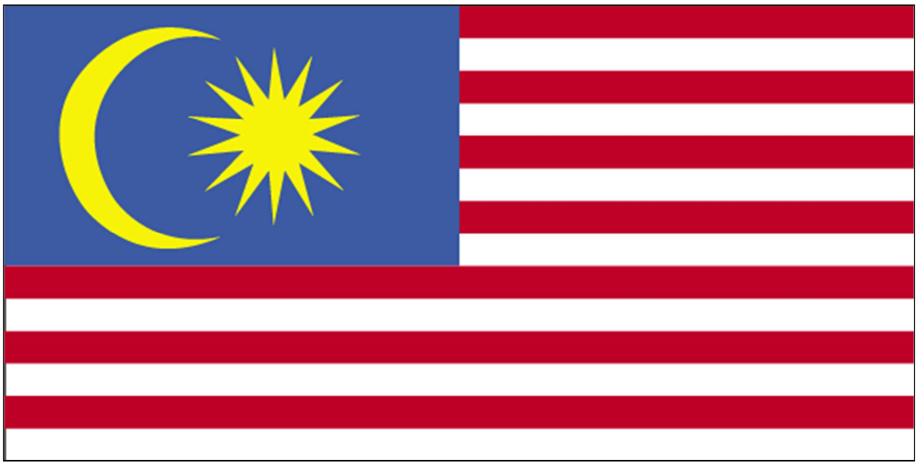
Rabobank

Country report **MALAYSIA**



Summary

Being one of the most open countries in Asia, Malaysia is sensitive to swings in external demand. With the expectation of slower growth globally, demand for Malaysia's electronics is expected to be weaker in 2012. On the upside, a rise of oil and gas prices would benefit Malaysia as a net energy exporter. Private consumption will likely receive a boost from the pre-election extras. Overall, economic growth is expected to be around 4% in 2012, which is somewhat lower than the 4.8% posted in 2011. The next general elections are expected to be held in the first half of 2012, but may be postponed to April 2013 at the latest. The ruling BN coalition is forecast to win and the key question will be whether BN is able to regain its traditional two-thirds majority. In 2011, Malaysia saw some anti-government protests and the government has since changed several laws and installed a committee to review the election process. To really calm anti-government sentiment, however, more has to be done. The government is unlikely to implement necessary reforms to improve the fiscal situation, which is acceptable now but will need attention in the longer term. The external position remains comfortable, with a current account surplus of around 10% of GDP.

Things to watch:

- General elections in 2012 (or April 2013 at the latest)
- Progress on demands regarding transparency to calm anti-government sentiment
- Implementation of fiscal reforms

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Malaysia

National facts		
Type of government	Constitutional monarchy	
Capital	Kuala Lumpur	
Surface area (thousand sq km)	330	
Population (millions)	26.6	
Main languages	Bahasa Malaysia	
	English	
Main religions	Muslim (60.4%)	
	Buddhist (19.2%)	
	Christian (9.2%)	
Head of State (supreme ruler/king)	Sultan ABDUL HALIM Mu'adzam Shah	
Head of Government (prime-minister)	NAJIB bin Abdul Razak	
Monetary unit	Ringgit (MYR)	

Economy	2011	
Economic size	*bn USD*	*% world total*
Nominal GDP	267	0.39
Nominal GDP at PPP	443	0.56
Export value of goods and services	247	1.13
IMF quotum (in mln SDR)	1487	0.68
Economic structure	*2011*	*5-year av.*
Real GDP growth	4.8	4.5
Agriculture (% of GDP)	10	10
Industry (% of GDP)	42	44
Services (% of GDP)	48	47
Standards of living	*USD*	*% world av.*
Nominal GDP per head	9339	87
Nominal GDP per head at PPP	15489	125
Real GDP per head	6277	77

Social and governance indicators	rank / total
Human Development Index (rank)	61 / 187
Ease of doing business (rank)	18 / 183
Economic freedom index (rank)	53 / 179
Corruption perceptions index (rank)	60 / 183
Press freedom index (rank)	141 / 178
Gini index (income distribution)	46.2
Population below $1.25 per day (PPP)	2%

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
Singapore	13	China	13
China	13	Japan	13
US	10	US	11
Japan	10	Singapore	11
Main export products (%)			
Machinery and transport equipment			47
Mineral fuels			19
Manufactured goods			10
Chemicals			7
Main import products (%)			
Machinery & transport equipment			49
Manufactured goods			14
Mineral fuels			11
Chemicals			9
Openness of the economy			
Export value of G&S (% of GDP)			92
Import value of G&S (% of GDP)			76
Inward FDI (% of GDP)			3.5

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

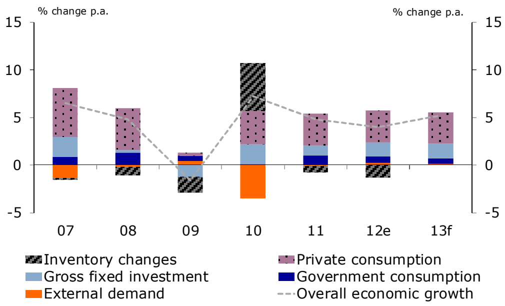
Economic structure and growth

Malaysia is a medium-income country in Southeast Asia. The country is divided over the peninsular Malaysia and Malaysian Borneo and borders Thailand, Indonesia and Brunei (over land) as well as Singapore, Vietnam and Philippines (over water). It has a diversified and competitive economy with a major industrial sector (mainly electronics), substantial natural resource wealth (oil and gas) and growing agricultural sector (largely palm oil and rubber). Malaysia is one of the most open countries in Asia with the export value of goods and services mounting to 92% of GDP in 2011. Singapore and China are its largest export partners, closely followed by US, the former no.1, and Japan. A share of the electronic parts exports to Singapore and China are inputs for final consumer goods shipped to the US and Europe. An escalation of the eurozone crisis could thus also affect Malaysia indirectly.

Economic growth was broad based in 2011 and is estimated to be 4.8%, which is lower than the recovery driven 7.2% of 2010 but in line with normal growth levels. Weaker external demand in the second half of 2011 for electronics was largely compensated by strong demand for palm oil and energy. Going forward, however, demand for Malaysia's export products is expected to be weaker in line with the global slowdown of economic activity. Private consumption is expected to receive a boost in 2012, as the government is handing out one-off extras in the run-up to the elections. Among others, public workers, who comprise about 10% of the work force, received a salary increase. Investment growth, which needs to come from the government as private investment is still restrained, is supported by different large infrastructure projects. Overall, economic growth is expected to be around 4% in 2012. Downside risks to this expectation are an escalation of the eurozone problems or a hard landing of the Chinese economy. On the upside, a rise in oil and gas

prices – for example due to increased tension in the Middle East – would benefit Malaysia as it is a net energy exporter.
Malaysia has a rather developed, competitive financial sector compared to other countries with a medium income level. Domestic credit to GDP is around 133% of GDP, compared to 106% in South Korea, 109% in Thailand and 36% in Indonesia. The banking sector is well capitalized and meeting Basel III requirements in 2015 is unlikely to be an issue. Since 2010, banks are required to report impaired loans rather than non-performing loans (NPL). Net impaired loans were 2.0% of total loans in July 2011, down from the recent peak of 2.5% in July 2011. Rising household debt and intensifying competition, especially for savings, might pose risks to profitability in the medium term. Regarding the former, household indebtedness was 77.6% of GDP in July 2011, up from 69% end 2010. As a third of household debt is unsecured, the government introduced extra regulation in 2010. A mitigating factor comes from the fact that household financial assets are about 2.3 times total household debts.

Figure 1: Economic growth



Source: EIU

Figure 2: Cultural diversity of Malaysia

Ethnic groups (%)		Religions (%)	
Malay	50.4	Muslim	60.4
Chinese	23.7	Buddhist	19.2
indigenous	11.0	Christian	9.1
Indian	7.1	Hindu	6.3
other	7.8	Traditional Chinese religions	2.6
		other	1.5
		none	0.8

Source: CIA Factbook

Political and social situation

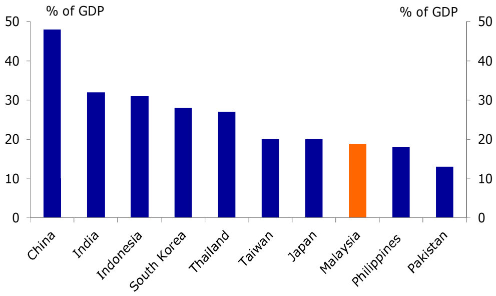
Malaysia is a country with a large Muslim population (60% of the population) as well as several substantial religious minorities. The ethnic diversity of Malaysia is also large with 50% ethnic Malay and 11% other non-Malay indigenous people (together called *bumiputra*), 24% Chinese, 7% Indian and 8% other ethnic backgrounds. The generally Muslim Malay are the largest population group, but the ethnic Chinese dominate the economy. While Malaysia prides itself with the peaceful coexistence of the different groups, tensions in the society seem to have increased in the past years and the religious and ethnic diversity plays a role in politics. Reforms of the 1969 *bumiputra* policy and discussions on the full adoption of hudud, a strict Islamic penal code, are recurring themes. The *bumiputra* policy, an affirmative action policy which aims to support ethnic Malays and other indigenous inhabitants, is a key issue of controversy. In 2011, the ruling Barisan Nasional (BN) coalition of prime minister Najib Razak withdrew the policy in the private sector, no longer demanding firms to give a minority stake to *bumiputra*. However, further reforms are not expected as PM Najib will not want to alienate conservative Malay, especially in the run-up to elections (more on that below) and in light of civil unrest seen in 2011.
Malaysia witnessed some rare anti-government protests 2011, although the civil unrest was by no means as large scale as in the Arab world. In July, the Coalition for Free and Fair elections (Bersih), supported by the opposition, organized a demonstration against unreliable voter lists and endemic vote buying. The heavy-handed response of security forces during the demonstration was widely criticized, which triggered the government to promise progress on the issues raised by Bersih. In August, a committee was installed to review the election processes (the opposition has asked not to call early elections until the committee is finished, which will probably not be until March 2012). Later, the government proposed changes to the controversial Internal Security Act

(ISA) and other rather strict security laws, demonstration rules and (some) relaxation of the very restricting media laws. Despite the changes, more reforms will be necessary to completely satisfy the demands of Bersih and really calm anti-government sentiment in the run-up to elections.
The next general elections are expected to be held in the first half of 2012, but could be postponed to April 2013 at the latest. The ruling multi-ethnic BN coalition consists out of several parties, mainly the Malay-supported United Malays National Organization (UMNO) and its coalition partners the Chinese-oriented Malaysia Chinese Association (MCA) and the Indian-supported Malaysian Indian Congress (MIC). BN has been in power since independence and is expected to win again. The key question will be whether BN is able to regain its traditional two-thirds majority. In the 2008 elections, the opposition Pakatan Rakyat (PR) alliance was able to withhold BN from the two-thirds majority for the first time since 1969. Although it was mostly the result of a no-confidence vote against BN, PR won support by proposing to abolish affirmative action and demand greater transparency. Whether PR will succeed again strongly depends on the ability of opposition leader Anwar to unite the opposition parties again, but infighting will make this challenging. Moreover, Anwar was recently acquitted of sodomy charges by the High Court of Malaysia, but the case might be reopened in appeal. The charges are said to be politically motivated, as conviction would lead to a jail sentence, taking Anwar out of the political equation for many years. While internal strife within the opposition PR has increased support for BN again, BN aims to regain support among ethnic minorities and younger and more educated Malaysians. Major themes are therefore the *bumiputra,* marginalization of the Chinese and Indian minorities and the widening wealth gap, as well as government transparency and widespread corruption.
Malaysia is one of the founding nations of the ASEAN (Association of South East Asian Nations) and generally maintains good relationships with its neighbors, largely based on economic ties, but several issues are ever present in Malaysia's foreign policy. The relation with Indonesia is occasionally strained by border disputes and migration issues. Problems in Thailand's southern states, which border Malaysia, also present reoccurring conflicts. Malaysia is one of the countries claiming part of the oil- and gas-rich South Chinese Sea, but has taken a conciliatory attitude towards China. ASEAN and China reached an agreement in August 2011 to set guidelines for cooperation in the area, which is expected to ease some of the tensions built up in the past years. Malaysia's relationship with the US and Europe is friendly, but not very close.

Economic policy

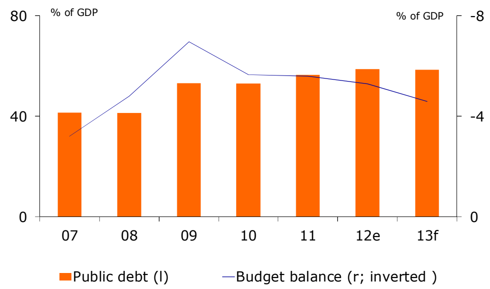
Key goal of the government is to boost income levels and make Malaysia a high income country. To achieve this, the government launched a number of programs in 2010, including the 10th Malaysia Plan (10MP), the Government Transformation Program (GTP), New Economic Model (NEM), Economic Transformation Program (ETP) and National Key Economic Areas (NKEA). Common themes of the different programs are enhancing competitiveness (e.g. via addressing corruption and improving education and infrastructure), improving efficiency (e.g. via reducing overlap between government and private sector) and boosting sectors with growth potential (e.g. the tourism and palm oil sectors). Success will depend, among others, on the government's ability to stimulate investment. Malaysia has one of the lowest investment rates in Asia – around 20% of GDP compared to about 30% of GDP in India and Indonesia and almost 50% of GDP in China – and especially private investment has been subdued since the 1998 Asia crisis.
Also part of 10MP is a reduction of the fiscal deficit and public debt. Malaysia's fiscal deficit was around 4% of GDP before the global financial crisis, but deteriorated to 7% of GDP in 2009 due to fiscal stimulus. In 2011, the general government deficit was still elevated at around 5.5% of GDP.

Figure 3: Investment (% of GDP)



Source: Capital Economics

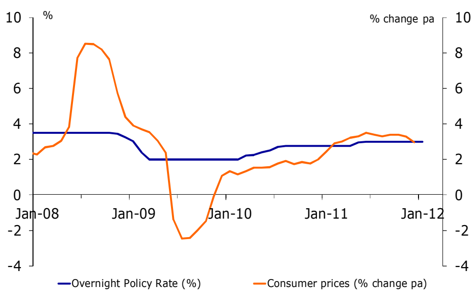
Figure 4: Fiscal indicators



Source: EIU

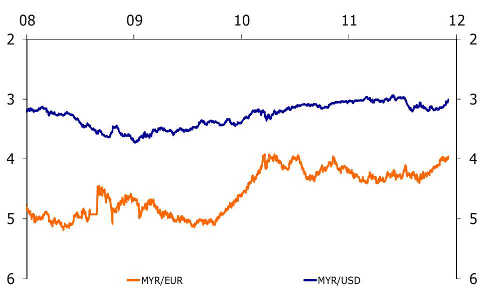
This year, budget expenditures are expected to rise by USD 2bn, among others due to one-off extras for civil servants, students, pensioners and low-income families in light of the upcoming elections. It is said that 53% of all households will receive an extra payment before the poll. Still, due to economic growth and some expenditure cuts in other areas, the fiscal deficit is expected to improve slightly to 5.3% of GDP – leaving little room for fiscal stimulus in 2012 if needed. Public debt is rather high at almost 60% of GDP (expectation for end 2012). The bulk of the government bonds is held domestically, but foreign interest has increased since end 2004, when foreign investment was negligible. In March 2011, a quarter of government securities were held abroad, but this has fallen since. Practically all government debt is ringgit denominated and placement of bonds is supported by the moderately developed capital market and high savings rate in Malaysia. To structurally improve the fiscal position of Malaysia, the government will need to address its dependency on oil-related revenues, reform the subsidy scheme, implement the long-discussed goods and services tax (GST) and reduce tax evasion. About a third of government revenue stems from the oil and gas industry. While this is lower than a few years ago, it still leaves the government very vulnerable to international oil price fluctuations. Oil prices also work through in the wide range of subsidies (14% of the total budget). As Malaysians are used to low petrol and cheap electricity prices, the government has lingered to implement this unpopular reform. The GST has also been around for a while, but has yet to be implemented. Finally, reducing tax evasion – currently only 1.9m people and companies pay taxes out of 6.6m registered tax payers – could provide valuable revenues. It is unlikely that these structural reforms will pass through the parliament before the elections, though.

Figure 5: Inflation and policy rates



Source: Reuters EcoWin

Figure 6: Exchange rate



Source: Reuters EcoWin

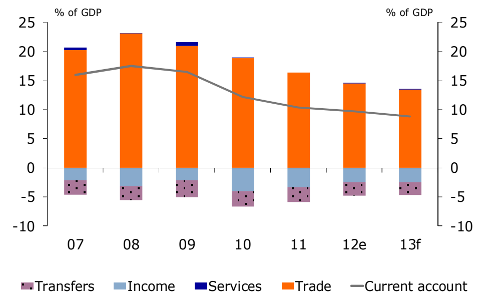
Inflation is expected to have been relatively modest between 3% and 3.5% in 2011, even though food prices are still elevated. These moderate price increases make Malaysia one of the few countries in the region where inflation is not a major issue. The Bank Negara Malaysia (BNM; the central bank) proactively started mopping up excess liquidity early 2010, but was unable to curb

food price pressures. In 2012, inflation is expected to ease even more, to around 2.5%, as economic growth is likely to slow this year and commodity prices are expected to ease. BNM, which has low and stable inflation as one of its main targets, has suggested that it will move its focus towards economic growth in 2012. Policy rate cuts are therefore possible if necessary to cushion the economy from weaker global demand. If the government is able to push through reforms in the subsidy scheme and the GST, inflation can be expected to be elevated from 2013 onwards, although the government will be cautious and only gradually increase prices.
In 2011, BNM has been rather active in the currency market, managing volatility, without returning to the peg that was in place until 2005. The Malaysian ringgit had been appreciating since early 2009, supported by recovering external demand and higher foreign portfolio inflows. To prevent a further deterioration of Malaysia's external position, the BNM intervened over the course of 2011, which slowed appreciation in the first half of 2011 and stemmed depreciation in the second half of 2011. In September 2011, when eurozone issues spooked investors, depreciating pressure on the ringgit grew, in line with other Asian currencies. This year, the BNM will remain cautious of a sharp appreciation of the currency, but upward pressure is expected to be benign on the back of subdued global demand.

Balance of Payments

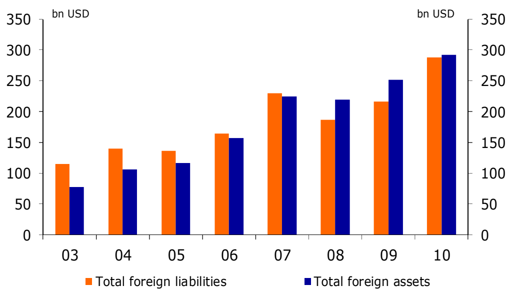
Malaysia generally has a comfortable current account surplus, although external demand has fallen on the back of economic woes in US and Europe in the past years. This resulted in a decrease of the current account surplus from around 15-16% of GDP up to 2009 to a little over 10% of GDP in 2011, which is still rather high. The large surplus on trade balance is the main determinant of the current account surplus in Malaysia, while the income and transfer balances tend to be small and in deficit. In the second half of 2011, demand for electronic parts and products, which account for half of Malaysia's exports, slowed. Total export value, however, did not drop as much, because demand for Malay commodities such as palm oil, crude oil and LNG (liquefied natural gas) was strong. This year, the current account surplus is expected to be around 10% of GDP as well, but a sharp contraction in the US or eurozone could depress export demand and therefore the current account surplus. The increased importance of regional trade should cushion weaker demand from the West. Moreover, a jump in oil and gas prices could support the country's current account balance, as Malaysia is a net energy exporter.

Figure 7: Current account balance



Source: EIU

Figure 8: International investment position



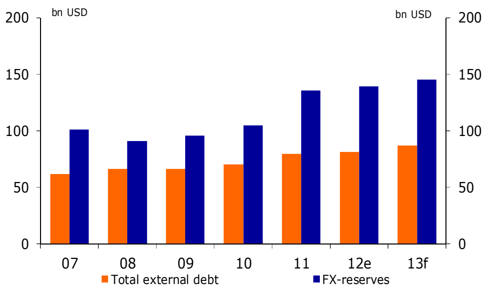
Source: IMF

Malaysia has been a net creditor since 2008, but a strong inflow of portfolio investment in 2010 and 2011 reduced this position. Net assets were 1.8% of GDP in 2010, down from 18.2% of GDP in 2009. Data for 2011 has not been published yet by the IMF, but Malaysia could become a net debtor again. While in the longer run this would make the country more vulnerable to changes in the external environment, in the short run the strong inflow of portfolio investment is more a sign of strong investor confidence in Malaysia. As result of the central bank's intervention to the stem the appreciation of the Malaysian ringgit and due to the strong investment flows, the foreign exchange (FX) reserves increased by nearly USD 31bn in 2011 to USD 135.4bn. This year, the increase is expected to be much more moderate, leading to a FX reserve level of USD 139bn end-2012. The increase could be higher as the change in international reserves is said to be underestimated, which is now partly showing up in other capital flows (a larger increase of FX reserves would make the other capital flows smaller).

External position

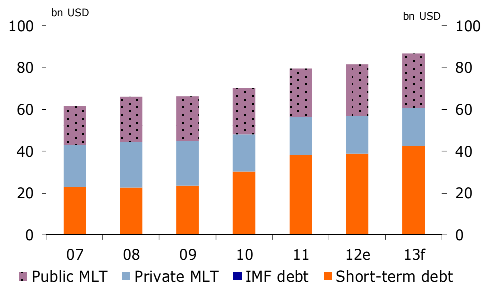
Total external debt of Malaysia is forecast at a low 30% of GDP in 2011 and 2012. In absolute numbers, foreign debt is around USD 80bn, which compares favorably to the FX reserves of about USD 135bn. Less positive is the high amount of short-term debt, which is close to 50% of total external debt. This can largely be explained by the openness of the Malaysian economy to foreign trade, as trade finance tends to be short term. In 2012, the main risk for reduced credit availability for Malaysia will likely stem from a global credit crunch in the wake of, for example, an escalation of the eurozone crisis. As this would also mean that the demand for trade-related finance in Malaysia drops, the country's large prevalence of short-term debt does not pose a huge risk. Malaysia's liquidity position is strong on the back of ample FX reserves, the surplus of the current account and low debt service costs. In 2012, the liquidity ratio is expected to be 158%, the import cover of FX reserves is set at 8 months and the debt service ratio (as % of current account receipts) is forecast to be 17%.

Figure 9: External debt and FX reserves



Source: EIU

Figure 10: Composition of external debt



Source: EIU

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Malaysia

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	6.5	4.8	-1.6	7.2	4.8	4.0	5.2
Consumer prices (average % change pa)	2.0	5.4	0.6	1.7	3.3	2.6	2.9
Current account balance (% of GDP)	15.9	17.5	16.5	12.1	10.4	9.7	8.8
Total foreign exchange reserves (mln USD)	101019	91149	95432	104884	135379	138980	145000
Economic growth							
GDP (% real change pa)	6.5	4.8	-1.6	7.2	4.8	4.0	5.2
Gross fixed investment (% real change pa)	9.4	1.1	-5.6	9.8	4.7	7.0	6.8
Private consumption (real % change pa)	10.5	8.7	0.7	6.5	6.4	6.1	6.0
Government consumption (% real change pa)	6.6	9.9	3.9	0.5	7.3	5.0	4.6
Exports of G&S (% real change pa)	4.1	1.7	-10.5	9.9	4.0	4.0	7.5
Imports of G&S (% real change pa)	5.9	2.1	-12.2	15.1	4.4	4.2	8.1
Economic policy							
Budget balance (% of GDP)	-3.2	-4.8	-7.0	-5.7	-5.6	-5.3	-4.6
Public debt (% of GDP)	42	41	53	53	56	59	59
Money market interest rate (%)	3.6	3.6	2.2	2.7	3.2	3.2	3.3
M2 growth (% change pa)	11	13	10	7	11	8	10
Consumer prices (average % change pa)	2.0	5.4	0.6	1.7	3.3	2.6	2.9
Exchange rate LCU to USD (average)	3.4	3.3	3.5	3.2	3.0	3.0	2.9
Recorded unemployment (%)	3.2	3.3	3.7	3.4	3.1	3.3	3.1
Balance of payments (mln USD)							
Current account balance	29770	38914	31801	28853	27834	27740	28220
Trade balance	37727	51261	40254	44744	43692	41480	43080
Export value of goods	176220	199733	157655	197440	212431	219690	237270
Import value of goods	138493	148472	117402	152696	168739	178210	194190
Services balance	794	51	1297	131	-44	110	220
Income balance	-4082	-7137	-4169	-9579	-9004	-7090	-8030
Transfer balance	-4668	-5262	-5580	-6444	-6810	-6750	-7050
Net direct investment flows	-2551	-7827	-6627	-6230	-253	-510	-90
Net portfolio investment flows	5388	-23961	-291	10200	9194	4980	3880
Net debt flows	8516	-1378	-1560	3601	8252	1810	5680
Other capital flows (negative is flight)	-22236	-15533	-18138	-26612	-14293	-30480	-31780
Change in international reserves	18887	-9785	5185	9812	30734	3530	5910
External position (mln USD)							
Total foreign debt	61566	66181	66390	70440	79625	81620	86870
Short-term debt	23100	22800	23695	30378	38422	38850	42600
Total debt service due, incl. short-term debt	19661	29398	31633	33677	38155	45020	45390
Total foreign exchange reserves	101019	91149	95432	104884	135379	138980	145000
International investment position	-4573	32982	35068	4303	n.a.	n.a.	n.a.
Total assets	224898	219182	251339	292270	n.a.	n.a.	n.a.
Total liabilities	229471	186200	216271	287967	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	20.2	23.0	20.9	18.8	16.3	14.4	13.4
Current account balance (% of GDP)	15.9	17.5	16.5	12.1	10.4	9.7	8.8
Inward FDI (% of GDP)	4.6	3.3	0.7	3.3	3.5	2.6	2.7
Foreign debt (% of GDP)	33	30	34	30	30	28	27
Foreign debt (% of XGSIT)	28	27	33	29	30	30	30
International investment position (% of GDP)	-2.4	14.8	18.2	1.8	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	9	12	16	14	15	17	16
Interest service ratio incl. arrears (% of XGSIT)	0	0	0	0	0	0	0
FX-reserves import cover (months)	7.3	6.1	7.9	6.8	8.0	7.8	7.5
FX-reserves debt service cover (%)	514	310	302	311	355	309	319
Liquidity ratio	167	150	158	153	161	158	158

Source: EIU