4. Debt Sustainability Analysis[109]

Malaysia faces a moderate debt sustainability risk. Under current policies, the debt ratio is expected to stabilize and decrease slightly over the medium term. Although the debt ratio and GFNs are projected to stay below the emerging market economies threshold, the debt ratio is projected to remain above the official debt ceiling until 2028. Large contingent liabilities in Malaysia increase fiscal risks. Malaysia should expedite subsidy rationalization and revenue mobilization to ensure that its debt ratio follows a firm downward trajectory, and strengthen fiscal management of contingent liabilities to mitigate risks.

Background

1. **Public debt initially decreased under the shift to post-pandemic policy normalization but later rose sharply in 2023[110].** The shift to policy normalization led to a fall in public debt from 63.3 percent of GDP in 2021 to 60.2 percent in 2022. However, the decline was temporary, as public debt surged by 4.1 percent of GDP to 64.3 percent of GDP in 2023**.** The rise was primarily due to lower inflation and growth, despite the stable interest rate and the smaller primary deficit resulting from strong tax revenue collection in 2023.[111]

2. **Gross financing needs (GFNs) have declined from the pandemic-era peak and remained stable.** GFNs fell from the peak of 11.6 percent in 2021 to 9.7 percent in 2022 before stabilizing at 9.8 percent in 2023. The rise in domestic amortization by 0.6 percent of GDP and in interest payments by 0.2 percent in 2023 were nearly offset by the lower primary deficit of 0.7 percent of GDP, resulting in a net 0.1 percent of GDP increase in the GFN ratio.

3. **Malaysia's public debt consists predominantly of ringgit-denominated bonds with long-term maturity, with a significant share held by nonresidents (Figure A4.1).** By the end of 2023, LCY-denominated and long-term maturity public debt represented 97.5 percent and 58.2 percent of total outstanding public debt, respectively. Meanwhile, nonresident holdings of government securities comprised 24.0 percent of total outstanding public debt. Of public external debt, 91.1 percent was denominated in local currency, and 98.7 percent is of medium and long-term maturity (Figure A4.2).

Macroeconomic and Fiscal Projections

4. **Baseline assumptions are underpinned by a positive growth outlook resulting from sound policy and structural reform commitment.** Growth is assumed to range between 4.6 and 4.9 percent in the medium term (2025-2028) on the back of sustained domestic demand, robust tourism recovery, a favorable export outlook and market-friendly policies as well as structural reforms aimed at improving the business environment and attracting foreign investment (Figure A4.3). Inflation is expected to pick up in the near term, assuming a hike in RON95 fuel prices from subsidy rationalization.[112]

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[109] Prepared by Dek Joe Sum

[110] The public debt sustainability analysis (DSA) for Malaysia covers the federal or central government, in line with the data on government debt reported by the authorities. This definition encompasses more than 90 percent of general government debt. However, it excludes local and state governments, as well as statutory bodies, which typically receive explicit government guarantees. Malaysia's contingent liabilities include government loan guarantees (GGs) provided to non-financial, government-related entities to primarily carry out infrastructure and other strategic projects.

[111] The evolution of gross debt dynamics depends on the nominal interest rate, real growth rate, inflation, exchange rate and primary balance. In 2023, contributions to debt dynamics from the nominal interest rate, real growth rate, inflation, exchange rate and primary balance were 2.6 percent, -2.1 percent, 1.1 percent, 0.1 percent and 2.5 percent of GDP respectively, which resulted in a net increase of 4.1 percent of GDP in the debt-to-GDP ratio.

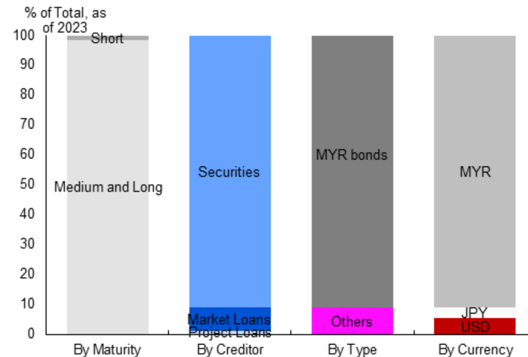
[112] See paragraphs 5 and 6 in the main report for more discussions on the macro-outlook.

5. The expected lower primary deficit in the medium term is mainly attributed to spending-based consolidation. Fiscal deficit continued to narrow to 5.0 percent in 2023 from 5.5 percent in 2022, and the government has committed to further fiscal consolidation in the medium term. The current DSA makes baseline assumptions that include anticipated fiscal savings from the diesel subsidy retargeting launched in June 2024 and a proposed two-phase staggered implementation of RON95 subsidy retargeting.[113] The planned one-off civil service wage hike in 2025 has been incorporated. Additionally, a pre-pandemic tax elasticity of 0.9 is assumed in making revenue projections.[114]

Figure A4.1. Public Debt Structure

Source: Ministry of Finance (MOF); AMRO staff estimates
Note: Public debt encompasses central government securities denominated in LCY and FCY.

Figure A4.2. Public External Debt Structure



Source: MOF; AMRO staff estimates
Note: Public external debt is defined as government's offshore borrowings and non-resident holdings of MYR-denominated government securities.

Table A4.3. Macroeconomic and Fiscal Indicators

	2018	2019	2020	2021	2022	2023	2024p	2025p	2026p	2027p	2028p
Macroeconomic indicators (Percent)											
Real GDP growth	4.8	4.4	-5.5	3.3	8.9	3.6	4.7	4.9	4.6	4.7	4.7
GDP deflator	0.6	0.1	-0.8	5.7	6.4	-1.9	2.5	3.2	2.0	2.0	2.0
Effective interest rate	4.4	4.4	4.3	4.3	4.2	4.3	4.2	4.4	4.5	4.4	4.4
Fiscal indicators (Percent of GDP)	2018	2019	2020	2021	2022	2023	2024p	2025p	2026p	2027p	2028p
Revenue	16.1	17.5	15.9	15.1	16.4	17.3	15.7	15.0	14.6	14.3	14.0
Expenditure	19.8	20.9	22.0	21.5	22.0	22.3	20.1	19.1	18.3	17.7	17.1
Fiscal balance	-3.7	-3.4	-6.2	-6.4	-5.6	-5.0	-4.4	-4.1	-3.6	-3.4	-3.1
Primary balance	-1.6	-1.2	-3.7	-3.9	-3.2	-2.5	-1.8	-1.4	-1.0	-0.8	-0.5
Public debt	51.2	52.4	62.0	63.3	60.2	64.3	64.4	63.7	63.4	62.9	62.1
Gross financing needs	8.1	8.0	11.6	11.6	9.7	9.8	8.6	8.2	7.8	7.5	7.2

Source: MOF; AMRO staff estimates
Note: The macroeconomic and fiscal indicators for 2024-2028 are based on AMRO staff projections.

Baseline Debt and GFN Projections

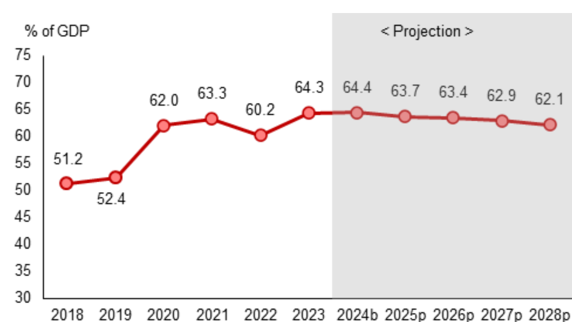
6. Under existing policies, the public debt-to-GDP ratio is projected to decline but fall short of the official desired medium-term targets and debt ceiling (Figure A4.4). The high share of rigid current spending is expected to undermine expenditure-based fiscal consolidation envisioned in the MTFF[115]and slow the decline in debt-to-GDP ratio. A phased implementation of RON95 subsidy retargeting based on AMRO's

[113] Diesel subsidy retargeting is expected to generate MYR4.1 billion, or 0.2 percent of GDP, in 2024, while a full-year implementation in 2025 will likely yield MYR5.6 billion, equivalent to 0.3 percent of GDP. A staggered two-phase RON95 subsidy retargeting is forecast to generate MYR2.8 billion (0.1 percent GDP) in 2024, followed by MYR10.4 billion (0.5 percent of GDP) in 2025. A full implementation of diesel and RON95 subsidy rationalization is expected to generate MYR18.7billion (1.0 percent of GDP) annually. The estimates reported have accounted for cash transfers to the bottom 40 percent of income earners. Assumptions on Brent crude oil for 2024 and 2025 are USD81.5 per barrel and USD76.2 per barrel respectively; exchange rate assumptions for 2024 and 2025 are USD/MYR 4.7 and USD/MYR 4.5 respectively. The assumptions on Brent crude oil price, real GDP growth, and fiscal consolidation pace in this DSA are different from the authorities in the 2024 Budget.
[114] See footnote 29 in the main report for more discussions on the new tax measures introduced in 2024. These measures are not expected to generate a substantial impact on tax revenue.
[115] In the 2024 three-year medium-term fiscal framework (MTFF), Malaysian authorities project the fiscal deficit to narrow to 3.5 percent of GDP in 2025 and 3.0 percent of GDP in 2026, a much quicker adjustment pace compared with AMRO estimates.

assessment is expected to generate positive fiscal savings in 2025, helping offset the one-time rise in civil service wage hike. Primary balance is expected to narrow but remains negative in the absence of new revenue measures. As a result, public debt ratio is projected to decline to 62.1 percent of GDP by 2028, but still above the 60 percent debt limit stipulated in the PFFRA. Fiscal savings from subsidy retargeting alone, is not sufficient to ensure fiscal consolidation at the authorities' desired pace amid a sizable rigid current expenditure and rising social expenditure needs. Hence, alternative sustainable revenue sources should be explored to put debt on a firm downward trend.

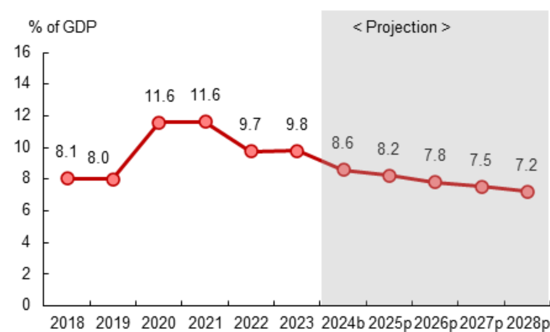
7. GFNs are expected to trend downwards in the medium term (Figure A4.5). GFN is expected to trend downward from 9.8 percent of GDP in 2023 to 7.2 percent in 2028. This can be attributable to a smaller primary deficit based on the government's commitment to fiscal consolidation in the medium term (Figure A4.7). Additional expenditures from the planned civil service wage hike in 2025 are expected to be fully offset by the fiscal savings from the diesel and RON95 subsidy rationalization, resulting in a smaller primary deficit in 2025 while holding all other factors constant.[116]

Figure A4.4. Public Debt



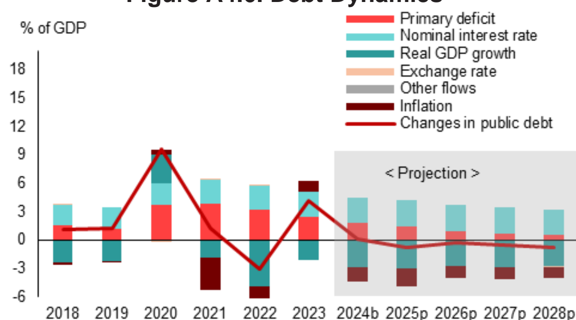
Source: MOF; AMRO staff estimates

Figure A4.5. Gross Financing Needs



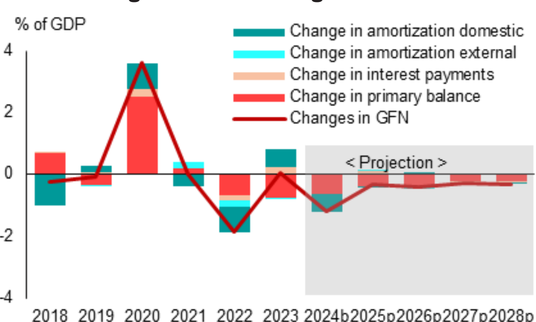
Source: MOF; AMRO staff estimates

Figure A4.6. Debt Dynamics



Source: MOF; AMRO staff estimates

Figure A4.7. Changes in GFN



Source: MOF; AMRO staff estimates

Macro-fiscal Risks—Stress Test

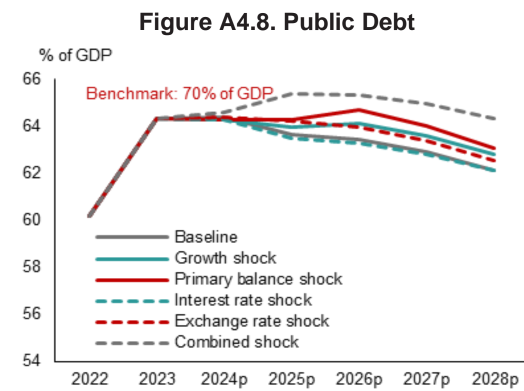
8. Stress test results indicate that public debt is most susceptible to a primary balance shock (Figure A4.8).[117] The primary balance may deteriorate if public expenditure reforms fail to gain support and lead to policy reversals or delayed implementation of the planned petrol subsidy rationalization. Setbacks in ongoing tax administrative reforms could

[116] AMRO estimates that the diesel and RON95 subsidy retargeting is expected to generate MYR16 billion fiscal savings, while the civil wage hike is estimated to incur MYR12 billion in additional expenditure.
[117] The scenarios for the stress test are as follows: 1) Real GDP growth shock: one standard deviation or a -1.0 percentage point shock to 2025 and 2026; 2) Primary balance shock: one standard deviation or a -1.5 percent of GDP shock to 2025 and 2026; 3) Interest rate shock: a +2 percentage point shock from 2025; 4) Exchange rate shock: a one-time +5 percentage point shock in 2025; 6) Combined shock: combination of growth (half size), primary balance (half size), interest rate and exchange rate shocks.

also stall the fiscal consolidation process. Downside risks to growth, such as a global economic slowdown, a fall in commodity prices or trade disruptions, could also derail the declining debt path. The stress tests show that exchange rate and interest rate shocks have relatively small impacts, in part due to Malaysia's favorable public debt profile.

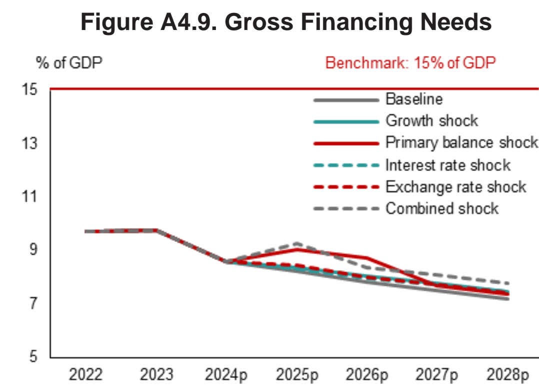
9. **GFNs are most sensitive to a primary balance shock (Figure A4.9).** A primary balance shock directly affects financing needs, while other shocks indirectly affect financing needs through the primary balance, interest payments, and amortization over time. Nevertheless, the GFN-to-GDP ratio remains firmly below the international threshold of 15 percent for emerging market economies despite the shocks.[118]

Figure A4.8. Public Debt



Source: MOF; AMRO staff estimates

Figure A4.9. Gross Financing Needs



Source: MOF; AMRO staff estimates

Country-specific Factors

10. **A worst-case scenario of the government having to fulfill its committed guarantees can pose serious challenges to public debt sustainability.**[119] The government's contingent liabilities are relatively large compared to regional peers, standing at 18.0 percent of GDP in 2023 (Figure A4.11). Assuming the government is required to fulfill all its committed guarantees[120] in 2025, the debt-to-GDP ratio is projected to surge to 75.6 percent in 2025 before gradually decreasing to 71.7 percent by 2028 (Figure A4.12). The GFN-to-GDP ratio is expected to spike to 10.1 percent in 2026, and average around 10.5 percent in 2027 and 2028 (Figure A.13). This represents the worst-case scenario among all shocks, surpassing the 70 precent debt threshold and the PFFRA debt ceiling.[121]

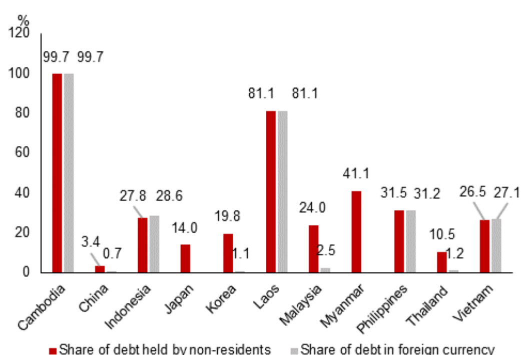
Debt Profile Vulnerabilities—Early Warning

11. **Market perceptions of sovereign risk have remained low and have shown signs of improving further.** The EMBI Global spread, which reflects the market perception of risk, has declined steadily by more than 20 bps since late 2023 (left panel in Figure A4.14). Low market perception of risk can be confirmed by the CDS spread, which showed similar movements to the EMBI Global spread. The narrowing spread is, in part, attributed to the structural reforms and market-friendly measures pledged by the authorities. Malaysia

[118] According to the IMF-WB DSA for Market Access Countries (MAC) (2013), the GFN threshold in percentage of GDP for emerging markets is 15 percent.
[119] Contingent liability shock is discussed differently due to Malaysia's large contingent liabilities and its significant impact on the country's debt sustainability. Contingent liability shock assumes the worst-case scenario of a one-off 18.0 percent of GDP shock materializing in 2025. An even amortization of principal and interest payments of committed guarantees over 10 years is assumed when calculating the medium-term GFNs.
[120] Contingent liabilities shock used in this DSA refers to committed guarantees provided under the Loans Guarantee (Bodies Corporate) Act 1965 [Act 96] and Section 14 of the Financial Procedure Act [Act 61]. Committed guarantee in Malaysia has a narrower scope compared to Government's contingent liabilities, which broadly includes financial obligations arising from committed guarantee, public-private partnership, and private finance initiative. The total size of contingent liabilities in 2023 amounts MYR 327.0 billion (18.0 percent GDP) while committed guarantees comprise about 67% of total contingent liabilities of MYR 221.4 billion (12.0 percent GDP).
[121] According to the IMF-WB DSA in MAC (2013), the threshold for the public debt-to-GDP ratio in emerging markets is 70 percent. The PFFRA requires public debt to be below 60 percent in the medium term, latest by 2028.

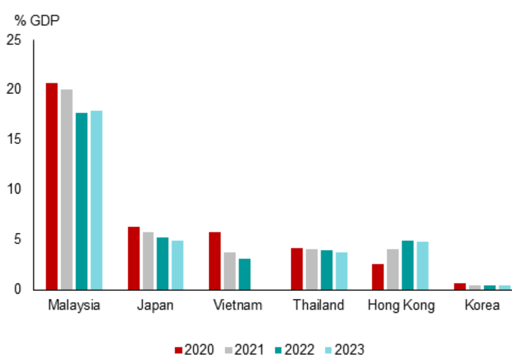
has also succeeded in maintaining the investment grade of sovereign credit ratings issued by major credit agencies.

Figure A4.10. External Public Debt



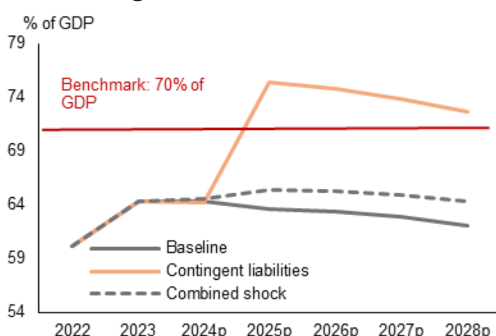
Source: CEIC; AMRO staff estimates
Note: Data is up to 2023. The share of debt denominated in foreign currency for Myanmar is not available.

Figure A4.11. Contingent Liabilities



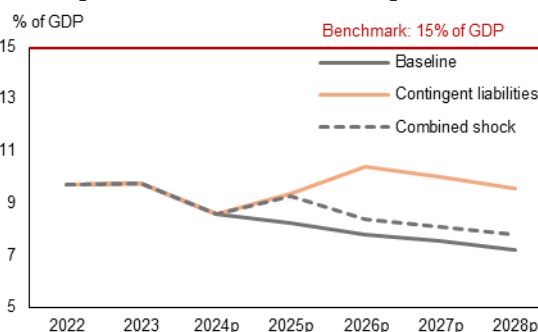
Source: CEIC; AMRO staff estimates
Note: Contingent liabilities here refer to publicly guaranteed debt by the government to allow cross-country comparison. The scope is different from the committed guarantee used in the DSA shock (refer to footnote 116).

Figure A4.12. Public Debt



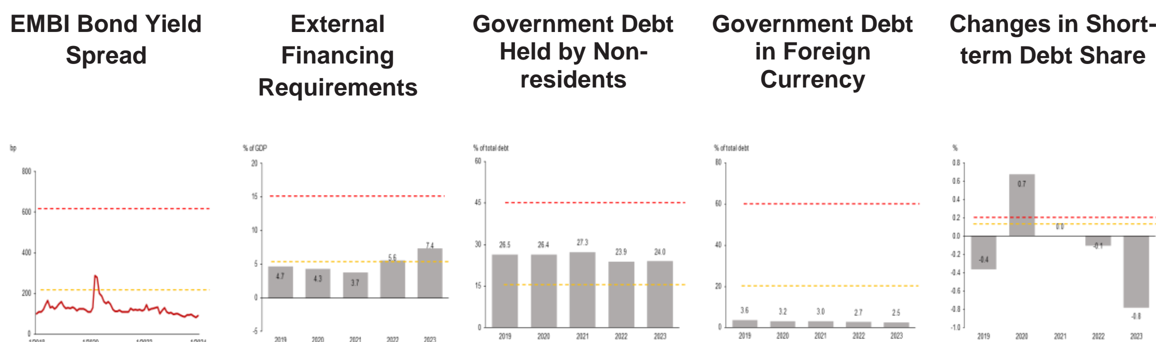
Source: MOF; AMRO staff estimates
Note: Combined shock does not include contingent liabilities shock.

Figure A4.13. Gross Financing Needs



Source: MOF; AMRO staff estimates
Note: Combined shock does not include contingent liabilities shock.

Figure A4.14. Debt Profile Vulnerabilities



Source: Haver Analytics; MOF; AMRO estimates
Note: 1) – – – Lower early warning (25 percent of the benchmark), – – – Upper early warning (75 percent of the benchmark). See IMF (2013) for a detailed discussion; 2) EMBI global spreads are computed by monthly average of daily spreads; 2) public debt denominated in non-local currency; 3) External financing requirements = current account deficit + amortization of public external debt + amortization of private external debt; 4) Public debt held by nonresidents is based on the jurisdiction of issuance; 5) Short-term debt is based on the original maturity.

12. Debt profile has been broadly sound (Figure A4.14). The share of short-term debt has been declining as the government moves to longer-term financing. The deep and

liquid domestic capital market as well as the broad investor base have enabled Malaysia to rely on debt denominated in the local currency, reducing currency risk. However, the share of debt held by nonresidents is between the lower and upper early warning thresholds, which have remained stable over the years, implying moderate vulnerability to rollover and interest rate risks. External financing requirements also exceeded the lower early warning threshold in 2022 and 2023, mainly due to higher external repayment obligations incurred by the private sector. However, the risk is mitigated by ample external assets held by resident institutions.[122]

Overall Assessment

13. The standard DSA results reveal the overall risk of public debt sustainability to be moderate (Figure A4.15). While public debt is projected to gradually flatten over the medium term and remain below the 70 percent threshold for emerging market economies, the baseline projection shows that public debt will remain above the official debt ceiling of 60 percent in the medium term. Malaysia's debt risk can be affected by a sudden materialization of contingent liabilities. The declining revenue trend, combined with rising social expenditure needs from health and education sectors, reflecting human capital development and population aging, are expected to increase fiscal risk.

14. Sustained fiscal reforms, with revenue mobilization measures, are required to maintain debt sustainability. Malaysia has implemented the diesel subsidy retargeting and should accelerate RON95 subsidy rationalization to improve public expenditure efficiency. Nonetheless, expenditure reprioritization alone is unable to meet medium-term fiscal targets set by the government. Additional major revenue sources should be explored, and in this regard, reintroducing GST can address the gap and put debt on a firm downward path. If policy risks materialize, such as policy withdrawals or a backlash from the fiscal reforms, these may push up the debt and GFN ratio, presenting a downside risk to debt sustainability. On the financing side, although GFNs are expected to decline steadily and remain broadly modest, a sudden shift in market sentiment or a rapid rise of financing costs could cause financing stress.

Figure A4.15. Heatmap of Public Debt Sustainability [123]

		2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Public Debt											
Gross Financing Needs											
Debt Profile	Market Perception of Sovereign Risk										
	External Financing Requirement										
	Public Debt held by Non-residents										
	Public Debt in Foreign Currency										
	Change in Short-term Debt Share										

Source: AMRO staff estimates
Note: 1) For Public Debt and Gross Financing Needs, the cell is highlighted in green if the benchmark is not exceeded under any shocks or the baseline, yellow if it is exceeded under any specific shock but not the baseline, and red if it is exceeded under the baseline; 2) For Debt Profile, the cell is highlighted in green if the country value is less than the lower early warning benchmark, red if it exceeds the upper early warning benchmark, and yellow if it is between the lower and upper early warning benchmarks.

[122] See paragraph 45 in the main report for more discussion on external assets held by resident institutions.
[123] The change in short-term debt share exceeded the upper-warning threshold in 2020 (reflected as red) due to the increased issuance of short-term debt instruments to finance COVID-19 expenditures.