Authorities' Statement on 2017 Malaysia Staff Report

1. The Malaysian authorities would like to thank the mission team for the constructive 2017 Article IV Consultation. We are encouraged by staff's assessment that the Malaysian economy is resilient and that the current macroeconomic policy settings are appropriately calibrated to the outlook and risks facing the economy and the financial system.

2. Amid a challenging external environment, the resilience and strong performance of the Malaysian economy is underpinned by the economy's strong fundamentals, ample buffers and a robust financial system. Appropriate macroeconomic policy settings and timely policy responses have further reinforced the economy's resilience. The authorities remain vigilant to near-term risks while continuing with structural reforms to raise productivity and competitiveness. Policy priority will remain focused on ensuring inclusive and balanced growth, including assisting the lower income groups and promoting balanced development across the country.

3. As a small highly open economy, with a financial system that is integrated with the international financial system, Malaysia remains exposed to developments in the global financial markets and to volatile capital flows. In this environment, policymakers need at their disposal a full array of policy instruments to safeguard the economy and financial system from the highly volatile and disruptive capital movements. As the global environment evolves and new challenges emerge, the authorities will constantly review and assess the appropriate policy response as we strive to preserve domestic macroeconomic and financial stability.

4. The Fund has an important role to play. In particular, the Fund should recognize the need for its members to have the flexibility to take all necessary measures to preserve macroeconomic and financial stability. The Fund should be receptive and open to new approaches and policy instruments needed to maintain stability and promote financial market development. Country specific circumstances and context must be taken into account and a "one size fits all" assessment must be avoided. In addition, in keeping with the Fund's record of advancing reforms in the international monetary system, these efforts should be widened to include advocating for greater transparency in the offshore financial markets to reduce speculative activities and their disruptive cross-border implications.

Recent Economic Developments and Outlook

5. Despite the challenging global environment, the Malaysian economy continues to perform well, growing by 4.2 percent in 2016 (2015: 5.0 percent), led by private sector activity. Private consumption was supported by continued wage and employment growth, with additional impetus from Government measures. Capital spending in the services and manufacturing sectors contributed to private investment growth of 4.4 percent (2015: 6.4 percent) amid the slowdown in oil and gas investment. Both inflation and unemployment remained low at 2.1 percent and 3.5 percent, respectively (2015: 2.1 percent and 3.1 percent, respectively). The current account balance remained in surplus (2.1 percent of GNI) while international reserves were at a comfortable level of USD95 billion at end February 2017, sufficient to finance 8.5 months of retained imports and are 1.1 times short term external debt.

6. The economy is projected to grow at a steady pace of 4 - 5 percent in 2017, supported by continued expansion in domestic demand and an improving external environment. Private sector activity will remain the key driver of growth amid continued fiscal consolidation. The on-going implementation of infrastructure projects and capital spending in the manufacturing and services sectors will support investment activity. The economy is set to benefit from the expected improvements in the growth prospects of major economies and from higher commodity prices. Between November 2016 and January 2017, exports grew by 10.6 percent, underpinned by higher external demand for both manufactured goods and commodities. Inflation is expected to be higher in 2017, reflecting primarily the pass-through of the increase in global oil prices into domestic retail fuel prices.

7. The authorities concur that there are a number of downside risks, primarily arising from uncertainties in the external environment and policies of major economies. In coping with external uncertainties, Malaysia will, as staff noted, continue to benefit from its diverse economic structure and strong fundamentals that were built over the years. Policymakers have the capacity to undertake necessary policy measures in the event of shocks. At the same time, the authorities also see more potential for upside risks. Higher growth in major economies could result in better-than-expected demand for Malaysia's exports, while faster recovery in oil and commodity prices would encourage more investment in the mining sector as well as contribute to higher oil-related income.

Adjusting to External Shocks

8. The authorities welcome staff's assessment that balance sheet strengths and exchange rate flexibility have enhanced Malaysia's resilience to capital outflows and that stress tests indicate external debt would remain manageable under a variety of shocks. These sources of strength reflect authorities continued focus on enhancing fundamentals and on implementing incremental reforms across a range of areas.

9. In 2016, the Malaysian financial markets experienced several episodes of capital flow volatility. As in past episodes of volatility and as acknowledged by staff, exchange rate flexibility and macroeconomic policy adjustments have played a central role in helping the economy adjust to these external shocks. Exchange rate flexibility remains a key shock absorber. Indeed, between May 2016 – February 2017, the ringgit depreciated by 12 percent against the US dollar. Where needed, Bank Negara Malaysia (BNM) intervened and provided liquidity to prevent excessive exchange rate volatility.

10. Despite these efforts, ringgit volatility intensified towards the latter part of 2016 and the exchange rate moved well beyond levels consistent with Malaysia's economic fundamentals. To some extent, this was contributed by the growing imbalances in the demand and supply of foreign currencies in the onshore foreign exchange market as well as the speculative activity in the ringgit offshore non-deliverable forward (NDF) market which had a disproportionate and detrimental impact on the ringgit onshore market. These imbalances are not self-correcting and will continue to prevail if no specific measures are taken. In fact, the period of excessive volatility is expected to persist, underscoring the importance of a comprehensive and long term approach to further strengthen our resilience to external headwinds.

Measures to Develop Onshore Foreign Exchange Markets

11. The authorities view the IMF staff's recommendation for the authorities to reconsider the recent measures that were introduced on 5 December 2016 to develop onshore foreign exchange markets (Box 1, page 20) as inappropriate. Despite the measures being only recently introduced, the IMF staff found it appropriate to make an assessment, which in our view is a prejudgement. The IMF staff failed to appreciate and contextualise the broad policy intention of the authorities despite a series of clarifications. As reiterated by the authorities, the measures were implemented for the development of onshore FX market and were purely prudential in nature. These measures do not in any way limit the flow of funds in and out of Malaysia. It also reflected our conscious and continuous efforts towards sustaining domestic economic and financial stability in light of dynamic changes that were going on in the global financial landscape. Our efforts to put in place clear policy measures to support market stability are directly in line with the IMF's call on managing volatile capital flows. Thus, it is extremely perplexing for the authorities to hear the divergent stance of the IMF concerning this issue.

a. The measures introduced in 2016 are part of a comprehensive strategy to develop a highly liquid and deep foreign exchange market in Malaysia that is commensurate with the economic growth and increasingly sophisticated needs of businesses and investors. Through these measures, financial market resilience will also be strengthened.

b. The data on non-resident holdings of government bonds clearly shows that non-residents are not in any way hindered in their investment activities in Malaysia. They continue to be freely allowed to liquidate and exit from the Malaysian market. A report recently published[1] showed a significant increase in the inflows into the stock market. This is evidence of the continued free flow of funds in the Malaysian financial market and therefore, does not support the views that the measures have caused issues for investors at large.

c. The conversion of export proceeds into ringgit is meant to address the structural imbalances of supply and demand for foreign currencies in the onshore FX market. The requirement does not in any way hinder exporters from holding more than 25 percent of export proceeds in foreign currency if they have a business need to do so. Additionally, the framework allows reconversion to foreign currency at the same rate with no additional cost incurred by exporters for building up their foreign currency balances to meet their imports and current international obligations.

d. The measures are also intended to streamline the rules relating to investment in foreign currency assets with the broad objective of mitigating potential systemic risk to the financial system. This is done through the management of large investments by residents with domestic ringgit borrowing. The limit aims at mitigating any potential risk to financial stability. Residents, including exporters, without domestic ringgit borrowings can continue to freely invest in foreign currency assets onshore and offshore up to any amount. The prudential limit is also in line with the IMF's view that macroprudential measures are primarily designed to limit systemic financial risk and maintain financial system stability.

[1] Report published by Malaysian Industrial Development Finance, a private investment holding company.

12. Since the introduction of the policy measures, the success of these measures is self-evident: market adjustments have taken place and the authorities have seen encouraging signs of improvement:

a. The onshore FX market has been sustained, recording daily average volume of USD9.2 billion across all types of FX transactions, with spot and forward market transactions, particularly for ringgit currency pair, of above USD2 billion, similar to the level recorded in December 2016.

b. The NDF volume has reportedly declined by 75 percent and adverse spillovers have been curtailed. A number of global and regional financial institutions no longer participate in this market and have undertaken orderly liquidation of outstanding positions.

c. Exchange rate volatility has declined with average ringgit intraday movement narrowing to around 61 points from an average of 82 points in December last year and bid-offer spread had narrowed noticeably to 20 points in January, reducing foreign exchange transaction costs.

d. There has been a much improved balance between export and import related flows since the measures were introduced.

13. Based on our assessment, the IMF has not recognised the need of members to have flexibility in preserving macroeconomic and financial stability. Staff's recommendation for the authorities to reconsider the measures is certainly premature and has not been supported by a thorough and rigorous assessment. More importantly, this assessment is clearly inconsistent with staff's acknowledgment that the measures are aimed at deepening the onshore financial markets (paragraph 18, pages 12 and 13).

a. Malaysia is an open economy that is dependent on international trade and therefore, excessive ringgit volatility could be potentially destabilising. As such, the authorities are obligated to constantly review the environment and use appropriate policy tools to respond to new and emerging risks or developments.

b. The structural imbalances in the foreign exchange market and the destabilising influence of the unregulated and opaque non-deliverable forward (NDF) market will not be self-correcting and will continue to prevail without specific measures by the authorities. Other central banks in multiple fora have highlighted this issue and initiatives are being undertaken to contain this market from exacerbating risks to global financial stability. The IMF should be more supportive of these measures instead of 'promoting' the voice of the selected few, in particular the financial market players who profit from this market to the detriment of the onshore market stability. The IMF itself has identified these vulnerabilities in its FSAP report on Malaysia in 2014.

c. The staff's recommendation for the authorities to reconsider the measures will create confusion as it is in contradiction with the following statements:

   i. The staff's explicit acknowledgment on the effectiveness of the measures by recognising that *"liquidity in the onshore market has normalized, the spot exchange rate volatility has come down, and the bid-ask spread has declined"*; and

   ii. The staff's suggestion that *"BNM should keep the new FX market measures under review"*.

Monetary Policy

14. After maintaining the Overnight Policy Rate (OPR) since July 2014, the Monetary Policy Committee (MPC) decided to reduce the OPR by 25 basis points to 3.00 percent in July 2016. The reduction was intended to ensure that the degree of monetary accommodativeness remained consistent with the assessment on the balance of risks to the growth outlook, amid stable inflation. In its meeting in March 2017, the MPC reaffirmed that at the current level of the OPR, the degree of monetary accommodativeness is consistent with the policy stance to support growth amid a stable core inflation. On monetary operations, BNM will continue to ensure that liquidity is sufficient to support the orderly functioning of the domestic financial markets. The MPC will continue to closely assess the risks surrounding the outlook for growth and inflation in deciding the stance of monetary policy moving forward.

Fiscal Policy

15. The authorities welcome staff's assessment that the medium term fiscal policy is well anchored on achieving a near-balanced federal budget by 2020. Fiscal deficit declined to 3.1 percent of GDP in 2016 and is projected to reach 3 percent in 2017. Prudent fiscal management has led to the reduction in federal government debt over the years, to 52.7percent of GDP in 2016 (2015: 54.5 percent of GDP). Of importance, the federal government's foreign currency debt only accounted for 1.9 percent of GDP or 3.6 percent of total outstanding federal government debt. The debt profile is also favorable, with about 70 percent of the debt with maturities more than three years.

16. The overall fiscal strategy focuses on containing operating expenditure while protecting capital development spending, as well as increasing revenue generation and enhancing tax efficiency. In 2016, lower expenditure on supplies and services, and subsidies led to a 4.5 percent decline in operating expenditure (2015: -1.2 percent), while net capital development spending increased by 12.5 percent (2015: 2.2 percent).

17. On the revenue side, the implementation of the Goods and Services Tax (GST) in 2015 was instrumental in diversifying fiscal revenue. Collection of GST is expected to increase by 3.9 percent to account for 18.2 percent of total revenue in 2017. Engagements with businesses and government agencies have been intensified to improve GST collection. Initiatives are on-going to further enhance the effectiveness of the GST framework as well as minimizing leakage through enhanced enforcement of tax compliance with close coordination among the various government agencies.

18. Over the past several years, the authorities have undertaken comprehensive subsidy rationalization reforms, including the full removal of fuel subsidies in 2014 and subsidy cuts for food items such as sugar and cooking oil. The removal of these broad-based subsidies has been replaced with more targeted assistance to the low income group. Several measures were introduced in the 2017 Budget to this effect. These include an increase in the amount of direct cash transfers; supply- and demand-side measures to increase the construction and purchasing of affordable houses; and additional personal income-tax relief. The introduction of the new corporate income tax is aimed at enhancing tax efficiency and stimulate further growth of businesses, including the small and medium enterprises.

19. On contingent liabilities, it is important to note that growth in these liabilities has been on a declining trend since 2011 and guarantees have been extended selectively to nonfinancial entities to undertake productive and strategic investments. About 36 percent of the outstanding guarantees were given to entities that undertake public transportation infrastructure projects, while guarantees given to the National Higher Education Fund Corporation (PTPTN) accounted for about 22 percent of the total guarantees. Repayment risks from student loans provided by PTPTN are generally contained and further mitigated with the listing of loan defaulters in the Central Credit Reference Information System.

20. To strengthen the institutional capacity of fiscal management, the Fiscal Policy Committee has established the Fiscal Risk and Contingent Liability Technical Committee in May 2016, to evaluate and propose measures to manage fiscal risks and contingent liabilities. The authorities appreciated the Fund's TA on Spending Reviews and look forward to the TA on Public Investment Management Assessment in April 2017.

Financial Stability

21. The Malaysian financial sector is robust and continues to support the economy. Furthermore, near-term risks to financial stability remain low and as noted by staff, contained. As highlighted in the staff report, Malaysia's banking sector is bolstered by strong capital buffers, adequate provisioning and liquidity, and stable funding conditions. NPLs remain low and asset quality is supported by sustained debt servicing capacity of borrowers, and banks' strong credit underwriting and risk management practices. Stress tests by BNM demonstrates the resilience of the banking sector to major shocks. This has been underpinned by BNM's intensive and proactive approach to financial sector regulation and supervision. Deep domestic financial markets and the presence of well-diversified domestic institutional investors continue to support orderly financial market conditions, especially during periods of large capital outflows. Financial intermediation remains healthy, with continued financing to households and businesses, including small and medium enterprises.

22. Risks to financial stability arising from household debts remained manageable. Households maintained strong financial buffers at the aggregate level with financial assets account for two times the debt level. Impaired loans of households have remained low at 1.1 percent of total banking sector loans while about 41 percent of borrowers of newly approved loans have debt service ratios of less than 40 percent. This reflects prudent credit underwriting and risk management practices.

23. Growth in aggregate house prices has moderated since end-2013 following the implementation of macroprudential and other measures aimed at curbing excessive speculation and risk-taking. While there are risks of oversupply in the office space and shopping complex segments, risks to the banking system remain limited, impaired loans ratio for these segments is low at 1.3 percent as at end-2016. Similar to staff, the authorities view the current macroprudential measures as being sufficient at this juncture. However, the authorities stand ready to act pre-emptively to address any potential build-up of risks.

24. Funding of Malaysian business is predominantly (74.2 percent) sourced from the domestic financial institutions and capital market, and denominated in ringgit. The aggregate corporate debt expanded annually at a slower pace of 8.6 percent in 2016. Banking system domestic exposures (including off-balance sheet exposures) to the oil and gas related sectors (including water transport) is relatively low at about 5 percent of business loans and 6 corporate bond holdings, or about 14

percent of total capital of banks. Based on stress tests on the debt servicing capacity of large borrowers, excess capital of banks is sufficient to cover more than two times the potential losses from simulated shocks (exchange rate, borrowing costs and earnings). Corporate borrowings are supported by generally healthy balance sheets and financials, with the median interest coverage ratio (ICR)[2] of 9.4 times and cash to short term debt ratio at 1.2 times for the nine months ending September 2016[3]. For the same period[4], corporate debt-at-risk[5] remains below that observed in other emerging market economies, despite increasing to 7.7 percent (2015: 6.2 percent). The increase was mainly attributed to firms in the automotive, real estate and oil and gas sectors, and is within BNM's expectations given the more challenging conditions in these sectors.

25. Malaysia remains committed towards meeting its five year National AML/CFT Strategic Plan objectives. In 2016, the focus was on strengthening risk assessment on threats of serious crimes and increased vigilance on the vulnerable sectors of money services businesses and designated non-financial businesses and professions through adequate resource prioritization for increased supervision and surveillance. In line with international efforts to combat terrorism and proliferation financing, Malaysia has issued several guidance on Targeted Financial Sanctions relating to terrorism financing to reporting institutions for greater clarity and better reporting.

Reforms to Enhance Growth Potential

26. Malaysia's reform initiatives are guided by the 11th Malaysia Plan (2016-2020), which aims to accelerate Malaysia's transformation into a high-income economy by 2020, while promoting more inclusive growth and raising productivity and competitiveness. Of importance, Malaysia has made important strides in reducing poverty and inequality over the past decades with a combination of anti-poverty and rural development programs focusing on promoting inclusion, livelihood and employment. In recent times, the removal of blanket subsidies has been accompanied by more targeted measures to assist the low- and middle-income groups.

27. Productivity has generally increased in recent years but lags behind advanced economies. Malaysia has set a productivity growth target of 3.7 percent per year from 2016 to 2020. In this regard, efforts to boost productivity will focus on accelerating innovation and entrepreneurship; leveraging advancements in technology; and inculcating green technology.

28. A key focus area is human capital development. The Malaysian Education Blueprint (2013-2025) is aimed at elevating the quality of school education, primarily through curriculum transformation, improve quality of teachers and increase English proficiency. In addition, the Malaysia Education Blueprint (Higher Education) 2015 – 2025 outlines 10 strategic shifts aimed at enhancing the Malaysian higher education system. Currently, the authorities are embarking on Redesigning Higher Education agenda. This agenda focuses on several areas, including more holistic student assessment method, greater academia-industry collaboration, empowering and the enhancement of work-based learning programmes. Efforts are also ongoing to increase the appeal of technical and

[2] Computed using earnings before interest, tax, depreciation and amortisation, consistent with the computation method used by the IMF.
[3] Based on 120 non-financial firms listed on Bursa Malaysia that account for 85% of market capitalisation (excluding financial institutions).
[4] For the 12 months ending September 2016.
[5] Measured as the share of debt borne by firms with an ICR of less than two times.

vocational education and training both to attract school leavers and to improve workforce participation rates through upskilling of unemployed, female and elderly workers. The measures have contributed to the improvement in graduate employability to 77.3 percent in 2016 (2012:74.4 percent).

29. The authorities have recently announced Transformasi Nasional 2050 (TN50), a 30-year national development initiative which spans the period 2020-2050. The TN50 policy document, which will be published in early 2020, will outline the economic, social, cultural and environmental targets that Malaysia aims to achieve by 2050. Engagement with various stakeholders is currently underway to develop the targets, which will provide continuity in the developmental goals for the nation beyond 2020.

Final Remarks

30. The external economic and financial environment will remain fraught with uncertainty and risks. As a small and highly open economy, Malaysia is highly exposed to external developments. The authorities, therefore, have to remain vigilant. Strengthening macroeconomic fundamentals, building up policy buffers and reducing imbalances will remain the authorities' priority. Proactive and well calibrated policies, supported by robust policy frameworks, will continue to be pursued as the authorities respond to the uncertain global environment in order to preserve macroeconomic and financial stability, and achieve sustainable and inclusive growth.