



MALAYSIA

May 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MALAYSIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 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 April 22, 2016 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 April 22, following discussions that ended on January 22, 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 March 30, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Malaysia.

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Washington, D.C. 20431 USA

IMF Executive Board Concludes 2016 Article IV Consultation with Malaysia

On April 22, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Malaysia.

Malaysia's highly open and diversified economy was hit by a number of external and domestic shocks since late 2014, including sharply lower energy prices, spillovers from China, capital outflows and domestic political controversy. The economy has remained resilient, although growth moderated to 5 percent in 2015 from 6 percent in 2014, led by domestic demand in the face of weak external demand. Inflation remained subdued, close to 2 percent, despite the significant depreciation of the ringgit against the U.S. dollar and the implementation of the GST. The current account surplus narrowed to about 3 percent of GDP.

The authorities have responded to the multiple shocks in a timely and decisive fashion and their policy agenda remains on track. Fiscal consolidation, including the introduction of GST in April 2015 and removal of costly and untargeted fuel and other subsidies starting in late 2014, have been effective in shielding the fiscal position from the effects of lower oil-related revenues and in diversifying the revenue base, with appropriate compensatory measures put in place to help offset the impact of fiscal consolidation on lower and middle income households. The medium-term fiscal strategy calls for further consolidation, balancing the budget and materially lowering the federal debt by 2020 while taking into account the economy's cyclical condition. Limited pass through of exchange rate changes to domestic prices and low prices of imports have helped to contain inflation closer to BNM's comfort range. Monetary policy remains accommodative, with cuts in the reserve requirements supporting domestic liquidity and growth. The authorities allowed the exchange rate to depreciate substantially, by about 25 percent against the U.S. dollar between July 2014 and December 2015, and also deployed US\$36.5 billion of reserves over the same period, including reserves accumulated during the post-GFC inflow period, to cushion the effect of capital outflows on the economy and maintain orderly market

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.

conditions. A series of well-targeted macroprudential policies remain in place and have helped build financial sector resilience as the financial cycle turns.

Staff expects economic growth to ease to a still robust 4.4 percent in 2016. Activity should continue to be underpinned by healthy, albeit moderating, domestic demand but constrained by weak external demand. Inflation will rise temporarily but remain close to 3 percent as the impact of lower oil prices wanes and a more depreciated exchange rate passes through to prices. The authorities' structural agenda includes continued focus on improving Malaysia's physical infrastructure and human capital endowment and pursuing economic reforms on a wide front in the context of their 11th Malaysia Plan, 2016–2020. Malaysia has ratified the Trans-Pacific Partnership and is an active participant in the ASEAN Economic Community which came into force in January 2016.

Executive Board Assessment²

Strong fundamentals, ample buffers, a robust financial system, and timely policy responses have enabled the Malaysian economy to weather external shocks, including from lower commodity prices and spillovers from trading partners. While the outlook for the economy is good, Directors agreed that the increasingly challenging environment requires continued implementation of sound macroeconomic policy. Pushing ahead with structural reforms will also be important to raise growth potential over the medium term.

Directors endorsed the current settings for fiscal policy, noting the authorities' continued commitment to fiscal consolidation as evidenced by the 2016 budget. They commended the authorities for the timely elimination of fuel price subsidies, and the implementation of GST, which has significantly diversified the revenue base away from reliance on oil and contributed to fiscal sustainability. Directors underscored that protecting and strengthening the fiscal position should continue to be a top priority, including by adhering to the federal budget deficit target for 2016 and by balancing the budget by 2020. Directors noted that automatic fiscal stabilizers should be allowed to operate to support the economy, and if needed, any additional fiscal stimulus should be targeted, temporary and consistent with the medium-term consolidation plan.

Directors concurred that the current accommodative monetary policy stance is appropriate in an environment of moderating growth and low inflation. Noting that exchange rate flexibility, combined with the use of reserves, had helped insulate domestic financial conditions from global cycles, Directors called for continued exchange rate flexibility, while maintaining an adequate level of reserves. Some Directors noted that the use of reserve adequacy metrics should be supplemented with a broader assessment of the country's economic and financial development.

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 noted that Malaysia's banking sector is well capitalized and resilient and that tighter financial conditions and macroprudential policies have resulted in a slowdown in credit growth. They noted the risks from the relatively high household and corporate debt, but agreed that further macroprudential policies are not needed at this time. They encouraged the authorities to closely monitor risks from rising NPLs as the financial cycle turns.

Directors welcomed the authorities' broad structural reform agenda, including the 11th Malaysia Plan, unveiled in May 2015. These reforms, along with recent international agreements, including the ASEAN Economic Community and the Trans-Pacific Partnership, should help boost productivity and enhance regional integration. In addition, Directors noted that improving the quality of education will be critical in achieving higher-income status. They also underscored the importance of high standards of governance of public enterprises and a clear communication of government-linked companies' investment and financing plans. Malaysia could also benefit from a Public Investment Management Assessment.

Malaysia: Selected Economic and Financial Indicators, 2011–17

	2011	2012	2013	2014	Est. 2015	Proj. 2016	Proj. 2017
Real GDP (percent change)	5.3	5.5	4.7	6.0	5.0	4.4	4.8
Total domestic demand	7.3	10.6	6.4	5.3	5.8	5.2	4.9
Consumption	8.4	7.7	7.0	6.4	5.6	5.5	5.3
Private consumption	6.9	8.3	7.2	7.0	6.0	5.9	5.3
Gross capital formation	4.5	18.3	4.9	2.6	6.4	4.5	3.9
Public gross fixed capital formation	2.6	15.9	1.9	-4.7	-1.0	0.6	1.8
Private gross fixed capital formation	9.5	21.4	12.8	11.0	6.4	5.3	5.0
Saving and investment (in percent of GDP)							
Gross domestic investment	23.2	25.7	25.9	25.0	25.1	25.7	25.6
Gross national saving	34.1	30.9	29.4	29.3	28.0	28.0	27.5
Fiscal sector (in percent of GDP)							
Federal government overall balance 1/	-4.6	-5.1	-4.2	-3.4	-3.2	-3.1	-2.8
Revenue	20.3	20.7	20.4	19.9	18.9	17.2	17.9
Expenditure and net lending	25.0	25.7	24.6	23.3	22.2	20.2	20.6
Federal government non-oil primary balance	-9.9	-10.3	-8.7	-7.3	-5.0	-2.9	-2.2
Consolidated public sector overall balance 2/	-3.3	-5.6	-6.0	-5.9	-8.9	-7.1	-6.6
General government debt	52.6	54.6	55.9	55.6	57.4	55.8	55.8
Inflation and unemployment (period average, in percent)							
CPI inflation (period average)	3.2	1.7	2.1	3.1	2.1	3.1	3.1
Unemployment rate	3.1	3.0	3.1	2.9	3.2	3.2	3.2
Macroeconomic variables (end of period, percentage change)							
Total liquidity (M3)	14.3	9.0	8.1	7.0	2.7	...	...
Credit to private sector	12.1	11.9	9.9	8.9	8.3	8.8	7.0
Credit-to-GDP ratio (end of period)	117.7	123.6	129.7	130.1	134.8	134.5	134.3
Overnight policy rate	3.00	3.00	3.00	3.25	3.25	...	...
Three-month interbank rate (in percent)	3.2	3.2	3.2	3.9	3.8	...	...
Non-financial Corporate Sector debt (in percent of GDP)	89.7	98.0	100.2	96.2	96.0	94.6	93.1
Non-financial Corporate sector debt issuance (in percent of GDP)	4.0	4.7	3.5	3.2	2.6	...	...
Household debt (in percent of GDP)	76.1	80.5	86.1	86.8	89.1	89.3	89.5
Household financial assets (in percent of GDP)	166.7	176.3	187.0	182.4	182.9	...	...
House prices (percentage change)	9.8	11.8	10.9	8.5	6.0	6.4	6.5
Exchange rates (period average)							
Malaysian Ringgit/U.S. Dollar (period average)	3.06	3.09	3.15	3.27	3.91	...	...
Real effective exchange rate (percentage change)	0.4	-0.2	0.5	-0.7	-7.9	...	...
Balance of payments (in billions of U.S. dollars)							
Current account balance	32.5	16.2	11.3	14.5	8.7	7.2	6.6
(In percent of GDP)	10.9	5.2	3.5	4.3	2.9	2.3	1.9
Goods balance	45.9	36.6	30.6	34.7	27.9	26.1	27.3
Services and primary income account balance	-6.6	-14.4	-13.8	-14.8	-13.5	-13.1	-14.1
Capital and financial account balance	7.6	-7.4	-6.4	-24.8	-13.9	-3.6	5.2
Of which: Net foreign direct investment	-3.1	-7.9	-2.0	-5.6	0.1	1.5	2.1
Errors and omissions	-9.1	-7.6	-0.2	-0.8	6.2	0.0	0.0
Overall balance	30.9	1.3	4.6	-11.2	1.0	4.5	12.4
Gross official reserves (US\$ billions)	133.6	139.7	134.9	115.9	95.3	99.8	112.2
(In months of following year's imports of GNFS)	7.4	7.7	7.4	7.4	6.4	6.3	6.6
(In percent of short-term debt) 3/	109.1	104.1	91.8	78.6	75.1	78.0	85.0
Total external debt (US\$ billions) 4/	169.4	196.9	212.3	213.3	194.2	196.8	205.7
(In percent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Of which: short-term (in percent of total) 3/	72.4	68.1	69.2	69.1	65.3	65.0	64.2
Debt service ratio							
(In percent of exports of goods and services) 5/	14.9	17.2	17.3	17.9	21.6	23.3	22.7
(In percent of exports of goods and nonfactor services)	15.9	18.1	18.4	19.0	22.9	24.6	23.9
Memorandum items:							
Nominal GDP (in billions of ringgit)	912	971	1,019	1,107	1,157	1,261	1,352

Sources: CEIC Data Co. Ltd; Data provided by the authorities; Dealogic; and IMF 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/ By remaining maturity.

4/ Staff estimates.

5/ Includes receipts under the primary income account.



MALAYSIA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

March 30, 2016

KEY ISSUES

Adjusting to shocks. The Malaysian economy has faced a sequence of shocks since mid-2014, including declines in commodity prices, spillovers from China, volatility of capital flows, and domestic political controversy. The economy's adjustment is aided by its diversified production and export bases, deep financial markets, strong regulatory framework, strong external position, flexible exchange rates, and responsive fiscal policy and reforms.

Outlook. The outlook for 2016 is shrouded in uncertainties, owing to a confluence of factors that include the global and regional trade slowdowns; China spillovers; the normalization path of U.S. interest rates; and the uneven strength of activity in Malaysia's other major trading partners. Nevertheless, growth should remain healthy at 4.4 percent.

Fiscal policy. The 2016 Budget, including the January recalibration, reaffirms the government's commitment to fiscal consolidation. Key reforms have been undertaken, including elimination of fuel price subsidies, expenditure rationalization, and GST implementation, which will contribute to fiscal sustainability over the medium term.

Monetary policy. The current accommodative monetary policy stance is appropriate in an environment of moderating growth and low inflation. Despite outflows, domestic liquidity remains adequate and monetary conditions are supportive of real activity.

Exchange rate flexibility. Facing sizeable capital outflows and a sharp fall in oil and commodity prices, the exchange rate depreciated substantially and BNM deployed reserves and there were only modest effects on domestic interest rates. Going forward, exchange rate flexibility should be the first line of defense to global financial volatility and external shocks. Reserves should be gradually rebuilt.

Financial cycle. The financial cycle is turning. However, Malaysia's banking sector is well-capitalized and is expected to be resilient through the cycle. Credit growth has moderated, a welcome development following several years of double digit growth. The authorities should monitor risks from rising NPLs as the financial cycle turns.

Structural policies. The 11th Malaysia Plan, unveiled in May 2015, aims to boost competitiveness and productivity by improving human capital and infrastructure. Together with enhanced trade agreements, including the ASEAN Economic Community and the Trans-Pacific Partnership, these efforts should anchor reforms that help boost productivity and enhance regional integration. Improving the quality of educational attainment will be critical in achieving high income status.

Approved By
**Hoe Ee Khor and
 Bob Traa**

Discussions were held in Kuala Lumpur and Kuching during January 11–22, 2016. The mission comprised Alexandros Mourmouras (Head), Niamh Sheridan, Juan Manuel Jauregui, Souvik Gupta (all APD), and Geoffrey Heenan (Resident Representative). Jeff Danforth (FAD) participated in some meetings. Hoe Ee Khor (APD Reviewer), Marzunisham Omar (OED), and Nooraihan Mohd Radzuan (OED) participated in the policy discussions. Simon Paroutzoglou and Justin Flinner (both APD) assisted in preparing this report.

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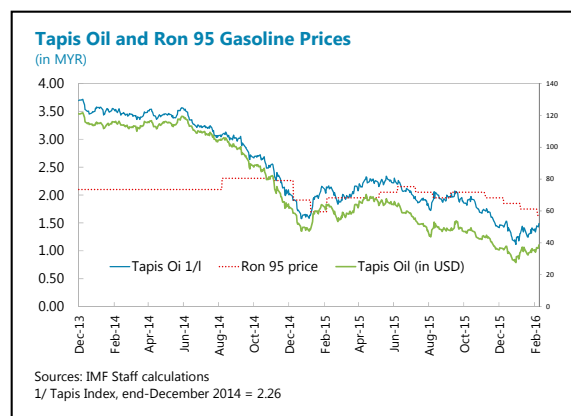
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RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

1. Recent developments. Malaysia's highly open and diversified economy was in a favorable position in mid-2014, with strong economic growth, a large current account surplus and substantial reserves. But the effects of multiple external shocks from lower commodity prices, capital outflows, slowdown in external demand, and China-related financial volatility, have been large and growth is slowing down. The ringgit depreciated by 25.5 percent against the U.S. dollar between July 2014 and December 2015, while US\$36.5 billion of reserves were deployed to cushion the capital outflows and maintain orderly market conditions (Figures 1–2).

2. Economic performance. Real GDP grew by 5 percent in 2015, down from 6 percent in 2014; and the positive output gap has narrowed. Private sector domestic demand was the main driver of growth. Exports picked up in the second half of the year on stronger external demand and a depreciated currency, and the current account remained in surplus. Investment has been resilient owing to the continued implementation of long-gestation projects in infrastructure and industry. The manufacturing and services sectors have also been resilient. Inflation has remained subdued as weaker demand and lower oil prices offset the impact of GST and currency depreciation. Credit growth is slowing to a more moderate pace.

3. Policy adjustments. The authorities' responses to shocks have been timely and their policy agenda remains on track and is in line with Fund policy advice (Appendix I). Fiscal consolidation is aimed at offsetting lower oil and gas related revenues and delivering medium-term sustainability. The introduction of GST and elimination of fuel subsidies in 2015 helped to diversify government revenues and protect the fiscal position from lower oil prices. Monetary policy was calibrated to support growth and contain inflationary pressure from the GST introduction and currency depreciation. A series of targeted macroprudential policies have helped build financial sector resilience as the financial cycle is turning.



4. Outlook. Staff expects economic growth to ease to 4.4 percent in 2016 and the economic environment has become more challenging. Activity should continue to be underpinned by healthy, albeit moderating, domestic demand but constrained by weak external demand. Credit growth is expected to slow down, dampening the accumulation of debt. Nevertheless, financial conditions are expected to remain accommodative of growth. Consumption growth will be supported by a temporary reduction in mandatory Employee Provident Fund (EPF) contribution rates, tax relief for middle and lower income taxpayers and expanded federal transfers to lower-income groups, lower fuel prices, and by high rates of household formation and strong employment. Private investment growth is projected to decelerate to about 5 percent. Inflation will rise temporarily in early 2016 as the impact of lower

oil prices wanes and a more depreciated exchange rate passes through to prices.¹ Over the medium term, potential growth will remain close to 5 percent but is likely to be slightly lower than previously projected owing to lower commodity prices, slower potential growth in China and other emerging markets, and lower potential growth in advanced economies. Despite the large negative terms of trade shock, the current account is projected to stay in surplus.

5. Risks. The outlook for 2016 is uncertain owing, inter alia, to the global and regional trade slowdowns, China-related volatility and spillovers and the normalization path of U.S. interest rates; (Appendix II).

- **External risks.** Despite significant capital outflows during 2015, foreign investors still hold sizeable positions in Malaysian Government Securities (MGS) and Malaysia remains vulnerable to further outflows, especially during periods of heightened global financial stress. Other risks include a sharper-than-expected slowdown in China in 2016–17; structurally weak growth in advanced and emerging market economies; and a further decline in energy and commodity prices.
- **Domestic risks.** These are related to a sharp rise in domestic debt in the post-GFC period: federal debt and contingent liabilities are relatively high, as is external and household debt. Realization of contingent liabilities would likely contribute to financial market volatility and potential spikes in sovereign bond yields. Risks of a severe downturn in the financial cycle appear to be relatively low: continuing growth and a resilient banking system, bolstered by BNM’s macroprudential policies, should limit any increase in non-performing loans (NPLs). Pass-through from the exchange rate to domestic prices needs to be monitored.

Malaysia: Outstanding Debt (In percent of GDP)		
	2008	2015 Est.
General government debt	39.9	57.4
Household debt	60.4	89.1
Nonfinancial corporate sector debt	94.4	96.0

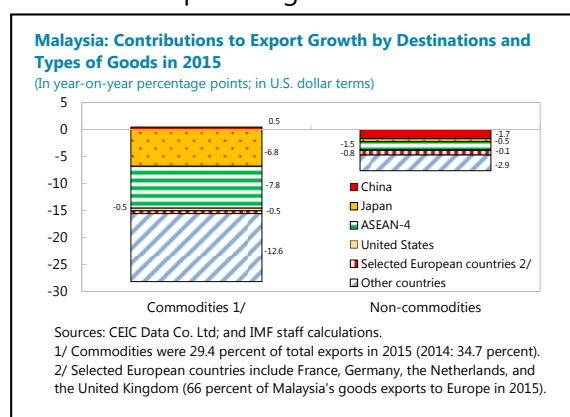
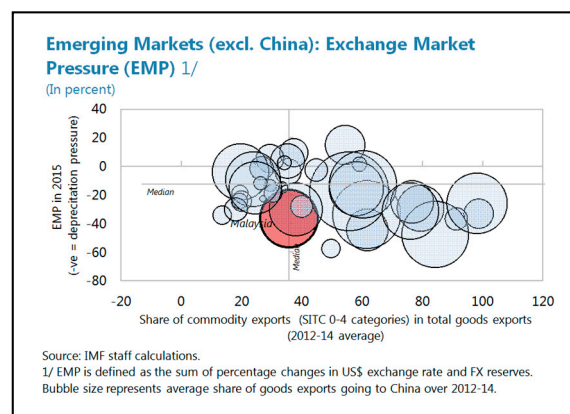
Sources: CEIC Data Co Ltd; and IMF staff calculations.

6. Authorities’ views. The authorities were in broad agreement with staff’s assessment. Malaysia’s diversified economy and strong macroeconomic fundamentals have blunted the impact of lower commodity prices. Nevertheless, growth has moderated and is expected to be between 4.0–4.5 percent for 2016, led by domestic demand. Consumption growth will remain healthy but at a slower pace. Private investment growth is also expected to moderate but will be sustained by the pipeline of strategic infrastructure projects. Manufacturing exports are expected to benefit from the depreciation of the ringgit. The authorities agree that externally driven volatility is likely to persist. They emphasized the low probability of fiscal contingent liabilities materializing. BNM assesses the probability of a sharp turn in the financial cycle as low and views the risks as manageable.

¹ Staff estimates suggest that exchange rate pass-through has historically been weak in Malaysia; however, given the large depreciation exchange rate pass-through could be stronger than in the past. Imported goods, not including oil, are 6.9 percent of the CPI basket. Using a common factor model, a near zero loading coefficient on the U.S. nominal effective exchange rate was found for inflation in Malaysia (see IMF (2015) *Regional Economic Outlook: Asia and Pacific*).

ADJUSTING TO EXTERNAL SHOCKS

7. Lower commodities prices. Malaysia's exports are diversified but oil and gas related commodities are important, accounting for about 10 percent of exports. The large fall in commodity prices has led to a significant narrowing of the current account surplus, to 2.9 percent of GDP in 2015, as weak commodity exports are only partially offset by a pickup in manufacturing exports (Appendix III). The decline in the current account surplus was reflected in lower corporate saving in the first instance. The deficit of the nonfinancial public sector (NFPS), which includes important government-linked companies (GLCs) such as PETRONAS, the national oil company, widened, reflecting, inter alia, the lagged adjustment of dividends to the budget by PETRONAS and continued implementation of domestic investment programs.² (Appendix IV) At the same time, offsetting measures have left the federal budget deficit little changed.³ Looking ahead, the NFPS deficit will gradually decline as public savings recovers over time. While the investment ratio is still projected to rise over time, its trajectory will be more modest. The current account is expected to narrow further, to about 1.6 percent of GDP over the medium term. Expenditure switching associated with a more competitive exchange rate should help boost exports but this will be offset by large import needs. Malaysia's prior experience with adjusting to lower commodities prices highlights the positive impact of fiscal reforms on growth (Appendix V).



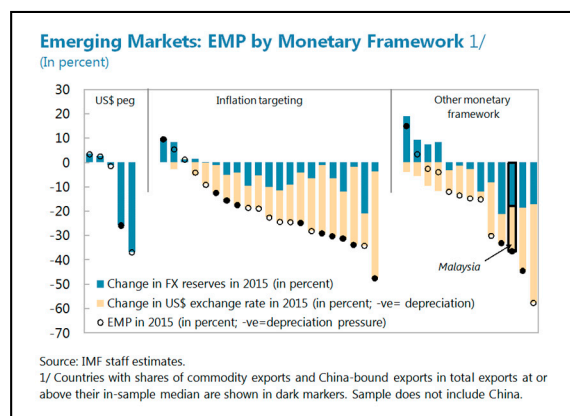
8. Spillovers from China. China is Malaysia's largest trading partner and spillovers through the trade and commodity channels are relatively important. Malaysia's exports to China comprise manufactures which are part of the regional supply chain as well as palm oil and other non-oil commodities. However, the direct spillover effects of developments in China on Malaysia's exports have been small thus far as confirmed from detailed goods exports data, decomposed by commodities and non-commodities and by country of destination. Much of the negative effect on the trade balance is from the impact of lower international prices of products Malaysia exports outside of China, for example, LNG exports to Japan and Korea. In addition, there may be

² PETRONAS dividends to the government were 26 billion ringgit in 2015 compared to 29 billion ringgit in 2014, while profits in 2015 declined to 21 billion ringgit compared to 48 billion ringgit in 2014.

³ The difference between the NFPS and federal deficits is due to GLCs' large capital expenditure programs. These GLCs are profitable and subject to market discipline. Their investment (part of the national five-year development plan) is financed out of earnings and issuance of debt and equity.

second round effects on exports, as other countries are negatively impacted, decreasing overall external demand for Malaysia.

9. Exchange Market Pressure (EMP). The extent to which Malaysia's FX market was affected by global shocks during 2015 in relation to its peer Emerging Market Economies (EMEs) can be gauged by a simple EMP index (Appendix VI).⁴ Malaysia's EMP showed a sizeable depreciation pressure and was higher than, for example, some Latin American EMEs. Malaysia's EMP was broadly in line with that predicted by cross-country regression analysis, with export exposure to China and to mineral fuels largely explaining it. In terms of composition of EMP, data analysis shows that changes in reserves contributed more in Malaysia than in most EMEs. This largely reflects a reduction in foreign holdings of the short-term BNM bills, which were used to sterilize and smoothen the impact of the global capital flow cycles on the domestic financial markets (see paragraph 12).

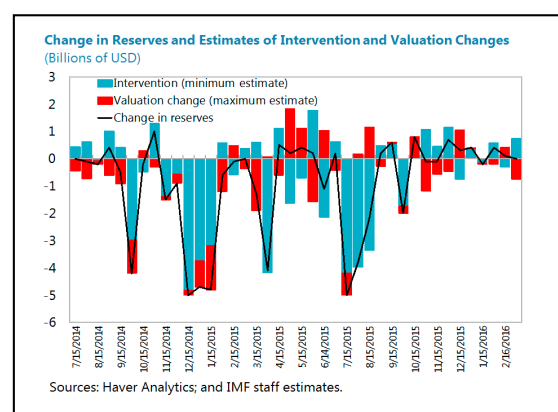
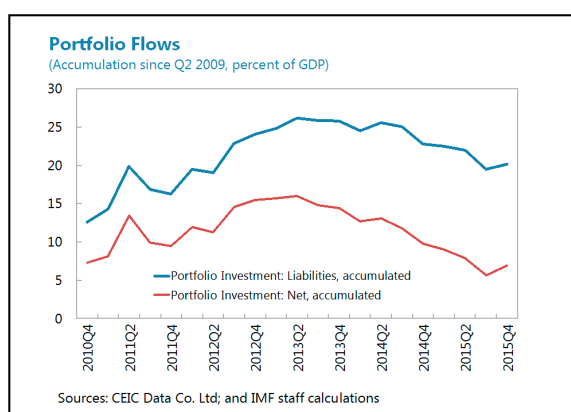


10. Authorities' views. The adjustment to lower commodity prices is ongoing, supported by Malaysia's diversified economy and government revenue sources. Furthermore, exchange rate depreciation is supporting manufacturing exports and is helping to partially offset the commodities price shock. The authorities remain committed to balancing the budget by 2020. Medium-term fiscal consolidation will be achieved primarily through expenditure rationalization and restraint. The authorities concur that spillovers from rebalancing of the Chinese economy could reduce growth and increase volatility; however, the Malaysian economy's enhanced trade linkages with other economies creates additional growth opportunities.

CAPITAL OUTFLOWS: STRESS TESTING RESILIENCE

11. Capital inflows and reversals. Malaysia has relied both on foreign reserves and the exchange rate to cushion the impact on the economy of shocks to capital flows and its terms of trade. Capital inflows in the post-GFC era were sizable, with cumulative portfolio inflows amounting to US\$81 billion (26 percent of GDP) between early 2009 and their peak in mid-2013. During this period, Malaysian institutional investors, including the Employees Provident Fund (EPF), were also diversifying their portfolio by investing abroad, easing demand for domestic

⁴ The EMP index combines the changes in the currency against the U.S. dollar and that in the FX reserves, inclusive of valuation effects.

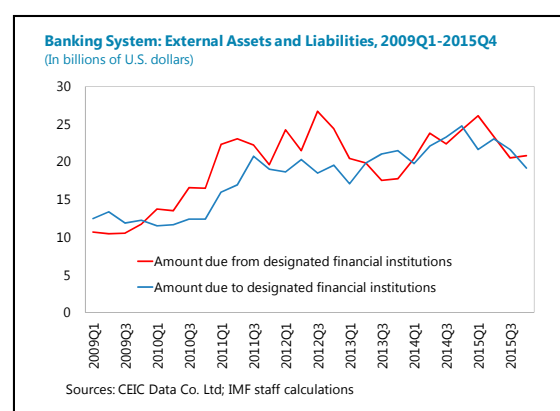


assets and reducing net inflows. BNM sterilized inflows by issuing bills, and changes in foreign holdings of BNM bills were matched by similarly sized changes in reserves. Reserves accumulated during inflow surges were used to cushion the impact of capital outflows during 2013–2015.

12. Recent volatility. Capital outflows were particularly high during 2015. In late 2014–early 2015 outflows were primarily from the equity market and were primarily in response to declining commodity prices and weak external demand. For the rest of the year, outflows were primarily from BNM bills largely reflecting the unwinding of the carry trades, and by June 2015, foreign holdings of BNM bills had shrunk to near zero. In contrast, foreign holdings of MGS have been relatively stable. These episodes were similar to earlier bouts of capital flow volatility and BNM used its reserves and the exchange rate to smooth the adjustment and maintain orderly market conditions. Reflecting the depth of Malaysia’s financial markets, the effects on domestic interest rates and the real economy were small.

13. Assessing vulnerabilities. Malaysia’s vulnerabilities arise mainly from high foreign holdings of MGS and equities, high short-term debt of the banking system, and high household and corporate sector debt. However, deep-pocketed domestic institutional investors and sizeable bank liquidity with BNM contribute to continued resilience (Appendix VII).

- The MGS market is deep and liquid and MGS yields are less volatile than government bond yields in other EMEs. Domestic institutional investors, with ample liquidity, tend to buy opportunistically when foreign investors exit and there is upward pressure on yields. Staff analysis suggests that these investors have balance sheet capacity to absorb additional MGS holdings of at least 5 percent of GDP, which would help stabilize the market.
- Short-term external debt of the banking system has increased to almost 23 percent of GDP by end-September 2015. This debt comprises short-term offshore borrowing and non-resident deposits. The rise in short-term offshore debt appears to be primarily related to centralization of overseas treasury operations of foreign branches of Malaysian banks and has been accompanied by an increase in short-term banking sector assets. Non-resident deposits amounting to



7.2 percent of GDP, of which two thirds comprise business deposits, have been stable so far. However, in a stress scenario, withdrawal of non-resident deposits could pose a vulnerability.

- Outstanding liquidity placed with BNM amounted was approximately RM 220 billion at end December 2015, of which approximately RM 50 billion represents statutory reserves, down from RM 320 billion in August 2014. BNM can release part of this liquidity to the banks in a stress scenario and offset the impact of outflows on their balance sheets.

14. Stress tests. Malaysia's external debt has increased from about 54 percent of GDP in 2009 to 65.6 percent at end-2015, of which one quarter comprises foreign holdings of local currency debt. A severe stress test that simulates a further outflow of foreign capital (similar in magnitude to that observed during the GFC) reaffirms that risks to Malaysia from capital outflows remain contained (Appendix VII). A substantial part of Malaysia's external debt, about 36 percent, is in its own currency and its exchange rate is flexible, allowing for more risk sharing with foreign investors: when shocks lead to outflows and currency depreciation, foreign holders experience valuation losses, reducing the drain on reserves and incentives to exit.

15. Authorities' views. The authorities agree that Malaysia's open economy and large financial sector expose the economy to capital flow volatility. Accumulation of reserves during post-GFC inflow surges helped limit the appreciation of the exchange rate and reduce excess liquidity in the banking system, thereby maintaining stable monetary conditions. Subsequently when flows reversed, the use of reserves and release of liquidity into the banking system insulated the impact on monetary conditions and the economy. In addition, exchange rate flexibility played a key role in the adjustment to lower commodity prices. The authorities noted that Malaysia's resilience to capital flow volatility is strong as demonstrated by the modest impact on the real economy during capital outflow episodes. They agreed with staff's assessment that the Malaysian economy can be resilient to a stress scenario due to its solid fundamentals and macroeconomic policies, including diversified sources of growth, current account surpluses and FDI inflows, manageable level of external debt, liberal capital accounts as well as a deep and diversified financial system.

POLICIES FOR RESILIENCE

16. Response to shocks. Uncertainty about external conditions requires continued fiscal prudence and flexibility in setting fiscal, monetary and exchange rate policies. With receding risks to price stability, monetary policy has more room to focus on domestic growth. Fiscal policy should persevere with growth-friendly consolidation over the medium term. While fiscal space is limited, temporary and targeted measures anchored in a medium-term consolidation plan can support aggregate demand. Exchange rate flexibility should continue to be the first line of defense to external shocks and reserves deployed to ensure smooth functioning of markets. Over the medium term, reserves can be gradually and opportunistically rebuilt. Staff supports the authorities' declaration to abstain from using capital controls on outflows.

A. Monetary Policy

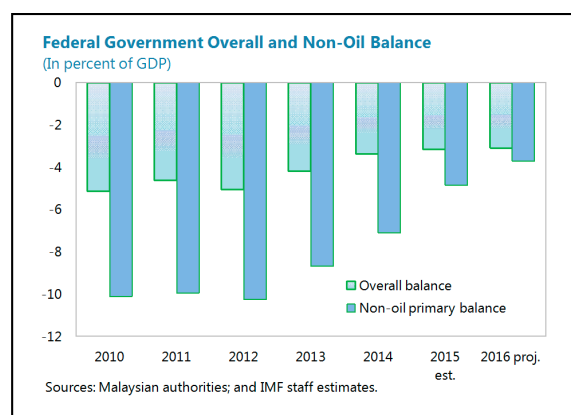
17. Appropriate stance. The current environment of moderating growth, low inflation and tightening credit conditions calls for accommodative monetary policies. BNM has kept its policy rate unchanged since July 2014, resulting in low real interest rates that are supportive of domestic demand. Capital outflows and implementation of liquidity coverage ratio (LCR) requirements led to a tightening of domestic liquidity conditions. Meanwhile, the recent 50 basis point reduction in the statutory reserve requirement ratio should help prevent an over-tightening of credit conditions. Inflation will peak in the first quarter due to the waning impact of earlier declines in oil prices but is expected to remain moderate during 2016 on modest exchange rate pass through.

18. Outlook and managing risks. No change in the policy rate is anticipated during 2016, in line with projections from an estimated Taylor rule (Appendix VIII). A reduction in the policy rate to aid growth in the near term would risk re-igniting strong credit growth. A tightening of interest rates should be considered if signs emerge of second round inflation pressures from the large exchange rate depreciation. In a risk scenario where prolonged capital outflows result in a significant tightening of domestic liquidity conditions, BNM could provide liquidity through open market operations and/or further lower the statutory reserve requirement. Going forward, given the lower level of reserves, greater reliance on exchange rate flexibility is recommended.

19. Authorities' views. The current stance of monetary policy is supportive of activity. Growth is expected to moderate while inflationary pressures are expected to remain subdued. Recent external and domestic developments have weakened the exchange rate, with capital outflows contributing to lower domestic liquidity. BNM will continue to ensure sufficient liquidity to maintain orderly markets and support growth. The authorities agreed with staff on the importance of exchange rate flexibility and on the need to rebuild reserves over the medium term. However, they would not rule out using reserves to buffer short-term capital flows as in the past.

B. Fiscal Policy

20. Background. Fiscal policies in recent years have strived to balance near-term support for growth with medium-term fiscal sustainability. The 2015 deficit target of 3.2 percent of GDP was achieved through introduction of the GST, subsidy reform, restraint in recurrent spending, and lagged adjustment in the PETRONAS dividend. These reforms will also help sustain the fiscal consolidation effort going forward although, in staff's view, balancing the budget by 2020 could require additional measures up to 1.2 percent of GDP.



21. 2016 Budget. The 2016 Budget, including the January recalibration, targets a deficit of 3.1 percent of GDP. Faced with further declines in oil and gas related revenues, the authorities cut spending on supplies and services and grants and refocused development expenditure on high impact projects with low import content. The measures adopted strove to mitigate the impact on the domestic economy and the fiscal impulse is -0.8 percent of GDP in 2015 and -0.1 percent of GDP in 2016. (Figures 4 and 5). In addition, measures were taken to support consumption by low and middle income earners: Employers Provident Fund (EPF) contributions were reduced temporarily by 3 percentage points (until end-2017); and additional tax relief was provided to those earning RM 8,000 or below per month.

Malaysia: Fiscal Developments 2014–16

Measures and Developments	Annual Impact (Percent of GDP)
Decline in Petroleum Income Tax	-1.9
Decline in Petronas Dividend	-1
Introduction of GST	+3.1
Elimination of Sales and Services Taxes	-1.6
Increased Social Spending	-0.3
Elimination of Fuel Subsidies for Consumers	+0.9
Other Net Savings	+1.1
Overall Deficit Reduction	+0.3

Sources: IMF staff calculations.

22. Policy response to shocks. If the economy is weaker than envisaged under the baseline, staff advises that the automatic stabilizers should be allowed to operate and the federal deficit could be allowed to rise slightly while maintaining commitment to the medium-term fiscal consolidation plan. Should the growth outlook deteriorate significantly, relatively high fiscal deficit and public debt afford limited space for a sustained countercyclical fiscal response. Any fiscal stimulus should be temporary, targeted and anchored in a medium-term fiscal consolidation program.

23. GST. The GST has played a critical role in the adjustment to lower oil prices. Its effectiveness could be enhanced by narrowing the list of exempt and zero-rated items. At 6 percent, the GST rate is low relative to other countries and could be increased to help achieve medium-term fiscal objectives.

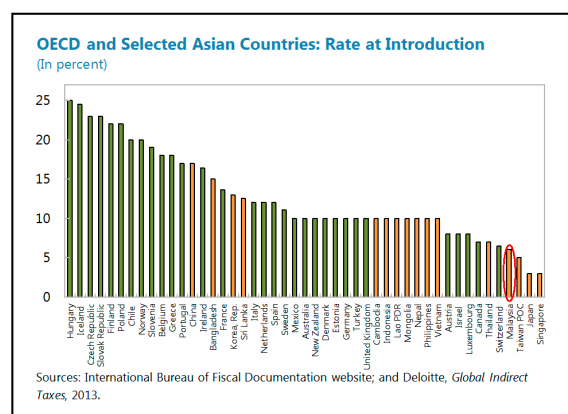
24. Federal debt and contingent liabilities.

Federal debt is expected to remain below the 55 percent of GDP ceiling in the short-and medium-term (Appendix IX). Contingent liabilities (in excess of 15 percent of GDP) require continuous monitoring. Staff recommends that a statement on fiscal risks be published annually to inform policy. Staff notes that a new statutory body, Public Sector Housing Financing Board, has been created which will manage housing loans to civil servants starting in January 2016. Associated assets and a portion of associated liabilities have been transferred to the new body, reducing federal debt by 2 percent of GDP but leaving general government debt unchanged. Although the default risk is low given at-source deductions from payroll, this requires transparent treatment in a fiscal risks statement.

25. Fiscal institutions and framework. Staff welcomes the adoption of a medium-term fiscal framework and the inclusion of three-year projections in the 2016 budget. Looking ahead, staff encourages additional information in future budgets, including annual projections of revenue and expenditure and an explicit link with 11th Malaysia Plan. Staff welcomes implementation of accrual accounting and outcome-based budgeting. Malaysia has made important strides in the provision of public infrastructure (Appendix X). Under the 10th Malaysia plan, the ratio of public capital stock to GDP has increased. Malaysia also fares well in surveys of infrastructure quality and access. Malaysia, as other countries, would benefit from a Public Investment Management Assessment (PIMA).

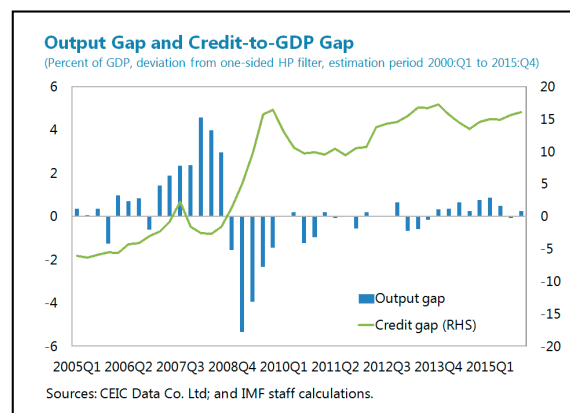
26. Nonfinancial public enterprises. The NFPS deficit is estimated to have increased from 5.9 percent of GDP in 2014 to 8.9 percent in 2015. This stemmed mostly from the fall in global oil prices, which lowered GLCs' operating surpluses, and continued implementation of GLC investment, which provided support to the economy. GLCs finance capital expenditure from retained earnings and the issuance of debt and equity. Clear communication of GLC investment and financing plans will be important to ensure markets are appropriately informed.

27. Authorities' views. The authorities reiterated their commitment to fiscal sustainability and achieving a budget that is broadly balanced in the medium term. For the 2016 Budget, the authorities noted the significant contribution from GST revenues and emphasized that expenditure restraint measures will focus on areas with low impact on aggregate demand. Although contingent liabilities are sizable, government loan guarantees have a low probability of being called as they are granted strategically to nonfinancial entities with healthy balance sheets.

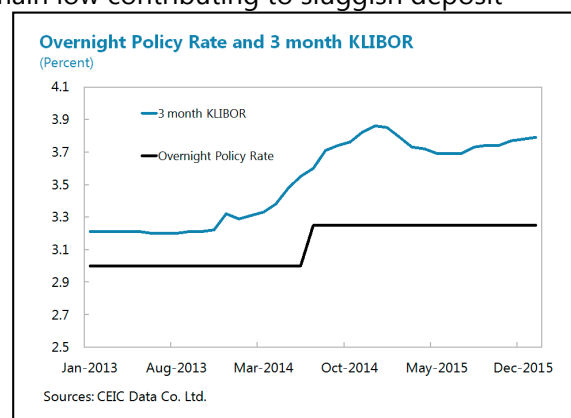


THE FINANCIAL CYCLE AND LEVERAGE

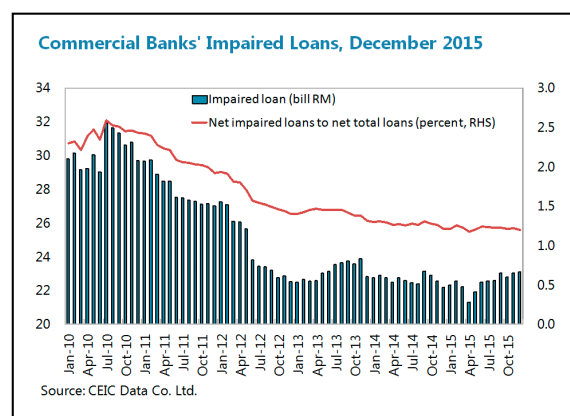
28. Background. The financial cycle is turning and loan growth continues to ease, reflecting macroprudential policies and macroeconomic factors. The turn in the credit cycle is lagging the turn in the economic cycle and, as a result, the ratio of credit to GDP has increased, widening the credit gap. However this is expected to reverse as nominal GDP growth picks up and outpaces more moderate credit growth. While credit markets are expected to remain supportive of growth, tighter credit conditions and high debt levels will weigh on domestic demand (Figure 7).



29. Banks. Banks' strong liquidity position with BNM has helped to cushion the impact of capital outflows. Real interest rates on deposits remain low contributing to sluggish deposit growth which, along with banks' adjustment to LCR requirements, has resulted in intensified competition for deposits. Banks' capital position strengthened in 2015, but profitability weakened slightly. Loan quality remains good although the NPL ratio was unchanged, consistent with slower economic growth (Figure 10). Banks' short-term FX debt has increased and although matched by an increase in FX assets, warrants careful monitoring. Malaysian banks are well placed to meet the Basel III capital and phased-in liquidity requirements. Significant progress has also been made in implementing key FSAP recommendations (Appendix XI).



30. Non-banks. Non-bank credit intermediaries contributed significantly to the build-up of household debt but growth in non-bank lending and the stock of debt to households have declined following implementation of macroprudential measures in 2013. Direct linkages between banks and non-banks are limited and covered by BNM's regulation on single counterparty exposures (Appendix 8, 2014 Malaysia Article IV Consultation).



31. Household debt and macroprudential policies. Household debt has increased by 15 percentage points of GDP since end-2009 but growth has begun to moderate as of late (Figure 8). Close to 50 percent of the debt is owed on residential property and about 60 percent are variable rate loans. Macroprudential measures have helped to curb household borrowing (Table 8). The impact of measures continues to be felt and the reduced loan applications and approvals reflect in part an enhanced framework for risk-based pricing of loans. Risks from high household debt are mitigated by strong household financial assets (including EPF savings and banking system deposits) and low unemployment. NPLs are likely to increase as the financial cycle turns but any increase is likely to be small. House prices are still growing but prices of high-end properties in Kuala Lumpur have declined slightly. Given the slowdown in loan growth and in housing, no further measures are recommended. LTV caps on second and first mortgages should be considered if rapid house price and credit growth were to reignite.

32. Corporate sector debt. Corporate sector debt, at 96 percent of GDP, is relatively high but its growth has moderated since the GFC (Appendix XII). Corporate debt risks in terms of maturity, currency, and exposure to commodities appear contained. Bank loans, representing about half of total corporate debt, are well diversified and predominantly medium term. Less than 26 percent of total debt is foreign-currency denominated and well below the emerging market average of close to 35 percent. BNM's approval regime for external borrowing ensures that corporates' foreign currency debt is either naturally hedged or is hedged using derivatives. Commodities account for less than 20 percent of listed corporate sector debt. Stress testing results imply that Malaysian corporates are resilient to declines in income, depreciation of the exchange rate, and increases in interest rates.

33. Authorities' views. The authorities concurred that the financial cycle is turning. Nevertheless, due to macroprudential policies and risk-based supervision, banks are expected to remain resilient. High underwriting standards imply that only a modest and manageable increase in NPLs is anticipated. Additional macroprudential measures are not needed at this time and there are no plans to wind down existing measures, given their prudential nature. Risks from non-financial corporate sector debt remain manageable, supported by generally healthy balance sheets and financial positions. Close to 73 percent of external borrowings were of longer maturities, exceeding one year, further reducing short-term risks. Outstanding non-financial corporate external debt is borne by domestic conglomerates and local outfits of multinational corporations (mainly in the form of inter-company loans). As part of BNM's approval consideration for external borrowings equivalent to RM 100 million and above, the borrowings should be adequately hedged or supported by foreign currency receivables.

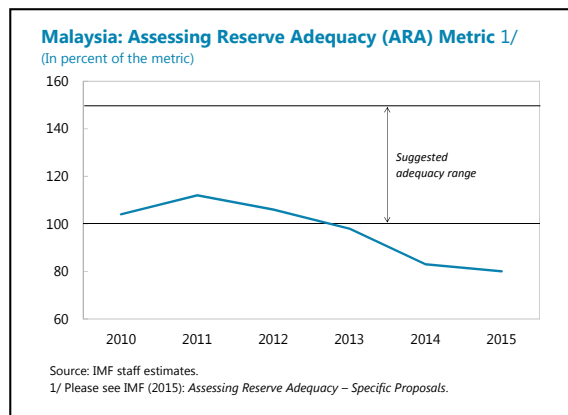
EXTERNAL SECTOR ASSESSMENT

34. External sector assessment. Malaysia's 2015 external position was stronger than warranted by fundamentals and desirable policies (Appendices XIII–XIV). The 2015 External Balance Assessment (EBA) estimates the cyclically-adjusted current account (CA) surplus to be 4.6 percent of GDP, with the CA norm at 0.5 percent of GDP. However, staff's estimate of the current account norm is 1.8 percent of GDP, which implies a CA gap of 2.8 percent of GDP, with the policy gap contributing –0.1 percent of GDP. The CA gap reflects structural factors, viz. low

investment since the Asian financial crisis on the back of high saving. While the gap has narrowed significantly in recent years—saving has declined and investment has increased, though at a slower pace—policy measures should help to further reduce this gap through, for example, improving social insurance institutions and addressing labor force skill mismatches.

Malaysia's real effective exchange rate (REER) is assessed to also be moderately undervalued, by 9.7 percent, consistent with the identified CA

gap. Reserves were above 100 percent of the IMF's reserve adequacy metric prior to the onset of the large shocks in 2014–15. The use of reserves to cushion capital outflows has resulted in a decline to 80 percent of the metric for 2015, which is below the suggest adequacy range of 100–150 percent. Going forward, staff recommends greater reliance on the exchange rate flexibility and that reserves be increased as opportunities present themselves. Malaysia's net international



Malaysia: Quantitative External Sector Assessment

	Norm 1/	Actual 1/	Gap
Current account			(In percent of GDP)
EBA 2.0 current account	0.5	4.6	4.1
<i>Of which:</i> Contribution of identified policy gaps 2/			-0.1
Unexplained residual			4.2
External sustainability approach 3/			1.9
Staff assessment	1.8	4.6	2.8
<i>Of which:</i> Contribution of identified policy gaps (based on EBA 2.0)			-0.1
Other			2.9
Exchange rate misalignment			(Percentage)
EBA Index real exchange rate regression approach 4/	...	...	-30.5
<i>Of which:</i> Contribution of identified policy gaps 2/	...	...	1.0
Unexplained residual	...	...	-31.5
EBA Level real exchange rate regression approach 4/	...	...	-24.0
<i>Of which:</i> Contribution of identified policy gaps 2/	...	...	1.4
Unexplained residual	...	...	-25.4
Staff estimate using elasticity approach 5/	...	...	-9.7

1/ Staff's estimate of the multilaterally consistent cyclically-adjusted norm and actual for 2015, based on EBA February 2016.

2/ Policy gaps refer to policy distortions that can arise from domestic policies and/or as a result of the policies of other countries. See 2015 Pilot External Sector Report.

3/ From EBA January 2016. Based on 2013 NFA/GDP ratio of -5.0 percent of GDP and an adjusted medium-term CAB of 2.0 percent.

4/ Misalignment based on EBA January 2016.

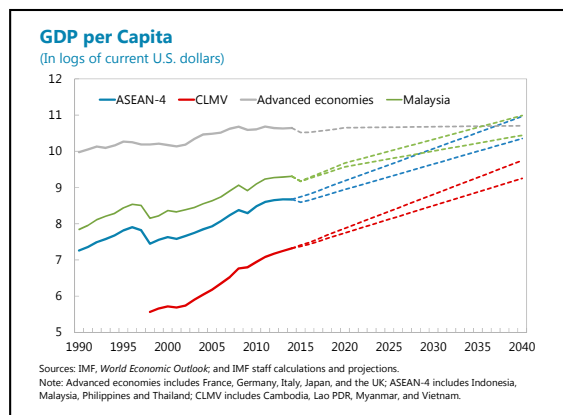
5/ The semielasticity of the current account balance with respect to the REER is $\eta_{CA} = -0.29$, computed according to $\eta_{CA} = \eta_{Xnc} s_{Xnc} - (\eta_M - 1) s_M - s_{Xc}$, where η_{Xnc} is the elasticity of the volume of non-commodity exports with respect to the REER, η_M is the elasticity of the volume of imports with respect to the REER, estimated at $\eta_{Xnc} = -0.82$, $\eta_M = 0.26$, $s_{Xnc} = 58.2$ percent is the share of non-commodity exports in GDP, $s_{Xc} = 16.8$ percent is the share of commodity exports in GDP, and $s_M = 61$ percent is the share of imports in GDP.

investment position is 8.4 percent of GDP at end-2015, a significant improvement over 2014 that is attributed to capital outflows and valuation effects.

35. Authorities' views. The authorities broadly agree with staff's assessment. Exchange rate adjustments continued to perform a critical role in absorbing external shocks. Exchange rate flexibility was complemented by foreign exchange intervention, utilizing reserve buffers in times of heightened volatility when market participants were prone to herd-like behavior. Despite the decline, Malaysia's international reserves remain ample. Reserves constitute only one-fourth of Malaysia's total external assets and other external assets also provide a cushion, if needed, against short-term claims. The authorities also note that the Fund's reserve adequacy metric uses an unfavorable binary classification under which Malaysia's exchange rate regime is classified as "other fixed" instead of "free floating." They emphasize the importance of judgment in making assessments and the need to avoid a rigid interpretation of any metric. The authorities expect the current account to remain in surplus over the medium term.

STRUCTURAL REFORMS FOR REAL CONVERGENCE AND INCLUSION

36. The challenge. Malaysia has made substantial progress in real convergence under the 10th Malaysia Plan.⁵ The challenge now is to make the leap to advanced country status by boosting productivity. The 11th Malaysia Plan, unveiled in May 2015, envisages investments in hard and soft infrastructure, including a high speed rail linking Kuala Lumpur to Singapore, expansion of the Kuala Lumpur metro system, and the Pan Borneo highway. These investments should help connectivity with neighbors, alleviate congestion in Malaysia's cities and make them more attractive to foreign investment and skilled labor.



37. Championing trade integration. Malaysia remains a champion of free trade and investment in ASEAN. The launch of the ASEAN Economic Community (AEC) in January 2016 following Malaysia's chairmanship should help reduce extensive intra-ASEAN non-tariff trade barriers and strengthen trade and investment, especially in services. Malaysia is also signatory to the Trans-Pacific Partnership (TPP), whose implementation starting in 2018 should help improve productivity through greater competition and better governance. Staff welcomes the authorities'

⁵ For an assessment of Malaysia's development record from a longer term perspective, see Alex Mourmouras and Niamh Sheridan, "Malaysia: Achieving High-Income Status through Resilience and Inclusive Growth," IMF Research Bulletin, December 2015, pp. 9-19: <http://www.imf.org/External/Pubs/FT/irb/2015/04/index.pdf>.

staunch support of free trade, despite domestic opposition.⁶ Viewed in their totality, better infrastructure and adherence to free trade should help make Malaysia more competitive.

38. Boosting human capital and home grown innovation. Improvements in workforce skills, more home-grown innovation and more intensive technology adoption will also be necessary if Malaysia is to avoid the middle income trap and become more inclusive. Staff encourages steadfast implementation of the Malaysia Education Blueprint 2013–25, which aims to boost student educational attainment and raise scores to the upper third of international comparisons. Malaysia’s education system needs continued transformation, with industry-led cooperative arrangements with universities and technical vocational institutes, as well as a sharpening of incentives in the allocation of research budgets and greater focus on commercialization of knowledge obtained from research and development.

39. Strengthening institutions. Recent events surrounding a government-owned strategic investment fund that is embroiled in scandal underscore the need to uphold high standards of governance and communication in public financial management. Transparency International’s Corruption Perceptions Index for Malaysia declined from 52 to 50 in 2015 and the ranking fell from 50th to 54th. Malaysia continues to score well on the World Bank’s Ease of Doing Business Index, ranking 18th in 2016. Staff welcomes steps currently under consideration to strengthen the Malaysia Anti-Corruption Commission and Malaysia’s engagement with its Financial Action Task Force peers to strengthen the domestic framework and implementation of laws relating to Anti-Money Laundering and Countering the Financing of Terrorism (AML-CFT). Staff also encourages the authorities to enhance the asset declaration system and strengthen law enforcement agencies’ capacity to conduct financial investigations.

40. Authorities’ views. The authorities agreed with the broad thrust of staff’s assessment. They reiterated their commitment to fiscal prudence and to fiscal and structural reforms to raise the efficiency and fairness of fiscal policy and to improve the quality of education and strengthen their investments in research and development. They also reiterated their commitment to trade integration and economic openness which will provide an anchor for reforms and help improve living standards for all Malaysians. They are confident that implementation of their wide ranging reform agenda will help Malaysia achieve high income status by 2020.

⁶ According to recent estimates (Petri and Plummer 2016), Malaysia’s gains from the TPP will amount to 5 percent of its GDP by 2025. See Peter A. Petri and Michael G. Plummer: The Economic Effects of the Trans-Pacific Partnership: New Estimates, Working Paper Peterson Institute for International Economics, Washington DC.

STAFF APPRAISAL

41. Outlook. Malaysia's highly open economy remains resilient despite being buffeted by multiple shocks since late 2014. However, growth is slowing down, the economic environment has become more challenging, and downside risks have risen. On-going re-balancing in China could imply additional spillovers in the near term. Uncertainty about the external environment, including the likelihood of persistently low commodity prices and more capital outflows, require continued prudence in selecting policy settings.

42. Fiscal policy. The authorities have broadened revenue bases and diversified them away from oil and gas related revenues in a timely manner. The NFPS deficit has risen as commodity prices declined, but this is expected to reverse in the medium term. Protecting and strengthening the fiscal position should continue to be the authorities' top priority, by adhering to the federal budget deficit target for 2016 and by balancing the budget by 2020. While automatic fiscal stabilizers should be allowed to operate if the economy is much weaker than envisaged, there is relatively little room for countercyclical fiscal policies. Given the relatively high federal debt and contingent liabilities, any fiscal stimulus should be targeted, temporary and consistent with the medium-term fiscal consolidation plan.

43. Monetary policy. In response to external shocks and capital outflows, BNM has allowed the ringgit to depreciate and deployed reserves to smooth the capital flow cycle and ensure orderly conditions in foreign exchange and financial markets. Going forward, BNM should rely more on exchange rate flexibility and intervene judiciously and gradually rebuild its stock of international reserves. While headline inflation is expected to rise temporarily in 2016, core inflation is well anchored, and BNM's current monetary policy setting is appropriate. However, the authorities should continue to monitor risks to inflation from stronger than expected exchange rate pass-through and a tightening of interest rates could be considered if signs of second-round effects emerge.

44. Financial sector. Macprudential policies and tighter financial conditions have resulted in lower credit growth, a welcome development following years of strong growth. Nevertheless, household and corporate sector debt remains elevated. Additional macprudential policies are not currently recommended. Liquidity remains adequate and supportive of growth. Malaysian banks are well capitalized and are expected to remain strong as the financial cycle turns but the authorities should monitor risks from rising NPLs.

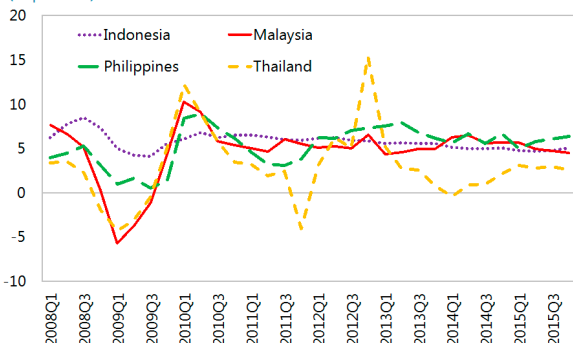
45. Structural policies. Implementation of reforms envisaged in the 11th Malaysia Plan and commitment to freer trade policies should all help anchor structural reforms and raise Malaysia's potential growth over the medium term. Further raising the skills of Malaysia's labor force, through steadfast implementation of education policies, will be critical in the nation's drive to become a high income nation. Recent events underscore the need to uphold high standards of governance and communication in public financial management.

46. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Malaysia: Growth and Exports

Malaysia's growth has weakened but remains resilient...

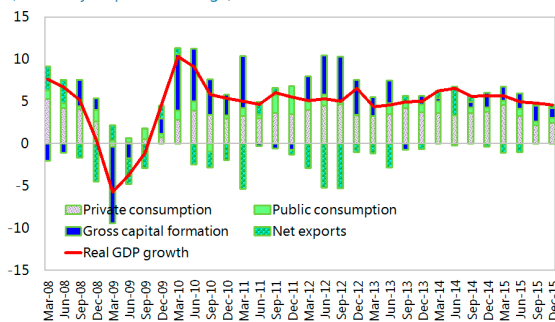
Real GDP Growth
(In percent)



Source: IMF, World Economic Outlook.

... supported by still robust domestic demand, despite a drag on private consumption from GST implementation.

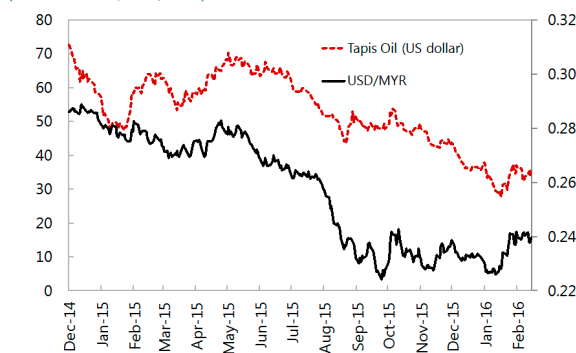
Contribution to Real GDP Growth
(Year-on-year percent change)



Source: CEIC Data Co. Ltd.

Global oil prices have fallen dramatically and the exchange rate has helped absorb the shock...

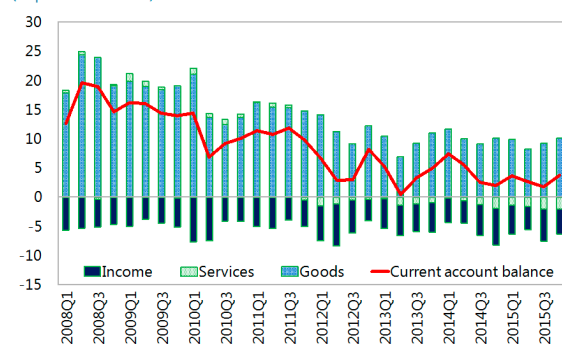
Tapis Oil Prices & Exchange Rate
(In U.S. Dollars, USD/MYR)



Source: Bloomberg

... but the current account surplus has declined.

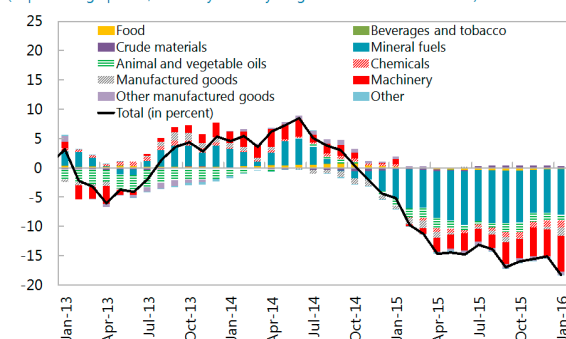
Current Account Balance
(In percent of GDP)



Source: CEIC Data Co. Ltd.

There have been very large declines in exports, measured in U.S. dollars in all sectors...

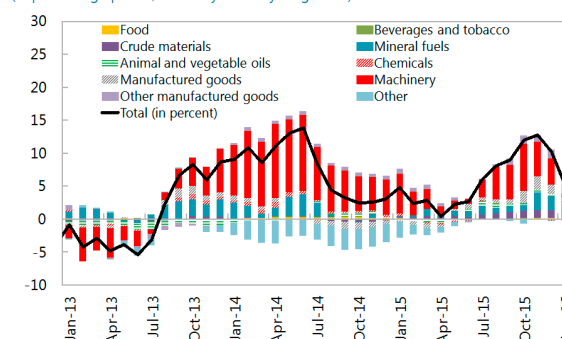
Malaysia: Contributions to Export Values
(In percentage points; 3-mma year-on-year growth in U.S. dollar terms)



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

...however, a weaker exchange rate helped boost manufacturing sector volumes until recently.

Malaysia: Contributions to Growth in Export Volumes
(In percentage points; 3-mma year-on-year growth)

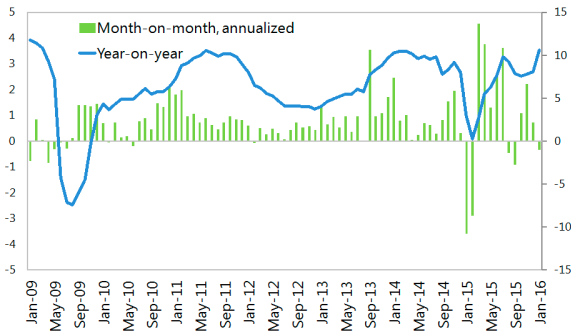


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 2. Malaysia: Inflation and Domestic Resource Constraints

Headline inflation remains moderate but has been volatile reflecting fuel price adjustments and GST implementation.

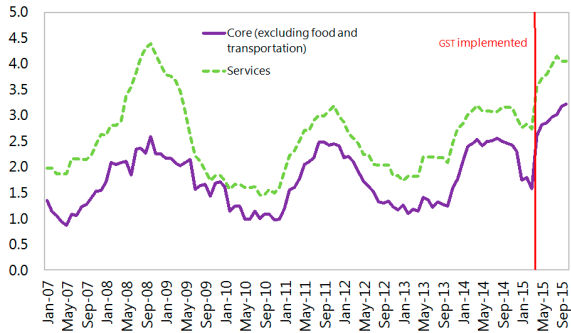
Consumer Price Index
(Percent change)



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

GST implementation in April 2015 increased core inflation.

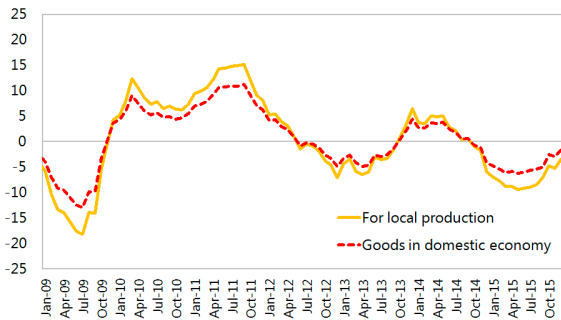
Inflation
(Year-on-year percent change)



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

Producer prices continue to decline.

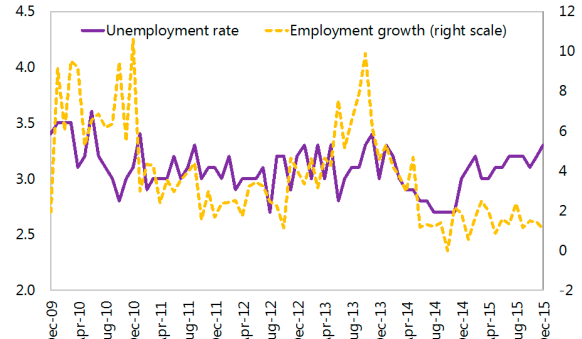
Producer Price Index
(Year-on-year percent change)



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

The labor market remains tight although the unemployment rate has increased since last year.

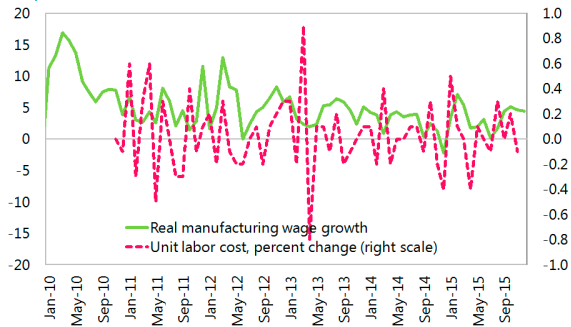
Labor Market Developments



Source: CEIC Data Co. Ltd.

Wage growth continues to be strong.

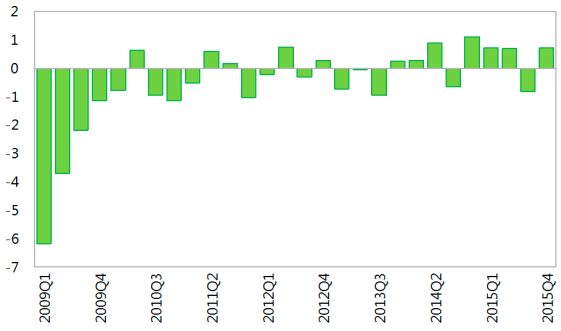
Real Wages and Unit Labor Costs in Manufacturing
(In percent)



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

The output gap has shrunk during the year, yet remains positive.

Output Gap
(In percent)



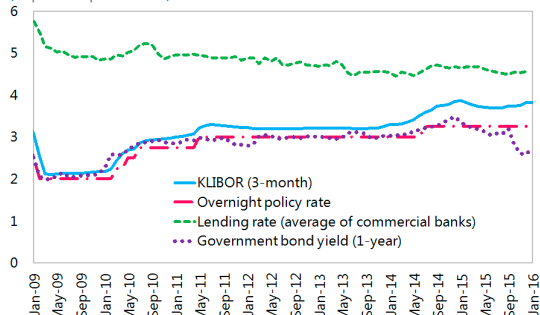
Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

Figure 3. Malaysia: Monetary Developments

BNM has left the policy rate unchanged since July 2014 but markets rates have increased slightly.

Interest Rates

(In percent per annum)

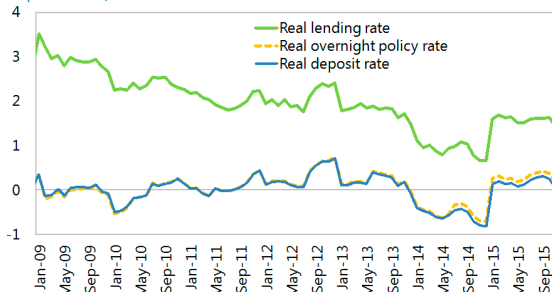


Sources: Bloomberg L.P.; and CEIC Data Co. Ltd.

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

Real Interest Rates

(Percent per annum; nominal rates adjusted for 1-year ahead inflation expectations)

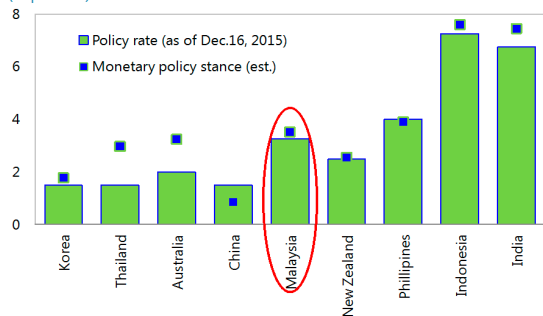


Sources: Bloomberg L.P.; CEIC Data Co. Ltd; Consensus Economics Inc.; and IMF staff estimates.

Policy rates are well calibrated to current conditions.

Monetary Policy Stances

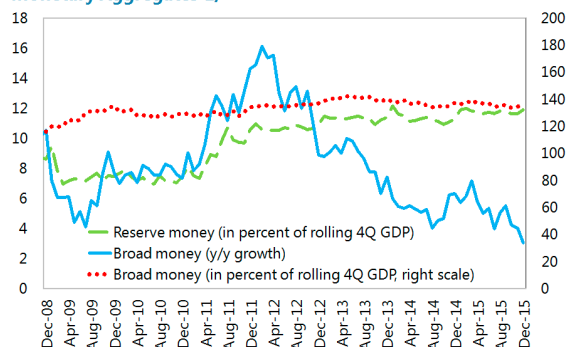
(In percent)



Source: IMF staff calculations.

Broad money growth has declined...

Monetary Aggregates 1/

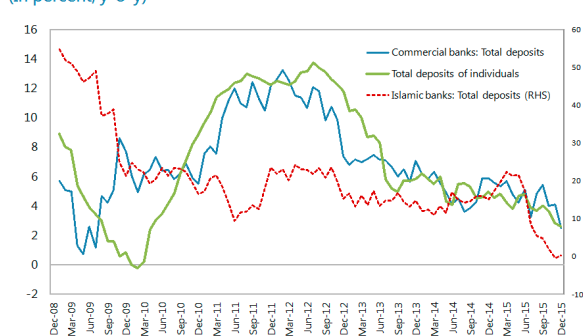


Sources: IMF, Integrated Monetary database; and IMF staff calculations.
1/ At depository corporations level.

... along with deposit growth. Reclassification of Islamic Banks' liabilities in July led to a decline in measured deposits.

Banking System Deposit Growth

(In percent, y-o-y)

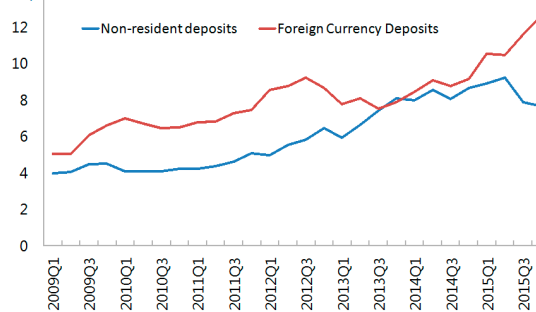


Source: Bank Negara Malaysia

Foreign currency deposits have increased while non-resident deposits fell during the second half of the year.

Foreign Currency and Non-Resident Deposits

(As percent of GDP)



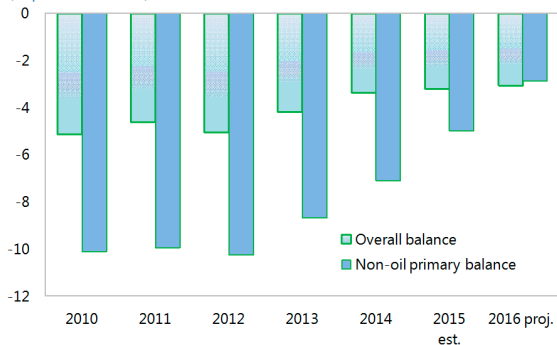
Source: CEIC Data Co. Ltd.

Figure 4. Malaysia: Federal Budget Developments

Sustained gradual deficit reduction, especially of non-oil primary balance...

Federal Government Overall and Non-Oil Balance

(In percent of GDP)

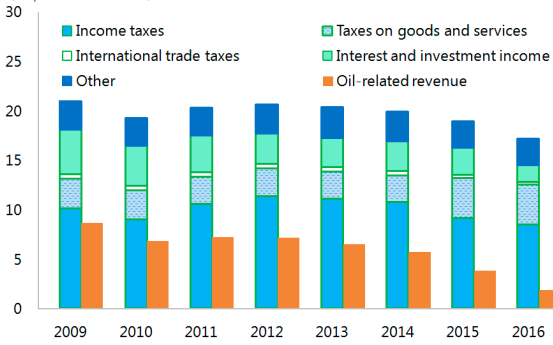


Sources: Malaysian authorities; and IMF staff estimates.

... in an environment of decreasing revenue...

Federal Government Revenue

(In percent of GDP)

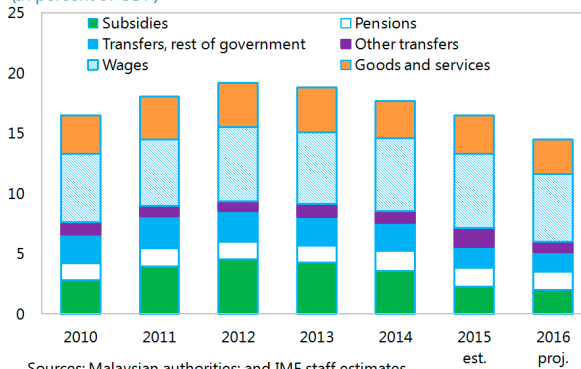


Sources: Malaysian authorities; and IMF staff estimates.

... with subsidy reductions and expenditure restraint.

Federal Government Current Expenditures

(In percent of GDP)

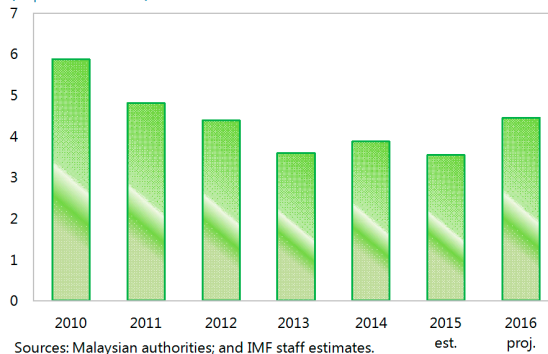


Sources: Malaysian authorities; and IMF staff estimates.

Development spending expected to grow moderately.

Federal Government Development Spending

(In percent of GDP)

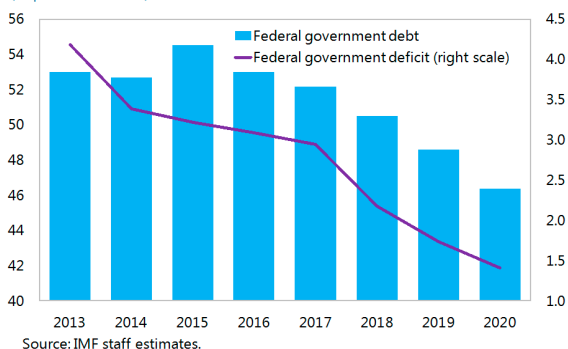


Sources: Malaysian authorities; and IMF staff estimates.

Debt and deficits are projected to fall...

Medium-Term Fiscal Outlook

(In percent of GDP)

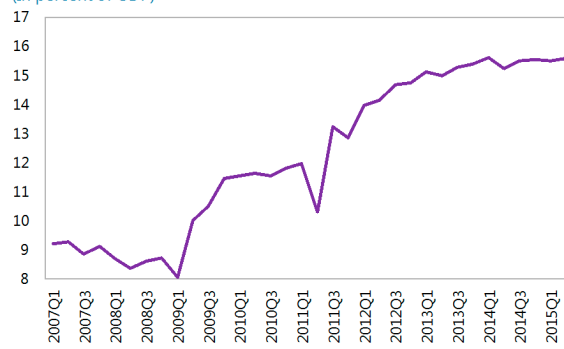


Source: IMF staff estimates.

Guarantees have stabilized after rising for several years.

Federal Government Loan Guarantees

(In percent of GDP)

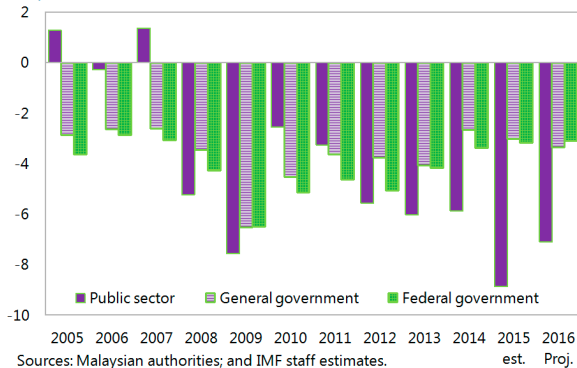


Source: CEIC Data Co.Ltd.

Figure 5. Malaysia: Public Sector Fiscal Stance and Prospects

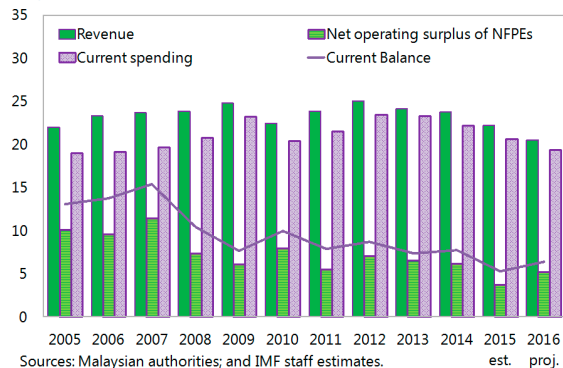
The NFPS deficit grew significantly in 2015...

Fiscal Balance
(In percent of GDP)



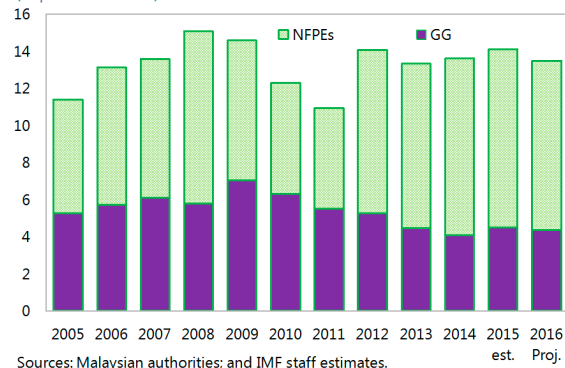
... as the fall in commodity prices hurt the NFPE surplus.

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



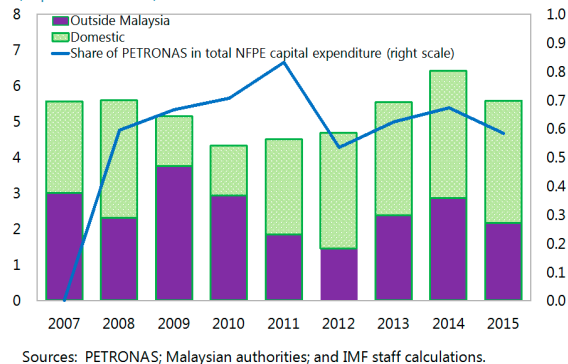
Development spending is kept broadly constant...

Development Spending
(In percent of GDP)



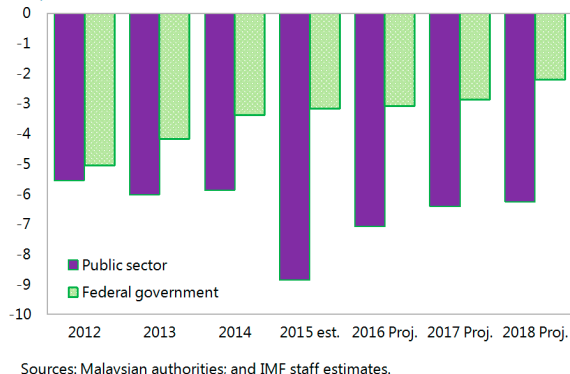
... as has development spending by PETRONAS.

Capital Spending by PETRONAS
(In percent of GDP)



The NFPS deficit is projected to decline over the medium term...

Fiscal Balance
(In percent of GDP)



... driving down debt.

General Government Debt
(In percent of GDP)

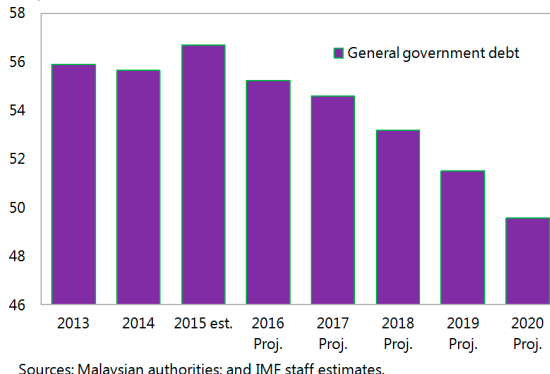
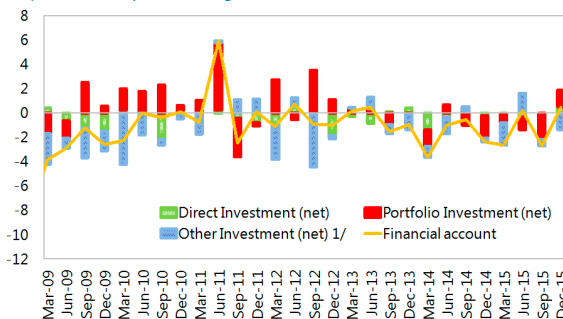


Figure 6. Malaysia: Capital Flows

In the post GFC-era, portfolio inflows and outflows have been large...

Financial Account

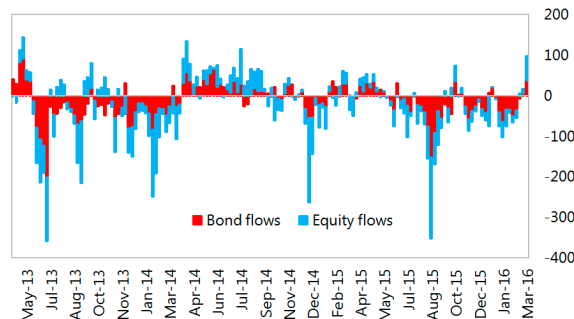
(In percent of 4-quarter rolling GDP)



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

... and very volatile.

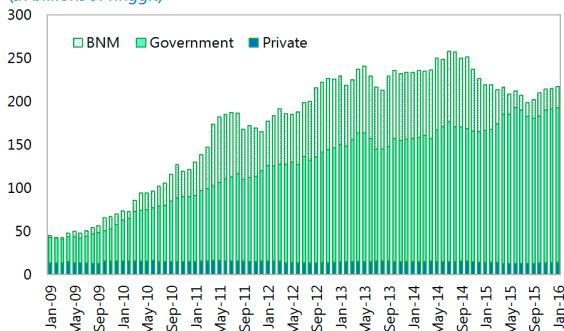
EPFR Global Funds Flows: Equity and Bond Funds 1/
(In millions of U.S. dollars)



Source: Haver Analytics.
1/ Monthly flows. Includes exchange traded funds and mutual funds.

Foreign holdings of debt securities rose steadily until mid-2014 and then declined with outflows from BNM bills and notes, although foreign holdings of MGS are less affected.

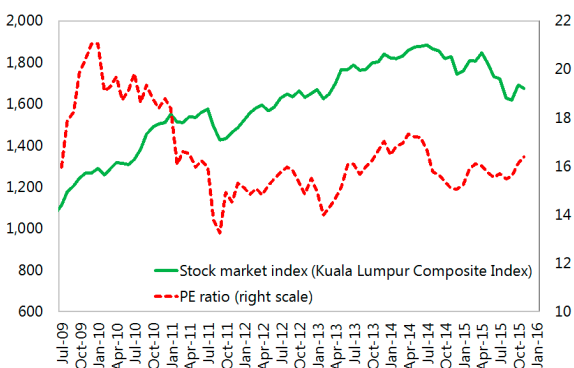
Foreign Holdings of Debt Securities
(In billions of ringgit)



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

The stock market has declined on equity outflows.

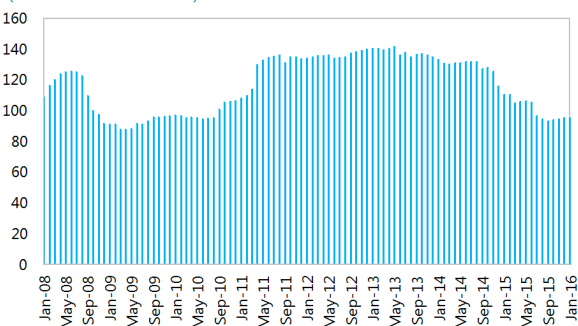
Stock Market Performance



Source: Bloomberg L.P.

BNM has intervened to cushion the impact of outflows...

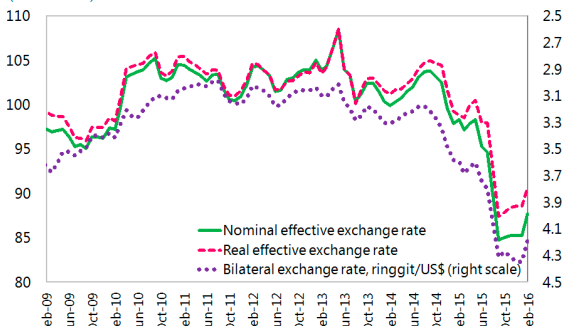
Reserves
(In billions of U.S. dollars)



Source: CEIC Data Co. Ltd.

... and there was a very large depreciation in the exchange rate.

Effective Exchange Rate
(2007=100)

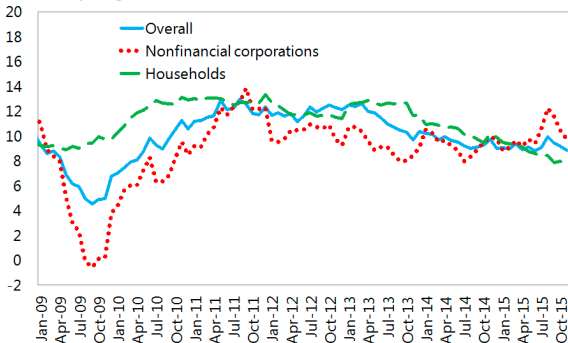


Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 7. Malaysia: Financial Sector Developments

Credit growth is declining for both households and the nonfinancial corporate sector.

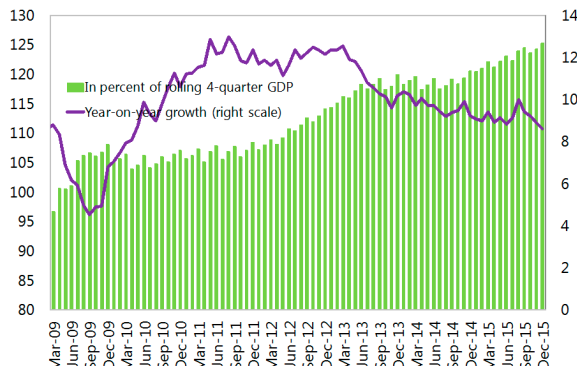
Banks' Claims on Private Sector
(Year-on-year growth)



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

Although credit growth has fallen, slower nominal GDP growth implies the credit-to-GDP ratio continues to rise.

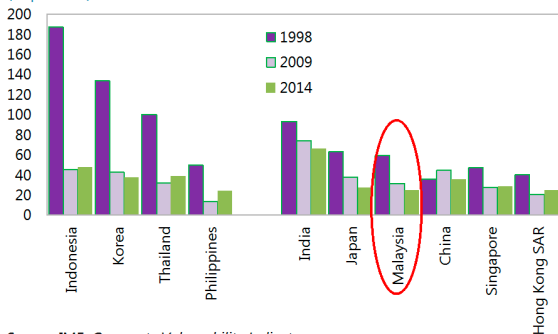
Banks' Claims on Private Sector



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

Corporate sector leverage remains below levels seen prior to the Asian Financial Crisis.

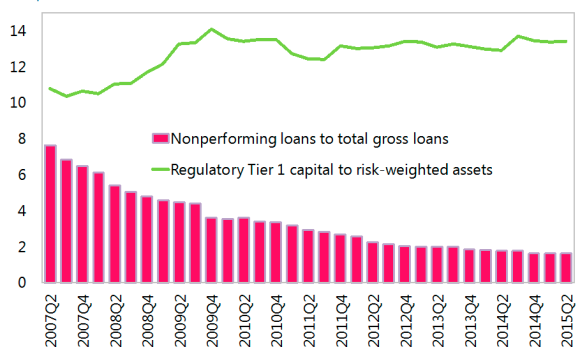
Corporate Debt-to-Equity Ratio 1/
(In percent)



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

The banking system is well capitalized, while credit quality has steadily improved.

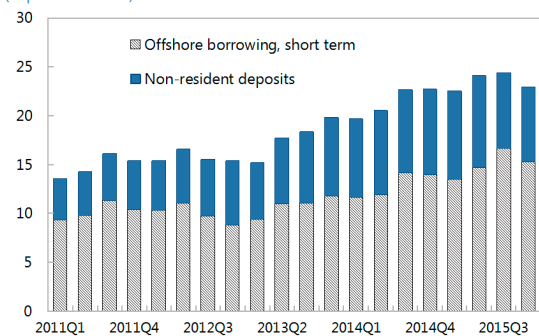
Banks' Financial Soundness Indicators
(In percent)



Source: IMF, Financial Soundness Indicators database.

Banking system short-term external debt has increased along with non-resident deposits...

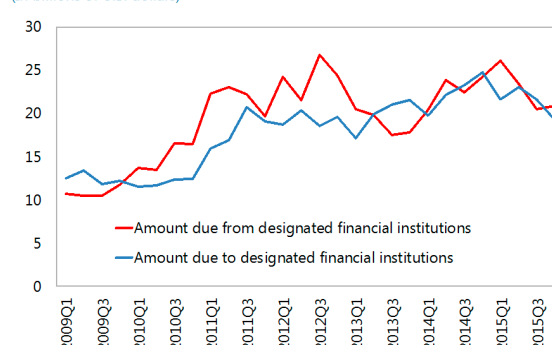
Banks' Short-Term External Debt: 2011:Q1–2015:Q4
(In percent of GDP)



Sources: CEIC Data Co. Ltd; IMF staff calculations

... but is matched by an increased in external assets.

Banking System: External Assets and Liabilities, 2009:Q1–2015:Q4
(In billions of U.S. dollars)

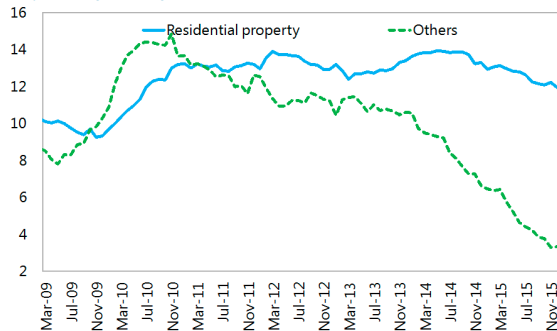


Sources: CEIC Data Co. Ltd; IMF staff calculations

Figure 8. Malaysia: Household Debt

Housing and personal loan growth is moderating...

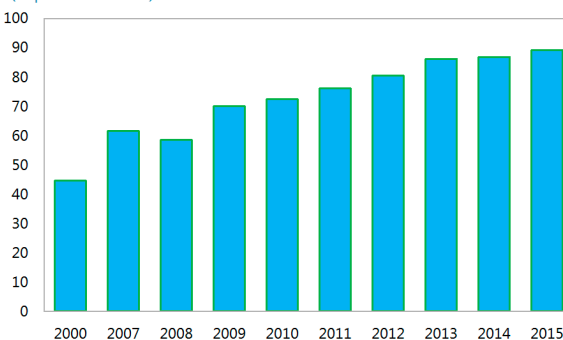
Household Loan Growth
(In percent, year-on-year)



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

... and the increase in household debt has moderated...

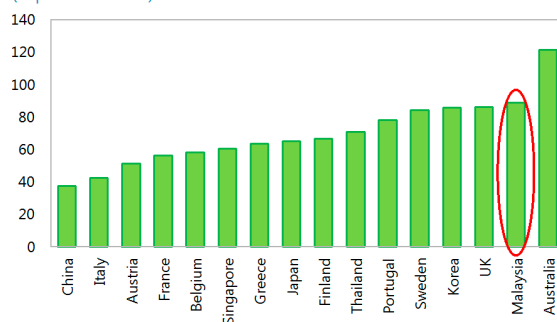
Household Debt
(In percent of GDP)



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

... but remains high compared to other countries...

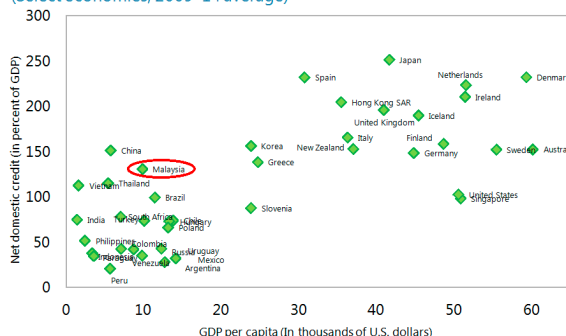
Household Debt, 2015 Q3
(In percent of GDP)



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

... and is above the ratio in countries with a similar GDP per capita

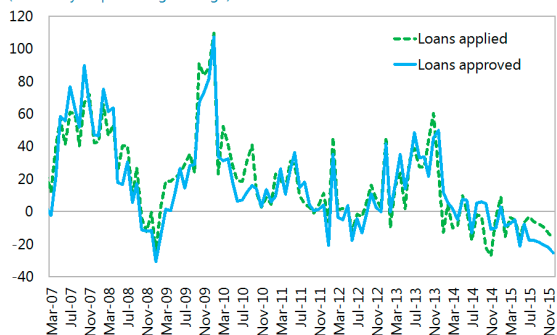
Net Domestic Credit and GDP per Capita
(Select economies, 2009–14 average)



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

Loan approvals and applications continue to decline as the financial cycle begins to turn.

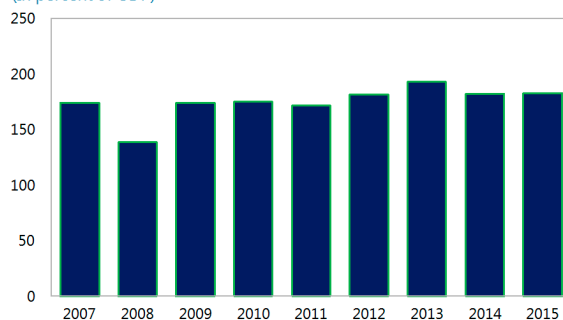
Malaysia: Loan Applications and Approvals
(Year-on-year percentage change)



Source: CEIC Data Co. Ltd.

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

Household Financial Assets
(In percent of GDP)

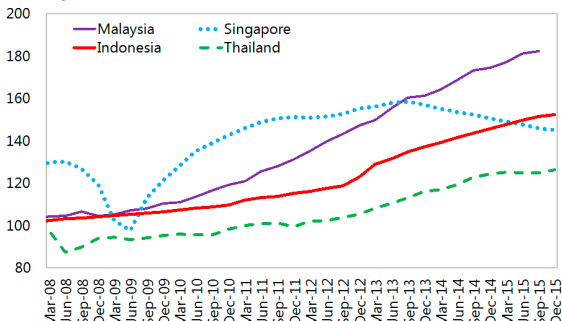


Sources: Malaysian Employee Provident Fund; CEIC Data Co. Ltd.; and IMF staff calculations.

Figure 9. Malaysia: House Prices

House prices continue to rise but the pace is moderating slightly.

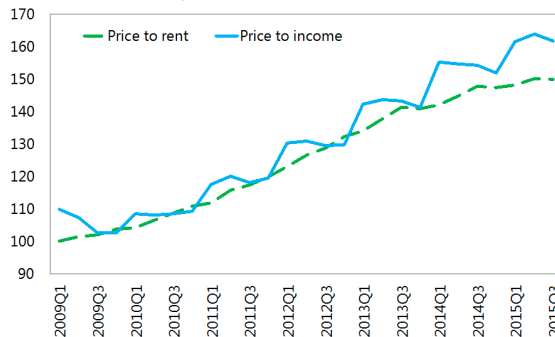
House Price Index
(2007:Q1 = 100)



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

House price increases have outpaced incomes and rents.

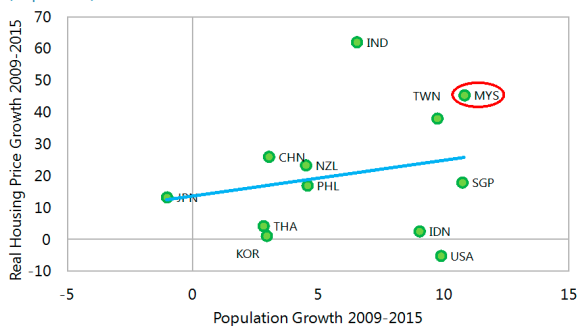
House Prices
(Ratio of indices, 2008Q4=100)



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

Although population growth is strong, this cannot fully explain the increase house prices compared with other countries.

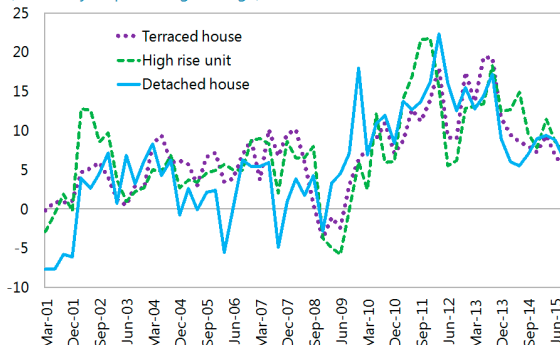
Housing Price and Population Growth
(In percent)



Sources: Global Property Guide; IMF, *World Economic Indicators*; and IMF staff estimates.

The housing market is cooling and house price growth in Kuala Lumpur is moderating.

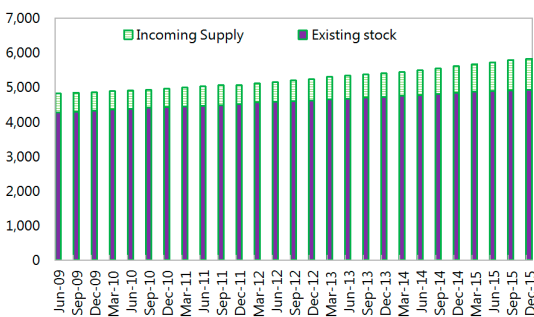
Malaysia: House Prices in Kuala Lumpur
(Year-on-year percentage change)



Source: CEIC Data Co. Ltd.

Residential supply has been increasing...

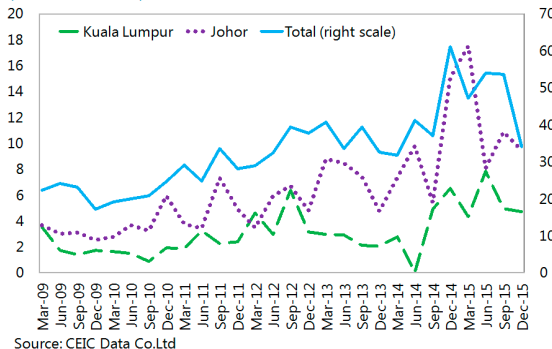
Residential Property Supply
(In thousand units)



Source: CEIC Data Co. Ltd.

... and has picked up in Kuala Lumpur, helping to ease the pressure on prices.

Residential Property: Construction Started
(In thousand units)

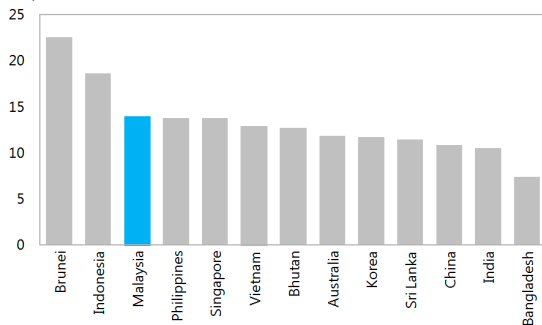


Source: CEIC Data Co. Ltd.

Figure 10. Malaysia: Financial Soundness Indicators, 2015:Q4

Malaysian banks' capital buffers are strong...

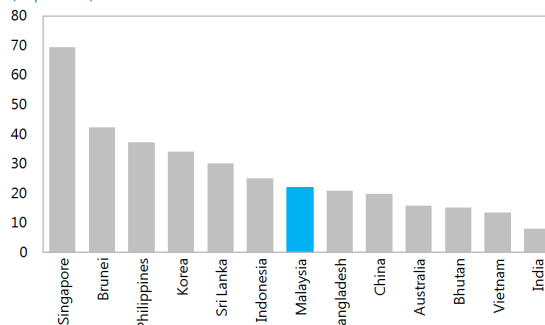
Regulatory Tier 1 Capital to Risk-Weighted Assets
(In percent)



Source: IMF, *Financial Soundness Indicators*.

... but one-year liquidity could improve further.

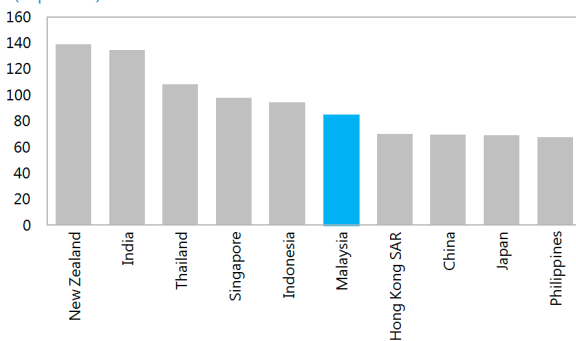
Liquid Assets to Short-Term Liabilities
(In percent)



Source: IMF, *Financial Soundness Indicators*.

Lending in proportion to deposits is reasonable...

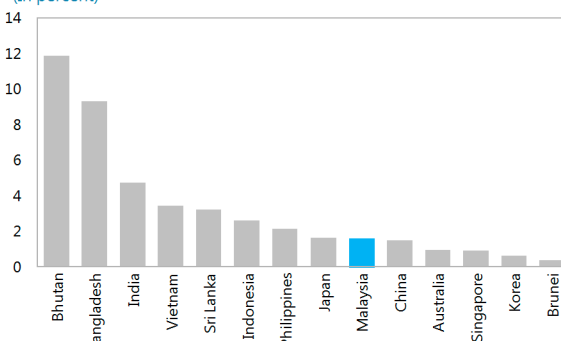
Loan to Deposit Ratio
(In percent)



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

... while asset quality is moderately high.

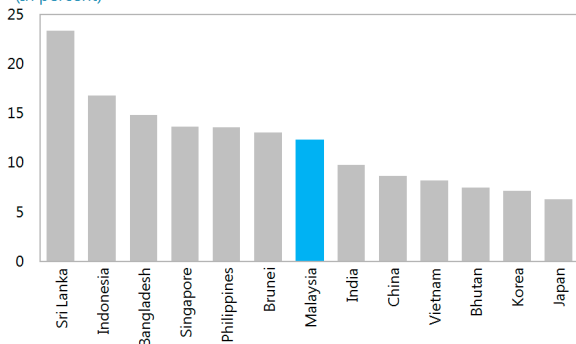
Nonperforming Loans to Total Gross Loans
(In percent)



Source: IMF, *Financial Soundness Indicators*.

Banks are profitable...

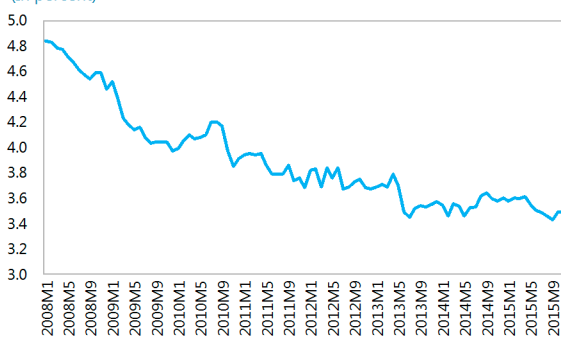
Return on Equity
(In percent)



Source: IMF, *Financial Soundness Indicators*.

... but interest rate spreads continue to decline, eroding profitability.

Interest Rate Spreads
(In percent)



Sources: Bank Negara Malaysia; and IMF staff calculations.

Table 1. Malaysia: Selected Economic and Financial Indicators, 2011–17

Nominal GDP (2015): US\$296 billion

Main export (percent of total): electrical & electronic products (39%), commodities (23%)

GDP per capita (2015): US\$9,556

Population (2015): 31.0 million

Unemployment rate (2015): 3.2 percent

	2011	2012	2013	2014	Est. 2015	Proj. 2016	Proj. 2017
Real GDP (percent change)	5.3	5.5	4.7	6.0	5.0	4.4	4.8
Total domestic demand	7.3	10.6	6.4	5.3	5.8	5.2	4.9
Consumption	8.4	7.7	7.0	6.4	5.6	5.5	5.3
Private consumption	6.9	8.3	7.2	7.0	6.0	5.9	5.3
Gross capital formation	4.5	18.3	4.9	2.6	6.4	4.5	3.9
Public gross fixed capital formation	2.6	15.9	1.9	-4.7	-1.0	0.6	1.8
Private gross fixed capital formation	9.5	21.4	12.8	11.0	6.4	5.3	5.0
Saving and investment (in percent of GDP)							
Gross domestic investment	23.2	25.7	25.9	25.0	25.1	25.7	25.6
Gross national saving	34.1	30.9	29.4	29.3	28.0	28.0	27.5
Fiscal sector (in percent of GDP)							
Federal government overall balance 1/	-4.6	-5.1	-4.2	-3.4	-3.2	-3.1	-2.8
Revenue	20.3	20.7	20.4	19.9	18.9	17.2	17.9
Expenditure and net lending	25.0	25.7	24.6	23.3	22.2	20.2	20.6
Federal government non-oil primary balance	-9.9	-10.3	-8.7	-7.3	-5.0	-2.9	-2.2
Consolidated public sector overall balance 2/	-3.3	-5.6	-6.0	-5.9	-8.9	-7.1	-6.6
General government debt	52.6	54.6	55.9	55.6	57.4	55.8	55.8
Inflation and unemployment (period average, in percent)							
CPI inflation (period average)	3.2	1.7	2.1	3.1	2.1	3.1	3.1
Unemployment rate	3.1	3.0	3.1	2.9	3.2	3.2	3.2
Macrofinancial variables (end of period, percentage change)							
Total liquidity (M3)	14.3	9.0	8.1	7.0	2.7	...	...
Credit to private sector	12.1	11.9	9.9	8.9	8.3	8.8	7.0
Credit-to-GDP ratio (end of period)	117.7	123.6	129.7	130.1	134.8	134.5	134.3
Overnight policy rate	3.00	3.00	3.00	3.25	3.25	...	...
Three-month interbank rate (in percent)	3.2	3.2	3.2	3.9	3.8	...	...
Non-financial Corporate Sector debt (in percent of GDP)	89.7	98.0	100.2	96.2	96.0	94.6	93.1
Non-financial Corporate sector debt issuance (in percent of GDP)	4.0	4.7	3.5	3.2	2.6	...	...
Household debt (in percent of GDP)	76.1	80.5	86.1	86.8	89.1	89.3	89.5
Household financial assets (in percent of GDP)	166.7	176.3	187.0	182.4	182.9	...	...
House prices (percentage change)	9.8	11.8	10.9	8.5	6.0	6.4	6.5
Exchange rates (period average)							
Malaysian Ringgit/U.S. Dollar (period average)	3.06	3.09	3.15	3.27	3.91	...	...
Real effective exchange rate (percentage change)	0.4	-0.2	0.5	-0.7	-7.9	...	...
Balance of payments (in billions of U.S. dollars)							
Current account balance	32.5	16.2	11.3	14.5	8.7	7.2	6.6
(In percent of GDP)	10.9	5.2	3.5	4.3	2.9	2.3	1.9
Goods balance	45.9	36.6	30.6	34.7	27.9	26.1	27.3
Services and primary income account balance	-6.6	-14.4	-13.8	-14.8	-13.5	-13.1	-14.1
Capital and financial account balance	7.6	-7.4	-6.4	-24.8	-13.9	-3.6	5.2
Of which: Net foreign direct investment	-3.1	-7.9	-2.0	-5.6	0.1	1.5	2.1
Errors and omissions	-9.1	-7.6	-0.2	-0.8	6.2	0.0	0.0
Overall balance	30.9	1.3	4.6	-11.2	1.0	4.5	12.4
Gross official reserves (US\$ billions)	133.6	139.7	134.9	115.9	95.3	99.8	112.2
(In months of following year's imports of GNFS)	7.4	7.7	7.4	7.4	6.4	6.3	6.6
(In percent of short-term debt) 3/	109.1	104.1	91.8	78.6	75.1	78.0	85.0
Total external debt (US\$ billions) 4/	169.4	196.9	212.3	213.3	194.2	196.8	205.7
(In percent of GDP)	56.8	62.6	65.7	63.1	65.6	63.6	59.7
Of which: short-term (in percent of total) 3/	72.4	68.1	69.2	69.1	65.3	65.0	64.2
Debt service ratio							
(In percent of exports of goods and services) 5/	14.9	17.2	17.3	17.9	21.6	23.3	22.7
(In percent of exports of goods and nonfactor services)	15.9	18.1	18.4	19.0	22.9	24.6	23.9
Memorandum items:							
Nominal GDP (in billions of ringgit)	912	971	1,019	1,107	1,157	1,261	1,352

Sources: CEIC Data Co. Ltd; Data provided by the authorities; Dealogic; and Fund 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/ By remaining maturity.

4/ Staff estimates.

5/ Includes receipts under the primary income account.

Table 2. Malaysia: Indicators of External Vulnerability, 2011–15

	2011	2012	2013	2014	Est. 2015
Financial indicators					
General government debt (in percent of GDP) 1/	52.6	54.6	55.9	55.6	57.4
Total liquidity (M3: percent change, 12-month basis)	14.3	9.0	8.1	7.0	2.7
Private sector credit (percent change, 12-month basis)	12.1	11.9	9.9	8.9	8.3
3-month interest rate (percent, 12-month average) 2/	3.2	3.2	3.2	3.5	3.7
External indicators					
Exports (percent change, 12-month basis in U.S. dollars)	15.0	-3.0	-3.1	2.6	-15.5
Imports (percent change, 12-month basis in U.S. dollars)	13.9	1.7	-0.3	0.8	-14.7
Current account balance (in billions of U.S. dollars)	32.5	16.2	11.3	14.5	8.7
Current account balance (in percent of GDP)	10.9	5.2	3.5	4.3	2.9
Capital and financial account balance (in billions of U.S. dollars)	7.6	-7.4	-6.4	-24.8	-13.9
Gross official reserves (in billions of U.S. dollars)					
In months of following year's imports of goods and nonfactor services	7.4	7.7	7.4	7.4	6.4
As percent of total liquidity (M3)	34.2	31.6	32.0	29.3	29.3
As percent of monetary base	440.2	420.7	451.8	416.4	411.3
Total short-term external debt by: 3/					
Original maturity (in billions of U.S. dollars)	80.8	92.7	103.3	103.6	82.0
Remaining maturity (in billions of U.S. dollars)	122.5	134.2	147.0	147.4	126.8
Original maturity to reserves (in percent)	60.5	66.4	76.5	89.4	86.0
Original maturity to total external debt (in percent)	47.7	47.1	48.6	48.6	42.2
Remaining maturity to reserves (in percent)	91.7	96.0	108.9	127.2	133.1
Remaining maturity to total external debt (in percent)	72.4	68.1	69.2	69.1	65.3
Total external debt (in billions of U.S. dollars) 3/					
<i>Of which</i> : public sector (medium- and long-term) 4/	60.1	71.9	72.9	69.7	70.1
Total external debt to exports of goods and services (in percent) 5/	62.5	74.8	81.8	80.3	87.2
External amortization of MLT debt to exports of goods and services (in percent) 5/	13.8	15.9	16.0	16.5	19.7
Financial market indicators					
Kuala Lumpur Composite Index (KLCI), end of period	1,484	1,648	1,840	1,819	1,818
10-years government securities yield (percent per annum, average)	3.9	3.5	3.7	3.8	3.8

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

1/ Gross debt.

2/ Discount rate on 3-month treasury bills.

3/ Staff estimates.

4/ Includes offshore borrowing and nonresident holdings of ringgit-denominated Malaysian government securities.

5/ Includes receipts under the primary income account.

Table 3. Malaysia: Balance of Payments, 2011–17

	2011	2012	2013	2014	2015	Proj. 2016	2017
	(In billions of U.S. dollars)						
Current account balance	32.5	16.2	11.3	14.5	8.7	7.2	6.6
Goods balance	45.9	36.6	30.6	34.7	27.9	26.1	27.3
Exports, f.o.b.	215.2	208.8	202.4	207.7	175.6	166.2	175.9
Imports, f.o.b.	169.3	172.2	171.7	173.1	147.7	140.1	148.6
Services and primary income account balance	-6.6	-14.4	-13.8	-14.8	-13.5	-13.1	-14.1
Receipts	56.0	54.3	57.2	57.9	47.2	45.4	48.2
Of which : primary income	17.2	13.7	15.1	16.0	12.5	10.6	11.1
Payments	62.6	68.6	71.1	72.7	60.7	58.4	62.4
Of which : primary income	24.2	25.3	25.9	27.4	20.7	19.6	20.8
Secondary income	-6.9	-6.0	-5.6	-5.4	-5.7	-5.8	-6.5
Capital and financial account balance	7.6	-7.4	-6.4	-24.8	-13.9	-2.7	5.8
Capital account	0.0	0.1	0.0	0.1	-0.3	0.0	0.0
Financial account	7.6	-7.5	-6.4	-24.9	-13.6	-2.7	5.8
Net foreign direct investment	-3.1	-7.9	-2.0	-5.6	0.1	1.5	2.1
Portfolio investment	8.5	20.7	-1.0	-11.8	-7.2	-3.5	4.7
Other investment	2.1	-20.2	-3.5	-7.5	-6.5	-0.7	-1.0
Errors and omissions	-9.1	-7.6	-0.2	-0.8	6.2	0.0	0.0
Overall balance	30.9	1.3	4.6	-11.2	1.0	4.5	12.4
Gross official reserves	133.6	139.7	134.9	115.9	95.3	99.8	112.2
In months of following year's imports of goods and nonfactor services	7.4	7.7	7.4	7.4	6.4	6.3	6.6
In percent of short-term debt 1/	109.1	104.1	91.8	78.6	75.1	78.0	85.0
	(In percent of GDP)						
Current account balance	10.9	5.2	3.5	4.3	2.9	2.3	1.9
(Excluding crude oil and liquefied petroleum gas)	4.5	-0.8	-3.0	-1.9	-2.1	-1.4	-2.1
Goods balance	15.4	11.6	9.5	10.2	9.4	8.4	7.9
Exports	72.2	66.4	62.6	61.4	59.3	53.8	51.0
Imports	56.8	54.8	53.1	51.2	49.9	45.3	43.1
Services and primary income account balance	-2.2	-4.6	-4.3	-4.4	-4.6	-4.2	-4.1
Capital and financial account balance	2.5	-2.3	-2.0	-7.3	-4.7	-0.9	1.7
Net foreign direct investment	-1.0	-2.5	-0.6	-1.7	0.0	0.5	0.6
	(Annual percentage change)						
Memorandum items:							
Export value growth (in U.S. dollars)	15.0	-3.0	-3.1	2.6	-15.5	-5.3	5.8
Export volume growth	5.3	-3.8	1.9	5.7	6.4	1.7	4.4
Import value growth (in U.S. dollars)	13.9	1.7	-0.3	0.8	-14.7	-5.1	6.1
Import volume growth	4.6	0.3	5.9	4.3	1.2	-0.5	5.8
Terms of trade	0.1	-0.7	-0.4	-0.3	-3.4	1.6	-0.7
Net international investment position							
(In billions of U.S. dollars)	11.5	-5.8	-14.3	-3.7	25.0	...	...
(In percent of GDP)	3.9	-1.8	-4.4	-1.1	8.4	...	...

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

1/ Based on staff's estimate by remaining maturity.

Table 4. Malaysia: Illustrative Medium-Term Macroeconomic Framework, 2011–21 1/

	2011	2012	2013	2014	Est.			Proj.			
					2015	2016	2017	2018	2019	2020	2021
Real sector (percent change)											
Real GDP growth	5.3	5.5	4.7	6.0	5.0	4.4	4.8	4.8	4.9	5.0	5.0
Total domestic demand	7.3	10.6	6.4	5.3	5.8	5.2	4.9	4.6	4.7	4.8	4.6
CPI inflation (period average)	3.2	1.7	2.1	3.1	2.1	3.1	2.9	3.0	3.0	3.0	3.0
Saving and investment (in percent of GDP)											
Gross domestic investment	21.1	25.7	25.9	25.0	25.1	25.7	25.6	25.5	25.6	25.9	26.0
Private, including stocks	13.6	15.0	15.4	15.7	16.1	17.0	17.2	17.2	17.4	17.5	17.6
Of which: gross fixed capital formation	12.6	14.7	16.0	16.6	17.2	17.0	17.2	17.2	17.4	17.5	17.6
Public	9.6	10.7	10.5	9.4	9.0	8.7	8.5	8.3	8.3	8.4	8.4
Gross national saving	34.1	30.9	29.4	29.3	28.0	28.0	27.5	27.3	27.3	27.4	27.6
Private	26.2	22.2	22.1	21.5	22.8	21.7	21.0	20.6	20.3	20.1	20.1
Public	7.8	8.7	7.3	7.8	5.2	6.4	6.5	6.8	7.0	7.3	7.4
Fiscal sector (in percent of GDP)											
Federal government overall balance	-4.6	-5.1	-4.2	-3.4	-3.2	-3.1	-2.8	-2.4	-2.0	-1.6	-1.3
Revenue	20.3	20.7	20.4	19.9	18.9	17.2	17.9	18.3	18.6	18.4	18.1
Tax	14.8	15.6	15.3	14.8	14.4	14.0	14.0	14.5	14.9	15.1	15.0
Non-tax	5.5	5.1	5.1	5.1	4.5	3.2	3.9	3.8	3.7	3.4	3.0
Expenditure	25.0	25.7	24.6	23.3	22.2	20.2	20.6	20.7	20.6	20.1	19.4
Current	20.1	21.3	21.0	19.8	18.8	16.7	16.8	16.6	16.5	15.8	15.2
Development	4.8	4.4	3.6	3.5	3.4	3.6	3.8	4.1	4.1	4.3	4.2
Federal government non-oil primary balance	-9.9	-10.3	-8.7	-7.3	-5.0	-2.9	-2.2	-1.6	-1.4	-1.3	-1.4
Consolidated public sector overall balance 2/	-3.3	-5.6	-6.0	-5.9	-8.9	-7.1	-6.6	-6.4	-6.2	-6.1	-6.0
General government debt	52.6	54.6	55.9	55.6	57.4	55.8	55.0	53.6	52.0	50.1	48.1
Of which: federal government debt	50.0	51.6	53.0	52.7	54.5	52.9	52.1	50.7	49.1	47.2	45.2
Balance of payments (in billions of U.S. dollars)											
Goods balance	45.9	36.6	30.6	34.7	27.9	26.1	27.3	29.7	33.0	36.6	40.0
Services and primary income account balance	-6.6	-14.4	-13.8	-14.8	-13.5	-13.1	-14.1	-15.4	-17.8	-20.2	-21.5
Current account balance	32.5	16.2	11.3	14.5	8.7	7.2	6.6	7.0	7.1	7.4	8.5
(In percent of GDP)	10.9	5.2	3.5	4.3	2.9	2.3	1.9	1.8	1.7	1.6	1.6
Capital and financial account balance	7.6	-7.4	-6.4	-24.8	-13.9	-2.7	5.8	6.6	9.2	2.5	0.4
Of which: Net foreign direct investment	-3.1	-7.9	-2.0	-5.6	0.1	1.5	2.1	2.3	1.7	1.0	0.0
Errors and omissions	-9.1	-7.6	-0.2	-0.8	6.2	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	30.9	1.3	4.6	-11.2	1.0	4.5	12.4	13.7	16.3	9.9	8.9
International trade (annual percent change)											
Export value	15.0	-3.0	-3.1	2.6	-15.5	-5.3	5.8	7.3	6.8	5.8	5.6
Import value	13.9	1.7	-0.3	0.8	-14.7	-5.1	6.1	7.1	5.9	4.8	4.8
Terms of trade	0.1	-0.7	-0.4	-0.3	-3.4	1.6	-0.7	-0.3	-0.3	-0.2	-0.1
Gross official reserves (in billions of U.S. dollars)											
(In months of following year's imports)	7.4	7.7	7.4	7.4	6.4	6.3	6.6	7.0	7.5	8.0	8.0
(In percent of short-term debt) 3/	109.1	104.1	91.8	78.6	75.1	78.0	85.0	91.3	98.8	100.8	101.5
Total external debt (in billions of U.S. dollars) 4/											
(In percent of GDP)	56.8	62.6	65.7	63.1	65.6	63.6	59.7	56.9	54.1	51.6	49.6
Short-term external debt (percent of total) 3/											
Debt-service ratio	72.4	68.1	69.2	69.1	65.3	65.0	64.2	63.2	62.2	61.2	60.3
(In percent of exports of goods and nonfactor services)	15.9	18.1	18.4	19.0	22.9	24.6	23.9	24.3	24.9	25.3	26.4
Net international investment position (in billions of U.S. dollars)											
	11.9	-5.8	-14.9	-4.0	25.0	...	...	...	...	...	...
Memorandum items:											
Nominal GDP (in billions of ringgit)	912	971	1,019	1,107	1,157	1,261	1,352	1,455	1,564	1,683	1,811

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

1/ Period ending December 31.

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

3/ By remaining maturity.

4/ Staff estimates.

Table 5. Malaysia: Summary of Federal Government Operations and Stock Positions, 2011–17

	2011	2012	2013	2014	2015	2016	2017
					Est.	Proj.	Proj.
I. Statement of Government Operations							
(In millions of ringgit)							
Revenue	185,419	200,913	208,001	220,626	219,155	216,356	241,633
Taxes	134,885	151,643	155,952	164,205	166,718	176,253	189,196
Other revenue	50,534	49,270	52,049	56,421	52,437	40,103	52,437
Expenditure	227,511	250,015	250,574	258,040	256,374	255,229	279,163
Expense	183,639	207,357	213,893	219,589	217,014	210,214	227,794
Compensation of employees	50,148	60,016	61,002	66,947	71,813	70,466	71,568
Use of goods and services	32,660	35,553	37,898	34,259	36,638	36,315	38,943
Interest	17,716	19,537	20,776	22,588	24,379	26,639	32,951
Subsidies	36,256	44,075	43,349	39,703	26,219	25,090	27,805
Of which : fuel subsidies (including cash assistance)	20,375	27,898	27,355	20,591	7,304	6,574	7,942
Grants	32,157	32,631	34,795	36,538	38,148	31,284	33,548
Social benefits and other expense	14,703	15,545	16,073	19,554	19,817	20,420	22,980
Net acquisition of nonfinancial assets	43,871	42,658	36,681	38,451	39,360	45,015	51,369
Gross operating balance	1,779	-6,445	-5,891	-1,037	2,141	6,142	13,839
Net lending/borrowing	-42,092	-49,103	-42,572	-37,414	-37,219	-38,873	-37,530
Overall fiscal balance (authorities' definition) 1/	-42,509	-41,951	-38,583	-37,414	-37,219	-38,873	-37,530
Net acquisition of financial assets	3,527	-5,773	-3,269	-4,207	-1,428	...	...
By financial instrument							
Currency and deposits	3,109	1,380	721	-1,145	-1,428	...	...
Loans and equity	417	-7,152	-3,990	-3,062	...	...	...
By holder residence							
Domestic	3,527	-5,773	-3,269	-4,207	-1,428	...	...
Foreign	...	...	...	...	...	...	...
Net incurrence of liabilities	46,168	43,317	39,083	36,845	35,791	38,873	37,530
By financial instrument							
Debt securities	45,619	43,331	39,305	37,201	...	...	...
Loans	550	-14	-222	-356	...	...	...
By holder residence							
Domestic	16,360	15,190	30,046	28,103	...	...	...
Foreign	29,808	28,127	9,037	8,742	...	...	...
(In percent of GDP)							
Revenue	20.3	20.7	20.4	19.9	18.9	17.2	17.9
Taxes	14.8	15.6	15.3	14.8	14.4	14.0	14.0
Other revenue	5.5	5.1	5.1	5.1	4.5	3.2	3.9
Expenditure	25.0	25.7	24.6	23.3	22.2	20.2	20.6
Expense	20.1	21.3	21.0	19.8	18.8	16.7	16.8
Compensation of employees	5.5	6.2	6.0	6.0	6.2	5.6	5.3
Use of goods and services	3.6	3.7	3.7	3.1	3.2	2.9	2.9
Interest	1.9	2.0	2.0	2.0	2.1	2.1	2.4
Subsidies	4.0	4.5	4.3	3.6	2.3	2.0	2.1
Of which : fuel subsidies (including cash assistance)	2.2	2.9	2.7	1.9	0.6	0.5	0.6
Grants	3.5	3.4	3.4	3.3	3.3	2.5	2.5
Social benefits and other expense	1.6	1.6	1.6	1.8	1.7	1.6	1.7
Net acquisition of nonfinancial assets	4.8	4.4	3.6	3.5	3.4	3.6	3.8
Gross operating balance	0.2	-0.7	-0.6	0.1	0.2	0.5	1.0
Net lending/borrowing	-4.6	-5.1	-4.2	-3.4	-3.2	-3.1	-2.8
Overall fiscal balance (authorities' definition) 1/	-4.7	-4.3	-3.8	-3.4	-3.2	-3.1	-2.8
II. Stock Positions							
(In millions of ringgit)							
Liabilities (nominal value)	456,128	501,617	539,857	582,828	...	...	...
By financial instrument							
Debt securities	392,033	439,970	481,895	519,452	...	...	...
Loans	64,095	61,647	57,962	63,376	...	...	...
By holder residence							
Domestic	333,755	352,359	381,426	415,285	...	...	...
Foreign	122,373	149,258	158,431	167,543	...	...	...
Memorandum items:							
Cyclically adjusted balance (percent of potential GDP)	-4.7	-5.1	-4.2	-3.7	-3.0	-3.0	-2.7
Structural primary balance (percent of potential GDP)	-2.7	-3.1	-2.2	-1.6	-0.9	-0.9	-0.3
Primary balance (percent of GDP)	-2.7	-3.0	-2.1	-1.3	-1.1	-1.0	-0.3
Non-oil and gas primary balance (percent of GDP)	-9.9	-10.3	-8.7	-7.3	-5.0	-2.9	-2.2
Oil and gas revenues (percent of GDP)	7.3	7.2	6.5	6.0	3.9	1.9	1.8
General government balance (percent of GDP) 2/	-3.6	-3.8	-4.1	-2.7	-3.0	-3.3	-2.9
Public sector balance (percent of GDP) 2/	-3.3	-5.6	-6.0	-5.9	-8.9	-7.1	-6.6
Nominal GDP (in millions of ringgit)	911,733	971,251	1,018,821	1,106,580	1,156,883	1,261,156	1,352,415

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

Table 6. Malaysia: Monetary Survey, 2011–15

	2011	2012	2013	2014	2015
(In millions of ringgit; end of period)					
Net foreign assets	356,968	347,381	337,357	325,974	361,178
Foreign assets	541,182	560,083	576,370	579,307	593,526
Foreign liabilities	184,214	212,702	239,014	253,333	232,348
Net domestic assets	908,896	1,012,215	1,100,908	1,200,173	1,212,278
Net domestic credit	1,127,900	1,254,165	1,384,099	1,521,790	1,642,173
Net credit to nonfinancial public sector	63,870	69,849	92,945	121,148	121,825
Net credit to central government	51,207	48,487	72,327	100,962	105,004
Net credit to state & local government	863	1,595	1,597	1,430	1,230
Net credit to nonfinancial corporations	11,800	19,766	19,022	18,756	15,590
Credit to private sector	988,555	1,108,437	1,221,315	1,334,134	1,448,858
Net credit to other financial corporations	75,475	75,880	69,839	66,508	71,491
Capital accounts	191,463	207,478	250,498	292,955	375,523
Other items (net)	-27,541	-34,472	-32,693	-28,662	-54,373
Broad money 1/	1,220,725	1,328,710	1,427,000	1,516,959	1,563,162
Narrow money	272,942	308,954	347,562	374,463	399,013
Currency in circulation	53,488	56,798	62,710	68,029	76,643
Transferable deposits	219,454	252,156	284,852	306,433	322,370
Other deposits	919,724	993,871	1,053,337	1,111,610	1,142,073
Securities other than shares	28,058	25,885	26,101	30,887	22,076
(Contribution to 12-month growth in broad money)					
Net foreign assets	6.8	-0.8	-0.8	-0.8	2.3
Net domestic assets	9.5	8.5	6.7	7.0	0.8
Memorandum items:					
Broad money (12-month percent change)	14.6	8.8	7.4	6.3	3.0
Currency in circulation (12-month percent change)	12.2	6.2	10.4	8.5	12.7
Money multiplier (broad money/narrow money)	4.5	4.3	4.1	4.1	3.9

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

1/ 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, 2011–15

	2011	2012	2013	2014	2015
	(In percent)				
Capital adequacy					
Regulatory capital to risk-weighted assets	17.7	17.6	14.6	15.4	16.3
Regulatory Tier 1 capital to risk-weighted assets	13.2	13.4	13.1	13.4	13.9
Asset quality					
Nonperforming loans net of provisions to capital 1/	11.6	8.3	8.1	7.0	6.8
Nonperforming loans to total gross loans	2.7	2.0	1.8	1.6	1.6
Total provisions to nonperforming loans	99.8	104.6	101.2	100.4	96.2
Earnings and profitability					
Return on assets	1.5	1.6	1.5	1.5	1.2
Return on equity	16.8	17.3	15.8	15.0	12.3
Interest margin to gross income	53.5	54.8	59.6	61.0	61.8
Non-interest expenses to gross income	45.2	45.0	42.6	43.0	46.7
Liquidity					
Liquid assets to total assets (liquid asset ratio)	12.9	13.8	13.2	13.3	22.1
Liquid assets to short-term liabilities 2/	36.6	42.5	41.0	43.2	...
Loan-deposit ratio 3/	80.9	82.1	84.6	86.2	88.7
Sensitivity to market risk					
Net open position in foreign exchange to capital	11.7	8.7	9.1	12.7	13.9
Sectoral distribution of total loans to nonbanking sector					
Residents	97.7	97.7	97.2	96.9	96.9
Other financial corporations	3.1	2.6	2.8	2.8	3.1
General government	2.7	2.6	2.1	1.7	1.4
Nonfinancial corporations	37.3	37.6	36.9	36.8	36.9
Other domestic sectors	54.4	54.9	55.4	55.6	55.5
Nonresidents	2.3	2.3	2.8	3.1	3.1

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

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

2/ Discontinued at end-2015.

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

Table 8. Malaysia: Macroprudential Measures Since 2010

(Based on effective date)

January 2010	Reintroduced 5 percent Real Property Gains Tax (RPGT) for properties sold in less than 5 years. The minimum house price for foreigners was increased to RM 500,000 from RM 250,000.
November 2010	Imposed LTV caps of 70 percent on third and subsequent mortgages.
February 2011	Capital risk-weights were raised to 100 percent for mortgages with LTVs exceeding 90 percent and were also raised for personal loans with a tenure of more than 5 years.
March 2011	The minimum income eligibility for new credit card holders was set at RM 24,000 per annum. Cardholders earning less than RM 36,000 per annum were limited to two credit card issuers and the maximum credit per issuer capped at two times monthly income.
December 2011	Introduced an LTV cap of 60 percent on housing loans for corporates.
January 2012	Issued guidelines on responsible financing and the computation of debt service ratios (DSR) based on a borrower's net income. Increased the RPGT rate to 10 percent on properties sold in less than 2 years and 5 percent RPGT for properties sold between 3 and 5 years.
January 2013	Increased the RPGT rate to 15 percent on properties sold before 2 years and to 10 percent on properties sold between 3 and 5 years.
July 2013	Imposed a maximum mortgage term of 35 years and a maximum tenure of 10 years on financing extended for personal use. Prohibited the offering of pre-approved personal financing products.
January 2014	Distinguished between RPGT for Malaysians, foreigners and corporates. For foreigners, the RGPT is 30 percent for properties sold before 5 years and 5 percent after 5 years. For Malaysians, the RPGT is 30 percent for properties sold up to 3 years; 20 percent up to 4 years; 15 percent up to 5 years; after 5 years 0 percent for individuals and 5 percent for corporates. Increased minimum house price for foreigners to RM 1,000,000. Banned Developers Interest Bearing Scheme (DIBS).

Appendix I. Malaysia—Staff Policy Advice from the 2013 and 2014 Article IV Consultations

Staff Advice	Policy Actions
Fiscal Policy	
Protect the fiscal position in the face of sharply lower oil and gas prices through gradual, growth-friendly multi-year fiscal adjustment (2014).	The authorities promptly revised the 2015 and 2016 federal budgets (January 2015 and January 2016 respectively) 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.
Broaden tax bases by implementing a GST and rationalizing tax incentives (2014, 2013).	The authorities introduced the GST in April 2015. They are undertaking a study on the effectiveness and costs of tax incentives.
Phase out expensive and poorly targeted fuel subsidies and continue gradual adjustment of administered prices for electricity and other services (tolls, utilities). Pass on to consumers changes in fuel prices with the objective of depoliticizing energy pricing (2014, 2013).	Fuel and other subsidies were removed starting in December 2014. The authorities have maintained their mechanism of monthly adjustment of fuel prices ever since. The issue has been depoliticized. Adjustments of toll, electricity and other utility tariffs are ongoing.
Expand cash transfers to lower income groups as integral component of fiscal reforms eliminating fuel subsidies and introducing GST (2014, 2013).	Cash transfers to lower income groups have been expanded starting with the 2015 budget. The 2014 Budget announced the creation of a comprehensive database on welfare recipients which could facilitate better targeting of transfers.
Gradually bring down federal debt to sustainable levels and balance the federal budget by 2020. Articulate credible revenue and spending measures to achieve that target. Introduce a medium-term fiscal framework (2014, 2013).	The authorities have announced their intention to gradually balance the federal deficit by 2020, which will result in a substantial decline in the federal debt to GDP ratio. They still need to identify concrete fiscal consolidation actions to achieve this. They have developed and published a medium-term fiscal framework which has been endorsed by the Fiscal Policy Committee.
Monetary, Exchange Rate, and Financial Policies	
Move from the current accommodative monetary policy stance toward a neutral stance consistent with the need to maintain price stability and curb financial imbalances once the uncertainty surrounding the global outlook dissipates (2014).	The authorities raised their policy interest rate in mid-2014 but have stayed pat since in view of continued heightened uncertainty surrounding the external and global outlooks in key emerging and advanced economies.
Maintain a flexible exchange rate as a shock absorber and a first line of defense against commodity price and capital flow shocks while using reserves and intervention to ensure orderly market conditions and avoid exchange rate overshooting (2014).	The authorities allowed the exchange rate to depreciate substantially in the face of multiple external shocks while also deploying some of their substantial reserves buffer to help the economy adjust to lower commodity prices and capital outflows. Going forward, they agree with staff that reserves will need to gradually be rebuilt and that they will rely even more on greater exchange rate flexibility in response to shocks.
Continue to employ macroprudential policies to dampen financial risks and monitor the increase in leverage throughout the economy, including in household and corporate debt (2014, 2013).	The authorities maintain macroprudential measures to curb household indebtedness and an enhanced framework for risk-based pricing to deal with rising household indebtedness. BNM is collecting granular data on household debt. These efforts have reduced risk from credit growth and also 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 steady implementation of structural reforms, including reforms to government-linked companies; liberalization of labor and product markets; and enhanced education and training.	Many recommendations from previous Article IV reports 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 are discussed in this staff report.
In order to achieve high income status and avoid the middle income trap, continue to: (i) prioritize infrastructure investment; (ii) further improve public financial management; (iii) boost spending on Research and Development to promote home-grown innovation; and (iv) improve the quality of education with a view to reducing skills mismatches in the labor force and raising productivity (2014, 2013).	In May 2015 the authorities unveiled their 11 th Malaysia Plan, spanning 2016–2020. The Plan continues the authorities' efforts to boost public capital through major infrastructure projects and also emphasizes home grown innovation and creating the foundations for a knowledge-based society through increased cooperation between government, education and industry in harnessing research and development and raising the quality of human capital.
Maintain an economic system that is highly open to trade and investment. Deepen regional economic integration and the pursuit of high-quality trade agreements that will gradually lower non-tariff trade barriers, improve services delivery, anchor growth-friendly reforms and bring large benefits for Malaysia and its trading partners (2014).	Malaysia has joined the TPP; the ASEAN Economic Community came into being in early 2016 following efforts of Malaysia during its ASEAN chair in 2015.

Appendix II. Malaysia—Risk Assessment Matrix 1/

(Potential deviations from the baseline)

Risks	Likelihood and Transmission	Expected Impact of Risk	Recommended Policy Responses
Persistently low energy prices , triggered by supply factors reversing only gradually (Medium-term).	High Lower commodity prices could affect future investment activities, leading to lower potential growth.	Medium 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 borrowing costs and/or a run by foreign investors.	The exchange rate can provide the first line of defense. Fiscal reforms to further reduce the reliance on oil revenues, such as increasing the GST rate and reducing exemptions, are critical. Investment in infrastructure and other productivity-boosting structural reforms could reduce reliance on the energy sector.
Tighter or more volatile global financial conditions : sharp asset prices adjustment and decompression of credit spreads (Short-term). Tighter or more volatile global financial conditions : Improving U.S. economic prospects leads to a further dollar surge (Short-term).	Medium Investors could reallocate additional assets away from Malaysia, resulting in capital flow reversals and further depreciation of the Ringgit. High As above, capital outflows are likely but Malaysia is already benefiting from improving U.S. economic prospects and could benefit even more in the future.	Medium High household and corporate debt increase Malaysia's vulnerability to external shocks, along with a high share of foreign holdings of MGS and equities makes these markets vulnerable to risk-on, risk off cycles. This risk is ameliorated by domestic institutional investors, who can provide offsetting demand during risk-off cycles, and the substantial share of debt denominated in local currency. Recent and earlier outflow episodes have had limited impact on credit or the real economy. Low As above.	The exchange rate should be allowed to continue to act as a shock absorber, intervening only to smooth excessive volatility. Liquidity support (including in FX) could be provided. If capital outflows threaten domestic activity, reserve requirements could be relaxed (as during the GFC). Given limited fiscal space, any fiscal expansion should be temporary, well-targeted, and anchored in a credible medium-term consolidation plan. As above.
Sharper-than-expected global growth slowdown : Significant China slowdown (Short- to medium-term). Sharper-than-expected global growth slowdown : Structurally weak growth in key advanced and emerging economies (Medium-term).	Low/Medium Trade (both volume and price), would be the dominant channel, with adverse second round effects on domestic demand. High/Medium Trade (both volume and price), would be the dominant channel, with adverse second round effects on domestic demand.	Low/Medium Weaker external demand would likely dampen domestic demand, lowering growth and increasing unemployment. 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 exchange rate should be allowed to act as a shock absorber, intervening only to smooth excessive volatility. A more accommodative monetary policy stance could be appropriate, if risks of fueling further financial imbalances are low. Any fiscal expansion should be temporary, well-targeted, and anchored in a credible medium-term consolidation plan. The ability of policy 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.
Fiscal risks from federal contingent liabilities (Short- and 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 limited and policy procyclicality would be heightened. 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 downturn in the financial cycle , accompanied by a decline in house prices. (Short- and medium-term).	Low A sharp decline in credit growth could be accompanied by a sharper than expected decline in house prices. The real economy would be adversely affected through weaker household, corporate and bank balance sheets, along with negative wealth and confidence effects.	Low to Medium Household debt is high at 89.1 percent of GDP and one half of this is mortgages. Offsetting this are high household financial assets. Existing macroprudential policies and improvements in underwriting standards in recent years should help curb any increase in NPLs and ensure the banking system remains resilient.	Monetary policy easing, exchange rate flexibility, along with a temporary fiscal stimulus anchored in a credible medium-term fiscal sustainability framework, could help support growth.

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 III. Malaysia—Malaysia’s Trade: The Role of Commodities and China¹

A. Background

Malaysia’s diversified economy. Malaysia has a highly open and diversified economy, with services accounting for 53.5 percent of GDP. Its exports are likewise diverse, although commodities account for about 19.2 percent. This appendix examines the effects on Malaysia’s trade of the sharp drop in commodities prices and the shift in China’s growth model. It also studies the sensitivity of the current account surplus to lower-for-longer oil and gas prices.

B. The Role of Commodities and China

Distinct but related phenomena. Although the commodities collapse and China’s rebalancing from investment to consumption are related, they are distinct phenomena:

- The rout in international oil prices is explained mostly by growing global excess supply and by changes in the structure of oil markets, in particular the resilience of large scale shale oil production in the United States; decisions by large producers (Saudi Arabia, Russia) to maintain output in the face of declining prices; the lifting of sanctions on Iran; and continued high levels of output from, inter alia, Iraq and Libya.
- China plays more of a major role in the recent broad-based decline in non-energy commodity prices, especially of metals where it accounts for about 50 percent of global demand. The rebalancing of the Chinese economy has led to sharp declines in these prices for two reasons.
 - Consumption and services use less capital and are less import-intensive in commodities, especially metals, than investment.
 - Commodities markets are forward-looking and expectations of slowing growth in China have also affected prices.
- Global financial market volatility also spiked after August 2015, following changes in China’s its exchange rate policy and sharp stock market decline.
- Malaysia is also affected by the slowdown in global and regional trade more generally, which is driven by technological change, has led to shorter regional and global supply chains, and also dampened global growth.

C. Exports and Imports in 2015

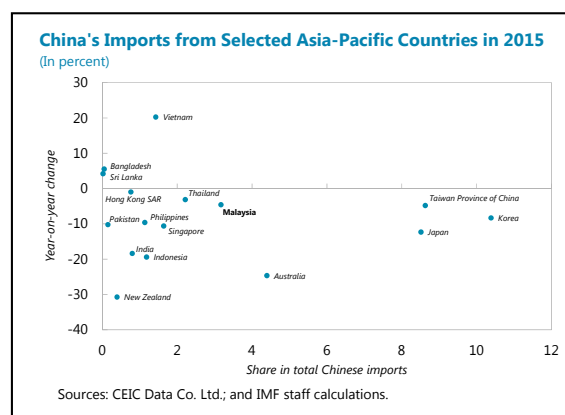
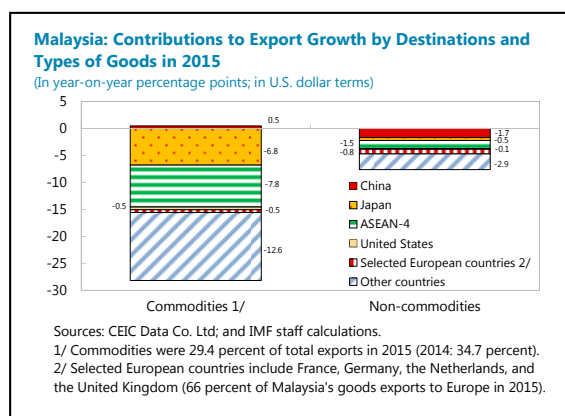
Developments in 2015. Malaysia experienced a broad-based decline in the prices of its exports in 2015. In U.S. dollar terms, export prices fell by about 20 percent. While oil and gas prices declined by nearly 50 percent, the unit price of palm oil exports fell by about 23 percent. The direct income loss resulting from lower prices of oil and other commodities at constant 2014 volumes is estimated

¹ Prepared by Juan Jauregui and Souvik Gupta (APD).

at 5.25 percent of GDP. However, depreciation of the ringgit in 2015 boosted export volumes, including in commodities, thereby mitigating the impact of this steep fall in prices. All in all, exports declined by 14.6 percent (in U.S. dollar terms) and commodity exports by about 28 percent.² However, the overall trade balance still remained in surplus, though smaller than in 2014, as imports also declined in 2015 by about 15.8 percent (in U.S. dollar terms). The decline in the trade balance in 2015 was driven by that in oil and gas trade.

D. Malaysia's Trade with China

A view from detailed trade data. Malaysia's detailed exports data, decomposed by commodities and non-commodities and destinations, shed further light. As discussed above, commodity exports suffered a sharp decline and much of this was due to lower prices and to destinations other than China. For example, Malaysia exports of LNG to Japan and Korea (two major destinations) declined significantly. Turning to trade with China, exports to China averaged 13 percent of total exports during 2011–15. They comprised mostly manufactures, including intermediate inputs and capital goods (electrical goods and electronics and other machinery), all part of the regional supply chain, as well as non-energy commodities such as palm oil. Exports to China fell by about 8 percent in 2015 (in U.S. dollar terms), driven by a fall in machinery and transport equipment exports (about 50 percent of total exports to China), while exports of commodities broadly remained resilient. Despite this significant drop, data show that China's imports from Malaysia were relatively less affected than that from most of the other countries in the region.



E. The Current Account: Malaysia is Not Headed for a Twin Deficit

Background. Malaysia's current account surplus fell from 4.3 percent of GDP in 2014 to 2.9 percent in 2015 as the oil and gas trade surplus shrank by 1.2 percentage points of GDP driven by the negative impact of lower mineral fuel prices. The non-oil and gas trade deficit (around 2 percent of GDP) and services and income account balances were largely unchanged from 2014.

² In ringgit terms, exports were up by nearly 2 percent in 2015, while commodity exports were down by close to 14 percent.

The impact of lower-for-longer oil on the current account. In light of the importance of “twin deficits” as signals of countries’ external and fiscal vulnerabilities, it is useful to ask whether Malaysia’s current account could turn negative if oil prices collapsed further and remained depressed over the medium term. This is an extreme scenario in which oil prices decline to around \$10–15 per barrel over the medium term—that is lower by close to 60 percent over the medium term over the baseline. The conclusion is that Malaysia’s overall CA balance is unlikely to go into deficit just because oil price fall to \$10–15 per barrel level over the medium term. This extreme oil price shock alone is not as severe as the CA shock scenario in the external DSA. The following considerations are relevant:

- **Oil: the effect of a permanent oil shock.** The medium-term impact on Malaysia’s external position of an extremely large permanent shock to oil prices can be ascertained by examining the effect of changes in oil prices on the ratio of the current account (CA) balance in relation to GDP (CA/GDP). Under the same volumes as in the baseline, we assume oil prices are permanently in the range of \$10–15 barrel. Moreover, we take into account the impact on nonoil export prices using the same elasticity to oil price change as in the baseline but applied to the above oil price path. Under these assumptions, the CA balance drops to 0.7 percent of GDP over 2016–21, as compared to a baseline of 1.8 percent of GDP.
- **CA elasticities.** Between 2006 and 2015, the average elasticity of the ratio of the current account balance in relation to GDP (CA/GDP) to oil price changes was -0.4, although this reflects a trend fall in the nonoil-and-gas CA balance. The oil and LNG trade balance has been fairly stable around 6 percent of GDP since 2006 (2015: 5 percent of GDP). Only 2009 and 2015 saw bigger swings in this balance, with 2009 witnessing a 2.3 percentage points of GDP drop from the peak of 7.5 percent of GDP in 2008 (2015 change was -1.2 percentage points of GDP). So, the true elasticity of CA/GDP to oil price changes would be lower.
- **Robustness checks.** While oil prices do not have much impact on imports as oil and gas imports are small, if the further drop in oil prices assumed above is related to global demand factors, import deflator should also fall, leading to a lower import for the same volume. Also, given that this is a large shock, there could be import compression from slower domestic demand and/or impact of exchange rate depreciation that might ensue, which is abstracted from here. As a result, changes in imports may offset the 1.1 percentage drop in CA balance mentioned above. In fact, adjusting the non-oil import deflator the same way as the non-oil export deflator above, the deterioration in CA balance is very small.³

GVAR analysis. Using a dynamic multi-country approach for the analysis of international transmission of shocks⁴, it is shown that a 1 percent permanent negative GDP shock in China could have significant effects on ASEAN-5 countries through trade and commodity price channels. The shock reduces growth in Malaysia by 0.3 percentage points following a 1 percent one-off shock to

³ The elasticity of nonoil deflator to changes in oil deflator is higher in the case of imports, likely reflecting the demand side impact.

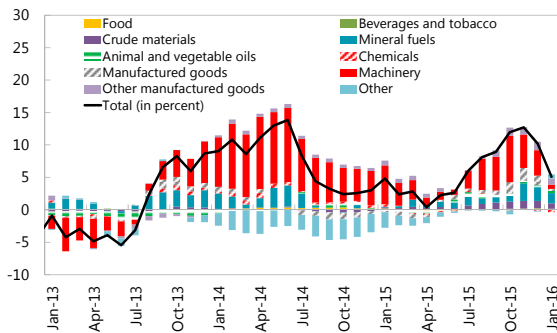
⁴ Cashin, Paul; Kamiar Mohaddes; and Mehdi Raissi, 2016, “China’s Slowdown and Global Financial Market Volatility: Is World Growth Losing Out?” IMF Working Paper No. 16/63 (Washington, D.C.).

GDP growth in China. Malaysia is the second country most affected, after Singapore. Furthermore, if China's growth slowdown coincides with global financial market volatility, it has the potential to create even larger spillovers to Malaysia, reaching 0.5 percentage points after one year.

Conclusion. China is Malaysia's largest trading partner and spillovers through the trade and commodity channels are relatively important. Malaysia's exports to China comprise mostly manufactures which are part of the regional supply chain. Malaysia is also a major exporter of palm oil and other non-oil commodities to China. Quantitatively, developments in China have had a significant impact on Malaysia thus far. Moreover, Malaysia's CA balance is unlikely to go into deficit in an extreme lower-for-longer oil scenario. Going forward, lower imports by China of manufactures and higher imports of services and consumption goods are likely to hurt commodities exporters but could benefit exporters of consumer services, like tourism, health and other services. Malaysia has a comparative advantage in some of these areas and could be a beneficiary. Malaysia could also stand to benefit from Chinese direct investment as Chinese producers relocate some of their production offshore to reduce costs and gain market share. Some of Malaysia's infrastructure needs could be financed by the Asian Infrastructure Investment Bank based in Beijing.

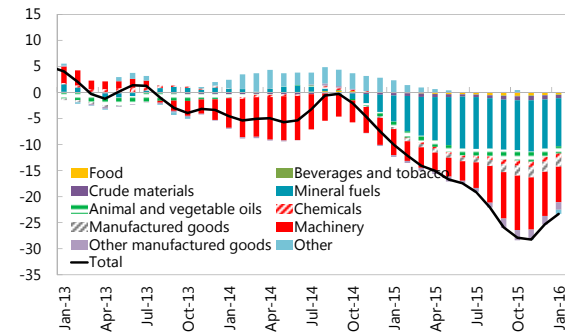
Figure III.1. Malaysia's Trade: The Role of Commodities and China Spillovers

Malaysia: Contributions to Growth in Export Volumes
(In percentage points; 3-mma year-on-year growth)



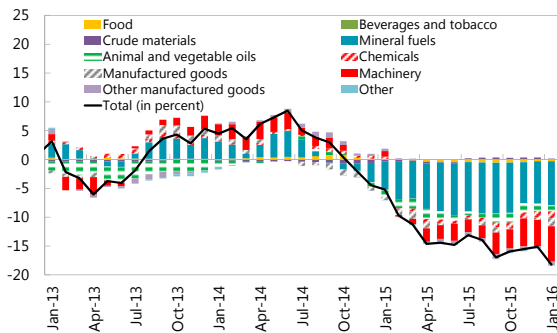
Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

Malaysia: Export Prices Growth Contribution
(In percent, 3-mma year-on-year growth)



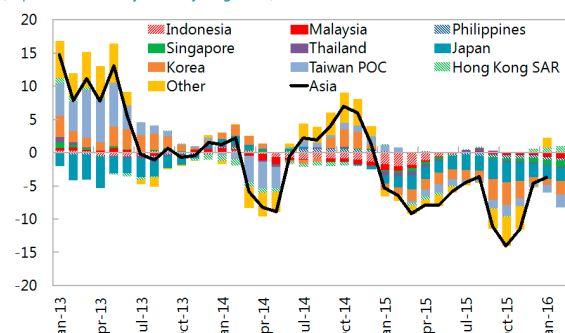
Sources: IMF, *Direction of Trade Statistics*; and IMF Staff estimates.

Malaysia: Contributions to Export Values
(In percentage points; 3-mma year-on-year growth in U.S. dollar terms)



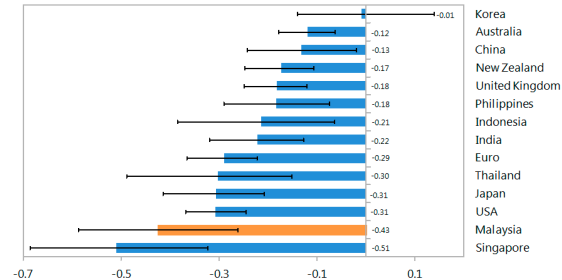
Sources: CEIC Data Co. Ltd.; and IMF staff calculations.

China: Import Values from Asia Growth Contribution
(In percent, 3-mma year-on-year growth)



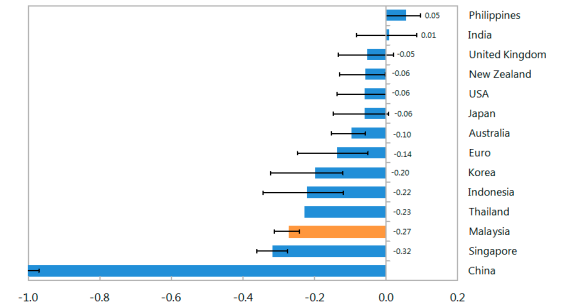
Sources: IMF, *Direction of Trade Statistics*; and IMF Staff estimates.

Average Output Responses to an Increase in Global Financial Market Volatility over the First Year 1/
(Percent change)



Source: IMF staff calculations
Notes: Depicts the percent change in output of a given country associated with a one standard deviation increase in financial stress index, together with the 16th and 84th percentile error bands.

Output Elasticities After a Negative GDP Shock in China 1/
(in percent of GDP)



Source: IMF staff calculations
Notes: Depicts the percent change in output of a given country associated with 1% permanent decline in China's GDP, together with the 16th and 84th percentile error bands.

Appendix IV. Malaysia—Malaysia’s Government-Linked Companies: An Update¹

Overview. Malaysia’s Federal Government owns (partially or wholly) a wide range of companies. These entities are strategic investors and companies, created with the aim of fostering national development while remaining competitive and delivering strong financial performance. Their savings and investment and response to large shocks, including the sharp drop in energy and commodity prices and large ringgit depreciation in 2014–15, are also macroeconomically and fiscally important. We can identify three groups:

1. **Government-Linked Investment Companies (GLICs).** There are five GLICs namely: Employees Provident Fund (EPF), Khazanah Nasional Berhad (Khazanah), Lembaga Tabung Angkatan Tentera (LTAT), Lembaga Tabung Haji (LTH) and Permodalan Nasional Berhad (PNB).
2. **Government-Linked Companies (GLCs).** These companies have a primary commercial objective and are under the control of a GLIC. A GLIC has control over a GLC when it is the majority shareholder or single largest shareholder and when it has the ability to exercise and influence major decisions such as appointment of board members and senior management, award of tenders and contracts and so on.
3. **G20.** This is a selection of large GLCs controlled by GLICs and is used as a proxy for performance of the GLCs. This list originally comprised of 20 GLCs but currently totals 17 due to various mergers, demergers and other corporate exercises over the years.

Scope. GLCs and GLICs encompass a broad spectrum and operate in almost all of sectors of the economy: banking and insurance, airlines and airports, transportation, water, energy, telecommunications, automotive, chemical and petrochemical, construction and infrastructure, media and communications, etc. PETRONAS, the national oil company, is a Fortune 500 company. Maybank, with presence in twenty countries, is now the fourth largest banking group by assets in ASEAN, and its Islamic banking division is the third largest Islamic bank in the world. CIMB, with operations in 17 countries, is now the fifth largest banking group in South East Asia. Axiata is one the largest telecommunication players in the region by market capitalization and revenue, with over 260 million customers across eight countries. Sime Darby has grown to become the world’s largest listed oil palm plantation company and is a leader in the production of certified sustainable palm oil.

Governance. GLCs were created with the aim of fostering national development. They operate within a clear governance structure and are expected to deliver financial performance, catalyze nation building and serve stakeholder interests. The authorities are committed to excellence in GLC management and encourage a culture of high performance in these companies. The Putrajaya Committee on GLC High Performance coordinates the initiatives and is chaired by the Prime Minister.

Financial metrics. GLCs employ more than 270,000 people and their operations are international in scope. About 35 percent of GLC employees are foreigners and more than one third are in overseas operations. The market capitalization of the G20 was about 35 percent of GDP in 2014. Net profits were 2.5 percent of GDP. The average ROE was 11 percent per annum in the last decade. Their revenue amounted to 21 percent of GDP in 2014, with a quarter of it being bank revenue. Among

¹ Prepared by Juan Jauregui (APD).

non-banking revenue, a quarter comes from the power sector, 17 percent from telecommunications, 17 percent automotive, 11 percent trading, 10 percent air transportation and 7 percent plantations.

GLC Transformation Program. The strengthening of GLC financial performance follows a 10-year GLC transformation program May 2004–July 2015. This program focused on enhancing GLC financial performance, institutionalizing good corporate governance, and contributing to national development as enshrined in the New Economic Model (NEM), Government Transformation Program (GTP) and Economic Transformation Program (ETP).² During this period, in addition to the growth in GLC capitalization and increase in profits and shareholder returns, GLCs and GLICs became stronger and expanded regionally and internationally. The G20 have revenue-generating operations in 42 countries and draw 34 percent of total revenue from abroad (2004: 28 percent) with an overseas asset base of 26 percent (2004: 11 percent). Following graduation from the GLC Transformation Program, a GLIC and GLC club aims to uphold the principles of the GLC Transformation Program. The aim is for GLCs and GLICs to contribute to national development goals as enshrined in the 11th Malaysia Plan.

PETRONAS is Malaysia's national oil company. Its macroeconomic importance is sufficient to merit in depth discussion. It is fully integrated in oil and gas and it is ranked among the largest corporations on FORTUNE Global 500. It has about 40,000 employees. Operating its core business in the upstream and downstream sectors, it has a presence in more than 50 countries since it was first incorporated in 1974. Among the oil and gas companies in Asia, it is the top five in terms of production and is the most profitable of all.

At the end of 2015, PETRONAS registered total assets of 51 percent of GDP; current assets are 16.2 percent of GDP; total debt is 15.2 percent of GDP; revenue was 22.8 percent of GDP in 2015, down from 30 percent in 2014 reflecting the decline in oil prices; and the profits before taxation were 3.2 percent of GDP in 2015, down from 7 percent in 2014. In 2015, earnings before interest, tax, depreciation and amortization were 6.5 percent of GDP, similar to the cash flow from operating activities, which was 6 percent, and to the capital expenditures, which were 5.6 percent.

The company is profitable and financially sound; however, revenue and profits fell markedly with oil prices starting in late 2014. PETRONAS has announced large expenditure cuts, most notably a 50 billion ringgit (4.5 percent of GDP) reduction in capital expenditure over the next four years, affecting mostly its foreign operations. The company is expected to remain profitable as it is assessed to be a low cost producer.

Macroeconomic relevance. GLCs' size and response to shocks are macroeconomically important. GLCs are significant drivers of corporate profits and savings and their investment projects form an important part of the five year national development plan. GLCs are profitable, subject to market discipline, and their investment is financed in part out of earnings and issuance of debt and equity. Starting in late 2014, lower commodity prices were reflected in lower corporate earnings and GLC savings. PETRONAS and other GLCs adjusted their dividend payments to the federal budget with a one year lag.³ GLCs also continued implementing domestic investment programs even as they cut

² See Appendix 9 in IMF Country Report 14/80.

³ PETRONAS profits for 2015 declined to RM 21 billion from RM 48 billion in 2014. The PETRONAS dividend paid in 2015 was RM 26 billion, down from RM 29 billion in 2014. In 2016, the budget anticipates a lower dividend of RM 16 billion.

back international capital expenditure plans. Together, these responses by the GLC permitted national investment to remain resilient while allowing breathing room for offsetting federal budget measures to kick in, thus providing a two-pronged help to the adjustment process. Looking ahead, GLC deficits are expected to gradually decline as cost cutting measures as well as exchange rate depreciation help to boost competitiveness and profitability and investment plans are adjusted in light with the new lower-for-longer prices for oil and other commodities.

PETRONAS is the largest corporation in the non-financial public sector and has a large impact in the consolidated fiscal accounts. The overall deficit of the non-financial public corporations (NFPCs) in 2015 is estimated to rise by RM 30.9 billion or 82 percent, to RM 68.4 billion (Table IV.1). The increase in the deficit is due to the decline in revenue by RM 70.7 billion to RM 400.7 billion. Current NFPC expenditure declined by RM 45.4 billion to RM 357.8 billion. The decline in revenue by 15 percent was partly offset by lower current expenditure (a decline of 11.3 percent), resulting in a decline of the current NFPC balance by RM 25.2 billion to RM 42.9 billion. In addition, the estimated increase in the NFPC deficit is also due to increase in capital expenditure by RM 7.7 billion to RM 113.4 billion.

PETRONAS alone is estimated to experience a drop in cash revenue of RM 75.5 billion to RM 261.9 billion and a decrease in operating cash expenditure of RM 53.5 billion to RM 236.4 billion. The decrease in revenue was partly mitigated by the decline in operating expenditure, resulting in a decline in the current balance by RM 25.2 billion in 2015. Of the RM 7.7 billion increase in capital expenditure, RM 5.6 billion was contributed by PETRONAS while Prasarana Sdn Bhd is estimated to account for RM 3.2 billion.

Table IV.1. NFPCs Financial Position, 2014–15

	2014 Actual	2015 Est.	Change
	(RM billion)		
Revenue	471.4	400.7	-70.7
o/w PETRONAS	337.4	261.9	-75.5
Current expenditure	403.2	357.8	-45.4
o/w PETRONAS	289.9	236.4	-53.5
Current balance	68.2	42.9	-25.2
o/w PETRONAS	47.6	25.5	-22.1
Capital expenditure	105.7	113.4	7.7
o/w PETRONAS	61.9	67.5	5.6
Prasarana Sdn Bhd	2.2	5.4	3.2
Overall NFPC balance	-37.5	-68.4	30.9
(in percent of GDP)	-3.4	-5.9	

Appendix V. Malaysia—Fiscal Reforms and Growth During an Earlier Oil Price Slump¹

Background. Malaysia is an upper middle income country whose diversified and highly open economy has been being buffeted by multiple shocks recently, including sharply lower oil and gas prices for its energy exports and repercussions from China’s growth slowdown and economic policy rebalancing. The authorities’ fiscal policy responses from 2014 to the present have been timely, decisive and consistent. They include large cuts in poorly targeted fuel subsidies and other non-priority spending and the introduction of a Goods and Services Tax (GST) in April 2015, which helped to broaden Malaysia’s revenue base and diversified it away from volatile oil and gas related revenues.

Lessons from 1986. Fiscal reforms from an earlier era of Malaysia’s recent economic history—those unleashed after the collapse in oil prices in 1986—contain useful lessons for policymakers in Malaysia and elsewhere. This appendix summarizes Malaysia’s fiscal policy and, in particular, its public investments in physical infrastructure and human capital and finds that these investments have made important contributions to economic growth. The appendix also outlines challenges facing Malaysia’s fiscal policy going forward, which include the need to improve the quality of education and the efficiency of spending.

Fiscal policy and endogenous growth. Endogenous growth theory provides the analytical framework for studying the effects of fiscal policy on long-term growth. Fiscal policy can impact growth through several channels: public investments in infrastructure and in research and development ameliorate market failures and negative externalities. Infrastructure helps to raise the supply of local, regional and global public goods, broadly construed to include soft capital (law and order and secure property rights) as well as hard infrastructure (roads and networks). Public spending on research and development helps to increase the stock of productive knowledge available to private firms and households.^{2,3,4} Public investments in health and education also help augment human capital and avoid inefficient under-investments, which are common among children from poor families given imperfections in markets for student loans. Public investments in education help to lift worker productivity and allow families to escape poverty traps, thereby lowering income inequality and promoting inclusion. There are also strong arguments⁵ that there are positive external effects on economic growth emanating from human capital investments.

Calibrating an endogenous growth model. The dividend from growth-friendly fiscal reforms can be assessed using an endogenous growth model along the lines described in the recent IMF Board Paper.⁶ In the model, long run growth is possible because accumulation of public and human capital

¹ Prepared by Jeff Danforth (FAD) and Alex Mourmouras (APD).

² Aghion, Philippe and Peter Howitt, 1998, *Endogenous Growth Theory*, Cambridge: MIT Press.

³ Arrow, Kenneth J, 1962, The economic implications of learning by doing, *Review of Economic Studies*.

⁴ Barro, Robert and Xavier Sala-I-Martin, 1995, *Economic Growth*, New York: McGraw-Hill.

⁵ Lucas, Robert J, 1988, On the Mechanics of Economic Development, *Journal of Monetary Economics*.

⁶ IMF, 2015, “Fiscal Policy and Long-term Growth,” (Washington, D.C.).

offset diminishing returns to physical capital accumulation. Fiscal policy can increase growth through a variety of channels: capital and labor tax cuts raise post-tax return on investment in physical and human capital, and higher public investment raises total factor productivity and growth by increasing the ratio of public to private capital stocks. A budget-balance neutral simulation of the model where capital and labor taxes are reduced by 5 percentage points and offset by higher consumption taxes increase the long run growth rate by close to one half of 1 percent relative to the initial steady state. Similarly, when public investment is scaled up by 1 percentage point of GDP, financed by cuts in unproductive spending, then the growth dividend is about 0.2 percent.

Malaysia's fiscal reforms during 1986–

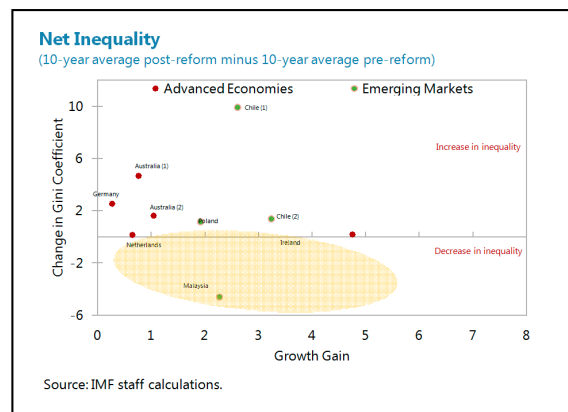
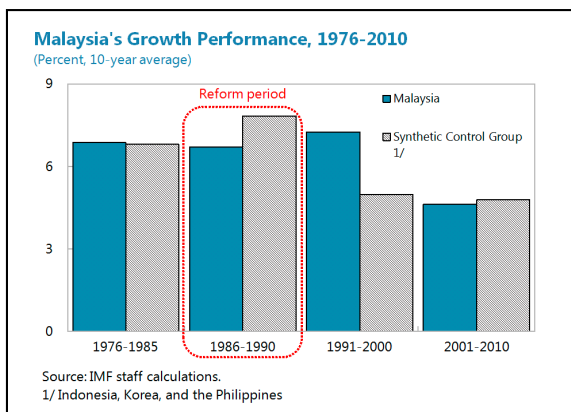
1990.

Malaysia embarked on significant fiscal and economic reforms following the collapse in oil prices in 1986. These reforms lasted until 1990 and provide

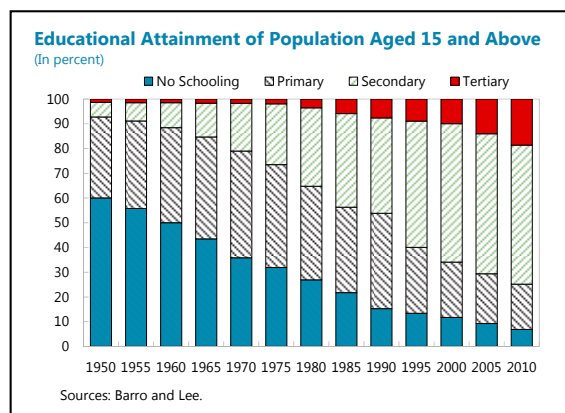
lessons for the future given the similar situation now with the recent collapse in oil prices. Malaysia's reforms at the time amounted to a large expenditure-based adjustment, featuring large cuts in current spending. The economy was deregulated and the tax system was reformed. Crucially, public enterprises (the government-linked companies or GLCs) were rehabilitated and privatized, resulting in a smaller public sector and less crowding out of private investment. Altogether this package of reforms helped to spur private investment and FDI inflows. In order to assess the potential impact of these reforms on Malaysia's growth, a novel approach—the synthetic control method—was used to create a counterfactual version of Malaysia's growth path in the absence of fiscal reforms.⁷ Using this method, the estimated growth dividend of fiscal and economic reforms was substantial, close to 2.25 percent. Growth averaged about 7 percent in the decade preceding reform (1976–1985), in line with peers, and about 7.25 percent in the following decade (1991–2000), compared to about 5 percent in the synthetic control group. In addition to the growth enhancing effects Malaysia's reforms were also associated with substantial declines in income inequality. The Gini coefficient after taxes and transfers declined by about 5 points.

Impact of Fiscal Reforms		
Fiscal Reform	Increase in Long-Run Growth Relative to Benchmark	Offsetting Measures
Reduction in capital tax of 5pp 1/ Reduction in labor tax of 5 pp	0.4-0.5 pp	Increase consumption tax
Increase in Public investment of 1 percent of GDP	0.15-0.2 pp	Reduce unproductive spending by 1 pp of GDP
Source: IMF staff calculations. 1/ pp = percentage points		

⁷ The synthetic control countries were Indonesia, Korea, and the Philippines.



Improving the quality of education.⁸ Malaysia has also made important strides to improve access to education. Enrollment rates for secondary education are rising and Malaysia has done better than some of its peers. In addition, the gap with advanced countries in Asia is slowly narrowing although it is still significant. In terms of tertiary education, Malaysia's enrollment rates have been steadily rising, although they still lag behind those in advanced countries in Asia. The quality of education remains an issue however. PISA scores in Malaysia are relatively low, creating an urgent need for reforms. Cross-country research⁹ has established a very close connection between economic growth and educational attainment—what students actually learn as opposed to input—based measures like money spent on education or years of schooling. This research underscores that improving Malaysia's educational attainment in absolute terms and among its peers in the region would create substantial growth dividends.



Cognizant of the stakes involved, the Malaysian authorities have devised an ambitious plan that aims to raise the percentage of highly educated workforce to 33 percent by 2020 and to increase productivity by creating skilled and human capital. The objective is to create a workforce that can utilize knowledge creatively and that possesses flexible and adaptable skills and the ability to enhance knowledge through lifelong learning. Similarly, one of the six strategic thrusts of the 11th Malaysia Plan is to accelerate human capital development and provide students a with "21st century education." Steadfast implementation of the education blueprint and of the 11th Malaysia Plan's human capital development objectives will be needed to meet these goals.

Recent fiscal reforms have helped to improve the composition of government spending, which has historically been skewed toward social benefits and subsidies. Starting in late 2014, poorly targeted

⁸ Malaysia, Ministry of Higher Education, 2012, The National Higher Education Strategic Plan, Malaysia Education Blueprint 2013–2025 (September).

⁹ Hanushek, Eric and Ludger Woessmann, 2012, Schooling, educational achievement, and the Latin American growth puzzle, *Journal of Development Economics*.

and costly fuel and other subsidies have been eliminated, with appropriate compensatory measures to offset the impact on lower income households. On net, recent data show that the share of social benefits and subsidies has declined. Another noteworthy feature is the high level government investment, whose share in Malaysia exceeds the average for all emerging market economies.

Conclusions. The conclusions in the FAD board paper are worth reiterating. Fiscal reforms make a difference for long-term growth: the evidence shows that growth increased by 0.75 percentage points in advanced economies and by even more in developing economies. Malaysia's experience underlines that reforms should be tailored to country-specific conditions and that their design matters: they are more effective when they are mutually reinforcing and when they are complemented by structural and macroeconomic policies. Lastly, when reforms are large and complex, reforms must contain measures to avoid equity-efficiency trade-offs in order to gain broad-based support.

Appendix VI. Malaysia—Exchange Market Pressure¹

Several global events during 2015—a sharp decline in the global oil prices, financial market volatility related to the developments in China, and the expectation of monetary policy normalization in the U.S.—impacted emerging market economy (EME) currencies. Malaysia was no exception and the exchange market pressure (EMP) was significant, higher than that in the median EME (Figure VI.1)². The ringgit depreciated by about 19 percent against the U.S. dollar, while the Bank Negara Malaysia deployed about 18 percent of its foreign exchange (FX) reserves to cushion the capital outflows. However, the impact on Malaysia’s domestic financial markets was relatively muted (Figure VI.1).

Among the EMEs, Malaysia’s goods exports has a relatively high exposure to China, although lower than some of the Latin American countries, while its exposure to commodity exports (defined as SITC 0-4 categories together) in total exports is similar to the median EMEs (Figure V.1). On the financial flows, Malaysia received relatively large inflows and its outstanding non-FDI liabilities were about 80 percent of GDP in 2014 (median for the EME: 49 percent of GDP).

Staff analysis, similar in spirit to Aizenman and Hutchison, finds that the country’s characteristics as of end-2014 (i.e. the initial conditions) in terms of export exposures to mineral fuel, China, and Russia; change in credit-to-GDP ratio and change in the real effective exchange rate (REER) in the preceding 2-3 years; and the share of FX denominated debt in nonfinancial corporate and household debt helped explain the variation in EMP in 2015 across the sample³. Regression models with several other indicators of initial conditions did not perform well. These additional indicators included expected growth and inflation differentials vis-à-vis the U.S.; trade openness; current account balance and its expected change in 2015; non-FDI external liabilities; monetary policy framework; FX reserve cover; and banks’ loan-to-deposit ratio.

Based on the results from the better-fitted models (Table VI.2), it appears that Malaysia’s EMP, and the associated depreciation of ringgit against the U.S. dollar, were broadly in line with that predicted by the cross-country experience. Export exposure to China and exports of mineral fuels had nearly equal importance in explaining Malaysia’s EMP in 2015 (models A3 and A6), but the former seems to have played a greater role in explaining the behavior of ringgit against the U.S. dollar (model B5). However, caution should be exercised in interpreting these results as the regression models do not fit well for all the countries, given the small sample size and the likelihood of omitted variable bias.

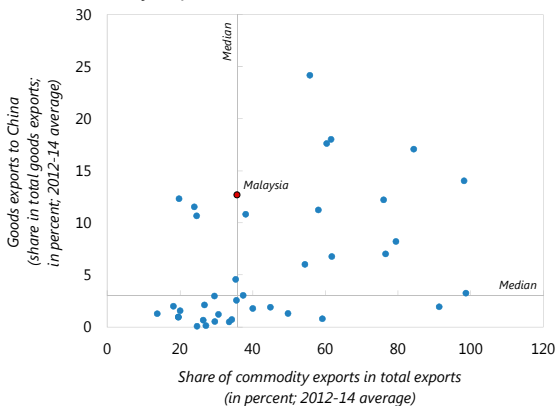
¹ Prepared by Souvik Gupta (APD).

² The sample of EMEs is drawn from the Fund’s *Vulnerability Exercise* for the EMs, excluding mainly those belonging to a common currency area and/or those who availed themselves of financial support from the Fund in 2015. In this analysis, EMP is defined as the sum of the percentage changes in the bilateral exchange rate against the U.S. dollar and in the central bank’s FX reserves. Alternative measures of EMP, for example, change in FX reserves relative to the base money or FX market interventions through other than the central bank, were not used due to data limitations. However, country rankings with respect to different measures of EMPs are expected to be highly correlated.

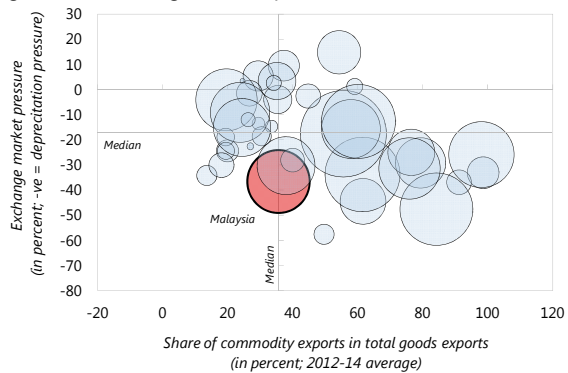
³ See Aizenman, Joshua and Michael M. Hutchison, 2010, Exchange Market Pressure and Absorption by International Reserves: Emerging Markets and Fear of Reserve Loss during the 2008-09 Crisis, NBER Working Paper Series, Working Paper No. 16260.

Figure VI.1. Exchange Market Developments in the Emerging Market Economies in 2015

Among the emerging market economies (EMEs), Malaysia's goods exports have a relatively high exposure to China, while commodity exports are at the median level.

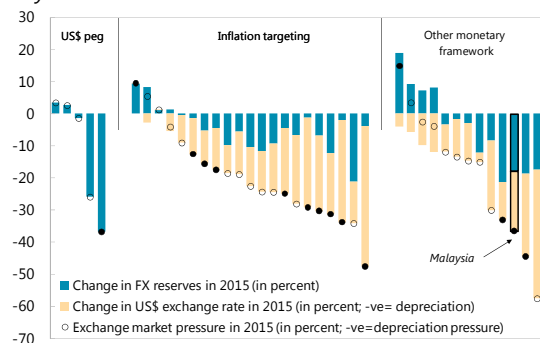


Faced with the twin external shocks, viz. a fall in oil prices and concerns about China, Malaysia experienced significant exchange market pressure (EMP) in 2015.



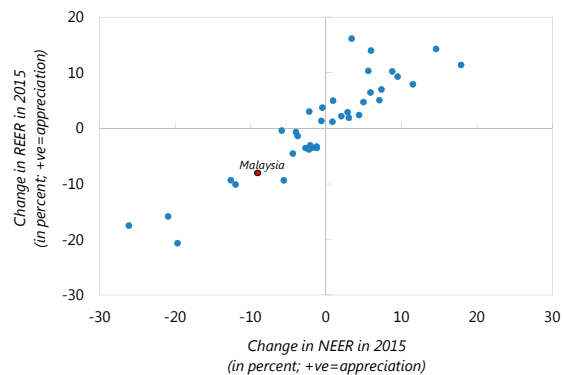
Note: Bubble size represents average share of goods exports going to China over 2012-14.

Depreciation of ringgit against the USD and deployment of foreign exchange reserves contributed about equally to Malaysia's EMP.



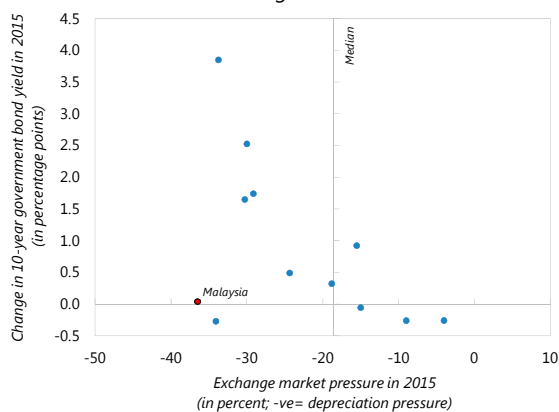
Note: Exchange market pressure are shown in dark markers for countries with shares of commodity exports and China-bound exports in total exports both being at or above their respective in-sample medians.

And, both the real effective exchange rate (REER) and the nominal effective exchange rate (NEER) depreciated.

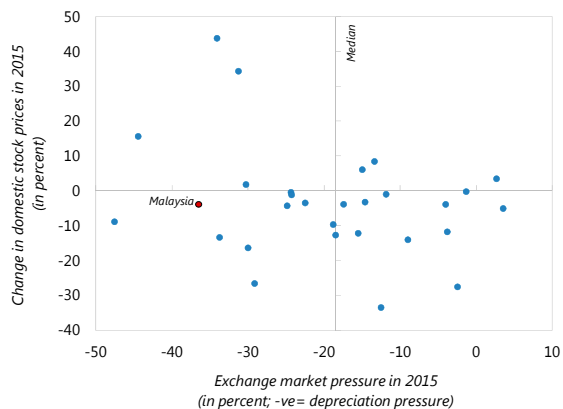


Note: Chart does not include Venezuela which saw a significant real appreciation in 2015.

Despite its above-median EMP among the EMEs resulting in significant capital outflows, Malaysia's long-term interest rates were little changed...



...and the impact on the domestic stock market was limited.



Sources: CEIC Data Co. Ltd.; Haver Analytics; and IMF, *Direction of Trade Statistics* database, *Information Notice System* database, *International Financial Statistics* database, *Vulnerability Exercise for EMs* database, *World Economic Outlook* database, and IMF staff calculations.

Table VI.2. Results from Selected Regression Analyses

Dependent variable: EMP in 2015							
	(A1)	(A2)	(A3)	(A4)	(A5)	(A6)	(A7)
Constant	3.8	15.1 [@]	2.1	3.6	2.2	-1.9	-2.1
Exports to China (dummy) 1/	-8.8 [@]	-8.2 [#]	-14.3 [*]	-8.7 [@]	-14.4 [*]	-12.9 [^]	-13.5 [^]
Exports to Russia (dummy) 1/	-12.7 [^]	-9.9 [#]	-14.3 [*]	-12.7 [^]	-14.3 [^]	-16.5 [*]	-16.6 [*]
Share of mineral fuel in exports (dummy) 1/	-14.0 [*]	-15.6 [*]	-13.6 [*]	-14.1 [*]	-13.4 [*]	-11.8 [^]	-11.0 [^]
GDP per capita (U.S. dollars)	-0.002 [*]	-0.002 [*]	-0.001 [^]	-0.001 [^]	-0.001 [^]	-0.002 [*]	-0.002 [*]
Stock of non-FDI liabilities (percent of GDP)		-0.17 [#]					
Change in credit-to GDP ratio over 2012-14			0.8 [*]		0.8 [*]	0.8 [*]	0.8 [*]
Change in REER in 2012-14				0.04	-0.03		-0.1
Share of FX denominated debt in non-financial corporate and household debt						0.2 [@]	0.2 [@]
No. of observations	39	35	39	39	39	36	36
R-squared	0.43	0.50	0.55	0.43	0.55	0.61	0.62
F-statistics	6.4 [*]	5.9 [*]	8.1 [*]	5.0 [*]	6.6 [*]	7.6 [*]	6.4 [*]
Akaike Information Criterion	8.1	8.1	8.0	8.2	8.0	7.9	8.0
Schwartz criterion	8.4	8.4	8.2	8.4	8.3	8.2	8.3
Durbin-Watson statistic	2.3	2.4	1.9	2.3	1.9	2.1	2.2
Actual (Malaysia)	-36.5	-36.5	-36.5	-36.5	-36.5	-36.5	-36.5
Fitted (Malaysia)	-35.8	-43.6	-30.7	-35.9	-30.7	-35.2	-35.0
Dependent variable: change in exchange rate against the U.S. dollar in 2015							
	(B1)	(B2)	(B3)	(B4)	(B5)	(B6)	(B7)
Constant	0.7	3.0	-0.4	-0.5	-1.3	-3.1	-2.5
Exports to China (dummy) 1/	-8.1 [*]	-9.6 [*]	-11.7 [*]	-7.1 [^]	-10.5 [*]	-13.5 [*]	-12.2 [*]
Exports to Russia (dummy) 1/	-13.7 [*]	-12.2 [*]	-14.7 [*]	-13.9 [*]	-14.8 [*]	-15.0 [*]	-14.9 [*]
Share of mineral fuel in exports (dummy) 1/	-5.6 [@]	-7.1 [^]	-5.3 [@]	-7.0 [^]	-6.6 [^]	-3.6	-5.5 [@]
GDP per capita (U.S. dollars)	-0.001 [^]	-0.001 [^]	-0.001 [^]	-0.001 [^]	-0.001 [@]	-0.001	-0.001
Stock of non-FDI liabilities (percent of GDP)		-0.05					
Change in credit-to GDP ratio over 2012-14			0.5 [*]		0.5 [*]	0.6 [*]	0.5 [*]
Change in REER in 2012-14				0.4 [*]	0.3 [*]		0.3 [^]
Share of FX denominated debt in non-financial corporate and household debt						0.02	-0.003
No. of observations	39	35	39	39	39	36	36
R-squared	0.49	0.57	0.62	0.59	0.69	0.65	0.71
F-statistic	8.2 [*]	7.8 [*]	10.7 [*]	9.6 [*]	12.1 [*]	9.0 [*]	9.6 [*]
Akaike Information Criterion	7.2	7.1	6.9	7.0	6.7	6.9	6.8
Schwartz criterion	7.4	7.3	7.2	7.2	7.0	7.2	7.2
Durbin-Watson statistic	2.0	2.2	1.5	2.1	1.6	1.8	1.6
Actual (Malaysia)	-18.7	-18.7	-18.7	-18.7	-18.7	-18.7	-18.7
Fitted (Malaysia)	-21.5	-26.4	-18.2	-22.0	-18.9	-17.9	-18.4

Note: *, ^, @, and # indicate that variables are significant at 1, 5, 10, and 15 percent levels respectively. All independent variables are as of end-2014.

1/ Dummy variable equals to unity if the respective independent variable is greater than the in-sample median, and zero otherwise (for Malaysia, the dummy variable for exports to Russia was zero, while the other two dummy variables were unity).

Appendix VII. Malaysia—Stress Testing Resilience to Capital Outflows¹

A. Background

1. Past resilience. Malaysia’s highly open economy has demonstrated substantial resilience to capital flow shocks and exchange market pressure since the GFC. Growth has averaged about 5.7 percent per annum since 2009, amid conditions of low inflation, full employment and low real interest rates. And while the external surplus has declined, it remains comfortably positive. Skillful macroeconomic management, including a flexible exchange rate and well timed counter cyclical fiscal policies, have played an important role in achieving resilience. Active forex intervention to cushion the impact of capital flows volatility on the economy was also an important component of the strategy. It helped to avoid exchange rate overshooting, ensured orderly market conditions, and stable monetary conditions at home in the face of large and volatile capital flows. And, as elaborated below, financial cushions other than reserves were also important in the strategy to deal with reversals in capital flows, including during the taper tantrum, decline in oil prices and heightened concerns about spillovers from China. Malaysia has important structural strengths: it continues to run current account surpluses, an important feature that separates Malaysia from twin-deficit economies. A decade of large current account surpluses, strong capital inflows, and a high savings rate have created “a structural liquidity surplus”, reflected in the accumulation of sizeable foreign currency reserves. In addition, there are several large institutional investors, such as the pension funds, the sovereign wealth fund (Khazanah Nasional) and the national oil company (PETRONAS), that can provide a cushion in turbulent times. Since the Asian financial crisis, a key policy priority has been to develop deep financial markets, and in particular, local currency bond markets; and Malaysia’s bond markets are now the third largest in Asia.

2. New vulnerabilities. Although Malaysia has dealt successfully with outflow episodes since the GFC, the current environment presents new vulnerabilities. Malaysia’s current account surplus has declined significantly to 2.9 percent of GDP in 2015 compared with 10 percent in 2010, and the non-oil current account moved into a deficit in 2012. Reserves have also declined, reflecting intervention and outflows from BNM bills and notes (as discussed in more detail below). Paralleling the post-GFC experience in other countries, Malaysia’s overall debt level is considerably higher, in particular for households and the general government (text table). External debt has increased from 55 percent of GDP at end-2010 to 65.6 percent at end-2015, with the increase primarily driven by capital inflows into local currency debt securities. However, local currency-denominated debt is 36 percent of total external debt, implying that “original sin” is less of an issue.

	2008	2015 Est.
General government debt	39.9	57.4
Household debt	60.4	89.1
Nonfinancial corporate sector debt	94.4	96.0

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

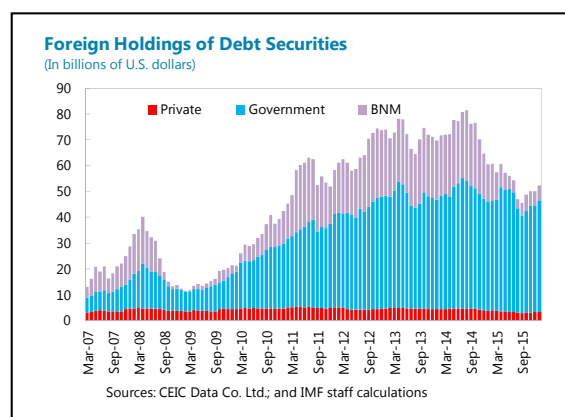
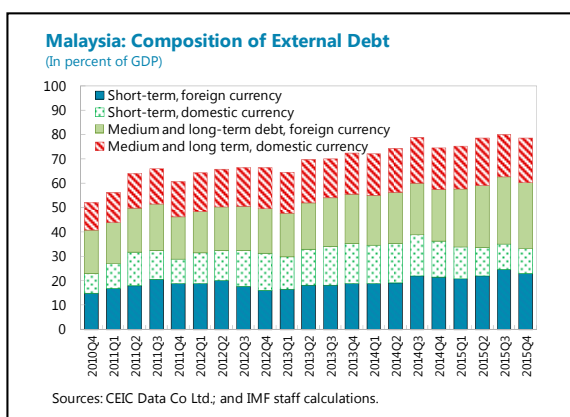
3. Outline. There are two parts to this appendix. Section B provides a detailed discussion of the components of Malaysia’s external debt, identifying the potential vulnerabilities associated with each

¹ Prepared by Niamh Sheridan (APD).

type of debt. A key finding is that not all components of external debt present the same risk and significant buffers should be taken into account in assessing Malaysia's external debt. The final section illustrates a tail-risk severe stress scenario—not unlike the GFC—where Malaysia faces a sharp slowdown in global growth and large capital outflows triggering currency depreciation and a further narrowing of the current account surplus. In this modified sudden stop scenario, the flexible exchange rate, forex intervention, and the response of domestic institutional investors all play an important role in mitigating the impact of the capital flow reversal and helping buffer the shock to the Malaysian economy. Nevertheless, such a scenario would lead to a further significant decline in reserves. Reduced fiscal space compared with during the GFC limits the scope for counter-cyclical fiscal policy.

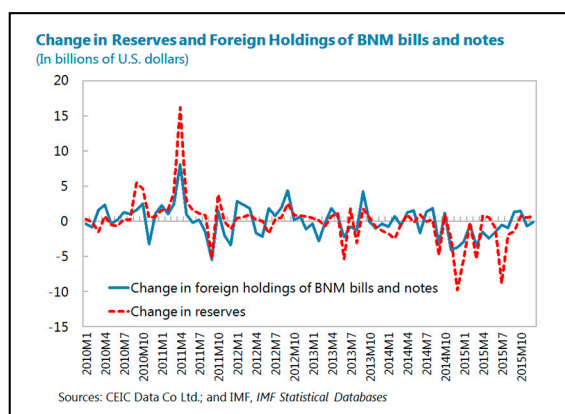
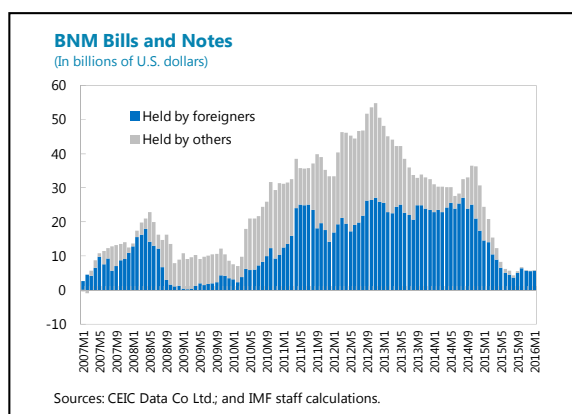
B. External Debt: Composition, Risks and Buffers

4. Composition of external debt. Several trends have driven the increase in external debt since end-2010, most significantly the increase in foreign holdings of local currency debt securities, both short-term and medium- and long-term. The text figure shows a decomposition of Malaysia's external debt by currency and maturity. The largest increases took place in short-term and medium- and long-term local currency denominated debt, reflecting the increase in foreign holdings of both Malaysian Government Securities (MGS) and BNM bills and notes. Foreign holdings of MGS increased from 9.1 percent of GDP (at end-2010) to 14.0 percent of GDP at end 2015. Short-term local currency external debt includes both non-resident deposits and foreign holdings of BNM bills and notes. The latter had also increased significantly, reaching 7.5 percent of GDP at end-2013 but has since declined to near zero as capital flows reversed. Short-term banking sector FX debt has also increased, from 8.2 percent of GDP at end-2010 to 15.2 percent by end 2015. Finally, exchange rate depreciation since mid-2014, along with US\$5 billion bond issuance by PETRONAS in March 2015, has increased medium-term FX denominated debt to 27 percent of GDP at end-2015 (up from 21 percent of GDP at end-2014).



5. Foreign holdings of BNM bills and notes. BNM uses these instruments in monetary policy operations to absorb excess liquidity from the banking system. BNM bills and notes were also sold directly to foreign investors during capital inflow surges to absorb the inflows in BNM's balance

sheet and wound down during outflows, helping to insulate the economy from swings in capital flows. Outstanding issuance of BNM bills and notes peaked at end-2012 at just over US\$50 billion, of which half were held by foreigners (see text chart). Foreign holdings were broadly unchanged in U.S. dollar terms until end-2014, although their share increased above 55 percent. Since then portfolio rebalancing along with the decline in oil prices has contributed to non-resident selling and liquidation on maturity. As a result, foreign holdings declined to less than US\$6 billion. Throughout the post-GFC period, changes in foreign holdings of BNM bills and notes and changes in reserves have tended to move together, although as the market shrank during 2015, the co-movement declined. The decline in foreign holdings of BNM bills and notes represented about one-third of the US\$36.5 billion decline in reserves between July 2014 and end-2015.



6. The Malaysian Government securities (MGS) market. The MGS market is deep and liquid, due in part to the role of several large domestic institutional investors, including the pension funds and insurance companies. Federal government debt in Malaysia amounted to 54.5 percent of GDP at end 2015 and comprised MGS, sukuk bonds referred to as Government Investment Issues (GII), external debt, Treasury bills and others. Outstanding MGS and GII are about 29.5 and 17.8 percent of GDP, respectively, and for many domestic investors, MGS and GII are close substitutes. By contrast, foreign investors distinguish between these securities; foreign participation in the GII market is significantly lower, at just 4 percent of the market compared with 45 percent of the MGS market (amounting to 13.3 percent of GDP). The second largest holder of MGS is the EPF whose holdings amount to 20 percent of outstanding MGS. The share of MGS in EPFs portfolio declined as the EPF increased overseas investments partially offsetting the impact of increased foreign participation in the MGS market.

7. The role of domestic institutional investors. Malaysia's deep-pocketed institutional investors play an important role in providing depth and stabilizing its financial markets. During times of stress, market-based and opportunistic purchases by domestic investors offset pressures in the MGS market when foreigners exit, for example during the Taper Tantrum in 2013 and other outflow episodes.² As a result MGS yields tend to be much less volatile compared to yields in other EM countries. In addition, yields are less influenced by common global factors; analysis in the GFSR (2015) shows that the correlation between MGS yields and the common factor in emerging market bond

² For example, EPF's holdings of MGS increased by RM 9.4 billion between end-June 2014 and end-September 2015.

yields is lower than for other countries with similar levels of foreign ownership. This behavior by the domestic investors helps prevent sharp increases in MGS yields and in turn protects the real economy. This financial adjustment to shocks has contributed significantly to Malaysia's resilience in recent years (for further discussion, see Appendix 8, 2013 Article IV consultation for Malaysia). The large insurance companies can also play a role in stabilizing the MGS market; this would occur mostly through portfolio reallocations along the yield curve (rather than through increased holdings).

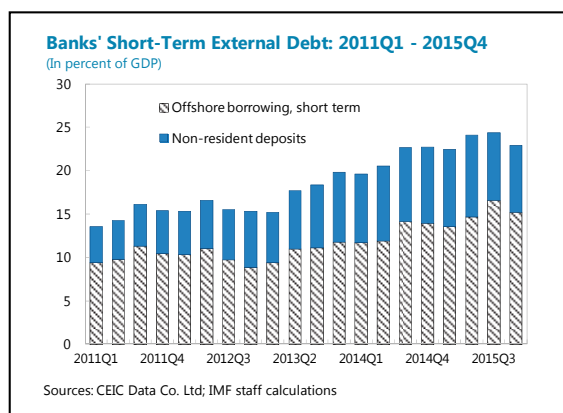
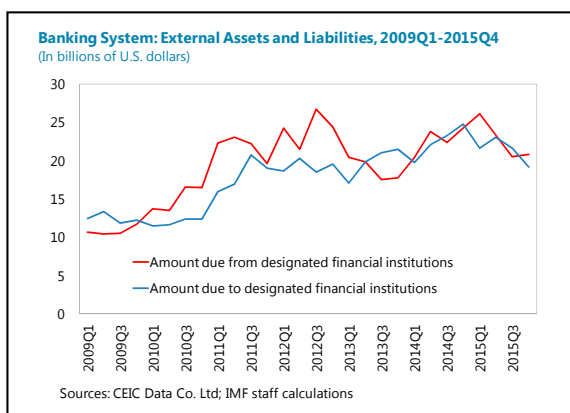
8. Balance sheet analysis. Whether domestic investors can continue to support the MGS market will depend on the strength of their balance sheets and capacity to reallocate the portfolios. Using balance sheet information for Malaysia's largest institutional investors, staff's analysis suggests that domestic investors have the capacity to purchase an additional 5 percent of GDP of domestic securities (table VII.1). The illustrative calculations are based on third quarter data for 2015 and rely on assumptions regarding the current allocation of assets into MGS compared with an estimated target allocation (based on the investors' strategic investment plans). This represents the capacity under the 'stock' heading and is estimated to be about 0.5 percent of GDP. In addition, there is a flow component based on new contributions in the case of the EPF and on maturing assets for banks and other investors. This calculation assumes the target allocation is maintained. Furthermore, the EPF has significant overseas assets that could be repatriated if Malaysia experienced significant capital outflows leading to a depreciated exchange rate which implies that the share of assets invested overseas moves above the strategic asset allocation. It is assumed that about 20 percent of overseas assets could be readily liquidated and repatriated, although this is a somewhat conservative assumption.

Table VII.1. Malaysia: Estimated Capacity for Additional Domestic Holdings of Government Debt
(In percent of GDP)

Estimated Capacity for Additional Domestic Holdings of Government Debt (In percent of GDP)						
	Total Assets	Overseas Assets	From domestic balance sheet expansion and asset reallocation			Repatriation of overseas assets
			Stock	Flow	Total	
Employees Provident Fund (EPF)	59.1	14.8	0.0	0.4	0.4	3.0
Banks	203.0	...	0.4	0.5	0.9	...
Others 1/	49.5	6.3	0.1	0.1	0.2	0.4
sub- total					1.6	3.3
Total						4.9

1/ KWAP, Khazanah, TLH, PNB.
Sources: Annual Reports; IMF staff calculations

9. Short-term debt of the banking system. The short-term debt of the banking system has increased from just under 15 percent of GDP in early 2009 to 22.9 at end-2015. Broadly speaking this debt is comprised of short-term offshore debt and non-resident deposits (see text chart). Off-shore borrowing appears to be primarily related to centralization of treasury operations in Malaysia of the overseas subsidiaries of the local banks. This debt is matched—in terms of size—by liquid assets. The text chart shows the external assets and liabilities of the banks, which together amount to about 10 percent of GDP. In a stress scenario, to the extent that this portion of bank balance sheets is unwound smoothly, there would be no call on reserves. On the other hand, non-resident deposits could represent a vulnerability during a capital flight episode.



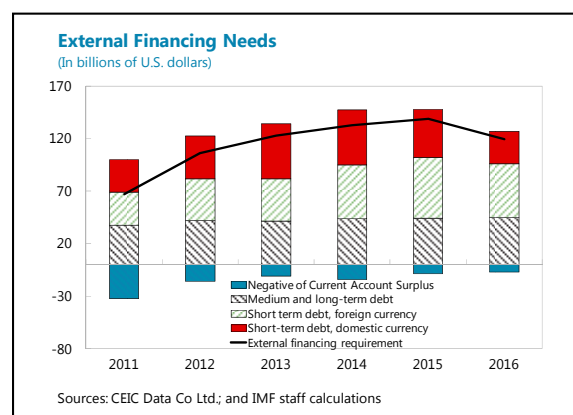
10. Medium- and long-term debt. Foreign-currency denominated medium- and long-term debt amounts to 26.9 percent of GDP and is primarily related to the public enterprises (8.4 percent of GDP) and the private non-bank sector (8.4 percent of GDP). As discussed in Appendix X on corporate sector debt, foreign currency denominated corporate sector in Malaysia is predominantly hedged, either naturally or through financial instruments, reducing balance sheet risks associated with FX denominated debt. Stress testing indicates that Malaysia's corporates can be resilient to declines in income, depreciation of the exchange rate, and increases in interest rates.

C. A Stress Scenario

11. A stress scenario. This extreme stress scenario assumes an external shock of similar scope and magnitude to the GFC, assumed to be a rare event. In this tail-risk scenario, Malaysia is assumed to face a sharp contraction in external demand along with a sharp reversal of capital flows. As a result, the current account surplus shrinks amid outflows from the domestic debt securities and equity markets. In this context, the exchange rate is assumed to depreciate by 25 percent, bond yields increase by 200 basis points, and the stock market decline by 30 percent.³

12. Baseline. Malaysia has significant external financing needs, reflecting short-term debt and amortization of medium- and long-term debt amounting to 38 percent of GDP. In the baseline scenario, the external financing needs are largely met by debt and net equity inflows, offsetting net FDI outflow.

13. Stress scenario assumptions. The following assumptions are made with regard to capital outflows. (Table VII.2)



- **Foreign holdings of MGS.** These are assumed to fall by half in ringgit terms, calibrated based on outflows during the GFC when holdings declined by 50 percent. However, the stock of MGS held by foreigners is much larger, both relative to GDP and market share, so the magnitude of the shock is now much greater than during the GFC. Therefore, it is assumed that MGS yields increase by 200 basis points⁴ which in turn causes domestic institutional investors to opportunistically reallocate their on-shore and off-shore asset holdings into the MGS market. An increase of 200bps in bond yields implies a reduction in bond prices of 8.5 percent (based on the assumption of a 5-year bond currently trading at par). Therefore, foreign investors seeking to reduce holdings of MGS would face losses on two fronts: capital losses from the sale of bonds and valuation loss from the depreciation of the exchange rate. Given initial holdings of

³ Bond yields are assumed to increase reflecting tighter liquidity in the bond market; however, it is assumed that BNM would not increase policy rates in an attempt to reduce capital outflows.

⁴ By contrast during the GFC yields initially increased by up to 100 bps during early 2008 but subsequently declined as central banks around the world loosened their monetary stance. As a result average yields during 2008 were slightly lower than in 2007. The assumed increase in yields is significantly larger than during the Taper Tantrum episode when yields increased temporarily by about 70 basis points between May and end-July.

US\$37.8billion, a reduction in foreign holdings by 50 percent, taking into account capital and exchange rate losses, would imply an outflow of US\$14.5billion.

- **Rollover rate for short-term debt.** It is assumed that the rollover rate for banks' short-term debt declines to 70 percent, based on the decline in short-term debt between September 2009 and March 2010. This assumption is applied only to that portion of debt estimated to be unrelated to banks' treasury operations; any drawdown of short-term debt related to liquidity management is offset by an equal decline in short-term assets and therefore would not create a call on reserves. Such a reduction in the rollover rate would create an outflow of US\$5.2billion.
- **Non-resident deposits.** An outflow of non-resident deposits of 30 percent is assumed, calibrated based on the reduction in short-term debt. It is assumed that non-resident deposits are primarily denominated in local currency and, as a result, this creates an outflow of US\$4.8billion.
- **Foreign-holdings of equities.** These are assumed to fall by 20 percent in ringgit terms, implying a fall in the foreign participation rate from 21.6 percent to 17.3 percent. This is significantly larger than the decline during the GFC when the foreign participation rate declined from 22 percent in 2008 to 21 percent in 2009. Outflows are sizeable at US\$10billion but are mitigated by a decline in the stock prices of 30 percent (assumed to be smaller than the 45 percent during the GFC) and the 25 percent depreciation of the exchange rate.
- **Current account balance.** In the baseline, Malaysia's external financing needs are offset by a sizeable current account surplus. It is assumed that the current account balance shrinks to zero but will not fall into deficit. In the stress scenario, the exchange rate depreciation would help offset the impact of the large external demand shock through expenditure switching.
- **Net FDI flows.** Malaysia has sizeable inward and outward FDI flows which are about 3.2 percent of GDP each in 2015. In the stress scenario, Malaysian companies are likely to scale back outward FDI investment. However, inward FDI could also be reduced due to the shock, and therefore no change in net FDI flows is assumed in this scenario.
- **Repatriation by domestic investors.** The balance sheet analysis of Malaysia's institutional investors highlighted the sizeable overseas assets of Malaysia's institutional investors. These were conservatively estimated at 3.3 percent of GDP, equivalent to US\$9.3billion, and create a new inflow in the stress scenario. In the absence of these inflows, the increase in MGS yields would likely be greater, increasing the capital losses for fleeing foreign investors.

Table VII.2. Malaysia: Stress Test: Assumptions and Estimated Outflows

	Value at end-2015 US dollars, billions	Stress scenario parameters and assumptions	Impact
Outflows			
Malaysian Government Securities (MGS)	37.8	Foreign holdings of MGS fall by 50 percent (in ringgit) <ul style="list-style-type: none"> • Calibrated based on 50 percent decline in foreign holdings during the GFC • 200 basis point increase in yields is estimated to reduce ringgit value of MGS by 8.5 percent • Exchange rate depreciation of 25 percent implies additional losses for foreign investors 	14.5
Short-term debt of the Banking System 1/	17.4	Rollover ratio declines to 70 percent <ul style="list-style-type: none"> • Banking system external debt fell by 70 percent between Sept. 2009 and March 2010 • Exchange rate depreciation of 25 percent implies losses for foreign investors 	5.2
Non-resident deposits	19.0	Non-resident deposits fall by 30 percent <ul style="list-style-type: none"> • Calibrated based on short-term debt assumption • Exchange rate depreciation of 25 percent implies losses for foreign investors 	4.8
Foreign holdings of equities (21.6 percent of stock market capitalization at end 2015)	85.3	Assumed to decline by 20 percent in ringgit terms (falling 17.3 percent share) <ul style="list-style-type: none"> • Foreign participation declined from 22 to 21 percent (or about 5 percent) between 2008 and 2009 • Stock market is assumed to decline by 30 percent (compared with 45 percent during GFC) • Exchange rate depreciation of 25 percent implies additional losses for foreign investors 	10.0
Offsetting inflows			
Current account surplus (projection for 2016)	7.2	Current account balance is assumed to decline to zero. <ul style="list-style-type: none"> • Current account balance declined by USD8 billion (or 6.5 percentage points of GDP) during the GFC 	0
Net FDI flows		Offsetting reductions in gross inflows and outflows are assumed	0
Repatriation of overseas assets by institutional investors		See text table	-9.3
Shortfall compared to the baseline (in US dollars, billions)			25.2
as percent of GDP			8.2
Estimated reserves, at end 2016			70.1

1/ Excludes external liabilities to designated financial institutions which are matched by assets, as discussed in the text.

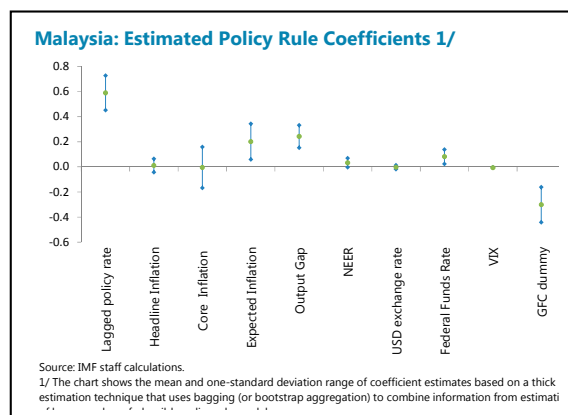
14. Conclusions. We considered a modified sudden stop scenario which resulted in a sizable external financing gap, a sharp depreciation of the exchange rate and a spike in bond yields. The weak currency and low asset prices triggered a repatriation of foreign assets, along with reduced outward FDI flows, would help close the gap. Reserves would be deployed to help smooth market volatility and maintain orderly market conditions during the outflows; as a result, reserves are projected to decline by US\$25.2billion. The composition of the adjustment assumed in this scenario is in line with other recent outflow episodes where the adjustment was shared by reductions in reserves and changes in the exchange rate.

Appendix VIII. Malaysia—Monetary Framework¹

1. Mandate. BNM has a dual monetary policy mandate, “to maintain price stability while giving due regard to the developments in the economy,” which in recent years has meant maintaining a low inflation of about 3 percent and positive and low real interest rates conducive to sustainable growth of the Malaysian economy. In addition, BNM is tasked with ensuring financial stability through its regulation and supervision of financial institutions under its jurisdiction, and with promoting a sound and inclusive financial system. In discharging its financial stability mandate, BNM works closely with Malaysia’s Securities Commission and other financial regulators in the Financial Stability Committee. The emphasis on sustainable growth over the medium-term distinguishes BNM’s mandate from inflation targeting and other regimes.

2. Instruments. BNM’s principal policy instrument is the overnight policy rate (OPR) although it also uses other tools at times, including the exchange rate and reserve requirements, to deliver monetary and financial stability. BNM has been successful in promoting monetary stability and Malaysia’s inflation has been relatively stable.

3. Estimated policy rules. Estimation of monetary policy reaction functions, or Taylor rules, provides an empirical description of the main variables driving monetary policy decisions.² The empirical approach relies on estimation of large numbers of possible specifications, rather than selection of a single best equation, to highlight the main drivers of interest rate policy decisions. Not unexpectedly, there are differences between Malaysia and other ASEAN-5 countries (Thailand, the Philippines, and Indonesia) which, unlike Malaysia, employ an inflation targeting framework. The estimated coefficient on the lagged policy rate is large implying a high degree of interest rate smoothing. Estimates of Taylor rules for BNM suggest that its monetary policy rule is more gradualist than typical. Compared with other ASEAN countries the estimated inflation reaction coefficient is lower and generally insignificant for Malaysia, with the empirical results suggesting greater relevance for inflation expectations than either headline or core inflation. By contrast, the output gap reaction coefficient is positive and significant for Malaysia whereas for the other ASEAN countries it is insignificant, reflecting Malaysia’s dual mandate. The results suggest little role for the changes in the exchange rate in influencing policy rate decisions. Higher global uncertainty (captured with either a global financial crisis dummy or the VIX) tended to lower policy rates in Malaysia; U.S. interest rates have a positive impact on domestic policy rates in Malaysia but the estimated size of the impact is small.



¹ Prepared by Niamh Sheridan (APD).

² See ASEAN Cluster Report on Monetary Frameworks, IMF Asia Pacific Department, forthcoming.

4. Managing the capital flow cycle. In recent years BNM has relied on both foreign reserves and the exchange rate to cushion the impact on the economy of swings in capital flows, commodities prices, and other external shocks. When capital inflows to EMEs surged following the GFC, BNM partly sterilized the liquidity impact of inflows through the issuance of bills which were purchased both by domestic residents, primarily banks, and also by foreigners. Increases in foreign holdings of BNM bills were matched by similarly sized changes in reserves. This helped limit appreciation of the ringgit and kept domestic real and nominal interest rates from falling as much as they would otherwise have. When the capital flow cycle turned, starting in mid-2013, and especially following the collapse in energy and other commodity prices starting in late 2014, reserves accumulated during inflow surges along with substantial ringgit depreciation were used to cushion the impact of outflows. Again, the impact on domestic interest rates was modest, shielding Malaysia's real economy from interest rate volatility typical in other EMEs.

5. Sustaining financial stability. BNM use of macroprudential policies has complemented monetary policy since the GFC. There have been several rounds of macroprudential policies (see table 8). Macroprudential policies have been enacted using a gradual, passed approach and have been targeted at speculation in the property market and at curbing the growth in personal unsecured lending. In July 2014, as inflation increased and real rates turned negative, BNM increased the OPR amid concerns about financial stability.

Appendix IX. Malaysia—Public Debt Sustainability Analysis

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 taking into account past macro-fiscal volatility; and (v) a standardized summary of risks in a heat map.
2. **Macro-fiscal assumptions.** Growth is projected at 4.4 percent in 2016, recovering to 4.8 percent in 2017 and 5 percent in the medium term. The federal government's deficit has been on a declining trend in recent years, reflecting the authorities' efforts to broaden and diversify revenue bases and reign in costly subsidies and rationalize spending. In staff's baseline projections, the federal government's deficit is reduced in the near term from 3.2 percent of GDP in 2015 to 1.3 percent in 2021. The projected fiscal consolidation is consistent with the authorities' targets and is supported by fiscal and structural reforms announced in recent budgets.
3. **Data coverage.** Consistent with the data on government debt reported by the authorities, this DSA covers the federal government budget. Local and state governments and statutory bodies that typically borrow from the federal government or receive explicit government guarantees are excluded. The liabilities of these entities are therefore captured in federal government's gross debt and stock of loan guarantees¹. Borrowing by state owned enterprises, which are in some cases under federal government guarantees, has increased in recent years, reflecting the increase in the NFPS deficit following the decline in oil prices. The NFPS and borrowing by GLCs are projected to decline over the medium term.²
4. **Choice of framework.** The levels of government debt and gross financing requirement in Malaysia exceed the thresholds for using the higher scrutiny framework. Federal 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, primary deficits have pushed the debt to GDP ratio to about the authorities self-imposed 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 at less than 8 percent in the medium term.
5. **Realism of baseline assumptions.** The median forecast error for real GDP growth during 2007–2015 is zero, suggesting no systemic projection bias that could undermine the assessment. The median forecast error for the GDP deflator is 2.3 percent, suggesting that staff forecasts have been conservative. The median forecast error for the primary balance suggests that

¹ Gross debt of consolidated general government is not published.

² It would be desirable to cast a broader perimeter of fiscal analysis, including government-linked companies. Staff has begun to assemble the sectoral balance sheets needed for a balance sheet analysis (BSA) of Malaysia's economy. During the last Article IV mission, the authorities discussed the role of BSA, including in tracing the response through various sectors of commodities or other shocks. They agreed to work with staff on this project.

staff projections have been slightly pessimistic (a forecast bias of -0.25 percent of GDP), but the forecast bias has improved in the later years.

6. Cross-country experience suggests that the projected fiscal adjustment is feasible. The maximum 3 year adjustment in the cyclically-adjusted primary balance (CAPB) over the projection period (1.6 percent of GDP) is ambitious but is premised upon concrete measures endorsed by the government. Finally, the maximum level of the primary balance (0.8 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 that Malaysia's government debt-to-GDP ratio remains below 65 percent, and its gross financing needs remain below 12 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 2021, but if the projected consolidation does not take place, captured under the constant primary balance simulation, it remains about constant before declining to 50 percent in the medium term. Under most macro-fiscal stress tests, the debt-to-GDP ratio continues to decline, although a one standard deviation shock to real GDP growth would raise the debt-to-GDP ratio initially to above 55 percent by 2018 before it declined in the following years. Something similar happens in a combined macro-fiscal shock that includes higher interest rates and a lower primary balance.
- A permanent oil price shock implies a flat debt-to-GDP profile in the medium term. The oil price shock assumed in the analysis is very large and amounts to a permanent reduction in the oil income of 1 percent of GDP. 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 of the government guaranteed loans, totaling 15 percent of GDP, over two years, would increase risks significantly. It would be accompanied by a persistent negative shock to growth and interest rates increase. In this scenario, the debt-to-GDP ratio would rise to a little above 65 percent of GDP. Although this is a low probability scenario, the simulations underscore the vulnerability posed by contingent liabilities.
- Gross financing needs under all scenarios remain at below 10 percent, except for the contingent liabilities scenario in which it peaks at 16 percent before declining later to below 12 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 debt-to-GDP ratio simulations is below 65 percent.

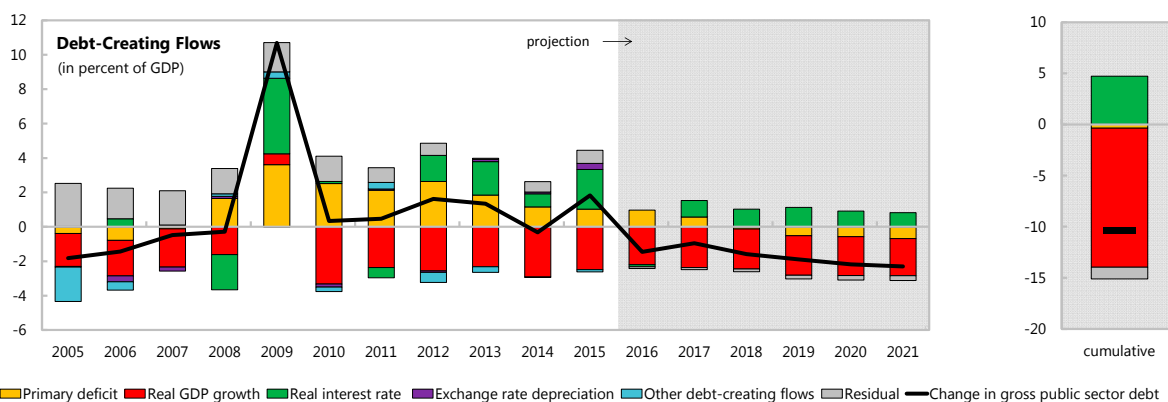
8. Heat map. Malaysia faces risks arising from its large external financing requirement and large share of public debt held by foreigners. At 47 percent, the external financing requirement is above the upper threshold of early warning benchmarks, while the share of debt held by foreigners is relatively 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 of this risk.

Figure IX.1. Malaysia: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario**Debt, Economic and Market Indicators ^{1/}**

	Actual			Projections						As of March 15, 2016		
	2005-2013 ^{2/}	2014	2015	2016	2017	2018	2019	2020	2021	Sovereign Spreads		
Nominal gross public debt	45.6	52.7	54.5	53.0	52.1	50.5	48.6	46.4	44.1	EMBI (bp) ^{3/}		
Public gross financing needs	9.1	9.0	9.4	8.0	7.9	7.9	8.0	7.9	6.8	CDS (bp)		
Real GDP growth (in percent)	4.8	6.0	5.0	4.4	4.8	4.8	4.9	5.0	5.0	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	3.2	2.5	-0.4	4.3	2.6	2.9	2.6	2.7	2.5	Moody's	A3	A3
Nominal GDP growth (in percent)	8.2	8.6	4.5	8.9	7.5	7.8	7.7	7.9	7.7	S&Ps	A-	A
Effective interest rate (in percent) ^{4/}	4.7	4.2	4.2	4.3	4.7	5.1	5.2	4.9	4.6	Fitch	A-	A

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021		
Change in gross public sector debt	1.2	-0.32	1.83	-1.5	-1.0	-1.6	-1.9	-2.2	-2.3	-10.4	
Identified debt-creating flows	-0.2	-0.91	1.07	-1.4	-0.8	-1.4	-1.7	-1.9	-2.0	-9.2	
Primary deficit	1.5	1.2	1.0	1.0	0.6	-0.1	-0.5	-0.6	-0.7	-0.4	
Primary (noninterest) revenue and grants	21.1	20.1	19.0	17.2	17.8	18.1	18.4	18.1	17.8	107.4	
Primary (noninterest) expenditure	22.6	21.3	20.1	18.1	18.4	18.0	17.9	17.6	17.1	107.1	
Automatic debt dynamics ^{5/}	-1.4	-2.1	0.2	-2.3	-1.4	-1.3	-1.2	-1.3	-1.3	-8.9	
Interest rate/growth differential ^{6/}	-1.3	-2.2	-0.2	-2.3	-1.4	-1.3	-1.2	-1.3	-1.3	-8.9	
Of which: real interest rate	0.7	0.8	2.3	-0.1	1.0	1.0	1.1	0.9	0.8	4.7	
Of which: real GDP growth	-2.0	-2.9	-2.5	-2.2	-2.4	-2.3	-2.3	-2.3	-2.2	-13.6	
Exchange rate depreciation ^{7/}	-0.1	0.1	0.4	...	...	...	...	...	...	...
Other identified debt-creating flows	-0.3	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
General government net privatization proceeds (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other change in financial assets	-0.3	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes ^{8/}	1.4	0.6	0.8	-0.1	-0.1	-0.2	-0.2	-0.3	-0.3	-1.1	



Source: IMF staff.

1/ Public sector is defined as the Federal government

2/ Based on available data.

3/ EMBI.

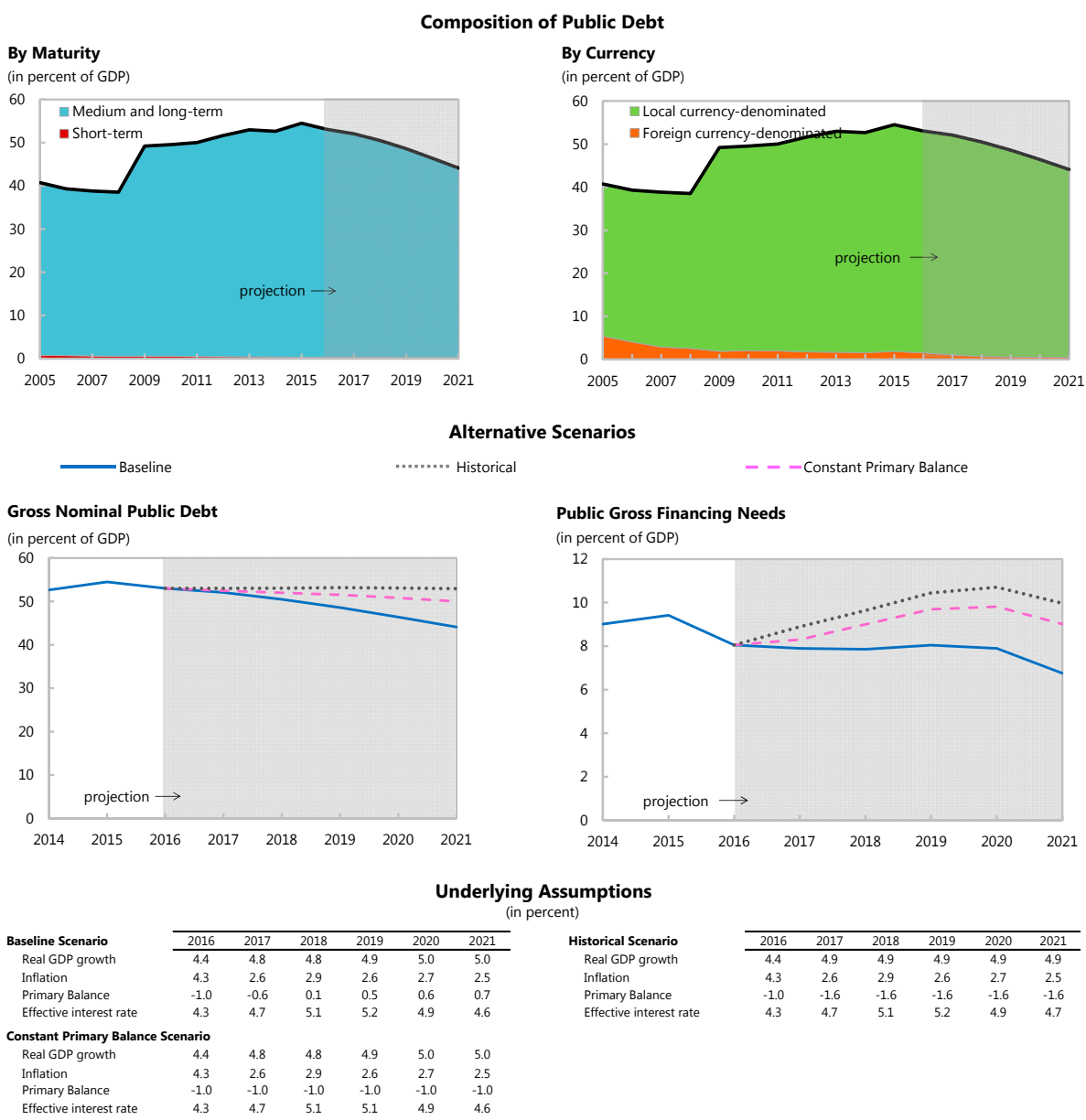
4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ Derived as $[(r - p(1+g) - g + ae(1+r)] / (1+g+p+gp)$ times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).6/ The real interest rate contribution is derived from the denominator in footnote 4 as $r - \pi(1+g)$ and the real growth contribution as $-g$.7/ The exchange rate contribution is derived from the numerator in footnote 2/ as $ae(1+r)$.

8/ For projections, this line 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 IX.2. Malaysia: Public DSA – Composition of Public Debt and Alternative Scenarios



Source: IMF staff.

Figure IX.3. Malaysia: Public DSA – Realism of Baseline Assumptions

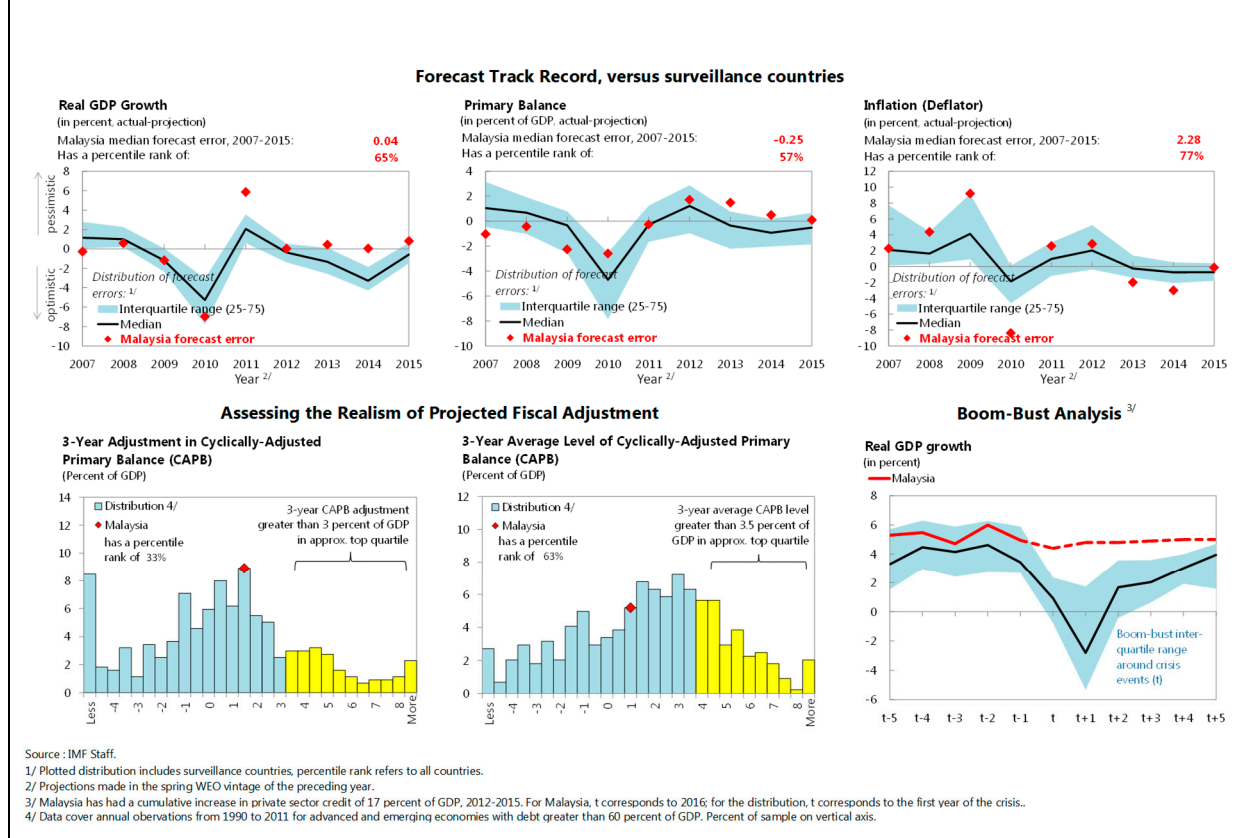
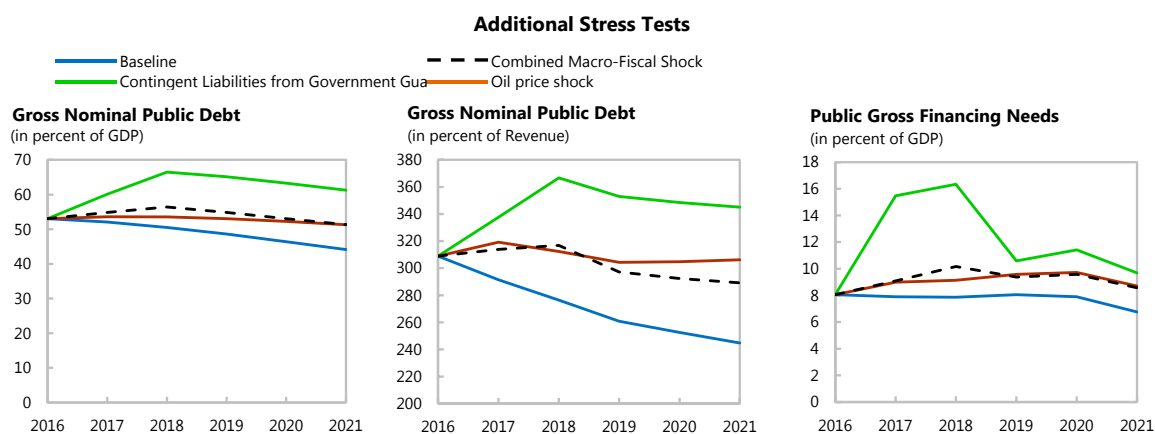
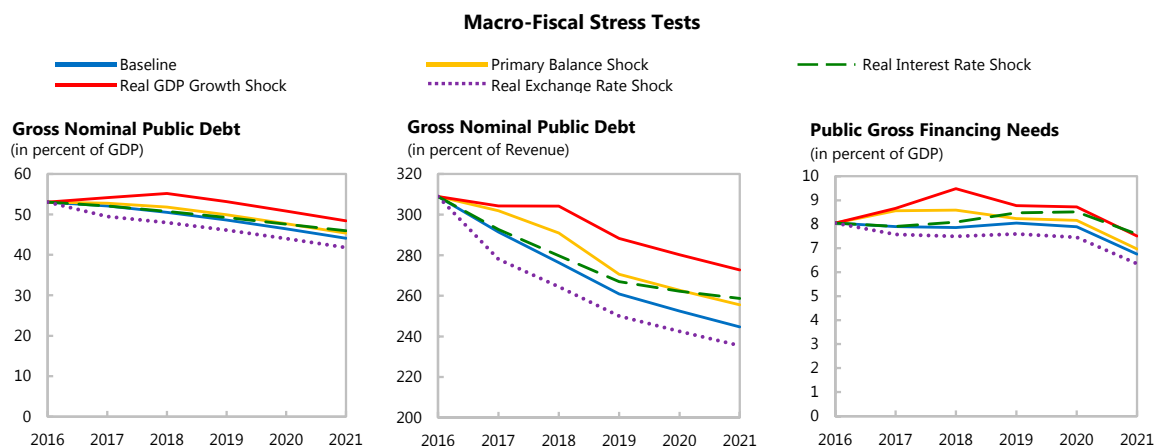


Figure IX.4. Malaysia: Public DSA – Stress Tests



Underlying Assumptions
(in percent)

	2016	2017	2018	2019	2020	2021
Primary Balance Shock						
Real GDP growth	4.4	4.8	4.8	4.9	5.0	5.0
Inflation	4.3	2.6	2.9	2.6	2.7	2.5
Primary balance	-1.0	-1.2	-0.5	0.5	0.6	0.7
Effective interest rate	4.3	4.7	5.1	5.2	4.9	4.6
Real Interest Rate Shock						
Real GDP growth	4.4	4.8	4.8	4.9	5.0	5.0
Inflation	4.3	2.6	2.9	2.6	2.7	2.5
Primary balance	-1.0	-0.6	0.1	0.5	0.6	0.7
Effective interest rate	4.3	4.7	5.6	6.0	6.1	6.1
Combined Shock						
Real GDP growth	4.4	2.4	2.4	4.9	5.0	5.0
Inflation	4.3	2.0	2.3	2.6	2.7	2.5
Primary balance	-1.0	-1.4	-1.3	0.5	0.6	0.7
Effective interest rate	4.3	4.7	5.6	6.1	6.1	6.2
Contingent Liabilities from Government Guarantees						
Real GDP growth	4.4	3.8	3.8	3.9	4.0	4.0
Inflation	4.3	2.6	2.9	2.6	2.7	2.5
Primary balance	-1.0	-8.1	-7.4	0.5	0.6	0.7
Effective interest rate	4.3	4.7	5.4	5.6	5.2	4.9
Real GDP Growth Shock						
Real GDP growth	4.4	2.4	2.4	4.9	5.0	5.0
Inflation	4.3	2.0	2.3	2.6	2.7	2.5
Primary balance	-1.0	-1.1	-0.9	0.5	0.6	0.7
Effective interest rate	4.3	4.7	5.1	5.2	4.9	4.6
Real Exchange Rate Shock						
Real GDP growth	4.4	4.8	4.8	4.9	5.0	5.0
Inflation	4.3	8.8	2.9	2.6	2.7	2.5
Primary balance	-1.0	-0.6	0.1	0.5	0.6	0.7
Effective interest rate	4.3	4.7	5.1	5.2	4.9	4.6
Oil price shock						
Real GDP growth	4.4	3.8	3.8	3.9	4.0	4.0
Inflation	4.3	2.6	2.9	2.6	2.7	2.5
Primary balance	-1.0	-1.6	-0.9	-0.5	-0.4	-0.3
Effective interest rate	4.3	4.7	5.1	5.2	4.9	4.7

Source: IMF staff.

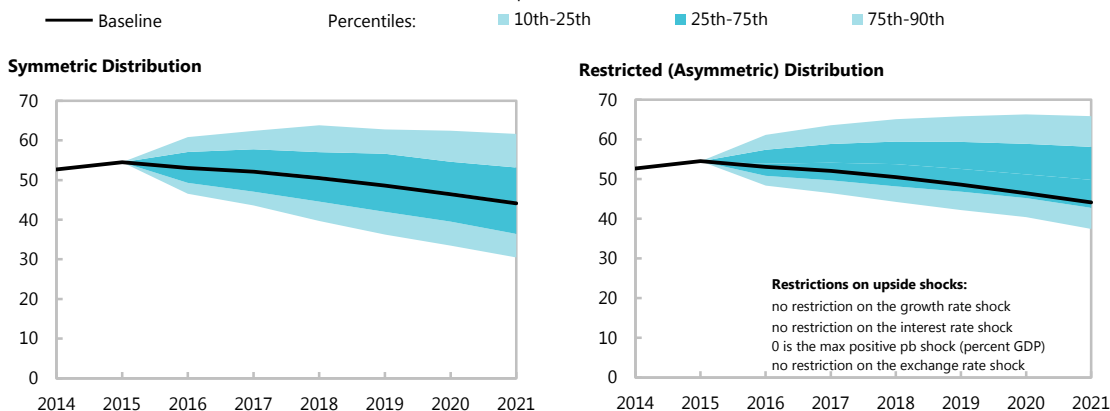
Figure IX.5. Malaysia: Public DSA – Risk Assessment

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

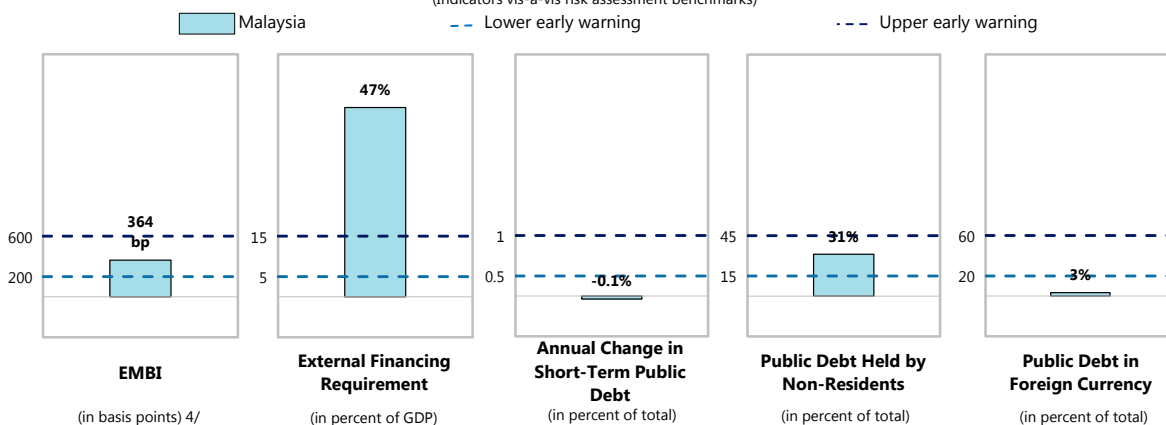
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



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/ An average over the last 3 months, 16-Dec-15 through 15-Mar-16.

Appendix X. Malaysia—Public Infrastructure: Trends and Quality¹

Background. Infrastructure gaps are large in Asia, with the Asian Development Bank estimating infrastructure needs of US\$8 trillion over 10 years. Malaysian policy makers have recognized the importance of infrastructure in their quest to turn Malaysia into a high income nation by 2020 and have made important strides in raising the quantity and quality of the country's infrastructure in recent years. A scaling up of public investment in the 10th Malaysia Plan, financed through budgetary resources and via increased use of public-private partnerships (PPPs) has resulted in an increase in Malaysia's public capital stock, as a share of GDP, while this ratio has declined in other Asia economies (Figure X.1). The increased use of PPPs in Malaysia mirrors the trend observed elsewhere in developing and emerging market economies.

The record. Malaysia fares well in surveys of infrastructure quality and access. While there are significant disparities in perception of infrastructure quality and measures of infrastructure access within Asia, Malaysia scores at the high end of the range, similar to advanced Asian countries (Figure X.1). Malaysia also ranks close to advanced Asian countries in terms of access to treated water and public education, which bodes well for inclusion and intergenerational income mobility, although it still lags behind in terms of roads, electricity production and public health infrastructure (Figure X.1). And while inefficiencies in public investment are sizable in developing and emerging markets in Asia and elsewhere, with the average country being 27 percent below the efficiency frontier, Malaysia's public investment efficiency gap is significantly lower, close to 11 percent similar to the gap in advanced economies (Figure X.1).

Public Investment Management. Judging from the survey results and available measures of public capital stocks, Malaysia's public investment management performance is good by international standards. Total investment has been at sustainable levels, allocations of investment between sectors have been stable and multi-year budgeting has been introduced. However, as with all countries, there is room to strengthen public investment efficiency further and some of the methods identified by the IMF² could be helpful in this regard. Specifically, a new diagnostic tool—the Public Investment Management Assessment (PIMA)—evaluates key public institutions in the planning, allocation and implementation phases of public investment projects. PIMA can help identify the institutions and specific public investment management areas that need improvement with the aim of supporting the infrastructure development pillar in the APEC Cebu Action Plan. FAD has also created a new tool, the PPP Fiscal Risks Management Model (PFRAM) that can assess the potential fiscal costs and risks arising from PPP projects – a tool that could be particularly relevant given Malaysia's relatively high public debt level and significant contingent liabilities. Examples in some advanced countries suggest that the risks posed by PPPs can be significant and, if not quantified, monitored and reported transparently, could contribute to a substantial weakening of public finances. In this context, publication of an annual fiscal risks statement in Malaysia would be extremely helpful.

¹ Prepared by Jeff Danforth (FAD) and Alex Mourmouras (APD).

² IMF, 2015a, "Making Public Investment More Efficient," (Washington, D.C.).

Conclusion. Malaysia has made important gains in scaling up its infrastructure in recent years and progress is likely to continue during 2016–2020. Despite the headwinds facing emerging market economies, the 11th Malaysia Plan envisages major projects such as completion of the KL metro, the Singapore-KL high speed rail and the Pan-Borneo highway. Empirical evidence suggests that public investment can have a positive impact on growth directly³ or indirectly by crowding in private foreign direct investment.⁴ High-quality infrastructure is also correlated with declines in income inequality.⁵

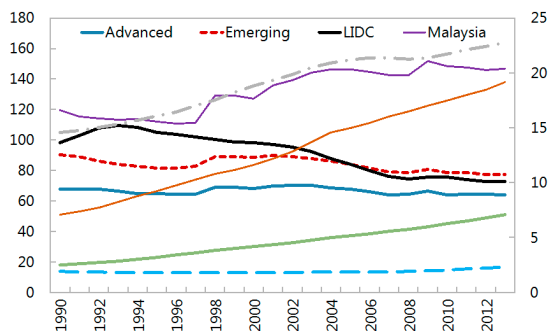
³ IMF, 2015b, World Economic Outlook, October 2014 (Washington, D.C.: International Monetary Fund).

⁴ IMF, 2015c, "Fiscal Policy and Long-term Growth," June 2014 (Washington, D.C.).

⁵ Severinatne, Dulani and Yan Sun, 2013, "Infrastructure and Income Distribution in ASEAN-5: What are the Links?" IMF Working Paper No. 13/41 (Washington, D.C.).

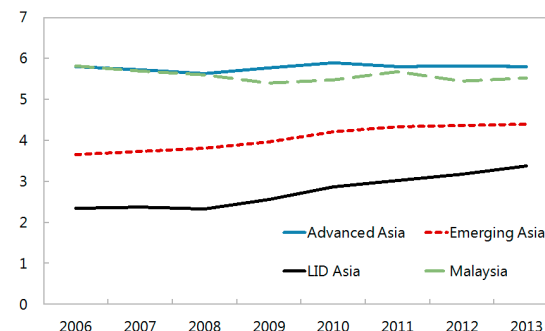
Figure X.1. Public Infrastructure Investment: Trends and Quality

Public Capital Stock and Real Public Capital Stock
(in Percent of GDP; thousands PPP\$ per capita, RHS)



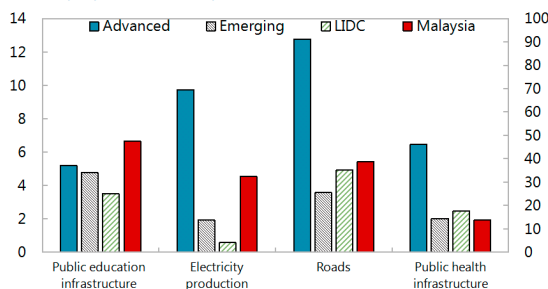
Sources: IMF Staff Calculations

Perception of Infrastructure Quality
(0=Low; 7=High)



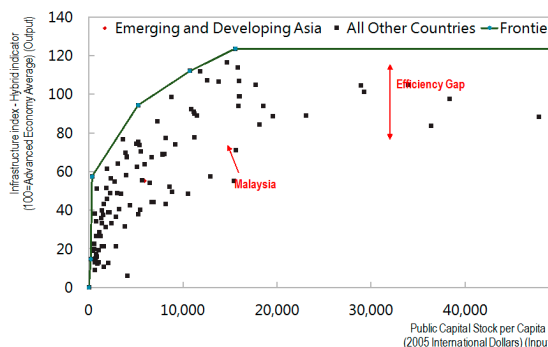
Sources: Global Competitiveness Report

Measures of Infrastructure Access
(Per 1,000 people; Percent of Population, RHS) 1/



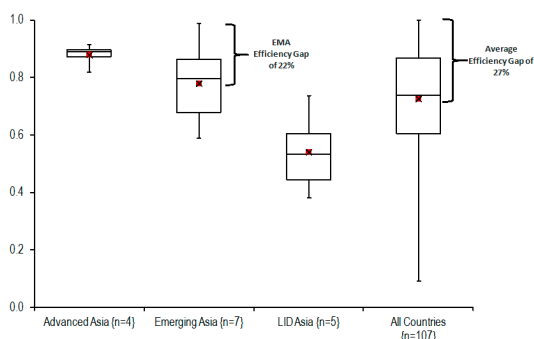
Sources: World Development Indicators (World Bank)
1/ Units vary to fit scale. Left hand axis: Public education infrastructure is measured as secondary teachers per 1,000 persons; Electricity production per capita as kWh per 1,000 persons; Roads per capita as km per 1,000 persons; and Public health infrastructure as hospital beds per 1,000 persons. Right hand axis: Access to treated water is measured as percent of population.

Public Capital Stock and Infrastructure Performance



Sources: IMF staff calculations

Public Investment Efficiency Index (PIE - X)



Sources: IMF staff calculations

Appendix XI. Malaysia—High Priority FSAP Recommendations

Strengthening Financial Sector Oversight
<p>Implement proposed new Financial Services Act (FSA) at an early date; and strengthen legal and regulatory requirements for Islamic banks.</p> <p><i>The FSA and related Islamic Financial Services Act (IFSA) were implemented on June 30, 2013. The IFSA strengthens legal and regulatory requirements for Islamic banks including those for capital, financial reporting, and audit. BNM has re-issued some polices and regulations under the new legislation, covering for example, powers relating to external auditors, financial reporting for Islamic banks, financial reporting for takaful operator, and streamlining capital funds for Islamic banks.</i></p>
<p>Strengthen framework for consolidated supervision of financial holding companies (FHC) including capital standards and risk management.</p> <p><i>BNM has extended its legal powers over FHC with the adoption of FSA and IFSA in June 2013. BNM is at the advanced stage of assessing the appropriate holding companies to be designated as FHC (for financial groups which have not been identified under the previous legislation, BAFIA 1989), as provided under the legislations. BNM has issued a strategy paper on the Bank's plan with regard to regulation and supervision of financial groups; issued final regulatory expectations extending to FHC the application of the standards on External Auditors, Financial Reporting, Capital Adequacy and Compliance. During 2016, BNM intends to issue concept paper on Corporate Governance, applicable to financial institutions and FHCs.</i></p>
<p>Ground the operational independence of the Securities Commission (SC) by changing the legal provisions on removal of Commission members and protections given to Commission members and its staff.</p> <p><i>Related amendments to the Securities Commission Act were passed by Parliament and came into effect on 15 Sept. 2015.</i></p>
<p>Strengthen the definition of connected lending.</p> <p><i>BNM issued a revised policy to strengthen the definition of connected lending that includes definition of influential shareholders as persons that are considered as connected to the banking institutions. This was added in the 'Guidelines on credit transactions and exposures with connected parties' in July 2014.</i></p>
Labuan International Business and Finance Center
<p>Impose prudential and regulatory requirements on Labuan financial institutions in line with international standards and best practice.</p> <p><i>-During 2014, Labuan FSA has completed the harmonisation of financial reporting standards to complement capital requirements and the enhancement to the fit and proper person requirements. During 2015, Labuan FSA has issued guidelines on the valuation of insurance liabilities which forms the initial part of the capital adequacy framework for (re)insurers and consultation paper on the proposed banking capital adequacy standards which adopt higher Basel requirements. The efforts to enhance the capital adequacy requirements for both (re)insurance the (re)takaful sector will continue to be pursued in 2016 and 2017. In addition, amendments to Labuan's legislations are currently being pursued to provide explicit enabling provisions for prudential requirements, including capital adequacy rules.</i></p>
<p>Undertake more proactive engagement and effective communication of LFSA with home supervisors and external auditors.</p> <p><i>Labuan FSA continues to sign new MoUs with home supervisors of Labuan entities, with 6 more MoUs added during the period from 2013 to 2015 covering areas of exchange of supervisory information and collaboration in enforcement. In 2013, Labuan FSA has also written to the home regulators of Labuan licensed entities to seek their confirmation that the coverage of their consolidated supervision includes Labuan entities and had obtained some responses.</i></p> <p><i>Labuan FSA is also working on strengthening the role of external auditors by requiring Labuan banking institutions and (re)insurers to appoint external auditors who are affiliated with the registered member of the Malaysia's Audit Oversight Board (AOB). This is to ensure sufficient quality and professional audit services are rendered to these financial institutions as a quality assurance measure. In 2016, Labuan FSA plans to develop a set of external audit requirements that will further enhance Labuan FSA's supervisory engagement of external auditors.</i></p>

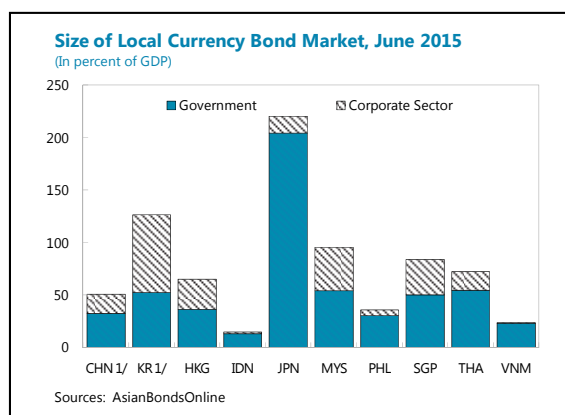
Appendix XI. Malaysia—High-Priority FSAP Recommendations (concluded)

Systemic Risk Management
<p>Formalize a high-level committee involving BNM, SC, PIDM and the fiscal authority with the responsibility for ongoing systemic risk monitoring, information sharing and crisis action.</p> <p><i>The Financial Stability Executive Committee (FSEC) formed in 2010 now also includes, the Chairman of the Securities Commission as a permanent member of the Executive Committee (since 2012) along with the BNM, PIDM and MoF.</i></p>
Macro-Financial Risks
<p>Enhance data capture for household sector to facilitate a more robust and granular monitoring and assessment of household sector leverage and issues especially in accordance to income category; and review effectiveness of macroprudential measures.</p> <p><i>Enhancements to the data capture for households are undertaken in phases. The first phase involves the matching of credit and income data from the tax authority. This is completed and ready for analysis after the final data quality check in 2016:Q1.</i></p>
<p>Adopt multiyear top-down and bottom-up macroeconomic stress testing, and introduce more conservative credit loss parameters in bottom up exercise.</p> <p><i>The Bank has implemented a top-down multi-year macro stress test framework in 2013, with a number of enhancements to the framework made in 2014 which include enhanced satellite models for multi-year income/expenses shocks and projections by detailed income segments (net interest income, net trading and investment income, fee income and staff costs/overheads); quantitative models to project multi-year balance sheet growth (credit, market, operational risk-weighted assets); and simulated multi-year Basel III phase-out of capital instruments.</i></p> <p><i>This is complemented with enhanced calibration methods (multivariate regressions) using a wider range of data inputs to derive better estimates of conservative sectoral credit risk shocks (probability of default, loss given default)</i></p> <p><i>The application of the multi-year stress test for bottom-up stress test has also been rolled out in 2014.</i></p>

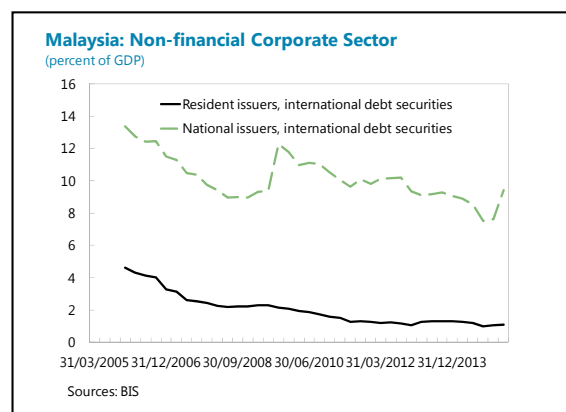
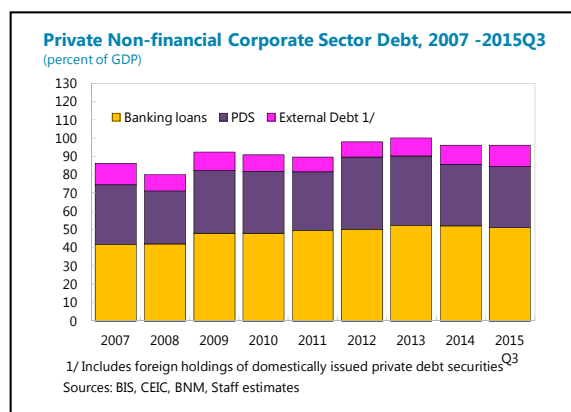
Appendix XII. Malaysia—Corporate Sector Debt¹

A. Background

1. Background. The rise in corporate debt of Emerging Market Economies (EMEs) in recent years, including corporate debt in foreign currencies, is a major macro-financial concern in light of U.S. dollar appreciation, lower commodity prices, and uncertainties about growth and policy prospects in China and other EMEs. Non-financial corporate sector debt is relatively high in Malaysia, but has not increased post-GFC as rapidly as in other EMEs. Malaysia has developed a deep and liquid local currency bond market that is now Asia's third largest market relative to GDP. Corporate bonds represent about 40 percent of the market.

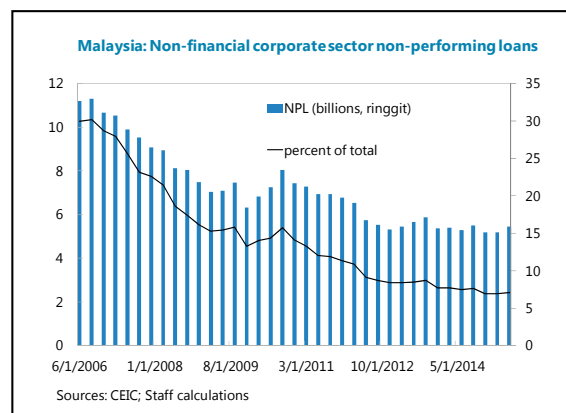
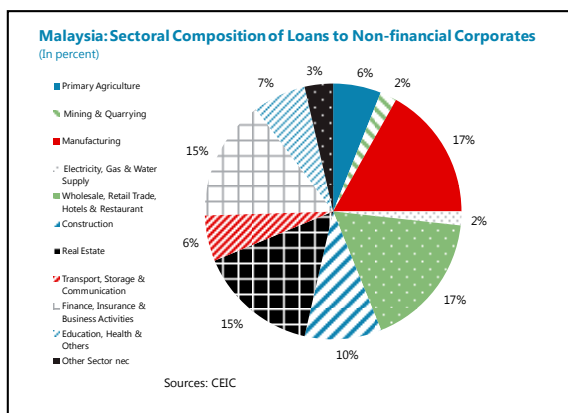


2. Debt. Non-financial corporate sector debt increased from 86 percent of GDP at end-2007 to 96.2 percent by September 2015, with foreign currency debt accounting for about half of the increase. In contrast with the government bond market, foreign holdings of local currency corporate bonds remain low, at just over 1 percent of GDP.



3. Banking sector loans. Loans to the non-financial corporate sector amount to about 36.2 percent of total loans and are well-diversified. Loans to the commodities-related sectors (primary agriculture; mining and quarrying; and electricity, gas, and water) are less than 12 percent of loans to the non-financial corporate sector. Construction and real estate loans are about 30 percent of non-financial corporate sector loans, although together with mortgages are about 55 percent of the total loan portfolio of Malaysian banks. Non-performing loans are low.

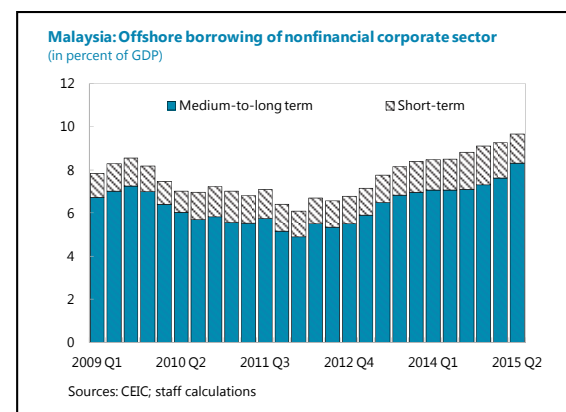
¹ Prepared by Niamh Sheridan (APD).



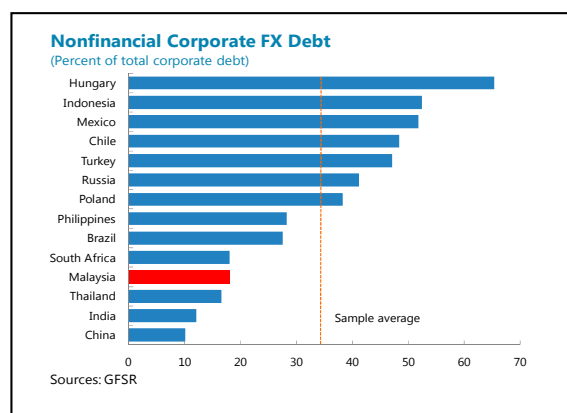
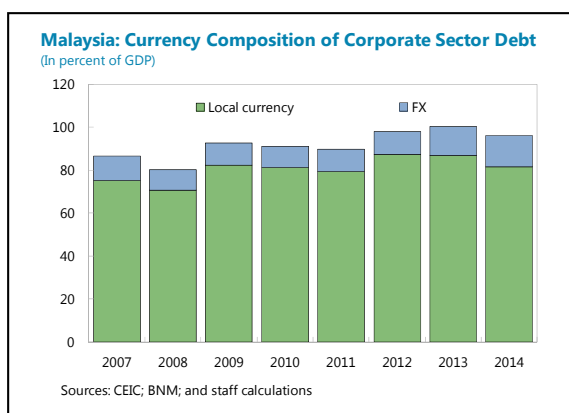
4. External debt. Offshore borrowing of the non-financial sector amounts to just over 10 percent of GDP and is predominately medium-to-long term. External borrowings are mainly in the oil and gas, power, telecommunications and aviation sectors.

5. Assessment of vulnerabilities. In general, high FX exposure, a heavily indebted commodity sector and overreliance on short-term debt have been cited as potential

vulnerabilities for commodity exporting emerging markets. However, Malaysia's corporate sector does not appear to be particularly vulnerable along any of these dimensions.

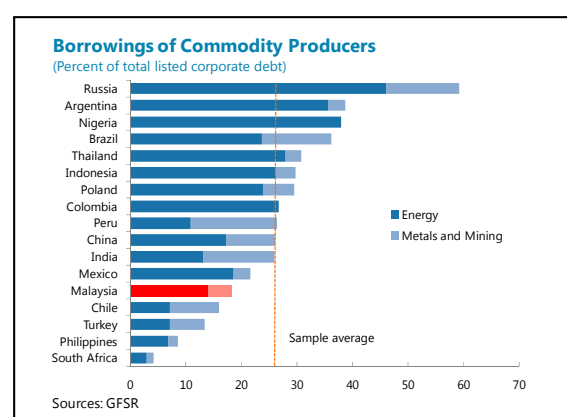


- **Maturity.** Short-term debt is less than 25 percent of total debt. In 2014, The average maturity of outstanding domestic corporate sector debt was 5.6 years. There is limited short-term FX borrowing.
- **Currency.** Non-financial corporate sector debt in Malaysia is predominately in local currency with only about 26 percent of total debt is denominated in foreign currency (domestic and external debt), well below the emerging market average of 35 percent. FX debt is either naturally hedged or is hedged using financial instruments.
- **Exposure to commodity prices.** The energy sector represents about 15 percent of total listed corporate sector debt, well below the average for commodity producers.



B. Stress Tests

6. Stress scenarios. In this section, stress tests are used to analyze the vulnerability of the Malaysian corporate sector to negative shocks to the exchange rate, earnings along with higher interest rates. Three tail risk downside scenarios are considered, summarized in the table below. In each scenario, earnings before interest and taxes are assumed to decline by 20 percent, with exchange rate depreciations of 20, 30, or 40 percent in the extreme case. A smaller depreciation against the euro is assumed to account for asynchronous monetary policy between the U.S. and Europe. Interest rates are assumed to increase by 200, 250, or 300 basis points².



	Depreciation against the US\$ (percent)	Depreciation against the euro (percent)	Decline in EBIT (percent)	Increase in interest rate (basis points)
Scenario 1	20	10	20	200
Scenario 2	30	15	20	250
Scenario 3	40	20	20	300

7. Assumptions. The stress test uses annual firm-level balance sheet information from Orbis data and includes 2,974 firms for Malaysia with total assets of US\$913billion. Orbis provides data on corporate balance sheet and income statement, e.g. asset, liability, revenues, interest expenses, corporate profits and loss accounts, etc. However, FX borrowings and hedging

² This is a large shock relative to the historical experience for Malaysia where the largest changes in the overnight policy rate in consecutive periods are -150 bps and +75 bps. However, corporates could face a large increase in interest rates if higher interest rates are accompanied by increases in either risk or term premiums.

at the firm level is not available through Orbis and therefore the following aggregate level assumptions are made:

- 26 percent of total debt is in foreign currency.
- 10 percent of total revenues are in foreign currency (assumed).
- 20 percent of FX debt hedged with financial instruments (assumed).

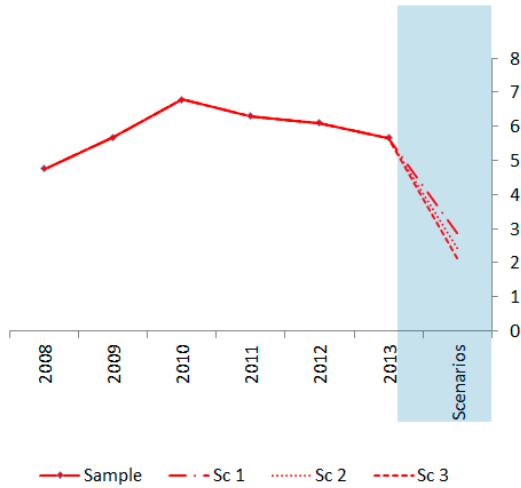
8. Results. The charts on the next page present the results of these stress test scenarios. In all scenarios there is a decline in the interest coverage ratio and the debt-to-earnings ratio declines. Much of the impact is due to the assumed drop in earnings, along with the increase in the interest rate. The differences across the scenarios are not large, illustrating the limited vulnerability to exchange rate shocks. Debt-at-risk, that is with an interest coverage ratio below 1.5, increases from 20 percent of total debt, affecting 26 percent of firms, to 50 percent of total debt and 42 percent of firms in the most severe scenario.

9. Conclusions. Although high at 96 percent of GDP, non-financial corporate sector debt in Malaysia does not appear to represent a significant vulnerability. Debt is mostly long term, in local currency, and is reasonably well-diversified. Stress testing indicates that Malaysian corporates are resilient to declines in income and exchange rates, and increases in interest rates.

Figure XII.1. Malaysia: Stress Scenarios

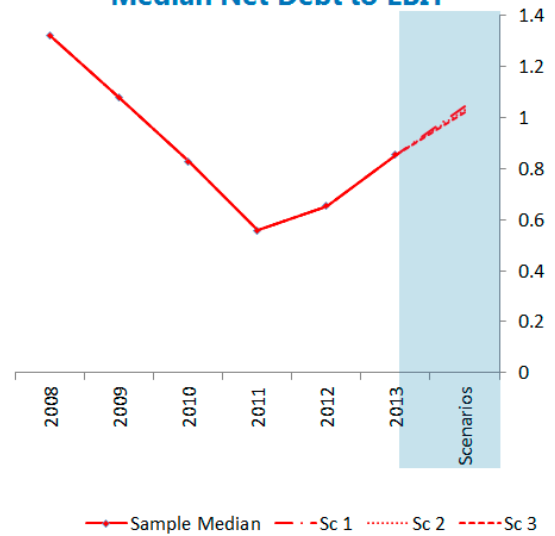
Impact on Debt-Serviceability

Median Interest Coverage Ratio



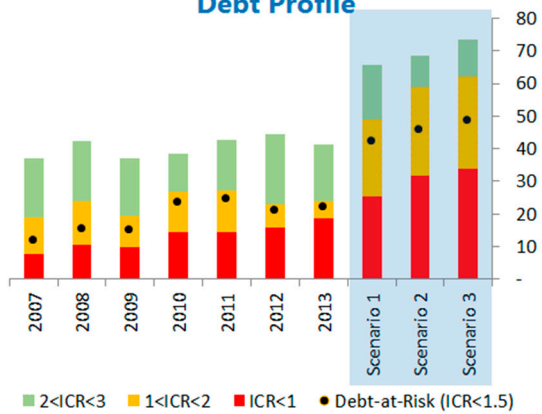
Impact on Leverage

Median Net Debt to EBIT



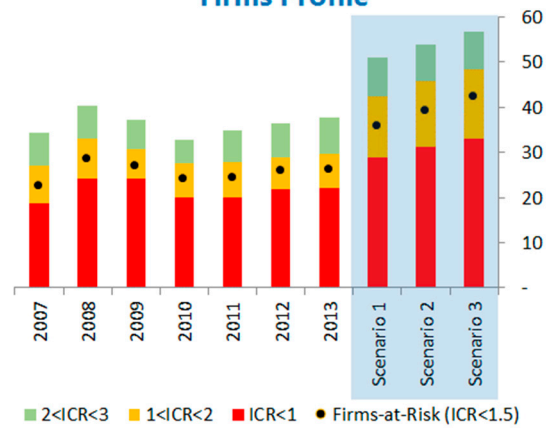
Impact on Debt at Risk (percent of total debt)

Debt Profile



Impact on Firms at Risk (percent of total firms)

Firms Profile



Source: Orbis; and IMF staff estimates.

Appendix XIII. Malaysia—External Sector Assessment, 2015

A. External Sector Developments

Current account (CA). Malaysia's CA surplus has declined by 8 percentage points since 2011 to 2.9 percent of GDP in 2015, following emergence of a deficit in the nonoil-and-gas trade balance on the back of a rise in investment, which bodes well for medium-term growth, and a decline in gross national saving during this period.

Malaysia's exports are diversified, but the decline in the CA surplus in 2015 by 1.4 percentage points of GDP was driven by the negative price impact from the lower mineral fuel prices: the trade surplus on account of crude oil and liquefied petroleum gas was lower by 1.2 percentage points of GDP, with the adverse impact from lower prices (about 2.5 percentage points of GDP, estimated at constant 2014 volumes) partly offset by higher exports volume. Depreciation of the ringgit in 2015 also boosted manufacturing exports volume, but prices in U.S. dollars declined.

The CA surplus is projected to decline to 2.3 percent of GDP in 2016 primarily reflecting a further weakening in the oil-and-gas trade balance, while the nonoil-and-gas balance is expected to improve on the back of a softening in domestic demand.

Real exchange rate. The average real effective exchange rate (REER) depreciated by 8 percent (y/y) in 2015 and the nominal effective exchange rate (NEER) by 9 percent (y/y).¹ The depreciation in the REER helped boost export volumes, but the negative price effect resulted in a drop in exports in U.S. dollar terms. Between December 2015 and February 2016 both the REER and the NEER appreciated slightly.

Capital and financial accounts. Malaysia has typically recorded net capital outflows. Although net foreign direct investment (FDI) flows are generally small, gross FDI flows are large, reflecting the growing importance of Malaysia as a direct investor abroad. However, the pace of FDI investment abroad has slowed down in the last few years. In 2015, FDI abroad was about 3.25 percent of GDP (down from 6.1 percent of GDP in 2011), nearly matching the FDI inflows. Net total outflows under the financial account were 4.6 percent of GDP in 2015, lower than that in 2014, amidst global uncertainty and domestic political concerns. Over the medium term, Malaysia is expected to receive net inflows, supported in part by further slowdown in outbound FDI.

Foreign reserves and international investment position. In 2015 Malaysia's exchange rate exhibited substantial variability against the US\$ and Bank Negara Malaysia (BNM) intervened to avoid ringgit overshooting and maintain orderly market conditions. Reserves accumulated during the capital inflow surges over 2010–13 were deployed to smooth out the impact of capital outflows on the ringgit, leading to a decline in the official reserves by nearly US\$37 billion (about

¹ Since 2000, movements in the REER have been driven almost entirely by the nominal exchange rate rather than inflation differentials.

28 percent) between August 2014 and December 2015.² As of February 2016, FX reserves were slightly up from their December 2015 level.

The international investment position (NIIP) recorded a net asset position of about 8.5 percent of GDP (in U.S. dollar terms) as of end-2015, improving for two consecutive years from a net liability position of about 4.5 percent of GDP in 2013 owing to capital outflows and valuation effects.³ Assets were at about 131 percent of GDP, of which two fifths were in the form of direct investments abroad and another one quarter in official reserve assets. Portfolio investments accounted for about two fifths of the gross liabilities (122½ percent of GDP) and about 60 percent of those investments were in debt instruments (including both ringgit- and foreign currency-denominated liabilities). Total external debt rose to 65.6 percent of GDP in 2015 (in U.S. dollar terms; 2014: 63.1 percent of GDP), of which 64 percent were in foreign currency. Short-term debt accounted for 42 percent of the total external debt, a decline from 2011–14 average of 48.3 percent, as nonresident holdings of BNM bills and notes declined since late 2014.

B. Standard Benchmarks

Current account. The External Balance Assessment (EBA) CA regression approach estimates that the cyclically-adjusted CA is stronger (by about 4 percent of GDP) than consistent with fundamentals and desirable policies (Table XIII.1). The estimated policy gap is about zero, similar to that in 2014, implying that nearly the entire gap was accounted for by a regression residual requiring interpretation. The relative contributions of various policy measures to the total policy gap remained broadly unchanged from 2014, while the change in the regression residual reflected a fall in the actual CA surplus, partly offset by cyclical factors arising from lower oil prices. However, in the EBA CA regression, Malaysia's CA is consistently underestimated across time, reflecting country-specific structural factors that are not well captured: for example, insufficient social safety nets (not fully captured by public health spending variable used in the regression) and structurally low investment since the Asian financial crisis, both of which push up the CA balance. Private investment has increased since 2011, but still remains relatively low at about 17 percent of GDP. It is difficult to separate the above factors into slow-moving structural ones (that are given in the short run and add to the gap) and controllable policy variables that explain the gap. Taking these factors and the uncertainty surrounding the updated model

² During the global financial crisis foreign reserves fell by about 28 percent between August 2008 and March 2009, but then registered a strong increase in early 2011; a decline was again recorded in August–September 2011. Gradual increases continued until mid-2013, when reserves declined. Between August 2014 and December 2015 reserves fell by nearly 28 percent.

³ The ratios to GDP are based on staff estimates at U.S. dollar values and may vary from the authorities' data mainly due to different exchange rate assumptions for converting nominal GDP in U.S. dollar terms. Ringgit-denominated debt held by nonresidents, including Malaysian government securities and BNM bills and notes, increased rapidly in the aftermath of the global financial crisis, but since August 2014 has declined as foreign investors largely reduced their exposures to BNM bills and notes. Short-term foreign-currency denominated external debt has risen in the last few years, largely due to banking sector activity, matched by an increase in short-term external assets.

estimates into account, staff assesses the norm to be 1.8 percent of GDP and the CA gap to be 2.8 percent of GDP (plus or minus 1 percent of GDP) in 2015.

Real exchange rate. The EBA REER index regression estimates Malaysia's REER to be 30.5 percent below levels warranted by fundamentals and desirable policies, though most of the gap is an unexplained residual. The analysis of the level REER provides an estimate of 24 percent undervaluation. Based on staff's assessment of the CA gap and the semi-elasticity of the current account with respect to the REER, the REER gap for 2015 is estimated to be 9.7 percent (plus or minus 5 percent)⁴.

Table XIII.1. Malaysia: Quantitative External Sector Assessment

	Norm 1/	Actual 1/	Gap
Current account			(In percent of GDP)
EBA 2.0 current account	0.5	4.6	4.1
<i>Of which:</i> Contribution of identified policy gaps 2/			-0.1
Unexplained residual			4.2
External sustainability approach 3/			1.9
Staff assessment	1.8	4.6	2.8
<i>Of which:</i> Contribution of identified policy gaps (based on EBA 2.0)			-0.1
Other			2.9
Exchange rate misalignment			(Percentage)
EBA Index real exchange rate regression approach 4/	...	...	-30.5
<i>Of which:</i> Contribution of identified policy gaps 2/	...	...	1.0
Unexplained residual	...	...	-31.5
EBA Level real exchange rate regression approach 4/	...	...	-24.0
<i>Of which:</i> Contribution of identified policy gaps 2/	...	...	1.4
Unexplained residual	...	...	-25.4
Staff estimate using elasticity approach 5/	...	...	-9.7
1/ Staff's estimate of the multilaterally consistent cyclically-adjusted norm and actual for 2015, based on EBA February 2016.			
2/ Policy gaps refer to policy distortions that can arise from domestic policies and/or as a result of the policies of other countries. See 2015 Pilot External Sector Report.			
3/ From EBA January 2016. Based on 2013 NFA/GDP ratio of -5.0 percent of GDP and an adjusted medium-term CAB of 2.0 percent.			
4/ Misalignment based on EBA January 2016.			
5/ The semielasticity of the current account balance with respect to the REER is $\eta_{CA} = -0.29$, computed according to $\eta_{CA} = \eta_{Xnc} s_{Xnc} - (\eta_M - 1) s_M - s_{Xc}$, where η_{Xnc} is the elasticity of the volume of non-commodity exports with respect to the REER, η_M is the elasticity of the volume of imports with respect to the REER, estimated at $\eta_{Xnc} = -0.82$, $\eta_M = 0.26$, $s_{Xnc} = 58.2$ percent is the share of non-commodity exports in GDP, $s_{Xc} = 16.8$ percent is the share of commodity exports in GDP, and $s_M = 61$ percent is the share of imports in GDP.			

⁴ The semi-elasticity is estimated at 0.29 and takes into account Malaysia's trade openness and commodity exports.

Foreign reserves. As of end-2015 official reserves stood at 80 percent (2013: 98 percent) of the IMF's composite reserve adequacy metric (RAM), and covered 75 percent and 24 percent of short-term external debt by remaining maturity (staff estimate) and broad money, respectively.⁵ The RAM is below the suggested adequacy range of 100-150 percent. The decline in the RAM reflects BNM's significant interventions in response to capital outflows in 2014-15. To raise reserves to a level adequate for precautionary saving, the authorities should gradually accumulate more reserves so that the RAM is closer to 100 percent.

Overall assessment. The external position in 2015 was stronger than that which is consistent with fundamentals and desirable policy settings, albeit less so than in 2014. An adverse terms-of-trade effect contributed to this softening of the external position. The depreciation of the currency boosted export volumes in 2015, partially offsetting the negative terms-of-trade shock.

C. Potential Policy Response

Over the past few years Malaysia's growth model has shifted more to domestic demand and both the current account surplus and the current account gap have narrowed. Looking ahead, over the medium term, increased public sector saving, as the Federal government consolidates its budget, will be offset by sustained private consumption and investment and is expected to result in a current account surplus in the range of 1.5-2 percent of GDP, further narrowing the gap with the norm. Staff views policy gaps as reflecting high precautionary saving and further need for investment facilitation (notwithstanding recent increases in the investment ratio). It would be useful to continue to improve social protection and social insurance institutions, including the introduction of an unemployment insurance system, ; increase private investment, including in physical infrastructure; and address labor-force skill mismatches and rigidities in the labor market. Consistent with the authorities' intentions, stronger social safety nets and efforts to further boost private investment would help to further moderate the current account surplus.

⁵ For details on the RAM please see IMF, 2015, Assessing Reserve Adequacy – Specific Proposals.

Appendix XIV. Malaysia—External Debt Sustainability Analysis

1. Malaysia's external debt increased by 2.5 percentage points of GDP in 2015 to about 65.5 percent of GDP.¹ Total offshore borrowing went up by 5 percentage points of GDP, mainly in the medium- and long-term, contributed about equally by public enterprises, including a US\$5 billion (1.7 percent of GDP) bond issuance by PETRONAS in early 2015, and the private sector. Nonresident holdings of local currency debt securities declined by 2.2 percentage points of GDP, driven by capital outflows from the short-term Bank Negara Malaysia bills. As of end-2015, short-term debt, by original maturity, accounted for about 42 percent of total external debt, down from 48.6 percent in 2014. Debt denominated in domestic currency accounted for 36 percent of Malaysia's external debt. As of end-2015, Malaysia's international investment position recorded a net asset position of about 8.5 percent of GDP (in U.S. dollar terms), improving for two consecutive years as capital outflows outpaced the current account surpluses.

	2014	2015
Total external debt (staff estimate) 1/	63.1	65.6
<i>Medium- and long-term</i>	32.4	37.9
Offshore borrowing	17.8	22.5
Public sector	7.9	10.1
Federal government	1.4	1.7
Public enterprises	6.4	8.4
Private sector	10.0	12.4
Nonresident holdings of ringgit-denominated debt securities	13.7	14.5
Government securities	12.7	13.6
Other securities	1.0	0.9
Other	0.9	0.9
<i>Short-term</i>	30.7	27.7
Offshore borrowing	13.5	14.0
Nonresident holdings of ringgit-denominated debt securities	5.1	2.1
Government securities	0.0	0.3
Other securities	5.1	1.9
Nonresident deposits	7.4	6.4
Other	4.6	5.1
<i>Memorandum items:</i>		
Total external debt (authorities)	67.5	72.1
Total external debt (authorities; billions of U.S. dollars)	211.8	192.2
Total external debt (staff estimate; billions of U.S. dollars)	213.3	194.2

Sources: Data provided by the authorities; 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.

2. The external Debt Sustainability Analysis (DSA) incorporates a few important revisions in the medium-term macroeconomic projections since the 2014 Article IV. Both exports and imports are now expected to grow at a slower average pace over the medium term, reflecting revisions in near-term growth owing to ongoing global developments. Moreover, the current account (CA) balance is projected to be weaker, though still in surplus. The CA balance will likely remain in a surplus even under a stress scenario where oil prices are significantly lower over the medium term than in the baseline (Appendix II). On the other hand, net non-debt-creating inflows are going to contribute more to the balance of payments as Malaysia's outbound foreign direct

	2014 Article IV	2015 Article IV
Real GDP growth (in percent)	4.9	4.8
GDP deflator in U.S. dollars (change in percent)	4.2	5.1
Nominal external interest rate (in percent)	5.3	2.9
Growth of exports (U.S. dollar terms, in percent)	5.5	4.2
Growth of imports (U.S. dollar terms, in percent)	5.8	4.1
Current account balance, excluding interest payments (in percent of GDP)	5.5	3.4
Net nondebt creating capital inflows (in percent of GDP)	-1.6	0.1

Source: IMF staff estimates.
1/ Covers the five-year periods of 2015-19 for 2014 Article IV and 2016-20 for 2015 Article IV.

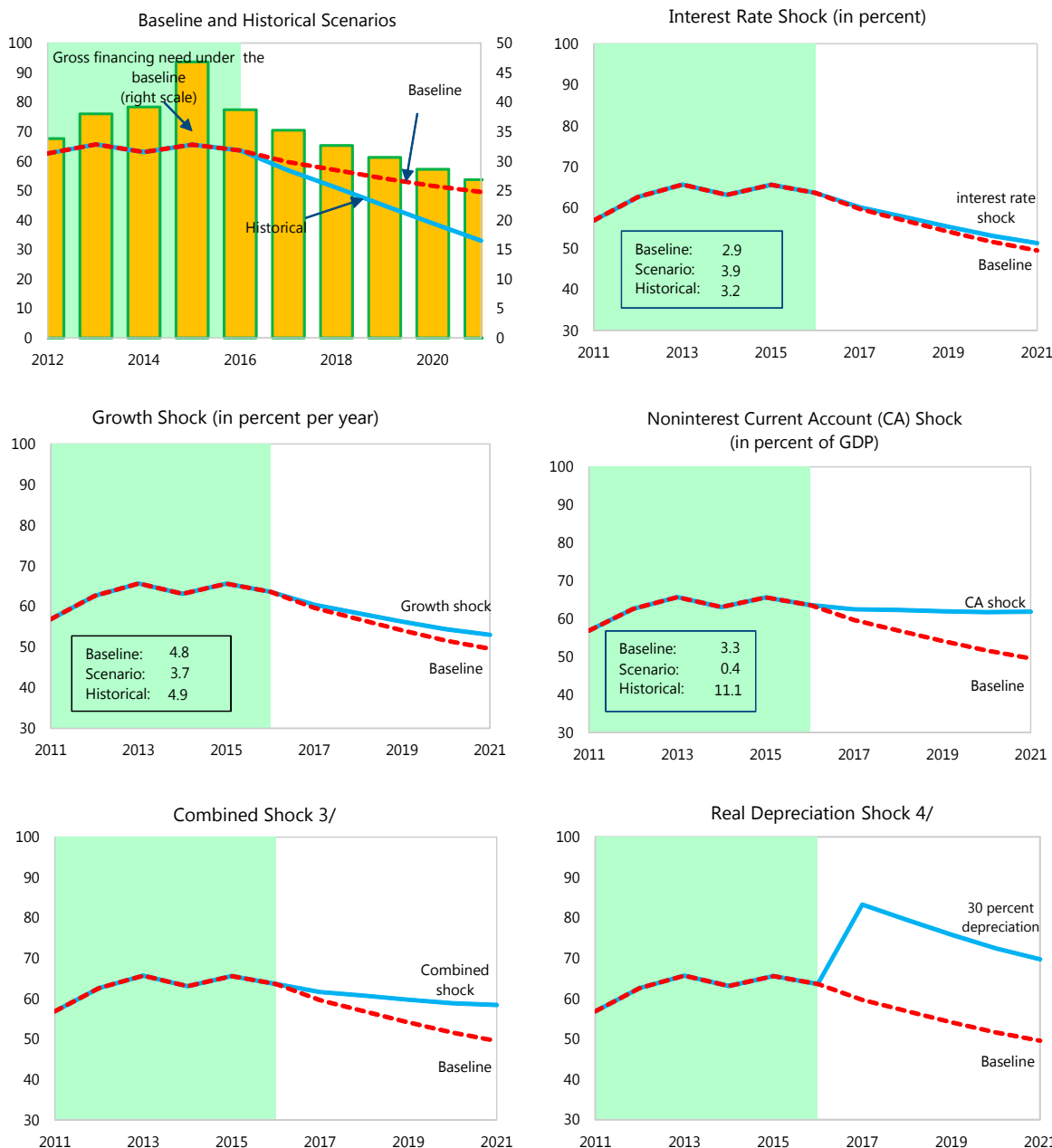
¹ Staff estimate of external debt-to-GDP ratio is based on U.S. dollar values. It differs from the ratio published by the authorities, based on ringgit value, mainly on account of exchange rate assumption for calculating GDP in U.S. dollar terms.

investment is expected to slow down. Finally, external debt service payments are updated in line with the new definition of external debt and revised assumptions on the global interest rates.

3. Over the medium term, Malaysia's external debt-to-GDP ratio is expected to remain on a steady downward path, falling to 49.5 percent by 2021. Under staff's baseline, this decline mostly reflects sustained current account surplus, averaging at about 1.8 percent of GDP. Share of short-term debt, by original maturity, is expected to gradually decline to about one-third of total external debt by the end of the medium term.

4. Standard stress tests under the external DSA indicate that external debt would remain manageable under a variety of shocks, including weaker GDP growth, a lower current account balance, and a one-time 30 percent depreciation of the ringgit. 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 exchange rate depreciation scenario, the debt ratio would rise sharply to 84 percent of GDP on impact, but would subsequently fall to about 70 percent of GDP by 2021. If the current account (CA) balance (excluding interest payments) is permanently lower or the economy is impacted by a combined interest rate, growth, and the CA shock, the external debt-to-GDP ratio will remain close to 60 percent over the medium term.

Figure XIV.1. Malaysia: External Debt Sustainability: Bound Tests 1/ 2/
(In percent of GDP)



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

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

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

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

4/ One-time real depreciation of 30 percent occurs in 2017.

Table XIV.2. Malaysia: External Debt Sustainability Framework, 2012–21
(In percent of GDP, unless otherwise indicated)

	Actual				Projections							Debt-stabilizing non-interest current account 1/
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021		
Baseline: external debt 2/	62.6	65.7	63.1	65.6	63.6	59.7	56.9	54.1	51.6	49.6	-2.6	
Change in external debt	5.8	3.0	-2.6	2.5	-2.0	-4.0	-2.8	-2.7	-2.5	-2.0		
Identified external debt-creating flows (4+8+9)	-4.6	-4.7	-6.4	2.1	-6.3	-4.8	-4.4	-4.0	-3.6	-3.3		
Current account deficit, excluding interest payments	-6.3	-4.6	-5.4	-4.4	-3.8	-3.4	-3.5	-3.3	-2.9	-3.1		
Deficit in balance of goods and services	-10.8	-8.5	-9.2	-7.6	-7.1	-6.6	-6.4	-6.2	-5.9	-5.8		
Exports	79.3	75.6	73.8	71.0	65.0	61.7	59.4	56.8	53.7	51.1		
Imports	68.5	67.1	64.6	63.4	57.9	55.2	52.9	50.6	47.8	45.3		
Net nondebt creating capital inflows (negative)	3.7	1.0	1.5	-0.2	-0.5	-0.2	-0.1	0.1	0.3	0.5		
Automatic debt dynamics 3/	-2.0	-1.1	-2.5	6.8	-2.0	-1.2	-0.9	-0.8	-1.0	-0.8		
Contribution from nominal interest rate	1.1	1.1	1.1	1.4	1.5	1.5	1.7	1.7	1.4	1.5		
Contribution from real GDP growth	-2.9	-2.9	-3.8	-3.6	-2.8	-2.7	-2.6	-2.5	-2.4	-2.3		
Contribution from price and exchange rate changes 4/	-0.2	0.7	0.1	8.9	-0.7	...	...	...	...	...
Residual, including change in gross foreign assets (2–3) 5/	10.4	7.7	3.8	0.3	4.4	0.9	1.7	1.2	1.1	1.3		
External debt-to-exports ratio (in percent)	79.0	86.8	85.4	92.3	97.9	96.6	95.8	95.3	96.0	97.1		
Gross external financing need (in billions of U.S. dollars) 6/	106.3	122.9	132.5	138.7	119.7	121.5	125.2	130.9	136.8	142.7		
In percent of GDP	33.8	38.0	39.2	46.8	38.7	35.2	32.6	30.6	28.6	26.9		
Scenario with key variables at their historical averages 7/						56.8	51.0	44.8	38.8	33.0	1.1	
Key macroeconomic assumptions underlying baseline					10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (in percent)	5.5	4.7	6.0	5.0	4.9	2.4	4.4	4.8	4.8	4.9	5.0	
GDP deflator in U.S. dollars (change in percent)	0.1	-1.8	-1.3	-16.5	2.7	10.6	0.0	6.4	6.2	6.3	6.4	
Nominal external interest rate (in percent)	2.1	1.8	1.8	2.0	3.2	1.6	2.4	2.7	3.2	3.3	2.9	
Growth of exports (U.S. dollar terms, in percent)	-1.8	-2.0	2.1	-15.8	3.5	13.3	-4.5	6.0	7.0	6.5	5.8	
Growth of imports (U.S. dollar terms, in percent)	3.8	0.6	0.7	-14.1	4.5	13.6	-4.6	6.3	6.8	6.5	5.6	
Current account balance, excluding interest payments	6.3	4.6	5.4	4.4	11.1	5.6	3.8	3.4	3.5	3.3	2.9	
Net nondebt creating capital inflows	-3.7	-1.0	-1.5	0.2	-2.2	2.5	0.5	0.2	0.1	-0.1	-0.3	

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 $[r - g - \rho(1+g) + \epsilon\alpha(1+r)] / (1+g+\rho+g\rho)$ 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 $[-\rho(1+g) + \epsilon\alpha(1+r)] / (1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\epsilon > 0$) 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.



MALAYSIA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

March 30, 2016

Prepared By

Asia and Pacific Department

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FUND RELATIONS

(As of February 29, 2016)

General Resources Account

	SDR Millions	Percent of Quota
Quota	3,633.80	100.00
Fund holdings of currency (exchange rate)	3110.65	85.60
Reserve tranche position	523.15	14.40
Lending to the Fund		
New Arrangement to Borrow	33.02	

SDR Department

	SDR Millions	Percent of Allocation
Net cumulative allocation	1,346.14	100.00
Holdings	821.90	61.06

Exchange Arrangement:

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

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

Capital control measures imposed in early 1994 and in 1998 in the wake of the Asian crisis have mostly been lifted, except for the internationalization of the ringgit. In particular, since May 2001, nonresident portfolio investors are freely allowed to repatriate their principal sums and profits out of the country at any time. Malaysia further liberalized exchange control regulations during 2002–13. The main measures were a relaxation of regulations on investment abroad by domestic institutions, an easing of regulations on ringgit borrowing obtained by nonresidents from residents for use in Malaysia, ringgit and foreign currency borrowing obtained by residents from non-residents, abolition of overnight limits on all foreign currency accounts maintained by residents and of the net open position limit imposed on licensed onshore banks, allowing residents to open and maintain foreign currency accounts for any purpose, abolition of several reporting requirements, and a relaxation of the conditions on residents and nonresidents to enter into foreign exchange forward contracts to hedge current and capital account transactions with licensed onshore banks.

The Malaysian authorities view remaining exchange control regulations as prudential in nature and necessary to ensure the availability of adequate information on the settlement of payments and

receipts as part of the monitoring mechanism on capital flows. These controls do not contravene Malaysia's obligations under Article VIII.

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

Article IV Consultation:

Malaysia is on the standard 12-month consultation cycle. Discussions for the 2014 Article IV consultation took place during November 13–24, 2014 (IMF Country Report No. 15/18). Staff discussions for the 2016 Article IV consultation were conducted on a mission to Kuala Lumpur during January 11–22, 2016. In addition, a staff visit took place during July 25–31, 2015.

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 fiscal ROSC mission was fielded in May–June 2011. A mission on fiscal risks took place in January 2013. A mission to assist with implementation of the Goods and Services Tax was conducted in March 2014. Several missions on Public Financial Management were fielded in 2014.

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. Technical Assistance

Monetary and Capital Markets Department (MCM): Mission in October 2009 on macrofinancial risk analysis and vulnerability analysis for corporate and financial institutions. Workshop in May 2010 on monitoring financial risks. 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 FAFT will continue to monitor the country's progress through its enhanced follow-up process.

Resident Representative/Advisor: None.

STATISTICAL ISSUES

(As of March 2016)

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

Malaysia: Table of Common Indicators Required for Surveillance
(As of March 23, 2016)

	Date of Latest Observation	Date Received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of Publication ⁶
Exchange rates	3/22/2016	3/22/2016	D	D	D
International reserve assets and reserve liabilities of the monetary authorities ¹	2/29/2016	3/7/2016	Bi W	Bi W	Bi W
Reserve/base money	2/29/2016	3/7/2016	Bi W	Bi W	Bi W
Broad money	2/2016	3/7/2016	M	M	M
Central bank balance sheet	2/29/2016	3/7/2016	Bi W	Bi W	Bi W
Consolidated balance sheet of the banking system	2/2016	3/7/2016	M	M	M
Interest rates ²	3/22/2016	3/22/2016	D	D	D
Consumer price index	1/2016	2/2016	M	M	M
Revenue, expenditure, balance and composition of financing ³ —general government ⁴	2015	2/2016	A	A	A
Revenue, expenditure, balance and composition of financing ³ —federal government	2015:Q4	2/2016	Q	Q	Q
Stocks of central government and central government guaranteed debt ⁵	2015:Q4	2/2016	Q	Q	Q
External current account balance	2015:Q4	2/2016	Q	Q	Q
Exports and imports of goods and services	1/2016	3/2016	M	M	M
GDP/GNP	2015:Q4	2/2016	Q	Q	Q
Gross external debt	2015:Q4	2/2016	Q	Q	Q
International Investment Position	2015:Q4	2/2016	Q	Q	Q

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

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

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

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

⁵Including currency and maturity composition.

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

**Statement by Marzunisham Omar, Executive Director for Malaysia and
Nooraihan Mohd Radzuan, Advisor to the Executive Director
April 22, 2016**

Amidst a challenging external environment, the Malaysian economy remains resilient, registering a strong growth of 5% in 2015. Strong fundamentals, ample buffers, a robust financial system and timely policy responses have enabled the Malaysian economy to weather multiple external shocks. In an environment of heightened uncertainty and downside risks in the global economy, the Malaysian economy will continue to benefit from having diversified sources of growth, economic flexibility, low unemployment, a strong external position, large buffers, a strong financial system and robust policy frameworks that have been built over the years. The authorities remain vigilant and focused on strengthening future resilience and accelerating Malaysia's transition into a higher value-added and high-income economy. Beyond the short term, measures include structural reforms to raise productivity and labor participation, strengthening institutions and physical infrastructure, and further advancing regional and global integration. Focus will continue to be accorded towards ensuring sustainable and inclusive growth, which includes uplifting the lower income groups and promoting balanced development.

1. 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 appreciate the frank and open discussions with the mission team. Our authorities broadly concur with the major policy recommendations put forth in the report. We are further encouraged by the assessment that the current policy stance is appropriately calibrated to the outlook and risks facing the economy and that Malaysia is resilient to capital outflows.

Economic Developments and Outlook

2. Despite the more challenging global environment, the Malaysian economy registered a strong growth of 5% in 2015 (2014: 6%), driven by private consumption and investment. Inflation remained low (2.1%) as lower global energy and commodity prices more than offset the effects from the weaker ringgit exchange rate, the implementation of the Goods and Services Tax (GST) and several upward adjustments in administered prices. Unemployment was low at 3.1% of the labor force and the current account balance remained in surplus (2.9% of GDP). After depreciating by 18.6% in 2015, the Malaysian ringgit has appreciated by around 9.5% against the US dollar, while the Kuala Lumpur Composite Index has increased by 1.5% amid resumption of capital inflows in 2016.

3. The strong growth performance amid multiple external shocks – sharp decline in oil prices, sizable shifts in capital flows and slowdown in external demand – is underpinned by the highly diversified structure of the Malaysian economy and sound financial system. While the commodity sector plays an important role, enabling Malaysia to benefit from the commodity super cycle, the commodities sector accounts for 18% of GDP and 19.2% of exports. This is a relatively small share compared to the services and manufacturing sectors (54% and 23% share

of GDP, respectively). Furthermore, about 80% of Malaysia's exports are manufactured goods, where electrical and electronics make up 36% of total exports. There is also significant diversity in terms of export markets, with the US, the European Union and Japan accounting for 29% of exports while China accounts for 13% of exports. Additionally, growth has become more balanced, anchored by sustained private sector-led domestic demand (69% share of GDP). The well-developed financial system, together with the high level of reserves, more flexible exchange rate and manageable level of external debt, have strengthened the capacity of the economy to cope with external shocks.

4. The Malaysian economy is expected to expand within the range of 4.0-4.5% in 2016, in line with staff estimates. Growth will be driven mainly by domestic demand, particularly from the private sector, with some support from external demand. While private consumption has moderated as households adjust to the higher cost of living, household spending is being supported by continued growth in income and employment. Investment activity is projected to remain broad-based, as capital spending by both the private and public sectors is expected to cushion the lower investments in the oil and gas sector. On the external front, manufactured and services exports are expected to improve, benefiting from the gradual improvement in US and euro area growth, and continued growth in the regional economies. Authorities view that the impact of China's gradual economic rebalancing on Malaysia's growth (which staff's sensitivity analysis implies could reduce Malaysia's growth by 0.12 percentage points in 2016) as manageable. As illustrated in staff's scenario analysis, Malaysia's overall current account balance is expected to remain in surplus, albeit by a smaller amount, even under an extreme oil price shock scenario. Headline inflation is expected to be moderately higher in the range of 2.5-3.5% in 2016, given the recent adjustments in administrative prices and the weaker ringgit exchange rate.

5. The authorities concur with staff that there are a number of downside risks and uncertainties to the economic outlook. Nevertheless, the authorities also see potential for upside risks. While China's rebalancing poses some uncertainties in the near term, the shifting patterns of consumption and trade that the transition is expected to entail will present significant opportunities for the Malaysian economy over the medium term, with the healthcare, education and tourism sectors likely to benefit. The ongoing recovery in advanced economies and continued healthy growth in most regional economies also pose upside risks.

Adjusting to Multiple External Shocks

6. Despite the multiple external shocks since late 2014, the current account continues to be in surplus, domestic financial markets remain orderly with no interruption to financial intermediation, and fiscal consolidation remains on-track. As a small open economy, with a financial system that is integrated with the international financial system, Malaysia will remain exposed to developments in the global financial markets and to volatile capital flows.

7. The combination of exchange rate flexibility and judicious use of international reserves have played an effective role in facilitating the economy's adjustment to the terms of trade shock and capital outflows. The ringgit depreciated by 27.7% against the US dollar between July 2014 and mid-January 2016, while reserves declined by USD36.7 billion during the same period. The authorities maintain the view that reserves, which were built during the period of inflows, are to be used during periods of heightened outflows in order to smooth excessive exchange rate volatility. Despite the volatility in capital flows, the deep financial market and sound financial system have ensured that financial intermediation remained uninterrupted and supported economic activity. The diversified structure of the Malaysian economy has also mitigated the spillovers from external developments.

8. On the issue of foreign exchange reserves adequacy, the authorities caution against a rigid interpretation of any metric, but rather, emphasize that an assessment of the adequacy of reserves should be undertaken with a broader assessment of Malaysia's economic and financial developments. Malaysia's reserves of USD97 billion are adequate to facilitate international transactions without disruptions and are sufficient to finance 8 months of retained imports and are 1.1 times the short-term external debt, higher than the international prudential benchmarks of 3 months and 1 time, respectively. Furthermore, the progressive liberalization of foreign exchange administration rules has resulted in a greater decentralization of reserves, as reflected in the increasing acquisition of assets abroad by resident banks and corporates. In particular, banks and corporates accounted for 75% of Malaysia's total external assets as at end-2015. This means that the Central Bank's reserves are only a quarter of the actual total reserves of the country. The availability of these external assets enables these entities to meet their external debt obligations without creating a claim on the Central Bank's reserves.

9. The authorities welcome staff's findings that even under a severe stress capital outflow scenario (including under more severe assumptions than the Global Financial Crisis), Malaysia's external sector and domestic financial sector are expected to remain resilient. Moving forward, continued exchange rate flexibility, a healthy level of reserves, and the availability of a wide range of monetary instruments will continue to accord authorities with the policy flexibility to manage external shocks. Authorities will remain focused on maintaining orderly financial market conditions and to undertake appropriate foreign exchange policy as necessary, including building up foreign exchange reserves buffers, which is consistent with the staff's recommendations.

Monetary Policy

10. Consistent with price stability, monetary policy stance remains accommodative and supportive of economic activity. The current level of the Overnight Policy Rate (OPR) is assessed to be appropriate given the balance of risks to the outlook for domestic inflation and growth, taking into consideration the greater downside risks emanating from the external environment and the higher headline inflation rate. The Monetary Policy Committee (MPC) of Bank Negara Malaysia (BNM) is closely monitoring the heightened external risks and assessing their implications on macroeconomic stability and the prospects for the Malaysian economy. In

addition, given the expectation of continued volatility in capital flows, BNM's monetary operations will be directed towards ensuring that liquidity will continue to be sufficient to support the orderly functioning of the domestic financial markets.

Fiscal Policy

11. The authorities have remained steadfast in their commitment towards fiscal consolidation and have consistently achieved its fiscal deficit reduction targets. Alongside cuts in recurrent spending, fiscal consolidation has been led by increased revenue generation from more diverse sources as well as enhanced tax efficiency and compliance – a strategy which will further ensure fiscal sustainability. These include the implementation of the GST, removal of fuel subsidies and enhancing efficiency of public service delivery. As a result of these measures, the share of operating expenditure as a percentage of GDP is expected to decline to about 17% in 2016 from 18.8% in 2015 while the share of oil related revenue to total Federal Government revenue has fallen from around 30% in 2014 to 21.5% in 2015 and is expected to decline further to 13-14% in 2016. Protecting the most vulnerable segments of the population is a vital element in the authorities' fiscal consolidation efforts. In this regard, in addition to increasing the quality of key public services and making cash transfers to low income households, the authorities continue to view the list of exempt and zero-rated items as important in the current environment to mitigate the impact of the GST on vulnerable groups.

12. The 2016 Budget, tabled in October 2015, was subsequently recalibrated in January 2016 to reflect expectations of lower oil prices (January 2016 assumption: USD 30-35 per barrel; October 2015: USD 48 per barrel). The pre-emptive recalibration entailed both compositional adjustments in Government spending and measures to broaden revenue sources (e.g. bidding of telecommunication spectrum and streamlining of the foreign worker levy system). As a result of these measures, the fiscal deficit is expected to continue to decline from 3.2% of GDP in 2015 to 3.1% of GDP in 2016, the seventh consecutive year of a decrease in the fiscal deficit to GDP ratio. The course of fiscal consolidation remains intact and will be underpinned by further reforms to broaden the Government's revenue base, rationalize subsidies and better optimize supplies and services expenditure. These measures will also help to contain the Federal Government debt-to-GDP ratio within 55%.

13. The authorities concur with staff that the risk of contingent liabilities materializing is low. Growth in contingent liabilities has been on a declining trend, with guarantees extended primarily for productive and strategic investments. These include guarantees to the National Higher Education Fund Corporation (19.8% share of total Government guarantees) and guarantees to DanaInfra and Prasarana (11.6% and 9.9% share, respectively) which fund Malaysia's public transport infrastructure projects. The other portion of guarantees is for Government-linked companies or statutory bodies with sound financial performance, minimizing the probability of contingency risks materializing. While Federal Government debt to GDP has risen since the GFC, refinancing and currency depreciation risks are mitigated by the favorable debt composition. About 70% of debt are expected to mature in more than 3

years while a large share of debt is denominated in domestic currency (97% share of outstanding debt).

14. Going forward, the conduct of fiscal policy will continue to be centered on ensuring sound public finances while remaining supportive of policies for sustainable and balanced economic growth. In particular, measures to improve the quality and efficiency of public service delivery will be complemented by socio-economic support to vulnerable households. The recently introduced Medium-Term Fiscal Framework will be an important anchor in supporting authorities' efforts to meet budgetary targets, improve expenditure prioritization, and foster improved government performance. This is also in line with the 11th Malaysia Plan, which aims to invigorate high value-added investments, intensify human capital development and enhance public sector delivery in a constrained fiscal space. Authorities welcome staff's in-depth analysis of Malaysia's structural fiscal reforms and have found the Fund's technical assistance to be highly practical. In this regard, the authorities look forward to further in-depth discussions on the recommendations put forth.

Financial Sector

15. Domestic financial stability continued to be preserved in 2015, supported by sound financial institutions and orderly financial market conditions. Stress tests undertaken by the authorities and staff have demonstrated the resilience of the banking system to major economic and financial market shocks. Of significance, as in previous episodes of heightened volatility and large capital flows, deep domestic financial markets (Malaysia's bond market is the third largest in Asia) and the presence of well-diversified domestic institutional investors continued to support orderly financial market conditions and sustained financial intermediation. Businesses, including small and medium enterprises, continue to have access to financing. While funding conditions were occasionally tighter amid the large volume of portfolio outflows, banking system liquidity has remained ample. BNM's monetary operations and the use of several policy instruments also ensured the availability of sufficient liquidity to support the orderly functioning of the money and foreign exchange markets.

16. Risks to domestic financial stability arising from household indebtedness and the property market continued to moderate, supported by strong overall household financial capacity as well as continued improvement in the quality of new household debt. Growth in household debt has moderated since its peak in 2010 to 7.3% as at end-2015, underpinned by the moderation in personal financing. About half of new loans approved were to borrowers with an aggregate debt service ratio not exceeding 40%, with the average debt service ratio for all new household borrowings remaining below 60%. At the aggregate level, household financial assets remained healthy at above 2 times household debt. The likelihood of a material impact on the stability of the financial system arising from exposures to the household sector remains low, given the strong capitalization and financial strength of financial institutions.

17. In the property market, growth in aggregate house prices appears to have stabilized as house buyers and developers continued to adjust to macroprudential and fiscal measures aimed at curbing excessive speculation and risk-taking. The growth of the Malaysian House Price Index has gradually slowed from 9.6% registered for the period 2010-2014 to around 8% registered over five consecutive quarters since 2Q 2014. Slower housing transactions mainly in the higher-priced segments, combined with continued strong demand for affordable houses, have encouraged a rebalancing of housing supply. Given the prevailing acute demand-supply gap in affordable housing, the risk of a more generalized correction in house prices is assessed to be low. An increase in the supply of affordable housing remains key to bringing about a further easing of upward pressures on house prices.

18. The authorities welcome staff's in-depth assessment of non-financial corporate sector debt and note staff's findings that corporate sector debt does not appear to present a significant vulnerability to the economy. Staff's stress testing, which indicates that Malaysian corporates are resilient to declines in income and exchange rates and increases in interest rates are also in line with authorities' own stress test results. As highlighted by staff, debt is mostly long term, in local currency, and is reasonably well-diversified. Corporate debt at risk, measured as the share of debt borne by firm with an ICR of less than 1.5 times, remains low and stable at 8.9% of total corporate debt. The debt servicing capacity of businesses is also supported by sound liquidity positions, with the median ratio of cash-to-short-term debt at 1.2 times. About three quarters of outstanding corporate debt continued to be funded domestically.

19. Despite the sharp depreciation of the ringgit exchange rate, risks from non-financial corporate external debt remain low. In addition to the mitigating factors outlined in the staff report - favorable maturity profile with limited short-term foreign currency borrowing, low currency risk as corporate sector debt is predominately in local currency and low exposure to the commodity sector - risks are further mitigated by the following factors:

- Trade credits and non-resident holdings of ringgit-denominated bonds, which pose limited currency risk, account for about 22% of total corporate external debt.
- Inter-company obligations account for about 43% of total corporate external debt, reducing funding and liquidity risks.

The authorities remain vigilant and continue to monitor developments in the household, property and business sectors closely. In this regard, they look forward to staff's further work on balance sheet analysis for Malaysia.

20. Efforts to strengthen safeguards against threats of money laundering and terrorism financing (ML/TF) continue to be a key priority for authorities. The September 2015 Financial Action Task Force (FATF)'s Mutual Evaluation Report on Malaysia's AML/CFT framework acknowledged Malaysia's well-developed legal and regulatory arrangements, and strong inter-agency coordination for the supervision of ML/TF. Drawing in part on the recommendations of the Report, the National Coordination Committee to Counter Money Laundering has formulated

a five-year National AML/CFT Strategic Plan to promote and protect the integrity of Malaysia's financial system and contribute towards mitigating criminal activity in the country. Based on the commitment demonstrated by Malaysia's action plan and the continuing progress in efforts to improve its AML/CFT program, Malaysia was granted full membership of the FATF in February 2016.

Regional initiatives

21. Malaysia remains committed to advance regional and global integration. Through collective efforts during Malaysia's Chairmanship of ASEAN in 2015, a number of key milestones were achieved in regional trade and financial integration, including the finalization and launch of the ASEAN Banking Integration Framework to provide greater market access and operational flexibility for Qualified ASEAN Banks. Malaysia will also continue to pursue initiatives to promote increased integration through mechanisms such as the Trans-Pacific Partnership and the Regional Comprehensive Economic Partnership.

Reforms to enhance growth potential

22. Under the 5-year 11th Malaysia Plan (2016-2020), reforms to accelerate Malaysia's transformation into a high-income economy by 2020 will continue, underpinned by measures to reduce income inequality, raise productivity and promote environmental sustainability. Of importance, Malaysia has made important strides in reducing poverty and inequality over the past decade with a combination of anti-poverty and rural development programs focusing on promoting inclusion, livelihood and employment. In recent times, the gradual removal of blanket consumer subsidies has enabled a shift towards more targeted income support measures for the low- and middle-income segments. More broadly, affordable housing schemes, the introduction of minimum wage policy since 2013 and continued promotion of financial inclusion have been the authorities' focus in ensuring inclusive growth. Moving forward, to raise productivity and improve income distribution, authorities remain focused on education reforms, particularly on industry-driven technical education and vocational training.

23. The Government will further pursue policies to improve the business environment. This includes modernizing corporate insolvency law and the implementation of measures to improve logistics and enhance trade facilitation. Measures to enhance competitiveness will also be complemented with efforts to ensure equitable growth and environmental sustainability. As part of the agreement reached under the UN Climate Change Conference (COP 21), Malaysia has submitted a target to reduce the emission intensity of GDP.

Final remarks

24. The authorities remain vigilant that the global economy is facing important economic realignments with considerable uncertainty on global growth prospects and increasing risk of international financial market and capital flow volatility. While Malaysia's diversified economy,

sound fundamentals, strong financial system and external position, and credible policy framework, have considerably strengthened the economy's resilience, the authorities remain committed to further strengthening policy buffers and reducing vulnerabilities. Over the medium term, the authorities will continue with the structural reform agenda as outlined in the 11th Malaysia Plan to transform Malaysia into a high income economy by 2020.