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THE MALAYSIAN ECONOMY

Developments and Challenges

Denis Hew

Introduction

Like many economies in Southeast Asia, Malaysia currently faces a number of challenges that could have a significant impact on its economic growth and development. Despite the fact that 2007 was generally seen as a good year economically, events in the second half of the year, particularly the U.S. sub-prime mortgage crisis, and poor U.S. economic data could trigger a recession in the world's largest economy, which in turn could lead to a global slowdown in 2008. Added to these concerns are the high oil prices and rising food and commodity prices, which could stoke fears of global inflation. All these downside risks would clearly affect macroeconomic stability in the region. Against this backdrop, Malaysia's relatively good economic performance in 2007 may be insufficient to guarantee that the country will be immune from the downside risks faced by the rest of the world.

At the same time, Malaysia is currently going through a challenging period in its economic development as it attempts to maintain its economic competitiveness vis-à-vis the emerging economies of China, India and, closer to home, Vietnam. Like a number of middle-income developing countries in the region, Malaysia has economically been "punching below its weight" in the sense that it is not maximizing its full economic potential. To address these challenges, Malaysia has been trying to develop two ambitious economic corridor projects that could revitalize its economy.

These two economic corridors are the Iskandar Development Region (IDR) in South Johor (which borders Singapore) and the Northern Corridor Economic Region (NCER) in the northern Peninsular Malaysia. Besides reviewing Malaysia's economic performance in 2007, this chapter will examine the development of these two economic corridors.

Economic Performance in 2007

Malaysia's economic performance in 2007 was better than market expectations. The country registered a real GDP growth rate of 6.3 per cent in 2007 (the

TABLE 1
Real GDP Growth by Expenditure
(Annual change in percentage, % yoy)

	2001	2002	2003	2004	2005	2006	2007
Private consumption	3.0	3.9	8.1	9.8	8.7	7.1	11.7
Public consumption	15.7	11.9	8.6	7.6	6.4	5.0	6.4
Gross fixed capital formation	-2.1	0.6	2.8	3.6	5.0	7.9	10.2
Public investment	13.3	20.6	-0.3	-21.5	6.8	8.9	n.a.
Private investment	-15.7	-23.3	8.8	46.5	3.3	7.0	n.a.
Domestic demand	3.0	4.0	6.6	7.7	7.3	7.0	10.5
Exports of goods and services	-6.8	5.4	5.1	16.1	7.9	7.4	3.7
Imports of goods and services	-8.2	6.2	4.5	19.6	8.9	8.6	4.1
Real GDP	0.5	5.4	5.8	6.8	5.0	5.9	6.3

Source: CEIC, Bank Negara Malaysia.

FIGURE 1
Growth in GDP, Domestic Demand and Net Exports

Source: CEIC, Bank Negara Malaysia.

FIGURE 2
Growth in Consumption and Investment, 2005–2007

Source: CEIC, Bank Negara Malaysia.

economy grew 5.9 per cent in 2006) which was higher than the Malaysian Institute of Economic Research's (MIER) projection of 6.1 per cent (see Table 1 and Figure 1).¹ A better than expected fourth quarter economic growth rate of 7.3 per cent helped to push up the overall economic growth for the year.

Economic growth in 2007 was predominantly driven by domestic demand, particularly from strong private consumption. Private consumption grew 11.7 per cent in 2007 compared with 7.1 per cent in 2006 (see Figure 2). Strong consumer spending over the past year was due to higher disposable incomes that created an overall positive wealth effects. The bullish domestic stock market and higher commodity prices and salary increments for civil servants all contributed to this state of affairs.

On the investment side, gross fixed capital formation (public and private investment) grew by 10.2 per cent compared with 7.9 per cent the previous year. Higher manufacturing capacity utilization rate (77 per cent in the fourth quarter of 2007) and improved business sentiments had contributed to the higher private investment activities over the past year. Public investment was also higher as government development expenditure for the Ninth Malaysia Plan gained momentum. Public investment included agriculture and rural development, utilities and transport infrastructure, education, and health services. (The Ninth Malaysia

Plan is a five-year economic development plan that allocates the government’s national budget to all economic sectors from 2006 to 2010.)

However, exports growth was weaker mainly due to the slump in global demand for electronics. Exports of electronics and electrical (E&E) products contribute about half of Malaysia’s total merchandise exports. Net exports of goods and services increased only by 0.9 per cent in 2007. Merchandise exports grew 2.7 per cent (10.3 per cent in 2006) while merchandise imports grew by 4.9 per cent (10.8 per cent in 2006). The trade account recorded a surplus of RM100.5 billion for the full year of 2007 (RM108.2 billion in 2006).

On the supply side, manufacturing sector growth decelerated significantly, dragged down by the downturn in the global electronics market. The manufacturing sector growth rate in 2007 more than halved to 3.1 per cent compared with 7.1 per cent over the same period in 2006 (see Figure 3). Nevertheless, signs of improvement in the E&E sector were reflected in the second half of the year, with stronger growth recorded in the third and fourth quarters of 2007 at 3.3 per cent and 5.6 per cent respectively.

The index of industrial production (IPI) had recorded weak growth and contraction (in March 2007) reflecting the weakness in output from the E&E sector. See Figure 4. Nevertheless, domestic-oriented industries were able to partially

FIGURE 3
Economic Growth by Sector, 2005–2007

Source: CEIC, Bank Negara Malaysia.

FIGURE 4
Index of Industrial Production, 2007

Source: CEIC.

take up the slack in export-oriented industries particularly in construction-related industries such as the production of iron and steel and fabricated metal.

Meanwhile, stronger consumer spending and a thriving tourism industry led to an expansion services sector. The sector grew by 9.7 per cent in 2007 compared with 7.2 per cent in 2006. Robust domestic demand and higher tourism receipts supported strong growth in the finance, insurance, real estate and business services; whole and retail trade, hotel and the restaurant industries. The Visit Malaysia Year 2007 tourism campaign appeared to have been successful. Malaysia attracted 19.1 million tourists from January to November 2007, which is a 19.2 per cent increase over the same period in 2006.

The year 2007 also marked the revival of the construction sector, which grew at 4.6 per cent after three consecutive years of contraction. Growth in this sector was underpinned by ongoing construction projects under the Ninth Malaysia Plan as well as economic growth corridors such as the IDR and the NCER.

Poor weather conditions led to poor performance in the agriculture sector especially during the first half of 2007. The sector contracted in the second quarter of 2007 by 0.9 per cent but showed signs of recovery in the second half of the year with increased production of crude palm oil. The agriculture sector grew by 2.2 per cent for the full year 2007 (5.2 per cent in 2006). After two years

FIGURE 5
CPI Inflation Rate, 2007

Source: CEIC.

of contraction, the mining sector expanded by 3.2 per cent due to a substantial increase in crude oil production.

Inflation, as measured by the change in consumer price index (CPI), was creeping upwards gradually over the year reaching 2.4 per cent in December 2007 (see Figure 5). In June 2007, the inflation rate was 1.4 per cent. This rise was mainly due to higher food and beverage prices. Inflation pressures will likely persist in 2008 as global prices for food and oil continue to rise or remain high. Domestic inflation pressures may also come from an expected cut in oil and gas subsidies by the Malaysian government after the general elections in March 2008.

The country's central bank, Bank Negara Malaysia (BNM), was maintaining a fairly tight monetary policy. The benchmark overnight policy rate (OPR) has been kept unchanged at 3.5 per cent, after raising the rate three times since November 2005 to keep inflation in check. BNM has decided not to raise interest rates given the robust domestic demand and stable labour market (unemployment rate in 2007 was estimated to be a low 3.3 per cent).² However, there may be some pressure to hike interest rates as a means to curb rising inflation in the coming year should global oil prices remain persistently high.

Fiscal policy remained moderately expansionary. Higher development expenditure under the Ninth Malaysia Plan has resulted in a fiscal deficit which is 3.2 per cent of GDP. Fiscal policy is likely to remain expansionary in 2008

as increased expenditure on planned development projects such as the IDR and NCER come onstream. The fiscal deficit is expected to be manageable as revenue collection will be boosted in the coming year from high international oil prices and a possible introduction of a goods and services tax.³

The ringgit weakened against the U.S. dollar in August 2007 as foreign portfolio investors exited the Malaysian financial markets due to the sub-prime mortgage crisis in the United States. Nevertheless the continued weakening of the greenback has led to the ringgit appreciating significantly against the U.S. dollar over the fourth quarter of 2007. From January to December 2007, the ringgit appreciated 5.9 per cent against the U.S. dollar. However, a stronger ringgit may negatively impact exports, especially if the U.S. dollar continues to weaken in 2008. Meanwhile, the ringgit depreciated against other major currencies such as the Japanese yen (2.5 per cent) and the euro (6.9 per cent) over the same period (see Figure 6).

On 1 April 2007, the foreign exchange administration rules were liberalized by BNM to support the development of financial markets and to enhance business efficiency. The liberalization measures included expanding the scope of licensed onshore banks' foreign currency business and facilitating investments in ringgit

FIGURE 6
Ringgit against Major Currencies in 2007

Source: CEIC.

assets by non-residents. The measures will also provide greater flexibility for businesses to manage financial risk.

International reserves remain high. As at 31 December 2007, international reserves amounted to RM335.7 billion which was sufficient to finance 9.2 months of retained imports and is 6.5 times the short-term external debt.⁴ Malaysia continues to be vulnerable to sharp portfolio capital outflows. Although international reserves remained over RM300 billion through the year, they dipped in August 2007 when financial markets in the region tumbled amidst concerns about a contagion effect arising from the sub-prime mortgage crisis in the United States. Nevertheless, given its robust international reserves, Malaysia is unlikely to impose the kind of draconian capital controls that were implemented in the 1997–98 Asian financial crisis.

Malaysia attracted RM33.4 billion worth of foreign direct investments (FDI) in 2007, a 65 per cent increase from RM20.2 billion in 2006.⁵ Much of this increase came from investments in the manufacturing sector especially E&E industries (RM13.7 billion in foreign investments in 2007). The recent relaxation of the foreign exchange administration rules should encourage more foreign investments into the country.

Regional Economic Outlook

According to the Asian Development Bank (ADB), the ASEAN region is projected to grow by 6.3 per cent in 2007 and 6.1 per cent in 2008 (see Table 2).⁶ The region grew 6 per cent in 2006. Robust economic growth in 2007 has been underpinned by robust domestic demand and exports.

ASEAN economic growth in 2007 was driven by the strong performance in Singapore, Malaysia, Philippines, Indonesia, and Vietnam. Underpinning domestic

TABLE 2
GDP Growth Rates

	2001	2002	2003	2004	2005	2006	2007 ^f	2008 ^f
ASEAN	1.9	4.9	5.4	6.4	5.6	6.0	6.3	6.1
China	8.3	9.1	10.0	10.1	10.4	11.1	11.4	10.5
Japan	0.2	0.3	1.4	2.7	1.9	2.2	1.9	1.7
USA	0.8	1.6	2.5	3.6	3.1	2.9	2.2	1.9
Euro Zone	1.9	0.9	0.8	2.0	1.5	2.8	2.6	2.1

Source: Asian Development Bank, IMF.

demand has been stronger than expected private consumption (due to salary pay hikes, higher overseas remittances and bullish stockmarkets) and pick-up in investments supported much of the economic expansion in the region. However, one of the region's largest economies, Thailand, had struggled over the past year due to ongoing political uncertainties that dampened consumer and investors confidence.

Looking ahead to 2008, the regional economic outlook is more uncertain. It remains unclear how seriously the U.S. economy will be affected by the sub-prime mortgage crisis. The U.S. Federal Reserve has cut interest rates aggressively over the past year to prevent a credit crunch that could potentially drag the economy into a recession. Although 2008 GDP growth estimates for the U.S. were revised significantly downwards, the possibility of an economic downturn remains fairly high in the light of recent unfavourable economic-related data released such as employment, consumer spending, housing foreclosures, and financial write-downs in the banking sector. Both fiscal and monetary stimulus are likely to be implemented over the next several quarters in 2008 to keep the U.S. economy from falling into a deep recession.⁷ As the world's largest economy and a major market for Asian exports, a sharp downturn in the U.S. economy will clearly have a major impact on the global economy.

Other downside risks that may affect the short-term regional economic outlook include:

- High oil prices are likely to persist and may slow down global economic growth. Crude oil prices, which hit over US\$100 a barrel mark in January 2008, are expected to remain high as supply conditions remain unpredictable. Although this region is vulnerable to high oil prices, the relatively strong economic fundamentals of many Asian economies are likely to provide, to some extent, a buffer against this risk. But, higher oil and food prices are stoking fears of global inflation that could make macroeconomic stability in the region more difficult to manage and maintain.
- Over the past few years, China's booming economy has been an engine of growth not only for Southeast Asia but for the entire global economy. However, China's economy are beginning to show signs of overheating — the economy was expected to grow by 11.4 per cent in 2007 (11.1 per cent in 2006). China's overheating economy was also reflected in inflation that reached an eleven-year high of 6.5 per cent in December 2007 with signs of further upward pressures in 2008. Despite administrative policy measures over the past few years to facilitate a softer landing, there is some

concern that the Chinese economy could be heading towards a hard landing over the coming year which would clearly have an impact on the region's growth prospects.

- The financial turmoil triggered by increasing defaults in the U.S. sub-prime mortgage market in the third quarter of 2007 will continue to keep global financial markets highly volatile in 2008.⁸ Given that many of these sub-prime mortgages were securitized in collateralized debt obligations (CDO), a loss in value in these financial instruments due to sub-prime loan defaults had led to huge financial write-downs reported by multinational banks such as Citigroup, JP Morgan and Merrill Lynch. Uncertainty in the international banking industry with regards to CDO risk exposure has resulted in a global credit crunch that will continue to be a problem that needs to be addressed by central banks in 2008. While implications from the U.S. sub-prime mortgage crisis are still unwinding, what seems clear is that a full-blown global credit crunch could lead an economic slowdown in the industrialized economies of the United States and Europe with negative implications on the economic prospects for this region.
- The United State's persistent current account deficit (6.2 per cent of GDP in 2006 and estimated to be 5.5 per cent in 2007), which is financed by surpluses in Japan, China, and oil-exporting countries investing in U.S. dollar assets, create global imbalances that are not only unsustainable but could destabilize the global economy. The combination of global imbalances that remain unchecked, a weakening U.S. dollar, volatile financial markets and a possible U.S. recession will have negative economic implications for the region.

Impact on Malaysia's Growth Prospects

Given that Malaysia's 2007 GDP growth of 6.3 per cent was well above market expectations, Malaysian Prime Minister Abdullah Badawi appears confident that the country should be able to easily achieve, if not beat, the official forecast target of 6 per cent to 6.5 per cent in 2008.⁹ In the light of the economic risks highlighted above, however, the global economic environment appears to be increasingly hostile in 2008. This would have an impact of ASEAN economies including Malaysia. Hence, the official growth forecasts may be overly optimistic given these downside risks especially if Malaysia's biggest trading partner, the United States, goes into an economic recession.

It seems likely that economic growth momentum observed in 2007 — driven by robust domestic demand growth — will continue to 2008. The planned cut in

corporate tax from 27 per cent to 26 per cent in 2008 and a further 1 per cent to 25 per cent in 2009 should help accelerate private investment growth in the near-term.

On the upside, the global demand for information and communications technology (ICT) products has shown signs of a recovery from the fourth quarter of 2007 and is likely to rebound in 2008. This should support industrial output and give Malaysia a much-needed boost in merchandise exports. The Semiconductor Industry Association (the trade association which represents the U.S. semiconductor industry) reported that global sales of semiconductors increased 3.2 per cent in 2007 to US\$255.6 billion compared with the previous year. The association noted that the drivers for demand for semiconductors such as personal computers, mobile handsets, and consumer electronics remained fairly robust in 2007 and projected a growth of 7.7 per cent in the global semiconductor industry in 2008.¹⁰

The tourism industry is expected to receive a boost with the liberalization of the region's busiest trade route to low-cost carriers (LCCs), i.e., between Kuala Lumpur and Singapore. In October 2007, Air Asia, the first Asian budget airline was given the green light to fly to Singapore from four Malaysian cities — Kuala Lumpur, Penang, Kota Kinabalu, and Kuching.¹¹ On 1 February 2008, Air Asia commenced operations on the Kuala Lumpur-Singapore route while Singapore LCCs, Tiger Airways and Jetstar Asia, commenced the Singapore-Kuala Lumpur route. With eighty destinations across Asia and Australia, Air Asia is poised to be a leading player in the regional hub for budget air travel industry.

Malaysia's Economic Corridors

One of the main concerns of Malaysian policy-makers is that the country is losing its economic competitiveness to new emerging countries, especially China and India. A McKinsey study on ASEAN competitiveness found that middle-income ASEAN countries have already lost their competitive edge to China.¹² Since the 1997 Asian financial crisis, Malaysia, like other middle-income ASEAN countries, has struggled to move up the value chain to improve its labour productivity, industrial efficiency, and technological innovation. Moreover, Malaysia's relatively low investment to GDP ratio over the past ten years would indicate that the country has not been maximizing its full economic potential.

In this light, two of Malaysia's largest and most ambitious economic corridors development projects, namely, the IDR and the NCER aim to address these growing economic challenges. Under the Ninth Malaysia Plan, the Malaysian government

aims to invest heavily in these two economic corridors as a means to attract FDIs and revitalize its under-achieving economy.

Iskandar Development Region

In November 2006, the Malaysian government launched the IDR, a twenty-year development project to develop South Johor which is the southernmost part of Peninsular Malaysia that borders Singapore. The IDR includes waterfront and residential development, a new administrative centre for the Johor state, transshipment and logistics hub, education and medical hubs and information as well as ICT infrastructure.

To avoid government red tape and to fast-track the implementation process, an important component of the IDR is the establishment of a one-stop government agency that would allow both federal and state governments to work closely together to facilitate a business-friendly environment.

The land area of the IDR is 2,217 sq. km, which is 3.6 times the size of Singapore and twice the size of Hong Kong. This relatively well-off part of Malaysia has a current population of 1.35 million people (43 per cent of Johor's population) and a GDP per capita of US\$14,790.

Logistically, the IDR is geographically well-positioned as it covers Senai International Airport to the north, Port Tanjung Pelepas in the southwest and Johor Port, Pasir Gudang in the southeast. The IDR is also linked to the North-South Expressway, a 772-km-long highway extending from the border of Thailand in the north to the border of Singapore in the south.

The IDR is not entirely a greenfield investment location. There are already existing development projects in the area including investments in manufacturing and property development that are worth about RM30 billion prior to the launch of the IDR. Industrial clusters that already exist in the area include E&E, petrochemicals, oleo-chemicals, food and agro-processing industries. The E&E cluster is the most dominant with almost half of total value added of the manufacturing sector in the IDR.

According to the government-released Comprehensive Development Plan (CDP) for the South Johor Economic Region, investments of about RM47 billion is required for the IDR to achieve a projected growth rate of 8 per cent over the period of 2006 to 2010. Over the subsequent five-year period, RM73 billion worth of investments will be required to sustain the same economic growth rate. In this light, the Malaysian government announced a package of investment incentives for the IDR in March 2007. To qualify for these incentives, the companies have to be in the following sectors:

- (i) creative industries;
- (ii) educational services;
- (iii) financial advisory and consulting;
- (iv) healthcare;
- (v) logistics; and
- (vi) tourism-related services.

These incentives include a ten-year exemption from corporate income tax and relaxation in foreign investment requirements, sourcing of capital and employment of foreign workers. Perhaps the most contentious investment incentive offered is the waiver on the affirmative action requirement in which foreign investors must offer a 30 per cent stake in their businesses to ethnic Malays.

These generous investment incentives are nevertheless not new. Similar incentives were offered in the past for foreign investments in high-technology manufacturing and for information technology industries in the Multimedia Super Corridor (MSC). However, the greater scale of industries covered and the suspension of the affirmative action policy has raised concerns of a political backlash among members of the United Malays National Organisation (UMNO), Malaysia's ruling party. For example, the proposal in November 2006 for a passport-free access zones between Singapore and the IDR was scrapped in April 2007 amidst fears that it would undermine Malaysia's sovereignty.

These investment incentives are also unlikely to attract significant foreign investment from Singapore due to the IDR's focus on the services sector. Singapore has been trying to relocate most of its manufacturing activities to cheaper locations such as Johor and Indonesia while focusing on higher value-added production and research and development (R&D). Instead of building closer industrial linkages with Singapore, the IDR appears to compete head-on with Singapore in service industries such as finance, logistics, healthcare and education.

The IDR is an ambitious development project. Its success will lie in proper planning and effective implementation. The IDR is envisaged to have in twenty years:

- a strong and efficient logistic system that will provide a high level of national and international accessibility and mobility;
- dynamic manufacturing and service clusters with well-developed linkages to regional and global markets; and
- world-class facilities that would attract a sizeable number of highly skilled professional workforce.

The key to this project succeeding would lie in forging closer economic and industrial linkages with Singapore. For example, it seems logical to strengthen the already existing industrial linkages between the two countries in the E&E sector, which can serve as an important building block to realize a dynamic economic region in southern Malaysia.

Northern Corridor Economic Region

The NCER was launched in July 2007 and encompasses the northern Malaysian states of Perlis, Kedah, and Penang plus north Perak. Like the IDR, the NCER is a long-term development project which spans eighteen years until 2025.

The overarching objective of the NCER is to expand and add value to existing sectors such as agriculture, manufacturing, tourism, and logistics. By using new industrial farming techniques and biotechnology, the northern region could potentially become a high-tech food producing zone. Penang — which was once the “Silicon Valley” of the East — could see its E&E industries revitalized through higher value-added activities in the area of design and R&D.

The NCER could also build upon existing well-established tourist destinations such as Langkawi and Penang to enhance the size and quality of the tourism industry there. The recent liberalization to allow budget airlines more access to tourism and business routes would also benefit the region. Given its proximity to Indonesia and Thailand, the NCER aims to position itself as a transportation and logistics hub for cross-border development projects such as the Indonesia-Malaysia-Thailand Growth Triangle (IMT-GT).

There is also a social equity dimension to the NCER as the northern region accounts for 17 per cent of Malaysia’s households living in poverty and 29 per cent of households living in hardcore poverty. For example, Kedah and Perlis have higher poverty levels than the national average. Besides poverty alleviation, the NCER project also aims to address low education attainment levels and poor school participation rates.

However, unlike the IDR, the NCER appears to be targeting local rather than foreign investors.¹³ This lack of interest among foreign investors to the NCER is not surprising given that the NCER includes the country’s poorer and least developed states (with the exception of Penang). Yet, without much-needed foreign investment, good infrastructure and access to high quality universities, the NCER is unlikely to take off. It would also be uncertain whether the NCER project will progress quickly should the opposition parties take control of some of the northern states after the March 2008 general elections.

Concluding Remarks

As the preceding discussion has shown, Malaysia's economic growth has been better than expected in 2007. The key driver of growth has been robust domestic demand, especially private consumption and government investments in development projects under the Ninth Malaysian Plan and economic corridors such as the IDR and NCER. Much of this economic growth momentum will be carried forward into 2008. However, GDP projections for 2008 will have to take into account the downside risks such as a possible U.S. recession, large global imbalances and higher oil prices (which are stoking fears of global inflation). These downside risks could potentially dampen world trade which in turn could have negative implications on the growth prospects of Malaysia and the entire East Asian region.

Against this scenario, the Malaysian government's investment in two ambitious economic corridors development projects, i.e., the IDR and the NCER, could partially cushion the possible impact of a global economic slowdown. For smaller countries, the strategy of developing economic corridors — leveraging on the advantages of contiguous economic regions — is seen as a means to maximize a country's economic potential by capitalizing on the complementarities that these economic corridors present.

In this regard, much work will therefore need to be done on how to formulate the right approach in developing these two economic corridors. While the IDR and the NCER may be long-term development projects, they nevertheless need to be carefully thought out. For instance, it makes more economic sense for the IDR to complement rather than compete with neighbouring Singapore, especially in the manufacturing and services sectors. Meanwhile, the NCER in north Peninsular Malaysia is a more challenging project given that it covers the poorer and less developed part of the country. Given that time may not always be on Malaysia's side, the next Badawi administration must be seen to put greater effort in ensuring that the necessary conditions for growth in these less developed parts of the country are conducive to investment, particularly in education and infrastructure development. This would require no less than the political will to implement many of the plans that are laid out in the drawing board.

Notes

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