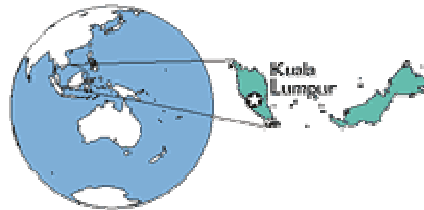


COUNTRY REVIEW

Malaysia



20 January 2010

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EULER HERMES COUNTRY RISK GRADE: A

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Generally good international relations (member of ASEAN).
- Impressive double-digit surpluses in the current account-to-GDP ratio since 2003, that were sustained in 2009.
- Ample foreign exchange reserves.
- Manageable external debt burden.
- Generally strong business environment.
- Robust and stable banking sector.

Weaknesses

- Significant ethnic-religious tensions and increasing public frustration over the *bumiputra* policy.
- Fiscal stimulus in 2009 has pushed the overall public sector budget balance into a deep deficit (estimated at 9.5% of GDP).
- Government intervention in and regulation of the economy remains an issue.

KEY RISKS

- **Recession-driven sharp rise in bankruptcies**
- **Vulnerability to volatile global oil prices**
- **Political instability is a medium-term risk**

Country Risk Assessment

Ratings	Malaysia		Median Grade A	Singapore	Peers	
	Latest	Previous			Taiwan	Chile
Systemic Political Risk:	P2+	P2+	P2+	P1	P2+	P1
Systemic Economic Risk:	E2	E2	E2	E2	E2	E2
ME rating:	ME2	ME2	ME2	ME2	ME2	ME2
<i>Structure</i>	2.3	2.3	3.3	3.3	4.0	4.0
<i>Policy</i>	4.3	2.2	2.2	3.8	1.9	2.8
<i>Solvency</i>	1.3	1.3	1.3	1.3	1.0	1.0
<i>External Liquidity</i>	2.8	1.7	2.5	2.3	2.8	3.8
SBE rating:	SBE2	SBE2	SBE2	SBE1	SBE2	SBE1
COUNTRY GRADE:	A	A		A	A	A

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Kuala Lumpur (Putrajaya is referred to as the administrative center)
Population:	27.014 mn (2008)
GDP:	USD 221772 mn (2008)
Currency:	Ringgit (MYR)
Form of state:	Constitutional monarchy / Parliamentary democracy
Head of government:	Prime Minister Najib Razak (since April 2009)
Next elections:	Legislative: 2013

Major Industries (% of GDP at market prices, 2008)	Global Assumptions	2009	2010	
Services	41.3%	Real GDP grth (% yr/yr) *	-3.9	0.9
Manufacturing	26.3%	Inflation (% av) *	-0.1	1.3
Mining	17.2%	Dated Brent (USD/b)	63	72
Agriculture	10.2%	* Major economies		
Construction	2.7%			

Main Exports (% of total, 2007)		Main Imports (% of total, 2007)	
Machinery, appliances, electronics	48.0%	Machinery, appliances, electronics	48.7%
Mineral products	14.5%	Base metals and articles thereof	10.4%
Animal or vegetable fats	6.1%	Mineral products	9.4%
Plastics and rubber	5.9%	Chemical products	5.7%
Chemical products	4.6%	Plastics and rubber	4.4%
Lead Export Markets (% of total exports, 2008)		Lead Import Markets (% of total imports, 2008)	
Singapore	16.3%	Singapore	21.9%
US	13.0%	China	12.8%
China	12.6%	Japan	9.9%
Japan	9.7%	US	7.9%
Thailand	4.2%	Thailand	5.7%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	156,331	186,588	221,773	207,105	227,327
Population (mn)	26.10	26.56	27.01	27.47	27.92
GDP per capita (USD)	5,991	7,026	8,210	7,540	8,142
Real GDP growth (% yr/yr)	5.8	6.2	4.6	-2.2	3.0
Inflation (% eop)	3.1	2.2	4.3	1.1	2.0
Fiscal balance (% of GDP, consolidated)	-0.3	1.5	-5.6	-9.5	-5.9
Current account balance (% of GDP)	16.3	15.5	17.5	16.0	11.0
External debt/GDP (%)	33.4	30.4	30.8	34.8	35.2
External debt/Exports of goods & services (%)	28.6	27.7	29.8	37.2	37.8
Debt-service ratio (%)	4.8	3.8	2.6	6.3	6.1
Foreign exchange reserves (USD mn)	81,724	100,635	90,605	92,900	95,000
Import cover (months)	6.6	7.2	6.1	7.4	6.4
Exchange rate assumption, MYR:USD (av)	3.67	3.44	3.34	3.52	3.35
f: CRU central forecast					

Sources: Central Bank, Department of Statistics, Ministry of Finance, Treasury, ADB, IMF, Euler Hermes CRU

Political Stability

Malaysia is home to ethnic-Malays and other indigenous groups (about 61% of the population) as well as to Chinese (24%), Indian (7%) and other minority groups. Religious divisions among Muslims, Buddhists and Hindus follow a similar pattern to the ethnic split. Since this make-up contains significant potential for ethnic-religious tensions, the long-ruling, Malay-dominated but multi-party, multi-ethnic Barisan National (BN) coalition, led by the United Malays National Organisation (UMNO), introduced a positive discrimination law in favour of Malays and indigenous groups (*bumiputra* policy) in response to race riots in 1969. Designed to narrow the income gap between wealthy Chinese and poor Malays, the *bumiputra* policy has helped to maintain racial harmony and a relatively stable political environment for most of the time, in particular during the premiership of Mahathir bin Mohamad, who ruled in a somewhat authoritarian way from 1981 to 2003. Initially strong public support for Abdullah Badawi, Mahathir's hand-picked successor, waned gradually and, in November 2007, the largest anti-government protests in more than a decade arose over growing popular frustration with the *bumiputra* policy. Badawi called early general elections for March 2008 which resulted in a heavy setback for the BN coalition. Although the BN still won the elections comfortably, securing 140 out of 222 seats in parliament, it lost its two-thirds majority (it had gained 198 seats in 2004). Moreover, the opposition also achieved control of five of the 13 state governments (up from one). Meanwhile, the small Sabah Progressive party has left the BN, reducing the coalition to 13 parties and its parliamentary seats to 137.

In an orderly transfer of power in spring 2009, Najib Razak, by then Badawi's deputy, smoothly took over both the leadership of UMNO and the premiership. Najib, who is expected to show stronger leadership than his predecessor, faces several challenges. He needs to reform UMNO and to repair divisions within the BN coalition as ties between the ethnic Malays and the Chinese and Indian minorities have become fragile. Meanwhile, there are also growing signs of dissent within the People's Alliance, the three-party opposition alliance that gained 82 seats in the March 2008 general elections. The parties are ideologically quite distinct from each other. Moreover, Anwar Ibrahim, the *de facto* leader of the alliance, is facing a controversial trial on charges of sodomy and thus is faced with time in jail. Without Anwar, the opposition is likely to be weakened substantially. However, the allegation—Anwar was jailed on similar controversial charges in 1999 (later overturned) when then prime minister Mahathir sought to neutralise him—may again boost public resentment against the BN and there is a risk of mass demonstrations if Anwar is found guilty.

Overall, we expect fierce political in-fighting between the BN and the opposition to continue but the BN should stay in power in 2010. It still controls policymaking and is able to pass urgent legislation if needed as it has done, for instance, in the wake of the global financial crisis, the impact of which on Malaysia has been mitigated by appropriate fiscal stimulus. We expect broad policy continuity in the near future and the risks to systemic political stability, though significant, to remain contained.

International relations are generally good. Malaysia's standing as a moderate Islamic democracy enhances its role as a bridge between the Western and the Muslim world. However, the country has adopted a hostile stance towards Israel, to which the Bank Negara Malaysia (BNM, the central bank) applies current and capital account restrictions. Some regional tensions with Singapore, Thailand and Indonesia exist, but do not threaten overall stability. As a member of ASEAN, Malaysia benefits from the regional organisation's free trade agreements with China, Australia, New Zealand and India, all of which came into effect at the start of 2010.

Economic Stability

Malaysia is an upper-middle income economy with estimated GDP per capita of USD7,500 in 2009, which has been turned successfully into a modern multi-sector economy with services accounting for about 41% of GDP, industry (including mining and construction) 48% and agriculture 10%. With an export-to-GDP ratio of about 95%, the economy is very open and re-exporting plays an important role. Although this creates external vulnerabilities—observable during the Asian Crisis in the 1990s as well as the current global economic crisis—the diversified export structure, combined with overall solid macroeconomic fundamentals, provide some cushion.

Robust real GDP growth has averaged 5.9% in 2002-2007 and 6.2% in Q1-Q3 2008, mainly driven by domestic demand, in particular by sound private consumption and investment. Growth decelerated sharply in the wake of the global economic crisis, to just 0.1% yr/yr in Q4 2008, and shifted to economic contraction of 6.2% in Q1 2009 as both domestic and external demand were hit hard. But like other countries in the region, Malaysia had a relatively strong position going into the global crisis, allowing fiscal expansion and monetary policy relaxation and is benefiting with an early recovery that should be maintained in 2010. Real GDP contraction moderated to 3.9% yr/yr in Q2 and 1.2% in Q3. On

the expenditure side, private consumption returned to growth of 0.5% in Q2 and 1.5% in Q3, and government consumption increased by 1% and 10.9%, respectively. Investment remained a large negative contributor (Q2: -9.6%; Q3: -7.9%). Both exports and imports continued to shrink sharply, resulting in a small negative net contribution of external demand. Based on early monthly indicators, we expect real GDP growth of about 2.5% yr/yr in Q4, resulting in a full-year decline of 2.2% or so in 2009. For 2010, we forecast growth of around 3%.

The federal government recorded annual average fiscal deficits of 3.4% of GDP in 2005-2007. The introduction of two fiscal stimulus packages since the intensification of the global economic crisis in autumn 2008 has widened the deficit to 4.8% in 2008 and the government estimates a hefty 7.4% deficit in 2009, the highest in Malaysia since 1987. For 2010, the government plans to scale back stimulus in order to reduce the federal deficit to 5.6% of GDP. In the past, substantial surpluses of government-linked companies (GLCs, some 40 companies including Petronas, the state oil company and Telekom Malaysia, the national telecom company) have alleviated financing needs and, supported by rising oil prices, have lifted the consolidated public sector balance into surplus in 2004-2007 (bar a minor deficit in 2006). This pattern has changed in 2008 as lower oil prices and the global crisis have since caused cumulative deficits of the GLCs. The overall public sector deficit reached 5.6% of GDP in 2008 and is estimated at 9.5% in 2009 as Petronas had to borrow about USD4.3bn in bonds and Islamic financing. Nonetheless, short-term financing needs of the public sector should remain manageable. The public debt burden is relatively high at about 56% of GDP, though three-fourths of this is domestic debt.

In July 2005 the then seven-year old peg of the Malaysian ringgit (MYR) to the USD (at 3.80 MYR/USD) was lifted and replaced with a (tightly) managed float against a trade-weighted basket of currencies. In the following three years, the MYR appreciated gradually by a total of about 14%, supported by surpluses on the current account and strong foreign direct investment (FDI) inflows. In the wake of the deteriorating external environment, the MYR lost most of that gain as it fell to 3.73 MYR/USD in early March 2009. Since then, the exchange rate has rebounded by about 10% to 3.35 MYR/USD in early 2010, albeit with some volatility. Inflation has been under control for many years; only a 41% cut of petrol subsidies in June 2008 pushed it temporarily to 8.5% yr/yr in July-August of that year. Price pressures waned thereafter as afore high global food and energy prices dropped significantly, and falling domestic demand in the wake of the global economic crisis resulted in annual deflation from June to November 2009. After 5.4% in 2008, annual average inflation is estimated at 0.6% in 2009 and forecast at 1.5% in 2010. Monetary policy relaxation of the BNM in the wake of the global crisis was appropriate. The benchmark policy interest rate was lowered in three steps by a total of 150 bps to 2% from November 2008 to February 2009.

Malaysia's external position has remained favourable despite the global turbulences. The current account in relation to GDP has posted another double-digit surplus of about 16% in 2009 and is forecast at 11% in 2010. Foreign exchange reserves, which fell from a peak of USD125bn in June 2008 to USD87bn in April 2009, have recovered to USD93bn at end-2009. This is sufficient to cover more than seven months of imports and about three times the external payments falling due in 2010. Accordingly, the external debt burden is low, estimated at 35% of GDP or 37% of export earnings in 2009. The debt-service ratio is very comfortable at about 6% in 2010.

Summarising, macroeconomic fundamentals have remained overall solid, despite the recession in 2009 and deteriorating public finances. The risk of an external liquidity or debt crisis is still low, and monetary policy has been appropriate to mitigate price and exchange rate volatility.

Structural Business Environment

The Structural Business Environment is strong though just short of our highest category. Malaysia ranks 49th out of 210 economies in our assessment overall, just behind Hungary and Slovenia and ahead of Saudi Arabia, Barbados, Cyprus and Italy. The main strengths are the highly flexible labour market, low tax and average tariff rates, a comparatively low level of perceived corruption, transparency of credit information and investment transactions, and banking system stability. However, state intervention in the economy is still significant and although the government is working on the elimination of non-tariff barriers to trade, they are still present and, together with non-transparent regulation, sometimes hamper the successful conduct of commercial transactions. Despite gradual improvement, foreign investors still complain about ownership limits and market distortions caused by the *bumiputra* policy. Moreover, even though private property is formally protected, the judiciary remains subject to political influence.

Various sources support our generally favourable but somewhat mixed assessment. The World Bank's *2009 Governance Research Indicator* survey puts regulatory quality, the rule of law and control

of corruption above the average for the East Asian region. Malaysia is ranked 56th out of 180 countries rated in Transparency International's *2009 Corruption Perception Index*. The Heritage Foundation's *2009 Index of Economic Freedom* assigns Malaysia an overall rank of 58 out of 179 countries and a regional rank of 9 out of 41 countries in the Asia-Pacific region. The Fraser Institute's *Economic Freedom of the World 2009* survey places the country at rank 66 out of 141. The World Bank's latest *Doing Business* survey ranks Malaysia 23rd out of 183 countries, just behind Belgium but ahead of Estonia. That survey places the country particularly well with regard to 'Getting Credit' (rank 1), which reflects measures on the availability of credit information and the legal rights of borrowers and lenders, and 'Protecting Investors' (rank 4), which includes the transparency of business transactions. According to the same survey insolvency procedures take less time, cost less and recovery rates are higher as compared to the regional average, however, they are generally worse than the OECD average. Further, the cost of enforcing commercial contracts is lower than the regional average but higher than the OECD average while the average time for a lawsuit in this context is longer than both the regional and the OECD average.

The banking system has remained stable. Financial sector liberalisation is still incomplete as foreign firm's participation remains restricted. However, continued reforms to strengthen the supervisory and regulatory framework in recent years as well as proactive policies have helped the banking system to cope well with global financial crisis. Banks are generally well capitalised, liquid, profitable and have low non-performing loans. The latter as a share of total loans stood at 1.9% in November 2009, down from 2.2% in 2008 and over 10% in 2002. Cautious credit monitoring has resulted in adequate private sector credit growth. Asset quality may still deteriorate somewhat in 2010, but a systemic crisis in the banking sector appears unlikely. Noteworthy, Islamic finance has gained market share as Malaysia seeks to become an international Islamic financial hub. In mid-2009, Islamic banks accounted for about 17% of total banking sector assets and *takaful* (Islamic insurance) operators held some 7% of total insurance assets.

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Charts

