

Malaysia: fragilities in the growth model

Hélène Drouot

Malaysia has been relatively resilient to shocks in recent years thanks to a unique growth model built around three pillars: political and social stability, economic interventionism – which has fuelled the country's industrialisation – and international expansion. Yet at a time when economic policy has little manoeuvring room and global trade is slowing down, Malaysia's growth model has to face new challenges if the country is to join the ranks of the high-income countries by 2020.

Built around political stability, economic interventionism and openness to international trade, the specific characteristics of Malaysia's growth model have enabled the country to weather the economic and financial shocks of recent years. The economy did not collapse despite the sharp drop in commodity prices, slowing global trade and China's economic slowdown.

Since 2013, however, it looks like the country's growth model has weakened. Social cohesion is eroding, and Malaysia, whose exports are highly integrated regionally, seems to be vulnerable to the diminishing advantages of participating in global value chains and to rising protectionism.

1970-2010: the New Economic Policy (NEP)

Malaysia has long been seen as the most politically stable country in the region. Since its independence in 1957, the successive governments have all been formed by the same coalition, Barisan Nasional (BN), comprised of 13 parties, including 4 national ones and 9 parties mainly representing the ethnic communities of Sabah and Sarawak.

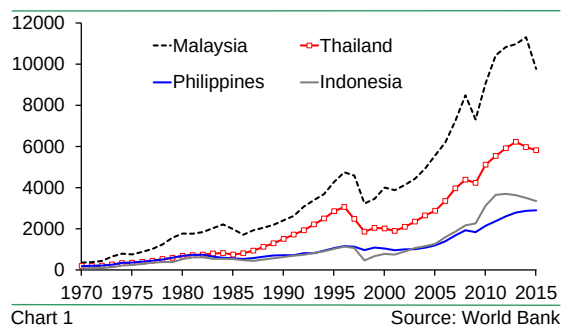
For more than forty years, the BN has successfully maintained a balance between the ethnic and religious communities. About 55% of the Malaysian population are Malay Muslim; 10% are other "indigenous" people, which along with the Malay form the category Bumiputra (literally, sons of the land or soil); 26% are Chinese (for the most part Buddhists and Christians) and nearly 9%, Indians (for the most part Hindu).

Taking advantage of the country's political stability, the New Economic Policy (NEP) launched in 1970 was built around three pillars: social justice in favour of Malays; economic interventionism; and accelerated development based on industrialisation. NEP's implementation is seen as a key factor that triggered Malaysia's economic boom.

Rapid economic development and the reduction of inequality

Bolstered by NEP, real GDP grew at an average annual rate of 6.4% between 1970 and 2010, and the country joined the ranks of the upper middle-income countries.

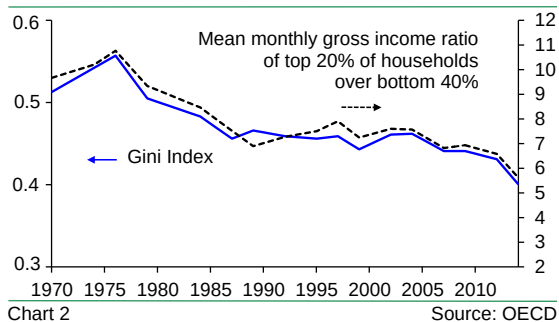
GDP per capita since 1970 (USD)



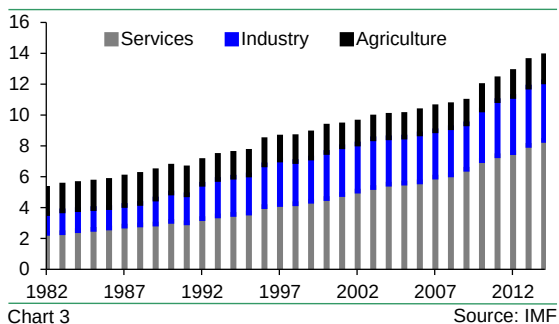
NEP also helped gradually reduce the level of inequality, measured by the Gini index¹, by combining rapid job growth, mainly in the services sector, with the economic integration of the Malays.



Gini index and income inequality



Employment by sector (millions)



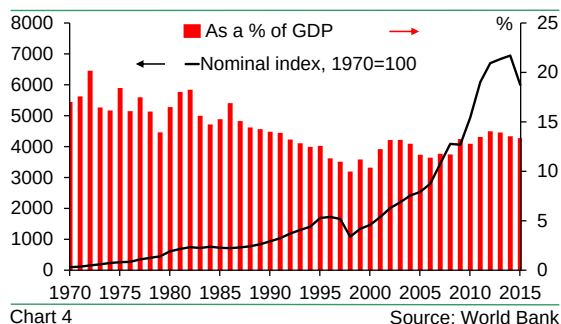
The government also favoured the creation of companies controlled and managed by Malays by introducing financial policy that provided incentives for banks to lend to new industrial companies.

Lastly, the State was heavily implicated in the economy, with the government intervening directly in the creation of companies in sectors it wished to develop. According to E. Lafaye de Micheaux (2012), the increasingly heavy weight of state intervention in business affairs can be measured by the increase in the number of state-owned companies, which "rose from 362 units in 1975 to 656 units in 1980 and to between 900 and 1014 units in 1985". In 1986, state-owned companies accounted for about 30% of GDP.

Starting in 1986, deregulation and privatisation of the economy did not call into question the State's high structural implication in the Malaysian economy. The

objective, which is still accurate, was to encourage economic growth that was not supported exclusively by the State and to introduce public-private partnerships. Yet the privatisation process was conducted without the State's withdrawal, and public spending continued to increase. Rather than orchestrating the State's withdrawal, it was more a matter of changing the form and method of its involvement.

Government expenditure



Economic diversification and opening to global trade

Another pillar of development was the economy's rapid diversification. Before the 1970s, Malaysia was the world's largest rubber and tin producer, and the agricultural sector accounted for nearly 50% of GDP and 80% of exports.

With the collapse of rubber and tin prices in the early 1980s, the country shifted its focus in the commodities sector to crude oil, natural gas and palm oil, which are still the country's main sources of production today. At the same time, under the guidance of economic policy, the country continued to diversify the economy by favouring the industrial and services sectors. Initially geared towards industrialisation based on import substitution, NEP steadily helped build an increasingly developed manufacturing industry.

The export base was expanded, rising from less than 50% of GDP in 1980 to more than 70% by 2010. Commodity exports (in the broad sense of the term) accounted for only 25% of exports in 2010, compared to nearly 80% in 1980. Malaysia also integrated itself into

the regional and global economy by gradually increasing the degree of sophistication of its exports.

GDP decomposition, by sector

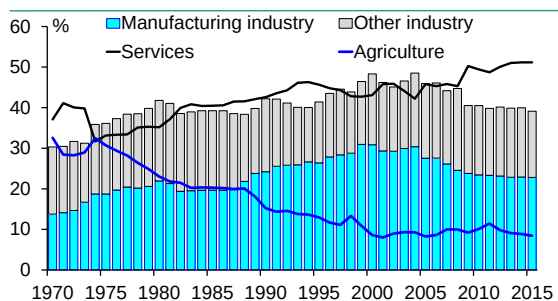


Chart 5 Source: World Bank

Share in exports

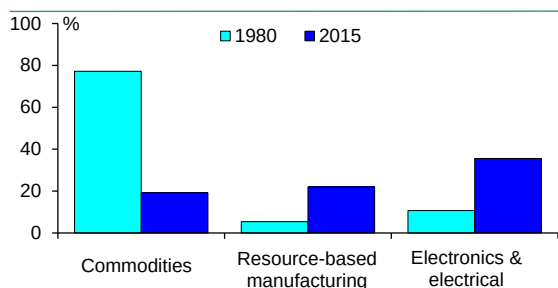


Chart 6 Source: OECD

The development of electronics and electrical components was particularly remarkable, and enabled the country to specialise in a sector with very few ties to the commodities sector. Today, this sector accounts for nearly 40% of total exports and has facilitated the country's insertion into regional and global value chains, thanks to the production of electronic components used in cell phones, computers and the automotive sector.

Exports to "traditional" trading partners, namely the western commodity importers, steadily lost ground in favour of regional partnerships, especially with China.

Exports to Asia and G3 countries (% of total exports)

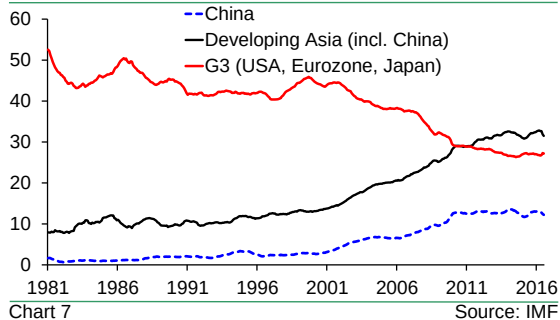


Chart 7 Source: IMF

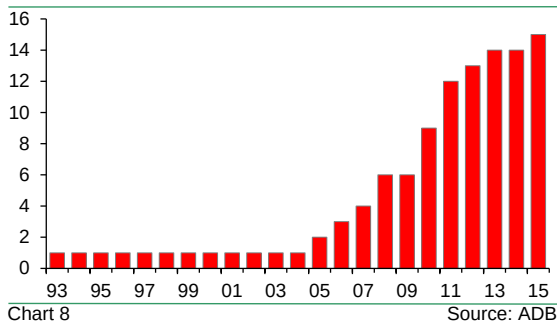
2010: the New Economic Model, a continuation of NEP

The New Economic Model (NEM) was launched in early 2010. Economically, this plan was intended to build on the previous economic transformation programme, "Vision 2020" introduced in 1991, by encouraging public and private investment with priority on infrastructure and the development of services. One of its goals was to generate productivity gains by promoting the emergence of a new economic model based on innovation, while pursuing the upmarket shift in exports.

Politically, the "One Malaysia" concept was introduced to reassure the various non-Malay ethnic and religious communities (notably Chinese and Indian) and to encourage a national Malaysian identity.

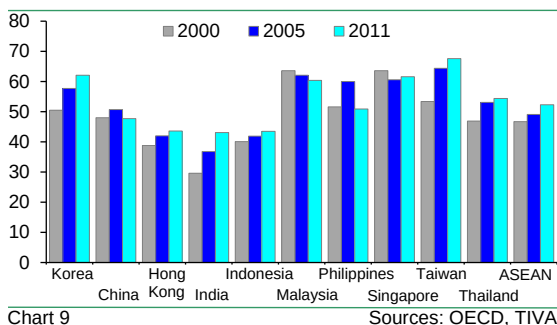
Lastly, from an international perspective, the goal was to take advantage of the country's geographic and geopolitical situation to gain maximum benefit from the regional integration process. Malaysia strengthened its commercial and economic ties with India and especially China, launched numerous regional initiatives within ASEAN, and signed numerous free trade agreements. To attract foreign direct investment, it eased the restrictions governing FDI.

Free trade agreements (signed and effective, cumulative)



The plan allowed Malaysia to remain one of the most highly integrated countries in the region. According to the global value chain participation index, calculated by the OECD and WTO, Malaysia has one of the highest participation rates in Asia.

Global value chains participation index



Although statistics are only available through 2011, a recent OECD study for the period 2009-2013 estimates that Malaysia alone accounts for 2.7% of total trade involving value chains and 5.7% of Asian trade (involving value chains), when the country represented only 0.4% of world's GDP and 2.5% of developing Asia's² GDP. This strong participation in global value chains makes Malaysia one of the most active countries in Asia.

The model has been winding down since 2013

The government is pursuing its target of transforming Malaysia into a fully developed country by 2020. On the political front, however, BN's popularity is eroding and the "One Malaysia" policy was not given a warm welcome by the local population.

Growth slows

Moreover, since mid-2014, real GDP growth has gradually slowed, from 6.5% y/y in Q2 2014 to 4% in Q2 2016, squeezed by the decline in oil and commodity prices, China's economic slowdown and the political crisis.

Yet even if commodity prices were to hold at low levels over the long term, Malaysia is unlikely to be hit as hard as the other oil exporting countries. First, as we have already seen, the commodities sector is no longer the sole growth engine. The services sector and industrial manufacturing now account for 55% and 25% of GDP, respectively.

Second, since 2014, Malaysia is a net oil importer and a net exporter of hydrocarbons. Statistics from the Energy Information Administration (EIA) show that over the past decade, Malaysia has developed its industries downstream, and as a result, the proportion of crude oil exports has diminished by nearly 40%. Petroleum products, in the broad sense of the term, now account for a much bigger share of exports than crude oil (9.2% of gross exports in 2013, vs. 3.2% in 2004).

Lastly, Petronas, the state-owned oil and natural gas exploration and production company, is seeking to change its strategy by diversifying into other products like liquefied natural gas (LNG). In other words, Malaysia's trade balance for basic goods is now more dependent on LNG (specifically, Japanese and South Korean demand) than crude oil.

The targets of the 11th Malaysian Plan (11MP), the latest 5-year plan unveiled in May 2015, are particularly ambitious. The government wants to strengthen average

annual growth from 5% to 6% between 2016 and 2020. The plan also encourages the development of new growth engines in the private sector, as well as higher value-added activities in the agriculture, manufacturing and services sectors. Although these ambitious growth and revenue targets will be hard to meet, the economy's relatively advanced infrastructure should facilitate the task. However, in the very short term, Malaysia has to face new drags on growth.

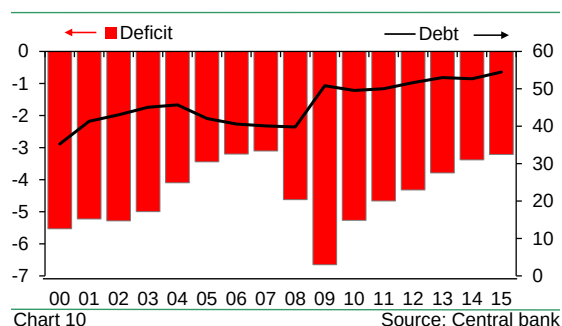
Fiscal consolidation

On the one hand, fiscal consolidation is curbing the government's manoeuvring room to boost growth. Since 2009, fiscal policy has concentrated on deficit reduction. This commitment has been maintained despite the slowdown in growth and the drop-off in commodity prices. The government is striving to balance the budget by 2020 and to reduce the public debt to 55% of GDP.

Since mid-2014, a series of measures have been introduced to increase and diversify the sources of revenues in response to the decline in oil-related activities (including Petronas' dividend payouts). These measures also included the restructuring of spending and a new policy of household transfers. In 2015, a 6% Goods and Services Tax (GST) was also introduced, along with an overhaul of the subsidies policies.

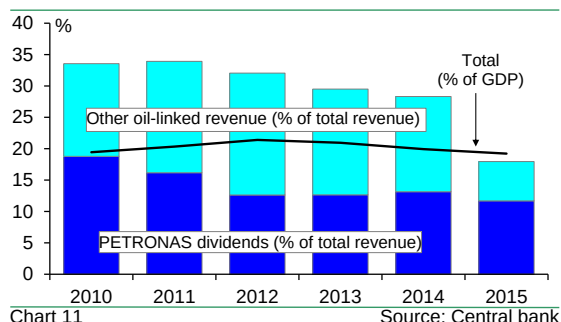
These policies have paid off. In 2015, the government met its deficit reduction target for the 6th consecutive year, reducing the deficit to 3.2% of GDP, compared to 6.5% of GDP in 2009.

Deficit and public debt (as a % of GDP)



At the same time, revenue from oil-related activities plunged, from an average of more than 30% of total revenues in 2010-2014 to 17% in 2015, even though revenues as a share of GDP remained relatively flat over the period at about 20% of GDP, thanks to improvement in collection and GST receipts.

Total government revenue and oil revenue



The government plans to continue reducing the deficit to 3.1% of GDP in 2016 and 3% in 2017, although slowly.

Exposure to slowing global trade

On the other hand, the dynamics of global trade, a major growth engine, are changing. Although cyclical components, such as the slow pace of global growth and investment, are partly to blame, they do not provide a sufficient explanation for the slowdown in trade. A combination of several structural factors seems like a more suitable explanation. One key factor seems to be the slower growth of global value chains, i.e. the international segmentation of the production process³.

According to a recent OECD study (2016), value chains grew at an average annual rate of 4% between 1991 and 2011, but have since contracted at an average rate of nearly 2% a year. This does not mean that the international segmentation of the production process is in regression, but that it is no longer playing the same role as an accelerator of trade, as it did before the crisis.

At the same time, the shift in China's growth model and its implications for the ASEAN countries as a whole is another source of fragility for Malaysia. Since

2009, China's foreign trade has continued to grow at a much faster pace than global trade, but its composition is not the same as the one that predominated before the crisis.

With the global economic slowdown on the one hand, and structural changes in the domestic economy (higher labour costs) on the other, China has had to shift its international insertion model. China's participation in global value chains is no longer the main engine of foreign trade. Its foreign trade momentum is now fuelled by "ordinary" trade, i.e. exports based essentially on local inputs, and imports designed mainly to satisfy domestic demand.

Under this new configuration, the most vulnerable countries are those with a double exposure to trade involving global value chains and Chinese final demand. Malaysia is one of the most vulnerable ASEAN countries for several reasons: 1) its high level of participation in global value chains (higher than the ASEAN average), 2) its strong regional integration (see chart 7), and 3) the fact that China alone accounts for 10% of the total value added of exports involved in final demand.

Exposure to China

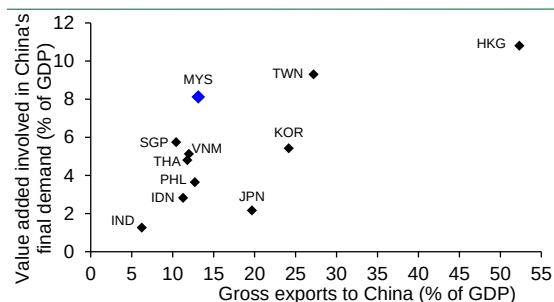


Chart 12

Source: OECD

In the longer term, the erosion of China's price-competitiveness should benefit the other Asian countries. Yet Malaysia does not benefit from a cost advantage (the wage differential with China is relatively low), so it must stand out on the basis of its non-price advantages (quality infrastructure, skilled labour force and business climate).

New headwinds

Malaysia's medium-term prospects are still favourable. If the country manages to improve its business climate, its integration in the regional economy and upmarket shift should ensure that it maintains a favourable positioning within the ASEAN countries. That said, in the medium term, increased protectionism and indebtedness could represent new vulnerabilities.

The country's image has been tarnished

The financial scandal surrounding the 1MDB fund has had international repercussions. Several countries, including Switzerland, the United States and Singapore, have opened investigations into embezzlement charges linked to the fund's financing. Looking beyond the 1MDB scandal, it is the quality of governance that is being called into question, and the country's capacity to improve its institutional framework.

Indeed, in the World Economic Forum's latest report on global competitiveness published in September 2016, Malaysia has fallen 7 ranks from the previous edition, after six consecutive years of improvement. The indicators that deteriorated most are access to financing, the fight against corruption and governance.

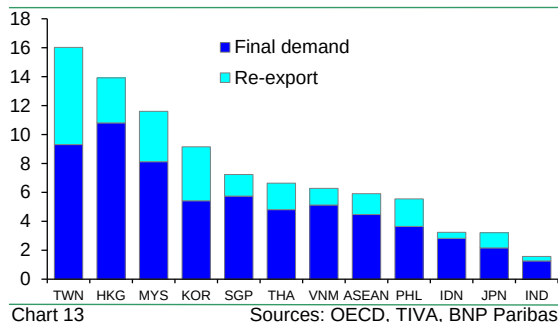
Rising protectionism

The rise of protectionism could well be another factor behind the slowdown in global trade. In its latest report, Global Trade Alert analysed global trade (in value) by product and noted that 1) the product groups that contributed more to the decline in the value of trade are also the ones skewed most by protectionist policies, and 2) since 2010 between 50 and 100 protectionist measures were implemented in the first four months of each year (higher customs tariffs, anti-dumping measures, and less conventional measures like restrictions that only national producers are allowed to benefit from stimulus measures, and local content requirements for investments or public markets), but 150 measures were identified in 2016. Once again, Malaysia's degree of openness and integration could be a handicap, especially if the free-trade agreements that it has already approved were to fall through.



Given the weight of exports to China for re-export purposes, Malaysia could also be hit indirectly by major restrictive measures against Chinese exports.

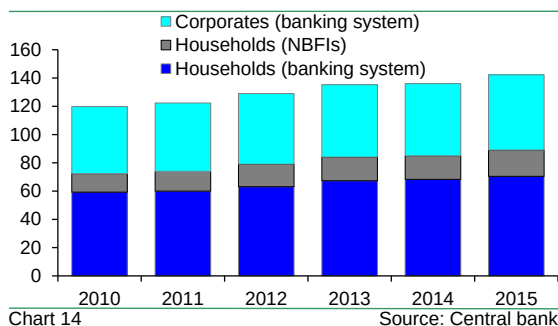
Decomposition of exports to China (as a % of GDP)



Household and public debts are high

Household debt has levelled off thanks to macro-prudential measures gradually introduced by the Central Bank since 2010. But it is still high at about 90% of GDP. Solid financial assets and low non-performing loan ratios attenuate the risks associated with household debt, but a sudden upturn in interest rates could weaken households (and the banking sector).

Private sector debt (as a % of GDP)



At the same time, public debt is more or less stabilised, but remains high. The federal debt ratio is expected to decline to 52% of GDP in 2016 (vs. 54.5% in 2015). This decline partially reflects the transfer of part of the federal debt pertaining to housing loans (equivalent to 1.8% of GDP) to a new off-balance sheet entity.

The general government debt has held steady at about 56% of GDP (excluding debt guarantee).

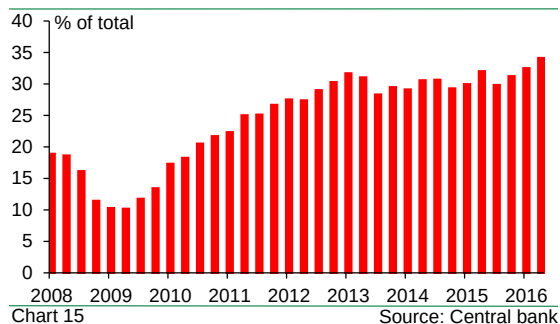
Contingent liabilities, estimated at about 15% of GDP, are unlikely to represent an additional risk. The state is the sole shareholder of the 1MDB fund, but any additional charges are unlikely to be big enough to disrupt the public finance equilibrium. Even though a parliamentary commission warned in April 2016 that the fund's debt amounted to about 4% of GDP, total assets were estimated at more than that amount. The government also seems to be reticent about extending its support beyond the level explicitly guaranteed in its support letter (about 1.5% of GDP).

Consequently, there seems to be little risk that any contingent liabilities will materialise in the very short term (severe growth shock or the simultaneous deterioration in the financial situation of several state-owned companies implying government intervention).

As in previous years, the debt will mainly be financed through domestic loans in the local currency, thanks to a broad base of local institutional investors. Despite the increase in the debt ratio and the simultaneous increase in contingent liabilities, the country's financing capacity has not been endangered, and the low proportion of public debt denominated in foreign currency (3.2% in Q3 2016) protects sovereign debt from exposure to currency risk. Lastly, the debt profile, comprised of long-term, fixed rate instruments (6 years on average), lends some stability to debt servicing.

Malaysia's biggest vulnerability is still the high proportion of debt held by non-residents (34% in Q2 2016). Despite better fundamentals and a healthier situation, the country seems to be more exposed to a shift in investor sentiment than the other Asian countries (Thailand, for example).

Foreign holdings of government securities



This strong resilience can be attributed to a unique development model combining strong state interventionism (national production in strategic sectors, public investment, especially countercyclical investment, management of imports and monitoring of inequality) and the development of the export manufacturing sector, while taking advantage of its comparative advantages to facilitate its integration in global and regional trade.

This positioning is currently being called into question. Internationally, Malaysia's positioning leaves the economy particularly vulnerable to the stagnation of trade, greater protectionist policies and a Chinese economic slowdown. Although the country is relatively well positioned to face up to these new challenges, it will also need to implement the necessary reforms to increase productivity, foster innovation, develop the middle class, and climb out of the ranks of "middle income" countries, in order to further increase its competitiveness faced with the rapid development of neighbouring countries.

Malaysia's solid fundamentals have enabled it to weather a series of shocks in recent years: the 2008-09 economic and financial crisis, the drop-off in commodity prices and the slowdown in global trade.

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helene.drouot@bnpparibas.com

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NOTES

¹ According to the INSEE definition, the Gini index (or coefficient) is a composite indicator of inequalities in wages (in income, standard of living, etc.). It varies between 0 and 1. It would be equal to 0 in situations of perfect equality in which all wages, income and standard of living, etc. were equal. At the other end of the scale, it would be equal to 1 in the most unequal situation possible, where all wages (income, standards of living, etc.) except one were zero. Between 0 and 1, the higher the Gini index, the greater the inequality.

² According to the IMF definition, developing Asia is composed of 29 countries : Composed of 29 countries: Bangladesh, Bhutan, Brunei Darussalam, Cambodia, China, Fiji, India, Indonesia, Kiribati, Lao P.D.R., Malaysia, Maldives, Marshall Islands, Micronesia, Mongolia, Myanmar, Nepal, Palau, Papua New Guinea, Philippines, Samoa, Solomon Islands, Sri Lanka, Thailand, Timor-Leste, Tonga, Tuvalu, Vanuatu, and Vietnam.

³ See C. Stephan, « Aux origines de la faiblesse du commerce mondial », BNP Paribas, Conjoncture n°11, Novembre 2016



GROUP ECONOMIC RESEARCH

■ **William DE VIJDER**
Chief Economist

+33(0)1 55 77 47 31

william.devijlder@bnpparibas.com

ADVANCED ECONOMIES AND STATISTICS

■ **Jean-Luc PROUTAT**
Head

+33.(0)1.58.16.73.32

jean-luc.proutat@bnpparibas.com

■ **Alexandra ESTIOT**

Works coordination - United States - United Kingdom - Globalisation

+33.(0)1.58.16.81.69

alexandra.estiot@bnpparibas.com

■ **Hélène BAUDCHON**

France (short-term outlook and forecasts) - Labour markets

+33.(0)1.58.16.03.63

helene.baudchon@bnpparibas.com

■ **Frédérique CERISIER**

Euro Area - European Institutions and governance - Public finances

+33.(0)1.43.16.95.52

frederique.cerisier@bnpparibas.com

■ **Thibault MERCIER**

France (structural reforms) - European central bank

+33.(0)1.57.43.02.91

thibault.mercier@bnpparibas.com

■ **Manuel NUNEZ**

Japan, Ireland - Projects

+33.(0)1.42.98.27.62

manuel.a.nunez@bnpparibas.com

■ **Catherine STEPHAN**

Spain, Portugal - World trade - Education, health, social conditions

+33.(0)1.55.77.71.89

catherine.stephan@bnpparibas.com

■ **Raymond VAN DER PUTTEN**

Germany, Netherlands, Austria, Switzerland - Energy, climate - Long-term projections

+33.(0)1.42.98.53.99

raymond.vanderputten@bnpparibas.com

■ **Tarik RHARRAB**

Statistics and Modelling

+33.(0)1.43.16.95.56

tarik.rharrab@bnpparibas.com

BANKING ECONOMICS

■ **Laurent QUIGNON**
Head

+33.(0)1.42.98.56.54

laurent.quignon@bnpparibas.com

■ **Céline CHOLET**

+33.(0)1.43.16.95.54

celine.choulet@bnpparibas.com

■ **Thomas HUMBLLOT**

+33.(0)1.40.14.30.77

thomas.humbloit@bnpparibas.com

■ **Laurent NAHMIAS**

+33.(0)1.42.98.44.24

laurent.nahmias@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

■ **François FAURE**
Head

+33.(0)1.42.98.79.82

francois.faure@bnpparibas.com

■ **Christine PELTIER**

Deputy Head - Greater China, Vietnam - Methodology

+33.(0)1.42.98.56.27

christine.peltier@bnpparibas.com

■ **Stéphane ALBY**

Africa (French-speaking countries)

+33.(0)1.42.98.02.04

stephane.alby@bnpparibas.com

■ **Sylvain BELLEFONTAINE**

Turkey, Brazil, Mexico, Central America - Methodology

+33.(0)1.42.98.26.77

sylvain.bellefontaine@bnpparibas.com

■ **Valérie PERRACINO-GUERIN**

Africa (English and Portuguese speaking countries)

+33.(0)1.55.77.80.60

valerie.perracino@bnpparibas.com

■ **Pascal DEVAUX**

Middle East, Balkan countries - Scoring

+33.(0)1.43.16.95.51

pascal.devaux@bnpparibas.com

■ **Anna DORBEC**

CIS, Central European countries

+33.(0)1.42.98.48.45

anna.dorbec@bnpparibas.com

■ **Hélène DROUOT**

Asia

+33.(0)1.42.98.33.00

helene.drouot@bnpparibas.com

■ **Johanna MELKA**

Asia, Russia

+33.(0)1.58.16.05.84

johanna.melka@bnpparibas.com

■ **Alexandra WENTZINGER**

South America, Caribbean countries

+33.(0)1.42.98.74.26

alexandra.wentzinger@bnpparibas.com

■ **Michel BERNARDINI**
Public Relation Officer

+33.(0)1.42.98.05.71

michel.bernardini@bnpparibas.com



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