Malaysia

Growth slowed last year as external demand softened and global trade tensions mounted. Inflation remained subdued, and the current account surplus widened. As demand continues to weaken this year, growth is forecast to slow further. Inflation will quicken back to trend as the effect of a temporary tax holiday fades. With the public sector role in investment shrinking, policies and programs are needed to boost private investment.

Economic performance

Despite softer exports and slowing domestic investment shaving 1.2 percentage points off the 2017 growth rate, growth in 2018 held up at 4.7% (Figure 3.26.1). Growth in exports of goods and services by volume plunged from 9.4% in 2017 to 1.5% as foreign demand weakened for electronics, palm oil, and refined petroleum products.

Domestic investment reversed 6.4% expansion in 2017 to contract by 4.4%. Public investment sank from stagnation in 2017 to a 5.2% decline as a new government suspended several public infrastructure projects that had been approved by the previous administration. Growth in private investment fell by more than half from 9.3% in 2017 to 4.5% last year with investors uncertain about the new government's policy direction, concerned about the trade conflict between the People's Republic of China and the US, and gloomy at the outlook for the global semiconductor market. Investment in residential construction fell as measures to curb the real estate market included shortened mortgage maturities and lowered loan-to-value ratios.

Continued strength in domestic consumption partly offset the slump in investment. Growth in private consumption surged from 7.0% in 2017 to a 6-year high of 8.1% thanks to modestly higher wages and expanded employment in the first half of the year, a temporary tax holiday, and higher government cash transfers to low-income households. The abolition of the goods and services tax ahead of the imposition of a new sales and services tax created a 3-month tax-free window in June–August that consumers and businesses used to generate substantial increases in retail sales (Figure 3.26.2). Growth in public consumption moderated, meanwhile, from 5.4% in 2017 to 3.3%.

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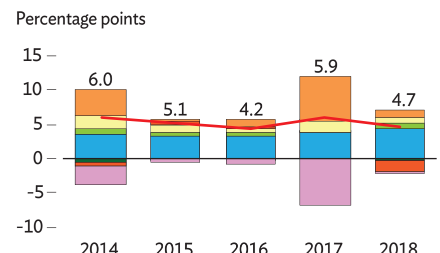
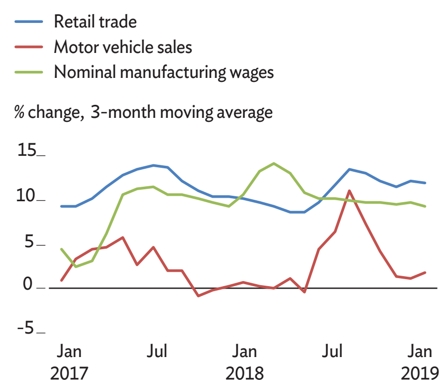
3.26.1 Demand-side contributions to growth



Sources: Haver Analytics; Bank Negara Malaysia. 2019. Monthly Statistical Bulletin. February. http://www.bnm.gov.my (accessed 25 February 2019).

3.26.2 Consumption indicators



Source: Haver Analytics (accessed 8 March 2019).

By sector, agriculture, industry, and construction slowed, but services improved on its growth rate in 2017. Agriculture reversed 7.2% expansion in 2017 to contract by 0.4% last year, largely because of softening palm oil prices internationally. Industry growth slowed from 4.9% in 2017 to 3.4% as external demand for electronics weakened and pipeline repairs disrupted production and drove down natural gas output. Construction growth slowed from 6.7% in 2017 to 4.2% last year as the new government decided to suspend several infrastructure projects. Meanwhile, services, providing more than half of GDP, improved on growth at 6.2% in 2017 with 6.8% expansion on buoyance in wholesale and retail trade and in finance and business services.

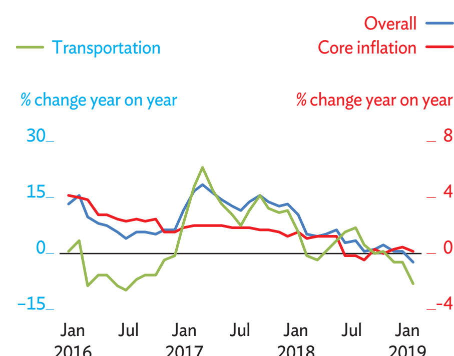
As growth slowed, inflationary pressures eased not only because of lower aggregate demand, but also reflecting the partial reintroduction of fuel subsidies and the windfall from the temporary tax holiday. Inflation thus fell from 3.8% in 2017 to 1.0% last year (Figure 3.26.3).

Growth in merchandise exports slowed in US dollar terms from 13.3% in 2017 to 10.5% in 2018. Merchandise imports also experienced slower growth, decelerating from 13.8% to 10.4%, largely because the slump in domestic investment cut demand for imports of capital and intermediate goods. On balance, the trade surplus rose by 10.8% to $30.1 billion last year. Net service receipts declined, however, as net payments to foreign service providers exceeded tourism receipts, and as foreign workers boosted their outward remittances. The current account surplus thus shrank from the equivalent of 3.0% of GDP in 2017 to 2.3% (Figure 3.26.4).

Meanwhile, the financial account registered net inflow for the first time in 7 years, at $4.7 billion. Portfolio capital net outflow of $11.0 billion was more than offset by larger net inflow of foreign direct investment and other inflows in the second half of the year. The overall balance of payments was thus a small surplus last year, and by December 2018 foreign exchange reserves stood at $99.8 billion, providing cover for 7.4 months of imports.

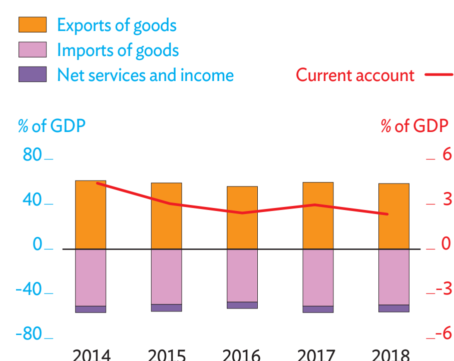
The budget deficit widened from the equivalent of 3.0% of GDP in 2017 to 3.7% in 2018, more than the 2.8% deficit originally targeted under the *2018 Budget Report*. The temporary reintroduction of fuel subsidies and the removal of the goods and services tax drained government coffers even as oil-related revenues picked up. The government had hoped to keep the budget deficit close to target by raising oil-related revenues and cutting nonessential spending, but government expenditure nevertheless grew by 9.6%, more than double the 2017 rate, on higher government transfers, debt service payments, and operating expenditure. Meanwhile, Bank Negara Malaysia, the central bank, maintained a neutral monetary policy, its overnight policy rate unchanged at 3.25%.

3.26.3 Monthly inflation



Sources: Haver Analytics; Bank Negara Malaysia. 2018. Monthly Highlights and Statistics. February. http://www.bnm.gov.my (accessed 8 March 2019).

3.26.4 Current account balance and components



Sources: Haver Analytics; Bank Negara Malaysia. 2019. Monthly Highlights and Statistics. February. http://www.bnm.gov.my (accessed 11 March 2019).

Economic prospects

With slower growth in the advanced economies and moderation in the global electronics trade, export growth is expected to remain weak. Domestic demand will continue to slow this year but is expected to pick up in 2020 with a recovery in private investment. GDP growth will likely slow this year to 4.5% and pick up to 4.7% in 2020 (Figure 3.26.5).

Private consumption growth is expected to pull back somewhat from last year's strong performance. Although the recent introduction of an income tax refund may boost consumption to some extent, the end of the temporary tax holiday last year with the introduction of the sales and service tax should moderate growth in private consumption to a still robust pace of 6.0% this year and next, underpinned as it is by low unemployment and rising wages. Growth in public consumption will continue to slow in both years as the government cuts costs.

Public investment is likely to slow in both years as well, with the government continuing to reconsider and reprioritize its investment program. With several large infrastructure projects already deferred, the government is looking at options to reduce costs on other projects currently in the works. Its renegotiation of several large investment projects has unsettled some private investors, adding to their concerns about weakening export prospects. The RAM business confidence index showed sagging sentiment in the initial months of 2019 (Figure 3.26.6).

Private investment is therefore likely to remain subdued this year. It is poised for recovery next year, though, with the implementation of a large backlog of projects with foreign direct investment. Historical trends show 60%–80% of investment approvals implemented after 2 years (Figure 3.26.7 and Table 3.26.2). A giant new refinery and petrochemical complex at Pengerang, on the southern coast of Peninsular Malaysia, is scheduled to become operational by the end of 2019 with the capacity to process 300,000 barrels of crude per day. The complex is expected to attract additional private investment to the Pengerang area as investors take advantage of enhanced feedstock availability and well-developed infrastructure, including a power plant, liquefied natural gas terminal, and deepwater port. This should help offset the lull in manufacturing investment.

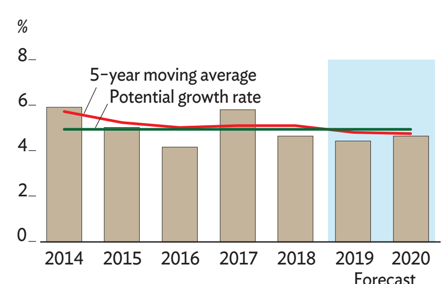
Agriculture will rebound this year from contraction last year, but growth will moderate again in 2020 as it returns to trend. Industry growth will slow to 3.1% this year, mainly because of weakness in manufacturing, but is expected to pick up to 3.8% in 2020 as private investment recovers. Some of the new investment into manufacturing may start kicking in with new production next year. Construction will stagnate this year and next as real estate remains weak and fewer construction permits are issued. Growth in services will moderate to 5.8%

3.26.1 Selected economic indicators (%)

	2019	2020
GDP growth	4.5	4.7
Inflation	2.0	2.7
Current account balance (share of GDP)	2.4	2.4

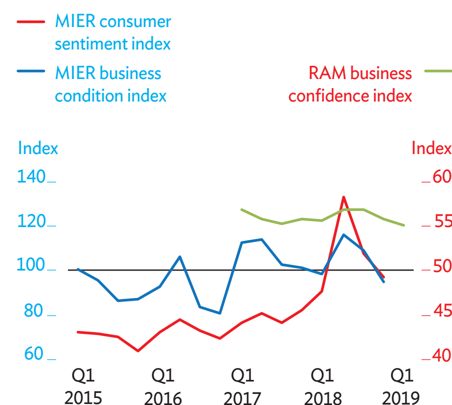
Source: ADB estimates.

3.26.5 GDP growth



Source: *Asian Development Outlook* database.

3.26.6 Consumer and business confidence indexes



MIER = Malaysia Institute of Economics Research.

Note: Above 100 indicates improvement in business conditions and rising consumer confidence.

Sources: Haver Analytics (accessed 11 March 2019); RAM Rating Services Berhad.

this year and next, returning to trend after the boost it got last year from temporary exemption from the goods and services tax.

Inflation is expected to rebound from its dip last year to 2.0% this year and 2.7% next year, despite slowing growth and lower global oil prices, with the fading of last year's downward pressure on prices from the tax holiday. In 2020, inflation should return to its medium-term trend (Figure 3.26.8).

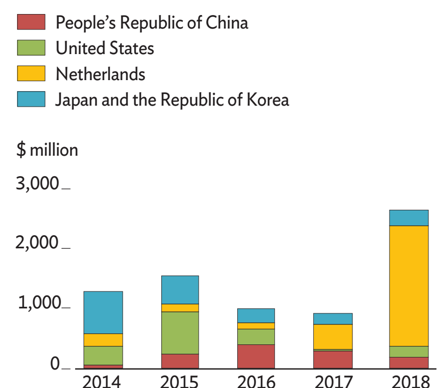
Export growth is expected to continue to slow in line with weaker global economic conditions. Import growth should also remain subdued with slowing economic growth at home. Although exports may get a small boost from resumed natural gas exports after last year's disruption, as well as some pickup from the redirection of manufacturing production with the trade conflict between the US and the People's Republic of China, export prospects remain muted. As the Pengerang petrochemical and refining complex hits full production in 2020, though, it will likely provide some impetus to exports. The suspension of infrastructure projects will reduce imports of construction materials and machinery, though these imports may revive in 2020 as private investment recovers. On balance, the current account surplus is forecast to widen marginally to the equivalent of 2.4% of GDP in 2019 and 2020. With foreign direct investment inflows more than offsetting portfolio outflows, the financial account is expected to remain in surplus. The external payments position should therefore remain comfortable.

Despite slowing growth, the government will consolidate its finances and pursue institutional reform to strengthen public finance and the fiscal management system. In line with consolidation, the government is adopting zero-based budgeting, which requires that all expenses be justified for each new period; improving government procurement systems; and moving away from cash to accrual accounting, counting income when it is earned and liabilities when they are billed, not when cash changes hands. The government is further committed to greater transparency in reporting contingent liabilities and off-budget investments.

Monetary policy is expected to be accommodative. The central bank is unlikely to raise its policy interest rate with inflation not forecast to breach the official target. The financial system remains strong, with banks well capitalized and sufficiently liquid to provide ample credit and to ride out any financial volatility. The resulting policy space allows the central bank to respond quickly and effectively as macroeconomic conditions evolve.

Risks to the outlook tilt downward. Any escalation of trade tensions between the US and People's Republic of China could derail Malaysia's highly trade-dependent economy. The new government's continuing reexamination of many large

3.26.7 High-tech manufacturing FDI approvals by country, Q1–Q3 2014–2018



Note: High-tech manufacturing includes machinery & equipment, electronics and electrical products, transport equipment, and scientific and measuring equipment.

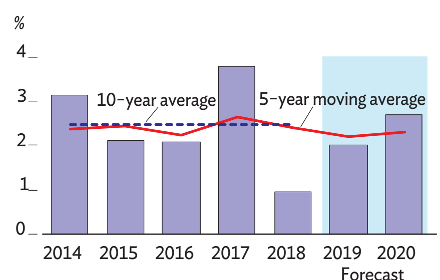
Source: Malaysian Investment Development Authority. http://www.mida.gov.my/home.

3.26.2 Investment approvals, 2018

Sector	Foreign (% total approvals)	Growth (% year on year) Foreign	Domestic
Primary	56.0	11.0	65.1
Manufacturing	83.0	24.0	43.5
Services	14.0	–25.0	10.5
Total	**46.0**	**–7.0**	**20.7**

Source: Malaysian Investment Development Authority. http://www.mida.gov.my/home.

3.26.8 Inflation



Source: *Asian Development Outlook* database.

infrastructure projects approved by the previous administration creates uncertainty for foreign and domestic investors alike. Finally, persistent oversupply in the housing market could trigger housing price declines and dampen confidence.

Policy challenge—boosting private investment to take up slack in public investment

Malaysia's export-led growth model has succeeded in establishing a strong manufacturing base, and its investment climate continues to be one of the most attractive in Asia. The model has enabled the country to raise the ratio of investment to GDP significantly over 25%, which is high by international standards. Almost half of domestic investment in 2000 to 2015 has been public (Figure 3.26.9).

The new government's decision to cancel or postpone investment projects is a tacit admission that the return on many public projects is low and will only add to the nation's indebtedness. It is thus highly likely that public investment will continue to slow in the coming years. As the government winds down many investment projects, it needs to consider how it can catalyze private investment.

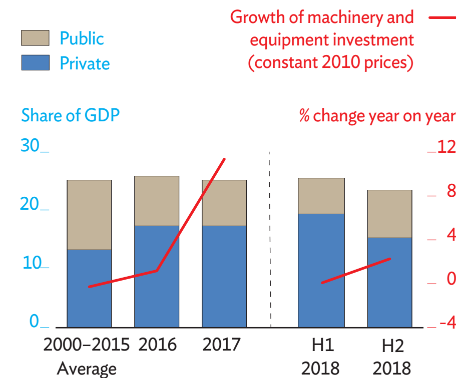
As policy makers strive to foster a new "entrepreneurial economy," to echo a phrase used in the 2019 budget, they need to pay attention to both the scale and the quality of private investment. This will be best achieved with policy measures that improve the business and investment climate in ways that attract private investors. This requires concerted action in three areas:

First, the government should minimize policy uncertainty by better communicating its capital spending priorities and enhancing transparency in its fiscal accounts, particularly on contingent liabilities and tax expenditure. The government is adopting some of these policies but should broaden their application to the rest of the public sector.

Second, the government should invest in strengthening workforce skills to attract private investment in high technology. Such investments align with the vision of making Malaysia—as articulated in the Industry 4.0 development strategy unveiled in November 2018—a strategic partner in smart manufacturing, a primary destination for high-technology industries, and a provider of total tech solutions for the region (Figure 3.26.10).

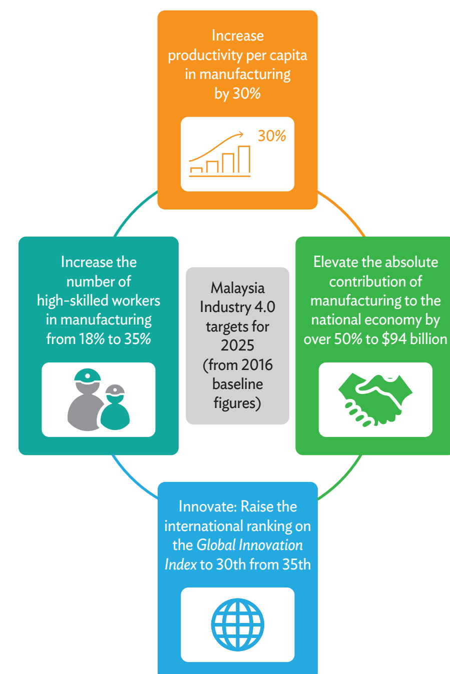
Finally, the government should minimize tax incentives for investors, which studies have shown are costly but tend to do little to sustain private investment over the long term. Rather than undermine fiscal revenue through tax incentives, the government can use the revenue it collects from investors for vocational training and enhancing workforce skills, among other priorities.

3.26.9 Share of investment in GDP and growth in machinery and equipment investment



H = half.
Source: Haver Analytics (accessed 8 March 2019).

3.26.10 National goals and targets under Industry 4.0



Source: ADB estimates based on Industry 4WRD: National Policy on Industry 4.0.