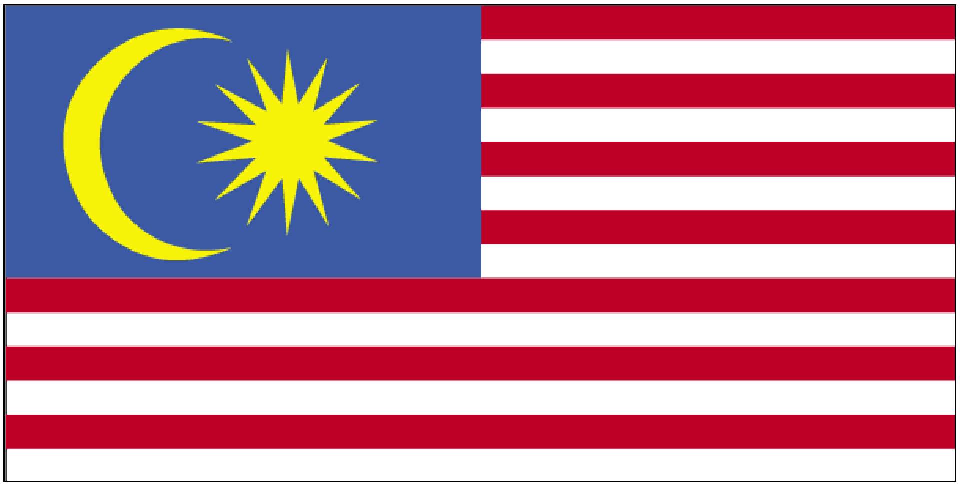
Rabobank

Country report

MALAYSIA



Summary

The global recession in 2009 hit Malaysia via the trade channel. The highly export dependent economy experienced a steep decline in external demand for its export products last year. This has resulted in a GDP contraction of 1.7% in 2009, but the road to recovery has been taken. A recovery in the political sphere is unfortunately not yet underway, as conflicts between the government and the opposition remain frequent and fierce. The political situation slows down the policy reform process and will remain unstable throughout 2010. The rapidly deteriorated fiscal situation poses large risks, more so as the fiscal consolidation plans seem unfeasible. The external position of the country is very healthy, as the level of foreign debt is rather low and as the trade surpluses have resulted in a large amount of FX-reserves.

Things to watch:

- The recovery of external demand
- Continuing conflicts between the government and opposition
- The fiscal consolidation plan in the upcoming 2010 budget

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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	Sultan MIZAN Zainal Abidin
Head of Government (prime-minister)	NAJIB bin Abdul Razak
Monetary unit	Ringgit (MYR)

Social and governance indicators	rank / total
Human Development Index (rank)	66 / 182
Ease of doing business (rank)	23 / 183
Economic freedom index (rank)	59 / 179
Corruption perceptions index (rank)	47 / 180
Press freedom index (rank)	131 / 175
Gini index (income distribution)	49.2
Population below $1 per day (PPP)	15.5%

Economy (2009)		
Economic size	*bn USD*	*% world total*
Nominal GDP	196	0.34
Nominal GDP at PPP	380	0.55
Export value of goods and services	182	1.17
IMF quotum (in mln SDR)	1487	0.68
Economic structure	*2009*	*5-year av.*
Real GDP growth	-2.4	5.8
Agriculture (% of GDP)	10	9
Industry (% of GDP)	42	45
Services (% of GDP)	48	45
Standards of living	*USD*	*% world av.*
Nominal GDP per head	6917	76
Nominal GDP per head at PPP	13425	121
Real GDP per head	5592	72

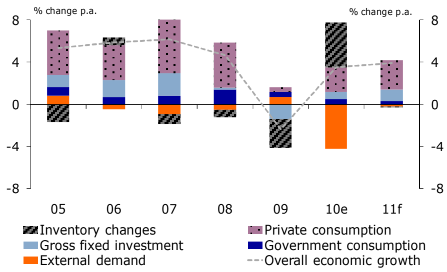
Foreign trade (2008)			
Main export partners (%)		*Main import partners (%)*	
Singapore	18	Singapore	26
US	14	China	15
China	14	Japan	12
Japan	11	US	9
Main export products (%)			
Machinery and transport equipment			44
Mineral fuels			14
Manufactured goods			10
Chemicals			7
Main import products (%)			
Machinery & Transport equipment			52
Manufactured goods			12
Mineral Fuels			9
Chemicals			9
Openness of the economy			
Export value of G&S (% of GDP)			93
Import value of G&S (% of GDP)			74
Inward FDI (% of GDP)			2.1

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

Economic structure and growth

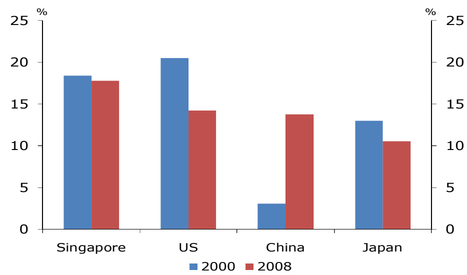
In 1948, the territory on the Malay peninsula was ruled by the British and formed the Federation of Malaya, which became independent in 1957. In 1963, Malaysia was formed when the former British colonies of Singapore and the East Malaysian states of Sabah and Sarawak joined the Federation. The early years of this new formation were a struggle, resulting in an armed conflict with Indonesia and the expulsion of Singapore. From 1981 to 2003, the country was led by PM Mahatir bin Mohamad, whose policies successfully diversified the economy from dependence on raw material exports to expansion in manufacturing, services and tourism. The economic structure of the country is dominated by services and industry, which make up 48% and 42% of the economy. Malaysia has one of the most open economies in Asia, as the import and export value of goods and services amounts to 159% of GDP. The country's main export products are electronics and electrical equipment with 48% of total exports, making external trade arguably overly dependent on this sector. Palm oil exports only constitute 6% of total exports, but is a very important export product for the country. Malaysia holds a strong position in this sector as it is the world's largest exporter of palm oil, and is the second largest producer after Indonesia. Singapore is its largest trade partner, trailed by the US, China and Japan. A positive factor has been the redirection of Malaysia's trade flows from the West to Asia in recent years. While exports to the US were reduced to 14% in 2008 from 21% in 2000, exports to China have increased to 14% in 2008, up from 3% in 2000. The redirection of trade has suited Malaysia well as it has resulted in a better diversification of its export markets.

Chart 1: Growth performance



Source: EIU

Chart 2: Direction of trade



Source: EIU

Nevertheless, final consumer demand comes from the West and Malaysian exports suffered as global demand steeply fell as of Q408. However, in Q309 the export decline stabilized after being down 21.9% yoy in H109. The latest data from October has shown a 15% mom uptick in exports, indicating exports are recovering along with global external demand. While the external sector was a large drag on economic growth, other drivers also contributed less to economic growth than in 2008. Government expenditures, private consumption, gross fixed investment all fell and notably destocking contributed to the fall in economic activity. As the rapid drawdown of inventories has resulted in very low levels of stock, restocking in order to enable firms to meet expected orders will be the main growth driver for 2010. However, this scenario is obviously contingent on a sustained global recovery of final demand. The economy is estimated to have contracted 1.7% in 2009 and is expected to grow at 4-5% in 2010.

The financial sector is very healthy and largely not affected by the global financial crisis. Malaysia's banking system had only very limited direct exposure to US subprime mortgages thus financial stability had not been under any real threat. Having said that, earnings and credit quality have been negatively affected by the economic slowdown.

Political and social situation

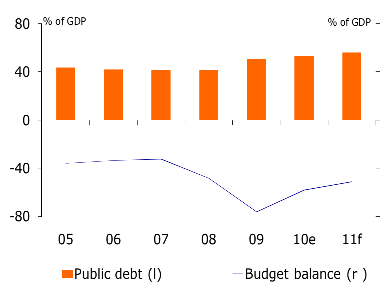
The political situation has become unstable ever since the ruling Barisan National (BN) coalition , led by former PM Baldawi, suffered severe losses in the March 2008 general elections. The result is that the BN only holds a simple majority as opposed to a two thirds majority required in the lower house to amend the constitution unchallenged. The BN has weakened further since the elections, when the coalition of the opposition, the Pakatan Rakyat (PR), tried to table a vote of no confidence in PM Badawi by wooing supporters from BN member parties. This resulted in Baldawi's resignation and it remains to be seen whether his successor, Razak will push through reforms. Razak is expected to be easily bribed by several vested interest groups. Furthermore, he needs to establish himself well within the coalition as he carries a lot of baggage; he is suspected of involvement in a number of corruption cases and having a role in a high profile murder case. Although the governing coalition has weakened severely, the opposition is not that strong either. The coalition of the opposition is very loose as it consists of three parties with distinctly different ideologies. With each of the parties following their own agenda, this makes for a very unstable coalition. Furthermore, the leader of the PR, Anwar Ibrahim, has not much credibility as a long-term leader as he faces sex-crime charges and can be sent to prison if found guilty.

Despite all the opposition's problems, it had managed to gain popularity by capitalizing on the failure of the BN to address longstanding social grievances. The main issues of public discontent encompass the widespread corruption, the growing wealth gap and the marginalization of ethnic minorities. The government did implement policies to ensure a fairer wealth distribution over the

years, but this has failed to bring significant improvements. The disparities between wealthier, better educated ethnic Chinese and the poor and low educated bumiputera (ethnic Malays and other indigenous people) remain high. Overall, we expect political instability to persist as the capability, willingness and integrity of the political leaders are very questionable, resulting in a slowdown of the policy reform agenda.
The country's foreign policy is mostly directed to improving economic ties with the rest of Asia, most recently with it largest trading partners Singapore and China. This is exemplified when PM Najib, during a recent visit to China, promoted a broadening of the base of trade with China. Trade relations with other Asian countries such as Australia, New Zealand and India have also strengthened in recent years. As Malaysia is one of the five co-founders of the Association of South East Asian Nations (ASEAN) and still plays a leading role, it is expected to continue to improve economic ties with its Asian neighbors.

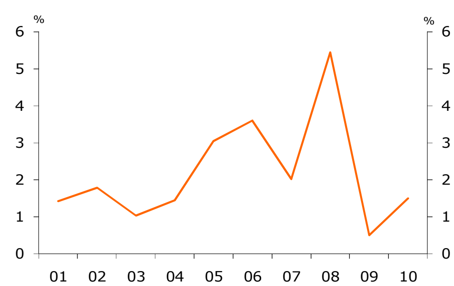
Economic policy
Public finances are weak in Malaysia, the budget balance has been in deficit ever since the Asian crisis in 1998 and the deterioration continued in the past year. The deficit was 7.6% of GDP in 2009, up from 4.8% in 2008. On the expenditure side, the main culprit was the large stimulus package equivalent to a large 9% of GDP in March 2009. This stimulus package was announced after a first one in November 2008, which amounted to only 1% of GDP and was deemed too small to be effective. On the revenues side, the global economic slump resulted in lower profits for Malaysian companies and lower corporate tax revenues. But more importantly, oil revenues weakened as global oil prices fell. Oil revenues for the Malaysian government are comprised of petroleum income tax, export duties, royalties. These revenues constitute 40% of total government revenues, making the government highly dependent on this sector. The combination of higher expenditures and lower revenues has resulted in an increase of public debt to 51% of GDP in 2009, up from 41% of GDP in 2008. The increase is substantial, but manageable as the debt is well-structured in terms of maturity and currency. Less than 20% of total public debt is short-term debt and less than 10% is denominated in foreign currency, resulting in low refinancing risks. Nevertheless, the fiscal situation has to be improved and this is not likely to happen in the short term. The 2010 budget was presented last November and seemed very ambitious, stating a budget deficit target of 5.6% of GDP. However, the revenues side of the fiscal equation is very weak and will not improve given the stimulus measures. PM Razak does plan to boost revenues by lowering the fuel subsidies, however not much other significant revenue raising measures are announced. The personal income taxes were lowered to 26% from 27% and corporate taxes at 25% will not be raised in order to attract FDI. PM Razak did announce to reinstate a property tax of 5% in January 2010 but then he reduced the scope of the property taxes after appeals from the business sector.

Chart 3: Public finances



Source: EIU

Chart 4: Inflation



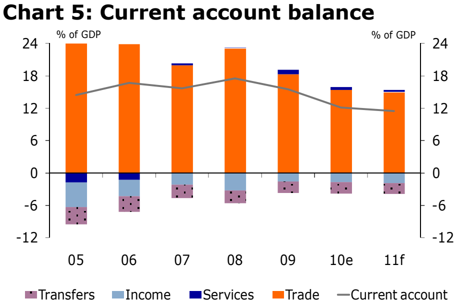
Source: EIU

This makes his commitment to fiscal consolidation highly doubtful and we believe the targeted budget deficit will not be met.
Inflation is not expected to be a policy concern in 2010. While inflation did reach a historically high 5.4% in 2008, a drastic fall in global commodity prices and the global recession resulted in a precipitous fall in headline inflation in 2009. In H209, the country experienced outright deflation, inflation for the whole year is estimated at 0.6%. The monetary policy stance became looser in 2009, with the main policy rate lowered to 2% from a high of 3.75% in 2008. The central bank, Bank Negara Malaysia (BNM), has left the policy rate at a low 2% so far as price pressures are likely to remain subdued in 2010. The one factor which will exert upward pressure on prices is the planned reduction in the fuel subsidy, however disinflationary factors are stronger. One factor keeping inflation in check is the maintenance of price controls, which are likely to continue to be applied to a range of basic goods. Another factor is the Malaysian currency, the ringgit (MYR), which is likely to appreciate against the USD in the coming year because of the positive interest rate differential, making imports cheaper.
Under the current exchange rate regime, the MYR is subject to a managed float against a trade weighted basket of currencies. It is expected that the BNM maintains the exchange rate at the current level, especially as the main advantage is that it reduces exchange rate risk for exporters. While the BNM stresses it does not aim to keep the MYR at a particular level, it does intervene to minimize volatility and to prevent misalignments of the exchange rate.

Balance of Payments

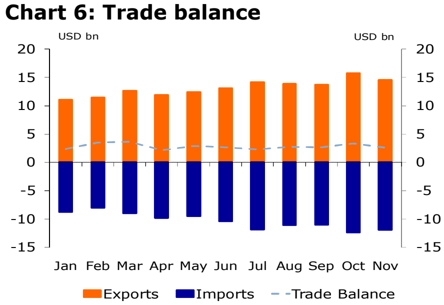
The current account balance is in a very healthy shape, posting large surpluses which have averaged 13% of GDP from 2000 until 2009. It recorded a 15.5% surplus in 2009, which is almost completely driven by the trade surplus. The surplus on the trade balance was 18.4% of GDP, as exports far exceed imports. Imports fell rapidly early 2009 as demand for intermediate and consumer goods waned. Imports recorded an 23.8% yoy decline in Q209, but the contraction has moderated to 18.3% in Q309, which is in line with the improved manufactured exports and higher private consumption spending. The country's main export products are electrical and electronics equipment, which constitute 48% of total exports, making the export basket undiversified. Hence, when global demand for these products fell, export volumes fell and remained low in H109 compared to last year. Exports are now picking up, recording a 15% mom increase in October 2009, which is still down on a yoy basis, but only by 1.5%. Going forward, we expect the upward momentum to continue if external conditions improve. A positive contribution to the momentum is Malaysia's ASEAN membership. ASEAN has signed free-trade agreements (FTA's) with China, Australia, New Zealand and India, all of which have come into effect on January 1st 2010. Imports are also expected to pick up if external conditions continue to improve. This will boost demand for imports of intermediate goods for use in manufacturing as well as firm domestic consumer

Chart 5: Current account balance



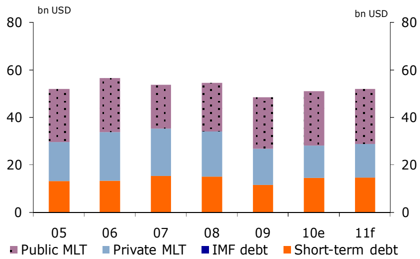
Source: EIU

Chart 6: Trade balance



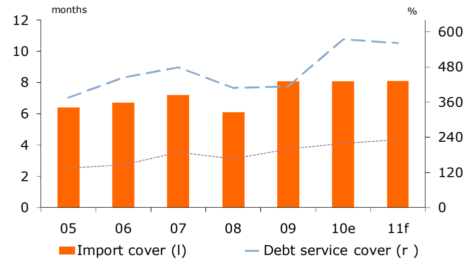
Source: Bank Negara Malaysia

Chart 7: External debt composition



Source: EIU

Chart 8: Covers offered by FX-reserves



Source: EIU

demand. The services account posted a small surplus of 0.8% of GDP in 2009 but rising transport costs could result in a shortfall this year. The income and transfer balances have traditionally been in a small deficit and are expected to remain so in 2010.The large net positive external trade position has resulted in a steady accumulation of FX-reserves over the years. In 2009, FX-reserves stood at USD 97bn, up from USD 91bn in 2008 and will likely grow at a similar rate in 2010. The large current account surpluses mean no external financing is required. FDI inflows are rather low, at only 2.1% of GDP in 2009. Although FDI is not needed to finance a current account deficit, it is needed for developing the country and the current level is far below potential. As the government has relaxed business regulations and started up several projects to attract FDI, it is expected to pick up modestly in 2010.

External position

Malaysia's external position is very good. Total external debt is rather low at only 25% of GDP and the maturity structure is also favorable, as short-term debt only constitutes 24% of total foreign debt. Furthermore, the huge level of FX-reserves, standing at USD 97bn in 2009, cover over 8 months of imports. The external debt service burden is very low, and covered by the FX-reserves with 413%. Additionally, the liquidity ratio stands at 166%, a sound level. The risk of an external payment default is very low.

Malaysia

Selection of economic indicators	2005	2006	2007	2008	2009	2010e	2011f
Key country risk indicators							
GDP (% real change pa)	5.3	5.8	6.2	4.6	-2.4	3.5	3.9
Consumer prices (average % change pa)	3.0	3.6	2.0	5.4	0.5	1.5	2.0
Current account balance (% of GDP)	14.5	16.7	15.7	17.6	15.5	12.2	11.5
Total foreign exchange reserves (mln USD)	69858	82132	101019	91149	97289	111870	121150
Economic growth							
GDP (% real change pa)	5.3	5.8	6.2	4.6	-2.4	3.5	3.9
Gross fixed investment (% real change)	5.0	7.5	9.6	0.8	-6.4	3.1	5.1
Private consumption (% real change)	9.1	6.8	10.4	8.5	0.8	4.3	5.2
Government consumption (% real change)	6.5	5.0	6.5	10.9	3.7	3.1	2.0
Exports of G&S (% real change)	8.3	6.6	4.5	1.3	-11.2	4.8	6.2
Imports of G&S (% real change)	8.9	8.1	6.0	1.9	-13.3	10.1	7.0
Economic policy							
Budget balance (% of GDP)	-3.6	-3.3	-3.2	-4.8	-7.6	-5.8	-5.1
Public debt (% of GDP)	44	42	42	41	51	53	56
Malaysia, Money market interest rate (%), N/A	2.9	3.6	3.6	3.6	2.2	2.5	3.0
M2 growth (% change pa)	6	11	10	11	4	11	10
Consumer prices (average % change pa)	3.0	3.6	2.0	5.4	0.5	1.5	2.0
Exchange rate LCU to USD (average)	3.8	3.7	3.4	3.3	3.5	3.4	3.3
Recorded unemployment (%)	3.6	3.3	3.2	3.3	3.6	3.6	3.4
Balance of payments (mln USD)							
Current account balance	19980	26200	29243	38914	30281	26580	26860
Trade balance	33156	37441	37190	51261	35934	33640	35160
Export value of goods and services	141808	160916	176433	199733	154520	171290	184080
Import value of goods and services	108653	123474	139243	148472	118587	137660	148910
Services balance	-2380	-1970	690	51	1647	1230	940
Income balance	-6318	-4712	-4055	-7137	-3047	-3540	-4390
Transfer balance	-4477	-4560	-4582	-5262	-4253	-4740	-4850
Net direct investment flows	994	53	-2687	-7827	-2505	-1230	-250
Net portfolio investment flows	-3700	3436	5380	-23961	-6585	-3510	1490
Net debt flows	601	1862	-798	-363	-6788	2010	1020
Other capital flows (negative is flight)	-13903	-19274	-12248	-16635	-8257	-9280	-19850
Change in international reserves	3972	12277	18890	-9872	6146	14580	9280
External position (mln USD)							
Total foreign debt	51981	56491	53717	54597	48520	51040	52100
Short-term debt	13176	13268	15250	15147	11574	14600	14600
Total debt service due, incl. short-term debt	18663	18483	21125	22316	23530	19490	21570
Total foreign exchange reserves	69858	82132	101019	91149	97289	111870	121150
International investment position	-19853	-6650	-5642	38650	n.a.	n.a.	n.a.
Total assets	116846	157297	224645	222106	n.a.	n.a.	n.a.
Total liabilities	136699	163947	230287	183456	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	24.0	23.9	20.0	23.1	18.4	15.4	15.0
Current account balance (% of GDP)	14.5	16.7	15.7	17.6	15.5	12.2	11.5
Inward FDI (% of GDP)	2.9	3.9	4.5	3.3	2.1	2.7	2.8
Foreign debt (% of GDP)	38	36	29	25	25	23	22
Foreign debt (% of XGSIT)	31	30	25	23	25	24	23
International investment position (% of GDP)	-14.4	-4.2	-3.0	17.4	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	11	10	10	9	12	9	9
Interest service ratio incl. arrears (% of XGSIT)	0	0	0	0	0	0	0
FX-reserves import cover (months)	6.4	6.7	7.2	6.1	8.1	8.1	8.1
FX-reserves debt service cover (%)	374	444	478	408	413	574	562
Liquidity ratio	148	157	166	155	166	167	165

Source: EIU