AMRO Annual Consultation Report

Malaysia – 2018-19

The ASEAN+3 Macroeconomic Research Office (AMRO)

May 2019

Acknowledgments

1. This Annual Consultation Report on Malaysia has been prepared in accordance with the functions of AMRO to monitor, assess and report its members' macroeconomic status and financial soundness, to identify relevant risks and vulnerabilities, and to assist them in the timely formulation of policy to mitigate such risks (Article 3 (a) and (b) of the AMRO Agreement).

2. This Report is drafted on the basis of AMRO's Annual Consultation Visit to Malaysia from 22-30 January 2019 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr. Sumio Ishikawa, Group Head and Lead Economist. The team members also included Ms. Diana del Rosario (Country Economist for Malaysia), Dr. Abdurohman (Fiscal Specialist), Mr. Justin Lim (Researcher), Dr. Dan Lu (Economist) and Mr. Phanomphone Keovongvichith (Associate). AMRO Chief Economist Dr. Hoe Ee Khor also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on Malaysia for 2018-19 was peer reviewed by Dr. Lee Jae Young (Group Head and Lead Economist) and Mr. Anthony Tan (Senior Economist); and approved by Dr. Hoe Ee Khor, AMRO Chief Economist.

3. The analysis in this Report is based on information available up to 11 March 2019.

4. By making any designation of or reference to a particular territory or geographical area, or by using the term "member" or "country" in this Report, AMRO does not intend to make any judgments as to the legal or other status of any territory or area.

5. On behalf of AMRO, the Mission team wishes to thank the Malaysian authorities for their comments on this Report, as well as their excellent meeting arrangements and hospitality during our visit.

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Executive Summary

The Malaysian economy proved resilient to escalations in U.S.-China trade tensions and domestic commodity supply disruptions in 2018, thanks to robust private consumption and low inflation that persisted through the year. Although the unexpected election outcome and heightened global risk aversion triggered sharp foreign capital outflows in May through the second half of the year, financial conditions have remained stable and BNM's reserves are adequate to cover external funding needs. Despite the revamp in fiscal management, fiscal consolidation has continued. Going forward, the policy mix should focus on sustaining fiscal consolidation efforts while safeguarding financial and external stability.

1. **The Malaysian economy remained resilient despite a moderation in 2018.** Robust private consumption drove real GDP to expand by 4.7 percent in 2018, although growth moderated from a three-year high of 5.9 percent in 2017. Private consumption in particular accelerated during the general elections in Q2 and when the goods and services tax (GST) was zero-rated in Q3. Meanwhile, growth eased on account of lackluster investment and a slower pace of export expansion. In 2019-2020, GDP growth is expected to remain moderate at around 4.6-4.7 percent, reflecting the ongoing fiscal consolidation, slowdown of the global electronics cycle, lower crude oil prices and spillovers from the uncertainty over the global trade outlook arising in part from the U.S.-China trade tension.

2. **Inflation has been subdued and is likely to remain benign through 2020.** Both headline and core inflation were generally on a declining trend in 2018. Notably, the headline and core inflation dipped below 1 percent in June through August when the GST was zero-rated and remained low despite the re-introduction of the sales and services tax (SST) in September. Looking ahead, headline inflation is expected to climb 60 basis points higher to 1.6 percent in 2019 before reverting towards the long-run trend of nearly 2.5 percent in 2020.

3. **The external position remains strong despite sizable portfolio investment outflows.** The current account remained in surplus in 2018, but was narrower owing to the wider primary income deficit. Likewise, after easing sharply in Q2 and Q3, FDI inflows rebounded in the final quarter to post a full-year average of 2.4 percent of GDP. These relatively steady foreign inflows cushioned the sizable portfolio investment outflows in 2018, particularly from non-residents in May and June, following the unexpected change in the Malaysian government and heightened risk aversion towards emerging markets more broadly. The balance of payments recorded a modest surplus in 2018, while foreign currency reserves held by Bank Negara Malaysia (BNM) have remained above USD100 billion, sufficient to finance seven months of retained imports and equivalent to the stock of short-term external debt.

4. **Financial conditions have remained accommodative notwithstanding the policy rate adjustment and capital outflows in 2018.** Bank lending rates stabilized over the course of the year after rising in tandem with the 25 bps policy rate hike in January 2018. Despite the capital outflows, banks' excess ringgit liquidity placed with the BNM was fairly stable throughout the year, while bank credit gained pace after a multi-year period of moderation for both households and businesses. Banks have significant capital and liquidity buffers, stable asset

quality and healthy funding profiles. However, regulators should continue to monitor the vulnerabilities from banks' exposure to the real estate sector and their elevated levels of external debt.

5. **While fiscal management has been restructured, fiscal consolidation has continued under the new government.** The budget deficit targets for 2018 and 2019 were revised up to 3.7 percent and 3.4 percent of GDP, respectively, to incorporate provisions for the outstanding tax refunds and commitments that were unbudgeted under the previous government as well as the special dividend from PETRONAS. Notwithstanding the revision, the adjusted fiscal deficit is set to decline in 2019 after netting out the one-off expenses and revenue items. Fiscal consolidation should continue given the sizable debt burden, especially when transfers for the servicing of some of the government-guaranteed debt are included.

6. **Downside risks have intensified, although the economy's sound fundamentals will serve as a buffer against adverse shocks in the near term.** Malaysia's highly open and commodity-oriented economy implies vulnerability to a deterioration in global demand, escalation of trade tensions, lower crude oil prices, and sharp reversals in investor sentiment arising from a sudden tightening in global financial conditions. Domestically, the narrowing tax base could impede the progress of fiscal consolidation over the medium term, if not reversed.

7. **Medium-term fiscal consolidation entails the need to improve the tax buoyancy within a broader set of fiscal reform initiatives.** The authorities are on the right track to initiate fiscal reforms in the areas of governance, expenditure and revenue. Increasing transparency in fiscal reporting, imposing a three-year expenditure ceiling, shifting to a targeted subsidy scheme and setting up a committee to review the existing tax system should aid in fiscal consolidation. In addition, existing revenue-mobilization efforts should aim at reversing the decline in the non-petroleum-related tax-to-GDP ratio.

8. **Monetary policy should remain on hold as it balances the need to support growth while containing risks to financial and external stability.** It would be prudent to maintain the current policy stance to support external and domestic stability given the uncertainty in the external environment and the high level of public and household debt. However, the degree of policy accommodation could be eased in the event of a sharper economic slowdown.

9. **Considering the high degree of financial openness, reserves should be higher to provide a stronger buffer to external shocks.** While reserves are currently adequate, it would be prudent for the BNM to build reserves to a higher level while allowing the currency to adjust flexibly to market conditions. A higher reserves cover would provide greater flexibility for the BNM to calibrate the monetary policy stance to support the economy against adverse shocks.

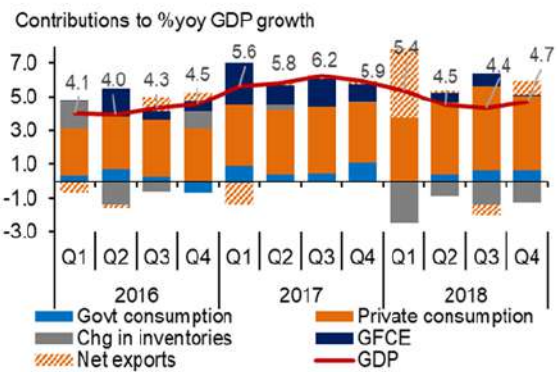
10. **A sustained and concerted effort to boost productivity is crucial in order to attain a more inclusive and high-income nation.** Innovation and R&D should be promoted to attract high value-added private investments, and consequently, raise the quality of employment and improve income distribution. In this regard, a well-coordinated set of efforts should be made to promote fair competition, greater technological adoption among firms, and human capital development.

A. Recent Developments and Outlook

A.1 Real Sector Developments and Outlook

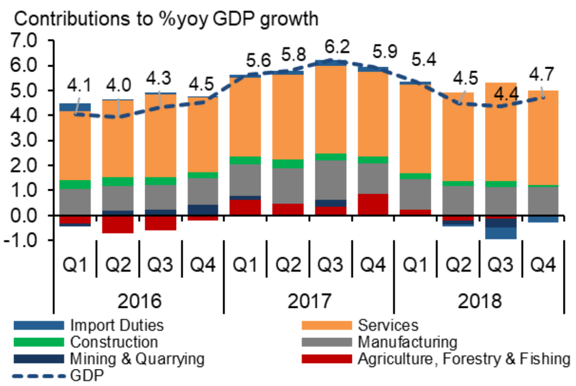
1. **The Malaysian economy continues to grow above potential despite a moderation in 2018.** Real GDP grew at 4.7 percent in 2018 following a three-year high of 5.9 percent in 2017, driven mainly by robust private consumption. Private consumption accelerated in Q2 during the general elections and in Q3 when the GST rate was brought down from 6 percent to zero. Strong consumer spending boosted the services sector, particularly retail trade, motor vehicles, and restaurants and accommodation. Meanwhile, growth eased on lackluster investment and a slower pace of export expansion. Investment had slowed after a strong performance in 2017, owing to the near-completion of a major oil and gas project, in addition to the other projects in the energy and utility sectors that have been completed, and supply overhang in certain segments of the real estate sector.[1] In addition, election-related uncertainties may have also held back capital spending. While export earnings moderated last year, volumes weakened significantly due to the supply disruption in natural gas and slowdown in electrical and electronics shipments.[2] Following the softening of economic activity, the positive output gap narrowed.

Figure 1. Real GDP Growth – Demand Side



Source: Department of Statistics Malaysia (DOSM)

Figure 2. Real GDP Growth – Supply Side



Source: DOSM

2. **Looking ahead, GDP growth is expected to remain moderate through 2020 owing to external headwinds and fiscal consolidation.** In 2019, GDP growth is expected to inch lower to 4.6 percent, reflecting the ongoing fiscal consolidation and headwinds arising from the slowdown of the global electronics cycle, lower crude oil prices, and uncertainty over the global trade outlook arising in part from the U.S.-China trade tension. Already, the leading index and manufacturing PMI point to softer near-term growth. Nonetheless, the economy will continue to be supported by buoyant private consumption – notwithstanding the re-introduction of the SST in 2018 – as inflation remains low while employment and wages have continued to rise.

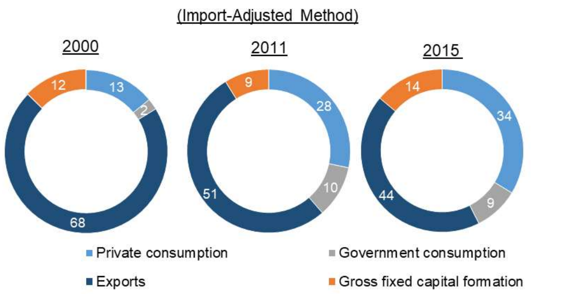
[1] The major oil and gas project refers to the USD16 billion Refinery and Petrochemical Integrated Development Project (RAPID) of state-owned energy firm Petroliam National Berhad (PETRONAS), for which construction started in 2013, and is set to be completed by early 2019.

[2] Mining sector output was pulled down by the drop in the supply of natural gas owing to pipeline issues in East Malaysia, and where production is only expected by PETRONAS to return to full capacity at the earliest by June 2019 given ongoing repairs and assessment works. Likewise, CPO output declined and cut agricultural sector output on a yoy basis in Q2-Q4 2018. On the demand side of the national income account, CPO dynamics was likely one driver behind the inventory drawdown in H1 given the sharp increases in overseas CPO shipments despite the drop in output during the period. CPO production weakened in 2018 following the surge in production (+15 percent) in 2017 owing to recovery from El Niño in the preceding year.

Moreover, the recovery in crude palm oil (CPO) and natural gas production is expected to support growth through 2020, although risks are tilted to the downside owing to a weakening of global demand. Reflecting the moderate growth, the positive output gap is projected to narrow over the medium term.

3. **In terms of value-added contribution, domestic demand has become the major component of the economy.** The rising contribution of domestic demand is led by private consumption, whose share has grown from 13 percent in 2000 to 34 percent of Malaysia's GDP in 2015. Government consumption has also grown in significance since 2000, although it slowed after 2011, owing to fiscal consolidation. The value-added analysis suggests that dependence on external demand has declined sharply over time although it remains large at 44 percent of GDP. Going forward, private sector domestic demand is expected to grow in importance as a driver of economic growth, in view of the growing external headwinds and fiscal constraints.

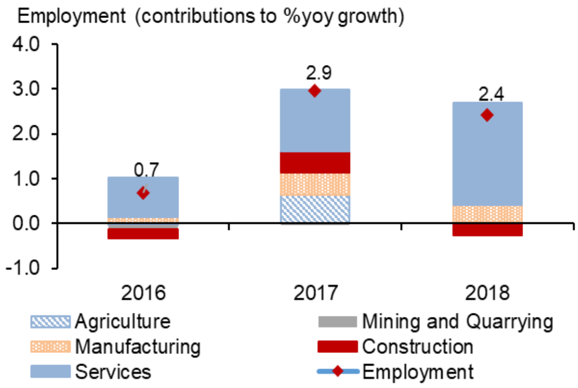
Figure 3. Value-added Contribution to Real GDP



Note: Based on the alternative GDP decomposition method of subtracting the import contents from final demand.
Source: DOSM; AMRO staff calculations

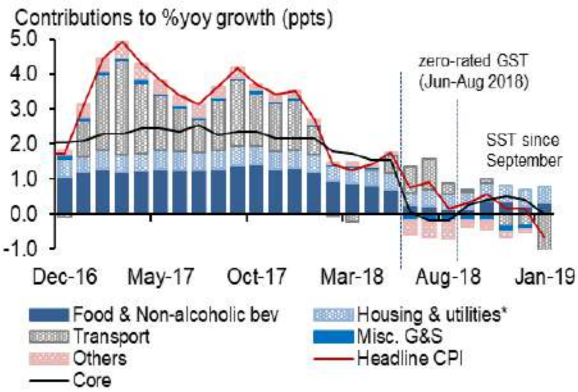
4. **Labor market conditions have been supportive of economic growth.** The unemployment rate has decreased steadily from 3.5 percent in 2016 to 3.3 percent in 2018. Employment grew by over 2 percent in 2018, driven primarily by the services sector and followed by manufacturing. Real wage growth in the manufacturing and services sectors, which account for over three-quarters of the total employment, also improved in 2018 relative to 2017.

Figure 4. Employment Condition



Note: Annual figures refer to Q4 of the cited year.
Source: DOSM

Figure 5. CPI Inflation



*Refers to housing, water, electricity, gas & other fuels
Source: DOSM

5. **Inflation has been subdued and is likely to remain benign through 2020.** Both headline and core inflation were generally on a declining trend in 2018. Headline inflation was initially dropped sharply as fuel prices were frozen starting in March 2018. Subsequently, headline and core inflation dipped below 1 percent in June-August when the GST was zero-rated, and have remained low despite the re-introduction of the SST in September. Inflation turned negative in January 2019 amid lower fuel prices, although this should be temporary given a

number of inflationary factors this year.[3] Looking ahead, headline inflation is expected to climb by 60 basis points (bps) to 1.6 percent in 2019 before reverting towards the long-run trend of nearly 2.5 percent in 2020.

Authorities' Views

6. **The authorities broadly concur with AMRO's assessment of the growth and inflation outlook.** According to the 2019 Budget announced in November 2018, the Ministry of Finance (MOF) expects the economy to grow by 4.9 percent in 2019 and headline inflation to settle in the 2.5-3.5 percent range. The MOF, however, cautions that the outlook may be subject to revision given the recent decline in crude oil prices and a moderation in global growth. The BNM, in its latest monetary policy statement, said it expects private sector demand to remain the key driver of economic growth as it offsets lower public spending arising from ongoing fiscal consolidation. Meanwhile, external demand is expected to soften amid weakening global growth momentum, and risks to the growth outlook are tilted to the downside primarily owing to a potential escalation of trade tensions and commodity-related shocks. Inflation is expected to be broadly stable, dampened by low crude oil prices and the impact of changes in the consumption tax policy. The absence of strong demand pressures is expected to contain underlying inflation.

A.2 External Sector and the Balance of Payments

7. **Merchandise exports grew moderately in 2018 as they showed signs of vulnerability to external headwinds.** Following an 18.8 percent expansion in 2017, merchandise exports grew at a slower rate of 6.8 percent in ringgit terms in 2018. In U.S. dollar terms, merchandise exports growth accelerated to nearly 20 percent yoy in H1 2018 – led by machinery and transport equipment, including electrical and electronic products – before decelerating to about 9 percent in H2 2018. The robust growth in H1 was driven by faster price increases which more than offset the slowdown in export volumes, particularly of machinery and transport equipment and natural gas shipments. Export prices, however, slowed down in H2 along with the continued easing in volume growth, owing to weaker demand from China, Hong Kong and the E.U. Moreover, netting out re-exports which accelerated last year, domestic exports exhibited a steady decline in growth amid the escalation of the U.S.-China trade tension and weaker global demand.[4]

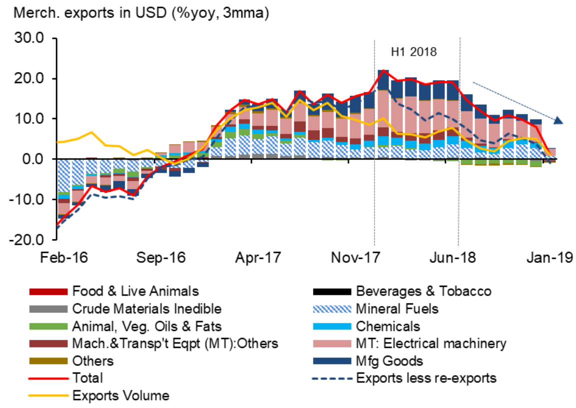
8. **The external position remains supported by a sustained current account surplus and steady FDI inflows despite sizable portfolio investment outflows.** The current account remained in surplus in 2018, but narrowed owing to a wider primary income deficit. The goods trade surplus was broadly maintained, propped up by subdued imports despite softer exports. After declining sharply in Q2 and Q3, FDI inflows rebounded in the final quarter – mostly into manufacturing and the non-financial services sectors – to post a full-year average of 2.4 percent of GDP, but they were lower than the preceding five-year average of 3.5 percent. These

[3] These factors include initiatives to broaden the SST coverage (such as the expansion to cover amusement park operations and cleaning services starting in March), the minimum wage hike in January, higher electricity tariffs in March-June, and introduction of a tax on sugar-sweetened beverages in July.

[4] Malaysia's re-exports accounted for 25 percent of total exports in 2018, rising sharply from 18.0 percent in 2017 and 16.9 percent in 2016.

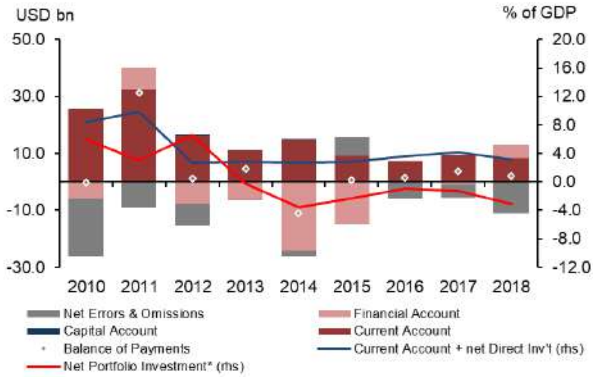
relatively steady foreign inflows cushioned the sizable portfolio investment outflows in 2018, particularly from non-residents in May and June following the unexpected change in the government and heightened risk aversion. Overall, notwithstanding the larger outflows in net errors and omissions, the BOP recorded a modest surplus in 2018.

Figure 6. Merchandise Trade



Source: BNM; DOSM

Figure 7. Balance of Payments



*Positive value means inflow.
Source: BNM; DOSM

9. **The BNM's reserves have declined since April 2018, reflecting vulnerabilities to capital outflows.** The BNM's foreign currency reserves fell USD8.1 billion by the end of the year following a steady build-up from January 2017 until April 2018. The decline was roughly in line with the outflows in non-resident portfolio investments, which caused the ringgit to depreciate, albeit less than other emerging market currencies. In 2019 so far, the ringgit has strengthened slightly against the dollar in line with the increase in reserves. As of March 2019, the BNM's foreign reserves remained adequate at USD103.0 billion and were sufficient to finance 7.5 months of retained imports. The reserves were also equivalent to the short-term (ST) external debt, although the coverage will be higher once the external debt is adjusted for the intragroup component of the Malaysian banking groups to reflect the lower risk of such liabilities (see Annex 1 on An Examination of Malaysia's External Debt). Moreover, the reserves-to-ST external debt ratio will remain above one after netting out the BNM's forward position from gross reserves. The BNM's net short position in the forward market grew over the course of 2018 as the central bank injected ringgit liquidity to ease the tightening impact of the capital outflows.

10. **The currently benign global financial conditions could provide an opportunity for the BNM to rebuild buffers amid a resumption of foreign capital inflows.** The current account surplus is expected to narrow slightly in 2019 as external demand softens while imports increase in line with a modest investment pick-up amid greater policy clarity under the new government. On the other hand, the rebound in FDI inflows in Q4 2018 could be sustained through 2019 following the surge in foreign investment approvals particularly from China, Indonesia, the Netherlands, Japan and the U.S., according to Q3-Q4 2018 data. Moreover, while subject to a high degree of uncertainty, financial markets' currently benign expectations of monetary policy normalization in the U.S. coupled with Malaysia's sound macro fundamentals – as demonstrated by the economy's resilience to external shocks and the government's firm commitment to fiscal consolidation – could lead to an inflow of foreign capital into the local debt

and equity markets. In the first two months of 2019, foreign investors turned into net buyers in the equity and debt markets after several months of net selling in 2018.

Authorities' Views

11. **The unexpected election outcome in May has prompted the BNM to take a cautious stance.** The BNM was active in the foreign exchange market in 2018 to smoothen out the ringgit's volatility following the sharp reversals in foreign portfolio investments in May-June and continued non-resident capital outflows through the rest of the year. It was also actively involved in FX swap operations to manage ringgit liquidity in the money market amid capital outflows. Its cautious stance contributed to the modest decline in reserves and a buildup in the short forward position, but within the BNM's undisclosed internal limits. The BNM also noted that its reserves only account for a quarter of the country's external assets. The remaining three-quarters are held by domestic corporations, saving institutions and banks, and these can be drawn upon by respective parties to meet their external obligations without creating a claim on the BNM's reserves.

A.3 Monetary Conditions and Financial Sector

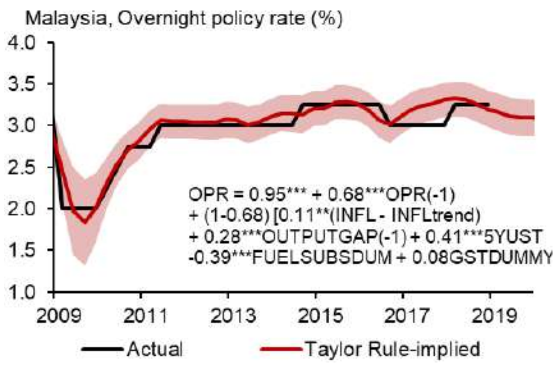
12. **Funding and liquidity conditions have remained conducive to financial intermediation despite the policy rate adjustment and capital outflows in 2018.** Borrowing costs increased by about 25bps following the policy rate hike of the same magnitude in January 2018. The interbank rates across maturities and the weighted average base rate – the reference rate for floating rate loans – subsequently stabilized over the course of the year. Despite the capital outflows, the banking system's surplus ringgit liquidity placed with the BNM – comprising placements, reverse repos and statutory reserves – remained ample at MYR175 billion as of January 2019. Meanwhile, bank credit growth started to gain pace at the start of 2018 after a multi-year period of moderation for both households and businesses. Based on our estimate of the Taylor Rule, the current overnight policy rate of 3.25 percent is at an appropriate level, in line with domestic and external developments.

13. **The financial sector is generally sound, although vulnerabilities arising from both banks' exposure to the real estate sector and elevated levels of external debt should be closely monitored.** Banks have significant capital and liquidity buffers, stable asset quality, healthy funding profile and slightly improved profitability. Nonetheless, the elevated household debt – although it is on a downward trend since 2015 – and moderately high non-financial corporate debt (relative to emerging market Asian peers) warrant continued monitoring for credit risk. For example, while gross impaired loan ratios are low and even lower when provisions are accounted for, some sectors such as transport, storage and communication, mining and quarrying, finance, insurance and business activities, and construction, either register higher ratios relative to end-2017 or are above the headline ratio of 1.5%.[5] Of the four sectors, banks have a higher exposure to real estate at 7 percent of total loans and construction at 5 percent, and thus closer monitoring of these two sectors continues to be warranted given the supply

[5] The impaired loans of the real estate sector are included under the 'finance, insurance and business activities' category.

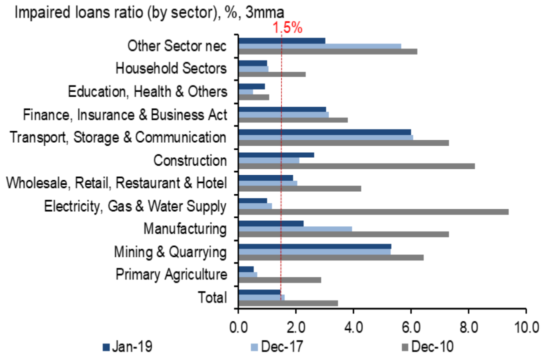
overhang in the high-end residential property segment as well as in the office space and shopping complexes (see Box A. An Update on the Property Market). Also, the country's external debt at 64.7 percent of GDP as of end-2018 and the short-term component (by original maturity) at 28.3 percent – with the banking sector accounting for over 70 percent of total short-term – are on the high side relative to emerging market peers. Although a considerable portion of the external debt is due to intragroup borrowings of Malaysia's banking groups, it still calls for continued vigilance on the part of regulators.

Figure 8. Actual vs. Taylor Rule-implied Policy Rates



Note: Assumes a 25bps hike in the U.S. Fed funds rate in 2019. INFL trend refers to the deviation of the headline inflation from trend.
Source: AMRO staff estimates

Figure 9. Gross Impaired Loans Ratio by Sector



Note: The ratio is in terms of total banking system loans of the said sector.
Source: BNM

Table 1. Selected Financial Soundness Indicators

Percent, %	2016		2017				2018			
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Common Equity Tier 1 Capital to Risk-Weighted Assets	13.3	13.6	13.1	12.9	13.2	14.0	13.2	13.3	13.2	13.1
Total Capital to to Risk-Weighted Assets	16.7	17.0	17.0	17.0	17.1	17.8	17.6	17.6	17.3	17.4
Impaired Loans to Total Gross Loans	1.6	1.6	1.6	1.6	1.7	1.5	1.6	1.6	1.5	1.5
Net Impaired Loans to Net Total Loans	-	-	-	-	-	-	1.0	1.0	0.9	0.9
Loan-to-Deposit Ratio	87.9	88.9	88.4	89.0	88.2	88.9	87.7	88.6	88.6	87.3
Loan-to-Fund Ratio	83.3	84.2	82.7	83.3	83.0	83.9	82.3	83.9	84.1	82.7
Loan-to-Fund and Equity Ratio	74.5	75.2	74.0	73.1	73.0	73.5	71.8	73.2	73.4	72.4
Non-interest Expense to Gross Income	43.6	44.0	45.6	43.8	43.6	43.1	42.3	41.3	41.9	-
Return on Assets, annualized	1.4	1.3	1.3	1.4	1.4	1.5	1.4	1.5	1.4	1.4
Return on Equity, annualized	12.8	12.5	11.8	12.7	12.8	13.0	12.4	13.3	12.7	12.6
Interest Margin to Gross Income	60.4	61.0	64.2	62.5	62.7	61.1	58.5	58.6	60.4	-
Liquidity Coverage Ratio	126.4	124.3	130.7	140.8	135.9	134.9	139.8	139.3	139.5	143.2
Liquid Assets to Short-Term Liabilities	134.7	134.5	138.1	150.2	143.3	142.0	152.8	151.7	144.8	

Source: BNM; IMF FSI Database

Authorities' Views

14. **The BNM continues to ensure financial conditions remain accommodative, while risks to financial stability are contained.** The BNM stresses the degree of monetary accommodativeness is consistent with its current monetary policy stance, while its monetary operations will continue to ensure sufficient liquidity to support intermediation activity and the orderly functioning of markets. Risks to financial stability from exposure to some sectors with a weaker credit outlook are mitigated by the banks' sound underwriting standards and risk management practices and also complemented by existing macro-prudential measures. As for the elevated external debt level, the BNM stresses that banks' short-term external debt is sufficiently backed by highly liquid assets, and anchored by their resilience to external funding and currency shocks under regular stress testing exercises. The external debt also has a

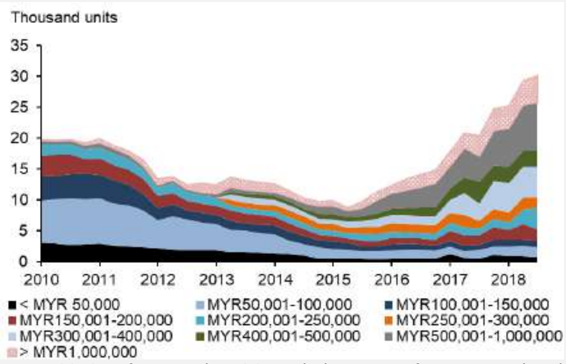
favorable risk profile: over a third of the short-term external debt is in the form of intragroup borrowings, which are less likely to be subjected to sudden withdrawals, and at least 30 percent of the total external debt is denominated in ringgit.

Box A. An Update on the Property Market[6]

Imbalances in the residential property market persisted towards the end of 2018. Overall house prices in Malaysia flattened off in 2018 after exhibiting a steady increase since 2009. Notably, prices fell by at most 3 percent in Q3 2018 in Kuala Lumpur and Penang. The weakness in prices reflects the increased overhang in housing supply, with the number of unsold units expanding 3.4 times to 30,115 units by Q3 2018 from the low in June 2015.[7] The supply glut was particularly pronounced in the higher-price segment, reflecting the supply-demand mismatch in the housing sector. Residential properties priced over MYR500,000 (USD122,000) accounted for 40 percent of total unsold units and 75 percent of total unsold by value in Q3 2018.[8] The number of unsold units in this segment grew nearly 8 times since the low in June 2015, whereas the number of unsold units in the affordable segment – priced at MYR250,000 (USD61,000) and below – expanded by only 1.9 times within the same period.

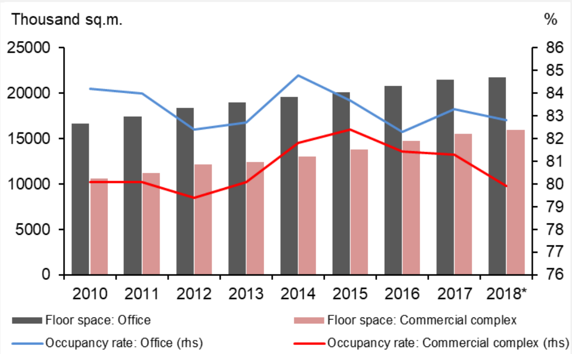
Activity in the commercial segment also softened amid increased supply in office and shopping spaces. Occupancy rates in the retail and office spaces dipped further to 79.9 percent and 82.8 percent respectively, in Q2 2018. Inventory has continued to increase in this segment, albeit at a slower pace in recent years following the downward trend in additional supply. Notwithstanding the slight pickup in the first three quarters of 2018, the number of transactions in the commercial sub-sector has likewise been on a declining trend since 2013. Meanwhile, values transacted were relatively more stable, although it dropped in Q3 2018.

Figure A1. Unsold Residential Property, by Price Range



Note: 2018 refers to the Q3 period. Data refer to completed residential property, where a breakdown by price range is available.
Source: MOF

Figure A2. Supply and Occupancy Rates, Office and Commercial Complex



*Refers to Q3 2018 period for floor space and Q2 2018 for occupancy rate.
Source: MOF

Measures have been taken to address the imbalance and overhang in some segments. In response to the imbalance in the residential property market, the government has suspended the development of residential properties, shopping malls and commercial complexes that are priced at over MYR1 million, since November 2017. This has prompted developers to focus instead on the sale of existing projects. The government has also encouraged the development of affordable

[6] Diana del Rosario (Economist).
[7] The unsold residential units figure cited in the article excludes service apartments and small office/home office (SOHO).
[8] The ratios refer to the unsold portion for of completed residential properties only. The Valuation and Property Services Department of the MOF also provides data on unsold properties that are undergoing construction and are yet to be constructed, although there is no corresponding breakdown by price range.

housing through various programs.[9] In addition, the BNM has instructed banks to strengthen their assessment of financing proposals for new property development or construction projects. These include more robust assessments of the viability of property development projects and greater consideration of location-specific factors, such as the impact of new developments on properties in the surrounding area, in credit assessment. Reflecting the caution taken by banks in the real estate sector, the BNM reported loan approval rates for the construction and purchase of office and shopping complexes declined in 2018. Speculation in the residential property segment has also remained in check, given the more subdued growth in the number of borrowers with three or more outstanding residential property loan accounts.

A.4 Fiscal Sector

15. **While fiscal management has been restructured, fiscal consolidation continues under the new government.** As a result of the new government's comprehensive review of public finances, the budget deficit targets for 2018 and 2019 were revised upwards to 3.7 percent and 3.4 percent of GDP, respectively, a significant deviation from the previous fiscal consolidation path that sought a near-balanced budget by 2020. The new deficit targets, however, incorporate provisions for the outstanding tax refunds and commitments that were unbudgeted under the previous government as well as the one-off special dividend from PETRONAS. Notwithstanding the revision, the fiscal stance is assessed to be expansionary in 2019 albeit with a contractionary bias (see Annex 2 on Assessing Malaysia's Fiscal Policy Stance), thereby reflecting continued fiscal consolidation.[10] After netting out the one-off expenses and revenue items, the adjusted fiscal deficit would be lower at 3.4 percent of GDP in 2018 and 2.9 percent in 2019. The lower deficit in 2019 largely reflects the reduction in current expenditure, particularly in the allocation for supplies and services, in line with the administration's drive to cut unnecessary spending – and subsidies and social assistance – given the plan to move towards a more targeted cash transfer and fuel subsidy system.

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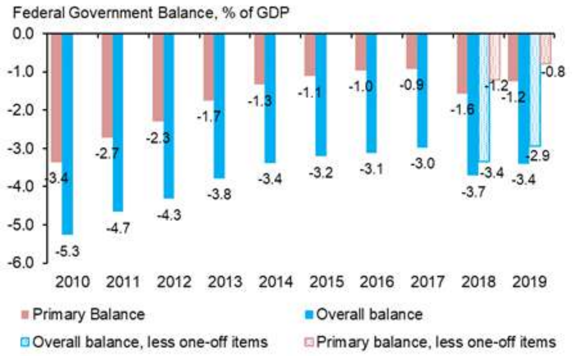
[9] For example, the government has pledged to build 100,000 homes valued at MYR300,000 and below by the end of 2019. The BNM also launched a MYR1 billion Fund for Affordable Homes in January 2019 to aid in the purchase of property priced up to MYR150,000 by those in the lower-income group (those with a monthly household income of <MYR2,300). The Fund will be complemented by a broader range of measures that include stamp duty exemption, affordable rates for mortgage protection cover, and waivers on the legal fees on sales and purchase and financing agreement, which are meant to reduce the ancillary costs of home ownership for buyers with a monthly income of up to MYR5,000 and looking to purchase a first home priced at MYR300,000 or lower.

[10] The current assessment on the fiscal stance is based on a recently agreed AMRO surveillance group-wide guideline to have an internally consistent assessment across countries. The above assessment of an expansionary fiscal stance is based on the cyclically-adjusted primary balance (CAPB), and the bias or fiscal impulse is derived from the annual difference in the CAPB. In an earlier discussion with the authorities, AMRO had indicated a contractionary stance for the 2019 Budget, which was based on the annual difference in the CAPB.

Figure 10. Fiscal Balance



Source: DOSM; 2019 Budget Speech (MOF)

Table 2. Adjusted Fiscal Balance

2018		2019	
Fiscal deficit, official (% of GDP)	**3.7**	Fiscal deficit, official (% of GDP)	**3.4**
One-offs (MYR bn)			
Compensation for the acquisition of the Eastern Dispersal Link in Johor	1.3	GST & Income tax refunds	37.0
GST refund	3.9	*Less* Petronas one-off special dividend	30.0
TOTAL	**5.2**	**TOTAL**	**7.0**
% of GDP	***0.4***	***% of GDP***	***0.5***
Fiscal deficit, adjusted	**3.4**	Fiscal deficit, adjusted	**2.9**

Note: Only the one-off items have been netted out. Off-budget items that have been brought to the Budget and which will continue to be serviced going forward are retained.
Source: 2019 Budget Speech (MOF)

16. **The new tax measures could potentially offset the revenue loss from lower oil prices.** According to our estimates, the fiscal deficit would widen by about 0.3 percent of GDP if crude oil prices stay at USD60 per barrel on average in 2019. Nonetheless, this petroleum-related decline in revenues can be fully offset by tax measures declared in the 2019 Budget Speech in November 2018 that have not yet been fully incorporated in the MOF's estimates of 2019 revenues. The various tax measures, which are to be implemented over the course of the year, could generate about MYR5 billion in additional revenues, equivalent to at least 0.3 percent of GDP (see Box B. Malaysia's Special Voluntary Disclosure Program). Meanwhile, the 2018 budget deficit outturn faced an upside from the stronger pace of revenue collections although the 3.7-percent-of-GDP target was still met eventually as spending was ramped up at the end of the year.

17. **The government has made efforts to enhance the transparency and accountability in public finance with a comprehensive liabilities reporting.** The federal government debt stood at 50.7 percent of GDP as of June 2018, below the self-imposed limit of 55 percent. But in line with the push to be more transparent and prudent in its fiscal management, the government has introduced a broader concept of its debt and liabilities, comprising government debt, committed government guarantees (GGs), the net debt of 1Malaysia Development Berhad (1MDB), and other liabilities.[11] Under this broader concept, the government has explicitly identified those government guarantees (as well as other liabilities) that receive recurring fiscal assistance due, for example, to early stage of operations and insufficient income stream. However, these expenses arising from the financial assistance have in practice been assumed under previous budgets, albeit under a different category from debt service charges. As such, the adoption of this broader concept and the continued assumption of these expenses going forward would not necessarily affect fiscal sustainability. Moreover, the fiscal burden of previously-unbudgeted expense items, such as the servicing of the 1MDB debt and the one-off

[11] Other liabilities refer to obligations (charges for availability, maintenance, asset replacement and other related ones) for public-private partnership (PPP) projects, with concession tenures ranging from 10 to 30 years and final payment commitment to end in 2047. PPP has been used for, among others, the construction of government buildings, the Government Integrated Telecommunication Network, Vehicle Fleet Management System, maintenance of federal roads, the National Enforcement and Registration (Biometric) System, the development of the naval base, and the development of quarters and facilities for the Royal Malaysia Police.

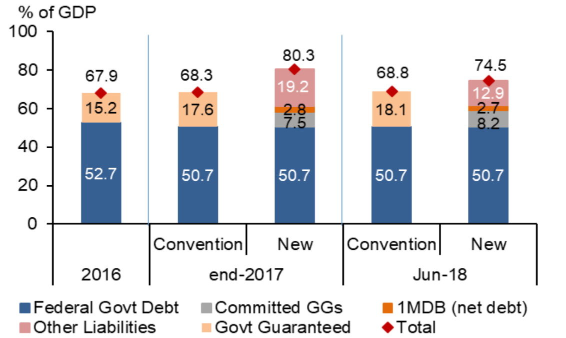
tax refund, are being managed through measures such as the one-off special dividend transfer by PETRONAS in 2019 as well as the selling of 1MDB's assets and other non-core assets of government-linked corporations.

Table 3. Revenue Estimates from the New Tax Measures

Tax Measures	MYR bn	% of GDP
1 Review of income tax relief	1.1	0.07
2 Real Property Gains Tax		
3 Increase in stamp duty		
4 Labuan Tax Reform		
5 Sugar-sweetened beverage	0.3	0.02
6 Special voluntary disclosure program	1.5	0.1
7 Service tax on imported services	1.0	0.07
8 Departure tax (6 months)	1.0	0.07
9 Enforcement: cigarettes	0.5	0.03
NET OVERALL GAIN	5.4	0.36

Note: The said measures were mentioned in the 2019 Budget Speech.
Source: MOF

Figure 11. Federal Government Debt and Liabilities



Other Liabilities refer to those projects under Public-Private Partnership (PPP), Pembinaan Blt Sdn Bhd (PBLT), and private finance initiatives (PFI). The Federal Government Debt stood at 51.8 percent of GDPas of end-2018.
Source: Fiscal Outlook and Federal Government Revenue Estimates 2019 (MOF)

Authorities' Views

18. **The government is strongly committed to meeting its fiscal deficit targets and continuing with fiscal consolidation.** The MOF shared that strong revenue receipts last year, including from the SST, provided an opportunity to bring forward some of the expenses in 2019 to cushion against the adverse impact of lower oil prices. The tax measures being put in place this year would also provide an added buffer to ensure the deficit target is met. At the same time, the government is undertaking an expenditure optimization exercise that involves streamlining the functions of ministries and agencies, scaling down and ceasing programs and projects with low multiplier effects to the economy, and improving government procurement policy. Even so, despite expenditure rationalization, the fiscal policy will remain supportive of Malaysia's economic development.

Box B. Malaysia's Special Voluntary Disclosure Program[12]

The government launched the Special Voluntary Disclosure Program (SVDP) in November 2018 as part of its fiscal reform initiative. The SVDP aims to encourage taxpayers to voluntarily declare any unreported incomes, including those in offshore accounts, under reduced penalty rates. The program has commenced since 3 November 2018 and will end by 30 September 2019. Since its launch, the Inland Revenue Board of Malaysia has issued an Operational Guideline on the SVDP, and stepped up efforts to increase public awareness through various media, and issued notifications to targeted individuals and business establishments.

The SVDP has unique features compared to other countries' tax amnesty programs, with potential revenue impact of at least 0.1 percent of GDP in 2019. The SVDP differs from a regular tax amnesty program in that it requires the payment of previous years' assessment of tax arrears with applicable tax rates. On the other hand, in some tax amnesty programs, such tax arrears are usually waived and only the penalty payment is made at reduced rates. The government initially estimated a

[12] Prepared by Phanomphone Keovongvichith (Associate).

revenue impact of MYR1.5 billion (0.1 percent of GDP) in 2019 from the SVDP, although it was also noted that impact could potentially reach MYR10 billion or 0.7 percent of GDP. As of 24 March 2019, a total of 203,325 people had voluntarily disclosed their undeclared incomes and paid MYR1.304 billion of taxes and penalties.[13]

Meanwhile, the SVDP could enhance tax compliance. Under the current system, less than 20 percent of the 14 million workforce and 1.1 million business establishments are paying income tax.[14] While Malaysia has had similar voluntary disclosure programs in 2015 and 2016, the current program could be more effective in improving tax compliance with the commencement of the Automatic Exchange of Information under the OECD Common Reporting Standards.[15]

B. Risks, Vulnerabilities and Challenges

19. Downside risks to the economy have intensified, although sound macro fundamentals will serve as a buffer to adverse shocks in the near term. Malaysia's highly open and commodity-oriented economy implies vulnerability to a deterioration in global demand, escalation of trade tensions, lower crude oil prices, and sharp reversals in investor sentiment arising from a sudden tightening in global financial conditions. Over the long term, the narrowing tax base could impede progress in fiscal consolidation.

Table 4. Summary Heat Map for Key Near-term Risks

Risks		Likelihood 2018	Likelihood 2019	Potential impact
Domestic	Delays in medium-term fiscal consolidation			**Medium**
External	Escalation of U.S.-China trade tensions			**Medium**
	Weaker global economic growth			**Medium**
	Lower crude oil prices			**Low to Medium**
	Sharp tightening in global financial conditions			**Medium**

Low Likelihood	**Low to Medium**	**Medium**	**High**

Source: AMRO staff assessment

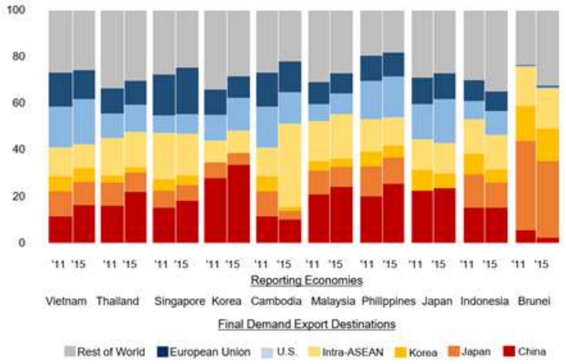
B.1 Near-term Risks to the Macro Outlook

20. **Weaker global demand and an extended period of uncertainty over the global trade outlook – particularly triggered by the U.S-China trade tensions – could lead to a sharp slowdown in economic activity.** Malaysia depends on China, the E.U., and the U.S. for over 40 percent of its exports using the value-added concept. As such, potentially higher tariffs arising from the U.S.-China trade tensions and weaker growth in the major economies could reduce export earnings, which in turn, could to lead to slower economic growth given the over 40 percent share of the external sector (using the value-added concept, see Figure 3) in the economy. Already, aside from the deceleration in domestic exports in 2018, Malaysia's exports to China have shown some sensitivity to the deterioration in China's manufacturing activity. In addition, weak export earnings could have a knock-on effect on the broader economy via

[13] As relayed to AMRO staff by the Ministry of Finance Malaysia.
[14] 2019 Fiscal Outlook and Federal Government Revenue Estimates, Ministry of Finance, Malaysia
[15] Malaysia signed the Multilateral Competent Authority Agreement on Common Reporting Standard (CRS) on 27 January 2016.

declines in investment sentiment in the export-oriented sectors and weaker consumer sentiment as the jobs outlook dims.

Figure 12. Share in Value-added Exports, Selected ASEAN+3 Economies



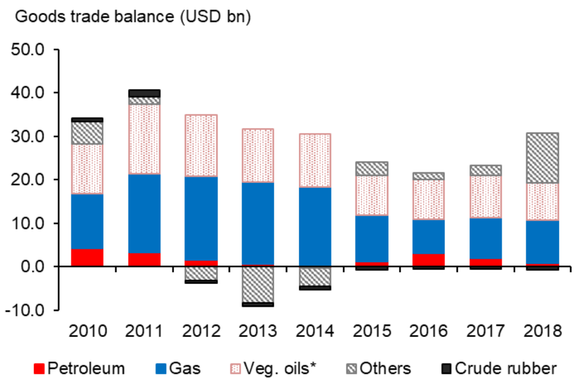
Source: OECD; AMRO staff calculations

Figure 13. Exports to China vs. China's Export Orders

Source: DOSM; IHS Markit

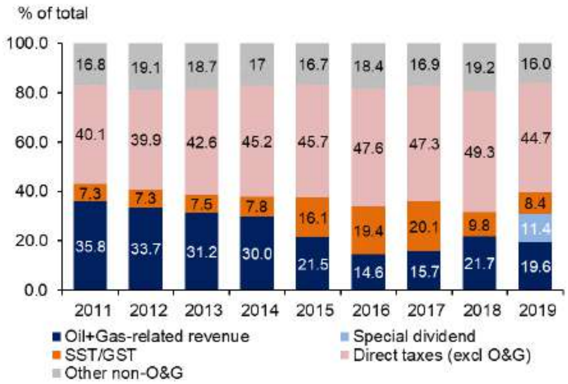
21. **In addition, lower crude oil prices could dampen export earnings and fiscal revenues.** Although the surplus in petroleum-related products only accounts for a relatively minor share of the surplus in the goods trade balance, lower crude oil prices also tend to have a lagged negative effect on gas prices. Malaysia maintains a more sizable surplus in gas products, accounting for about a third of total surplus. As such, lower crude oil prices could dampen exports and contribute to a narrowing of the trade surplus. Moreover, the fiscal position is vulnerable to oil price shocks given the still significant share – although much reduced – of oil and gas-related revenue to total revenue. Given the effect that oil prices may have on the trade balance and fiscal position, the ringgit could also come under pressure if global crude oil prices were to decline sharply.

Figure 14. Trade Balance, Breakdown by Commodity



*Vegetable oils and Fats serve as a proxy for palm oil, as there is no available data on palm oil imports.
Source: DOSM

Figure 15. Fiscal Revenue, Breakdown by Component

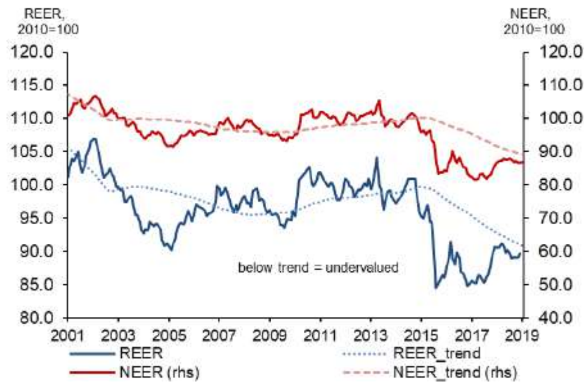


Source: MOF

22. **A sudden tightening in global financial conditions could lead to sharp non-resident capital outflows, putting downward pressure on the ringgit.** Admittedly though, odds of such a scenario materializing have diminished due to increased downside risks to the global growth outlook, which has led monetary authorities of the advanced economies to take a more dovish stance on policy normalization. The risk of volatile capital flows in Malaysia has been further mitigated by the curb on speculative activity, as evident in the higher proportion

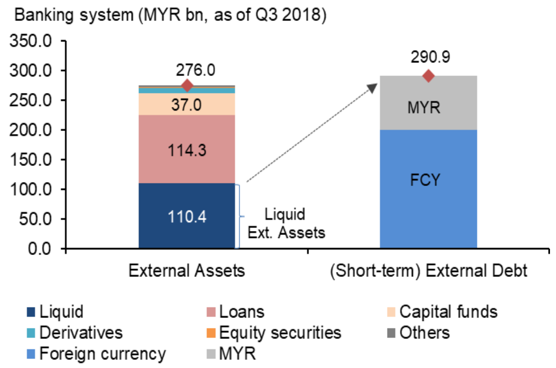
of long-term non-resident investors since end-2016 when the BNM rolled out FX administration measures. Still, the risk of sudden market adjustments and sharp capital outflows remains significant given a potential re-escalation in U.S.-China trade tensions or a sharp decline in crude oil prices in the event of a slowdown in China's growth, which could weaken the fiscal position.[16] Sizable capital outflows, in turn, could place the ringgit under considerable depreciation pressure and wider currency misalignments (See Box C. Stress Testing Resilience to Capital Flows – An Update), while demand from domestic institutional investors could avert a sharp correction in bond and equity prices. The economic impact of a ringgit depreciation is, however, mitigated by the sizable proportion of the external debt that is in local currency, at about 31 percent. As for the potential liquidity impact on the banking system, the risk is low – notwithstanding the system's net short-term external liability position – given that banks' external debt is predominantly in the form intragroup exposures while banks have ample liquidity buffers and are not necessarily reliant on wholesale funding. [17,18]

Figure 16. NEER, REER against Trend



Note: Trend refers to the 5-year historical moving average.
Source: BIS

Figure 17. Liquid External Assets vs. Short-term External Debt – Banking System



Note: Liquid external assets consist of deposits and interbank placements, bonds and notes, and money market instruments. Short-term external debt is a component of external liabilities.
Source: BNM

16 Despite the ongoing trade negotiations between the U.S. and China, the risk of a re-escalation in U.S.-China trade tensions remains given that the U.S. still intends to put in place an enforcement mechanism that could involve punitive tariffs in the event that China reneges on the eventual deal.

17 Banks' intragroup borrowings account for 51 percent of banks' short-term external debt and 38 percent of total short-term external debt, per end-2018 data. The banking system's liquid (domestic and external) assets also comfortably exceed short-term liabilities (see Table 1). The potential impact on the banking system of tighter global financial conditions is further mitigated by the low reliance of onshore banks on external debt to fund domestic intermediation activities. To illustrate, onshore banks' external debt comprise less than 8 percent of their total liabilities, and non-resident deposits make up only 6 percent of total deposits. In particular, the net external liability position of the domestic banking group (DBG) reflects excess liquidity sourced from related offices and medium- to long-term funding raised in international wholesale and capital markets.

18 External liabilities comprise external debt, custodial securities held on behalf of non-resident clients, capital funds maintained by non-residents in resident banks, primarily for locally-incorporated foreign banks (LIFBs), and financial derivative balances. External debt refers to the portion of external liabilities that require payment of principal and/or interest.

Box C. Stress Testing Resilience to Capital Flows – An Update[19]

While past episodes of sharp capital reversals saw orderly market adjustments, Malaysia remains susceptible to volatile capital flows. Malaysia's strong fundamentals, flexible exchange rate, sizable foreign currency (FCY) liquidity and overseas assets as well as adequate FX reserves and timely FX intervention have enabled the effective management of capital flow and exchange rate volatility. As risks of heightened risk aversion remain in the near term, Malaysia's current account surplus has also continued to narrow and the external debt has remained elevated, although reserves have improved somewhat since the sharp decline in mid-2015. Against these recent developments, this box seeks to revisit and update the stress-testing exercise on the resilience of capital outflows that was conducted by IMF staff in 2016.[20]

Table B1. Malaysia Stress Test: AMRO's Assumptions and Simulated Impacts

	Value as at end-2018, USD bn	Stress scenario parameters and assumptions	Impact, USD bn
Outflows			
Foreign holdings in LCY debt securities	44.7	Foreign holdings of LCY debt securities fall by 50 percent (in MYR) - Calibrated based on the decline in foreign holdings during the GFC and - 200bp increase in yields is estimated to reduce the value of a 5-year MGS by an estimated 8.5 percent - FX depreciation of 20 percent implies additional losses for foreign investors	-17.0
Foreign holding of equities	96.3	Assumed to decline by 20 percent (in MYR) - In addition, stock market is assumed to decline by 30 percent (compared with 45 percent during the GFC) - FX depreciation of 20 percent implies additional losses for foreign investors	-2.7
Short-term external debt of the banking system	11.8	Rollover ratio declines to 70 percent - Banking system external debt by 70 percent between Sept 2009 and March 2010	-3.0
Non-resident deposits	23.7	Non-resident deposits fall by 30 percent - Calibrated based on short-term debt assumption - FX depreciation of 20 percent implies additional losses for foreign investors	-6.5
Total impact			**-29.2**
Offsetting Inflows			
Current Account Balance	8.3	Current account balance is assumed to decline to zero. - Current account balance declined by USD8 billion during the GFC	0.0
Estimated resident FCY deposits in the banking system	23.2	- Assumed 50 percent can be used for FX swap transactions with the BNM	11.6
Repatriation of overseas assets by institutional investors		- Assumed 3 percent of GDP of overseas assets can be repatriated under the stress scenario (following IMF's conservative estimate in 2016)	10.6
Total impact			**22.2**
Reserves as at end-2018	**101.4**		
in percent of ARA (%)	**121**		
Estimated Reserves as at end-2019			**94.5**
in percent of ARA (%)*			**113**

Note: ARA refers to the IMF's Assessment of Reserves Adequacy. *Denominator in the computation of ARA refers to 2018 data.
Source: Bank Negara Malaysia Q3 2018 Quarterly Bulletin; Q4 2018 Quarterly Bulletin; IMF and AMRO staff estimates

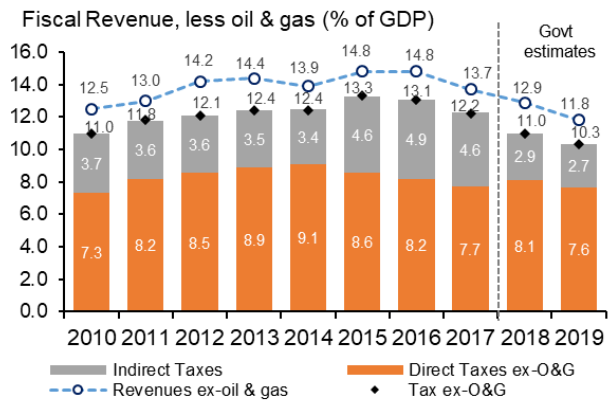
[19] Prepared by Justin Lim (Researcher) and Diana del Rosario (Economist).
[20] Appendix VII. Malaysia—Stress Testing Resilience to Capital Outflows. In *Malaysia: 2016 Article IV Consultation Report* (May 2016).

A tail-risk scenario similar to the GFC could lead to a considerable decline in Malaysia's reserves, although residents' external assets and FCY deposits also provide substantial cushion. The extreme stress scenario largely follows that of the IMF, except for the slight modification in the degree of FX depreciation to take into account the lower crude oil price in the current period relative to pre-GFC.[21] With growth slowing down sharply under the stress scenario, large capital outflows trigger ringgit depreciation and the current account surplus down to zero. The capital outflows, which would entail a commensurate drawdown of USD29 billion on reserves to smoothen market volatility, stem from the unwinding of foreign investments in the domestic debt and equity markets (USD20 billon) and the withdrawal of non-resident deposits as well as placements in the interbank market (nearly USD10 billion). On one hand, the repatriation of a portion of Malaysia's sizable external assets can partially offset the large outflows and drawdown on reserves. In addition, the BNM will be able to conduct FX swap transactions with local banks given the sizable FCY deposits of residents in the domestic banking system, in turn alleviating considerable depreciation pressures on the ringgit. Together, these offsetting inflows provide substantial cushion against external shocks. Reserves at an estimated USD95 billion would remain well above the conventional metric of three months of imports and the ARA metric meets the recommended threshold of 100 percent by the IMF.

B.2 Longer-term Challenges and Vulnerabilities

23. **The narrowing tax base poses a constraint to the fiscal space and could impede fiscal consolidation efforts in the medium term.** The tax-to-GDP ratio has declined steadily since 2015 even after netting out petroleum-related income tax revenues. Additionally, overall tax buoyancy has fallen to a level below one since 2014. The decline in the tax base is intensified further by the shift from the GST back to the SST in September 2018 which entails a revenue loss of at least 1.4 percent of GDP per annum. Unless checked, the narrowing tax base will limit the fiscal space to counter adverse economic shocks and constrain the pace of fiscal consolidation going forward.

Figure 18. Tax Revenue, Breakdown by Component



Source: DOSM; MOF

24. **Malaysia has achieved remarkable economic progress over the past four decades, and is now facing the challenge of becoming more inclusive and achieving a higher level of economic development.** The country has evolved from its heavy dependence on commodities in the 1970s and rapid industrialization in the 1980s through the 1990s to the shift to higher value-added production in the 2000s with the rise of China's export-oriented manufacturing sector. The economic transformation has resulted in a marked increase in household incomes – elevating Malaysia to upper middle-income status – and a sharp reduction in poverty rates. However, while income inequality has also fallen, it remains high. To drive inclusive growth and advance to high-income nation status, the government is aiming to shift the economy's growth drivers from traditional factor inputs towards total factor productivity. While

[21] The MYR/USD exchanged rate has a tendency to be correlated with crude oil prices such as within the 2012-16 period, likely a reflection of Malaysia's commodity-oriented economy.

progress has been made in raising productivity across sectors, significant structural challenges remain, such as the existing skill gaps among local graduates, continued high dependence on semi- and low-skilled workers including foreign labor, and enterprises' currently limited adoption of technology and digitalization.

Authorities' Views

25. **The authorities also recognize the risks and vulnerabilities mentioned above, even as they highlight the strengths of the economy.** The BNM has noted that trade tensions are beginning to have a material impact on global trade and investments. The external sector also faces downside risks from lower oil prices, although they are somewhat mitigated by Malaysia's diversified export base, with electrical and electronics (E&E) comprising nearly 40 percent of total exports and also the greater focus on higher value-added downstream manufacturing activities such as chemical-related and refined petroleum products as well as optical and scientific equipment. Meanwhile, revenue-enhancing measures are in place to ensure the budget deficit target is met despite lower oil prices. However, the decline in the tax ratio can be associated with reduced earnings of the commodities sector in recent years, which is estimated to account for over 40 percent of the total corporate income tax receipts. Short-term liquidity and funding risks arising from the banks' external debt are largely mitigated by banks' ample liquidity, given liquidity coverage ratios are well in excess of the regulatory minimum. Moreover, banks' holdings of liquid foreign currency (FCY) assets can be tapped to cover for immediate FCY liabilities in periods of tightened liquidity.[22] Meanwhile, risks arising from overseas operations are assessed by the BNM to be low as these operations are supported by strong capital and liquidity buffers as well as sound asset quality.

C. Policy Discussions and Recommendations

26. Given the economy's resilience to heightened external headwinds, the policy mix should focus on continued fiscal consolidation while safeguarding financial and external stability. Over the medium to long term, structural reforms should be geared towards improving the fiscal space and enabling a robust economy that is driven by considerable gains in productivity.

C.1 Ensuring Fiscal Sustainability

27. **Reforms to increase the transparency, accountability and efficiency of public finance, while resolving to continue with fiscal consolidation, are highly commendable and should be continued.** The authorities are on the right track to proactively initiate fiscal reforms in the areas of governance, expenditure and revenue, such as by increasing transparency in fiscal reporting, imposing a three-year expenditure ceiling, and setting up a committee to review the existing tax system. In this regard, the fiscal adjustments in 2018 and 2019, when large outstanding liabilities are settled with the aid of special petroleum-related dividend transfers, can be treated as one-off, and underlying fiscal consolidation should continue. Indeed, the 2019 Budget reflects efforts to cut unnecessary spending, review the cost structures of existing government contracts, and reform the existing subsidy and social assistance

[22] Liquid FCY assets comprise cash and cash equivalents, unencumbered debt securities held and interbank placements.

schemes to make them more targeted. In addition to the focus on expenditure optimization, we would advise that the 'zero-based budgeting' approach that was adopted in the 2019 Budget should work in conjunction with a 'performance-based budgeting' framework[23] in order to enhance the efficiency and effectiveness of public spending. Moreover, planned fiscal initiatives such as the passing of the Fiscal Responsibility Act and Government Procurement Act, full disclosure of the government's assets and liabilities as well as fiscal risk assessment, adoption of accrual-based accounting system, and the creation of a Debt Management Office should be undertaken as soon as possible, and their progress of implementation monitored by the Public Finance Committee.

28. **Measures to broaden the tax base should be vigorously pursued to facilitate fiscal consolidation and increase fiscal policy space.** Given the decline in the tax-to-GDP ratio, ongoing efforts to broaden the tax base are commendable. For one, the establishment of the Tax Reform Committee in 2018 is a crucial move to facilitate a comprehensive review of the existing tax system. Already, measures set to be implemented this year such as the gradual expansion of the SST coverage, the imposition of a tax on imported services, and the Special Voluntary Disclosure Program would help augment fiscal revenues, especially against the downside impact from lower crude oil prices. Going forward, the tax reform momentum will have to be intensified by realigning taxation with economic activities along value creation. Such initiatives would involve, for example, the continued expansion of the SST base to include online services – set to be implemented in 2020 – as a form of a tax on profits of the digital economy, especially pertaining to activities outside Malaysia. In addition, ongoing efforts to rationalize the tax policy and streamline the over 100 types of tax incentives should carry on. Likewise, efforts to strengthen tax collection should continue, including an improvement in tax administration and audit to enhance tax compliance. Overall, revenue-mobilization efforts should aim at reversing the decline in the non-petroleum-related tax-to-GDP ratio.

Authorities' Views

29. **The government stresses that it is advancing fiscal reforms in a comprehensive manner with the goal of strengthening the fiscal position while sustaining economic growth.** It is pushing for fiscal governance – particularly, responsible fiscal principles, medium-term fiscal targets, and high standards of fiscal reporting – in the form of legislation, as that can be more effective in ensuring compliance as compared to the administrative form. Likewise, it is working to enhance the efficiency of revenue generation by conducting a comprehensive review of the tax system and collection. It is also considering to set an oil price threshold, beyond which additional revenues can be set aside to mitigate the impact of adverse shocks or cushion revenue loss. As for the third area of fiscal reform, the government aims to increase the efficiency and productivity of government spending by reviewing the implementation of programs and projects to become more targeted and needs-based.

[23] Performance-based budgeting aims to make national budgeting processes more aligned with medium-term strategic plans, and helps to provide incentives to improve public service delivery. According to the World Bank (2018), Malaysia has been implementing outcome-based budgeting, although performance reporting and evaluation have yet to be fully developed.

C.2 Maintaining an Accommodative Monetary Policy

30. **Notwithstanding the low headline inflation, it is advised that monetary policy remains on hold as it maintains the balance between supporting growth and containing risks to financial and external stability.** While the ongoing fiscal consolidation entails a greater role for monetary policy in supporting growth, it would be prudent to maintain the current policy stance in view of the uncertainty in the external environment and high household debt. However, it would be appropriate to consider easing the monetary policy stance should the Malaysian economy slow down sharply as a result of an escalation in U.S.-China trade tensions or a sharp deterioration in global economic conditions.

31. **A higher reserves buffer would provide greater flexibility for the BNM to calibrate policy tools to support the economy against adverse shocks.** The BNM's FX reserves are adequate by standard international metrics but relatively low compared to emerging Asian peers. In this regard, the BNM is advised to opportunistically build up its reserves during periods of capital inflows, while it continues to manage the exchange rate flexibly as a buffer against external shocks. The use of swaps in the forward market to sterilize the liquidity impact of capital outflows has worked well so far. However, it would be prudent to contain the use of FX swaps to mitigate the rollover risk. As for the FX administration measures that were introduced since late-2016, the BNM should continue to consult with market participants to ensure that the onshore hedging market is sufficiently deep and liquid to meet their needs.

Authorities' Views

32. **Monetary policy is guided by the risks surrounding growth and inflation as well as destabilizing financial imbalances.** The BNM stressed that it takes into account multiple factors in determining the direction of monetary policy. It noted that it does not take an activist approach in conducting monetary policy. The BNM's use of the FX swap operations is within the Bank's internal limit.

C.3 Prudent Macro-prudential Policy to Safeguard Financial Stability

33. **Malaysia's relatively liberalized financial sector calls for continued vigilance and a constant review of the financial supervision framework.** It is noteworthy that the BNM has appropriately responded to the Malaysian financial institutions' expansion across a wide range of activities and markets within and across national boundaries by broadening its prudential regulatory and supervisory framework to cover the full spectrum of group-wide activities and risks. Going forward, existing consolidated-level prudential regulation and supervision should be constantly enhanced to keep pace with the emerging risks in the financial system and contain the risk of contagion from the financial institutions' regional expansion. In view of the rollover risk with interbank funding, it will be prudent to continue conducting periodic stress-testing exercises to assess the adequacy of the banks' FCY liquidity position.

34. **Macro-prudential measures can be deployed to address the imbalance in the property sector and contain risks to overall financial stability.** Macro-prudential measures implemented by the BNM since 2010 have brought down household credit growth to more

moderate levels. Going forward, these measures would have to be maintained given the still high level of household debt and the supply overhang in the property sector. On the latter, targeted prudential measures and incentives should remain in place to encourage developers to construct more affordable rather than high-end residential property and for the market to absorb gradually the overhang in property supply. In this regard, the adjustments in the real property gains tax and stamp duty that were announced in November 2018 are steps in the right direction to discourage speculative purchases and reduce the overhang in the supply of high-end property, while they are being complemented by special measures aimed to make affordable homes more accessible to low-to-mid-income and first-time buyers. Considering the correction in high-rise property prices in major cities such as Kuala Lumpur, regulators are advised to keep on ensuring that banks' lending standards for real estate sector loans – especially the bridging loans of developers – remain prudent, with banks refraining from excessive risk-taking behavior while preserving asset quality.[24]

Authorities' Views

35. **The authorities are paying close attention to contain the risks emanating from financial imbalances.** Under the BNM's consolidated supervision framework, financial institutions are subject to ongoing reporting requirements, annual macro and micro stress-testing exercises, and prudent internal limits for interbank borrowings, FCY funding and liquidity positions, as well as FCY market risk exposure. Additionally, existing macro-prudential measures remain relevant given the elevated level of household indebtedness and pockets of financial stress in certain segments, as indicated by the increase in loan impairment ratios for higher-valued properties. They will continue to be reviewed as conditions warrant.

C.4 Structural Reforms

36. **A sustained and concerted effort to boost productivity in line with the priorities laid out in the Mid-term Review of the 11th Malaysia Plan is crucial to attaining a more inclusive and high-income nation.** In the face of rapid technological change, domestic constraints arising from the ongoing fiscal consolidation and external headwinds, there is an urgent need to promote innovation and R&D in order to drive productivity and stimulate private sector investment. To raise the quality of employment and improve income distribution, a dynamic ecosystem of globally competitive and high value-added private enterprises that are supported by quality infrastructure, efficient utilities, and innovative and skilled workforce should be fostered. As such, a well-coordinated set of measures to promote fair competition, human capital development and greater technological adoption by firms should be prioritized. To this end, the authorities have rightly focused on the initiative to rationalize and streamline fiscal incentives so that they encourage the adoption of new technology across sectors and the further development of the services sector, through the expansion of quality tertiary education and vocational training.

[24] According to the BNM, banks have remained cautious in lending for the construction of residential and non-residential properties, with the loan approval rate moderating to 72.2 percent and 73.1 percent, respectively, at end-2018 from 85.7 percent and 88.3 percent, respectively, in 2015.

Authorities' Views

37. **The new government is fully committed to further advance economic development and improve the well-being of the people.** As an initial step, it recently established the Economic Action Council (EAC) – a 16-member council comprising of public and private sector leaders and chaired by the Prime Minister – with the overarching goal of stimulating Malaysia's economic growth, ensure equitable wealth distribution and improve the well-being of the people. In addition, the EAC is tasked with examining issues related to the cost of living, employment, poverty and home ownership.

Appendices

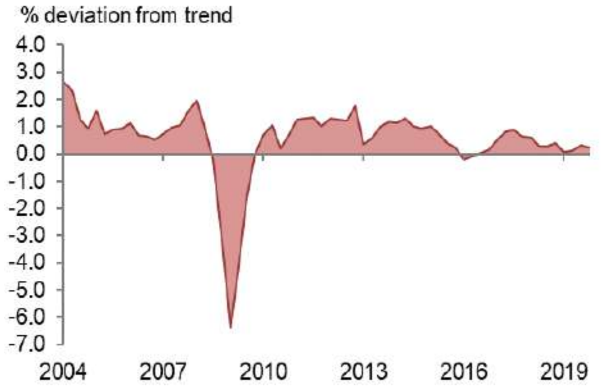
Appendix 1. Selected Figures for Major Economic Indicators

Figure 1.1. Real Sector

Growth eased in 2018 owing to lackluster investment activity and slower export expansion.

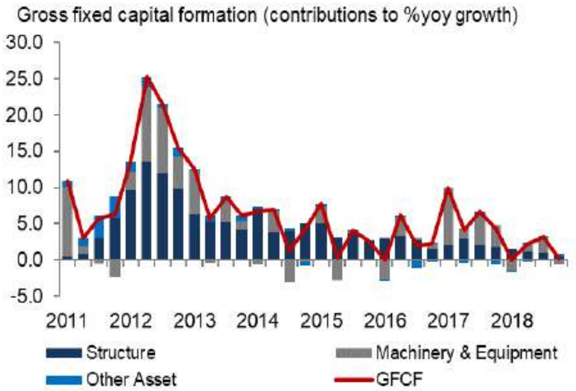
Source: Department of Statistics Malaysia (DOSM)

The output gap has remained positive, but is narrowing.



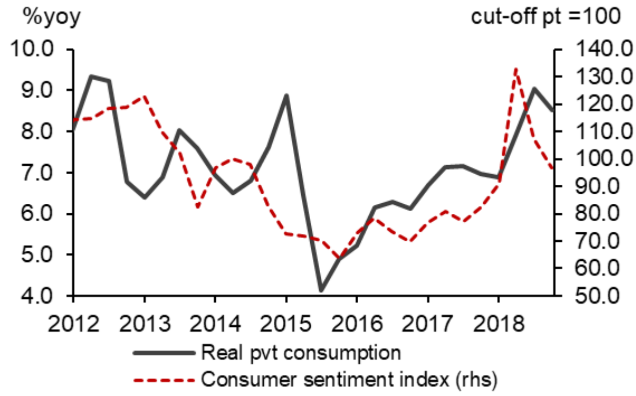
Source: AMRO estimates

The investment slowdown was mainly on account of weaker increases in machinery and equipment purchases.



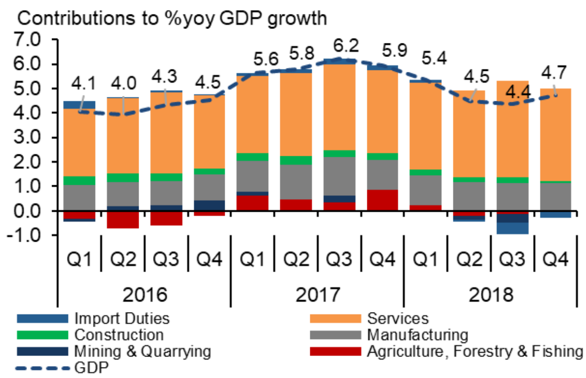
Source: DOSM

Private consumption strengthened further in 2018 as sentiment improved with the implementation of the zero-rated GST in June-August.



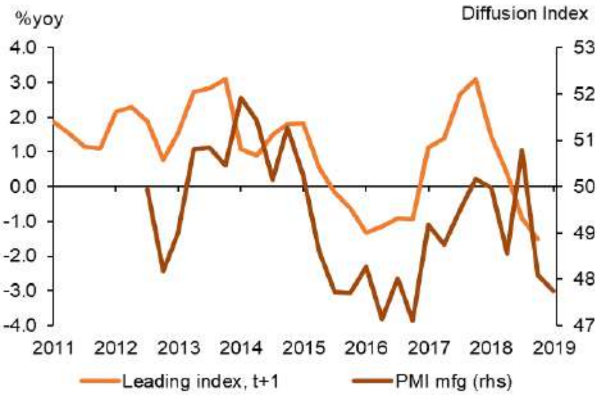
Source: DOSM; MIER

Supply side growth in 2018 was dampened by lower palm oil (agriculture) and natural gas (mining) output.



Source: DOSM

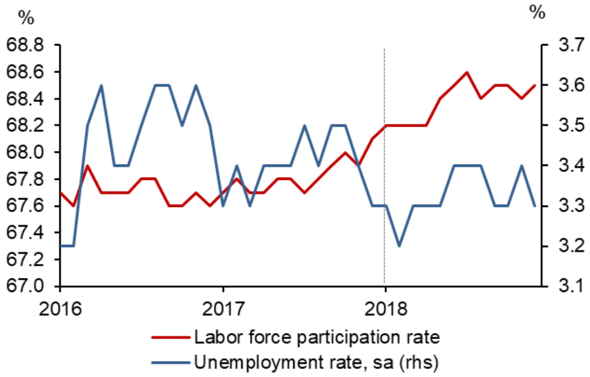
Leading indicators point to softer near-term growth.



Source: DOSM; IHS Markit

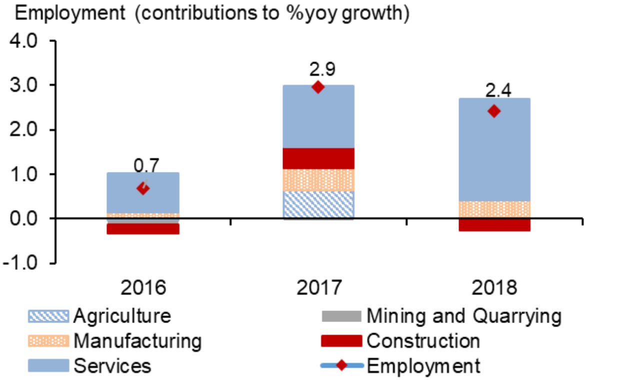
Figure 1.2. Labor and Inflation

Labor market conditions have been supportive of growth, given lower unemployment rates and higher labor force participation rates.



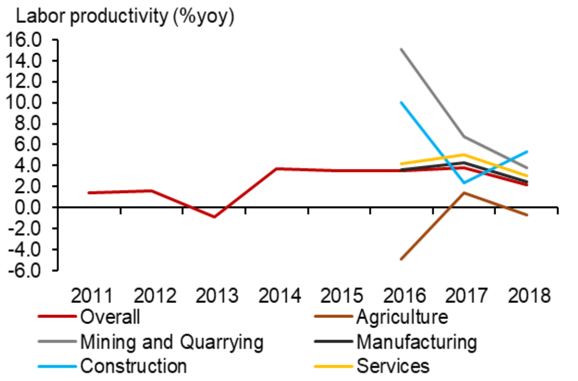
Note: Uses monthly data for the two featured series
Source: DOSM

Employment growth was sustained in 2018, driven by the services sector and followed by manufacturing.



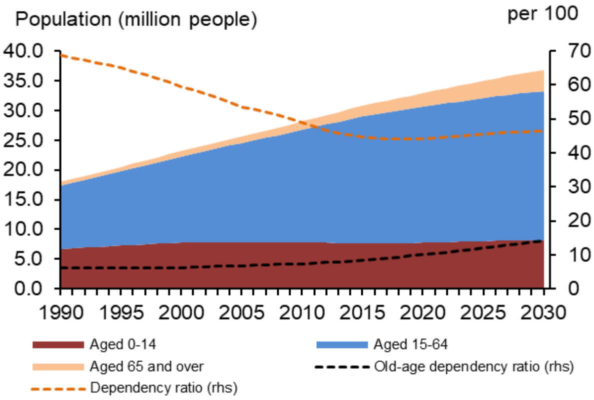
Note: Annual figures refer to Q4 of the cited year.
Source: DOSM

However, labor productivity growth has been subdued, and even dipped for most sectors in 2018.



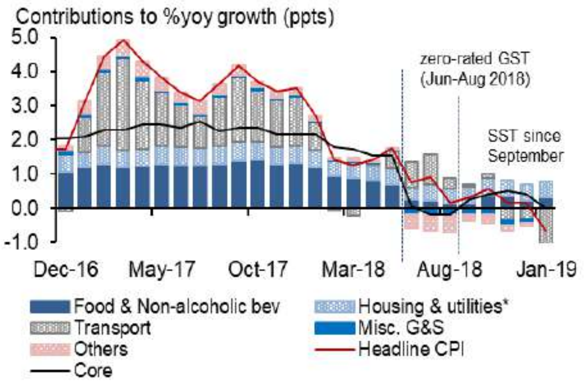
Note: Annual figures refer to Q4 of the cited year.
Source: DOSM

The dependency ratio is projected to bottom out in the near term as the increase in the working age population slows and is far outpaced by the old.



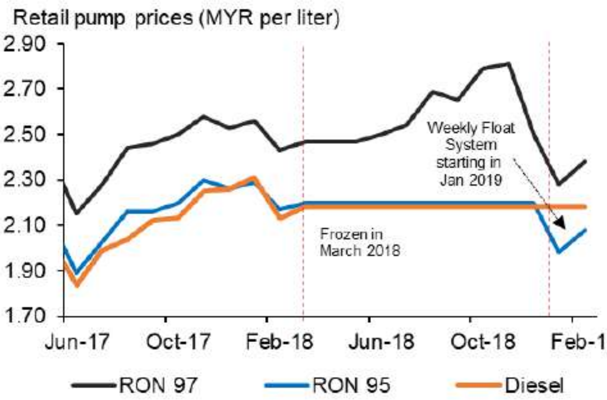
Source: U.N. Population Statistics

Inflation has remained low despite the resumption of the sales and service tax in September 2018.



Source: DOSM

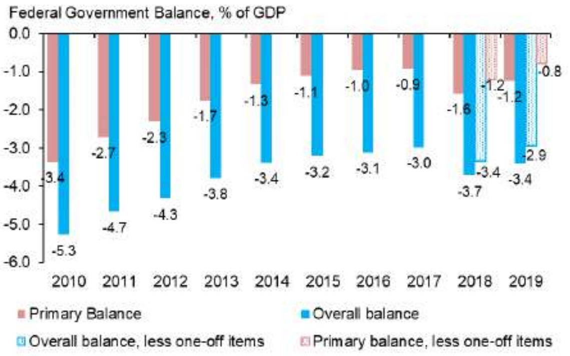
Most fuel prices fell in January 2019 as the price freeze was relaxed and the weekly float system was re-introduced.



Source: Ministry of Domestic Trade, Co-operatives and Consumerism

Figure 1.3. Fiscal Sector

Fiscal deficit targets for 2018-19 have been re-adjusted…



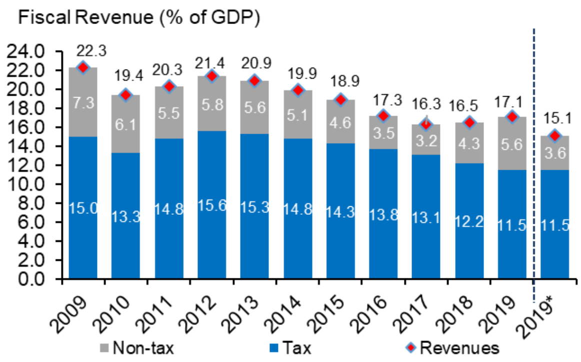
Source: DOSM; 2019 Budget Speech (MOF)

…largely to provide for previously unbudgeted expenses and revenue items.

2018		2019	
Fiscal deficit, official (% of GDP)	3.7	Fiscal deficit, official (% of GDP)	3.4
One-offs (MYR bn)			
Compensation for the acquisition of the Eastern Dispersal Link in Johor	1.3	GST & Income tax refunds	37.0
GST refund	3.9	*Less* Petronas one-off special dividend	30.0
TOTAL	**5.2**	**TOTAL**	**7.0**
% of GDP	***0.4***	***% of GDP***	***0.5***
Fiscal deficit, adjusted	3.4	Fiscal deficit, adjusted	2.9

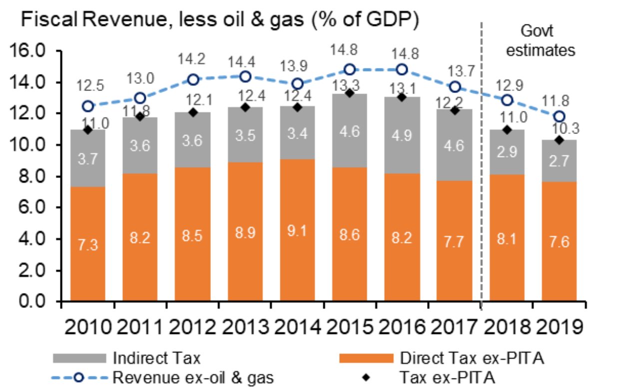
Note: Only the one-off items have been netted out. Other off-budget items that have been brought to the Budget and which will continue to be serviced going forward are retained.
Source: 2019 Budget Speech (MOF)

The fiscal revenue is estimated to decline further in 2019, after netting out PETRONAS' one-off special dividend.



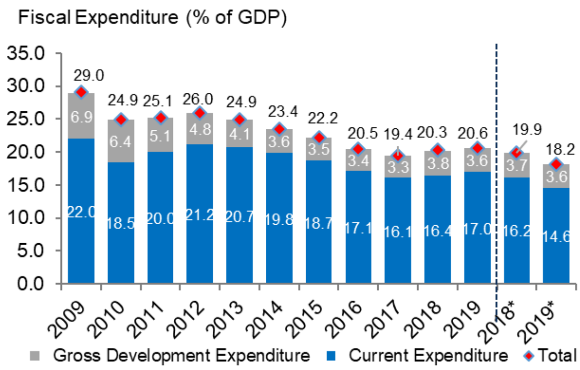
*Less one-off special dividend from PETRONAS
Source: BNM; DOSM; 2019 Budget Speech (MOF)

The tax-to-GDP ratio has been on a steady decline since 2015 for both non-petroleum-related direct and indirect taxes.



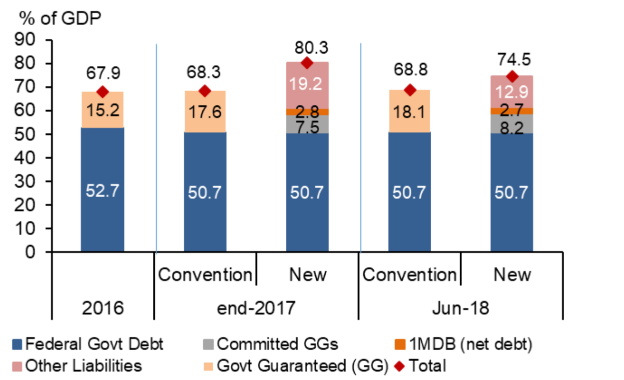
Source: BNM; DOSM; MOF

Containing the 2019 fiscal deficit entails a cut in current expenditure, especially supplies and services as well as subsidies and social assistance.



*Less one-off items: In 2018, GST refund (under CE) and compensation for the acquisition of the Eastern Dispersal Link in Johor under DE. In 2019, less MYR37 bn GST and Income tax refunds under CE.
Source: DOSM; 2019 Budget Speech (MOF)

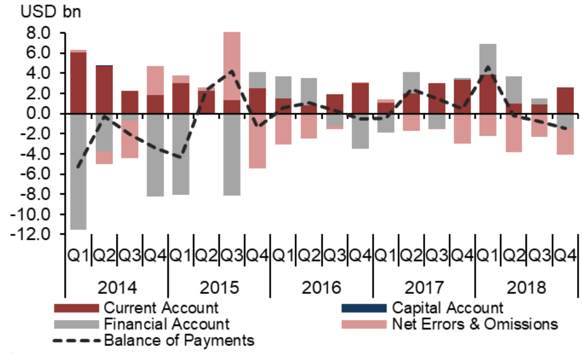
Government debt remains below the self-imposed limit of 55 percent of GDP, although overall liabilities have risen to include committed GGs, 1MDB debt and others.



Note: Other Liabilities refer to those projects under Public-Private Partnership (PPP), Pembinaan Blt Sdn Bhd (PBLT), and private finance initiatives (PFI). The Federal Government Debt stood at 51.8 percent of GDP as of end-2018.
Source: Fiscal Outlook and Federal Government Revenue Estimates 2019 (MOF)

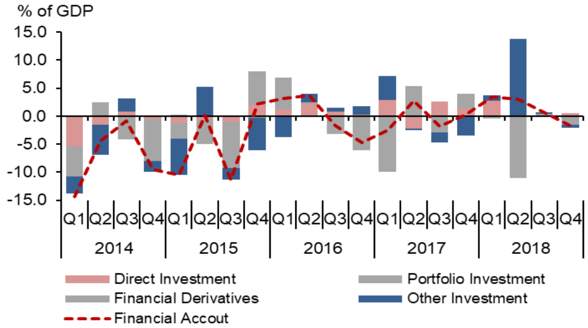
Figure 1.4. External Sector

The BOP recorded a surplus in 2018, notwithstanding the deficits in Q2-Q4.



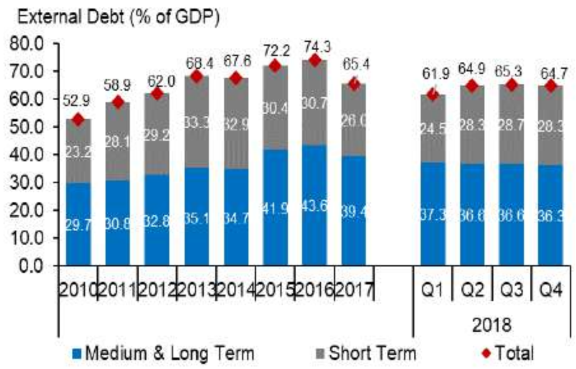
Source: BNM

The financial account posted a surplus in H1 2018 owing to net FDI inflows in Q1 and offshore borrowing in Q2.



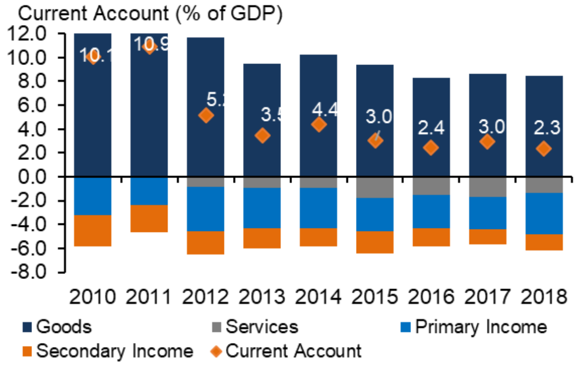
Source: BNM; DOSM

Indeed, short-term external debt picked up in Q2 2018, but has since eased.



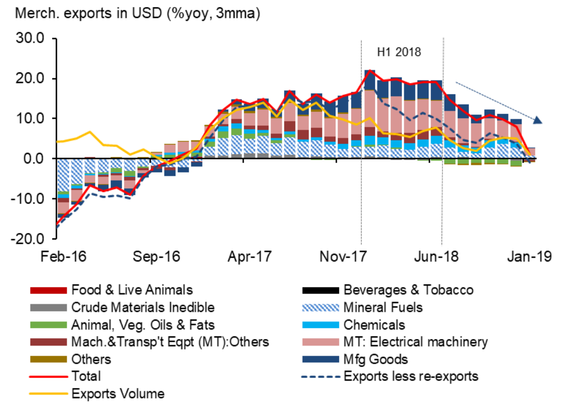
Source: BNM; DOSM

The current account sustained a surplus in 2018, although a smaller one, owing to a wider primary deficit.



Source: BNM

Exports grew at a decent pace, but were on a slowing trend throughout 2018.



Source: DOSM

Malaysia's exports to China have been volatile, but exhibit correlation with the deterioration of new export orders in China's manufacturing sector.

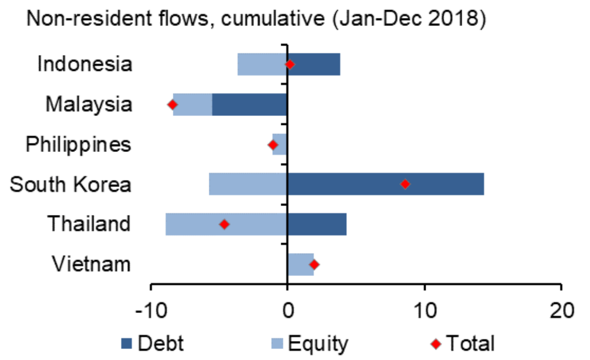
Source: DOSM; Haver Analytics

Figure 1.5. Capital Flows and Financial Market Developments

Non-residents net-sold bonds and stocks in 2018, although Q1 2019 recorded modest inflows.

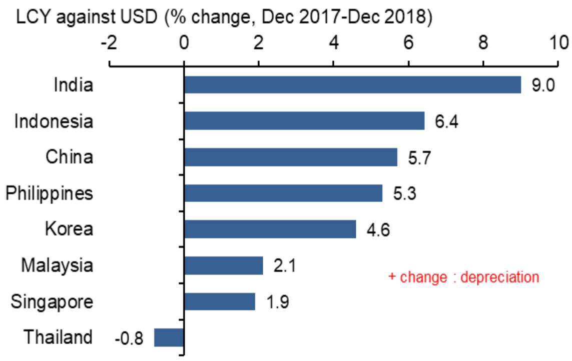
Note: Government securities comprise Malaysian Government Securities (MGS), Malaysian Government Investment Issues (MGII), and Government Housing Sukuk (SPK).
Source: BNM; Bursa Malaysia

Malaysia recorded sizable non-resident outflows in 2018 owing to the unexpected change in government and broader risk aversion.



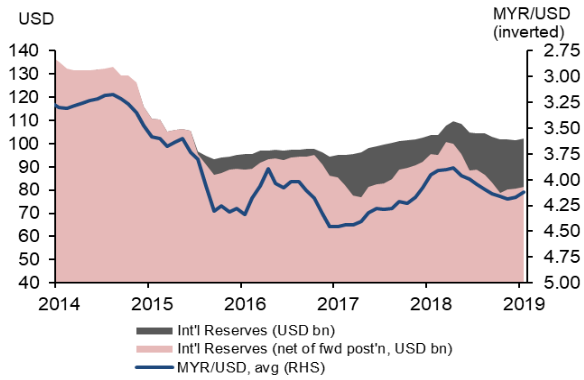
Source: CEIC; National sources

Yet, the depreciation of the MYR/USD in 2018 was modest relative to EM-Asian peers.



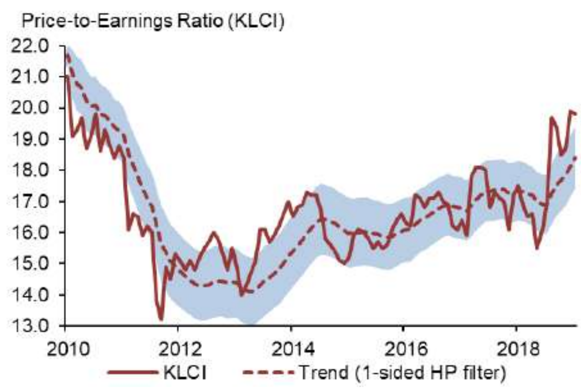
Rates used are end-of-period.
Source: BIS

Markets may be pricing the MYR in line with the BNM's net reserves, as implied by the tight co-movement between the two.



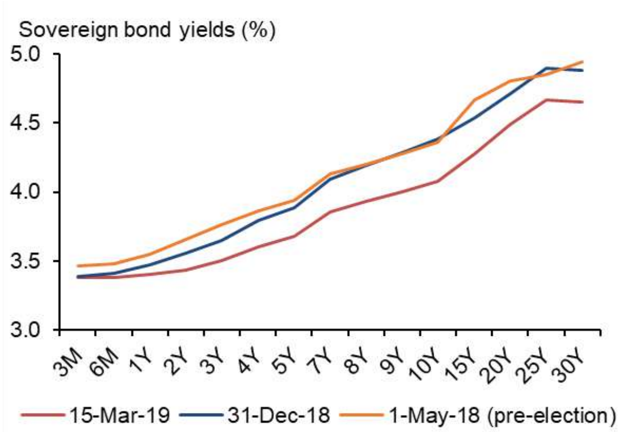
Source: BNM

The PE ratio is elevated due to weak corporate earnings and buoyant local institutional demand.



Source: Bursa Malaysia; AMRO

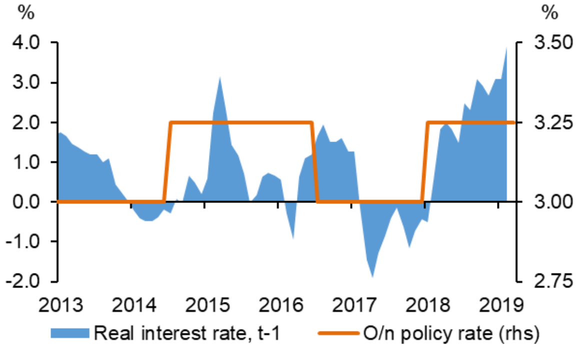
Bond yields have adjusted downwards from last year.



Source: AMRO

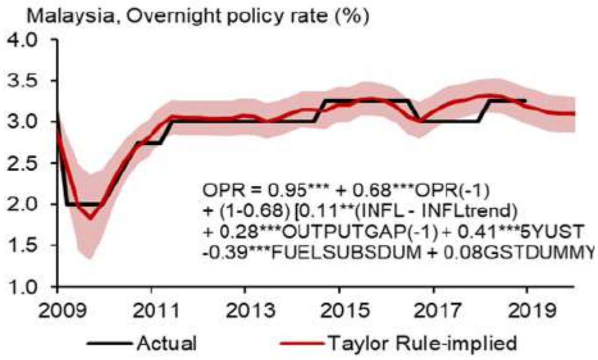
Figure 1.6. Financial Sector

The policy rate has been kept steady after it was raised by 25bps in January 2018.



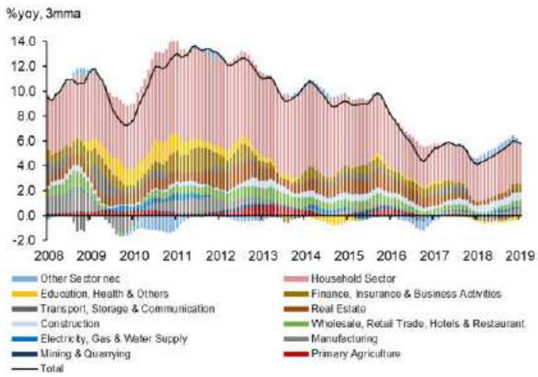
Source: BNM

It may be prudent to maintain the policy rate despite what the Taylor Rule suggests, to prevent undue pressure on the ringgit and a rapid debt build-up.



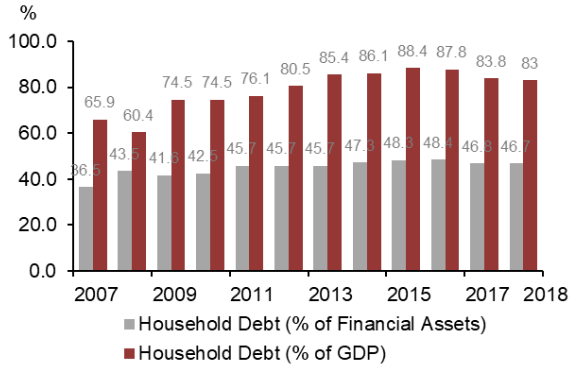
Source: AMRO estimates

After all, loan growth appears to have turned around since the start of 2018.



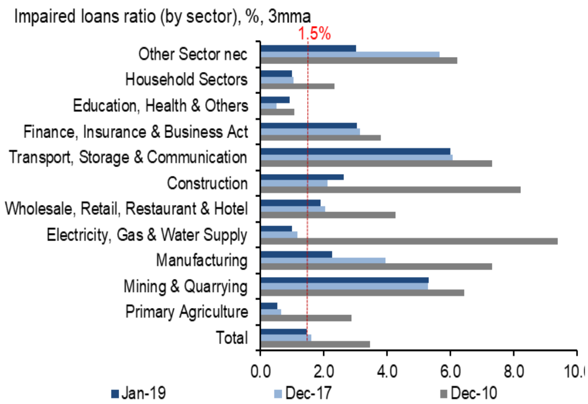
Source: BNM

And while the household debt-to-GDP ratio has moderated since 2016, it remains elevated.



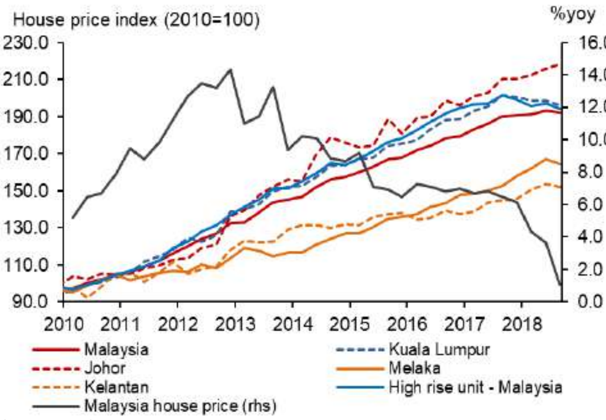
Source: BNM; DOSM

Bank asset quality remains high, although pockets of risk exist in sectors such as construction and real estate where bank exposure is significant.



Source: BNM

House price inflation has eased, particularly for high-rise units in Kuala Lumpur.



Source: MOF

Appendix 2. Selected Economic Indicators for Malaysia

	2015	2016	2017	2018	Projections 2019	Projections 2020
Real sector and prices	(in percent change, unless specified)					
Real GDP	5.1	4.2	5.9	4.7	4.6	4.7
Private consumption	6.0	6.0	7.0	8.1	5.3	5.9
Government consumption	4.5	0.9	5.4	3.3	2.6	1.7
Gross capital formation	6.7	3.3	6.4	-4.4	7.8	6.3
Gross fixed capital formation	3.6	2.7	6.2	1.4	2.5	3.7
Exports of goods and services	0.3	1.3	9.4	1.5	0.8	1.1
Imports of goods and services	0.8	1.3	10.9	0.1	1.7	1.7
Labor market	(percent)					
Unemployment rate	3.2	3.5	3.4	3.3	3.3	3.2
Prices	(in percent change, unless specified)					
Consumer price inflation (period average)	2.1	2.1	3.8	1.0	1.6	2.2
Core inflation (period average)		2.5	2.3	0.8	1.4	2.1
GDP deflator	-0.4	2.0	3.8	0.9	1.6	2.0
External sector	(in billions of U.S. dollars, unless specified)					
Current account balance	9.0	7.2	9.4	8.3	8.0	8.7
(in percent of GDP)	3.0	2.4	3.0	2.3	2.1	2.1
Trade balance	28.0	24.6	27.2	30.1	31.0	31.8
Exports, f.o.b.	174.4	165.6	187.7	207.4	218.6	230.2
Imports, f.o.b.	146.5	141.0	160.5	177.3	187.6	198.3
Services balance	-5.3	-4.6	-5.3	-4.9	-4.5	-4.2
Receipts	34.8	35.6	37.0	39.7	42.7	45.6
Payments	40.1	40.1	42.3	44.5	47.3	49.8
Primary income, net	-8.2	-8.3	-8.5	-12.2	-13.2	-13.2
Secondary income, net	-5.5	-4.5	-4.0	-4.7	-5.2	-5.7
Financial account balance	-14.2	-0.1	-1.1	4.6	6.3	4.7
Direct investment, net	-0.5	3.3	3.8	2.8	6.7	8.9
Direct investment Assets	-10.2	-10.2	-5.6	-5.8	-6.4	-6.5
Direct Investment Liabilities	9.7	13.5	9.4	8.6	13.1	15.4
Portfolio investment, net	-6.7	-3.4	-3.6	-11.0	1.6	1.6
Net acquisition of financial assets	-2.3	-3.6	-4.5	-2.3	-2.9	-3.3
Net incurrence of liabilities	-4.4	0.2	0.9	-8.7	4.5	4.9
Other investment, net	-8.3	0.2	-1.2	12.6	-1.0	0.8
Net errors and omission	6.4	-5.8	-4.4	-11.0	-5.5	-5.5
Overall balance	1.0	1.4	3.8	1.9	8.8	7.8
Official reserves asset (end-period)	95.3	94.5	102.4	101.4	110.2	118.0
(in months of goods & services imports)	6.1	6.3	6.1	5.5	5.6	5.7
Total external debt (percent of GDP)	72.2	74.3	65.4	64.7	64.2	63.7
Short-term external debt (percent of total)	42.0	41.3	39.7	43.8	44.0	44.0
Short-term external debt (ratio to international reserves)	1.2	1.1	1.2	1.0	1.0	1.0
Fiscal sector (National Government)	(in percent of GDP)					
Government revenue	18.9	17.3	16.3	16.3	17.0	15.7
Government expenditure	22.1	20.4	19.3	20.0	20.4	18.8
Fiscal balance	-3.2	-3.1	-3.0	-3.7	-3.4	-3.1
Primary balance	-1.1	-1.0	-0.9	-1.5	-1.2	-0.9
Government debt	54.4	52.7	50.7	51.8	52.3	52.0
Government guaranteed debt	15.3	15.2	17.6	18.1	18.0	17.5
Monetary sector	(in percent change, end-period unless specified)					
Broad money	3.0	3.2	4.9	8.0	5.2	5.4
Of which: Private sector claims	8.3	5.8	5.8	6.4	6.6	6.8
Of which: Loans	8.2	6.0	3.8	5.0	5.6	5.7
Of which: Securities	8.6	4.0	23.6	16.7	14.3	14.5
Memorandum items:						
Exchange rate (MYR per USD, average)*	3.91	4.15	4.30	4.04	4.05	4.01
Exchange rate (MYR per USD, eop)*	4.29	4.49	4.06	4.14	4.05	4.01
Nominal GDP (in billions of ringgit)	1,158.5	1,231.0	1,353.4	1,429.8	1,519.9	1,623.3
Nominal GDP (in billions of U.S. dollar)	297.5	297.3	315.3	354.5	375.1	404.7
GDP per capita (in U.S. dollar)	9,515.5	9,397.3	9,832.6	10,948.5	11,458.7	12,236.4

*Daily MYR per USD rates at noon as obtained from the BNM website
Source: National Authorities; AMRO staff estimates and projections

Appendix 3. Balance of Payments

	2014	2015	2016	2017	2018
	(in billions of ringgit, unless specified)				
Current account balance (I)	48.6	35.2	29.9	40.3	33.5
Trade balance	113.3	109.2	102.0	116.8	121.4
Exports, f.o.b.	678.9	681.3	686.9	807.0	836.4
Imports, f.o.b.	565.5	572.1	584.8	690.2	715.0
Services balance	-10.7	-20.6	-18.9	-22.8	-19.7
Receipts	137.6	136.1	147.6	159.2	160.0
Payments	148.3	156.7	166.5	182.0	179.7
Primary income, net	-36.6	-32.1	-34.6	-36.4	-49.4
Secondary income, net	-17.4	-21.3	-18.6	-17.3	-18.8
Capital account (II)	0.3	-1.1	0.1	0.0	-0.1
Financial account (III) (+ indicates net inflows)	-80.0	-55.4	-0.2	-4.7	18.6
Direct investment, net	-18.0	-1.8	13.8	16.2	11.3
Overseas direct investment	-52.6	-39.7	-42.2	-24.2	-23.3
Foreign direct investment	34.6	37.9	56.0	40.4	34.6
Portfolio investment, net	-39.4	-26.1	-14.2	-15.4	-44.4
Portfolio investment assets	-28.1	-9.1	-15.0	-19.4	-9.1
Portfolio investment liabilities	-11.2	-17.0	0.8	4.1	-35.3
Financial derivatives, net	-1.0	-0.7	-0.8	-0.2	1.0
Other investment, net	-21.7	-26.8	1.0	-5.3	50.7
Net errors and omission (IV)	-13.0	-32.2	-23.9	-19.1	-44.3
Overall balance (= I + II +III + IV)	-44.1	-53.5	5.9	16.4	7.7
Change in Reserve Assets	44.1	53.5	-5.9	-16.4	-7.7
Memorandum items:					
Current account balance (in percent of GDP)	4.4	3.0	2.4	3.0	2.3
Official reserve assets (in billions of U.S. dollar)	115.9	95.3	94.5	102.4	101.4
In months of goods & services imports	6.4	6.1	6.3	6.1	5.5
Changes in official reserve assets (in billions of U.S. dollar)	-19.0	-20.6	-0.8	7.9	-1.0
Exchange rate (MYR per USD, eop)	3.50	4.29	4.49	4.06	4.14
Nominal GDP (in billions of U.S. dollar)	338.3	297.5	297.3	315.3	354.5

Note: Based on calendar year, unless otherwise mentioned.
Source: Malaysian authorities; AMRO staff calculations

Appendix 4. Statement of Government Operations

	2014	2015	2016	2017	2018E	2019B
General Government	(in billions of ringgit, unless specified)					
Revenue (I)	220.6	219.1	212.4	220.4	236.5	261.8
Tax Revenue	164.2	165.4	169.3	177.7	174.7	176.2
Direct Tax	126.7	111.8	109.6	116.0	133.5	135.1
Income Tax	116.6	101.6	99.6	105.2	125.6	126.8
Companies	65.2	63.7	63.6	64.5	70.5	70.2
Petroleum	27.0	11.6	8.4	11.8	16.8	18.1
Individuals	24.4	26.3	27.6	28.9	34.8	35.0
Others	10.1	10.2	10.0	10.9	7.9	8.3
Stamp duty	6.5	6.0	5.7	5.7	6.0	6.3
Others	3.6	4.2	4.3	5.2	1.9	2.0
Indirect	37.5	53.7	59.7	61.6	41.2	41.1
Export duties	1.9	1.0	1.0	1.4	1.6	1.6
Import duties	2.7	2.7	2.9	2.8	2.8	2.9
Excise duties	12.9	11.9	11.7	10.1	10.7	11.4
Goods and Services Tax (GST)	0.0	27.0	41.2	44.3	19.1	-
Sales Tax	10.9	5.2	0.1	0.0	2.9	13.9
Service Tax	6.3	3.0	0.1	0.0	1.1	8.1
Others	2.8	2.7	2.7	3.0	3.0	3.2
Non-Tax Revenue	53.9	51.5	40.0	39.5	57.9	81.6
Petroleum royalty	6.5	5.1	3.7	4.4	5.2	5.6
Investment & Return on Investment	33.8	32.8	21.4	21.6	36.9	59.5
PETRONAS dividend	29.0	26.0	16.0	16.0	26.0	54.0
Non-Revenue Receipts & Federal Revenue Territories	2.5	2.2	3.1	3.2	3.8	4.0
Expenditure (II = III + V - VI)	258.0	256.3	250.8	260.7	289.8	313.9
Current Expenditure (III)	219.6	217.0	210.2	217.7	235.5	259.9
Emoluments	66.9	70.1	73.1	77.0	81.3	82.0
Retirement charges	18.2	18.9	21.0	22.8	25.8	26.6
Debt service charges (IV)	22.6	24.3	26.5	27.9	30.9	33.0
Domestic	22.1	23.7	25.7	27.2	30.1	32.3
External	0.5	0.6	0.7	0.7	0.7	0.7
Supplies and services	34.3	36.4	30.1	34.7	36.5	29.1
Subsidies	39.7	27.3	24.7	22.4	28.1	22.3
Asset Acquisition	1.8	1.7	0.7	0.5	0.6	0.7
Others	36.1	38.4	34.1	32.4	32.3	66.2
Development Expenditure (V)	39.5	40.8	42.0	44.9	54.9	54.7
Security	4.3	4.8	4.8	5.3	5.3	7.1
Economic	23.3	23.3	25.1	24.2	33.0	29.2
Social	10.5	11.2	10.4	12.4	14.5	15.2
General administration	1.3	1.6	1.6	2.9	2.0	3.2
Loan recovery (VI)	1.1	1.5	1.3	1.9	0.6	0.7
Current balance (= I - III)	1.0	2.1	2.2	2.7	1.0	2.0
In percent of GDP	*0.1*	*0.2*	*0.2*	*0.2*	*0.1*	*0.1*
Overall balance (= I - II)	-37.4	-37.2	-38.4	-40.3	-53.3	-52.1
In percent of GDP	*-3.4*	*-3.2*	*-3.1*	*-3.0*	*-3.7*	*-3.4*
Primary balance (= I - II + IV)	-14.8	-12.9	-11.9	-12.5	-22.4	-19.1
In percent of GDP	*-1.3*	*-1.1*	*-1.0*	*-0.9*	*-1.6*	*-1.2*
Memorandum items:						
Oil and gas-related revenue (in percent of total revenue)	30.0	21.5	14.6	15.7	21.7	30.9
Nominal GDP	1,106.4	1,158.5	1,231.0	1,353.4	1,433.1	1,531.1

Note: E = government's revised estimate; B = Budget estimate, excluding 2019 Budget measures. Estimates in this table are all of the government's.
Source: Malaysian authorities; AMRO staff calculations

Appendix 5. Data Adequacy for Surveillance Purposes: a Preliminary Assessment

Key Indicators for Surveillance	Data Availability[(i)]	Reporting Frequency/ Timeliness[(ii)]	Data Quality[(iii)]	Consistency[(iv)]	Others, if any[(v)]
National Accounts	• Available	• Quarterly GDP data is available two months after the reference period	-	-	-
Balance of Payments (BOP) and External Position	• Available	• Quarterly BOP data is available two months after the reference period	-	-	• Net errors and omissions can be sizable and make data analysis and interpretation difficult
State Budget and Government/ External Debt	• Available • Data for the consolidated public sector only includes data for 29 of the main non-financial public enterprises	• Quarterly federal government budget data is available two months after the reference period • Top-line budget data for the consolidated public sector is available on a yearly basis in October, 10 months after the reference period • Government debt and external debt are available on a quarterly basis, two to three months after the reference period		-	• Government guarantees that require fiscal support have been identified, but their corresponding annual budget expense is not explicitly identified
Money Supply and Credit Growth	• Available	• Money supply and credit growth data is available on a monthly basis, one month after the reference period	-	-	-
Financial Sector soundness indicators	• Available • Lack of data availability on household disposable income	• Banking sector soundness indicators are available on a monthly basis, two months after the reference period • Official household debt-to-GDP data is released on a yearly basis, with a time lag of three months	-	-	-
State-owned enterprises (SOE) statistics	• Available if publicly listed on the stock exchange, otherwise limited	-	-	-	-
Others, if relevant	-	-	-	-	-

Notes:
(i) Data availability refers to whether the official data are available for public access by any means.
(ii) Reporting frequency refers to the periodicity of the available published data. Timeliness refers to how up-to-date the published data are relative to the publication date.
(iii) Data quality refers to the accuracy and reliability of the available data given the data methodology.
(iv) Consistency refers to both internal consistency within the data series and horizontal consistency with other data series.
(v) Other criteria might also apply. Examples include, but are not limited to, potential areas of improvement for data adequacy.

Source: AMRO staff compilation. This preliminary assessment will form the "Supplementary Data Adequacy Assessment" in the EPRD Matrix.

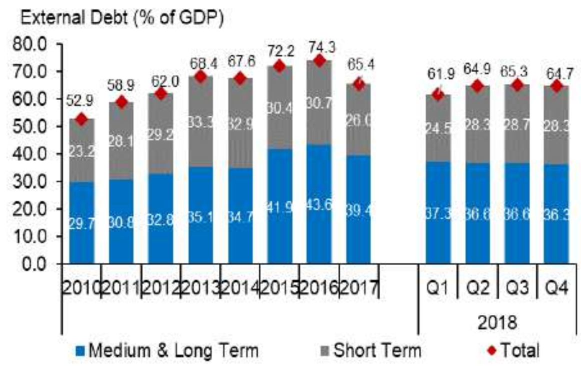
Annexes: Selected Issues

Annex 1. An Examination of Malaysia's External Debt[25]

Malaysia's external debt is high compared to other emerging Asian countries. However, the high level of external debt can be attributed to the openness of Malaysia's financial sector and capital account, as reflected in the domestic banks' extensive overseas operations, the large number of foreign banks in the country, and the creation of the Labuan International Business and Financial Centre as well as the country's position as a leading global hub for Islamic finance. Alongside the progressive liberalization of the financial sector, Malaysia's long history of foreign bank presence, the prolonged period of strong economic growth and trade expansion, large FDI inflows and a high savings rate have underpinned the dynamic financial system that it is today. This selected issue discusses Malaysia's external debt developments in detail against the backdrop of such an evolving economic landscape.

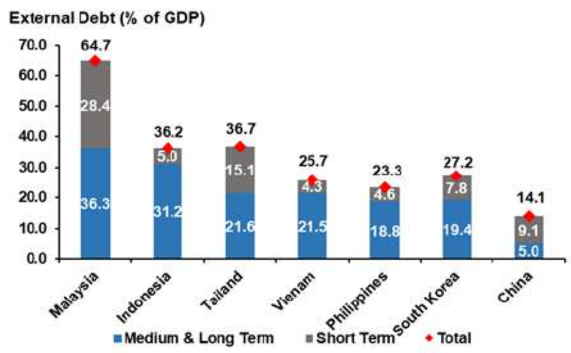
1. **Malaysia's level of external indebtedness stands out among emerging Asian economies, despite a decline from its peak in 2016.** The country's external debt fell to 64.7 percent of GDP at the end of 2018, from a peak of 74.3 percent at end-2016. The decline is evident in both the medium- and long-term components, which decreased by 7.3 ppts, and the short-term component, which fell by 2.4 ppts in this period (Figure A1.1). However, despite the decline, both the total and short-term external debt figures remain higher in Malaysia than its emerging markets peers in Asia (Figure A1.2). For example, both Indonesia and Thailand have lower external debt of about 36 percent of GDP, and their proportion of short-term external debt to GDP is also lower than Malaysia's. The Philippines and Vietnam, meanwhile, have substantially lower external debt-to-GDP ratios of 23-26 percent and short-term components that comprise less than 20 percent of the total.

Figure A1.1 External debt – Malaysia



Source: BNM; DOSM

Figure A1.2 External Debt – Selected Asian Countries



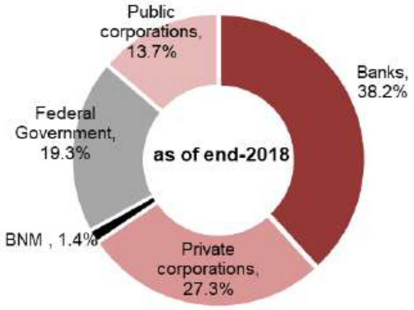
Source: BNM; DOSM

2. **Malaysia's elevated level of external debt can be traced to a number of factors.** The bulk of Malaysia's external debt is due to banks and corporations, which account for 38.2 and 41.0 percent of the total, respectively, according to end-2018 data (Figure A1.3). The relatively high level of external debt among banks and corporates can be traced back to the long history of merchandise trade and foreign bank presence in Malaysia as well as the

[25] Prepared by Diana del Rosario (Economist) and Dan Lu (Economist).

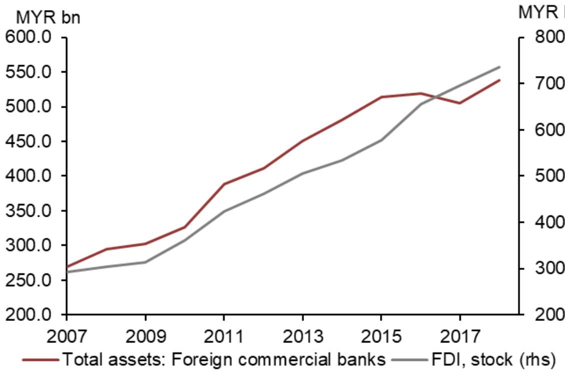
prolonged period of strong economic growth since the 1980s, which have substantially increased domestic savings and attracted large FDI inflows. Foreign banks were initially set up in Malaysia in the 19th century to support the financial needs of the early European traders, and their numbers subsequently grew with Malaysia's increased prospects for trade and foreign corporate investments.[26] Likewise, the rapid multi-decade economic expansion since the 1980s and the current account surplus that persisted from the late 1990s have enabled Malaysian firms – supported by the domestic banks – to expand overseas. For instance, the consolidation of the banking system after the 1997-98 Asian Financial Crisis subsequently prompted the domestic banks to capitalize on both domestic and international opportunities amid the rising trend of globalization.[27] Additionally, the progressive liberalization of the country's FX administration rules, which led to greater flexibility in mobilizing foreign currency funds, facilitated the influx of foreign investments and the aggressive overseas expansion of Malaysian firms (BNM 2018). Accordingly, both trade financing as well as intercompany and interbank lending activities grew, contributing to the build-up in external debt. A quick cross-country comparison shows that apart from external debt, Malaysia also stands out among the ASEAN economies in terms of real per capita income growth, FDI inflows, merchandise trade and outward direct investments over the past three to four decades (Figures A1.4-6).

Figure A1.3 External Debt by Institution



Source: BNM

Figure A1.4 Malaysia's FDI Stock and Foreign Commercial Banks' Assets

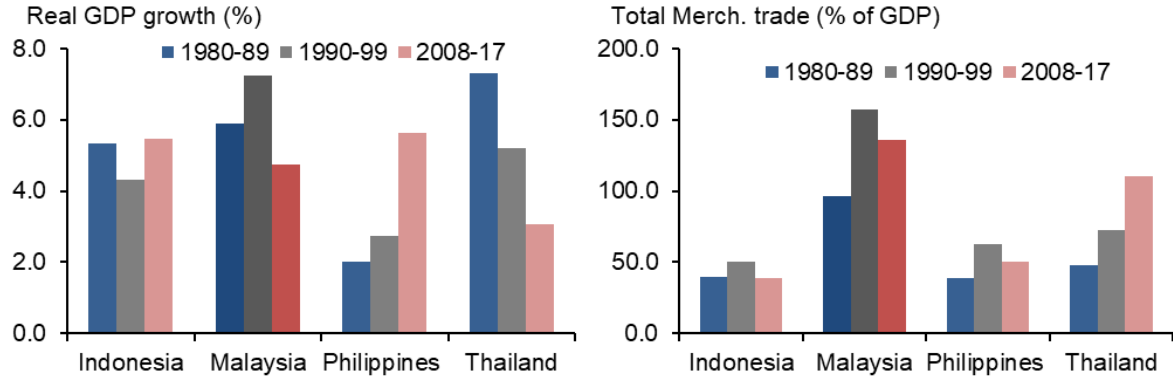


Source: BNM; DOSM

[26] Dominating Malaysia's banking system in the past, foreign banks were known to possess deep knowledge of the local market. In 1957, at the time of Malaysia's independence from the U.K., foreign banks accounted for over 90 percent of the banking market. Their dominance declined progressively in the following years with the deliberate government policy to develop the domestic financial sector, which led to the growth of the domestic banks. In recent years, foreign commercial bank assets have accounted for about 20 percent of the total banking market, with domestic commercial banks accounting for the rest. A survey conducted by Ahmad (2013) indicates that foreign banks expanded in Malaysia as they followed their existing global clients in their cross-border activities, sought new opportunities and supported trade finance, and that they were also encouraged by deregulation of the banking industry, Malaysia's growth potential and strategic location in the ASEAN region.

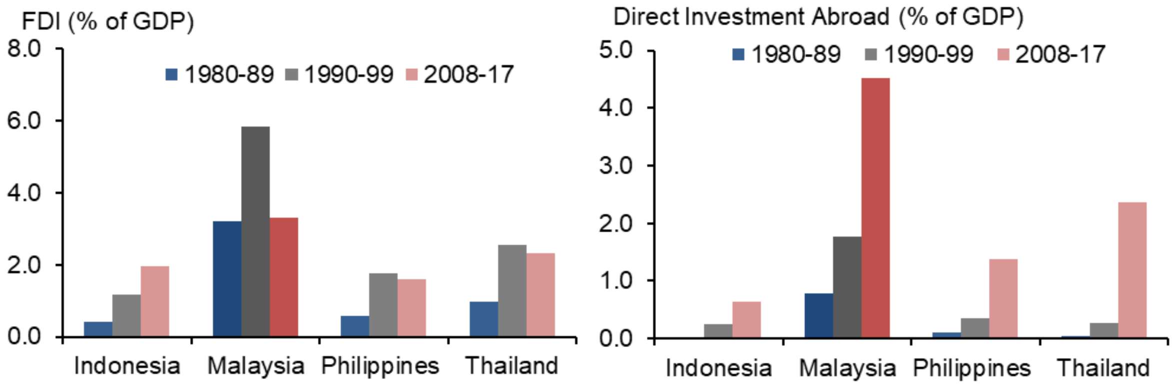
[27] Following case studies of four Malaysian banks – Maybank, CIMB, Public Bank, and RHB – Ahmad (2012) concludes that the internationalization of these banks is motivated by a mix of factors related to both their domestic markets (push factors: government initiatives, small size, low and limited growth) and the attractiveness of their target markets (pull factors/location advantages: high market growth, low to moderate levels of competition).

Figure A1.5 Real GDP growth and Goods Trade – ASEAN-4



Source: World Development Indicators

Figure A1.6 FDI and Outward Direct Investment – ASEAN-4



Source: World Development Indicators

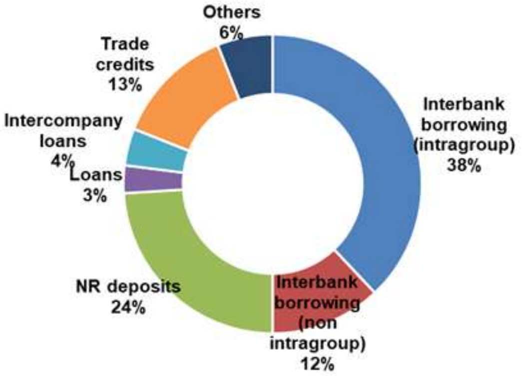
3. **Notably, domestic banks' overseas expansion and the large presence of foreign banks in Malaysia can explain over a third of the short-term external debt.** Intragroup borrowing accounts for 38 percent of short-term external debt and 51 percent of banks' short-term external debt, according to end-2018 data (Figure A1.7). Such a high proportion of intragroup borrowing primarily reflects the centralized liquidity management operations of the domestic banking groups (DBGs). Malaysian banks' overseas subsidiaries pass on the management of their excess cash and liquidity needs to their respective headquarters in Kuala Lumpur for cost efficiency and greater coordination within the group, while also in compliance with regulatory liquidity requirements.[28] Likewise, intragroup borrowing also arises from foreign bank placements with Malaysian banking subsidiaries (the locally-incorporated foreign banks or LIFBs, for short), for the funding of operations (primarily in trade and as part of the pooling and re-distribution of excess liquidity within their respective global banking groups. These borrowings are from related counterparties and are thus less likely to be withdrawn suddenly. According to the BNM, such borrowings amount to 62 percent of the foreign currency component of the short-term external debt.

4. **Preliminary analysis indicates that Malaysia's short-term external debt is in line with the openness of its financial sector.** A cross-country comparison shows that the size

[28] Since the 2008 Global Financial Crisis, regulators have imposed measures that require banks to have enough liquidity to manage their daily and monthly operations even during adverse shocks. In this regard, the Basel Committee on Banking Supervision in 2013 presented a set of monitoring tools for intraday liquidity management among universal banks. However, regulatory compliance would involve heavy investment in IT infrastructure (such as powerful management information systems) and manpower to deal with vast amounts of transaction data that are generated on a day-to-day basis (PwC, 2017).

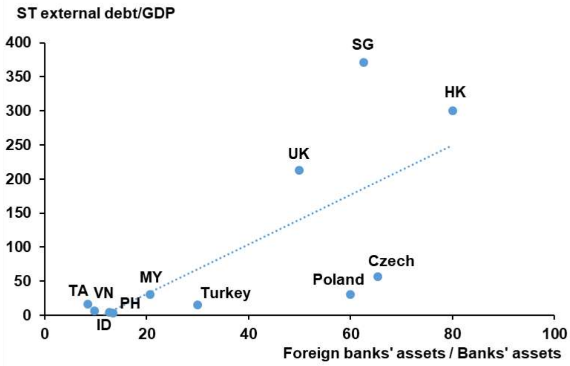
of a country's short-term external debt tends to be positively related with the openness of the financial sector, as proxied by the share of foreign banks' assets to total. Figure A1.8 shows that while Malaysia is somewhat different from other emerging Asian economies, its larger short-term external debt could actually be associated with its relatively liberalized financial sector. Meanwhile, the chart also shows that Malaysia still has a long way to go to become a full-fledged financial center such as Singapore, Hong Kong or the U.K. The short-term external debt in these financial hubs is mainly attributed to the banks' offshore borrowing, which arises from the pooling and redistribution of excess liquidity among related entities.

Figure A1.7 Short-term External Debt, by Instrument



Source: BNM

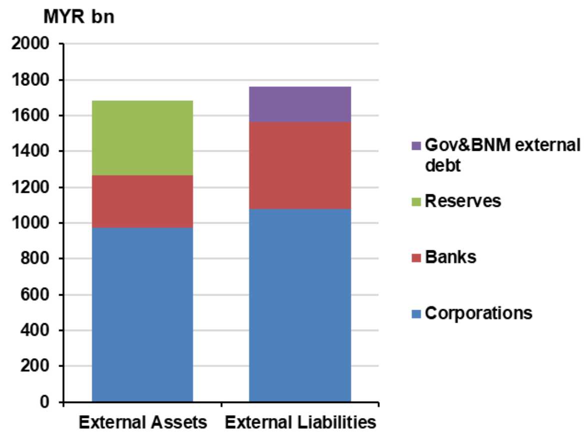
Figure A1.8 External Debt vs. Foreign Banks' Assets – Selected Countries



Source: National Authorities; AMRO staff calculations

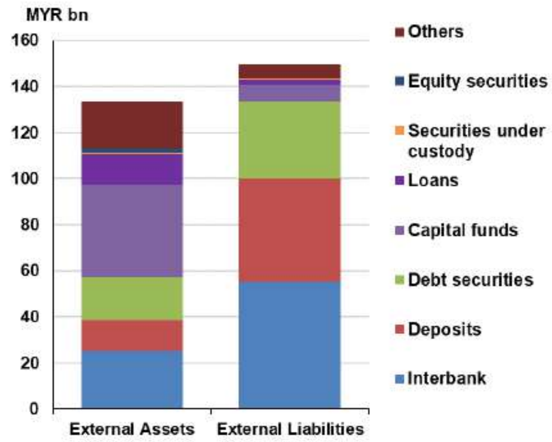
5. Although Malaysia stands out with its large external debt, external assets are also substantial on the back of sustained current account surplus, with the net international investment position (IIP) almost balanced. Malaysia's external assets have increased over the past decade together with the external liabilities. Total external assets amounted to MYR1.7 trillion (118 percent of GDP) by the end of 2018, and the net investment position at -MYR77.7 billion. About 75 percent of external assets are held by corporates and banks (Figure A1.9); this share is higher than for regional peers by 10 to 20ppts (Indonesia 64 percent, Thailand 56 percent and Philippines 54 percent). At times of external stress, these external assets – particularly the liquid FCY-denominated portion – can be drawn upon to meet borrowers' external debt obligations without having to draw upon the BNM's foreign reserves. Corporations, in particular, have substantial external assets to match their liabilities, which could provide a 'natural hedge' against external shocks. The currency composition is also another mitigating factor to currency depreciations, with FCY-denominated assets constituting 94 percent of total external assets and only 42 percent of total external liabilities.

Figure A1.9 External Assets and Liabilities (IIP)



Note: Corporations' external assets are estmated by deducting banks' external assets and reserves from the IIP assets, while corporations' external liabilities are inferred by deducting bank's external liabilities, federal government's and BNM's external debt from the IIP liabilities. Banks' external assets and liabilities are obtained from BNM's Financial Stability Review – First Half 2018.
Source: BNM; AMRO staff calculations

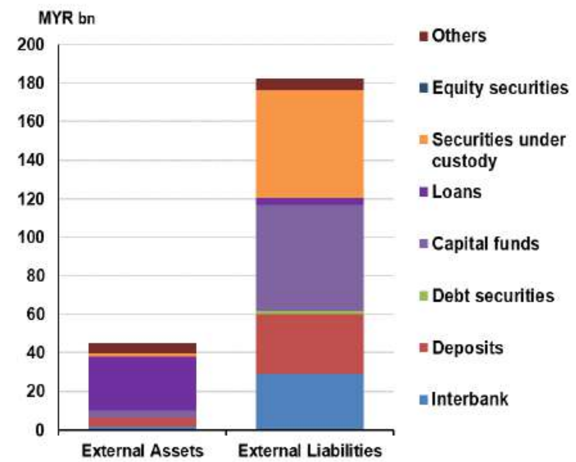
Figure A1.10 External Position of DBGs



Note: Data as of June 2018.
Source: BNM; AMRO staff calculations

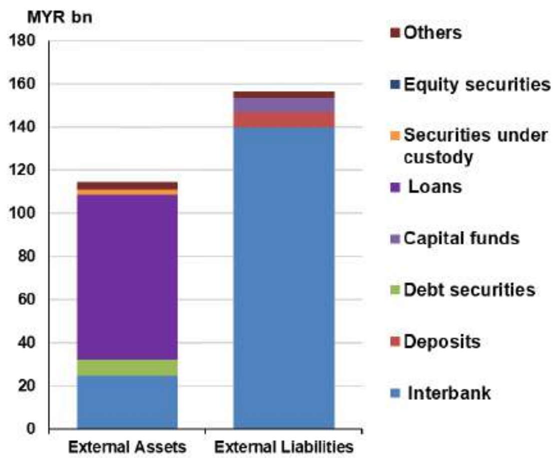
6. **While the banking system's external liabilities are greater than external assets (Figure A1.9), such net liability positon is mainly attributed to the LIFBs while the DBGs have a nearly balanced position.** The DBGs have extensive operations in the region, such as in Indonesia, Thailand and Singapore. As such, they hold substantial assets overseas, including in their subsidiaries, although they are also exposed to contagion and liquidity risks in countries where they have substantial investment exposure. In contrast, LIFBs have a larger net external liability position (Figure A1.11), as their operations focus more on the domestic market. While LIFBs receive placements from their parent banks based overseas and funding from external sources, they have sizeable domestic assets primarily coming from lending – likely in the form of trade financing – as well as other short-term investments.

Figure A1.11 External Position of LIFBs



Note: Data as of June 2018.
Source: BNM; AMRO staff calculations

Figure A1.12 External Position of Labuan Banks



Note: Data as of June 2018.
Source: BNM; AMRO staff calculations

7. **Labuan banks, which are located in the Federal Territory of Labuan, are unique as a significant proportion of their borrowings are 'back-to-back' in nature with limited**

liquidity and funding risks. Labuan banks are offshore banking subsidiaries set up in the Labuan financial center – located to the north of Borneo – by either Malaysian banks or foreign financial institutions. Labuan banks enjoy favorable regulatory and tax treatments granted to the Labuan financial center, and they play an important role in channeling financing from their parent financial institutions either outside or inside Malaysia. A significant proportion of their borrowings are from related offices and typically match with their lending in terms of amount, currency and tenure. These special features of Labuan banks minimize their exposure to liquidity and exchange rate risks.

8. The BNM has adopted multiple measures to monitor and contain the risks related to banks' and corporations' external liabilities. Banks are subject to the BNM's prudential requirements to contain liquidity and funding risk[29], while corporations are required to demonstrate that their FCY borrowings are for productive purposes and supported by FCY earnings, or sufficiently hedged. To contain the risk of financial institutions' overseas operations, foreign expansion moves by banks and other financial institutions such as insurers also require prior BNM approval, which takes into account, amongst others, the strength of the financial institution's financial capacity, risk management infrastructure and practices, and oversight by the parent institution. As part of its consolidated supervision, BNM imposes monthly reporting requirements on the overseas operations of financial institutions, and conducts onsite examination of the overseas operations of domestic banks.

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[29] Banks are required to establish and report to the BNM internal limits to contain liquidity and funding risks, such as against banks' ratios of net offshore (also, net domestic interbank) borrowing/acceptance to total domestic deposit and investment account funds, among many others. Meanwhile, banks are also required to monitor and report their liquidity needs in major currencies, such as USD and SGD, on an on-going basis.

Annex 2. Assessing Malaysia's Fiscal Policy Stance[30]

Changes in fiscal balance reflect both the economic cycle as well as discretionary measures. A widening budget deficit, therefore, is not necessarily an indication of a more proactive fiscal policy to support growth. It may stem from poor revenue performance due to a cyclical downturn. Thus, the decomposition of fiscal policy into cyclical factors and discretionary measures is important to enable us to assess the fiscal stance and deploy appropriate and prudent policies throughout the business cycle. This selected issue estimates the cyclically-adjusted primary balance and fiscal impulse to assess the fiscal policy stance and direction of fiscal policy in an appropriate manner.

1. **The cyclically-adjusted primary balance (CAPB) is estimated to measure the discretionary part of the fiscal policy.** Compared to the primary balance, CAPB can provide a better measure of fiscal policy stance, since it excludes the impact of the fluctuations stemming from the business and commodity cycles as well as one-off policy measures. In addition, separating cyclical factors from discretionary factors enables the government to measure the automatic stabilizer component of fiscal policy and, in turn, the size of fiscal stimulus needed to support growth during economic downturns.

2. **The CAPB is derived from revenue and non-interest expenditure on a cyclically-adjusted basis.** It requires estimates of potential revenue and expenditure, which depend on potential output, as follows:

$$\boldsymbol{CAPB} = [\boldsymbol{R} - OGR - OOR]\left(\frac{\boldsymbol{Y^p}}{\boldsymbol{Y}}\right)^{\varepsilon_R} - [\boldsymbol{G} - OGG - OOG]\left(\frac{\boldsymbol{Y^p}}{\boldsymbol{Y}}\right)^{\varepsilon_G}$$

where *R* is nominal revenue; Y^p is potential output; *Y* is actual output; ε_R is the elasticity of revenue with respect to output gap; *G* represents non-interest expenditure; and ε_G is the elasticity of non-interest expenditure with respect to output gap. In this estimation, the oil and gas-related component in revenue (OGR) and expenditure (OGG), and the one-off measures both on revenue (OOR) and expenditure (OOG) are also excluded. The estimation of the CAPB involves the estimation of elasticity of both revenue and expenditure with respect to output gap.[31]

3. **The fiscal policy stance is assessed both with the negative CAPB and fiscal impulse.** The fiscal stance at a particular time can be assessed by flipping over the sign of the CAPB (Figure A2.1). A deficit CAPB (positive fiscal stance) implies an expansionary fiscal policy. In contrast, a surplus (negative fiscal stance) is considered as a contractionary fiscal policy. Alternatively, fiscal stance is frequently assessed using fiscal impulse, which is defined as the difference between the fiscal stance at time *t* and fiscal stance at *t-1*. Fiscal impulse indicates whether fiscal policy is becoming more expansionary or less contractionary (positive

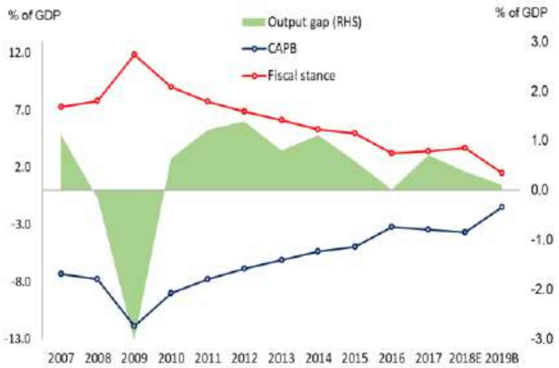
[30] Prepared by Abdurohman (Specialist).
[31] In many cases, for most developing countries, revenue elasticity is assumed to be 1 (i.e. revenue is perfectly correlated with the cycle) and expenditure elasticity to be 0 (i.e. expenditure is not affected by the business cycle, except for unemployment benefits). This assumption will be used here for simplicity.

impulse), less expansionary or more contractionary (negative impulse), or neutral (zero impulse) compared to last period.

4. **Based on the estimation of CAPB, fiscal policy in Malaysia has maintained a generally expansionary stance**. During the 2008-09 GFC, the government participated in a G20 initiative to support the global economy through the adoption of an expansionary fiscal policy which is globally synchronized. As a result of the fiscal stimulus program in 2009,[32] the CAPB widened from 7.5 percent of GDP in 2008 to 11.8 percent in 2009 (Figure A2.1). During the GFC, the primary balance deficit was larger than the CAPB deficit as revenue collection was weaker due to economic contraction. Since then, fiscal policy has remained expansionary but has been tightening as the government has been trying to reduce the budget deficits. The fiscal position has gradually improved over time as indicated by the narrowing overall fiscal deficit (Table A2.1).

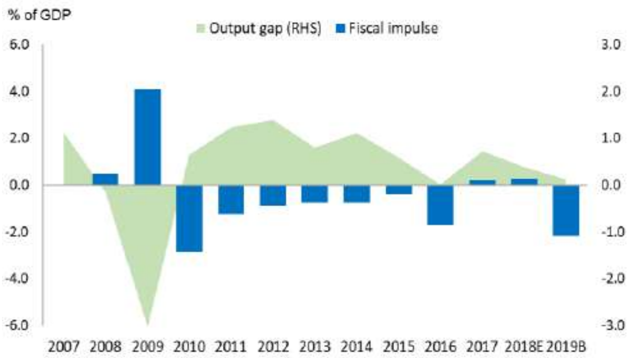
5. **The estimated fiscal impulse shows a clearer picture of fiscal consolidation in Malaysia**. As the output gap bounced back to positive territory in 2010, the government started to pursue fiscal consolidation. Figure A2.2 shows that the estimated fiscal impulse was in negative territory from 2010 to 2016, indicating that discretionary fiscal policy was becoming less expansionary over time, until 2017 and 2018 when it turned to slightly more expansionary.

Figure A2.1: Output Gap and Fiscal Stance



Note: CAPB stands for cyclically-adjusted primary balance. CAPB and fiscal stance are derived from the primary balance netting out the one-off components and oil and gas component.
Source: MOF; AMRO staff estimates

Figure A2.2: Output Gap and Fiscal Impulse



Note: Fiscal impulse is derived from the primary balance netting out the one-off components and the oil and gas component.
Source: MOF; AMRO staff estimates

6. **The widening budget deficit in 2018 under the new administration does not necessarily indicate a significant change of policy stance to spur growth.** The officially revised budget estimated that the budget deficit would go up sharply to 3.7 percent of GDP from the 3.0 percent outturn in 2017. Part of the increase in the budget deficit comes from the revenue loss from the re-adoption of the SST and the assumption of one-off expenditure items that were previously unbudgeted (see Table 2 on page 13). Excluding the one-off policy measures and the oil and gas-related component, the estimated CAPB deficit will widen from 3.4 percent to 3.7 percent in 2018, suggesting that the fiscal policy stance in 2018 can still be considered expansionary (Figure A2.1 and Table A2.1). Looking at the annual change (fiscal

[32] The government launched a stimulus package of MYR60 billion (about 9 percent of GDP) in 2009 which comprised of MYR15 billion in the form of a fiscal injection, MYR25 billion in Guarantee Funds, MYR10 billion for equity investment, MYR7 billion for private finance initiatives and off-budget projects, and MYR3 billion as tax incentives.

impulse) in Figure A2.2, the discretionary policy measures are expected to lead only to a small positive fiscal impulse of 0.2 percent of GDP in 2018, indicating a relatively small increase in the expansionary fiscal policy stance. The discretionary revenue measures as reflected by revenue impulse (Table A2.1), show an expansion of 0.7 percent of GDP, but it would be offset by shrinking expenditures of 0.5 percent of GDP.

Table A2.1 Malaysia's Fiscal Indicators

Items	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018E	2019B
Headline Fiscal Indicators (% of GDP)													
Revenue	21.0	20.8	22.3	19.4	20.3	21.4	20.9	19.9	18.9	17.3	16.3	16.5	17.2
Expenditure	24.6	25.5	29.0	24.9	25.1	26.0	24.9	23.4	22.2	20.5	19.4	20.3	20.7
O/w Interest payment	1.9	1.7	2.0	1.9	1.9	2.0	2.0	2.0	2.1	2.2	2.1	2.2	2.2
Loan recovery	0.5	0.1	0.1	0.2	0.1	0.3	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Primary balance	-1.2	-3.0	-4.7	-3.4	-2.7	-2.3	-1.7	-1.3	-1.1	-1.0	-0.9	-1.6	-1.3
Primary balance (excl. OG)	-7.1	-7.8	-12.3	-8.9	-7.6	-6.7	-6.0	-5.2	-4.8	-3.2	-3.3	-3.6	-1.5
Fiscal balance	-3.1	-4.6	-6.7	-5.3	-4.7	-4.3	-3.8	-3.4	-3.2	-3.1	-3.0	-3.7	-3.4
Fiscal balance (excl. OG)	-7.9	-7.2	-13.4	-9.6	-7.3	-5.8	-5.9	-5.4	-6.8	-5.3	-5.3	-5.6	-3.5
Cyclically adjusted fiscal indicators (% of GDP)*)													
Discretionary measures													
Revenue	13.2	13.0	13.4	12.6	13.1	14.0	14.5	14.2	15.0	14.9	13.7	13.0	12.0
Revenue impulse	0.5	-0.1	0.4	-0.8	0.4	0.9	0.5	-0.3	0.8	-0.1	-1.2	-0.7	-1.0
Expenditures	20.9	20.9	25.3	21.8	20.9	21.1	20.7	19.6	20.0	18.2	17.3	16.7	13.5
Expenditures impulse	0.8	0.0	4.4	-3.5	-0.9	0.2	-0.4	-1.1	0.5	-1.8	-1.0	-0.5	-3.2
CAPB	**-7.3**	**-7.8**	**-11.9**	**-9.0**	**-7.7**	**-6.8**	**-6.1**	**-5.3**	**-4.9**	**-3.2**	**-3.4**	**-3.7**	**-1.5**
Fiscal stance	7.3	7.8	11.9	9.0	7.7	6.8	6.1	5.3	4.9	3.2	3.4	3.7	1.5
Fiscal impulse	0.0	0.5	4.1	-2.9	-1.3	-0.9	-0.8	-0.8	-0.4	-1.7	0.2	0.2	-2.2
Memorandum													
Real GDP growth	6.3	4.8	-1.5	7.4	5.3	5.5	4.7	6.0	5.1	4.2	5.8	4.8	4.5
Output gap (RHS)	1.1	-0.2	-3.0	0.6	1.2	1.4	0.8	1.1	0.6	0.0	0.7	0.4	0.1

Note: *) The cyclically adjusted fiscal indicators are calculated by netting out cyclical factors, one-off measures and oil and gas-related components. The output gap is calculated using the following formula: $Ygap = \frac{Y_t - Y^*}{Y^*}$ where Ygap is output gap, Yt is output at time t, and Y* is potential output. Fiscal impulse refers as an annual change of fiscal stance. Revenue (expenditure) impulse is calculated as an annual change of the cyclically adjusted revenue (expenditure). Figures for 2019 use the nominal GDP from the AMRO staff projection which may be slightly different from the official projection.
Source: MoF; AMRO staff calculations

7. **The discretionary policy measures in the 2019 budget are expected to contribute to a negative fiscal impulse.** Excluding the oil and gas-related components, one-off measures (special PETRONAS dividend) and cyclical factors, the revenue measures will provide a stimulus of around 1 percent of GDP to the economy. However, the discretionary expenditure measures are estimated to reduce fiscal impulse by 3.2 percent of GDP. The government's commitment to reduce wastages and leakages has slowed expenditure growth in the 2019 budget. Considering revenues and expenditures together, the discretionary measures in the 2019 budget appear to be much less expansionary as they will likely to contribute a negative fiscal impulse of 2.2 percent of GDP (Table A2.1).

8. **Given a conservative approach in revenue projection, the budget outturn in 2019 is likely to record a lower-than-planned fiscal deficit, implying that discretionary fiscal policy will be even less expansionary than intended.** According to the 2019 budget formulated in late 2018, total revenue is projected to increase by 10.7 percent in 2019. However, the projected revenue has not incorporated fully the revenue enhancing measures

introduced in early 2019. Based on historical practices, the likely lower disbursement of the development spending than in the budget, will also weaken further fiscal impulse in 2019.

Conclusion

9. Calculating the CAPB, as well as identifying the fiscal stance and fiscal impulse, can help policymakers evaluate fiscal policy more correctly. Greater attention to the CAPB rather than the headline fiscal balance target can help to strengthen the design of the fiscal policy framework. In addition, presenting the CAPB in budget documents can enhance public understanding of fiscal policy over the business cycle. During periods of economic boom, using the CAPB in budget formulation can help policymakers recognize the transitory revenue, which should be saved as a fiscal buffer. On the other hand, during downturns, the CAPB can guide the government in estimating the size of the fiscal stimulus needed to support economic growth.