effective interest rate (in percent) [4/]	4.5	4.2	4.5	5.1	5.0	5.0	5.2	5.3	5.8

As of January 02, 2018		
Sovereign Spreads		
EMBIG (bp) 3/		122
5Y CDS (bp)		59
Ratings	Foreign	Local
Moody's	A1	A3
S&Ps	A-	A
Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.7	-1.7	-2.0	-0.6	-1.1	-1.3	-1.5	-1.8	-2.0	-8.4	
Identified debt-creating flows	1.4	0.6	-1.8	-0.7	-0.9	-1.1	-1.3	-1.7	-1.9	-7.6	
Primary deficit	2.8	1.2	1.1	0.9	0.4	0.0	-0.3	-0.7	-1.2	-0.8	-0.7
Primary (noninterest) revenue and grants	19.8	17.0	16.5	16.3	16.4	16.5	16.5	16.5	16.6	98.8	
Primary (noninterest) expenditure	22.6	18.2	17.6	17.2	16.8	16.5	16.2	15.8	15.4	97.9	
Automatic debt dynamics [5/]	-1.2	-1.0	-2.8	-1.6	-1.4	-1.2	-1.0	-1.0	-0.7	-6.8	
Interest rate/growth differential [6/]	-1.2	-1.1	-2.6	-1.6	-1.4	-1.2	-1.0	-1.0	-0.7	-6.8	
Of which: real interest rate	0.9	1.1	0.2	0.9	0.9	1.1	1.0	1.1	1.4	6.4	
Of which: real GDP growth	-2.1	-2.2	-2.8	-2.5	-2.3	-2.2	-2.1	-2.1	-2.0	-13.2	
Exchange rate depreciation [7/]	0.0	0.1	-0.2	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.2	0.4	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (1) (e.g., drawdown of dep	-0.5	-0.1	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroare	0.4	0.5	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.2	-2.4	-0.2	0.0	-0.2	-0.2	-0.2	-0.2	-0.1	-0.8	



Source: IMF staff.

1/ Public sector is defined as the Federal Government.

2/ Based on available data.

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

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

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

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

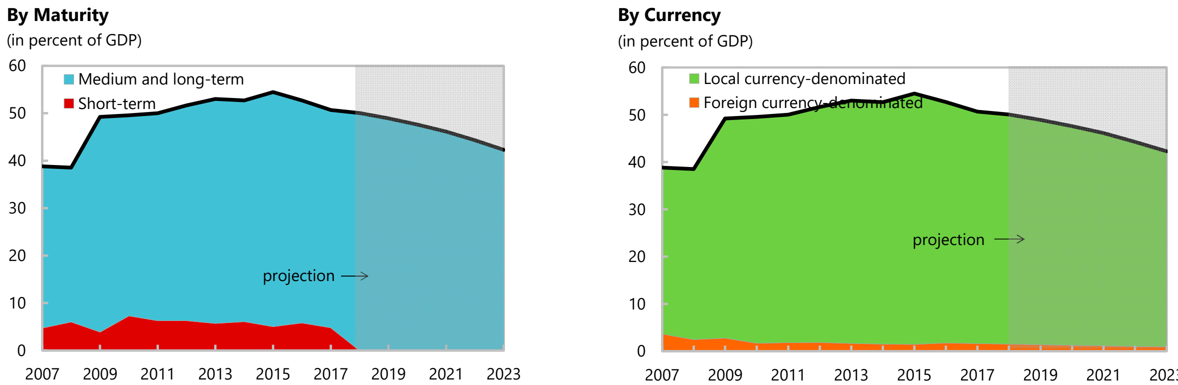
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

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

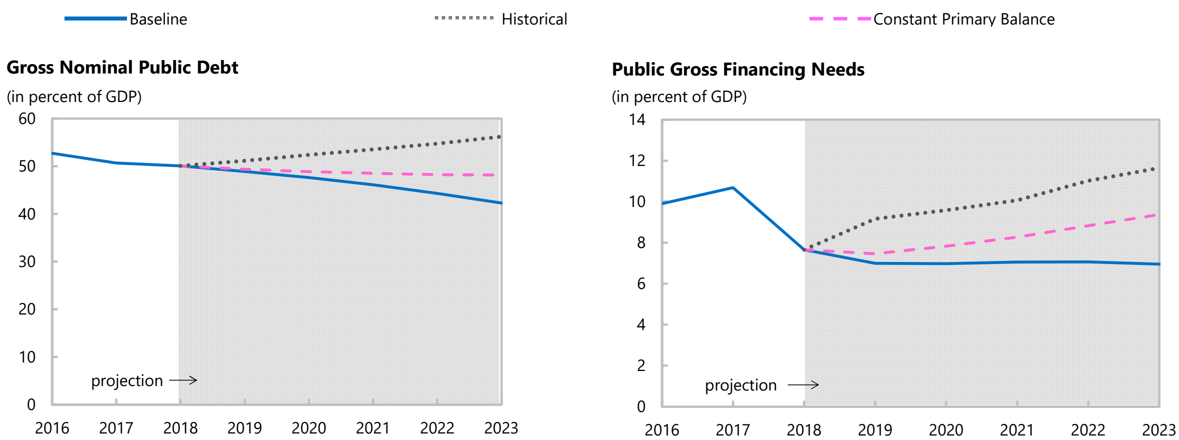
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 2. Malaysia: Public DSA—Composition of Public Public Debt and Alternative Scenarios

Composition of Public Debt



Alternative Scenarios



Underlying Assumptions

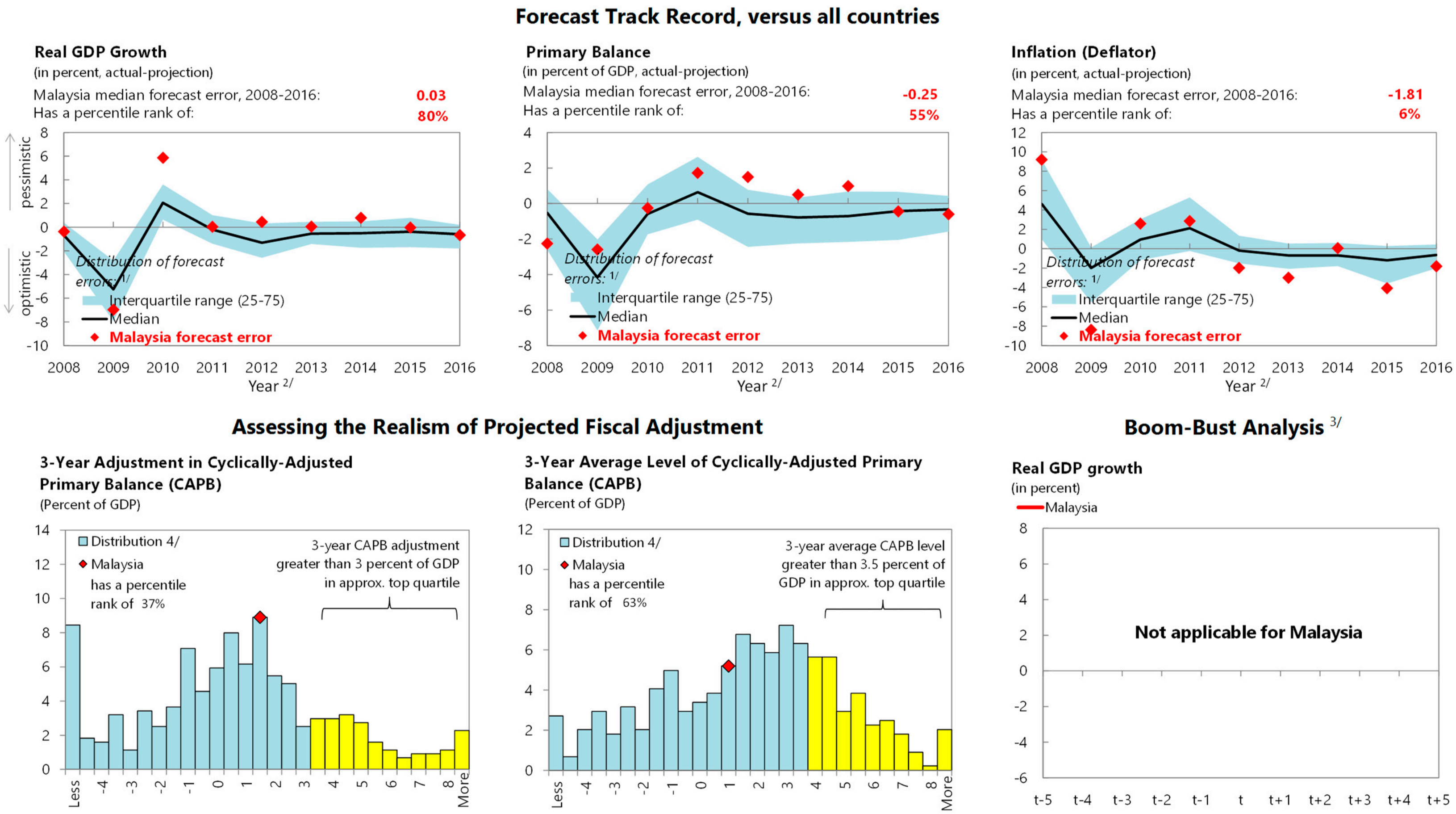
(in percent)

Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	5.3	5.0	4.9	4.7	4.9	4.9
Inflation	3.1	2.8	2.5	2.7	2.6	2.4
Primary Balance	-0.9	-0.4	0.0	0.3	0.7	1.2
Effective interest rate	5.1	5.0	5.0	5.2	5.3	5.8
Constant Primary Balance Scenario						
Real GDP growth	5.3	5.0	4.9	4.7	4.9	4.9
Inflation	3.1	2.8	2.5	2.7	2.6	2.4
Primary Balance	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Effective interest rate	5.1	5.0	5.0	5.2	5.3	5.7

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	5.3	4.7	4.7	4.7	4.7	4.7
Inflation	3.1	2.8	2.5	2.7	2.6	2.4
Primary Balance	-0.9	-2.6	-2.6	-2.6	-2.6	-2.6
Effective interest rate	5.1	5.0	4.9	5.0	5.1	5.4

Source: IMF staff.

Figure 3. Malaysia: Public DSA—Realism of Baseline Assumptions 1/



Source : IMF Staff.

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

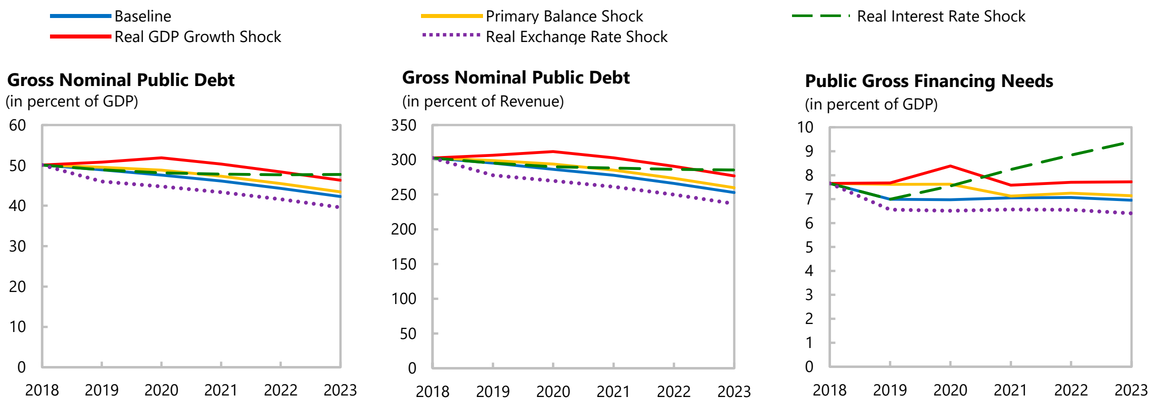
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Malaysia, as it meets neither the positive output gap criterion nor the private credit growth criterion.

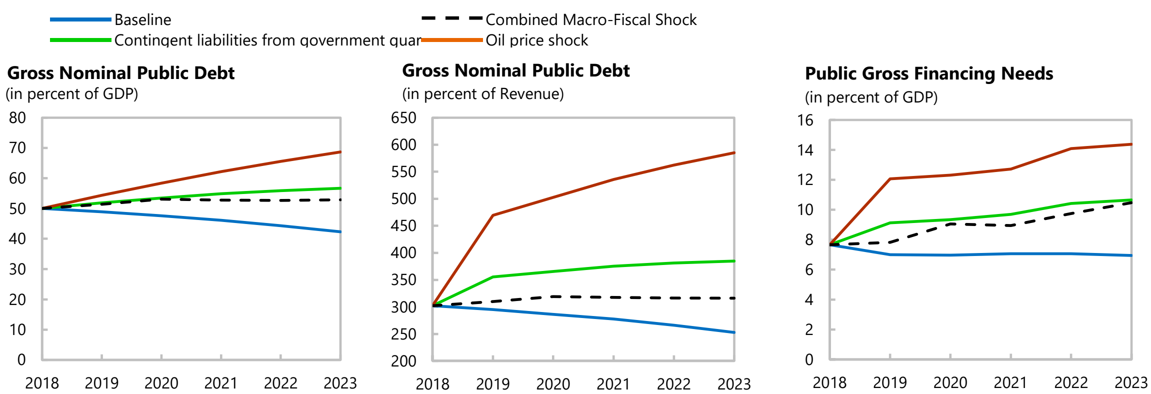
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 4. Malaysia: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	5.3	5.0	4.9	4.7	4.9	4.9
Inflation	3.1	2.8	2.5	2.7	2.6	2.4
Primary balance	-0.9	-1.0	-0.7	0.3	0.7	1.2
Effective interest rate	5.1	5.0	5.0	5.2	5.4	5.8
Real Interest Rate Shock						
Real GDP growth	5.3	5.0	4.9	4.7	4.9	4.9
Inflation	3.1	2.8	2.5	2.7	2.6	2.4
Primary balance	-0.9	-0.4	0.0	0.3	0.7	1.2
Effective interest rate	5.1	5.0	6.2	7.8	9.1	10.6
Combined Shock						
Real GDP growth	5.3	2.6	2.5	4.7	4.9	4.9
Inflation	3.1	2.2	1.9	2.7	2.6	2.4
Primary balance	-0.9	-1.0	-1.0	0.3	0.7	1.2
Effective interest rate	5.1	5.0	6.3	7.9	9.2	10.6

Real GDP Growth Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	5.3	2.6	2.5	4.7	4.9	4.9
Inflation	3.1	2.2	1.9	2.7	2.6	2.4
Primary balance	-0.9	-0.9	-1.0	0.3	0.7	1.2
Effective interest rate	5.1	5.0	5.0	5.3	5.4	5.8
Real Exchange Rate Shock						
Real GDP growth	5.3	5.0	4.9	4.7	4.9	4.9
Inflation	3.1	10.3	2.5	2.7	2.6	2.4
Primary balance	-0.9	-0.4	0.0	0.3	0.7	1.2
Effective interest rate	5.1	5.0	5.0	5.2	5.3	5.7

Source: IMF staff.

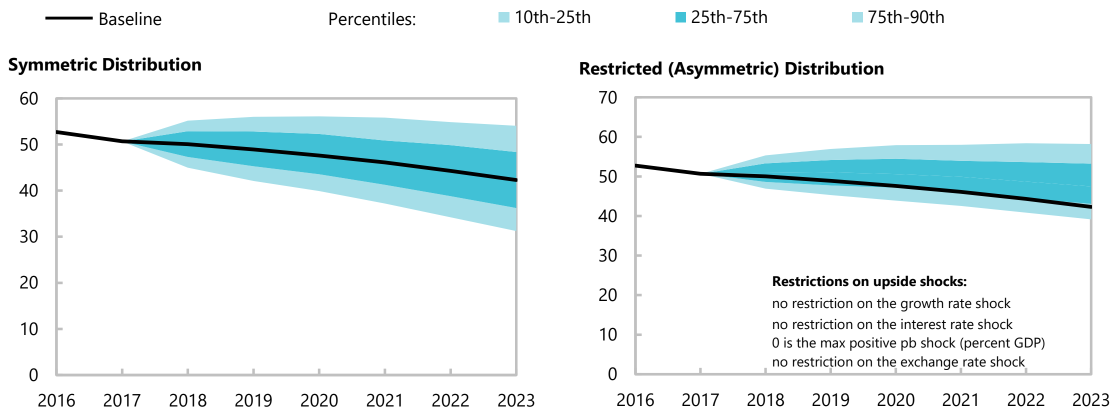
Figure 5. Malaysia: Public DSA Risk Assessment

Heat Map

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

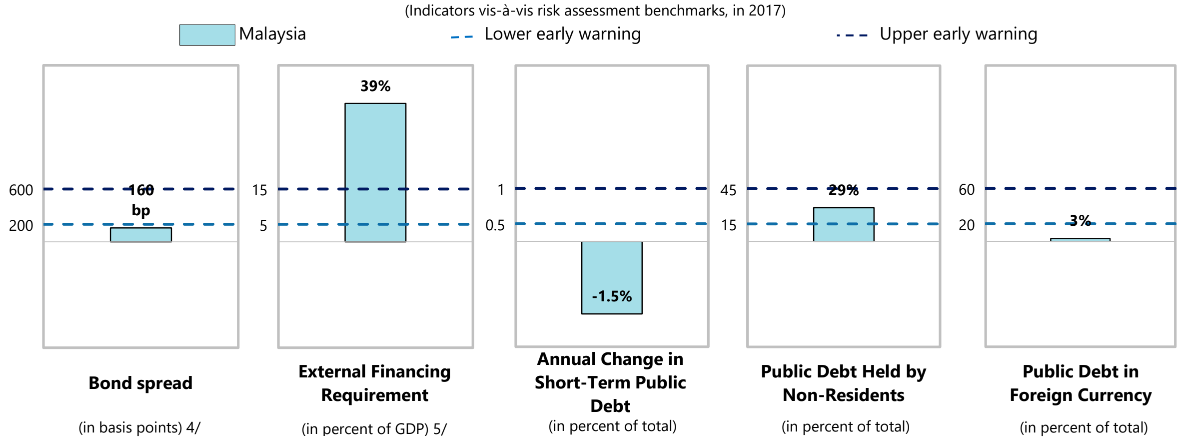
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



Source: IMF staff.

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

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

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

Lower and upper risk-assessment benchmarks are:

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

4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 04-Oct-17 through 02-Jan-18.

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

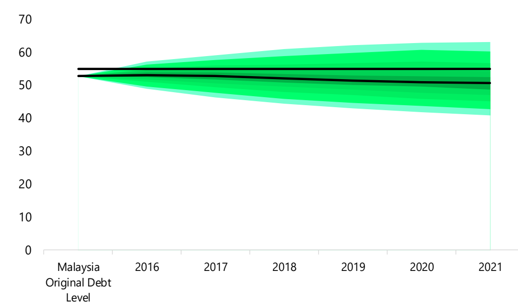
Appendix V. Calibration of Fiscal Objectives

1. **The analysis in the Appendix illustrates the implications of the debt limit for the conduct of fiscal policy.** It finds that, under unchanged policies, maintaining public debt below the policy objective over time would require a significant reduction in today's debt-to-GDP ratio. Otherwise, the policy response to shocks may be more restricted than in the past. The debt reduction can be achieved with a low deficit sustained over the long term.

2. **Fiscal deficit reduction is driving Malaysian debt down consistently.** As shown in the Debt Sustainability Analysis (DSA) in Appendix IV, the Federal Government Debt is expected to fall to less than 45 percent of GDP by 2022. The debt is expected to fall in the baseline and under a variety of shocks. Even under the most severe shocks the projected levels are sustainable.

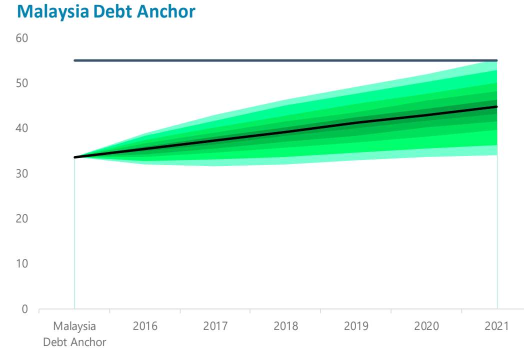
3. **Fiscal policy is currently anchored by debt and deficit targets.** The Malaysian authorities of Malaysia are conducting fiscal policy with an objective of achieving a near balance over the medium term. This objective has been the driver of the continuous fiscal deficit reduction over the past several years. Together with this objective, the ceiling of 55 percent of GDP for federal government debt,[1] has been a major anchor of the fiscal policy.

Malaysia Original Debt Level



Source: IMF staff calculations.

Malaysia Debt Anchor



Source: IMF staff calculations.

4. **Staff analysis show that, under unchanged policies, macroeconomic shocks can drive the overall level of debt above the ceiling.** A calibration of the level of debt based on the distribution of macroeconomic and policy shocks observed in Malaysia in the last two decades show that at the current level of debt, there is a 25 percent of probability that the debt level will exceed the ceiling of 55 percent of GDP.[2] These probabilities express the past behavior of the fiscal deficit. In future shocks, and given the current level of debt and policy commitments, the authorities may choose to respond to shocks differently than in the past, which means adjusting fiscal policy,

---

[1] There is a legal ceiling of 55 percent of GDP for securities, that is, Malaysian Government Securities (MGS), Malaysian Government Investment Issue (MGII), and Malaysian Islamic Treasury Bills (MITB). In addition, there are ceilings for external debt at 35 billion ringgit and Treasury Bills at 10 billion ringgits. The authorities have conveyed their policy of aiming at having overall federal government debt below 55 percent of GDP.

[2] The analysis follows the methodology presented in "How to Calibrate Fiscal Rules: A Primer" by FAD. This stochastic analysis estimates a multivariate normal distribution of the variables involved in a debt accumulation equation. It complements the DSA, which is based on the baseline debt projections and deterministic shocks applied to the baseline.

following their current policy commitments and preserving debt below the ceiling. Indeed, the analysis is showing that at current debt levels, unless the authorities decide to react differently to shocks than in the past, there is a 25 percent probability that the debt would breach the ceiling.

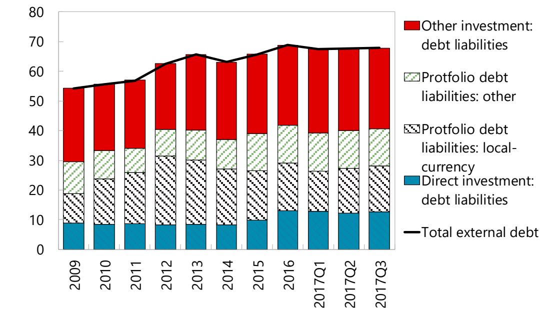
5. A level of debt lower than projected for the medium term would be consistent with the current ceiling and past policy reactions. According to the calibration done by staff, under unchanged policies, a debt level of 34 percent of GDP would allow the overall debt to remain under the ceiling of 55 percent of GDP with 95 percent probability. Such a level would allow reaction to shocks in the same way as in the last two decades without imposing additional restrictions to policymaking.

6. Gradual fiscal consolidation would be an alternative and more prudent way to raise gradually the probability of maintaining the debt-to-GDP ratio under the 55 percent ceiling. Debt has been falling at current deficit levels and is expected to fall, under staff's baseline projections for the medium term, to 45 percent of GDP as the deficit is expected to fall to 1.5 percent of GDP. Alternative consolidation paths could also be appropriate depending on the macroeconomic circumstances.

Appendix VI. External Debt Sustainability Analysis

1. **A surge in portfolio debt flows after the Global Financial Crisis contributed to most of the increase in Malaysia's external debt in the last eight years.** Since 2009, Malaysia's external debt-to-GDP ratio has trended upward, rising by 13½ percentage points of GDP by 2017Q3. As of end-September 2017, Malaysia's external debt stood at about 67¾ percent of GDP (2009: 54¼ percent of GDP). A little more than one-half of this increase was due to the rise in portfolio debt liabilities, particularly nonresident investment in Malaysia's local-currency debt market. Most of this increase took place between 2009 and 2013 on the back of a surge in capital inflows. While portfolio debt liabilities, as a share of GDP, have declined since then, reflecting the capital outflows Malaysia experienced in subsequent years, increases in other debt liabilities contributed to an increase in the overall debt ratio.

Malaysia: External Debt
(In percent of GDP; based on U.S. dollar values)



Sources: Bank Negara Malaysia; and IMF staff calculations.

2. **More recently, the external debt-to-GDP ratio has declined from its peak in 2016Q2.**

- As of 2017Q3, the external debt-to-GDP ratio was lower by 4¼ percentage points from its level a year ago, largely reflecting the portfolio debt outflows that occurred during 2016Q4 and 2017Q1, and valuation effects.
- While the stock of nonresidents' portfolio debt investment has gone up from its low in 2017Q1, lower net offshore borrowing has helped reduce the overall debt ratio relative to end-2016.
- The share of short-term debt has increased in the last three quarters, but remains below its peak in 2014. The recent rise in short-term external debt is primarily associated with higher nonresident deposits with banks and other short-term borrowings, including trade credit. As of September 2017, short-term debt accounted for about 44 percent of total external debt.

Malaysia: Profile of External Debt
(In percent of GDP, unless otherwise mentioned; by original maturity; end of period)

	2014	2015	2016	2017Q3
Total external debt (staff estimate) 1/	63.1	65.8	68.9	67.8
Medium- and long-term	32.4	38.1	40.5	38.0
Offshore borrowing	17.8	22.7	24.3	22.6
Public sector	7.9	10.1	10.1	9.7
Federal government	1.4	1.7	1.6	1.3
Public enterprises	6.4	8.4	8.5	8.4
Private sector	9.9	12.6	14.2	12.9
Banks	3.1	4.0	4.0	3.1
Nonbanks	6.8	8.7	10.3	9.8
Nonresident holdings of ringgit-denominated debt instruments	13.7	14.5	15.3	14.3
Government securities	12.8	13.6	14.3	13.6
Other securities	1.0	0.9	1.0	0.7
Other	0.9	0.9	0.9	1.0
Short-term	*30.7*	*27.7*	*28.3*	*29.8*
Offshore borrowing	14.3	14.0	15.6	15.8
Public sector	0.0	0.0	0.0	0.0
Private sector	14.3	14.0	15.6	15.8
Banks	12.6	12.7	12.9	12.9
Nonbanks	1.7	1.3	2.8	2.9
Nonresident holdings of ringgit-denominated debt instruments	5.1	2.1	0.8	1.2
Government securities	0.0	0.3	0.1	0.2
Other securities	5.1	1.9	0.7	1.0
Nonresident deposits	6.6	6.4	6.5	7.0
Other	4.7	5.1	5.4	5.7
Memorandum items:				
Total external debt (authorities)	67.5	72.1	74.5	65.0
Total external debt (authorities; billions of U.S. dollars)	211.8	192.2	202.3	204.7
Total external debt (staff estimate; billions of U.S. dollars)	213.4	195.0	204.2	207.0
Share of short-term debt (in percent of total external debt)	48.7	42.0	41.2	44.0

Sources: Bank Negara Malaysia; and IMF staff calculations.

1/ Used for the purpose of the Debt Sustainability Analysis and based on staff's estimate of external debt and nominal GDP in U.S. dollar. Authorities' data are in ringgit terms. Difference with the authorities' debt-to-GDP ratio is mainly on account of the exchange rate assumption for nominal GDP in U.S. dollar.

- Debt denominated in domestic currency accounted for about one-third of total external debt as of 2017Q3, reflecting significant presence of nonresident investors in Malaysia's local-currency bond market.

- Malaysia's net international assets were about 1¾ percent of GDP as of 2017Q3, as compared to 5¼ percent of GDP in end-2016, This decline in net international assets reflects changes in direct investment and portfolio investment positions, which are partly offset by an increase in reserve assets, and valuation effects.

3. Over the medium term, the external debt-to-GDP ratio is expected to decline steadily, falling to about 54 percent by 2022. Under staff's baseline scenario, this path reflects continued current account (CA) surplus (excluding interest payments). Relative to the previous Article IV consultation, staff's baseline macroeconomic assumptions have been revised to reflect stronger external demand and its spillover onto overall economic growth in the near term. The share of short-term debt, by original maturity, is assumed to gradually decline to about one-third of total external debt by the end of the projection period.

Malaysia: Comparison of Selected Medium-Term Macroeconomic Projections 1/

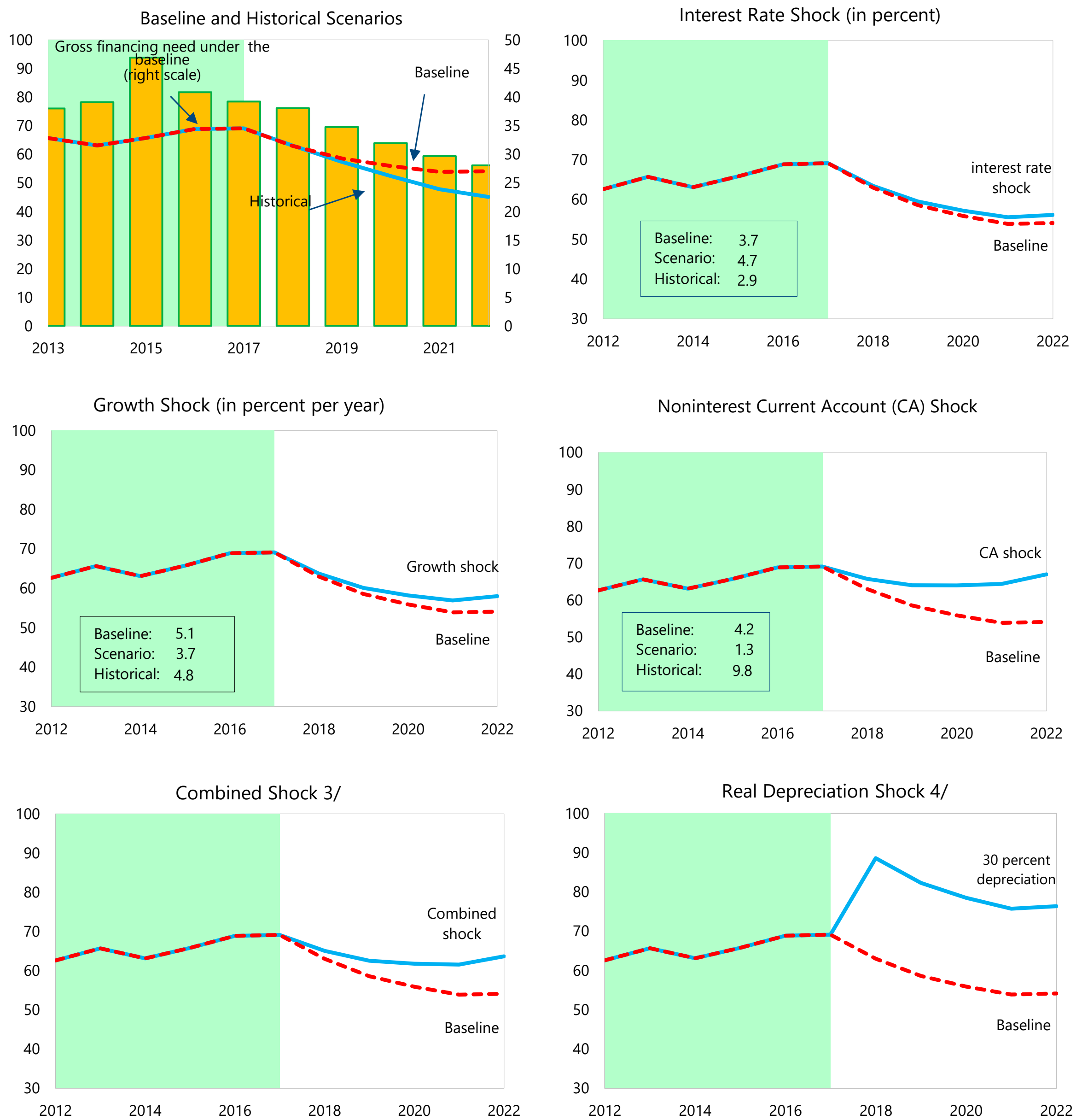
	2017 Article IV	2018 Article IV
Real GDP growth (in percent)	4.8	5.1
GDP deflator in U.S. dollars (change in percent)	3.7	4.0
Nominal external interest rate (in percent)	4.0	3.7
Growth of exports (U.S. dollar terms, in percent)	4.6	6.5
Growth of imports (U.S. dollar terms, in percent)	4.4	6.6
Current account balance, excluding interest payments (in percent of GDP)	4.1	4.3
Net nondebt creating captial inflows (in percent of GDP)	0.2	0.0

Source: IMF staff estimates.
1/ Covers the five-year periods of 2017-21.

4. Standard stress tests under the external DSA indicate that external debt would remain manageable under a variety of shocks. Under most of these scenarios, the external debt-to-GDP ratio rises above the baseline over the projection period by only modest margins. However, in the case of the one-time real exchange rate depreciation scenario, the debt ratio would rise sharply to close to 90 percent of GDP on impact, although it would subsequently fall to about 77 percent of GDP by 2022. Risks from a sharp exchange rate depreciation is partly mitigated by the fact that about one-third of total external debt is denominated in local currency, as indicated above. Also, banks' foreign currency debt is subject to prudential measures and intercompany FX loans are usually available on concessional terms. If the CA balance (excluding interest payments) is permanently lower or the economy is impacted by a combined interest rate, growth, and current account shock, the external debt-to-GDP ratio would remain between 56 and 67 percent over the medium term.

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

(In percent of GDP)



Sources: Data provided by the authorities; and IMFstaff 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 2017.

Table 1. Malaysia: External Debt Sustainability Framework, 2013–22

(In percent of GDP, unless otherwise indicated)

	Actual						Est.	Proj.					
	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022	Debt-stabilizing non-interest current account 1/
Baseline: external debt 2/	65.7	63.1	65.8	68.9			69.1	63.0	58.6	55.9	53.9	54.1	-1.5
Change in external debt	3.1	-2.6	2.7	3.1			0.2	-6.1	-4.4	-2.7	-2.0	0.2	
Identified external debt-creating flows (4+8+9)	-4.6	-6.6	2.4	-4.4			-8.2	-5.7	-4.8	-4.3	-3.8	-3.7	
Current account deficit, excluding interest payments	-4.6	-5.5	-4.2	-3.6			-4.7	-4.4	-4.5	-4.1	-3.8	-3.7	
Deficit in balance of goods and services	-8.5	-9.3	-7.7	-6.7			-7.1	-6.5	-6.2	-5.9	-5.7	-5.6	
Exports	75.6	73.8	70.6	67.7			71.3	67.1	64.2	61.7	59.3	56.8	
Imports	67.1	64.5	62.9	61.0			64.2	60.6	58.0	55.8	53.6	51.2	
Net nondebt creating capital inflows (negative)	1.0	1.5	0.2	-1.0			-0.9	-0.1	0.2	0.1	0.4	0.6	
Automatic debt dynamics 3/	-1.1	-2.5	6.5	0.2			-2.6	-1.2	-0.5	-0.3	-0.5	-0.5	
Contribution from nominal interest rate	1.1	1.1	1.2	1.3			1.8	2.0	2.3	2.3	2.0	1.9	
Contribution from real GDP growth	-2.9	-3.8	-3.6	-2.8			-3.7	-3.3	-2.8	-2.6	-2.4	-2.4	
Contribution from price and exchange rate changes 4/	0.7	0.1	8.9	1.8			-0.7	...	...	...	...	...	
Residual, including change in gross foreign assets (2−3) 5/	7.7	4.0	0.2	7.5			8.4	-0.4	0.4	1.7	1.8	3.9	
External debt-to-exports ratio (in percent)	86.8	85.5	93.2	101.8			97.0	93.9	91.2	90.6	90.9	95.3	
Gross external financing need (in billions of U.S. dollars) 6/	122.9	132.2	139.0	121.2			123.3	133.7	135.0	135.7	137.7	140.8	
In percent of GDP	38.0	39.1	46.9	40.9			39.2	38.1	34.8	32.0	29.7	28.1	
Scenario with key variables at their historical averages 7/								63.0	57.4	52.4	47.8	45.1	0.8
Key macroeconomic assumptions underlying baseline					10-Year Historical Average	10-Year Standard Deviation							
Real GDP growth (in percent)	4.7	6.0	5.0	4.2	4.8	2.4	5.8	5.3	5.0	4.9	4.7	4.9	
GDP deflator in U.S. dollars (change in percent)	-1.8	-1.4	-16.5	-4.0	1.6	10.7	0.2	6.1	5.4	4.2	4.2	3.2	
Nominal external interest rate (in percent)	1.8	1.8	1.6	1.9	2.9	1.6	2.8	3.3	4.1	4.3	3.8	3.8	
Growth of exports (U.S. dollar terms, in percent)	-2.0	2.0	-16.1	-4.1	1.7	13.1	11.6	5.1	5.9	5.1	4.9	3.6	
Growth of imports (U.S. dollar terms, in percent)	0.6	0.6	-14.4	-3.1	2.9	13.5	11.6	5.4	5.8	5.2	4.8	3.4	
Current account balance, excluding interest payments	4.6	5.5	4.2	3.6	9.8	5.6	4.7	4.4	4.5	4.1	3.8	3.7	
Net nondebt creating capital inflows	-1.0	-1.5	-0.2	1.0	-2.3	2.4	0.9	0.1	-0.2	-0.1	-0.4	-0.6	

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

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

2/ Staff estimates and projections. Malaysia has made a methodological change about external debt statistics. The new methodology statistics begin in 2009.

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

4/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

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

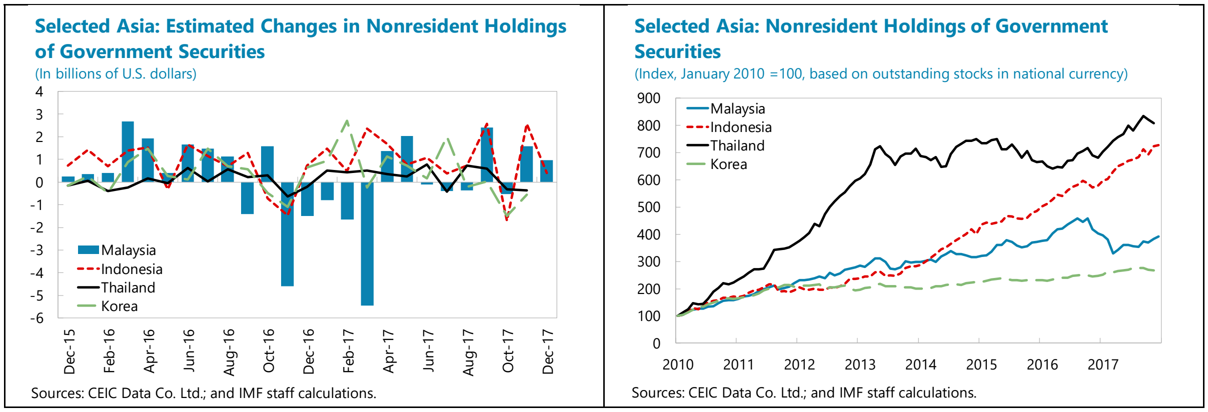
6/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

Appendix VII. Determinants of Nonresident Bond Flows[1]

1. Well-functioning public debt markets generally provide more stable budget financing and contribute to financial deepening and economic development. In Malaysia, nonresident flows into the Malaysian government securities (MGS) market may have lowered the cost and smoothed the cyclicality of funding. Nonresident (NR) holdings of MGS exceeded 50 percent in 2016, often associated with sizable underlying gross flows (Figure 1). The analysis in this Appendix attempts to answer the following two questions: (1) What is driving the nonresident flows into Malaysia's MGS market? and (2) Do these flows contribute to the volatility of the FX market?

Figure 1. Nonresident Investments in Government Securities in Select Asian Countries



2. To answer Question 1, we estimated a model based on the following (unobserved) supply and demand functions for bonds:

Supply: $$bondi_t = \alpha_0 - \alpha_1 dMGS_t + \alpha_2 D_t + \alpha_3 Controls_t + \varepsilon_t \qquad (1)$$

Demand: $$dMGS_t = \beta_0 + \beta_1 bondi_t - \beta_2 VIX_t + \beta_3 Controls_t + \nu_t \qquad (2)$$

Where variables are defined as follows:

bondi	Nominal yield on 1-year MGS (annualized);
D	General government budget deficit (percent of GDP);
dMGS	Net change in NR position in MGS market (percent of GDP);
VIX	Global stock market volatility index.

Fiscal policy (D) is determined independently of the financing choices (therefore it is exogenous) and, together with the nonresident flows, influences bond yields. Similarly, VIX is a variable exogenous to the MGS market but along with bond yields determines the appetite of nonresident investors for MGS. Substituting (2) into (1) results in the reduced form equation containing (on the right-hand side) all exogenous and control variables:

[1] Based on a forthcoming IMF Working Paper.

$$bondi_t = k_0 - k_1 VIX_t + k_2 D_t + k_3 Controls_t + \omega_t \quad (3)$$

3. Since both equations are identified (due to the presence of at least one exogenous variable in each), a Two-Stage Least Squares approach (2SLS) was chosen for estimation, augmented for autocorrelation (see below). In the first stage, *bondi* is regressed on *all* exogenous variables and controls. In the second stage, *dMGS* is regressed on the fitted value of *bondi* (i.e., *bondihat*) from the first stage and *own* exogenous variables and controls.

4. For the purpose of estimation, five control variables were added to the regressions: (i) the nominal yield on 1-year US treasury bonds, annualized (usrate); (ii) the consumer price inflation, annualized (inflation); (iii) the general government debt, in percent of GDP (Debt); (iv) the depreciation of the ringgit/US$ exchange rate, log of ratio (depreciation); and (v) the standard deviation of daily ringgit/US$ exchange rates within each quarter (stdevfx). Finally, the following dummy variables were added: (i) PostGFCdummy, for the Global Financial Crisis; (ii) TtantrumDummy, for Taper Tantrum; and (iii) PostMeasuresDummy, for the December 2016 FX market measures. Quarterly series (for 2005Q1–2017Q2) were used in the estimation to minimize the potential effect of the debt issuance calendar on nonresident flows. After testing for (and finding strong evidence of) autocorrelation, we estimated the equation using Prais–Winsten transformation (a GLS method) to account for serially correlated errors. Results are reported in Table 1.

Table 1. 2SLS Regression Results

	Dependent variable:			
	Bondi (1st Stage)		Nonresident flows (2nd Stage)	
	Coef.	t-stat.	Coef.	t-stat.
Bondihat			0.05^	1.58
Debt	0.22***	3.72		
Deficit	-0.01	-0.79		
USrate	0.15***	2.61		
Inflation	0.058**	2.20	-0.016*	-1.96
VIX	0.00002	0.05	-0.002*	-1.85
StdevFX	-1.66	-1.45	-0.86*	-1.90
Depreciation			-1.53***	-4.17
PostGFCDummy	0.42**	2.04	1.12***	4.17
TtantrumDummy	0.072	0.50	-0.11**	-2.02
PostMeasuresDummy	0.3	1.46	-0.23***	-4.78
Q2dmmy	0.065	1.47	0.004	0.17
Q3dummy	0.124**	2.33	-0.017	-0.65
Q4dummy	0.069	1.57	0.003	0.13
Constant	3.77***	4.72	-0.06	-0.58
No. of observations	70		69	
R-sq.	0.67		0.58	
F-stat.	9.66		7.23	

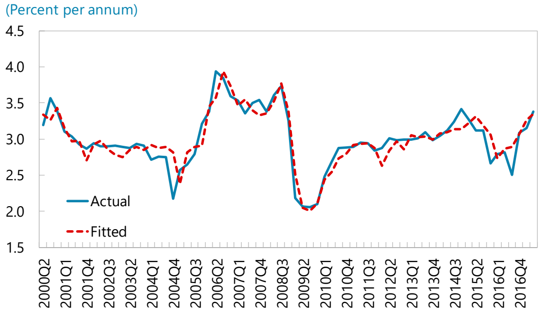
Note: ***, **, *, and ^ indicate significance at 99, 95, 90, and 88 percent confidence levels, respectively.

Figure 2 depicts actual and predicted values of the interest rate and nonresident flows, confirming model's good fit.

Figure 2. Actual vs. Fitted Values of Dependent Variables

Malaysia: Secondary Market Yield on 1-Year Conventional Government Securities

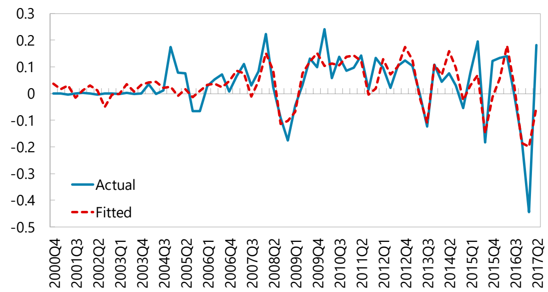
(Percent per annum)



Sources: Bank Negara Malaysia; and IMF staff estimates.

Malaysia: Nonresident Flows into Conventional Government Securities

(Ratio to GDP)



Sources: Bank Negara Malaysia; and IMF staff estimates.

5. The following are the summary findings in response to Question 1:

- Bond yields respond to supply and demand factors as expected, with the coefficients on the fiscal policy variable, the US Treasury bond rate, and CPI inflation of the expected sign and statistically significant;
- Nonresident flows respond to both domestic/pull as well as foreign/push factors adequately (the latter being global liquidity and risk conditions as captured by the US TB yield and VIX respectively), demonstrating risk aversion;
- NR flows are deterred (strongly) by FX volatility as well as expected depreciation; both as expected.

6. To answer Question 2, we switch to monthly series (using data for June 2005 through October 2017) to assess the short-term dynamics of the exchange rate and its interplay with other factors. A Generalized Autoregressive Conditional Heteroscedasticity (GARCH) model is the most appropriate methodology given the characteristics of the depreciation series. Following the finance literature (see Engle, 1982; Bollerslev, 1986),[2] we employ a standard GARCH (1,1) structure:

$$\ln(e_t / e_{t-1}) = \mu + time + \varepsilon_t \tag{4}$$

$$\omega_t^2 = \alpha_0 + \alpha_1 \varepsilon_{t-1}^2 + \alpha_2 \omega_{t-1}^2 + \alpha_3 dMGS_t + \nu_t \tag{5}$$

Where $Var_t(\varepsilon_t) = \omega_t^2$, ε_{t-1}^2 represents (the square of) past innovations and ω_{t-1}^2 represents the lagged forecast variance. The results of the estimation are reported in Table 2, showing the sign of coefficients to be conform to expectations. The baseline specification (columns 1–2) suggests that contemporaneous values of nonresident flows are associated with lower exchange rate volatility.

[2] Engle, Robert , 1982. "Autoregressive Conditional Heteroscedasticity with Estimates of the Variance of United Kingdom Inflation," Econometrica 50, issue 4, pp. 987-1007.

Bollerslev, Tim, 1986. "Generalized Autoregressive Conditional Heteroscedasticity," Journal of Econometrics 31, pp. 307-327.

Since this could be measuring the effect of policy (i.e., BNM's intervention in the FX market), we replaced it with the lagged value of the nonresident flows (results reported in columns 3-4). The relationship becomes statistically insignificant, suggesting that nonresident flows per se are unlikely to be a source of volatility.

Table 2. GARCH Model Estimation Results

	Dependent variable: depreciation					
	Coef.	z score	Coef.	z score	Coef.	z score
Depreciation						
constant	-0.0062***	-2.80	-0.0054**	-2.25	-0.0045**	-2.26
time	0.00004	1.45	0.00005*	1.70	0.00006**	2.04
crude oil price change					-0.064***	-4.96
Heteroskedasticity						
dMGS	-0.0006***	-3.55				
dMGSlag			0.00044	1.07	-0.00004	-0.15
postGFCdummy					0.99**	2.15
ARCH						
arch	0.23**	2.01	0.23**	2.17	0.19*	1.70
garch	0.51***	4.74	0.67***	4.77	0.5*	1.87
No. of observations	148		147		147	

Note: ***, **, and * indicate significance at 99, 95, and 90 percent confidence levels, respectively.

7. **A third specification was also estimated.** To account for other factors that may influence both the trend as well as volatility of the exchange rate, we included crude oil price change in equation 4 and postGFCdummy in equation (5). Results are reported in columns 5-6.

8. **The following conclusions can be drawn in response to Question 2:**

- Exchange rate behavior demonstrates dependence on past realization of "innovation" and variance (estimates of both α_1 and α_2 are positive and significant), suggesting that exchange rate volatility in Malaysia has a persistent pattern;
- A GARCH model shows no statistically significant positive contribution of nonresident flows to FX volatility (measured by the variance of the ringgit exchange rate);
- Crude oil prices have an expected/predictable effect on devaluation and FX volatility has gone up since the start of the GFC

9. **The analysis provided above offers some useful conclusion for policy conduct.** Given the unambiguously negative impact of FX volatility on nonresident MGS flows, the results suggest that more FX flexibility could deter speculative flows. In addition, to safeguard against potential large-scale selloffs, wider fiscal/treasury buffers would be advisable, despite the costs associated with keeping them. The latter should be viewed as an insurance premium for lowering the risks associated with large-scale selloffs.

Appendix VIII. FX Market Measures, 2016–17

1. **On December 2, 2016, The Financial Markets Committee (FMC, instituted by Bank Negara Malaysia in mid-2016) announced a package of measures designed to foster the development of the onshore foreign exchange (FX) markets.** The measures are still in place, and include the following:

- To enhance further onshore FX risk management, both resident and nonresident institutional investors can dynamically take onshore forward positions on a portfolio basis up to 25 percent of foreign currency or ringgit-denominated assets, without documentary evidence, with a licensed onshore bank or an appointed overseas office. A one-time registration with Bank Negara Malaysia (BNM) is required.

- Residents can hedge foreign currency exposures and cancel hedging positions for US$/MYR and CNH/MYR currency pairs with a licensed onshore bank without documentary evidence up to an aggregate net open position limit of 6 million ringgits per client per licensed onshore bank. Participants also must give a one-time declaration of hedging intent.

- With effect from December 5, 2016, resident exporters can retain up to 25 percent in foreign currency proceeds from their exports of goods and the balance should be converted into ringgit with a licensed onshore bank. However, exporters can hold or reconvert their export proceeds (at zero bid-ask spread if undertaken simultaneously) to meet projected loans, imports, and other current account obligations for up to six months ahead. The authorities' stated objective is to rebalance the demand and supply of foreign currency in the onshore market. The converted amounts could be deposited in a special facility, earning a higher interest rate of 3.25 percent and available until end-2017, subject to further review. (Following the planned review, on December 15, 2017, the BNM announced that this facility will be discontinued at end-2017 and that the outstanding balances in the facility can continue earning 3.1 percent interest up to March 31, 2018). Previously, export proceeds were required to be repatriated within six months, but there was no conversion requirement. This measure aims to enhance onshore FX liquidity, while it could potentially increase the transaction costs for exporters.

- Prudential limits on foreign currency (FC) investments by residents with domestic ringgit borrowing have been extended to include FC investments onshore and apply to all residents (including exporters, who were previously exempted) with ringgit borrowing for prudential reasons. The authorities' stated objective is to streamline the existing policy to ensure its consistent application to all residents with domestic ringgit borrowing regardless of their exporter status. The authorities viewed the streamlining as crucial to ensure these residents do not pose any systemic risk to the onshore financial market arising from non-servicing of debt by resident investors (including exporters) with domestic ringgit borrowing. These measures could limit some of these residents' FC investments, while those without domestic ringgit borrowing may continue to invest up to any amount.

- Prior to the December 2016 announcements, the BNM also enhanced the enforcement of the existing regulations on banks' non-involvement in offshore ringgit transactions. Onshore banks engaging in ringgit foreign exchange transactions in the onshore market are required to provide attestation of their non-participation or non-facilitation of offshore ringgit trading and obtain attestation from non-resident banks and securities companies of non-participation in offshore ringgit trading. The requirement that onshore banks do not participate in or facilitate offshore ringgit derivative trading has been in place since 1998.

2. In April 2017, the FMC announced a second series of initiatives to develop onshore financial markets, which came into effect on May 2, 2017:

- A series of measures were introduced with the stated objective to further broaden and deepen the onshore financial market. These measures allowed registered investors to hedge up to 100 percent of their underlying assets as well as manage an additional 25 percent of FX exposures. The framework was also extended to corporates, enabling them to hedge up to 100 percent of their obligations without documentary evidence. A one-time approval from BNM is required. In addition, the flexibility to actively manage FX risk exposures up to an aggregate net open position limit of 6 million ringgits per client per bank without documentary evidence was expanded to include GBP, EUR, and JPY (in addition to the US$ and CNH).

- Supporting the aspiration to promote a financial market that is trusted, competitive, and resilient, Principles for a Fair and Effective Financial Market were introduced, in a document outlining five universal principles as guidance and serving as an anchor to promote a fair and effective functioning of financial markets. A Code of Conduct for Malaysian Wholesale Financial Markets was also issued. The Code of Conduct sets out the principles and standards to be observed by market participants and the role of industry associations in preserving market order and stability.

- To improve liquidity in the conventional secondary government securities (MGS) market and facilitate more effective hedging of interest rate risk, the regulated short-selling framework was liberalized to allow all residents to participate in short-selling activities.

- To support future market development, induce greater transparency and facilitate surveillance on the onshore financial market, information reporting and settlement infrastructure will be enhanced. The large value payment system, Real-time Electronic Transfer of Funds and Securities System (RENTAS), is being enhanced via development of segregated securities accounts up to fund manager level. The system will be able to ease reporting burden on custodians, provide real-time information for surveillance purposes and benefit the market through publication of detailed information.

3. During a speech delivered at an event sponsored by the Financial Market Association of Malaysia on November 17, the BNM Governor announced the following measures adopted by the FMC to further deepen onshore financial markets:[1]

- Extending the short-selling framework to Malaysian government investment issues (MGII) by both conventional and Islamic banks to increase liquidity and boost trading activities for these Islamic securities in the secondary market as well as tighten the pricing gaps and yield differences between MGS and MGII.

- Expanding the eligible collateral for liquidity operations with the BNM to include Bankers Acceptances (BAs) and Negotiable Instruments of Deposits (NIDs) issued by AAA-rated onshore licensed banks. This will enable banks to obtain liquidity under BNM's Standing Facilities by pledging these money market instruments. The measure is expected to provide an impetus to the trading activities of NIDs and BAs and improve pricing.

- Introducing Bank Negara Interbank Bills (BNIBs) in ringgit and foreign currency, made available to onshore banks through auctions to manage ringgit and foreign currency liquidity and interest rate exposures and help provide competitive pricing on FX for all tenors.

[1] Prior to this announcement, the BNM issued a supplementary notice in September 2017 to facilitate foreign exchange risk management by nonresident nonbank participants of their ringgit-denominated crude palm oil futures or options on crude palm oil futures contracts undertaken on the derivatives exchange.

Appendix IX. The Role of Female and Non–Citizen Workers in the Labor Market[1]

Malaysia's labor market has undergone significant shifts in the last three decades. This appendix focuses on the contribution of female workers and non–citizen workers to these shifts.

1. The 11th Malaysia Plan (11MP, 2016–20) incorporates strategies and targets to boost productivity, improve labor market efficiency and institutions, encourage higher female labor force participation, create more skilled jobs, and reduce reliance on low-skilled non-citizen workers. This appendix focuses on summarizing staff's findings on two aspects of the authorities' agenda: contributions from female and non–citizen workforce to Malaysia's economy in recent years.

Table 1. Malaysia: Selected Targets under the 11th Malaysia Plan (11MP, 2016–20)

	10MP actuals	**11MP goals**	2016 actuals
Real GDP growth (percent, average)	5.2	**5-6**	4.2
Per capita GDP (US$, end of period)	10,440	**15,690**	9,850
Labor's share of income (percent, end of period)	~35	**40**	…
Female labor force participation (percent, end of period)	54.1	**59**	54.3
Share of skilled employment (percent, end of period)	25.5	**35**	27.3
Labor productivity growth (percent, average)	1.8	**3.7**	3.5
Total factor productivity growth (percent, average) 1/	1.8	**2.3**	0.1

Sources: 11th Malaysia Plan; Department of Statistics, Malaysia; and World Bank.

1/ Staff estimates for the 10th Malaysia Plan period (10MP, 2011–15) and 2016. See IMF Country Report No. 17/101 (Appendix III) for methodological discussion. Productivity growth was higher in 2017.

2. Malaysia's labor force growth has trended downward in recent years despite gains in the overall labor force participation rate. In the post–Global Financial Crisis period, higher female labor force participation rate and inflows of non–citizen workers have helped partially offset the impact of slowing working–age population growth. Since the early 1980s, Malaysia experienced net employment gains in every year, a significant achievement, helping keep the overall unemployment rate largely stable since the late 1990s. Labor productivity growth averaged at about 2 percent per annum over 2001–16.

Employment of the Female Workforce

3. Over 2010–16, contributions of female workers to employment and economic growth grew at a faster pace than males (Figure 1). Based on a growth accounting exercise with human capital formation, staff finds that contribution from female employment to real GDP growth has more than trebled. Female employment growth has more than doubled over 2010–16, compared to 2000–09, and was also higher than male employment growth. Moreover, the gender gap in average years of schooling has shrunk, providing additional contributions from female human capital formation. Gross school enrollment ratios in secondary and tertiary education are also higher for

[1] This appendix is based on a Selected Issues Paper. Malaysia–specific data used in this study come from various publications by the Department of Statistics, Malaysia (e.g., Labor Force Surveys, Salaries and Wages Surveys, the 2016 Economic Census).

females, particularly in tertiary education. This is likely reflected in the higher share of skilled occupations in female employment.

4. **Malaysia has potential for further improving the female labor force participation rate.** Despite improvements, female labor force participation rate remains low, both in absolute term and relative to male participation rate vis-à-vis some of the regional economies and the OECD average. Official statistics reveal that housework or family responsibility is the dominant factor for women not seeking employment, contributing to a sharp fall in participation rates among women aged 30 years and more. In contrast, in the OECD countries, for example, female labor force participation rates do not fall until later in the life cycle.

5. **While socio–cultural factors could potentially be at play, further policy actions may help improve female labor force participation.** Studies have shown that beyond demographic factors, such as number of children, household size etc., policy interventions can also help boost female labor force participation.[2] Measures related to tax incentives to companies for setting up childcare facilities and/or encouraging them to allow flexible work arrangements could help them retain married women workers. IMF (2012) also documents that a shift away from labor to consumption taxes could potentially boost labor demand as the latter reduce non–wage labor costs. In the Malaysian context, this would imply further upgrading the Goods and Services (GST) tax framework, with the additional revenues spent on growth–enhancing items, including physical and human capital. Higher growth and employment will help absorb the additional female labor supply. Some of the Budget 2018 measures, for example, increasing the duration of maternity leave in the private sector to match that of the public sector and temporary exemptions from individual income tax for women with a career break of at least 2 years, have the potential of further incentivizing women to join the workforce.

Employment of Non–Citizen Workers

6. **Non–citizen workers accounted for about 15½ percent of the labor force in 2016.** The non–citizen labor force, as compared to the citizen labor force, has a higher share of male or rural job seekers; and is younger, but with less years of schooling (Figure 2). Non–citizen workers have much higher shares in lower–skilled jobs, which reflect their relatively lower education levels compared to citizens. Faster growth in the non–citizen labor force over 2010–16, relative to 2001–09, contributed to an increase in the labor force by about 7 percent, adding an 0.4 percentage points per annum to real GDP growth (direct impact).

7. **Demand for non–citizen workers varies by sectors and states.** Non–citizen workers are primarily employed in three sectors: agriculture, forestry, and fishing; manufacturing; and construction. Non–citizen workers account for significant shares of employment in crude palm oil and electrical & electronics (E&E) sectors – two important sectors in the Malaysian economy.

[2] For example, Gonzales, C.; S. Jain-Chandra; K. Kochhar; and M. Newiak, 2015, "Fair Play: More Equal Laws Boost Female Labor Force Participation", IMF Staff Discussion Notes, SDN/15/02, International Monetary Fund, and IMF, 2012, "Fiscal Policy and Employment in Advanced and Emerging Economies", Policy Paper, International Monetary Fund, June 2012.

Geographically, two states (Sabah and Selangor) together accounted for more than one–half of overall non–citizen employment in 2016.

8. There are concerns in the public discourse that the influx of non–citizen workers has led to depressed wages and reduced job opportunities for lower–skilled workers. However, without establishing any causality, the following were observed in Malaysia since the GFC:

- The wage gap between lower–skilled/less–educated workers and higher–skilled/tertiary–educated workers has shrunk, reflecting implementation of a minimum wage policy from 2013 and relative tightness of lower–skilled segment of the labor market.[3]
- Related to above, for the entire economy, labor's share in total income has risen. As firms adjusted, the capital/labor ratio has grown at a slightly faster pace relative to 2001–08.
- Workers with no formal education or with primary education do not seem to have experienced unfavorable unemployment outcomes relative to the national average. In contrast, unemployment rate for tertiary–educated workers, majority of whom are citizens, has been consistently higher–than–national average, a pattern not observed in most OECD countries, for example, and needs attention.

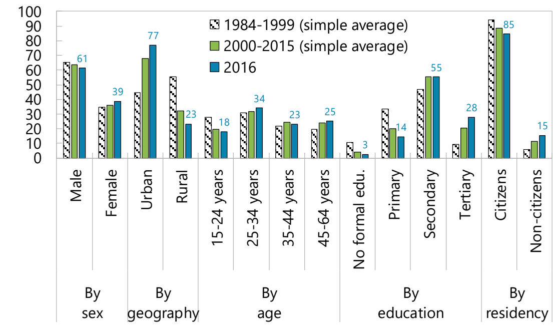
9. Reforming non–citizen worker policies and processes will involve structural shifts in certain key sectors and should be phased in. Malaysia remains an attractive destination for immigrant workers in the region and, as Malaysian citizens get more educated and seek employment in higher–skilled occupations, non–citizen workers can help fill in the vacancies in the lower–skilled occupations. However, the authorities aim to increasingly rely on higher–skilled non–citizen workers within an overall limit, and encourage increased employment in high–skilled jobs and adoption of technology as the economy moves up the value chain. While the aim is to improve productivity, changes in non–citizen worker policies should be phased in to allow important sectors of the economy time to adjust. The authorities should continue consultation with industries on the pace of adjustment and should rely on market–based mechanisms, as fixed numerical limits tend to lose relevance over time and lead to distortions and/or misreporting.

[3] A World Bank study found positive impact of immigration on overall employment and wages for Malaysian citizens. However, this study also finds that a 10 percent rise in immigration has a small negative impact on wages of the less–educated Malaysian workers, but about five and half times larger negative impact on immigrant workers' wages (World Bank, 2015, "Immigrant Labour", Malaysia Economic Monitor, December 2015).

Figure 1. Malaysia: Selected Labor Market Statistics–Overall and Female Workers

In the last three decades, Malaysian labor force has become more urban and educated. Shares of female and foreign workers have risen in recent years.

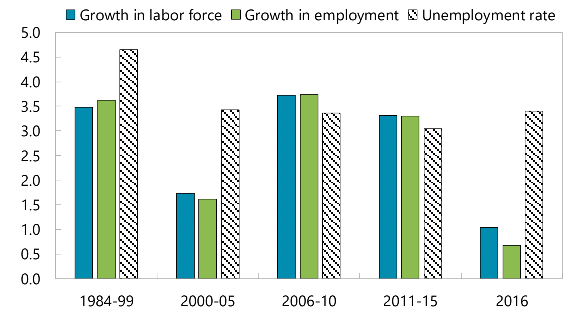
Malaysia: Selected Characteristics of the Labor Force
(Shares in percent of the total labor force)



Sources: Department of Statistics, Malaysia; and IMF staff calculations.

Employment growth has kept pace with labor supply, helping maintain a stable overall unemployment rate for nearly a decade and a half now.

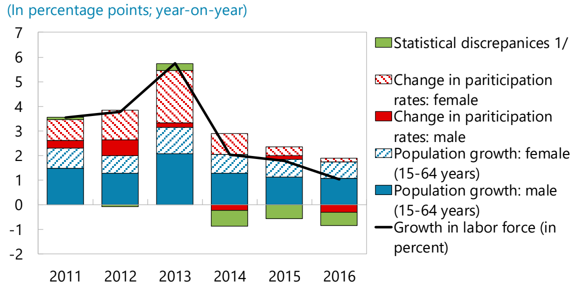
Malaysia: Labor Force, Employment, and Unemployment
(In percent; growth rates are in compound annual rates for the pre-2016 periods)



Sources: Department of Statistics, Malaysia; CEIC Data Co. Ltd.; and IMF staff calculations.

In recent years, higher female labor force participation rates have helped partly offset the impact of slowing working-age population growth on labor supply.

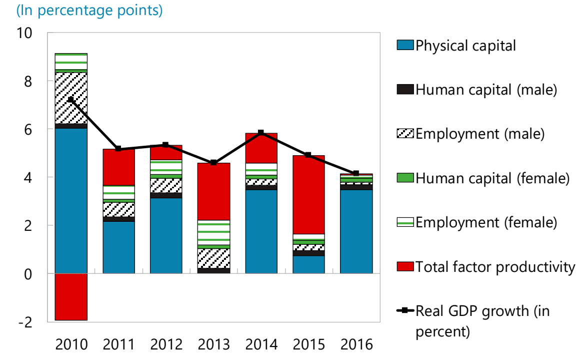
Malaysia: Contributions to Labor Force Growth
(In percentage points; year-on-year)



Sources: Department of Statistics, Malaysia; CEIC Data Co. Ltd.; and IMF staff calculations.
1/ Statistical discrepancies are due to differences in labor force participation rates between the population-based estimates and labor force survey-based estimates.

Female labor's average contribution to real GDP growth has grown faster than males', reflecting faster growth in female employment and educational attainment.

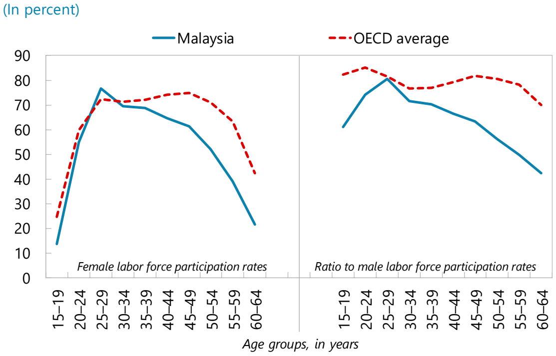
Malaysia: Contributions to Real GDP Growth
(In percentage points)



Sources: Department of Statistics, Malaysia; and IMF staff estimates.

Despite recent improvements, the female labor force participation rate remains lower than the OECD average, particularly for women aged 30 years or more.

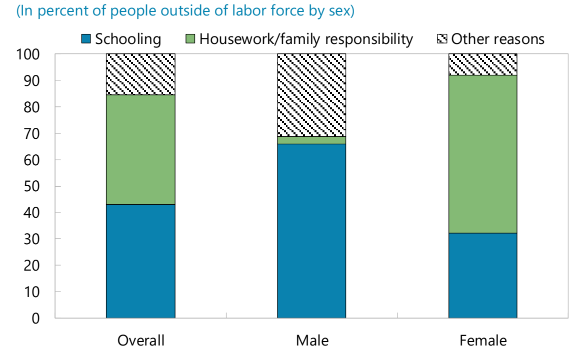
Malaysia and OECD: Female Labor Force Participation, 2016
(In percent)



Sources: Department of Statistics, Malaysia; OECD.Stat; and IMF staff calculations.

Further policy actions are needed to encourage more women join the labor force, most of whom are currently discouraged because of family responsibilities.

Malaysia: Reasons for Being Outside of Labor Force, 2016
(In percent of people outside of labor force by sex)

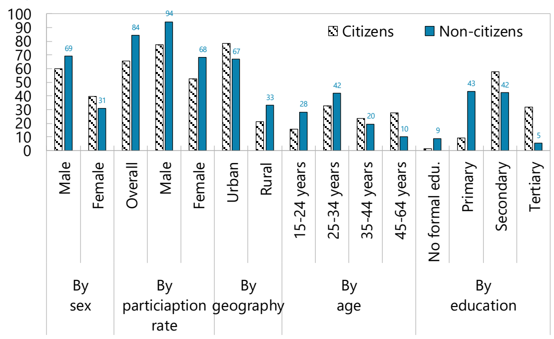


Sources: Department of Statistics, Malaysia; and IMF staff calculations.

Figure 2. Malaysia: Non-Citizen Workers and Other Labor Market Indicators

Non-citizen labor force has a higher share of male, younger, and less educated job seekers than citizens.

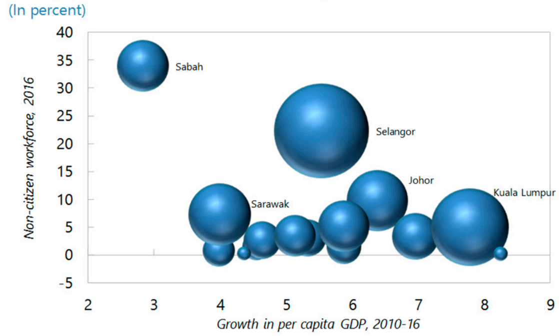
Malaysia: Labor Force by Residency Status, 2016
(In percent)



Sources: Department of Statistics, Malaysia; and IMF staff calculations.

Demand for non-citizen workers is relatively greater in agriculture, manufacturing, and construction sectors. Two states account for the employment of more than half of total foreign workers.

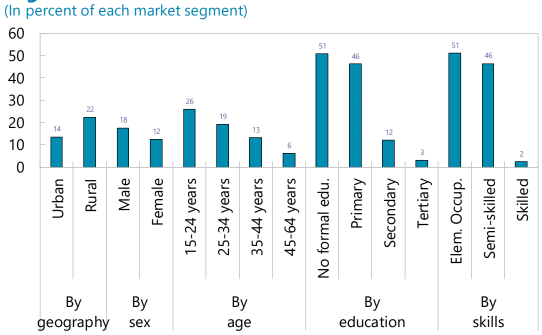
Malaysia: Non-Citizen Workers by States 1/
(In percent)



Sources: Department of Statistics, Malaysia; and IMF staff calculations.
1/ Bubble sizes represent share in national GDP.

Non-citizen workers' employment is concentrated in elementary and semi-skilled occupations.

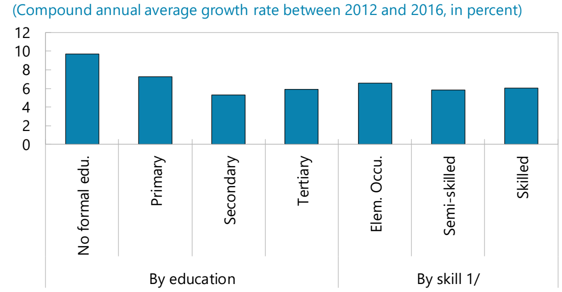
Malaysia: Share of Non-Citizen Employment by Market Segments, 2016
(In percent of each market segment)



Sources: Department of Statistics, Malaysia; and IMF staff calculations.

Wages for less-educated/skilled workers have grown relatively faster, reflecting implementation of minimum wages and tightness of these segments of the market.

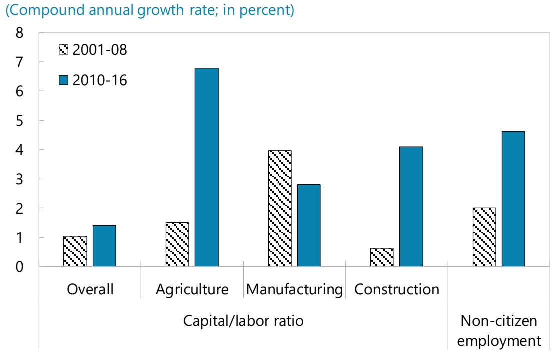
Malaysia: Growth in Average Salaries and Wages
(Compound annual average growth rate between 2012 and 2016, in percent)



Sources: Department of Statistics, Malaysia; and IMF staff calculations.
1/ Skilled-workers are defined by the following occupations: managers, professionals, technicians and associate professionals. Semi-skilled workers are those who are neither in skilled occupations nor in elementary occupations.

The capital-labor ratio has continued to improve as firms adjusted to a rising share of labor income in total income.

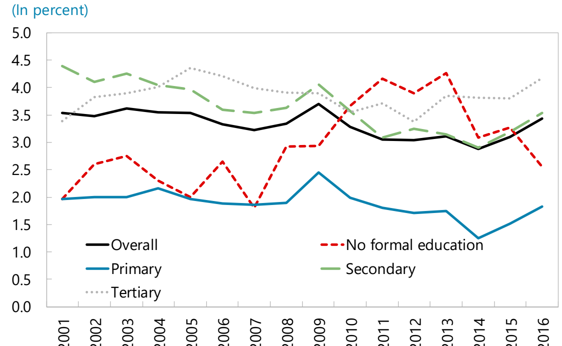
Malaysia: Capital-Labor Ratio and Non-Citizen Employment
(Compound annual growth rate; in percent)



Sources: Department of Statistics, Malaysia; and IMF staff calculations.

The unemployment rate is lower for less-educated workers and highest for tertiary-educated workers.

Malaysia: Unemployment Rate by Educational Attainment
(In percent)



Sources: Department of Statistics, Malaysia; and IMF staff calculations.

MALAYSIA

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 24, 2018

Prepared By | Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of December 31, 2017)

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

II. General Resources Account

	SDR Millions	Percent of Quota
Quota	3,633.80	100.00
Fund holdings of currency (exchange rate)	3,130.79	86.16
Reserve tranche position	503.01	13.84
Lending to the Fund		
New Arrangement to Borrow	37.63	

III. SDR Department

	SDR Millions	Percent of Allocation
Net cumulative allocation	1,346.14	100.00
Holdings	821.81	61.05

Exchange Arrangement:

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

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

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

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

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

Malaysia, in accordance with the UN Security Council resolutions implements the freezing without delay funds and other financial resources, including funds derived or generated from property owned or controlled directly or indirectly by the designated individuals and entities. These measures are maintained for the reasons of national and international security and have been notified to the Fund pursuant to the IMF Executive Board Decision No. 144 (52/51). Malaysia also restricts any dealings or transactions with Israeli/Israel-related entities/individuals as well as in Israeli Shekel; however, since these restrictions affect the underlying transactions themselves, they are not subject to Fund jurisdiction under Article VIII, Section 2(b).

Article IV Consultation:

Malaysia is on the standard 12-month consultation cycle. Discussions for the 2017 Article IV consultation took place during November 30–December 15, 2016 (IMF Country Report No. 17/101). Staff discussions for the 2018 Article IV consultation were conducted on a mission to Kuala Lumpur during November 28–December 8, 2017. In addition, a staff visit took place during September 13–19, 2017.

Financial Sector Assessment Program (FSAP) Participation:

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

Technical Assistance:

Fiscal Affairs Department (FAD): A mission on expenditure review was conducted in December 2016. A Public Investment Management Assessment (PIMA) mission took place in May 2017. A mission on treasury modernization was fielded in July 2017.

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

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

Statistics Department (STA): A mission to assist with implementing the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*) was conducted during May–June, 2013. Technical assistance missions on Government Financial Statistics were conducted during 2014.

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

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

Resident Representative/Advisor: None.

STATISTICAL ISSUES

(As of January, 2018)

I. Assessment of Data Adequacy for Surveillance
General: Data provision is broadly adequate for surveillance. However, further efforts to improve statistics for the consolidated general government and public sector are necessary.
National accounts: Currently, the Department of Statistics Malaysia (DOSM) compiles and publishes annual and quarterly estimates of GDP by activity and by expenditure at current and constant prices, and annual estimates for gross disposable income, saving, and net lending for the economy based on the *2008 SNA*. The quarterly data are released about one and a half month after the reference quarter. **Price statistics**: The CPI and the PPI are available on a timely and comprehensive basis. From January 2016 onward, the CPI basket of goods and services has been updated based on the *Household Expenditure Survey* 2014.
Government finance statistics: There is a need to improve the timeliness, detail, and availability of data on nonfinancial public enterprises (NFPEs) and the state and local governments. Dissemination of more detailed data on non-listed NFPEs' assets and liabilities and domestic and foreign financing by type of debt instrument and holder would be desirable; efforts in this direction will require continued close collaboration among the Economic Planning Unit (EPU), the Treasury, and Bank Negara Malaysia (BNM). There is also a need to disseminate more information on public private partnerships.
Monetary statistics: The monetary and financial statistics (MFS) are reported on a timely and regular basis and are broadly in conformity with the Fund's data needs. There is a need to improve the institutional coverage of the financial corporations, sectorization of the domestic economy, and classification and valuation of financial instruments to ensure full adherence to the IMF's *Monetary and Financial Statistics Manual.* In addition, due to the growing importance of insurance corporations, pension funds, and other financial intermediaries in Malaysia, coverage of MFS should be expanded to include these institutions. The MFS missions of January 2004 and 2005 developed an integrated monetary database to be used for publication and operational needs of the BNM, STA, and APD. The Bank Negara Malaysia reports data in STA's standardized report forms (SRFs) which provide more detailed classification of certain items, fuller sectoral and instrument breakdown, and currency aggregation. MFS based on the SRFs are published in the quarterly *IFS Supplement on Monetary and Financial Statistics*.
Balance of payments: Department of Statistics Malaysia compiles and publishes quarterly balance of payments estimates in accordance with the sixth edition of the Balance of Payments Manual and the SDDS. The quarterly data are released about one and a half month after the reference quarter. No data are shown for the capital transfers or acquisition/sale of nonproduced nonfinancial assets, and transactions in reserve assets are computed as differences in amounts outstanding and thus include valuation changes. The international investment position data on other investment—assets and liabilities—are reported only in an aggregate form.
II. Data Standards and Quality
Malaysia subscribes to the Special Data Dissemination Standard (SDDS). It is using a timeliness flexibility option for general government operations (within six quarter lags after the end of reference year).

Malaysia: Table of Common Indicators Required for Surveillance
(As of January 24, 2018)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	1/24/2018	1/24/2018	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	1/15/2018	1/22/2018	Bi W	Bi W	Bi W
Reserve/base money	10/31/2017	1/2018	Bi W	Bi W	Bi W
Broad money	10/2017	1/2018	M	M	M
Central bank balance sheet	10/31/2017	1/2018	Bi W	Bi W	Bi W
Consolidated balance sheet of the banking system	10/2017	1/2018	M	M	M
Interest rates[2]	1/24/2018	1/24/2018	D	D	D
Consumer price index	12/2017	1/24/2018	M	M	M
Revenue, expenditure, balance and composition of financing[3]—general government[4]	2016	12/2017	A	A	A
Revenue, expenditure, balance and composition of financing[3]—federal government	2017:Q2	12/2017	Q	Q	Q
Stocks of central government and central government guaranteed debt[5]	2017:Q2	12/2017	Q	Q	Q
External current account balance	2017:Q3	11/2017	Q	Q	Q
Exports and imports of goods	11/2017	1/2018	M	M	M
Exports and imports of services	2017:Q3	11/2017	Q	Q	Q
GDP/GNP	2017:Q3	11/2017	Q	Q	Q
Gross external debt	2017:Q3	11/2017	Q	Q	Q
International Investment Position	2017:Q3	11/2017	Q	Q	Q

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

Statement by the Staff Representative on Malaysia
February 9, 2018

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

Monetary policy. On January 25, 2018, Bank Negara Malaysia raised its overnight policy rate by 25 basis points to 3.25 percent. This policy move was a pre-emptive action designed to prevent the build-up of risks from interest rates being too low for a prolonged period, against the expectation of continued strength in economic activity in 2018. Staff agree that the move is appropriate, also in light of growing uncertainty regarding oil prices and, therefore, the path of inflation in 2018, as highlighted by the Monetary Policy Committee statement. The stance of monetary policy remains accommodative given the outlook on headline inflation. Markets largely expected the rate increase, and it does not alter Fund staff's baseline projections.

Statement by Juda Agung, Executive Director for Malaysia, Mohamad Hasni Shaari, Senior Advisor to the Executive Director, and Harizal Bin Alias, Advisor to the Executive Director
February 9, 2018

On behalf of the Malaysian authorities, we thank the IMF team for the constructive and comprehensive discussions on macroeconomic developments and policy issues in Malaysia. We are encouraged by staff's assessment that the Malaysian economy is resilient and that the current macroeconomic policy settings are appropriately attuned to the outlook and risks facing the economy and the financial system.

We continue to have strong concern on the Fund's inflexibility to be receptive and open to new approaches and policy instruments needed to maintain stability and promote financial market development. Our authorities are also deeply concerned with staff's lack of understanding of the domestic context which can diminish the Fund's role as trusted adviser. The Fund should be more flexible and open to new approaches and policy instruments needed to maintain stability and promote financial market development. Contextualization of country specific circumstances must be taken into account adequately and "one size fits all" assessment must be avoided. In addition, measures that have yielded clear positive outcomes for a country to be more resilient and safeguard against shocks should be recognized. This would enable the Fund to be more effective in advancing reforms in the international monetary system.

Our authorities wish to record their disappointment on the fact that staff did not adequately reflect the Authorities' Views in the Staff Report as conveyed during series of meetings and feedback. In particular, the authorities firm view that the Financial Markets Committee (FMC) measures introduced in December 2016 are not CFMs was not adequately recorded in the Authorities' Views. This omission is highly regrettable and staff's failure to reflect clearly Authorities' Views can mislead the Board, investors and market. Our authorities further cautioned that any inappropriate assessment by the Fund, particularly on the onshore FX measures, could potentially lead to unintended market consequences and should be avoided altogether.

Our authorities felt that assessment by staff, as in the past, did not provide enough consideration on the negative spillover effects by a neighboring market that had caused instability and disorder to the Malaysian financial market. The authorities also felt that market failure and unfettered and opaque NDF were tolerated to the detriment of members' financial market stability. These challenges are not self-correcting and will continue to prevail if no specific measures are taken. This is where the Fund as a multilateral institution responsible in advancing global financial stability, should play a role in reducing disruptive cross-border implications of NDF market.

Economic Developments and Outlook

The Malaysian economy registered robust growth of 5.9% in the first three quarters of 2017. Growth in Q4 2017 is expected to be sustained at a similar pace and based on this performance, growth for the whole 2017 is expected to exceed the upper end of the official range of 5.2 – 5.7% released earlier (2016: 4.2%). Continued expansion in domestic demand and improving external environment which benefitted the export sector, was the main driver to this better-than-expected growth performance during the year. Inflation remained low (January - November 2017: 3.4%; 2016: 2.1%) and labor market conditions remained favorable amid stable unemployment rate (November 2017: 3.3%; 2016: 3.5%). Malaysia's external position strengthened amid a more favorable external environment, supported by broad-based improvement in the global economy and relatively lower volatility in the international financial markets. The current account balance recorded a healthy surplus (1Q-3Q 2017: 2.8% of GDP; 2016: 2.4% of GDP) while international reserves were at a comfortable level of USD103 billion (as at January 15, 2018), sufficient to finance 7.2 months of retained imports and 1.1 times short term external debt as at 29 December 2017. After depreciating by 5.9% in 2016, the Malaysian ringgit appreciated by around 10.4% against the US dollar in 2017. Similarly, backed by the resumption of capital inflows, the Kuala Lumpur Composite Index increased by 9.4% in 2017.

The prospects for the Malaysian economy over the medium term remain positive. For 2018, the Malaysian economy is projected to expand between 5.0 – 5.5% in line with staff's estimates. Supported by strong economic fundamentals, domestic demand will remain the key driver of growth, particularly from continued expansion in the private sector expenditure. Private consumption will be the largest driver of growth, supported by improvements in income and labor market conditions. Investment activities are expected to be sustained by the implementation of infrastructure projects and continued capital investment by manufacturing and services firms. Favorable global outlook will provide additional support to the Malaysian economy through healthy exports sector. Manufactured and services exports will continue to record positive growth, benefiting from the further strengthening in US and euro area growth, and continued growth in the regional economies. The higher commodity prices are also expected to lend support to Malaysia's current account surplus.

In the medium term, inflationary pressure is expected to moderate. The expected improvement in domestic demand condition will be accompanied by continued expansion in productive capacity, which will contain the potential upward pressures on core inflation. Nevertheless, movement of the headline inflation will be affected by the uncertain movements in the global energy and commodity prices.

Our authorities concur that risks to the growth outlook are balanced. Better-than expected global demand and stronger-than-expected spillovers from the external sector performance to the domestic economy are the two potential risks factors that could provide further impetus to the growth momentum. However, downside risks to domestic growth remain, emanating mainly from the external developments including the performance and policies of major trading partners which could affect trade performance and financial markets sentiments.

Our authorities welcome staff's assessment that Malaysia's external debt remains manageable under a variety of shocks. Malaysia's external debt stood at RM873.8 billion or USD204.7 billion as at end-September 2017, equivalent to 65% of GDP (2016: RM916.9 billion or USD202.3 billion; 74.5% of GDP). Malaysia's external debt is supported by a favorable debt structure with about 34% of external debt denominated in ringgit. The remaining external debt denominated in foreign currency are mostly held by banking institutions, which are subject to the central bank's prudential management.

Staff's assessment on Malaysia's higher external financing vulnerabilities relative to peer median does not sufficiently take into account Malaysia's degree of openness and financial market depth. For instance, Malaysia has the second-largest local-currency denominated bond market in Asia (relative to GDP, excl. Japan), with active non-resident participation. The banking sector's external exposures is also in line with centralized liquidity management practices of domestic banks with large regional footprint and strong presence of locally-incorporated foreign banks. Importantly, any assessment should also consider Malaysia's external assets. Malaysia's external assets are predominantly denominated in foreign currency (95% share) while a significant share of Malaysia's liabilities are in domestic currency (59.5%). Non-FDI foreign-currency assets exceed foreign-currency liabilities. Hence, the potential claim on international reserves from non-FDI liabilities would be limited. Taken collectively, these factors have enhanced Malaysia's resilience against external shocks and exchange rate movements.

Adjusting to external shocks

As a highly open economy, with a financial system that is integrated with the international financial system, Malaysia remains exposed to developments in the global financial markets and volatile capital flows. In the current environment, policymakers need at their disposal a full array of effective policy tools to safeguard the stability of the economy and financial system. As the global environment evolves and new challenges emerge, policymakers need to be agile in its approach and to constantly recalibrate the most appropriate policy response.

Our authorities wish to reiterate that the FMC measures introduced in December 2016 are not to limit capital flows, and hence, should not be classified as capital flow management measures (CFMs). Rather, these measures are solely for the development of onshore market and for prudential reason. The authorities strongly disagree with staff's recommendation to phase out the measures as the measures introduced have yielded positive benefits to Malaysia. The authorities call for the Fund to be more pragmatic in application of the Institutional View on Capital Flow and call staff to continue to deepen their understanding on country specific circumstances.

Our authorities disagree with staff's assessment that suggest the authorities have no clear strategy in implementing the onshore FX measures, despite the clear and extensive explanation on the measures. Since December 2016, the Financial Markets Committee (FMC) has introduced a series of measures designed to foster the development of the onshore foreign exchange (FX) markets. The measures are indeed part of the comprehensive long-term strategy to develop a highly liquid and deep FX market in Malaysia that commensurate with the strong economic growth and increasingly sophisticated needs of businesses and investors. Therefore, our authorities are of the view that staff needs to have a holistic understanding of the measures implemented. In this regard, our authorities stand ready to further engage with staff for the Fund to develop a holistic understanding on this matter.

Our authorities view the recommendation by staff for the authorities to communicate to the public on the FX market strategy as inappropriate and misleading as it gives the impression that the authorities were not robust in implementing and communicating the policies to the public. The statement is not consistent with the press release issued on 11 December 2017 where the Fund has acknowledged continuous communication undertaken by the authorities. Market consultation and robust communication strategy have been anchoring the formulation of policies. In fact, the measures were carefully deliberated pre- and post-measures by the FMC which consists of representatives from the industry, including corporates. Our authorities have been conducting continuous wide-ranging engagement with over 3,600 corporations from government agencies, association of companies, commercial banks, local and foreign media, analysts, and fund managers and have addressed concerns raised. In addition, all FMC measures were made transparent to the public and communicated via press statements, speeches and periodic market updates published on the BNM's website.

Our authorities are concerned with the suggestion that exporters with unhedged ringgit domestic borrowing as source of financial instability as it lacks rationale and basis. The exporters with domestic ringgit borrowing are freely allowed to manage their FX risk. The underlying issue is not FX exposure arising from the unhedged ringgit borrowing by exporters, rather, on the impact of debt servicing capacity of all residents with domestic borrowing (including exporters) arising from their large investments abroad and the use of scarce domestic resources for such investment.

Our authorities also clarified the FMC measures represented a balanced approach in terms of fostering the above objectives and addressing the impact from external spillovers. The cost indicated by market participants are mainly related to compliance to the existing regulation. The suggestion by staff that the measures have increased compliance cost lacks evidence. In addition, our authorities strongly disagree with the suggestion that the measures had a sustained negative impact on market sentiment. The decline in MGS weight in JP Morgan's GBI EM Global Diversified Index is a reflection of broadening country coverage and relative market issuances. The reduced foreign investors' interest was only temporary that reflects sell-off by speculative investors, an intended policy outcome by our authorities. In fact, interest of investors into the Malaysian market has resumed, particularly the long term investors, underscored that the measures have not led to a sustained erosion of market confidence.

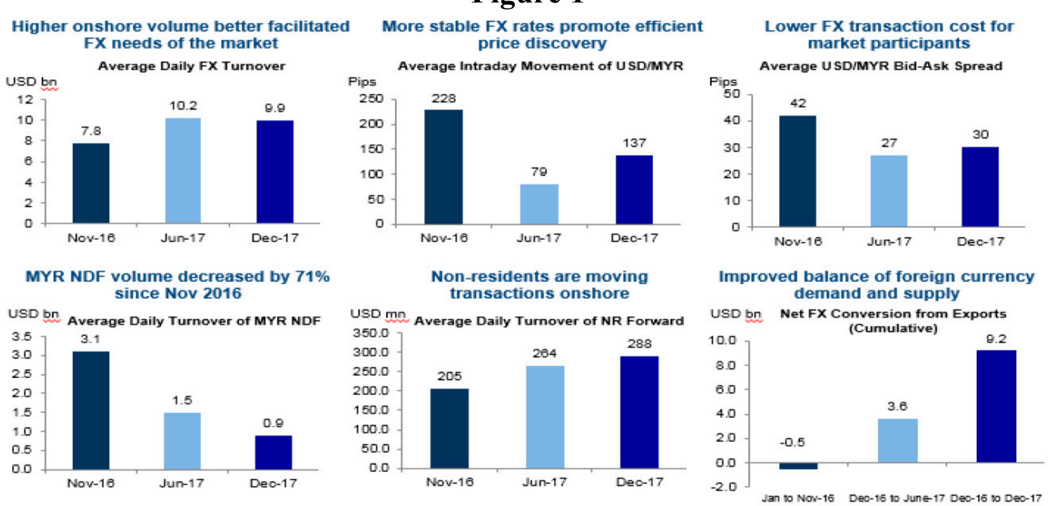
Our authorities wish to re-emphasize the following:

a. The conversion of export proceeds into ringgit is meant to address the structural imbalances of supply and demand for foreign currencies in the onshore foreign exchange market. The requirement does not in any way hinder exporters from holding more than 25 percent of export proceeds in foreign currency if they have genuine business need. The framework allows reconversion to foreign currency at the same rate with no additional cost incurred by exporters for building up their foreign currency balances to meet their imports and current international obligations.

b. The prudential limit on foreign currency investments by residents with domestic ringgit borrowing is to streamline the rule relating to investment in foreign currency assets with the broad objective of mitigating potential systemic risk to the financial system. This is done through the management of large investments by residents with domestic ringgit borrowing. Residents, including exporters, without domestic ringgit borrowings can continue to freely invest in foreign currency assets onshore and offshore up to any amount.

The Fund's rigidity towards policy subscription instituted under the Institutional View led to the apparent failure of staff to adequately recognize the effectiveness of the authorities' measures. Since its implementation, the measures have yielded clear positive outcomes (see Figure 1). Market adjustments have gradually taken place. Liquidity in the onshore FX market, as reflected in the higher average daily turnover, has deepened significantly, enabling a better facilitation of FX needs of the market. Bid-ask spread has narrowed, which contributed to reduced transaction costs for market participant. Net FX conversion has increased significantly, contributing to the rebalancing of the foreign currency demand and supply.

Figure 1



Note: Volatility refers to the difference between MYR/USD interbank intraday highest and lowest rate. Offshore rate refers to the NDF 1-month rate while onshore rate refers to the spot rate.

Source: Bloomberg, Bank Negara Malaysia

Monetary Policy

After maintaining the Overnight Policy Rate (OPR) since July 2016, the Monetary Policy Committee (MPC) decided to normalize the degree of monetary accommodation by raising the OPR by 25 basis points to 3.25% in January 2018. The MPC assessed that there would be faster expansion in global growth, with more balanced risks to the outlook. The domestic economy is firmly on a steady growth path, and headline is expected to average lower in 2018. The adjustment also pre-emptively ensures that the stance of monetary policy is appropriate to prevent the build-up of risks that could arise from interest rates being too low for a prolonged period. The normalization would contribute towards preserving the sustainability of growth, while ensuring ample policy space. At the current level of the OPR, the stance of monetary policy remains accommodative and supportive of growth. The MPC will continue to closely assess the risks surrounding the outlook for growth and inflation in deciding the stance of monetary policy moving forward.

Fiscal Policy

Our authorities welcome staff's assessment that the planned pace of consolidation for 2017-18 is appropriate. The fiscal deficit declined to 3% of GDP in 2017 and is projected to reach 2.8% in 2018. Similarly, prudent fiscal management has led to the consistent reduction in federal government debt over the years, projected to be 50.9% of GDP in 2017 (2016:52.7% of GDP).

Fiscal consolidation is ongoing while sound macroeconomic environment will continue to support private sector activity. To drive the fiscal consolidation efforts, the authorities are currently implementing the Medium-Term Fiscal Framework (MTFF) which acts as the principal planning mechanism to optimize fiscal revenues and expenditures. Under the framework, the fiscal deficit level is targeted to be gradually reduced during the period of 2018 – 2020 with target to achieve a balanced budget in the next 5 years. Based on this framework, our authorities have implemented several initiatives to improve both revenue enhancement and expenditure efficiency. Among the initiatives include enhancing tax administration and compliance; expenditure rationalization and optimization; strengthening budget management and control, as well as improving fiscal policy institution.

To strengthen the institutional capacity of fiscal management, the Fiscal Policy Committee established the Fiscal Risk and Contingent Liability Technical Committee in May 2016. The committee is mandated to evaluate and propose measures to manage fiscal risks and contingent liabilities. Our authorities also extended their appreciation to the Fund's TA on Public Investment Management Assessment in April 2017.

Financial Sector

Our authorities welcome staff's assessment that the Malaysian financial sector is resilient and that the overall risks are contained. This assessment is consistent with the outcome of the regular stress tests conducted by the authorities and by the individual banking institutions separately. The stress test results demonstrated that Malaysia's banking system is resilient to major macroeconomic shocks. The strength of the Malaysian financial system is also underpinned by strong balance sheet, asset quality and capital buffers both at the system and institutional levels. Nevertheless, our authorities acknowledge risks to financial stability remained, particularly risks emanating from the household, business and property sectors. In this regard, BNM continues to focus its surveillance and supervisory activities to contain emerging risks, both domestically and internationally. BNM's assessments are as follow:

a. Concerns on high household indebtedness are mitigated as measures put in place by BNM in the past few years are working well and remain relevant to contain financial stability risk. The level of household debt continues to record its moderating growth trend for the sixth consecutive year supported by macroprudential measures and prudent underwriting standards by banks to ensure borrowers are credit worthy.

b. Corporate leverage, including external borrowings, continues to be supported by sound debt servicing capacity and hedging practices. The increase in the overall debt level of corporate sector in recent years is in tandem with economic expansion, thus the financing needs. The concern on corporate leverage is mitigated by the corporate sector's healthy balance sheets, sustained financial strength and good debt servicing capacity that is based on the prudent cash flow projections from business operations.

c. The imbalances in the property market remain, but are currently contained to the specific property segments, namely the high-end high-rise residential and commercial property. Banking system's exposures to these higher-risk segments are limited. This reflects continuous improvements in bank's credit risk management practices including refinements in their risk appetite and underwriting standards to account for increased risks associated with lending to property sector. BNM is developing a holistic solution to promote a sustainable property market, including a legislation for the residential rental market and the second National Housing Policy to drive a medium-term strategy for the housing market development. Given that risks to domestic financial stability are well-contained amid a favorable economic outlook, BNM is of the view that no further macroprudential or other policy measures are needed at this point.

Malaysia remains committed towards addressing the deficiencies in its AML/CFT regime and meeting its five-year National AML/CFT Strategic Plan objectives. As at 2017, 80 percent of the action plans have been completed or are in progress to be completed within the estimated timeline. This includes the enhancement in ML/TF risk understanding, legal and operational reform.

Reforms to enhance growth potential

Reform initiatives as outlined in the 11th Malaysia Plan (11 MP) (2016-2020) have also made further progress. Aims to accelerate Malaysia's transformation into a high-income economy by 2020, the main thrust of the 11 MP is to promote a more inclusive growth and raise productivity and competitiveness. Reaching a half-way of its implementation term, the mid-term review to evaluate the progress of the 11 MP is currently on-going. Led by the Economic Planning Unit, the review started in July 2017 and is aimed to evaluate progress on the targets, initiatives, programs and development projects outlined in the 5-year plan. Most importantly, the review will identify gaps and the necessary steps that need to be taken to improve the implementation progress, so that the targets will be achieved. The report of the 11 MP mid-term review will be presented to the parliament by July 2018.

Among the key initiatives under 11 MP is the implementation of Malaysia Productivity Blueprint. Launched in May 2017, it defines five key strategic thrusts to raise labor productivity - building workforce of the future; driving digitalization and innovation; making industry accountable for productivity; forging a robust ecosystem; and securing a strong implementation mechanism. The blueprint aims to achieve the labor productivity growth target of 3.7% by 2020.

Our authorities are in the process of formulating the Transformasi Nasional 2050 (TN50) - a 30-year national development initiative which will provide continuity in the developmental goals for the nation beyond 2020. Engagement with various stakeholders to formulate TN50 is currently underway and the policy document will be published in early 2020. TN50 will outline the economic, social, cultural and environmental targets that Malaysia aims to achieve by 2050.

Conclusion

Strong and resilient macroeconomic fundamentals accord Malaysia the ability to manage current challenges and pursue structural reforms. The Malaysian economy's strengths are derived from its highly diversified economic structure, resilient external position and policy flexibility. Looking ahead, the challenging global environment necessitates continued emphasis on enhancing the nation's economic resilience and broadening growth sources. These structural reforms and pre-emptive policy measures are envisaged to provide greater support to Malaysia's future growth prospects.