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Malaysian Economy：Performance and Outlook

～Sustainability of its Current Account Surplus and its Risk Factors～

Akira Nakamura
Deputy General Manager and Principal Economist
akira_nakamura@iima.or.jp
Economic Research Department
Institute for International Monetary Affairs (IIMA)

＜Summary＞

1. The growth rate of the Malaysian real GDP has picked up since the latter half of 2016. Unemployment rate remains low, and consumer inflation has been relatively stable. The budget deficit for a single year has been small. The economy is expected to continue to be on an expansion path for the moment, with no big causes for concern found in the domestic economy.
2. The country continues to have a current account surplus but the surplus has tended to decline mainly because of a decrease in the trade surplus with its ratio to nominal GDP declining to 2.0% in 2016. On the other hand, the deficit in the primary income balance has been narrowing since 2015, putting a brake, albeit a small, on the decline in the current account surplus.
3. The level of foreign exchange reserves stood at $96.4 billion, or equivalent of 8.2 months of imports, as of May 2017. It has satisfied the requirement for the external settlement. The ratio of short-term external debts to foreign exchange reserves reached 80% at the end of 2015, recording a rather high level among the world emerging economies. However, as

Malaysia has a net asset balance in its international investment position, the high level of short term debts is unlikely to instantly raise a concern for the Malaysia's payment ability of its external debts.

4. A short-run concern for the narrowing current account surplus is likely to be wiped out as the decline in trade surplus, the main cause of the narrowing current surplus, has been now halted and the trade surplus is expected to increase with an increase in exports reflecting (i) an expansion of the overseas economies, (ii) depreciating Malaysian ringgit and (iii) bottoming out of the falling price of mineral fuels.
5. However, as it is highly possible that it will become difficult for Malaysia to have an expanding trade surplus in the long run, it will have to achieve and sustain a primary income surplus in order to maintain a surplus in the current account balance. Actually, the primary income balance is expected to turn into a surplus from now on.
6. If the primary income balance does not shift to surplus, the current account may fall into deficit coupled with the narrowing surplus in trade and services account, which needs a careful attention. In order to create a surplus in the primary income balance, the creditors will be required to make a careful management and operation of their overseas investment assets so that the profits on them could be surely produced and repatriated.
7. A current risk factor is the development of political situation. Important political schedules have become unpredictable as is shown in the possibility that the general election of the House of Representatives (Dewan Rakyat) which is formally slated for April 2018 is likely to be accelerated to 2017. If the ruling coalition parties should lose the number of seats due to a fund problem involving Prime Minister Najib Razak relating to a state investment fund, it will lead to a confused political situation with a growing concern over the delay of policy implementation, ultimately inviting a stagnation of inward direct investment and a fall of its currency ringgit. So the future political development will require a careful watch, but at the current moment its possibility is considered to be not so high.

1. Economic growth re-accelerating since the latter half of 2016

The Malaysian economy continued to decelerate until the first half of 2016 following the slowdown in 2015, mainly reflecting the slowdown in exports to the advanced economies, main destinations of Malaysia's exports, and a decline in prices of natural resources, its main export items, as well as stagnant domestic capital investment by the companies affected by these factors to lower their investment incentives. On the other hand, private consumption was relatively robust supported by the increase of minimum wages and the impact of cash payments to the low income households. As a result, the real GDP grew in 2016 by a relatively strong 4.2% from a year earlier, although slowing from the growth of 5.0% recorded in 2015 (Chart 1).

By contrast, the real GDP growth picked up since the latter half of 2016 supported by the solid private consumption and pickup in exports buoyed by the recovery of the world economy coupled with an impact of depreciation of the ringgit. After growing by 4.5% year over year in the October-December period of 2016, the real GDP rose in January-March quarter of 2017 by 5.8% y/y, the strongest growth since January-March period in 2015. The Malaysian economy is expected to continue to grow in the time ahead, supported by the expansion of the global economy centering on advanced economies and the past depreciation of the ringgit as well as by the bottoming out of commodity prices. In the World Economic Outlook released in April, the IMF forecast a continuation of moderate growth for the Malaysia's real GDP, projecting it at 4.5% for 2017, and 4.7% for 2018. Given the high growth seen in the January-March period, it is highly likely that the growth rate in 2017 may be a bit higher than the forecast of the IMF.

Chart 1：Malaysia: Real GDP Growth Rate

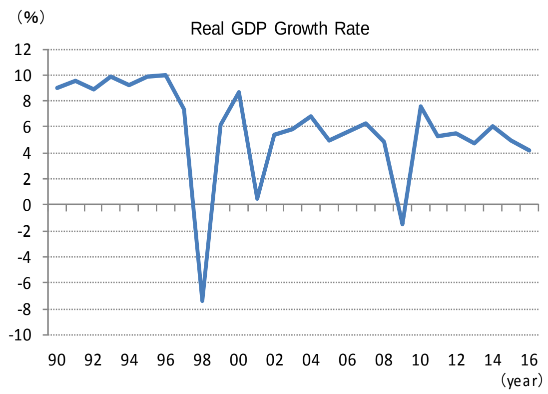
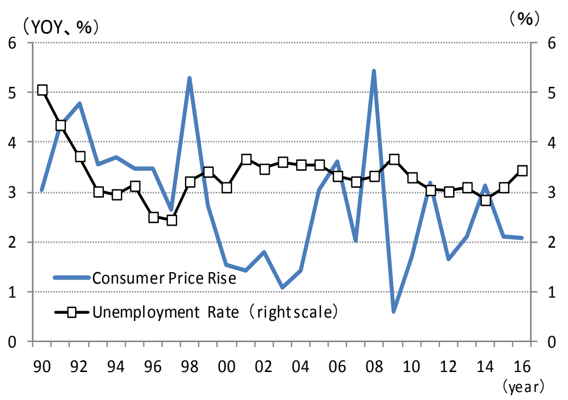


Chart 2：Malaysia: Consumer Price and Jobless Rate



（Source）IMF and Bank Negara Malaysia

In the meanwhile, employment situation had a generally good development, and although unemployment rate rose in two consecutive years, it averaged at 3.5% in 2016, lower than the peak rate in the past 20 years (Chart 2). On a monthly basis, it has tended to fall after reaching 3.6% in November 2016.

Despite the rise in food and beverage, consumer price inflation generally remained stable thanks to a fall in fuel prices reflecting lower oil price. It rose by 2.1% in 2016, the same rate as in 2015. Headline consumer inflation increased in early 2017 due to higher energy prices, but with the stabilized core prices excluding food and energy and a lull in energy prices it is recovering its stability after April (Chart 2).

Fiscal balance has been in red and in 2015 and 2016, the ratio of the deficits to nominal GDP expanded its negative values in two consecutive years. However, thanks to the introduction of the Goods and Service Tax (GST) which contributed to halt the decrease in the revenues, the ratio remained at a relatively low level of around 3% (Chart 3). On the other hand, government debt outstanding continued to expand, reaching almost 60% of nominal GDP at the end of 2015, which is among the highest levels in Emerging Asian countries (Chart 4). On the basis of this situation, the Malaysian government aims at achieving a balanced budget by 2020 through the review of both revenues and expenditures. The IMF forecasts a budget deficit of about 2% for 2020.

Chart 3：Malaysia: Fiscal Balance
（% of nominal GDP）

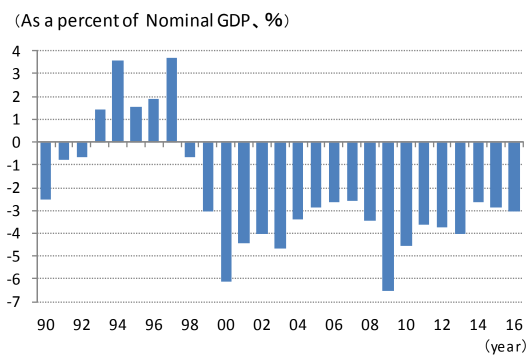
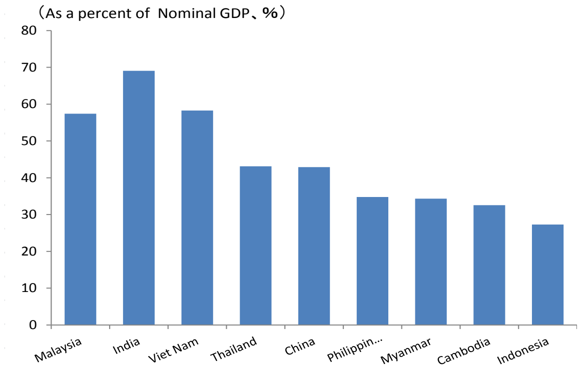


Chart 4：Public Debts Outstanding in Asia
（% of nominal GDP, end of 2015）

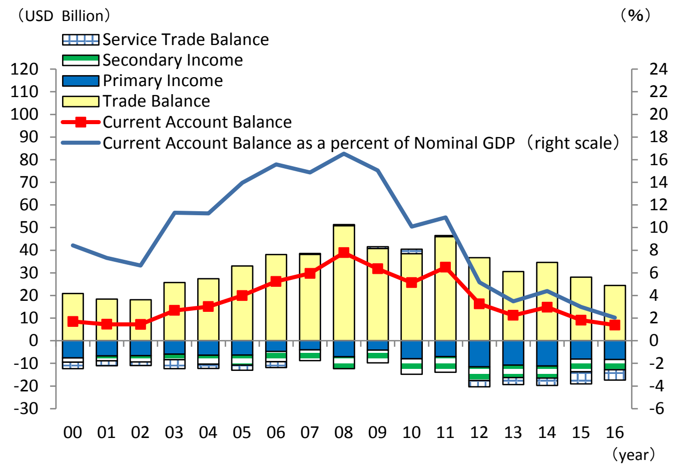


(Source) IMF, Bank Negara Malaysia

2. Narrowing Current Account Surplus and Net Asset Position in International Investment Position

The current account balance in Malaysia has been in surplus, but on a decreasing trend owing to a narrowing trade surplus. The surplus declined to 2.0% of nominal GDP in 2016. In the meanwhile, the primary income balance, consisting mainly of direct investment income and portfolio investment income, saw the deficits gradually decline since 2015, putting a little brake on the decrease of the current account surplus (Chart 5).

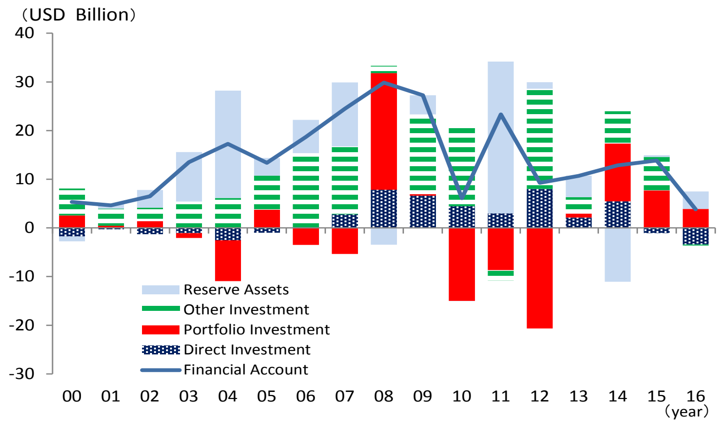
Chart 5：Malaysia: Current Account Balance



(Source) IMF and Bank Negar Malaysia

While the current account surplus continues, in the financial account balance, acquisition of external assets by Malaysian investors (capital outflow) continued to exceed foreign acquisition of Malaysian financial assets (capital inflow) (Chart 6). The net excess of acquisition of external assets by Malaysian capital, however, has been on a downward trend in line with the decline in the current account surplus. On the portfolio investment, net acquisition of external assets by Malaysian capital exceeded the net foreign acquisition of Malaysian assets for the three consecutive years from 2014 to 2016, while on the direct investment foreign acquisition of Malaysian assets exceeded for two successive years of 2015 and 2016.

Chart 6：Malaysia: Development in Financial Account Balance



(Note) Positive figures in financial account balance indicate net acquisition of foreign assets by Malaysian investors (capital outflow), while negative figures indicate net foreign acquisition of Malaysian assets (capital inflow).

(Source) IMF and Bank Negara Malaysia

In the meanwhile, foreign exchange reserves decreased noticeably in 2014 and 2015. It suggests that the Bank Negara Malaysia (central bank) intervened in the market by selling the dollar for the ringgit to put a brake on the fall of the ringgit. However, the fall of reserves stopped in 2016 and the level stood in May 2017 at $96.4 billion or equivalent to 8.2 months of imports, and it is judged to have met the required level adequate for external settlement of payments[1] (Chart 7).

Chart 7：Malaysia: Foreign Exchange Reserves

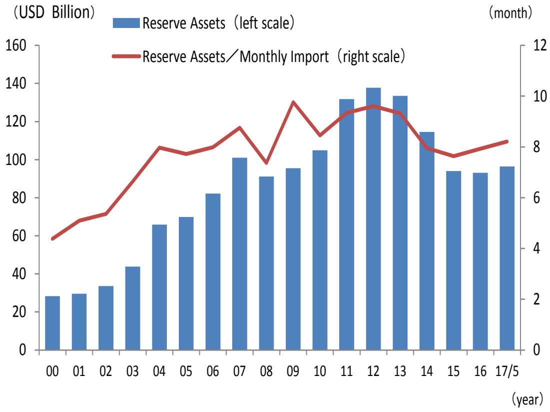
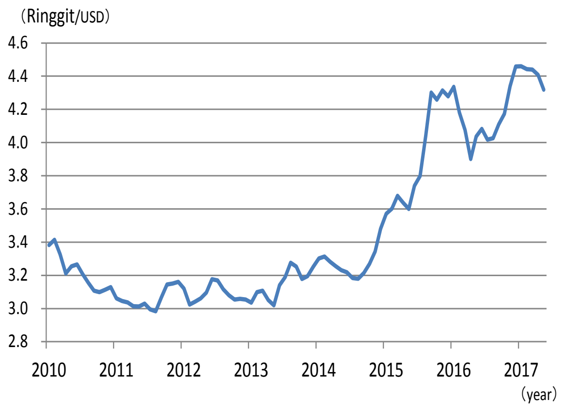


Chart 8：Development of Malaysian Ringgit

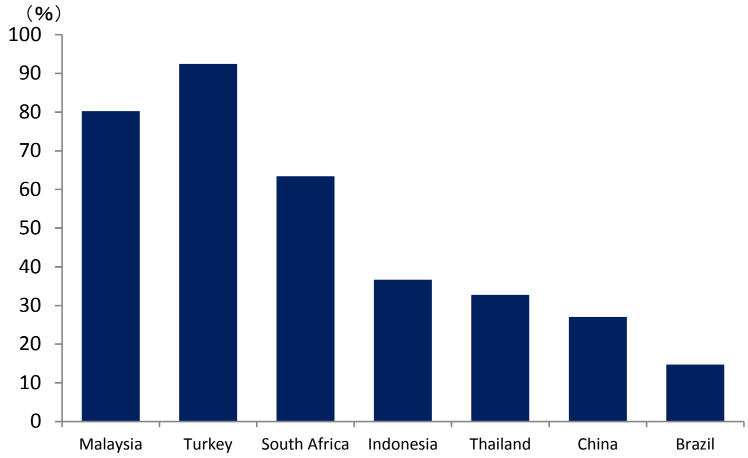


(Source)　IMF and Bank Negara Malaysia

The ratio of short-term external debts to foreign reserves reached 80% at yearend of 2015, ranking high among emerging economies (Chart 9). As Malaysia has a net asset position in its international investment position (IIP), however, it is highly unlikely that the high level of short-term debt immediately triggers a concern over its payment capacity of external debts, yet optimism is not warranted given the recent development of the current account surplus (Chart 10). For, if the current account surplus continues to decline in the time ahead, and eventually turns into deficit, an expansion of external debts will be accelerated through the net foreign acquisition of Malaysian assets.

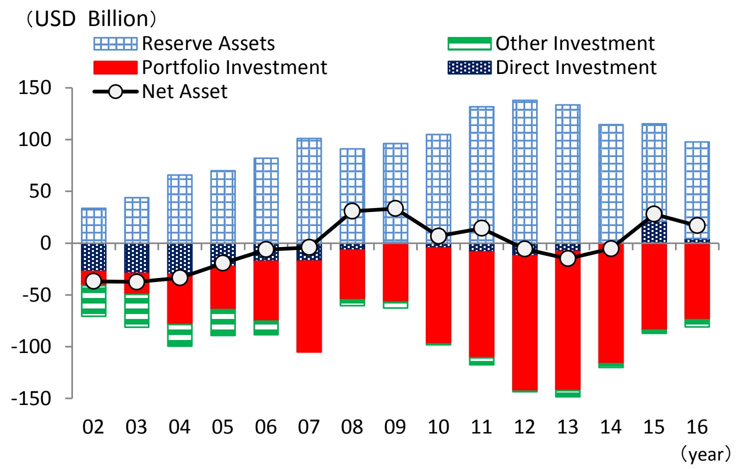
[1] Please refer to the Supplementary Note 1 for the measures the BNM implemented to counter the depreciation of the Malaysian ringgit.

Chart 9：Ratio of Short-term debts to Foreign Exchange Reserves



(Source) World Bank

Chart 10：Malaysia: International Investment Position



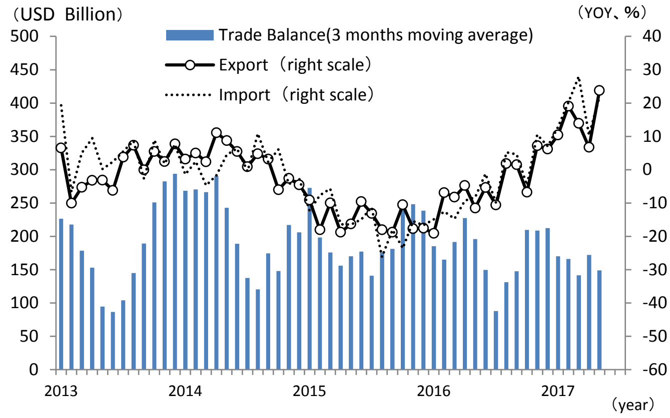
(Note) Others include bank loans, etc.
(Source) BNM

3. Sustainability of current account surplus and long-term challenges

(1) Trade balance determines the short term development of the current account balance

A key to the forecast of the sustainability of the current account surplus is the development of trade balance. The Trade balance decreased in two successive years of 2015 and 2016, helping narrow the current account surplus (Chart 5). However, since the middle of 2016, there has been a halt in the downward trend of trade deficit while exports accelerating a pace of increase (Chart 11).

Chart 11 : Malaysia; Exports/Imports and Trade balance



(Source) BNM

Chart 12 : Main Export Partners

(%)

	Percent Distribution
China	12.5
U.S.	10.2
Japan	8.1
Hong Kong	4.8
India	4.1
Australia	3.4
Korea	2.9
Taiwan	2.7
ASEAN(except Malaysia)	29.4
EU	10.2

The biggest destination of Malaysia's exports is China, with the highest share of 12.5%, and there is a possibility that if the Chinese economy happens to slow down in the future, it will have a negative impact on the expanding Malaysian exports. On the other hand, the U.S. (10.2% of total exports), Japan (8.1%), the EU (10.2%) and other ASEAN countries (excluding Malaysia, 29.4%), combined composing about 60%, are expected to see their economy expand and Malaysia can expect higher exports to them. So on the whole, favorable factors that drive the Malaysian exports will continue to dominate in the future (Chart 12).

Further the exports will be supported by the depreciating ringgit and bottoming out in the prices of mineral fuels, main export items of Malaysia. Even taking into account a certain amount of increase in imports, trade surplus is expected to be on an upward trend for the time to come.

(2) Income balance has the key in the long-run～Future of the Malaysia's current account surplus judged from the Stage theory of BOP development

In the long run, the income balance, in addition to the sustainability of trade balance, will have an important role to the sustained current account surplus. Malaysia has a surplus in trade and services balance while deficit in the primary income balance, and a current account surplus as the trade surplus exceeds the income deficit. This trend has been maintained since 1998[2]. Looking from the stage theory of the balance of payments development, which asserts that the

[2] Only the primary income balance is treated here, as the share of the secondary income balance is very small and is not considered to influence the development of the current account balance. Exclusion of it from the discussion will have no impact on the substance of the consideration.

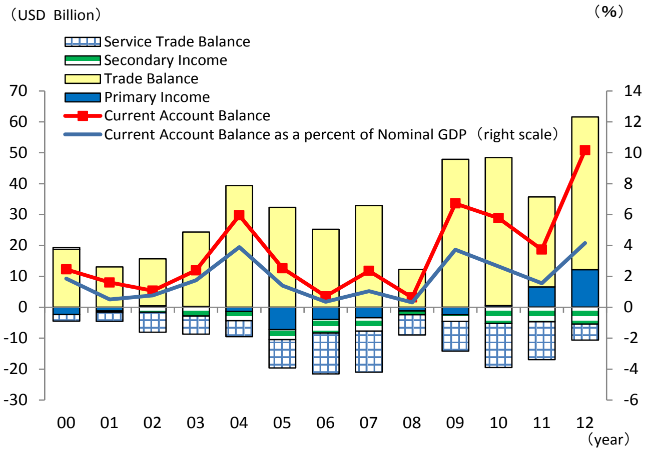
structure of the balance of payments changes in line with the economic development of a country, Malaysia is seen to have been in the stage of debt repayment country for long[3]. According to the theory, the industrial productivity of a country reaches its peak during the period of debt repayment country. Since Malaysia has experienced this period already for 20 years, there is a possibility that Malaysia will see it more difficult than before to expand its exports based on the increased industrial productivity.

What is expected to contribute to a sustainable current account surplus is the primary income balance that is expected to turn to surplus. Malaysia has a net asset position in the IIP, as the direct investment shifted to net asset position (Chart 10). Although the primary income balance is still in red, its amount has been declining and it is expected to shift to a surplus in the time ahead.

Looking at the case of Korea, which emerged as an export-oriented industrial country ahead of Malaysia, the surplus in trade and services almost hit the peak by the middle of the 2000s, while the primary income balance narrowed its deficits since 2005 to turn to surplus in 2010 (Chart 13). Since then, Korea has enjoyed a surplus both in trade and services account and primary income account. Based on the stage theory of Balance of Payments (BOP) development, Korea is judged to have shifted from debt repayment country to immature creditor country in around 2010. In order to maintain the current account surplus, Malaysia also needs to make the primary income balance turn into surplus and maintain that situation for some time. If it cannot do it, Malaysia is likely to be forced to recede from the stage of debt repayment country to a stage of mature debtor country, meaning that due to narrowing trade and services surplus and continuing primary income deficit, Malaysia’s current account will eventually fall into deficit.

[3] Please refer to the Supplementary Note 2 in the annex.

Chart 13：Korea's Current Account Development



(Source) IMF, "International Financial Statistics"

What is noteworthy in this regard is the development of external direct investment. Malaysia's external direct investment is mainly directed to mining industry including energy related areas, finance and insurance, and information and telecommunications. Recent big projects mainly relate to the ones aimed to protect the country's interest in emerging countries and to promote energy development (Charts 14). It will be important for the Malaysian creditors to make appropriate management and administration of their investment so that those projects and other direct investment can surely produce profits and those profits are smoothly repatriated. It is also necessary for the investors to carefully select the future investment projects.

Chart 14：Malaysia's Direct Investment

(USD Million、%)

	2014	2015	2016	
	Amount	Amount	Amount	Percent Distribution
Agriculture, Forestry & Fishery	483.3	862.5	258.4	2.5
Mining (including oil & gas)	7100.4	6793.7	3314.7	32.7
Manufacturing	165.4	-241.2	1733.0	17.1
Construction	133.8	141.5	-128.7	-
Information & Communication	2502.3	955.9	777.7	7.7
Financing & Insurance	3626.6	1263.1	2159.8	21.3
Others	2080.7	403.5	2028.5	20.0
Total	16092.5	10179.0	10143.4	100.0

(Source) Bank Negara Malaysia

4. Political Risk Factors

A big risk factor for the short run, say in a year or so, is the political development. On a political schedule, a general election of the lower house is slated for in April 2018, but there is a widespread view that Prime Minister Najib will hold an election during the year 2017. The United Malay National Organization (UMNO), the biggest party in the ruling coalition that PM Najib leads, has been promoting their preparations for the election especially with advocating an increase of supporting funds for low income earners, while the opposition parties have failed to reach an agreement on collaboration among them, unable to make preparations for the election.

Prime Minister Najib has been faced with problems of money laundering and misappropriation of the fund of 1 Malaysia Development Berhad (1MDB) and the dissatisfaction of the people does not seem to have been dissipated. So, if the ruling coalition happens to lose the number of parliamentary seats in the general election, concerns will grow over the confusion of the political situation and delay of policy implementation, leading to a stagnation in inflow of direct investment and a fall of the ringgit. Although the direction of political development will thus require careful attention, it is judged the possibility is not so high at the current moment.

5. Conclusion

The Malaysian economy has continued to recover since the middle of 2016, with unemployment rate lowering and inflation remaining relatively stable. The review of expenditures and revenues has succeeded to some extent in reducing the fiscal deficit which has come down to a small figure on a single year base. Thus there are no big uncertainties in the domestic economy.

On the balance of payments, it seems the short-term concern over the decline of current account surplus may be wiped out. For its main factor, the decline in trade surplus, has been touching the bottom, and it is expected to take an upward trend as exports will continue to increase thanks to (i) expansion of the global economy, (ii) depreciation of the ringgit, and (iii) bottoming out of the fuel prices.

On the other hand, it will be difficult for Malaysia to continue to enjoy an ever expanding trade surplus in the long run, and in order to keep its current account surplus, it is needed to promote a shift to surplus in the primary income balance and to maintain its surplus. Malaysia has already had a net asset position in the IIP and the deficit in the primary income balance has been declining and is likely to turn to a surplus. Unless this surplus is achieved, the current account may fall into the red due to a decreasing trade surplus coupled with the continued deficit in the primary income balance. In this regard, the Malaysian creditors are required to make a cautious and appropriate management and administration of their external investment so that profits will be surely produced on their investment and repatriated to contribute to the shift to surplus of the primary income balance.

A risk factor at the moment is the political development in Malaysia. The general election is slated for in April 2018, but there is a spreading rumor that Prime Minister Najib may advance the election to sometime in 2017, causing an uncertainty in the important political calendar. There is a possibility that the dissatisfaction of the people for Mr. Najib has not been dissipated because he has been faced with the funding problems of the country’s government investment company. If the ruling coalition happens to suffer a big loss in the number of parliamentary seats in the election, concerns over political confusions and possible delay of policy implementation will grow, leading to a slowdown in the inward foreign direct investment and a fall in the Malaysian ringgit. So the political development may require a careful attention, but for the moment the possibility of this scenario seems to be limited[4].

【Supplementary Note 1】

The Malaysian ringgit remained weak in the latter half of 2016 reflecting narrowing of trade and current account surpluses. After the victory of Republican candidate Donald Trump in the U.S. presidential election in last November, the pace of the fall accelerated due to undergoing appreciation of the dollar. In such an environment, the Bank Negara Malaysia notified again on November 13 to remind the domestic banks that they had been prohibited from engaging in non-deliverable forward (NDF) transactions. The measures were intended to put a brake on the decrease by regulations, given the decrease in the foreign exchange reserves, and probably the NDF transactions were chosen because the ringgit had declined sharpest in the NDF transactions of the currency pair of ringgit/dollar than in any other transactions. As the NDF transactions were frequently used in the acquisition of the Malaysian government bonds by

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[4] Refer to the Supplementary Note 2 for the reasons.

foreigners, the notification had a meaning of virtual tightening of regulation on the NDF transactions and produced a big side effect of a fall of foreign investment in the Malaysian government bonds. The exchange rate of the ringgit also continued to fall, with no intended effect to become apparent.

With the ringgit continuing to fall, the BNM announced on December 2, to introduce a new regulation, effective on December 5, to oblige the domestic enterprises to exchange to the ringgit more than 75% of their foreign exchange earnings on exports. The exchange rate of the ringgit started to rise after the announcement, but the upward trend did not last for long, it turned downward again after the middle of December. The rate hit the bottom early January 2017, and since it has been generally on an upward trend. The current resilience of the ringgit is not based on the regulation on currency transactions but rather considered to reflect the improved fundamentals of the Malaysian economy, including (i) rise of the real GDP growth rate, (ii) resumed expansion of its trade and current account surpluses, and (iii) bottoming out of resource prices. The improvement of the macro economy and its environment is expected to continue for the time being, underpinning the exchange rate of the ringgit.

【Supplementary Note 2】

According to the Balance of Payments (BOP) Stage Theory of Development, a country’s economy undergoes the 6 stages of development, namely (1) immature debtor country, (2) mature debtor country, (3) debt repayment country, (4) immature creditor country (5) mature creditor country and (6) asset disposition country, as is shown in Table 1 and each stage is considered to be accompanied with corresponding BOP structures. This theory assumes the economy that develops through the deepening of capital accumulation and rising and then declining industrial productivity thereof. This is normally attributed to the case of export oriented industrial countries.

The debt repayment country which Malaysia is currently considered to belong to has the characteristics of positive balance (surplus) on the current account and trade and services account, negative balance (deficit) on the primary income account, resulting in a current account surplus and also positive balance (net acquisition of foreign assets, net capital outflow) in the financial account.

Table 1：BOP Stage of Development by account

	Balance on Trade and Services	Balance on Income	Current Account Balance	Financial Balance	IS Balance
(1) Immature Debtor Country	－	－	－－	－－	I ＞ S
(2) Mature Debtor Country	＋	－－	－	－	I ＞ S
(3) Debt Repayment Country	＋＋	－	＋	＋	I ＜ S
(4) Immature Crecitor Country	＋	＋	＋＋	＋＋	I ＜ S
(5) Mature Creditor Country	－	＋＋	＋	＋	I ＜ S
(6) Asset Disposition Country	－－	＋	－	－	I ＞ S

(Note) ＋sign in the current account denotes a surplus, －sign a deficit while in the financial account ＋sign denotes the country's net acquisition of foreign assets (net outflow of capital) and －sign foreigners' net acquisition of a country's domestic assets (net capital inflow)。

(Source) Tadao Hata, Keikichi Honda, and Yozo Nishimura (2012) "Structure of International Finance", 4^{th} edition, Yuhikaku Alma, etc.

The ASEAN countries can be classified as follows based on the application of the BOP stage theory as far as possible. As the theory is usually applied to export-oriented industrial countries, city state Singapore with a high share of financial services and oil producing Brunei are omitted in the discussion. Also the Philippines and Vietnam are excluded from the discussion because their current account surpluses are highly dependent on a huge inflow of workers' remittance which the international migrant workers overseas send home.

Table 2：BOP Stage of Development of ASEAN countries

	Balance on Trade and Services	Balance on Income	Current Account Balance	Applicable Countries
(1) Immature Debtor Country	－	－	－－	Cambodia, Lao PDR, Myanmar
(2) Mature Debtor Country	＋	－－	－	Indonesia, Thailand
(3) Debt Repayment Country	＋＋	－	＋	Malaysia
(4) Immature Crecitor Country	＋	＋	＋＋	No applicable country
(5) Mature Creditor Country	－	＋＋	＋	
(6) Asset Disposition Country	－－	＋	－	

(Note) The same as the Table 1 above.

Address: 3-2, Nihombashi Hongokucho 1-Chome, Chuo-ku, Tokyo 103-0021, Japan
Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422
〒103-0021　東京都中央区日本橋本石町 1-3-2
電話：03-3245-6934（代）ファックス：03-3231-5422
e-mail: admin@iima.or.jp　URL: http://www.iima.or.jp