Economic Developments in 2017

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Economic Developments in 2017

THE INTERNATIONAL ECONOMIC ENVIRONMENT

World economy recorded a broad-based and synchronised improvement

The year 2017 witnessed a strong rebound in economic activity, propelling the global economy to record its highest growth rate since 2011. World trade growth exceeded global GDP growth for the first time since 2014. The improvement in economic activity was broad-based across the advanced and emerging market economies, leading to a series of upward revisions in growth forecasts by international organisations and national authorities throughout the year. The renewed strength in GDP growth was driven mainly by robust investments in the advanced economies, which in turn fostered favourable external demand, particularly for Asia. Amid improving demand, several major central banks raised their key policy rates as part of their policy normalisation. While headline inflation edged higher, the core inflation remained low in many advanced economies, reflecting the softness in wage growth amid subdued productivity growth. Global financial markets recorded strong performance, in line with the upswing in global growth. Market volatility, surprisingly, remained low despite uncertainties due to geopolitical tensions. The rise in scepticism over globalisation in the previous year showed signs of diminishing as key election results in the EU suggested lower risk of upheaval from the populist movement. In this environment, policymakers continued to undertake various policy actions, including monetary, fiscal and structural reforms, to achieve country-specific objectives such as strengthening macroeconomic fundamentals and ensuring more sustainable growth in the medium term.

Stronger world growth

The global economy recorded its fastest growth since 2011. The International Monetary Fund (IMF)'s global growth projection for 2017 was revised upwards from 3.4% to 3.7% between October 2016 and January 2018, reversing a long streak of eleven downward revisions since 2010.

Advanced economies experienced robust economic growth, supported by stronger domestic demand. In the US, rising GDP growth was driven by the pick up in consumer spending amid tighter labour market conditions and more positive consumer sentiments. The increased participation in the labour workforce was met with strong job creation and solid employment growth, driving the unemployment rate to the lowest level since 2001. In the euro area, GDP growth expanded at a faster pace. This was supported by improvements in business and consumer confidence, and favourable financing conditions, which in turn boosted income and spending. Of significance, uncertainties surrounding several key elections in the euro area and the outcome of the Brexit negotiations that persisted throughout the year had limited impact on the upward growth trajectory.

Amid stronger consumer demand, investment in the US and euro area also increased. This was supported by buoyant business sentiment, rising profits and the need to upgrade existing capital stock across major economies. The resumption of investment activity in the advanced economies was an important development given weakness in the previous year, particularly in machinery and equipment investments in the US. More importantly, the broad-based improvements in investment played a bigger role in driving global trade (Constantinescu et al., 2015). As such, global trade recorded its fastest growth since 2011 (2017: 4.2%; 2011: 7.1%). The remarkable trade resurgence in 2017 was broad-based across product categories and markets. The upswing in the technology sector also helped to support the strong rebound in trade volumes.

Such recovery in global trade provided further impetus to growth in many major Asian economies. Stronger demand for electronics & electrical (E&E) products, particularly semiconductors used in memory chips for smartphones and personal computers (PCs) was a key factor in driving the trade upswing in Asia, given the exposure of some countries to the global technology cycle. As a result, GDP growth in the Asian economies was predicated on strong double-digit export performance.

Besides the favourable external environment, domestic demand continued to be the main anchor for most countries in Asia. In PR China, growth was resilient despite ongoing structural reforms to rebalance the economy towards a consumption-led growth model. Rising household incomes, in particular in the rural areas, and high job creation raised consumption growth. Overall investment remained strong, supported by improvements in manufacturing and infrastructure spending. Capital expenditure by manufacturers was driven by better external demand. Residential investment moderated amid measures targeted at cooling the property market. In the ASEAN region, higher infrastructure spending by both the public and private sectors was a key growth driver as countries enhanced rural and urban mobility through transportation connectivity for further economic development. Coupled with sizeable government measures to support economic activity for lower income households, fiscal support also lent further impetus to domestic demand in Asia.

Higher global headline inflation but muted core inflation

Global inflation rates edged higher during the year as global demand conditions improved and commodity prices recovered in the second half of 2017. Core inflation remained modest in many of the countries.

In the first half of 2017, the IMF's commodity price indices trended downward, attributable mainly to higher-than-expected US shale production and rising agricultural food output which led to lower commodity prices. The indices returned to an upward trend in the second half of the year. The index for crude oil was lifted mainly by the announcement of Organization of the Petroleum Exporting Countries (OPEC) and some non-OPEC oil exporters to extend their oil output cuts until the end of 2018. Brent crude oil prices breached USD60 per barrel, the highest in two years. Similarly, metal prices such as copper, iron and zinc improved, supported by strong global demand and PR China's efforts to reduce surplus capacity by targeting inefficient and illegal production of minerals. Agricultural commodity prices, including food, also improved during the year reflecting stronger global demand amid supply shortages.

Table 1.1

World Economy: Key Economic Indicators

	Real GDP Growth (Annual change, %)		Inflation (Annual change, %)	
	2016	2017*e*	2016	2017*e*
World Growth	**3.2**	**3.7**	**-**	**-**
World Trade	**2.5**	**4.7**	**-**	**-**
Advanced Economies				
United States	1.5	2.3	1.3	2.1
Japan	0.9	1.7	-0.1	0.4
Euro area	1.8	2.3	0.2	1.5
United Kingdom	1.9	1.7	0.7	2.6
Other Advanced Asian Economies				
Korea	2.8	3.1	1.0	1.9
Chinese Taipei	1.4	2.9	1.4	0.6
Singapore	2.0	3.6	-0.5	0.6
Hong Kong SAR	2.1	3.8	2.4	1.5
The People's Republic of China	**6.7**	**6.9**	**2.0**	**1.6**
ASEAN-4				
Malaysia	4.2	5.9	2.1	3.7
Thailand	3.3	3.9	0.2	0.7
Indonesia	5.0	5.1	3.5	3.8
Philippines	6.9	6.7	1.8	3.0
India[1]	**7.1**	**6.6**	**5.0**	**3.3**

[1] For India, GDP data is presented on a fiscal year basis
e Estimate

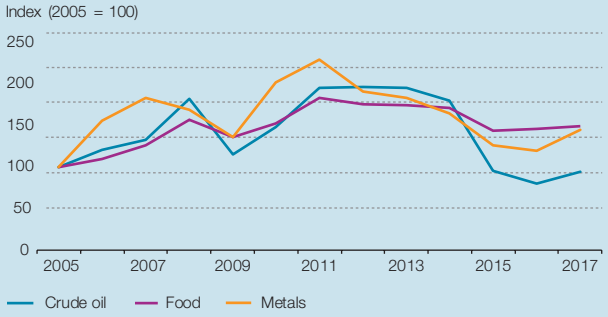
Source: International Monetary Fund (IMF) and National Authorities

The recovery in commodity prices in 2017 contributed to higher headline inflation in the advanced economies, averaging 1.9% in 2017 (2016: 0.8%). Similar trends were observed in some Asian economies for example, the Philippines and Thailand experienced higher inflation due to rising costs of transportation and utilities.

Despite the uptick in headline inflation, underlying inflation remained subdued. Several explanations have been put

Chart 1.1: Indices of Primary Commodity Prices

Major commodity price indices resumed their upward trends in the second half of 2017



Source: International Monetary Fund (IMF)

forth to describe the muted inflation environment. These include the rising influence of more integrated global product, labour and capital markets; subdued labour productivity growth weighing on wages; and the role of technology in increasing efficiencies while lowering the cost of goods. The disconnect between strong growth and muted inflationary pressure remained a conundrum for major central banks during the year. In the advanced economies, the UK was an exception to this trend. The sharp depreciation of the sterling pound was translated into higher prices.

Mixed policy actions

Despite the synchronised nature of the global growth recovery, monetary policy in the advanced and Asian economies diverged. Policy actions taken were tailored to factors specific to the individual economies. Broadly, the monetary policy stance among the advanced economies was skewed towards gradual normalisation. The US Federal Reserve continued to normalise its monetary policy by hiking the federal funds rate target three times in 2017 by a total of 75 basis points to end the year with a range of 1.25%-1.50%. The Bank of England raised its benchmark interest rate by 25 basis points for the first time in a decade as inflation began to accelerate. The European Central Bank announced a reduction of asset purchases by halving its monthly purchase rate to EUR30 billion until September 2018. The environment of robust economic growth allowed for monetary policy normalisation in the advanced economies to take place in an orderly manner. In contrast to the advanced economies, waning inflation in some Asian economies, such as Indonesia and India, had prompted central banks to lower their benchmark interest rates. Similarly, the Bank of Japan (BoJ) maintained its massive stimulus programme in an effort to induce higher inflation which has fallen short of the BoJ's official target of 2% since the first quarter of 2015.

Besides monetary policy, several advanced economies also adopted fiscal and structural policies during the year to bolster macroeconomic fundamentals. In the US, the Tax Cuts and Jobs Act passed both chambers of Congress on 20 December 2017, ushering in major changes to personal and corporate tax rates, and international business taxation. In the euro area, efforts were aimed at maximising the impact of labour and product market reforms. For example, changes in legislation in France that decentralised collective bargaining led to faster labour market adjustment through greater flexibilities in hiring, wage-setting and labour mobility.

To strengthen macroeconomic fundamentals and enhance the sustainability of medium-term growth prospects, Asian policymakers undertook further structural reforms. In PR China, efforts were focused on policy reforms to reduce overcapacity and debt, while maintaining the gradual shift towards a more sustainable consumption-driven growth model. The Chinese government also intensified promotion of investment under the Belt and Road Initiative particularly for infrastructure networks. Further, ASEAN economies in particular announced measures to accelerate infrastructure investment, prioritising both physical and soft infrastructures. Measures included upgrading transportation networks, enhancing existing public-private partnership (PPP) frameworks, and increasing broadband penetration.

The cyclical upturn after seven years of muted growth following the Global Financial Crisis provided an avenue for many economies to remain steadfast in undertaking various policies to achieve more inclusive and sustainable growth. Despite the strong growth recorded during the year, policymakers continue to face various challenges including an aging population, increasing global leverage, technological disruption and growing income inequality. Active and consistent recalibration of policies are critical for the implementation of structural reforms, to strengthen economic fundamentals and to sustain the current growth momentum.

THE MALAYSIAN ECONOMY

Overview

The Malaysian economy performed strongly in 2017, registering a growth of 5.9% (2016: 4.2%). Growth was anchored by domestic demand, reflecting faster expansion in both private and public sector spending. Similar to the region, Malaysia benefited from the broad-based global recovery, with gross exports increasing at its fastest pace since 2004. The materialisation of positive spillovers from the external sector further reinforced domestic demand.

The Malaysian economy recorded a higher growth of 5.9% in 2017, as the strength in domestic demand was further boosted by a rebound in exports

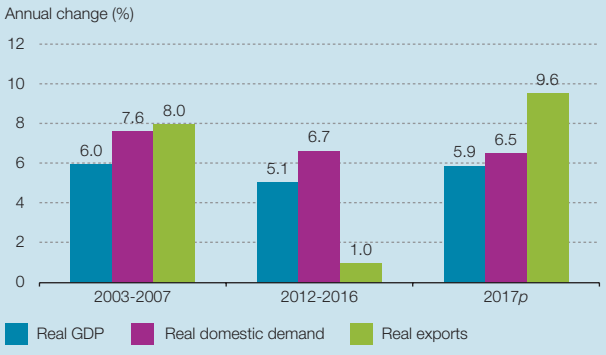
A key highlight for the year was the rebound in gross exports, which advanced by 18.9% (2016: 1.2%). The stronger performance was due mainly to higher demand by major trading partners such as PR China, ASEAN, the EU, US and Japan, following the upswing in the global technology cycle, investment expansion in the advanced economies and the turnaround in commodity prices.

The global technology upswing was supported by a number of launches of popular flagship smart devices in 2017, which triggered a wave of new orders for firms along the supply chain of these products. In the case of Malaysia, which is the world's seventh largest semiconductor exporter with extensive linkages in the global value chain (GVC), the technology upcycle translated into robust demand for E&E products from regional and advanced economies. As a result, exports of semiconductor devices accelerated by 23.1% during the year (2016: 5.2%). The favourable environment of stronger demand, particularly from the regional economies, and a revival in investment activity in the advanced economies also lifted exports of non-E&E products (18.6%; 2016: 3.0%), such as petroleum, chemical, rubber and iron & steel products. After declining for two consecutive years, commodity exports turned around in 2017 to register a strong positive growth, supported largely by the recovery in major commodity prices, in particular for crude oil and liquefied natural gas (LNG).

Although real GDP growth was lifted by the external demand, domestic demand continued to anchor growth in 2017, underpinned by strong fundamentals, better labour market conditions and improving sentiments. Positive spillovers from the external sector to domestic demand began to materialise in the first half of 2017. The stronger external demand benefited private investment in particular, as firms in both export- and domestic-oriented industries embarked upon capacity expansions, including replacement and acquisitions of machinery and equipment to meet the higher demand. These developments directly benefited the labour market with faster employment and wage growth. These factors, together with Government measures to increase disposable income, further raised household spending. Public sector expenditure remained supportive of growth, as spending was prioritised towards critical infrastructure and essential public services.

Chart 1.2: Real GDP Growth

Strong performance in real GDP in 2017



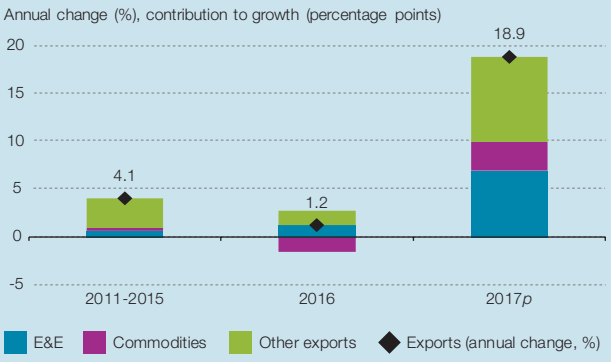
p Preliminary

Note: Excluding real GDP growth during the period of the Global Financial Crisis

Source: Department of Statistics, Malaysia

Chart 1.3: Gross Export Performance by Products

Robust demand for E&E products boosted export performance



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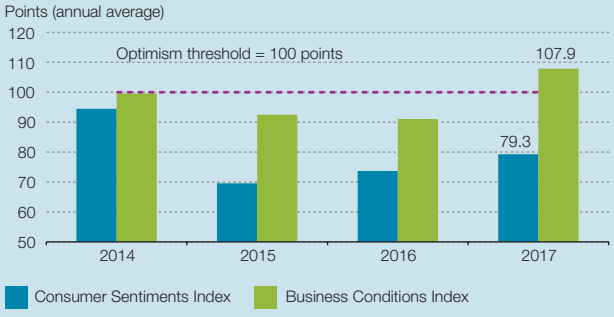
Source: Department of Statistics, Malaysia

Chart 1.4: MIER Consumer Sentiments and Business Conditions Index

Consumer and business sentiments improved during the year



Source: Malaysian Institute of Economic Research (MIER)

Following the expansion in both domestic and external demand, gross imports registered a double-digit growth of 19.9% (2016: 1.9%). Higher imports were attributable to intermediate and capital goods, in line with robust manufacturing exports and the more rapid investment activity in the manufacturing and services sectors, respectively. Overall, the trade surplus expanded to RM97.2 billion (2016: RM88.1 billion), supported by rapid export growth. The current account of the balance of payments registered a higher surplus, arising mainly from the larger goods surplus. Malaysia also continued to experience significant two-way movement of capital flows. In line with the improvement in international investor sentiments, non-resident portfolio inflows resumed in the second quarter of 2017, while foreign direct investment (FDI) inflows exceeded direct investment abroad (DIA) outflows over the year.

The strong performance of the external sector in 2017 reflects the outcome of structural policies undertaken over the decades that has resulted in the economy being highly open, diversified and served by multiple sources of growth. Malaysian producers, for instance, are deeply integrated in the GVC. Consequently, this enabled Malaysia to benefit from the broad-based upturn in the global economy. Critical investments undertaken in the manufacturing sector, including in the E&E sub-sector, and the enabling infrastructure such as transport, logistics and communication services, also allowed firms to leverage swiftly on the uptick in global demand. Another critical factor is the presence of backward and forward linkages from exports to various industries in the manufacturing and services sectors. The close linkages within the Malaysian economy amplified the positive spillovers of the higher export orders, which together with improving business sentiments, gave rise to more business activity, investment spending, hiring in the labour market and income growth.

The positive economic environment of robust growth and vibrant trade has provided a valuable window of opportunity to pursue pre-emptive critical reforms and structural adjustments within the Malaysian economy. Fiscal consolidation efforts were on track, while monetary policy remained accommodative. Quality investments that ensure Malaysia's future-readiness, such as in the high-technology manufacturing and advanced services sectors, continued to be prioritised, leveraging on the established regional economic corridors and their respective focus areas.

Initiatives were also undertaken to raise productive capacity and remove constraints to growth, including encouraging the use of the sharing economy and ongoing investments in upskilling and training of the workforce. In 2017, employment gains kept pace with labour force expansion, with stronger employment driven by high-and mid-skilled workers. Productivity growth also picked up during the year, mainly driven by the manufacturing and services sectors. Going forward, the pursuit of productivity-driven growth highlights the importance of measuring and monitoring relevant metrics and indicators to aid policy making. To this end, the Malaysian Bureau of Labour Statistics[1] (MBLS) was established to integrate information collection on the labour market, including data on labour productivity and skills gaps. Collectively, these measures aim to maximise new sources of growth for the economy through lifting productivity and efficiency of existing assets.

Domestic Demand Anchored Growth in 2017

The Malaysian economy registered a robust growth of 5.9% in 2017 (2016: 4.2%). Domestic demand continued to anchor growth during the year, supported by faster expansion in both private and public sector spending. On the external front, real exports registered the strongest growth rate since 2010, underpinned by strong global expansion, particularly in the case of Malaysia's key trading partners, and higher global commodity prices.

[1] For further details, please refer to the White Box on 'The Malaysian Bureau of Labour Statistics'.

Table 1.2

Malaysia - Key Economic Indicators

	2015	2016	2017*p*	2018*f*
Population (million persons)	31.2	31.6	32.1	32.9
Labour force (million persons)	14.5	14.7	15.0	15.3
Employment (million persons)	14.1	14.2	14.5	14.8
Unemployment (as % of labour force)	3.1	3.4	3.4	3.2 ~ 3.5
Per Capita Income (RM)	36,093	37,792	41,072	42,834
(USD)	9,242	9,110	9,551	10,885[3]
NATIONAL PRODUCT (% change)				
Real GDP at 2010 prices	5.0	4.2	5.9	5.5 ~ 6.0
(RM billion)	1,063.4	1,108.2	1,173.6	1,240.1
Agriculture, forestry and fishery	1.3	-5.1	7.2	3.6
Mining and quarrying	5.3	2.2	1.1	1.8
Manufacturing	4.9	4.4	6.0	5.9
Construction	8.2	7.4	6.7	7.3
Services	5.1	5.6	6.2	6.1
Nominal GNI	5.2	6.2	10.1	6.9
(RM billion)	1,125.6	1,195.5	1,316.3	1,407.6
Real GNI	6.8	4.4	6.1	5.6
(RM billion)	1,039.0	1,084.9	1,150.8	1,215.0
Real aggregate domestic demand[1]	5.1	4.3	6.5	5.7
Private expenditure	6.1	5.6	7.5	7.6
Consumption	6.0	6.0	7.0	7.2
Investment	6.3	4.3	9.3	9.1
Public expenditure	2.1	0.4	3.3	-0.9
Consumption	4.4	0.9	5.4	0.6
Investment	-1.1	-0.5	0.1	-3.2
Gross national savings (as % of GNI)	29.0	29.1	29.2	28.8
BALANCE OF PAYMENTS (RM billion)				
Goods balance	109.2	101.4	118.1	120.5
Exports	681.3	686.1	808.9	865.9
Imports	572.1	584.7	690.8	745.3
Services balance	-20.6	-19.1	-23.1	-23.2
Primary income, net	-32.1	-34.6	-36.1	-39.1
Secondary income, net	-21.3	-18.6	-18.6	-19.3
Current account balance	35.2	29.0	40.3	38.9
(as % of GNI)	3.1	2.4	3.1	2.0 ~ 3.0
Bank Negara Malaysia international reserves, net[2]	409.1	423.9	414.6	-
(in months of retained imports)	8.4	8.7	7.2	-
PRICES (% change)				
CPI (2010=100)	2.1	2.1	3.7	2.0 ~ 3.0
PPI (2010=100)	-7.4	-1.1	6.7	-
Real wage per employee in the manufacturing sector	3.7	4.1	2.2	-

[1] Exclude stocks
[2] All assets and liabilities in foreign currencies have been revalued into ringgit at rates of exchange ruling on the balance sheet date and the gain/loss has been reflected accordingly in the Bank's account
[3] Based on average USD exchange rate for the period of January-February 2018
p Preliminary
f Forecast

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia, Ministry of Finance, Malaysia and Bank Negara Malaysia

Table 1.3

Malaysia - Financial and Monetary Indicators

FEDERAL GOVERNMENT FINANCE (RM billion)	2015	2016	2017*p*
Revenue	219.1	212.4	220.4
Operating expenditure	217.0	210.2	217.7
Net development expenditure	39.3	40.6	43.0
Overall balance	-37.2	-38.4	-40.3
Overall balance (% of GDP)	-3.2	-3.1	-3.0
Public sector net development expenditure	140.4	158.1	146.7
Public sector overall balance (% of GDP)	-7.7	-7.3	-4.7
EXTERNAL DEBT			
Total debt (RM billion)	837.0	916.1	883.4
Medium- and long-term debt	485.1	539.1	506.3
Short-term debt	351.9	377.0	377.1
Debt service ratio[1] (% of exports of goods and services)			
Total debt	22.7	24.8	22.1
Medium- and long-term debt	22.5	24.6	21.9

MONEY AND BANKING		Change in 2015		Change in 2016		Change in 2017	
		RM billion	%	RM billion	%	RM billion	%
Money supply	M1	14.0	4.1	20.4	5.7	41.9	11.0
	M3	41.3	2.7	49.3	3.1	76.7	4.7
Banking system deposits		28.8	1.8	26.5	1.6	67.8	4.0
Banking system loans[2]		105.4	7.9	76.4	5.3	62.9	4.1
Loan to fund ratio (%, end of year)[3&4]		83.0		84.3		84.0	
Loan to fund and equity ratio (%, end of year)[3,4&5]		74.6		75.3		73.7	

INTEREST RATES (%, AS AT END-YEAR)	2015	2016	2017
Overnight Policy Rate (OPR)	3.25	3.00	3.00
Interbank rates (1-month)	3.45	3.10	3.08
Commercial banks			
Fixed deposit 3-month	3.13	2.92	2.94
12-month	3.31	3.06	3.10
Savings deposit	1.04	0.99	0.97
Weighted average base rate (BR)	3.77	3.62	3.64
Base lending rate (BLR)	6.79	6.65	6.68
Treasury bill (3-month)	2.74	3.06	2.86
Malaysian Government Securities (1-year)[6]	2.59	3.26	2.89
Malaysian Government Securities (5-year)[6]	3.47	3.70	3.56
EXCHANGE RATES (AS AT END-YEAR)	**2015**	**2016**	**2017**
Movement of Ringgit (%)			
Change against SDR	-15.1	-0.8	5.2
Change against USD	-18.6	-4.3	10.4

[1] Includes prepayment of medium- and long-term debt
[2] Includes loans sold to Cagamas
[3] Deposits exclude deposits accepted from banking institutions. Loans exclude loans sold to Cagamas and loans extended to banking institutions. Beginning July 2015, loans exclude financing funded by Islamic Investment accounts
[4] Funds comprise deposits and all debt instruments (including subordinated debt, debt certificates/sukuk issued, commercial paper and structured notes)
[5] Equities comprise ordinary and preferred shares, share premium and retained earnings
[6] Refers to data from Fully Automated System for Issuing/Tender (FAST), Bank Negara Malaysia

p Preliminary

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Table 1

Real GDP by Expenditure (2010=100)

	2017*p*	2016	2017*p*	2016	2017*p*
	% of GDP	Annual change (%)		Contribution to growth (ppt)	
Domestic Demand[1]	**92.2**	**4.3**	**6.5**	**3.9**	**6.0**
Private sector expenditure	71.2	5.6	7.5	3.8	5.3
Consumption	*53.7*	*6.0*	*7.0*	*3.1*	*3.7*
Investment	*17.4*	*4.3*	*9.3*	*0.7*	*1.6*
Public sector expenditure	21.0	0.4	3.3	0.1	0.7
Consumption	*13.0*	*0.9*	*5.4*	*0.1*	*0.7*
Investment	*8.0*	*-0.5*	*0.1*	*0.0*	*0.0*
Gross Fixed Capital Formation	*25.4*	*2.7*	*6.2*	*0.7*	*1.6*
Change in stocks	**0.0**			**0.2**	**0.0**
Net Exports of Goods and Services	**7.8**	**1.5**	**-1.1**	**0.1**	**-0.1**
Exports	72.9	1.1	9.6	0.8	6.7
Imports	65.1	1.1	11.0	0.7	6.8
Real Gross Domestic Product (GDP)	**100.0**	**4.2**	**5.9**	**4.2**	**5.9**

[1] Excluding stocks
p Preliminary

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

Private consumption growth improved to 7.0% in 2017 (2016: 6.0%), supported mainly by continued wage and employment growth, with additional impetus from Government measures. Aggregate nominal wages[1] in the private and public sectors grew by 6.4% and 6.2%, respectively in 2017 (2016: 4.3% and 6.4%, respectively). Civil servants continued to benefit from the upward revision in their salaries that took place in July 2016. Consumer spending was further supported by Government measures to increase household disposable income, such as the reduction in employees' contribution to the Employees Provident Fund (EPF) by three percentage points (11% to 8%) and higher *Bantuan Rakyat 1Malaysia* (BR1M) payouts. Some of these measures were enacted to support the economy in March 2016 on account of the more challenging outlook. The recovery in consumer sentiments from its lowest level in 2015 also contributed to the stronger private consumption growth in 2017.

Public consumption growth expanded by 5.4% (2016: 0.9%) due to higher spending on supplies and services by the Federal Government amid sustained growth in the emoluments. The increased expenditure on supplies and services was mainly attributable to spending on maintenance and minor repair works.

Gross fixed capital formation (GFCF) grew at a faster pace of 6.2% in 2017 (2016: 2.7%), driven by improvements in both public and private investments.

Public investment recovered to register a marginal growth of 0.1% in 2017 (2016: -0.5%). This was supported by continued spending by both the General Government and public corporations, mainly in the downstream oil and gas (O&G) and transport & utilities sub-sectors. The continued capital outlays were also to accelerate urban and rural development.

Private investment growth accelerated to 9.3% (2016: 4.3%), as firms benefited from the conducive external and domestic operating environment. The strong growth in exports led to positive spillovers to the domestic economy, as firms embarked upon capacity expansion to cater to higher orders. Financing conditions, profitability and business sentiments also improved during the year. On a sectoral basis, private investment growth continued to be underpinned by the implementation of new and ongoing projects in the manufacturing and services sectors.

[1] For further details, please refer to the White Box on 'Improved Labour Market Conditions'.

In terms of assets, investment in machinery and equipment grew by 11.3% (2016: 1.1%), due in part to the production and capacity enhancements by firms in response to stronger demand. Growth of investment in structures, which accounts for 54.7% of total GFCF, remained moderate at 4.0% (2016: 4.9%), mainly reflecting a slowdown in residential investment. Growth of investment in other assets remained in contraction at -0.8% (2016: -4.3%) due to lower capital expenditure in the development of intellectual property products, particularly mineral exploration.

During the year, gross national savings (GNS) grew by 10.8% (2016: 6.6%), to increase slightly to 29.2% of gross national income (GNI, 2016: 29.1% of GNI) on account of more rapid growth in private savings (11.5%; 2016: -1.9%) and normalisation of growth in public savings (8.1%; 2016: 52.2%). Gross capital formation expanded by 8.2% (2016: 9.5%), resulting in a wider savings-investment gap of 3.1% of GNI (2016: 2.4% of GNI).

Improved Labour Market Conditions

The unemployment rate was steady at 3.4% in 2017 (2016: 3.4%, average 2011-2016: 3.1%) as stronger employment gains kept pace with labour force expansion. The labour force expanded by 303,000 people, while net employment gains amounted to 295,000 jobs. As a result, the labour force participation rate edged higher to 67.8% (2016: 67.7%) and employment growth tripled to 2.1% (2016: 0.7%). Industrial engagements[1] throughout the year corroborated the improving business sentiments. Employers were optimistic about the business outlook and thus continued to expand their workforce accordingly.

Table 1

Selected Labour Market Indicators

	2013	2014	2015	2016*r*	2017*p*
Employment ('000 persons)	13,545	13,853	14,068	14,164	14,459
Labour force ('000 persons)	13,981	14,264	14,518	14,668	14,971
Unemployment rate (% of labour force)	3.1	2.9	3.1	3.4	3.4
Layoffs[1] (persons)	33,086	25,917	38,499	37,699	35,097
Foreign workers ('000 persons)	2,250	2,073	2,135	1,866	1,797

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r Figures have been revised to reflect latest population estimates
[1] Constitutes workers affected by retrenchments and voluntary separation scheme (VSS) offerings

Source: Department of Statistics, Malaysia, Ministry of Human Resources, Ministry of Home Affairs and Bank Negara Malaysia estimates

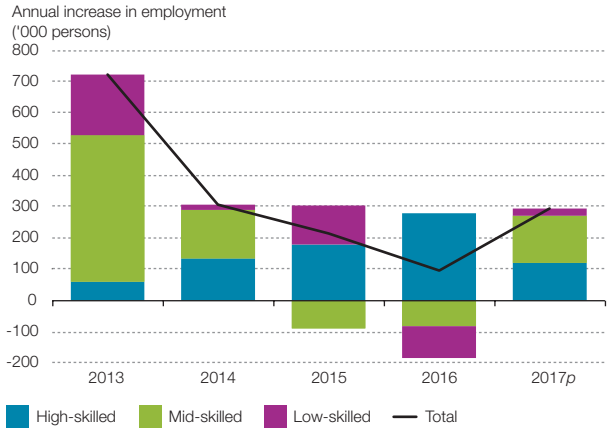
At the macro-level, employment gains were mostly driven by high- and mid-skilled workers, as both increased by 121,100 and 150,700 persons, respectively. High-skilled workers as a share of total employed persons increased marginally to 27.6% (2016: 27.3%), while mid-skilled workers still command the largest share of 59.5%. The share of low-skilled workers is unchanged at 13.0%. Latest data[2] suggest that high-skilled workers faced the lowest median wage growth at 3.1% to RM3,994 as compared to that of mid-skilled (5%, RM1,447) and low-skilled (10%, RM1,100) workers. The number of documented unskilled and semi-skilled foreign workers in Malaysia has declined to 1.8 million in 2017 (2016: 1.9 million). Correspondingly, its share to the labour force also declined to 12.0% from 12.7% at end-2016, below the 15% threshold set in the 11th Malaysia Plan.

[1] As part of assessments of the Malaysian economy, the Bank undertakes regional economic and industry surveillance through its offices in Penang, Johor Bahru, Kota Kinabalu, Kuching and Kuala Terengganu. For more information, see Box Article on 'Broadening Economic Surveillance through Bank Negara Malaysia's Regional Offices' in Bank Negara Malaysia's Annual Report 2013.
[2] Based on the 2016 Salaries and Wages Survey by the Department of Statistics, Malaysia (DOSM).

Reported layoffs in 2017 continued on a decreasing trend (35,097 persons; 2016: 37,699 persons), approaching the long-run average[3] of 30,000 persons per annum. These layoffs were concentrated within the manufacturing sector, reflecting industry-specific restructuring exercises, as multinational firms reconfigure their global value chains to reflect changing business needs. The stronger performance of the sector has, however, led to a net employment gain of 23,709 persons within the same period. Of significance, layoffs were highly context-specific, and partly reflects the flexibility of the labour market to adapt to changes in the operating environment, such as increases in efficiency and greater adoption of technology. As such, the implementation of the Employment Insurance System (EIS) on 1 January 2018 is crucial to mitigate the impact of involuntary separations to employees, by protecting workers' welfare and ensuring training and upskilling during periods of job transitions.

Chart 1: Net Employment Gains by Skill Level, 2013-2017

Net employment gains[1] driven by mid- and high-skilled job creation



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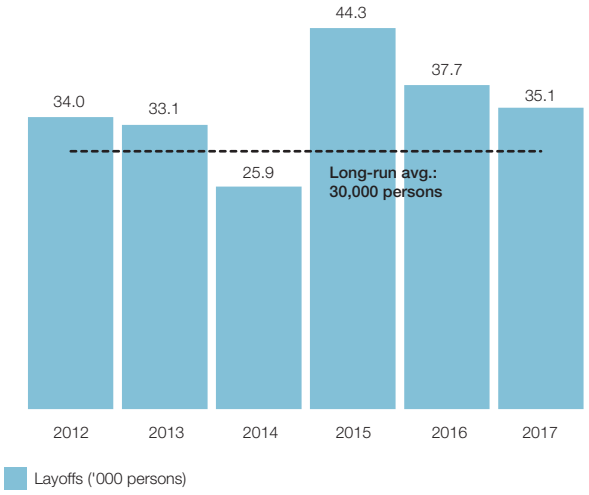
[1] Refers to the difference between employment level in a given year compared to the previous year

Source: Department of Statistics, Malaysia, Ministry of Human Resources and Bank Negara Malaysia estimates

Chart 2: Layoffs, 2012-2017

Reported layoffs continued its downward trend since 2015



Source: Department of Statistics, Malaysia, Ministry of Human Resources and Bank Negara Malaysia estimates

Aggregate nominal wages in the private[4] and public sectors grew by 6.4% and 6.2% respectively in 2017 (2016: 4.3% and 6.4%, respectively). Wage growth in the private sector was driven mainly by the services sector. In particular, the stronger wage growth in major services sub-sectors[5] (5.4%; 2016: 3.6%) was attributable to the *wholesale and retail trade* and *professional services* sub-sectors. In the manufacturing sector, higher wage growth (8.6%; 2016: 6.2%) was in line with the strong production in both export- and domestic-oriented sub-sectors. The continued positive impact of the salary increment for civil servants in July 2016 also contributed to overall wage growth.

Labour productivity, as measured by real value-added per worker, rose by 3.6% in 2017 (2016: 3.5%) driven mainly by productivity gains in the manufacturing and services sectors (4.7% and 4.2%, respectively; 2016: 4.1% and 3.6%, respectively). The better performance in these sectors was attributable to productivity gains in the retail trade, and manufacturing of transport equipment sub-sectors.

[3] The long run average is the average annual layoffs from 2000-2016, excluding the crisis period of 2008-2009.
[4] Private sector wages is derived from the salaries and wages data published in the Monthly Manufacturing Statistics and Quarterly Services Statistics by the Department of Statistics, Malaysia. It covers 62% of total employment.
[5] 'Major services sub-sectors' includes *wholesale and retail trade, accommodation and food and beverage, information and communication, transportation and storage, health, education, arts, entertainment and recreation, and professional and real estate services* sub-sectors.

The Malaysian Bureau of Labour Statistics

Post 2008-2009 financial crisis, there has been an increasing focus on issues surrounding the quality of economic growth and its impact on the people and communities. Discussions on jobs, inequality, social mobility and cost of living have all led to a growing demand from both policymakers and the research community for more high-frequency and granular set of labour statistics. The intent is that greater visibility on these issues will enrich public discourse and better inform policy deliberations and formulation.

Over the last decade, Malaysia has enhanced the labour statistics landscape. The publication of the annual GDP by income approach and wage conditions of key services industries has improved surveillance of both structural and cyclical policies. While progress has been made, there remain areas for improvement. The economic landscape has evolved rapidly with data flows increasing voluminously. Approaches to capture, manage and analyse data have also been revolutionised.

Recognising these challenges, the Government decided to establish the Malaysian Bureau of Labour Statistics (MBLS) as one of the major programmes within the Department of Statistics, Malaysia (DOSM). The MBLS is tasked with producing quality, timely and comprehensive labour market data. It is envisaged that highly-demanded information, such as wages, job creation and labour costs by industry will be accessible to policymakers and the public at a higher frequency (e.g. monthly, quarterly series) and with sufficient granularity (e.g. breakdown by key sectors and industries).

Among the critical gaps (Chart 1) in current official statistics that MBLS aims to address include the lack of available insights on "total hours worked" by key economic sectors. This will be an important enhancement to the existing labour productivity statistics, which is measured as the real value-added per employed persons. While the latter is quite useful, it runs the risk of overstating productivity gains, particularly if greater output is obtained from longer working hours. These nuances cannot be gleaned from the headline employment figures alone. Through the collection of data on total hours worked, MBLS will be able to measure labour productivity with greater accuracy. Also, greater insights into labour costs scaled to output by key industries would allow for more granular monitoring of wage pressures in the economy. This can help policymakers better discern if wage pressures are broad based or contained in specific industries. Such information is important to inform the choice of policy responses, if any, be it through monetary policy adjustments or targeted industry interventions.

Chart 1: Current Gaps in Selected Labour Market Statistics

MBLS is tasked to address current gaps in labour statistics landscape

Selected Labour Indicators by Key Economic Sectors	Monthly	Quarterly	Annually
Salary and wages			
Layoffs, vacancies, quits by occupations			
Hours worked[1]			
Hiring sentiments			
Long-term unemployment (total economy)			

Not available Available Some indicators available

[1] Available on an annual basis in the Labour Force Survey (breakdown by gender). Industry breakdowns are unavailable.

Source: Bank Negara Malaysia's assessment

Incorporating the latest concepts and methodologies to account for employment developments in new growth areas such as the sharing economy (e.g. Airbnb, Uber) and the digital economy (e-commerce) would allow further customisation and recalibration of related policies such that they better deliver the intended outcomes. Indicators such as long-term employment by various durations and underemployment could offer much richer analysis on existing slack in the economy. In the period following the Global Financial Crisis (GFC), those indicators were heavily used by policymakers in the advanced economies to gauge the underlying health of the labour market and the risks of skills deterioration arising from being unemployed for long durations. In regards to the supply of labour, job retraining program design and its implementation could be adjusted for better delivery and results.

There is a clear need to further enhance labour market information through modernisation of data collection and management. Greater adoption of e-surveys and use of administrative data in various agencies are imperative. This could also be further advanced through the leveraging of Big Data analytics, in arriving at the needed

statistics. For example, data scraping on salary and wages from job postings and portals could provide deeper understanding on wage developments by location or by position. All things considered, this will require greater collaboration, data standardisation and sharing among various stakeholders.

Acknowledging the need for more data sharing and adoption of more modern statistical practices, the Labour Statistics Planning Group (LSPG) was established to oversee the inception and operationalisation of the MBLS. The LSPG, chaired by the Director General of the Economic Planning Unit (EPU), is a critical nucleus and platform for future inter-agency data collaboration through the leveraging of administrative data from the five core members[1] and ten satellite members[2]. Readily-available administrative data (e.g. registration, transaction and record keeping) by various ministries and agencies, if integrated and utilised effectively with advanced statistical methods could potentially transform data analysis for policy formulation through more focused and evidence-based approaches. This includes contributors' records from the Employees Provident Fund (EPF) which can be used to better augment the monthly employment statistics. Similarly, information collected from the recently implemented Employment Insurance System (EIS) can offer high-frequency updates on unemployment conditions in the economy.

While it is still early days, the MBLS has already published data on labour productivity, employment, and salaries and wages based on the 2016 Economic Census, with longer-term goals that include statistics on the informal sector and labour costs. It is envisaged that it will also spur greater in-depth research by academia, think tanks and analysts, while contributing towards identifying better policy design and interventions (e.g., enhancing training and talent development programmes, reforming education).

The MBLS is building on the previous efforts made to strengthen the statistics landscape to meet the increasing demands for more varied, high-frequency, and granular data. It is important to note that this is by no means an isolated endeavor. It runs in tandem with a larger statistical review across the public sector to strengthen current governance and institutional arrangements. This is to ensure that Malaysia's overall statistical system remains relevant, progressive and effective in rapidly changing times.

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[1] Economic Planning Unit (EPU), Ministry of Finance (MOF), Department of Statistics, Malaysia (DOSM), Bank Negara Malaysia (BNM), and Ministry of Human Resources (MOHR).

[2] Institute of Labour Market Information and Analysis (ILMIA), Employees Provident Fund (EPF), Public Service Department (JPA), Social Security Organisation (SOCSO), Inland Revenue Board of Malaysia (LHDN), Ministry of Home Affairs (MOHA), Ministry of Education (MOE), Ministry of Higher Education (MOHE) and Accountant General's Department of Malaysia (AGD).

Most Economic Sectors Recorded Higher Growth

On the supply side, most sectors registered higher growth in 2017. Malaysia's growth performance remained principally driven by the services and manufacturing sectors, which benefited from marked improvements in domestic and external conditions.

Growth in the services sector expanded at a faster pace of 6.2% (2016: 5.6%) amid broad-based improvements across most sub-sectors. On the consumer front, better labour market conditions and improving consumer sentiments lifted growth in the *retail, food and beverages and accommodation* and *motor vehicles* sub-sectors. The *finance and insurance* sub-sector registered higher growth, benefitting from the strong pick-up in capital market activity, particularly from initial public offerings. In the *transport and storage* sub-sector, growth was supported by stronger trade and air passenger traffic growth. Growth in the *information and communication* sub-sector was also higher, reflecting higher demand for data communication and computer services.

The manufacturing sector expanded further in 2017 (6.0%; 2016: 4.4%), driven by higher growth in the domestic-oriented industries, and continued expansion in the export-oriented industries. In the domestic-oriented industries, production of both commercial and consumer transport equipment turned around, reversing a

Table 1

Real GDP by Kind of Economic Activity (2010=100)

	2017*p*	2016	2017*p*	2016	2017*p*
	% of GDP	Annual change (%)		Contribution to growth (ppt)[1]	
Services	54.4	5.6	6.2	3.0	3.4
Manufacturing	23.0	4.4	6.0	1.0	1.4
Mining and quarrying	8.4	2.2	1.1	0.2	0.1
Agriculture	8.2	-5.1	7.2	-0.4	0.6
Construction	4.6	7.4	6.7	0.3	0.3
Real Gross Domestic Product (GDP)	**100.0**[1]	**4.2**	**5.9**	**4.2**	**5.9**

[1] Figures may not necessarily add up due to rounding and exclusion of the import duties component
p Preliminary

Source: Department of Statistics, Malaysia

decline in the output of motor vehicles in the previous year. Growth in the domestic-oriented industries was further supported by stable demand for food-related products and construction-related materials. Growth in the export-oriented industries was in tandem with the broad-based recovery in global demand, which supported the increased production of E&E and resource-based products such as palm oil-related and petroleum-related products.

The construction sector registered a moderate growth of 6.7% (2016: 7.4%). Growth was supported mainly by the *civil engineering* sub-sector, due to steady progress of large petrochemical, transportation, and utility projects. The *special trade* sub-sector benefited from increased activity from projects in the early stages of construction, such as land clearing, piling and land reclamation work. Growth in the *residential* sub-sector moderated, consistent with the record-high number of unsold residential properties. In the *non-residential* sub-sector, growth was sustained by higher activity from mixed developments, industrial and social projects such as theme parks and sports complexes, which was offset by the ongoing weakness in the commercial segment due to an oversupply of office space and shopping complexes.

Agriculture production growth rebounded to 7.2% (2016: -5.1%), driven mainly by a turnaround in crude palm oil (CPO) production, as yields recovered from the negative impact of El Niño in 2016.

In the mining sector, growth moderated to 1.1% (2016: 2.2%), reflecting the voluntary crude oil supply adjustments by PETRONAS, in line with the OPEC agreement to restrain oil production until end-2018. Growth remained supported by higher production in the natural gas sub-sector, reflecting the increased capacity of natural gas facilities.

EXTERNAL SECTOR

Strong external sector performance, supported by the significant upturn in global growth and trade activity, and improvement in international investor sentiments

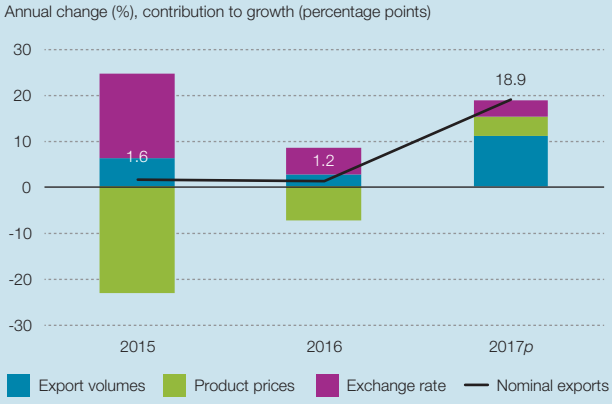
Malaysia's external position improved significantly in 2017, amid broad-based improvement in the global economy and relatively lower volatility in the international financial markets. As an economy with a high degree of openness to trade and investment flows, Malaysia was well-positioned to benefit from these favourable conditions. This, in turn, contributed to a buoyant export performance, higher current account surplus, continued inflows of FDI and resumption of portfolio investment inflows by international investors. Malaysia's external debt declined, with risks mitigated by favourable currency and maturity profiles. Sufficient international reserves continued to serve as a buffer against potential external shocks and volatility.

Robust exports, driven by double-digit growth in export volumes and turnaround in export prices

Against the synchronous and more entrenched expansion in the advanced and emerging economies,

Chart 1.5: Contribution of Export Volumes, Product Prices and Exchange Rate to Gross Export Growth

Robust gross export growth driven by export volumes



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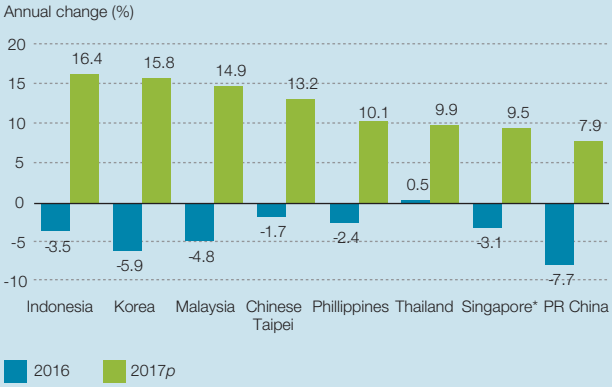
Source: Department of Statistics, Malaysia

Chart 1.6: Regional Export Performance in US Dollar Terms

Stronger gross export growth (in US dollar terms) in line with regional countries



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*Non-oil domestic exports

Source: Department of Statistics, Malaysia and Bloomberg

global trade activity rebounded, particularly in the Asian region. Malaysia benefited significantly from the resurgent external demand from trade partners, facilitated by the economy's deep integration into GVCs, and a highly-diversified composition of export products and markets.

The acceleration in gross exports during the year was mainly driven by export volumes (Chart 1.5), which registered double-digit growth for the first time since 2004 (11.1%; 2016: 2.6%). The faster growth in export volumes was led by manufactured exports, in response to higher export-weighted global demand (3.6%; 2016: 3.1%). The revival in global consumer and business spending, in tandem with the launches of popular flagship smart devices, and investments in machinery and equipment, spurred an upswing in the global technology cycle. This induced stronger demand for E&E products, with E&E export volumes advancing by 16.8% during 2017 (2016: 3.4%), driven mainly by semiconductor exports. As a result, Malaysia's share of the global market for semiconductor exports increased to 5.9%[2] (2016: 5.7%).

Export volumes for non-E&E manufactured products also rebounded sharply (11.4%; 2016: -0.9%), driven by robust demand for petroleum, chemical, rubber and iron & steel products. For commodities however, export volumes moderated to 2.2% (2016: 9.5%) as higher LNG output from new production facilities in Sarawak was partially offset by lower crude petroleum exports amid the OPEC agreement to restrain oil production.

The turnaround in overall export product prices (4.3%; 2016: -7.4%) provided further impetus to gross export growth. This is particularly evident for commodity exports, which benefited from the recovery in prices for crude oil (+21.7%) and LNG (+13.6%) during the year (2016: -16.1% and -26.9%, respectively). Prices of manufactured exports was broadly sustained after declining for three consecutive years (2014-2016: -9.2%), partly supported by higher average selling prices for electronic components such as semiconductors and memory chips to fulfil rising global demand and tighter supply conditions. This was evidenced by very high capacity utilisation rates in the manufacturing sector, which rose to its highest post-GFC levels in many of the major economies such as the EU, US and PR China.

Removing the impact of exchange rate movements, in US dollar terms, Malaysia emerged as the third-best export performer in the region after Indonesia and Korea, with gross exports improving by 14.9% (2016: -4.8%, Chart 1.6). This shows that the exchange rate was not the main driver of the strong performance of gross export growth.

Gross imports registered double-digit growth of 19.9% (2016: 1.9%), mainly reflecting higher imports of intermediate goods, capital goods, and goods for re-exports. Stronger intermediate and capital goods imports (20.0% and 15.3%, respectively), was in line

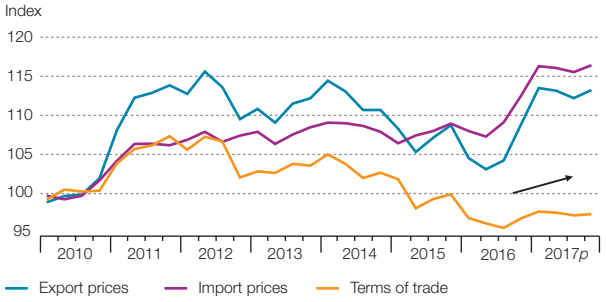
[2] January-November 2017 figures, as published by Global Trade Atlas.

Developments in Malaysia's Terms of Trade

Terms of trade refers to a country's export prices in relation to its import prices. It can be interpreted as the amount of imported goods a country can purchase per unit of exported goods. The terms of trade is represented by an index, which is calculated by dividing the price index of exports by the price index of imports and multiplying by 100. Improving terms of trade indicates that for every unit of exports sold, more units of imported goods could be purchased. In comparison, when the terms of trade worsens, the country needs to export more units for the same level of imports.

Chart 1: Malaysia's Terms of Trade

Improving terms of trade in 2017



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Source: Department of Statistics, Malaysia

Malaysia's terms of trade improved in 2017, but it had been on a declining trend since 2011. This was attributed mainly to:

- The slump in commodity prices; and
- Sluggish manufacturing export prices due to higher competition and industry consolidation, particularly in the E&E sector.

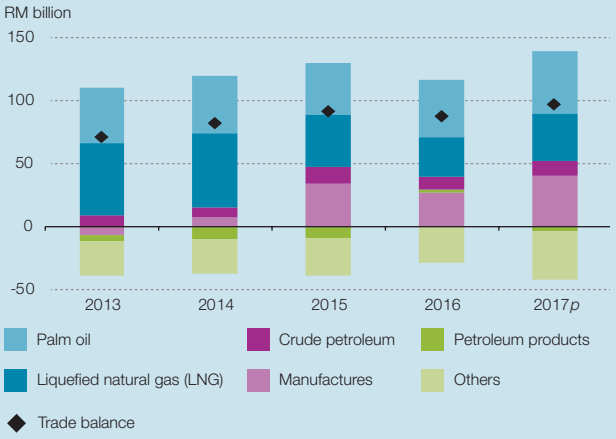
On a year-on-year basis, Malaysia's terms of trade strengthened in 2017. Since its trough in March 2016 of 96.0 points, the terms of trade improved amid a recovery in commodity prices and higher prices for manufactured exports. The terms of trade peaked at 98.0 points in February 2017 before moderating slightly to 97.7 points in December 2017.

The improvement in the terms of trade generated positive spillovers to the domestic economy. Firstly, higher demand for Malaysia's export products induced greater demand for labour and increased wages. This trend was particularly apparent in the manufacturing sector, which recorded robust employment and wage growth. Insights from surveillance conducted by the Bank's regional offices also indicated that firms in the export-oriented manufacturing sector reported a higher amount of overtime work to raise production and fulfil orders. The improvement in labour market conditions, in turn, resulted in higher household incomes and consumer spending. Secondly, the increased export orders and higher capacity utilisation rates[1] (82.6%; 2016: 77.5%) resulted in more firms embarking upon investment activity. Greater revenue and profits were also generated as firms benefited from both higher average selling prices and increased sales volume.

[1] Source: Malaysian Institute of Economic Research's capacity utilisation rates.

Chart 1.7: Trade Balance by Commodities

Higher trade balance supported by larger surplus in E&E and commodities



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Source: Department of Statistics, Malaysia

with the robust manufacturing exports and more rapid investment in the manufacturing and services sectors. Imports of high-value items, including a floating structure, oil & gas vessels and aircrafts provided further impetus to capital imports, particularly during the first quarter of the year. Better re-export activity was driven mainly by petroleum and E&E products, catering primarily to regional demand.

Overall, Malaysia's trade balance improved to RM97.2 billion (2016: RM88.1 billion), supported by higher surplus in E&E and commodities, that offset the continued deficit in non-E&E manufactured goods, such as machinery, equipment & parts, transport equipment and iron & steel products.

The current account balance improved to RM40.3 billion, or 3.1% of GNI, compared to the previous year (2016: RM29.0 billion or 2.4% of GNI).

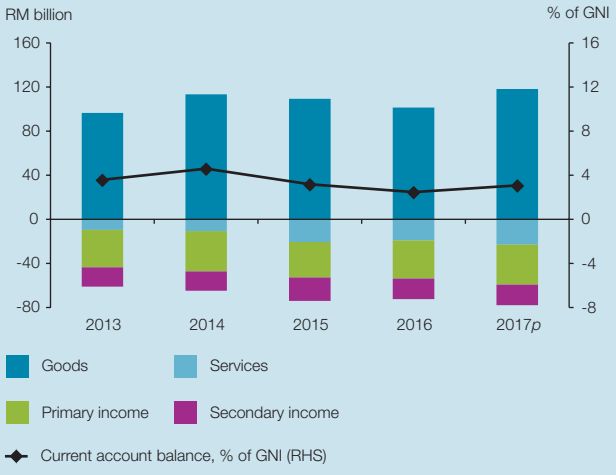
The current account registered a higher surplus, largely due to a higher goods surplus[3] following the strong export performance, which more than offset widening deficits in the services and primary income accounts.

In tandem with robust trade and higher domestic investment activity, the services account registered a wider deficit, due mainly to larger deficits in transportation and insurance services (-RM29.7 billion and -RM8.9 billion, respectively). The transportation deficit reflected heavy reliance on foreign service providers particularly in the sea and air freight segments. Air passenger and port segments nevertheless continued to register net surplus balances. In the travel account, a higher surplus was recorded (RM33.0 billion; 2016: RM31.5 billion), driven mainly by greater per capita spending by tourists in Malaysia. This offset the lower number of tourist arrivals (25.9 million tourists; 2016: 26.8 million tourists), reflecting mainly fewer tourists from ASEAN, India, the UK and Australia.

In the income account, the primary income deficit widened to RM36.1 billion (2016: -RM34.6 billion), due to larger investment income accrued to FDI in Malaysia, particularly in the manufacturing sector following the strong performance of export-oriented multinational companies. This was partially offset by higher income from DIA by Malaysian companies mainly in the finance & insurance and manufacturing sectors, supported by a more favourable global economic climate. FDI returns continued to outpace DIA returns, registering 10.6% and 5.1%, respectively (2016: 9.3% and 3.7%, respectively). The secondary income account recorded a sustained sizeable deficit (-RM18.6 billion: 2016: -RM18.6 billion) driven by foreign workers' remittances.

Chart 1.8: Current Account Balance

Higher current account surplus in 2017 attributable mainly to a larger goods surplus



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Source: Department of Statistics, Malaysia

[3] A difference between the goods surplus and trade surplus may arise from the exclusion of goods for processing, storage and distribution in the goods accounts as per the 6th Edition of the Balance of Payments and International Investment Position Manual (BPM6) by the IMF.

Significant cross-border capital flows

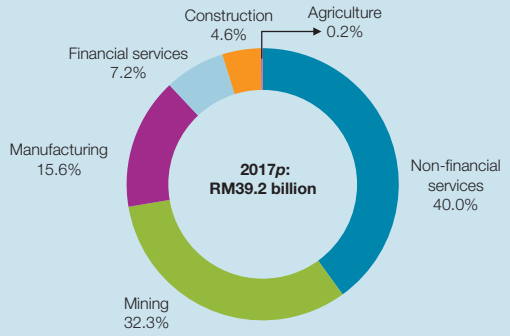
The financial account recorded a net inflow of RM2.3 billion (2016: net outflow of RM1.1 billion), attributable to continued long-term non-resident investment inflows in the form of FDI, and a resumption of portfolio investments by non-residents, driven by robust domestic growth, improvement in global growth prospects, and less volatile financial market conditions. These inflows were partially offset by DIA, albeit at a more moderate pace, and portfolio investments abroad by resident banks and institutional investors.

The *direct investment* account recorded a net inflow of RM12.4 billion (2016: net inflow of RM14.1 billion), as net FDI inflows exceeded net DIA outflows. The economy's growth performance and improved outlook provided support to Malaysia's attractiveness as an investment destination for international investors, leading to continued inward long-term direct investments by non-residents. FDI inflows amounted to RM39.2 billion, equivalent to 3.0% of GNI (2016: net inflow of RM47.2 billion or 3.9% of GNI), mainly in the form of equity capital injections from parent companies abroad and earnings retained for reinvestments in the domestic economy amid higher corporate profitability during the year. In terms of economic sectors, FDI remained broad-based. The largest recipient sector was non-financial services, particularly the real estate and information and communication services sub-sectors. FDI in the mining sector was also higher, increasing by 54% from the previous year to support ongoing upstream oil and gas exploration and extraction activities following the recovery in global oil prices. In terms of source countries, Europe and Asia were significant FDI contributors, particularly Hong Kong SAR, PR China, and the UK.

DIA by Malaysian companies registered a more moderate net outflow of RM26.8 billion, equivalent to 2.0% of GNI (2016: net outflow of RM33.1 billion or

Chart 1.9: Net Foreign Direct Investment by Sectors

Foreign direct investment[1] channelled mostly into the non-financial services sub-sector



[1] Foreign direct investment as defined according to the 5th Edition of the Balance of Payments Manual (BPM5) by the International Monetary Fund (IMF)

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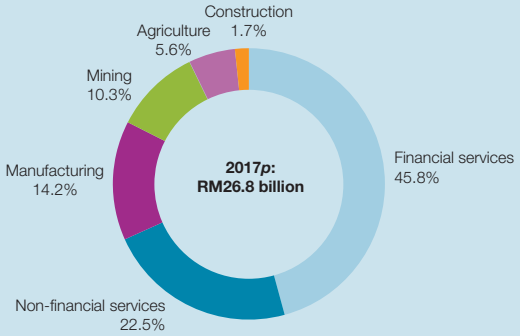
Source: Department of Statistics, Malaysia

Chart 1.10: Net Direct Investment Abroad by Sectors

Direct investment abroad[1] channelled mostly into the services sector



[1] Direct investment abroad as defined according to the 5th Edition of the Balance of Payments Manual (BPM5) by the International Monetary Fund (IMF)

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Source: Department of Statistics, Malaysia

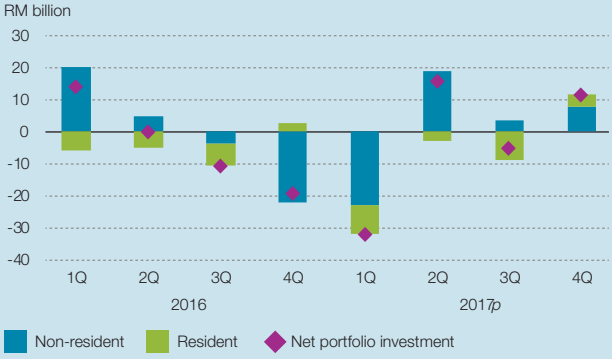
2.8% of GNI). The investments were mainly in the form of retained earnings and inter-company loan extensions to subsidiaries abroad. By sector, DIA was channelled mainly into the finance and insurance services sub-sector. DIA in the mining sector declined, reflecting the downscaling of upstream oil and gas investment activities abroad by the national oil company. ASEAN and Europe were major recipients of DIA by Malaysian companies, particularly Singapore, the UK and Indonesia.

Sufficient reserves and manageable external debt, while substantial capital flows were intermediated efficiently in the domestic financial markets

The *portfolio investment* account registered a lower net outflow of RM9.2 billion (2016: net outflow of RM15.4 billion), due mainly to a turnaround in non-resident portfolio investments, which recorded a net inflow of RM7.3 billion (2016: net outflow of RM0.4 billion), amid continued net acquisition of foreign financial assets by resident fund managers (net outflow of RM16.5 billion; 2016: net outflow of RM15.0 billion). Despite some volatility in the first quarter, non-resident portfolio investment flows saw a return to the domestic capital markets, reflecting purchases of domestic equity securities which were partially offset by a net liquidation of short-term domestic debt securities in the first quarter of 2017. In particular, foreign holdings of Malaysian Government Securities (MGS) declined during the quarter following a rebalancing of asset

Chart 1.11: Portfolio Investments

Resumption of portfolio investment inflows by non-residents



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Source: Department of Statistics, Malaysia

exposures to the emerging market economies by international asset managers. This was due to market expectations in March 2017 of monetary policy normalisation by the US Federal Reserve, renewed volatility in global oil prices, and the reduction of Malaysia's weightage in the JP Morgan GBI-EM Index following the inclusion of Argentina, Czech Republic and Uruguay in the index. As a result, non-resident holdings of public debt instruments declined to 16.4% as at end-March 2017 (end-December 2016: 20.8%). These large flows of funds were well-intermediated by Malaysia's deep and diversified financial market, and highly-capitalised and liquid banking system. The presence of domestic institutional investors supported demand during periods of financial market

stress and capital outflows. Despite net outflows from debt securities, foreign purchases of equity securities resumed in the first quarter of 2017 (end-March 2017: non-residents held 22.4% of total market capitalisation; end-December 2016: 22.3%), amid stronger corporate earnings, better ringgit performance and improved economic prospects.

Non-resident portfolio investment inflows into the domestic financial markets resumed amid lower financial market volatility for the rest of the year. The improvement in investor sentiments was supported by expectations of better corporate earnings, sustained strong exports growth, better-than-expected economic performance, and domestic growth prospects. These factors supported non-resident portfolio investment inflows into both the equity and debt markets, despite the maturing of a few tranches of MGS and Government Investment Issues (GII). Consequently, non-resident holdings of domestic equity securities and public debt instruments rose to 23.2% and 17.7%, respectively, as at end-December 2017.

The *other investment* account recorded a net outflow of RM1.3 billion (2016: net inflow of RM1.0 billion), due mainly to net outflows in the corporate sector. This reflected mainly the placements of currency and deposits abroad and a net repayment of loans owed to non-residents. These outflows were partially offset by net inflows in the banking sector, due mainly to the placements of currency and deposits in domestic financial institutions, extension of loans to Malaysian banks from financial institutions abroad and the repayment of loans previously extended by domestic banks. These interbank transactions, which vary in both magnitude and direction every quarter, underscored the treasury management strategies of individual banking institutions. The public sector registered a net outflow, attributable to the repayment of long-term loans by the general government. Errors and omissions (E&O) amounted to -RM51.9 billion, or -2.9% of total trade (2016: -RM13.2 billion or -0.9% of total trade), partly due to foreign exchange revaluation losses on international reserves arising from the appreciation of the ringgit over the year. Excluding revaluation losses, the E&O declined to -RM26.3 billion, or -1.5% of total trade.

Following these developments, the international reserves of Bank Negara Malaysia amounted to USD102.4 billion as at end-2017 compared to USD94.5 billion as at end-2016. Besides the support from a higher current account surplus and continued inflows of FDI, the reserves level also reflected foreign exchange revaluation changes. The weakening of the US dollar against most of the currencies in the diversified foreign currency reserve assets during the year, except in the first quarter, contributed to the increase in reserves level. As at 15 March 2018, international reserves amounted to USD103.9 billion. The international reserves remain adequate to facilitate international transactions and sufficient to finance 7.3 months of retained imports and is 1.1 times the short-term external debt. Over the past 20 years, Malaysia has cultivated a wide range of monetary policy instruments and pursued greater exchange rate flexibility through deregulation and liberalisation. These have enabled the economy to reduce its reliance on the Bank's international reserves in managing external pressures.

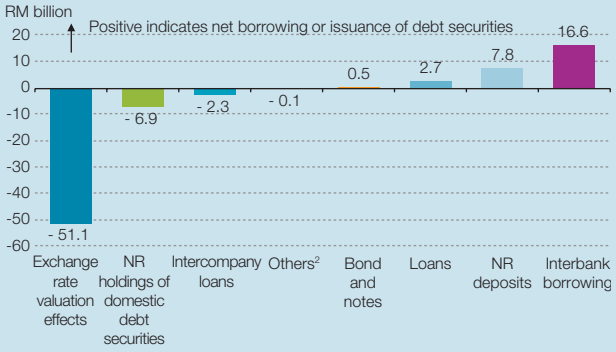
Of significance, the international reserves are not the only means for the country to meet its external obligations. Approximately 75% of external assets are held by domestic corporations, banks, and institutional investors. These external assets enable these entities to meet their external obligations without creating a claim on international reserves.

Manageable external debt

Malaysia's external debt declined to RM883.4 billion as at end-2017, equivalent to USD215.5 billion or 65.3% of GDP (2016: RM916.1 billion, equivalent to USD202.3 billion or 74.5% of GDP). The lower external

Chart 1.12: Changes in Total External Debt in 2017

Lower external debt in 2017
Net change[1]: -RM32.8 billion

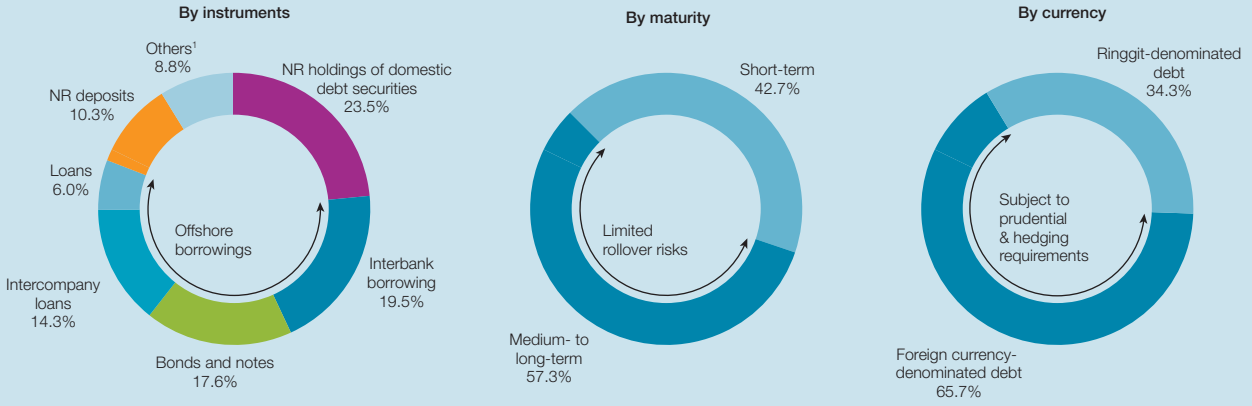


[1] Changes in individual debt instruments exclude exchange rate valuation effects
[2] Comprises trade credits, IMF allocation of SDRs and other debt liabilities
Note: NR refers to non-residents
Figures may not necessarily add up due to rounding

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Chart 1.13: Breakdown of Malaysia's Total External Debt (% share)

Favourable external debt profile



[1] Includes trade credits, IMF allocation of SDRs and miscellaneous, such as insurance claims yet to be disbursed and interest payables on bonds and notes

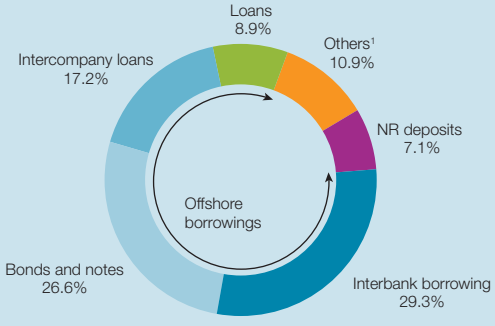
Source: Bank Negara Malaysia

debt was mainly attributed to valuation effects following the strengthening of the ringgit against most currencies during the year. Excluding valuation effects, Malaysia's external debt position increased by 1.4% of GDP, attributable mainly to increases in interbank borrowing and non-resident (NR) deposits.

Risks from external debt remain manageable, mitigated by its currency and maturity profiles. More than a third of external debt is denominated in ringgit (34.3%), mainly in the form of NR holdings of domestic ringgit debt securities and ringgit deposits in domestic banking institutions. As such, these liabilities are not subject to valuation changes from the fluctuations of the exchange rate. During the course of the year, the total NR holdings of domestic debt securities decreased by 3.2% to RM207.4 billion (end-2016: RM214.2 billion). This largely reflects the maturing MGS and GII, as well as Bank Negara Monetary Notes. In contrast, NR holdings of ringgit-denominated deposits in domestic banking institutions increased by RM0.8 billion or 1.6% to RM50.1 billion, equivalent to 55.0% of total NR deposits.

Chart 1.14: Breakdown of Foreign Currency-denominated External Debt (% share)

Foreign currency-denominated debt subjected to prudent liquidity management practices and hedging requirements



[1] Includes trade credits and miscellaneous, such as insurance claims yet to be disbursed and interest payables on bonds and notes

Source: Bank Negara Malaysia

The remaining portion of total external debt of RM580.7 billion (65.7% share) is denominated in foreign currency (FC), which are subject to prudential and hedging requirements on banking institutions and corporations. The bulk of these obligations are offshore borrowings[4], raised mainly to expand productive capacity and to better manage financial resources within corporate groups. As at end-2017, offshore borrowing was lower at 37.5% of GDP compared to 60.0% of GDP during the Asian Financial Crisis.

Of the total FC-denominated external debt, around one third is accounted for by interbank borrowing and FC deposits in the domestic banking system, which increased by RM9.9 billion from end-2016. This reflects banks' intragroup liquidity management and placements of deposits by foreign parent entities, which are subject to prudent liquidity management practices, such as internal limits on funding and maturity mismatches. The next largest component is long-term bonds and notes

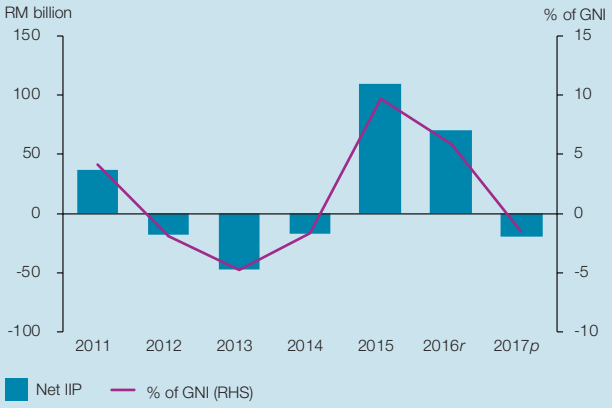
[4] Comprised mainly of foreign currency loans raised, and bonds and notes issued offshore.

issued offshore (26.6% share or RM154.2 billion), primarily to finance asset acquisitions abroad that will generate future income. FC-denominated intercompany loans was lower by RM12.9 billion following net repayment during the year. These obligations are normally subject to flexible and concessionary terms, such as a flexible repayment schedule or lower interest rates.

From a maturity perspective, more than half of the total external debt is skewed towards medium- to long-term tenures (57.3% of total external debt), suggesting limited rollover risks. Additionally, not all short-term external debt pose a claim on reserves. In 2017, Malaysia recorded a higher current account surplus from the favourable external demand environment, and continues to experience a net short-term external asset position. This indicates that most borrowers are able to meet their external obligations given the steady stream of foreign currency earnings via trade activities and accumulation of external assets. As at end-2017, Malaysia has a net short-term asset position of RM268.1 billion. The sustained net short-term asset position reflects the economy's ability to service short-term external debt falling due. Furthermore, Malaysia has a net foreign currency asset position, as the bulk of liabilities are in ringgit and assets are mostly denominated in foreign currency. This means that Malaysia's external position is well-protected from a sharp exchange rate depreciation.

Chart 1.15: Net International Investment Position (IIP)

IIP registered a net liability in 2017

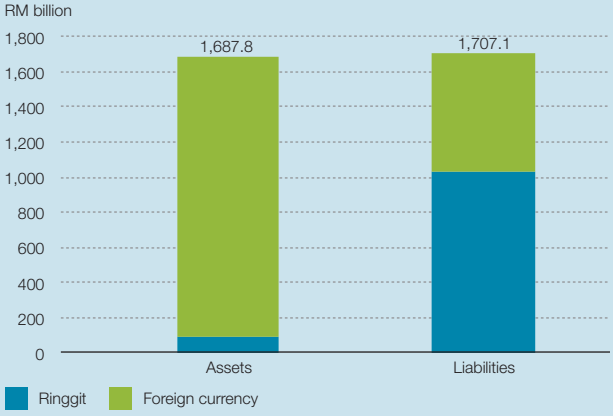


p Preliminary
r Revised
Source: Department of Statistics, Malaysia

As at end-2017, Malaysia recorded a marginal net liability position of RM19.3 billion, equivalent to -1.5% of GNI, compared to a net asset position of RM70.1 billion, or 5.9% of GNI in 2016. The appreciation of the exchange rate (as at end-2017) was the key driver of the reversal in Malaysia's net international investment position (IIP). This underscores the role of the exchange rate as a shock absorber in influencing the IIP. The appreciation of the ringgit reduced the country's external assets, most of which are denominated in foreign currencies, when valued in ringgit terms. The impact of the stronger ringgit on external liabilities was relatively smaller given the high share of ringgit-denominated liabilities, namely in the form of non-resident holdings of domestic debt and equity securities as well as placement of deposits in the domestic banking system.

Chart 1.16: International Investment Position (IIP) by Currency

Foreign currency external assets exceed foreign currency external liabilities



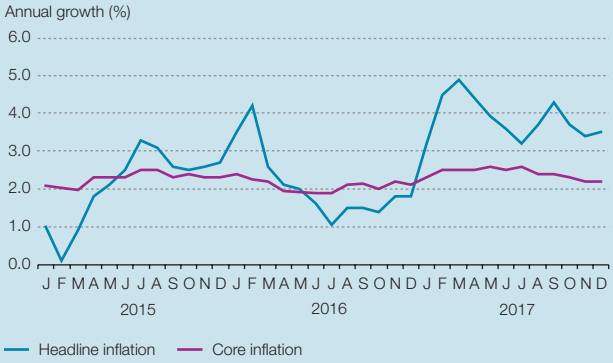
Source: Bank Negara Malaysia

Headline inflation increased in 2017

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), increased to 3.7% in 2017 (2016: 2.1%). While the inflation numbers were within the Bank's expectations, inflation during the year remained volatile and was driven mainly by higher domestic fuel prices. Higher external and domestic costs from higher global commodity prices and disruptions in domestic food supplies respectively also contributed to inflation during the year. However, the stronger ringgit exchange rate since April 2017 helped to contain the increase in cost of production for domestic goods. Underlying inflation, as measured by core inflation, was also higher during the year, averaging at 2.3% in 2017 (2016: 2.1%).

Chart 1.17: Consumer Price Inflation

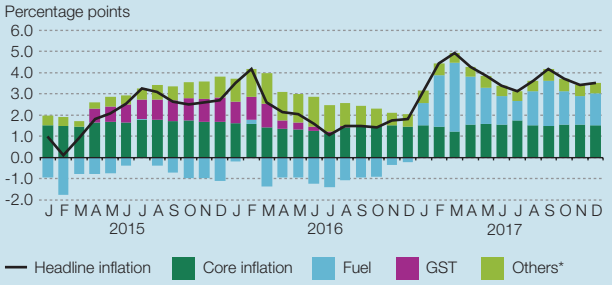
Headline inflation increased to 3.7% in 2017



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.18: Contributions to Headline Inflation by Components

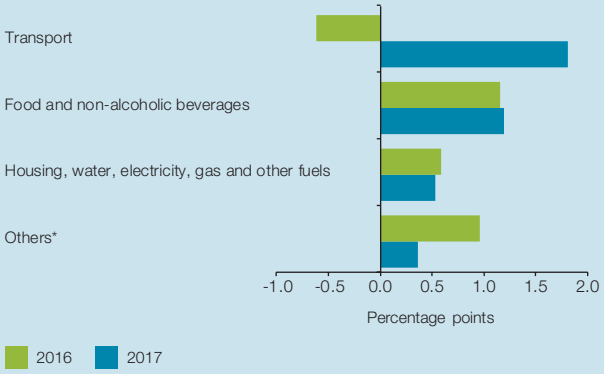
Headline inflation was driven mainly by higher domestic fuel prices



* Others include price-volatile items and other price-administered items
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.19: Contributions to Inflation by Categories

Contributions from the *transport* and *food and non-alcoholic beverages* categories were higher



* Others include clothing and footwear, alcoholic beverages and tobacco, health, education, communication, recreation services and culture, furnishings, household equipment and routine household maintenance, restaurants and hotels and miscellaneous goods and services categories

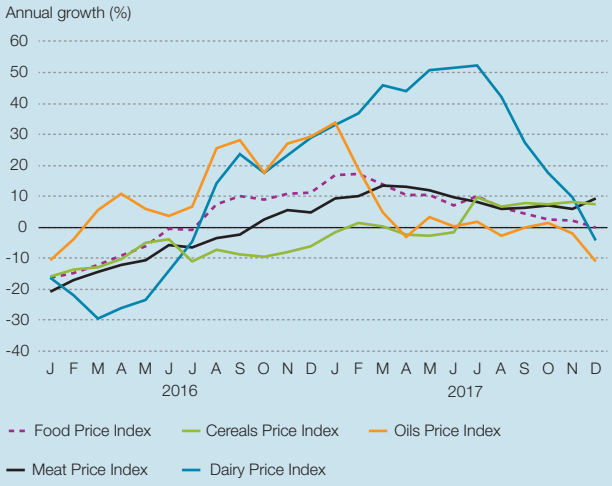
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Externally, global commodity prices were higher in 2017, driven by increases in the prices of oil and food. Global oil prices rose during the year following OPEC's agreement to cut production effective from 1 January 2017. The stronger-than-expected global oil demand since the second quarter of the year amid production cuts led to falling inventories, which also supported the increase in oil prices. The rise in global oil prices was further compounded by unexpected supply disruptions in the US Gulf Coast due to Hurricane Harvey at the end of August and geopolitical tensions in the Middle East towards the end of the year. Global food prices also increased during the year, driven mainly by stronger global demand amid supply shortages. The Food and Agriculture Organisation of the United Nations (FAO) Food Price Index, rose by 8% in 2017 (2016: -1.5%). With the exception of cereals, the annual rate of increases in prices for other food categories, notably meat, oils and dairy categories, accelerated during the third quarter of 2016, before slowing down in the second quarter of 2017. Specifically, palm oil prices also rose to a four-year high in the fourth quarter of 2016 as a result of tight supplies before declining in March 2017. Cereal prices only started to increase in the second half of 2017, driven partly by higher wheat prices following yield concerns from a worsening drought in the US and Canadian regions. The higher global commodity prices, coupled with a slight increase in import partners' inflation, resulted in higher cost for domestic producers.

Domestically, higher costs stemmed from supply disruptions and price adjustments that had been occurring since late 2016. In 2017, there were intermittent disruptions to the supply of fresh food caused by

Chart 1.20: FAO Food Price Index

Global food prices rose by 8%



Source: Food and Agriculture Organisation of the United Nations (FAO) Food Price Index

adverse weather conditions during the monsoon season in January, the outbreak of bird flu in February and adverse sea conditions in May. As a result, inflation for price-volatile items remained relatively high at 4.9% (2016: 5.6%, 2011-2015: 4.4%). The impact of several revisions to prices that took place in the second half of 2016 persisted into 2017. These revisions included an increase in satellite TV charges in August 2016 and the removal of the subsidy for cooking oil in November 2016. The impact of these revisions however, lapsed towards the end of 2017, leading to a moderation in inflation in the fourth quarter.

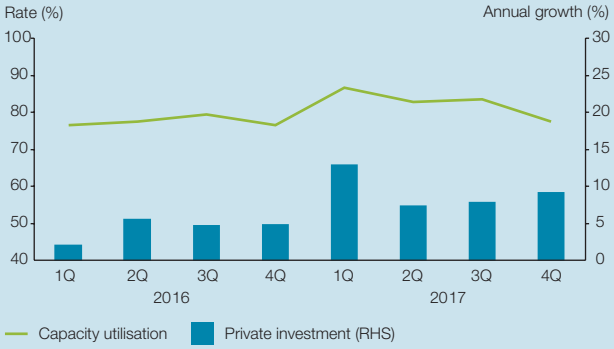
In terms of impact on CPI, the higher global oil prices during the year had a direct impact through domestic fuel prices. Prices of RON 97 petrol, RON 95 petrol and diesel were adjusted higher by 34 sen, 41 sen and 47 sen, respectively. The impact on inflation was compounded by the significantly lower global oil prices in the base period of 2016. As a result, *transport* inflation rose to 13.2% (2016: - 4.6%).

The higher external and domestic costs were also passed through indirectly to the prices of goods and services. Based on the Bank's industrial engagements[5], firms took advantage of the relatively stronger demand during the year to increase their retail prices, easing the compression of their margins, especially for firms in the *food away from home* and *furnishings, household equipment and routine household maintenance* categories. For example, fast food and wheat-based food products experienced upward price revisions during the year. The higher global palm oil prices also led to higher prices for non-durable household goods, such as washing powders and detergents. However, the adjustments were moderate as firms remained cautious. The impact was also partially contained by the stronger ringgit exchange rate since April 2017. These price revisions, coupled with slightly higher inflation of rental during the year, led to core inflation rising to 2.3% during the year.

Demand-driven inflationary pressures in the economy remained largely stable during the year, given the lack of persistent tightness in capital stock and absence of significant wage pressures. In 2017, firms in the manufacturing sector operated at a relatively high capacity utilisation rate of 82.6% (2016: 77.5%), supported by the increase in private sector spending and higher exports. While spare capacity has narrowed, it did not translate into broad-based price pressures. In terms of capital stock, the higher capacity utilisation was expected to lead to some tightness for firms. However, this tightness was not expected to persist and exert upward pressure on inflation as incoming investments, especially in machineries and equipment, would expand firms' productive capacity over time to cater to the stronger demand. In the labour market, there remained spare capacity even as the underutilisation of labour was declining. The unemployment rate during the year remained stable (3.4%; 2016: 3.4%) as the higher employment growth (2.1%; 2016: 0.7%) was matched by growth in the labour force (2.1%; 2016: 1.0%). While wages per worker grew in the manufacturing sector, it was offset by higher productivity, resulting in lower unit labour costs. In the services sector, unit labour costs were also lower given the stable growth in wages per worker amid increase in productivity.

Chart 1.21: Private Investment in Malaysia and Capacity Utilisation in the Manufacturing Sector

Higher growth in private investment would expand productive capacity in the manufacturing sector



Source: Department of Statistics, Malaysia and Malaysian Institute of Economic Research (MIER)

Chart 1.22: Unemployment Rate, Employment and Labour Force

Unemployment rate remained stable as higher employment growth was matched by growth in the labour force

Source: Department of Statistics, Malaysia

[5] The industrial engagements were undertaken by the Bank's Regional Economic Surveillance (RES) team.

Low-Skilled Foreign Workers'[1] Distortions to the Economy

By Ang Jian Wei, Athreya Murugasu, Chai Yi Wei

Introduction

A prerequisite to achieving a high income and developed nation is the progression to a 'high-productivity, high-income' workforce. Fundamentally, Malaysia would benefit from a clear shift away from an economy that is input-based and dependent on cost suppression as a source of competitive strength, to one that competes on the quality of its labour force, technical skills and product offerings. Such a shift requires the implementation of well-aligned, coordinated and consistent public policies. These policies encompass talent development, research and development, and industrial upgrading initiatives. Importantly, these policies need to be coherent, well-communicated and mutually-reinforcing.

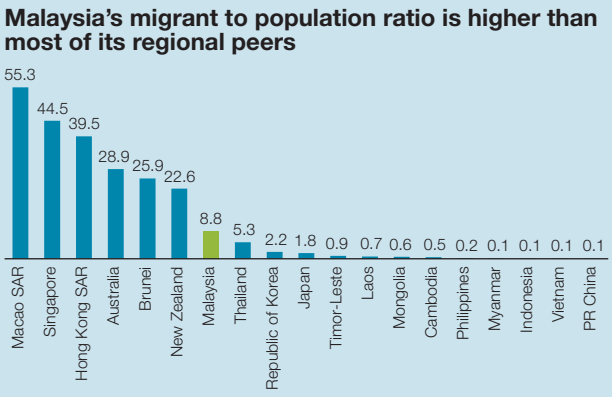
The vision is for Malaysia to become an economy with the know-how and competitiveness to produce sophisticated goods and services that can command a market premium. Currently, while Malaysia has made progress on several fronts, there remains a broad reliance on low-cost production models that lean on low-skilled labour while keeping a lid on wages to maintain business margins. The relative ease of obtaining low-skilled foreign workers in Malaysia contributes to these tendencies.

The purpose of this article is to highlight the costs of unchecked dependence on low-skilled foreign workers and how they weigh on Malaysia's efforts to raise productivity and create higher-skilled and better-paying jobs. Several policy thrusts are highlighted to build on the progress that has been made and to ensure policy alignment with Malaysia's long-term economic objectives.

History and Context

Malaysia's economy has long benefited from a supportive immigration stance. Malaysia is among the countries with a high ratio of migrants to total population in Asia Pacific (Chart 1). However, most of the migrants in Malaysia have low education attainment. Only 5.2%[2] of them are tertiary educated. In contrast, other economies like Australia, Singapore and Hong Kong SAR have intentionally planned to attract more skilled migrants[3].

Chart 1: Share of Total Migrants to Population (%)



Source: Conference Board, United Nations, CEIC, CIA 'The World Factbook'

[1] This refers to the workers who are employed under the Visitor Pass (Temporary Employment). The term 'foreigners' used in this article refers to the 'non-citizens' obtained from the Labour Force Survey.

[2] Refers to non-citizen employed persons in Malaysia (2016 Labour Force Survey, DOSM).

[3] 8.8% of non-citizens working in Malaysia are high-skilled. The corresponding share for Singapore, Hong Kong SAR and Australia is 14.0%, 11.6% and 58.5% respectively.

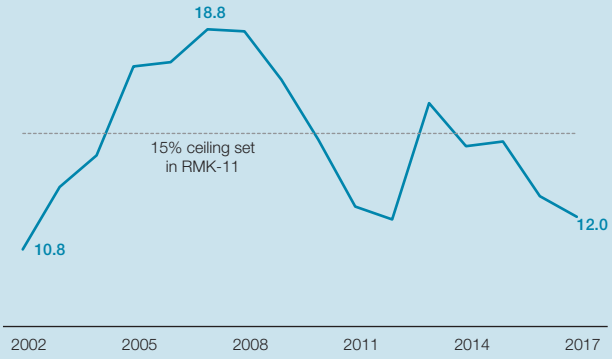
In the 1970s, foreign workers in Malaysia were mostly employed in the rural plantation and construction sectors in small numbers to meet seasonal demand. The rapid industrialisation and economic growth in the 1980s transformed a situation characterised by high unemployment in the mid-1980s to full employment by the early 1990s, with widespread labour and skill shortages, and rising wages[4]. This attracted both documented and undocumented foreign workers in large numbers. These workers eased production pressures and were compatible with the low value-added production of Malaysia then. However, what was initially conceived as a transitionary support[5] to alleviate production constraints and enable firms to move up the value chain has become a more entrenched feature of the Malaysian economy.

The share of documented foreign workers to labour force rose sharply from 10.8% in 2002 to a peak of 18.8% in 2007 (Chart 2). It was only within the past four years that the numbers have trended downwards since 2013, although amid strong industry pushback. Foreigners hold more than a fifth of the jobs in the agriculture, construction and manufacturing sectors (Chart 3).

While this served Malaysia well previously, the transition to a high-income economy requires a major shift from labour-intensive business models to those that are driven greatly by productivity gains, technological edge and sophisticated technical know-how. The ease and availability of these low-skilled workers at a cheap cost create deep distortions that disincentivises firms to transform.

Chart 2: Share of Documented Foreign Workers (% of labour force)

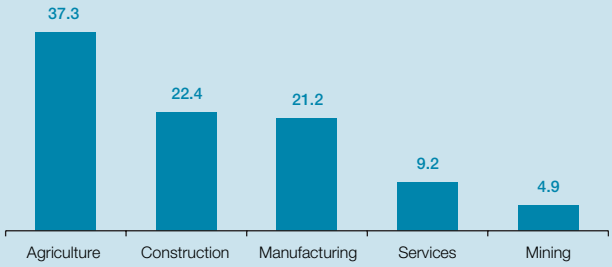
Foreign worker share of labour force has trended downwards of late



Source: Ministry of Home Affairs (MOHA), Department of Statistics Malaysia (DOSM)

Chart 3: Share of Foreigners* to Employment by Sector, 2016 (%)

Foreigners take up more than a fifth of employment in the agriculture, construction and manufacturing sectors



*Refers to non-citizens in the Labour Force Survey Report 2016

Source: Department of Statistics, Malaysia

The Macroeconomic Costs of Foreign Workers

Critically, the readily available pool of cheaper low-skilled foreign workers distorts domestic factor prices, and thus discourages industrial upgrading. It makes labour relatively cheap when compared to capital, and thus weakens incentives for firms to substitute labour for technology, or for greater value adding activities from employment of higher-skilled labour. While grants and incentives for automation and technology adoption are helpful, they are by themselves insufficient to create the necessary push for firms to move up the value-chain. Since 2008, around RM8 billion has already been allocated by the Government to assist with technology adoption and commercialisation efforts.

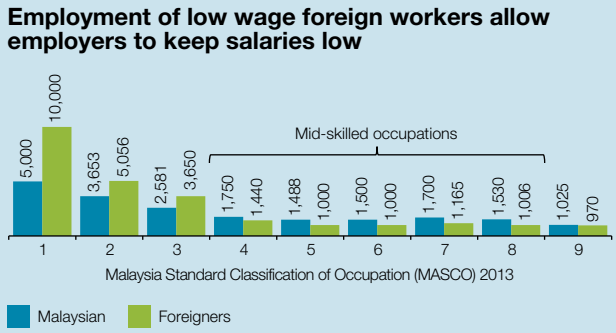
Observations from other advanced and emerging Asian economies are illustrative of this point. While public sector support for automation and talent policies are common, the drive for more efficient and sophisticated capabilities is often accompanied by pressures of rising costs, some of which are policy induced. These factors motivated the initial wave of Japanese investments into other parts of Asia in the 1980s[6] and the more recent ones from PR China to Vietnam. While this was done to take advantage of the cheaper labour and land in the recipient countries,

[4] Kanapathy, V. 2001. International Migration and Labour Market Adjustments in Malaysia: The Role of Foreign Labour Policies.
[5] Carpio, X. et.al 2015. Foreign Workers in Malaysia: Labour Market and Firm-Level Analysis.
[6] Sheng, A. 2009. From Asian to Global Financial Crisis: An Asian Regulator's View of Unfettered Finance in the 1990s and 2000s.

the remaining business segments in both Japan and PR China were compelled to undergo sharp productivity increases and industrial upgrading to remain competitive.

Malaysia's transition to a high-income and developed nation is at risk, as long as firms are still engaged on a 'race to the bottom' in relation to labour costs and are unwilling to pay more, despite commensurable productivity gains had they adjusted. Employment of cheaper foreign workers vis-à-vis locals allows employers to keep wages low and in doing so, obviates the pressure to change the status quo. This distorts the natural wage clearing mechanisms that would have otherwise driven wages upwards. Studies[7] have pointed to some forms of depression on overall wages, and particularly on wages of low-skilled locals. Median wages of foreign workers are generally lower than those of locals (Chart 4), especially in mid-skilled occupations where 60.8% of locals are employed. It is entirely plausible that the very high presence of foreign workers in the private sector could widen wage differentials and deter job creation for locals. This is most evident in the Gulf Cooperation Council economies where 88% of private-sector jobs created from 2000-2010 were taken by foreign workers, of which 85% of them were low-skilled[8].

Chart 4: Median Monthly Salary of Firms by Occupations* and Nationality, RM



*High-skilled workers: Occupations Classification 1 to 3; Midskilled: 4 to 8; Low-skilled: 9

Note: 1. Managers; 2. Professionals; 3. Technicians and associate professionals; 4. Clerical support workers; 5. Service and sales workers; 6. Skilled agricultural, forestry, livestock and fishery workers; 7. Craft and related trade workers; 8. Plant and machine operators and assemblers; 9. Elementary occupations

Source: National Employment Returns 2016

Much has been said about the reluctance of local workers in undertaking 'dirty, dangerous and difficult' (3D) jobs. While cultural factors and the inherent nature of the work do play a role in deterring local involvement, it may also be argued that it is partly due to local wage conditions. Of the approximate 200,000 daily commuters from Malaysia to Singapore, it was found that 40% were working in mid- to low-skilled jobs, motivated mainly by higher wages[9]. This includes occupations that are often avoided in Malaysia such as plant and machine operators and assemblers, cleaners and labourers. In other words, at a more attractive level of wages, Malaysian workers would not shun 3D jobs.

While this is a limited example, it does suggest that current wages in Malaysia may be too low to attract local workers. Employers may also be reluctant to increase them due to the presence and abundance of cheaper alternatives. In the same vein, so long as blue-collar wages continue to face downward pressures, employers will not be hard pressed to adopt productivity-enhancing measures. Consequently, Malaysia risks being trapped in a low-wage, low-skill conundrum.

This can be observed through the share of job creation by skills from 2011 to 2017. When taken with other factors, Malaysia's share of low-skilled job creation has increased to 16% from 8% in 2002 to 2010 (Chart 5). In fact, 73% of net jobs created in 2015 to 2016 went to foreigners (Chart 6), of which almost all of them had at most a secondary education.

7 World Bank 2015. Malaysia Economic Monitor: Immigrant Labour; Athukorala, P. et.al 2012. 'The Impact of Foreign Labor on Host Country Wages: The Experience of a Southern Host, Malaysia'; Ismail, R. et.al 2014. The Impact of Foreign Workers on Wages: A Case Study of Malaysian Firms.

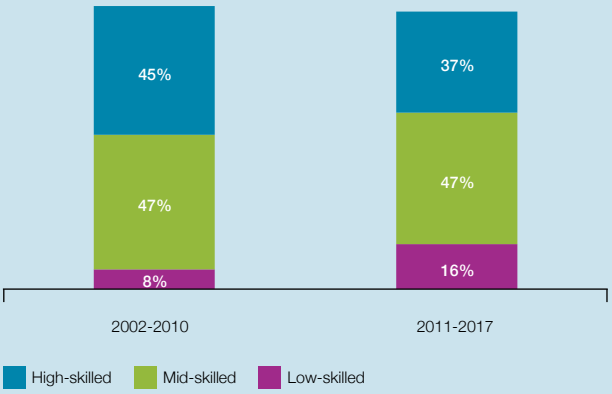
8 International Monetary Fund (IMF) 2016. Economic Diversification in Oil-Exporting Arab Countries.

9 Institute of Labour Market Information and Analysis 2017. A Study on Malaysians Working in Singapore.

On the other hand, the number of graduates in Malaysia increased by around 880,000 persons over the similar period, but with a corresponding high-skilled job creation of only 650,000 persons. This translates into increasing graduate unemployment from 2011 to 2016, outstripping that of non-graduates (Chart 7).

Chart 5: Share of Job Creation* by Skill Level

An increasing share of net job creation is taken up by low-skilled workers in recent periods

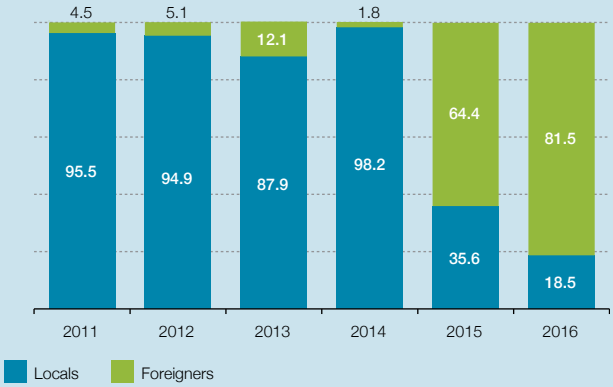


*Defined as net change in employment

Source: Department of Statistics, Malaysia and Bank Negara Malaysia's estimates

Chart 6: Share of Job Creation* by Citizenship (%)

In the past two years, a large share of net jobs created went to foreigners



*Defined as net change in employment

Source: Bank Negara Malaysia's estimates using Department of Statistics, Malaysia's data

Chart 7: Unemployment Rate of Graduates and Non-graduates (%)

Graduate unemployment has increased more sharply since 2011

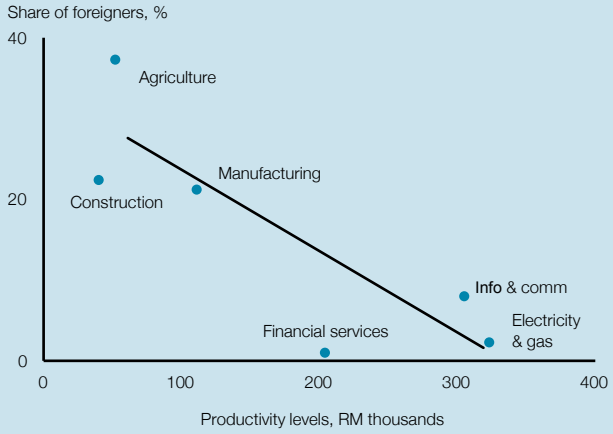
Source: Department of Statistics, Malaysia and Bank Negara Malaysia's estimates

It is also observed that industries with low productivity have a high share of low-skilled foreign workers (Chart 8), with a greater reliance on longer working hours to produce output. One study[10] found that South Korea increased real GDP per hour from USD4.7 in 1980 to USD25.4 in 2010, while Malaysia only registered an increase to USD7.1 in 2010 from USD5.3 in 2000. South Korea did this while reducing average weekly working hours from 49 hours to 44 hours from 2000 to 2008, while Malaysia's held steady at 49 hours. Malaysia's labour-intensive methods and longer working hours are clearly less efficient than those obtained through technological advancement and automation. This is seen through the gap between Malaysia and Asia's average usage of industrial manufacturing robots (Chart 9).

[10] Rasiah, R. et.al 2015. Industrialization and labour in Malaysia.

Chart 8: Productivity and Share of Foreigners[11] by Industries

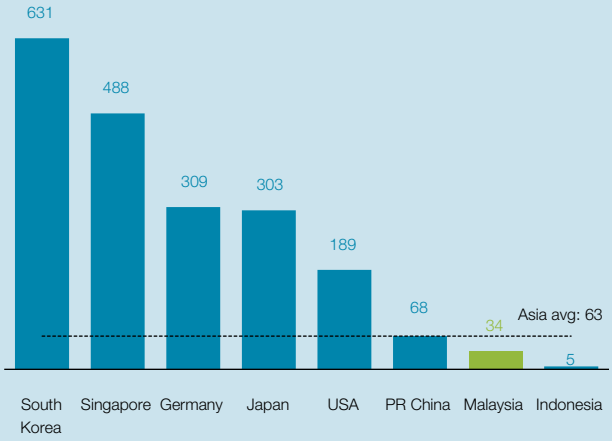
Productivity of industries negatively correlates with share of foreigners



Source: Department of Statistics, Malaysia and Bank Negara Malaysia's estimates

Chart 9: Robot Density* in the Manufacturing sector (2016)

Malaysia's robot density is below the Asian average



*Number of robots per 10,000 employees

Source: International Federation of Robotics

This raises an important point. With the advent of global value chains (GVCs) and the disruptive nature of technologies, two things are likely to unfold. First, competition on the low value-added and labour-intensive segments is likely to increase as more countries plug into the GVCs. Second, the fast-changing nature of technology cycles coupled with declining prices would provide more opportunities for others to leap frog and rapidly close the progress gap. In the past decade, labour costs in Asia have increased by 10% to 15%[12], leading to a convergence of labour and automation costs. Every year, the amount of time it takes for a firm's investment in robots to pay off (known as the "payback period") is narrowing sharply[13]. Malaysia's competitors are also actively embarking on industrial upgrading. Reliance on low-wage, low-cost production methods is an untenable long-term strategy with risks of Malaysia being left behind.

Malaysia's dependence on low-skilled foreign workers adversely shapes its reputation as a labour-intensive and low-cost destination to foreign investors. Increasingly, this affects the type of initial investments that foreign investors propose to bring to Malaysia. They are likely the less complex segments of their production chain, with many seeking to primarily leverage Malaysia's relative ease of hiring foreign workers and lower labour costs. This results in foreign multinationals relocating lower value-added processes to Malaysia, while moving higher productivity and value-added processes to neighbouring economies such as Singapore and PR China. In the end, this self-reinforcing image further locks Malaysia into this low-cost bind that would require significant resources to undo. This also worsens the displacement of local talent migrating to higher-paying employment countries, culminating in a brain-drain for Malaysia.

While the hiring of more low-skilled foreign workers does create demand for local workers in mid-skilled and supervisory jobs, it is arguable as to whether this is the most desired route in achieving that outcome. Automation and the adoption of more sophisticated technologies also create their own demand for higher-skilled workers. These positions usually come with better wages and can be filled by retrained unemployed graduates.

There are also several non-economic implications that must be considered. Over-concentration of migrant workers in urban areas may pose a strain on public amenities and infrastructure as well as resulting in additional fiscal costs

[11] Refers to non-citizens from the Labour Force Survey (LFS) 2016. While this figure also captures high-skilled migrants, 94.6% of non-citizens have at most a secondary education, making it a useful proxy for low-skilled foreign workers. The LFS would also capture information on both documented and undocumented workers. One limitation, however, is that the LFS does not capture information of workers who are living in communal housing, which may lead to an underestimation of workers in the agriculture and plantation industries. In contrast, the data by the Ministry of Home Affairs on the number of workers with Visitor Pass (Temporary Employment) only measures the number of documented foreign workers.

[12] RBC Global Asset Management. Global Megatrends: Automation In Emerging Markets.

[13] Sirkin H. et.al 2015. The Robotics Revolution: The Next Great Leap in Manufacturing.

to governments. Many also remit a significant share of their income abroad, thus reducing domestic spillovers in the domestic economy. Total outward remittances in 2017 remain sizeable at RM35.3 billion, of which the bulk was accounted for by foreign workers.

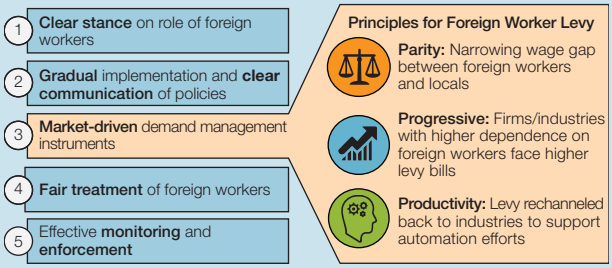
More pressing and worrying is the presence of many undocumented migrants in Malaysia. Estimates of their numbers vary greatly[14]. This impedes policy discussions and underestimates the full-impact of their employment on the Malaysian economy at large. Also, undocumented migrants who avoid compulsory health screening can potentially be a source of communicable diseases[15].

Policy Changes

Malaysia's efforts to reign in its dependence on foreign workers began in the early 2000s with the 8th Malaysia Plan. While it may not be easy, the challenge at hand is not insurmountable. Since the 11th Malaysia Plan, there has been greater clarity and a renewed focus to resolve the issue at hand. This has resulted in the steady decline in the share of documented foreign workers from 16.1% in 2013 to 12.0% of labour force in 2017.

Going forward, more can be done to build on the progress made. The end objective is to ensure that the future foreign worker management system in Malaysia is clearly articulated, firmly implemented, and more aligned to Malaysia's economic objectives. To this end, there are five key points that are worth pursuing (Chart 10).

Chart 10: Comprehensive 5-point Action Plan



Source: Bank Negara Malaysia

Firstly, there needs to be a clear stance on the role of low-skilled foreign workers in Malaysia's economic narrative. While these workers will continue to play an important role in supporting the Malaysian economy, there needs to be clarity as to where foreign workers are most needed and the manner in which they can be best engaged to support productivity growth and industrial upgrading. This includes clearly identified timelines for policy changes or the ease to obtaining up-to-date information on the existing framework. More importantly, policies on this front must be done in sync with other Government initiatives, be they talent development, labour market reforms, or enhancement to the existing incentives structure for attracting foreign direct investments (FDI).

Secondly, policy implementation and changes need to be gradual and clearly communicated to the industry. While reforms on foreign worker policies are necessary for Malaysia's long-term benefit, it will undoubtedly result in short-term adjustments to the economy. This will naturally result in industry pushback and eventually, the relocation of labour-intensive and low value-added goods and services production to other countries with abundant and cheaper labour. This will free up the requisite talent and fiscal resources to be redirected to more productive and complex industries. Most critically, it will allow affected industries and workers to prepare ahead for the incoming changes. This reduces the risks of policy reversals and aids policymakers in managing this delicate transition.

[14] Figures vary from official estimates of 600,000 persons by Jabatan Imigresen (2017) to alternative sources such as the 1.3 million undocumented workers registered under the 6P programme in 2013 (excluding East Malaysia and unregistered foreign workers) and 1.7 million persons indicated by the Malaysian Employers Federation (MEF) in 2017.

[15] Kanapathy, V. 2004. International Migration and Labour Market Adjustments in Malaysia: Economic Recovery, The Labour Market, and Migrant Workers in Malaysia.

Frequent policy reversals have complicated enforcement and increased business uncertainties. One example involves the several changes to the rules in foreign worker levy with regards to the party who should bear the cost – whether the employers or the workers themselves. Since the introduction of the levy in 1992, Malaysia has changed its stance on the matter three times within the last 10 years. The recent re-imposition of the levy on employers through the Employers Undertaking (effective 1 January 2018) is a step in right direction. This is in line with the Government's objective to develop a more effective means to manage demand for foreign labour and to encourage productivity gains among firms. Imposing the levy on workers does little in contributing to this outcome.

Thirdly, existing demand-management tools (such as quotas, dependency ceilings and levies) can be reformed to be more market-driven, while incentivising the outcomes that are in line with Malaysia's economic objectives. These tools should respond to evidenced-based labour and skills shortages as per Australia and Canada that rely on a mix of metrics to inform the recalibration of their immigration policies. Some foreign worker measures, such as the existing dependency ceilings, are argued to be either arbitrary, not sufficiently binding or simply hard to implement and enforce (Table 1).

Table 1

Selected Dependency Ceiling* by Industries

Industry	Quota determinants	Determinants	No. of foreign workers
Restaurants	Number of chairs	70-139 chairs	11 kitchen assistants, 12 helpers
		140-250 chairs	12 kitchen assistants, 20 helpers
		> 250 chairs	20 kitchen assistants, 30 helpers
Agriculture	Hectares	Oil palm: 8 hectares	1
		Rubber: 4 hectares	1
		Cocoa: 3.7 hectares	1

*Sets the upper limit for foreign worker intake by industry

Source: Ministry of Home Affairs (MOHA)

Reforms on the existing levy system can help disincentivise low-cost operations and prod firms to reduce dependence on foreign workers over time. There are three ways in which reforms can do so. The first would involve narrowing the wage per hour gap between local and foreign workers, arising from statutory exemptions. Internal estimates suggest that the average cost of hiring foreign workers on a per hourly basis is 30% lower than that of a local. While the upfront costs (e.g. compulsory medical check-ups, travel) of hiring the former may appear sizeable, it is important to note that these workers are usually subjected to longer working hours and that they do not enjoy the usual statutory benefits (e.g. Employer's EPF and SOCSO contributions) that locals do. In effect, the lower cost structure increases the appeal of foreign workers to employers over locals. Embedding the statutory costs in the levy calculations will help reduce this gap towards parity.

This can then be followed by making the levy system more progressive, so that industries or firms that are more dependent on foreign workers will face a higher total levy cost. The calculations can be made more nuanced, factoring the automation possibilities, wage growth and productivity improvements of each industry. The upcoming implementation of the multi-tiered levy in 2019 is a welcomed development, as it allows for a more differentiated deterrent mechanism depending on the firms' workforce profile. In line with best practices, the levy that is collected should be rechannelled back to the industry to support automation efforts.

Fourthly, there is room to ensure better treatment of foreign workers, be it improvements in working conditions or ensuring that foreign workers are paid as agreed. The questionable living and working conditions of foreign workers in certain industries do not merely raise concerns on workers' welfare but are symptomatic of the unhealthy business drive of certain unscrupulous employers to improve cost competitiveness. There are ongoing efforts by the Government to broaden the enforcement of minimum housing and amenities standards, from workers in the mining

and estate industries to all relevant sectors. Additionally, the 2018 Budget announcement to ensure payment of foreign workers' salary through bank accounts will better leverage technology to prevent employers from withholding wages or make unfair deductions from their salaries.

Lastly, it is also important to note that these proposed reforms must be complemented with effective monitoring and enforcement on the ground, particularly with respect to undocumented foreign workers. Without addressing this challenge, any additional tightening in foreign worker policies will only penalise law-abiding employers. It may also lead to greater risks of corruption and employers circumventing existing regulations by resorting to the available pool of undocumented foreign workers.

Conclusion

While Malaysia has clearly benefitted from the presence of foreign workers in the past, the role that foreign workers play in the Malaysian economy must keep up with the times. Future foreign worker management policies, if poorly designed and inconsistently applied, will only detract from the progress that has been made to gradually wean Malaysia's dependence on foreign workers.

A high-dependence on them, if left unabated, will weaken the case for automation, suppress overall wages, and deter adoption of productivity-enhancing efforts. It will also hinder the creation of high-skilled jobs and adversely shapes Malaysia's reputation as a low-skilled, labour-intensive investment destination. When taken together, these factors trap Malaysia in a low-wage, low-productivity bind. The prevalence of large segments of undocumented workers in Malaysia compound the socio-economic costs.

While this challenge may seem daunting, critical reforms are very much within Malaysia's reach. Clear communication and firm implementation will help reduce the risks of policy reversals, and will aid Malaysia's transition into a high-income economy. If history were to serve as a guide, Malaysia's current economic strength is a result of bold reforms taken at the most critical junctures. Malaysia should seize the opportunity now to set itself on a more productive, sophisticated and sustainable economic growth path going forward.

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A Critical Assessment of Direct Investments Abroad (DIA) and the Changing Nature of Foreign Direct Investments (FDI)[1]

Introduction

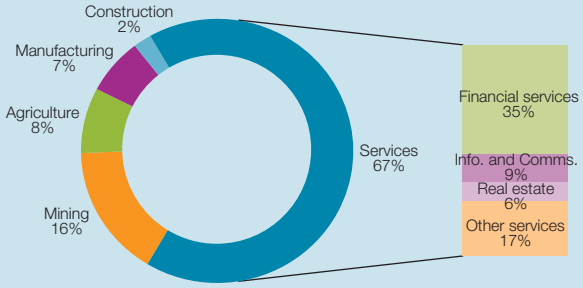
Building on from previous articles on the performance of Malaysia's direct investments abroad (DIA)[2] and investment incentives framework[3], this article presents a critical assessment on the positive spillovers and policy challenges of DIA and FDI to the Malaysian economy. A broad framework in assessing the costs and benefits of both DIA and FDI is applied, combining quantitative and qualitative perspectives. This includes measurable impacts such as investment, exports, value added, and employment; and associated costs such as tax revenue foregone, and investment income payments. We also take into consideration the less tangible benefits and costs associated with DIA and FDI, and the overarching backdrop of rapidly-changing global economic, industrial, and technological trends. The article concludes with a discussion on policy strategies, with an eye on ensuring the country maximises the economic and financial benefits from these ventures, and minimises potential exposure to risks.

I. Developments and Drivers of Direct Investments Abroad (DIA)

DIA by Malaysian companies has increased at a rapid pace, reflecting the maturity of domestic firms and limited domestic natural resources, facilitated by strategic national policy initiatives. Since 2001, on average, the stock of Malaysia's DIA increased by 20.7% per annum, from RM31.7 billion in 2001, to register outstanding DIA of RM522.5 billion as at end-2017. Between 2005 through 2014, DIA flows have averaged RM39.1 billion per annum, or 4.7% of nominal GDP. Since 2015, however, DIA flows have moderated somewhat, with average outflows amounting to RM33.7 billion per annum, or 2.7% of GDP between 2015 and 2017, reflecting a more cautious approach given greater uncertainty in the global growth environment and low global oil and commodity prices since December 2014. The depreciation of the ringgit in this period, which rendered investments abroad more expensive for domestic firms, may have also contributed to the moderation. As at end-2017, DIA was accumulated mainly in the financial services sub-sector (34.7% of outstanding DIA), followed by the mining and agriculture sectors (15.8% and 7.8%, respectively), and the information and communication services sub-sector (9.1%). By destination[4], DIA was channelled mainly to Southeast Asian economies, particularly Singapore and Indonesia, followed by European countries, and North America, particularly to Canada (Chart 1)[5].

Chart 1: Outstanding Direct Investments Abroad

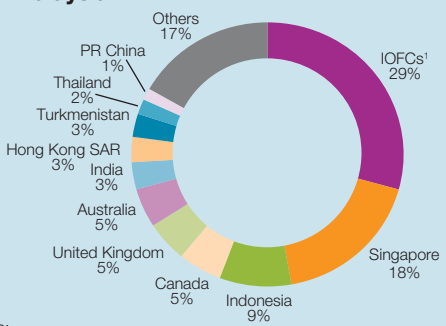
i) By economic sectors: DIA largely concentrated in the services sector



Note:
Banks and insurance companies account for 23% of DIA stock in the financial services sub-sector (or 8% of total DIA stock). The remaining 77% (27% of total DIA stock) comprise investment holding companies. Figures may not add up due to rounding.

Source: Department of Statistics, Malaysia

ii) By immediate destination countries: Southeast Asia, Europe and North America are the largest destinations for Malaysian DIA



Note:
International Offshore Financial Centres (IOFCs) include Mauritius (7%), Cayman Islands (6%), Isle of Man (5%), Bermuda (5%), British Virgin Islands (3%), Netherland Antilles (2%), Marshall Islands (1%), Bahamas (1%), Jersey and Seychelles (1%). Figures may not add up due to rounding.

[1] This article was written in collaboration between the Economics and Foreign Exchange Administration Departments.
[2] BNM Annual Report, 2016. 'Payoffs from Going Global: Assessing the Returns from Malaysia's DIA'.
[3] BNM Quarterly Bulletin, 3Q 2017. 'Rethinking Investment Incentives'.
[4] In line with the 6th Edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6), Malaysia's DIA data is recorded by immediate destination basis, and not the ultimate country of destination.
[5] DIA intermediated through IOFCs account for 29% of outstanding DIA stock. Investment via IOFCs, where investable funds are pooled before being directed to economic sectors in various locations, is a common global practice for companies operating internationally.

DIA was initially driven by the pursuit of natural resources in the 1980s and 1990s, mainly undertaken by Government-linked companies (GLCs) in the oil and gas and palm oil industries. Since the mid-2000s, however, private companies, particularly in the financial services and telecommunication industries, began to display greater interest and capability in venturing abroad to expand into new markets and customers, achieve greater economies of scale, and acquire strategic assets. These developments took place amid increased regional economic cooperation through bilateral and regional agreements, and are complemented by national policy initiatives, particularly the progressive liberalisation of foreign exchange administration (FEA) rules on residents' investments abroad in 2005. The flexibility to mobilise foreign currency funds was a key enabler for Malaysian firms to pursue opportunities abroad and strategic tie-ups with established international industry players, access new markets, acquire technical know-how, and fast-track technological transfers in various phases of the production process. Additionally, domestic industrial policies have nurtured market leaders well-placed to advance the strategic interests of the country in key industries. Furthermore, the development of the financial system in Malaysia has given rise to a strong banking system and large base of capable institutional investors, including provident and pension funds, and private and public asset managers, who invest the nation's savings abroad to maximise returns and diversify risk exposures. DIA was further supported by macroeconomic push factors, such as the strengthening of the ringgit between 2005 and 2013, and, after the Global Financial Crisis, the lower interest rate environment and relatively strong growth of emerging markets, which led to more attractive valuations of foreign assets.

II. Spillovers from DIA to the Malaysian Economy

(i) Establishment of the Malaysian Brand in the Global Market

In the past few years, we have begun to witness positive spillovers from DIA through the establishment of the Malaysian brand in the global market, and the increased benefits accruing to large Malaysian conglomerates. These companies, who are already market leaders in their respective industries, have investments that span across the globe and have since been recognised as capable industry players in their own right. As a result, fourteen Malaysian companies are ranked in the "2017 Forbes Global 2000" list of the world's largest public companies[6]. Unsurprisingly, the country's home-grown oil and gas company was the 125th largest corporation by total revenue on the "Fortune Global 500" list, topping the rank for Malaysia. The Bank's industrial engagements have also uncovered some anecdotal evidence of more intangible benefits, in the form of technological and knowledge transfers in selected industries like the utilities, financial services, leisure and hospitality, and tourism industries (please refer to the 'Information Box on Case Study of Top Resident Investors' at the end of this article, for more details).

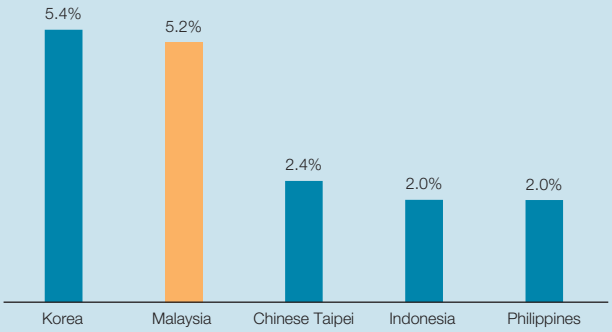
(ii) Limited Evidence of Domestic Spillovers and Forward Linkages

Malaysia's DIA has generated a return on its outstanding assets (return on assets, ROA) of 5.2% per annum, between 2010 and 2017. Compared to regional peers, Malaysian corporates have performed relatively well on their investments abroad (Chart 2). The investment income accrued from DIA has helped offset some of the primary income payments in the current account. While the primary income deficit has remained sizeable (amounting to an average of RM32.1 billion per annum between 2010 and 2017), without the commensurate increase in income receipts from DIA, these deficits would have been almost double (at RM63 billion per year, on average). From the international investment position (IIP) perspective, DIA has also diversified Malaysia's external asset composition. In 2004, the proportion of external assets was heavily dominated by official foreign exchange reserves (60.6% of total external assets in the IIP; DIA share: 11.7%). As at end-2017, however, the DIA share of total external assets increased to 31%, with reserves accounting for a smaller share (24.6%). The diversification of external assets is important, given that the large portion of external liabilities is accounted for by domestic corporations and banks. A more balanced risk portfolio in terms of the composition of external assets and liabilities ensures that the country is not solely reliant on reserve assets to balance its external liabilities exposure.

[6] By order, these companies are Malayan Banking Berhad, Tenaga Nasional Berhad, Public Bank Berhad, CIMB Group Holdings Berhad, Sime Darby Berhad, Genting Berhad, Petronas Chemicals Group Berhad, RHB Bank Berhad, Hong Leong Financial Group Berhad, Axiata Group Berhad, MISC Berhad, Maxis Berhad and AmBank Group and Petronas Gas Berhad, as listed.

Chart 2: Return on Assets of Direct Investments Abroad

Malaysia's DIA one of the best performers in the region



Notes:
1. Average return on DIA between 2010 and 2016 for Chinese Taipei
2. DIA stock for Indonesia and Philippines as at end-3Q 2017
3. Approximated 2017 annual income data for Philippines

Source: Department of Statistics, Malaysia, National Authorities, and Bank Negara Malaysia estimates

Economic theory, however, suggests that investments abroad should enhance trade and investment linkages and performance, foster internationally-competitive firms, increase high-technology industrial clusters and high-skilled employment domestically, and even increase the Government's tax revenue through stronger and more sustainable growth. Of interest, studies on the domestic impact of DIA on home countries have been relatively limited, compared to studies on the impact of FDI on host countries. This is partly due to the lack of comparable and reliable data, particularly for emerging and developing economies. For advanced economies, while findings are generally rather mixed, literature indicates that DIA tend to have positive spillovers in the home country, in terms of economic and domestic investment growth, high-skilled job creation, technology transfers, and exports performance. More recently, a few studies reported that Korean DIA has been found to have a positive impact on exports, domestic productivity, and employment. These trends may be different, however, for different sectors in which DIA has taken place, and even according to the different investment destinations[7].

For Malaysia, the domestic economic spillovers of DIA are not yet discernable. Findings from empirical studies indicate DIA has not been found to have a positive correlation with Malaysia's growth or trade performance, raising concerns that DIA may have come at the expense of growth domestically. Low domestic spillovers may also point to the limited formation of deeper backward linkages[8]. This may be due to the fact that DIA is largely concentrated in the services sector, which may offer fewer opportunities to form backward linkages, compared to sectors like manufacturing. Insights from industrial engagements allude to other structural constraints, such as the relatively lower capabilities of domestic firms to provide products and services meeting both the needs of Malaysian firms conducting businesses abroad and foreign firms operating in the country. These studies also point to the difficulties in quantifying the domestic impact of outward investments by resident companies. Even with tangible impacts like exports, investment, and employment, data limitations may limit deeper quantitative analysis, while more qualitative indicators like technology and knowledge transfers, and upgrading of value chains present an even bigger challenge.

Low repatriation from income and dividends earned from investments abroad is another factor that underscores the low impact of DIA on the domestic economy (for more details, please refer to the Information Box on *'Case Study of Top Resident Investors'*). Between 2010 and 2017, DIA have accumulated income amounting to RM149.4 billion, of which 30.1% are retained abroad for reinvestment and 51.8% are declared as dividends.

[7] Kim, S (2000) and Ahn et al (2005). Positive correlation with trade is more statistically significant for 'high-tech' and 'medium-tech' industries. While DIA is positively correlated with total factor productivity and employment in general, DIA into PR China displays a negative effect.

[8] Goh and Wong (2014), Goh et al (2013), Wong (2013) and Chen et al (2012).

Estimates using internal data on cross-border banking flows indicate that only 51% of income are repatriated back to Malaysia. Out of these, an even smaller proportion are permanently retained in Malaysia to be re-channelled into further expansion of domestic operations or investment in domestic activities. In sum, the cost and benefit analysis of DIA must account for a wider set of considerations, and extend beyond simplistic profitability considerations for the investor.

(iii) Challenges and Concerns Surrounding DIA

On occasion, a few DIA projects have also been confronted with external headwinds and exposure to regulatory uncertainty, which may have affected the viability and profitability of these particular investments, and attracted prominent media attention. These include regulatory changes and restrictions in host countries, stiffer-than-expected competition in certain sectors, acquiring investments at high valuations, and venturing into assets beyond core business sectors or mandates. In addition, the rapid expansion of domestic banking groups across borders has contributed to greater interlinkages and increased complexity in managing potential risks to financial stability. These include increased complexities in terms of ensuring compliance with regulatory developments, managing enterprise-wide capitalisation, liquidity and business risks, and undertaking recovery and resolution planning. These observations, however, should not be generalised to represent the entirety of Malaysia's DIA. As noted earlier, on the whole, Malaysia's DIA has performed relatively well. At 5.2% between 2010 and 2017 ROA is slightly above the average global growth of 3.9% in the same period, and comparable to average regional[9] growth rates of 5.3%.

III. Developments and Drivers of Foreign Direct Investments (FDI)

Foreign direct investments have been a key driver facilitating Malaysia's productive expansion from a commodity-dependent, agriculture-based economy into an industrialised economy with a vibrant manufacturing base well-positioned in the regional and global trade value chain. The rapid industrialisation of developing countries in the 1970s-1980s was a pivotal period, with significant investments by multinational corporations in Malaysia, particularly in the manufacturing and mining sectors. These developments were shaped by the intensification of global manufacturing value chains, technological progress, a favourable demographic profile, and modern domestic infrastructure. At the same time, key domestic policies such as the Promotion of Investments Act 1986, liberalisation of foreign equity rules in the manufacturing sector, and the gradual liberalisation of foreign equity rules in selected services sub-sectors have continued to attract foreign investments and enhance the competitive environment in domestic industries. In the last 16 years, outstanding FDI in Malaysia increased by 9.9% per annum, from RM129.1 billion in 2001 to RM565 billion as at end-2017. In terms of economic sectors, FDI has been channelled mainly into the manufacturing sector (41% of outstanding FDI), followed by the financial services, wholesale and retail trade, and mining sectors (21.3%, 7.2%, and 6.9%, respectively). Most FDI flows are from regional economies like Singapore, Japan, and Korea, again underscoring the importance of regional trade and investment ties; followed by investments from Europe and North America (Chart 3).

IV. Benefits and Costs Associated with FDI

(i) A Catalytic Force in Malaysia's Economic Development

FDI is widely-acknowledged to have been a game-changer in Malaysia's economic development and came at the right time for Malaysia to partake in the globalisation surge that began in the 1980s. The increase in FDI, which, at its peak, registered flows amounting to 10.5% of GDP in the 1990s, brought a corresponding rise in the share of manufactured exports, employment, and income per capita. According to newly-released Inward Foreign Affiliates Statistics 2016 (Inward FATS 2016) published by the Department of Statistics, Malaysia (DOSM), exports generated by foreign firms amounted to RM292.8 billion, or 31.8% of gross exports in goods and services in 2016. Foreign firms have also created job opportunities, directly employing 847,300 workers (approximately 5% of total employment)[10]. The productivity of FDI firms are also significantly higher than the national average, with value added per worker at approximately three times higher than national productivity levels, at RM237,000 per worker per year on average between 2010 to 2016, compared to RM72,520 per worker nationally.

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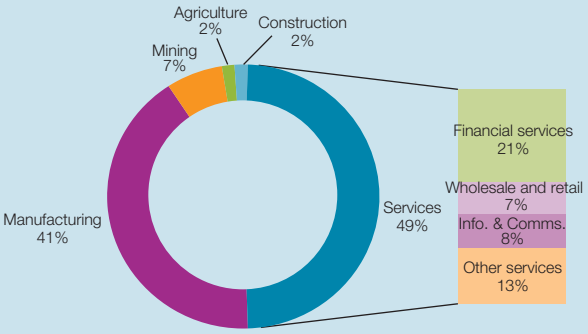
[9] Regional countries refer to Indonesia, Phillipines, Singapore and Thailand, which account for 29% of Malaysia's outstanding DIA stock.

[10] A key difference between FATS and direct investment data from the BOP is the equity threshold applied. Under BOP, a direct relationship is established at a 10% minimum equity stake in a related enterprise. Under FATS, control of an affiliate by an ultimate parent company arises when equity interest is more than 50%.

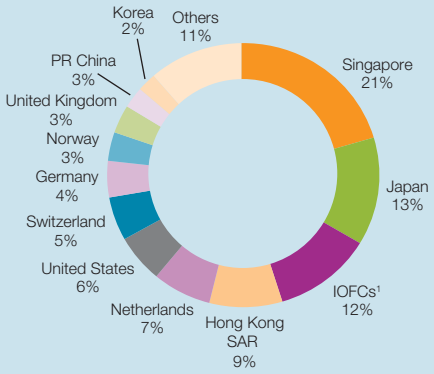
Chart 3: Outstanding Foreign Direct Investments

i) By economic sectors: FDI channelled mainly into the services and manufacturing sectors



Note:
Banks and insurance companies account for 63% of FDI stock in the financial services sub-sector (or 13% of total FDI stock). The remaining 37% (8% of total FDI stock) comprise investment holding companies. Figures may not add up due to rounding.

ii) By source countries: Largest FDI investors are from regional countries, Europe and North America



Note:
International Offshore Financial Centres (IOFCs) include British Virgin Islands (4%); Bermuda (3%); Jersey (2%); Cayman Islands (1%); Bahamas (1%); and Mauritus, Barbados, Panama, Samoa and Isle of Man (1%). Figures may not add up due to rounding.

Source: Department of Statistics, Malaysia

These investments have facilitated Malaysia's diversification away from a reliance on agriculture and minerals. This, in turn, has contributed to the fundamental strength of the economy. With the help of FDI and a rich and deep domestic ecosystem of production facilities, infrastructure, supporting services and talent, Malaysia is now firmly entrenched in the regional and global trade value chain.

(ii) Increasing Indication of Diminishing Net Benefits to the Economy

However, there is evidence that benefits to the country have been narrowing. The prevalence of labour-intensive and low-cost modes of production have led to the slow development of domestic value chains and ancillary services, and high reliance on imported goods, services, and foreign workers. This is evidenced by the slowing growth of domestic content in exports and lower spending on research and development by foreign MNCs. According to data compiled by the OECD, domestic content in Malaysia's gross exports is lower than regional average and regional economies (60.9% in 2014; regional average: 69%; Philippines: 76.3%; PR China: 70.7%). R&D spending by US FDI companies in Malaysia has also declined since 2012 (4.6% of total output; 3.6% share of output in 2014), and is lower than regional economies (India: 11.1%; Chinese Taipei: 4.9%; PR China: 4.5%)[11], indicating that technology transfers by foreign companies have plateaued. Inward FATS also point to other examples of waning benefits to the domestic economy, for example in declining shares of value added from foreign companies (2010: 19.5% of total value added; 2016: 18%), and investment (2010: 22.4% of gross fixed capital formation; 2016: 20.1%). Foreign firms have also contributed to the general trend of increased participation of low-skilled foreign workers in domestic industries[12]. While these trends are also contributed by local firms, unchecked reliance on low-skilled foreign workers have led to deep distortions, including the prevalence of low-skilled job creation and depressed wages in the Malaysian economy. The wider impact of these issues, such as stagnant wages amid rising cost of living, is disproportionately felt by the most vulnerable members of society. For example, reliance on low-skilled foreign workers tends to displace local workers in the low-skilled category, who also tend to be members of households in the bottom 40% of the household income distribution (B40). These industrial trends lead to the slow development of value creation among domestic suppliers and service providers, low pace of innovation and technological adoption, and wage and price distortions, which tend to outweigh some of the benefits of FDI.

[11] For a more detailed account, refer to Box Article on 'Rethinking Investment Incentives' in BNM's 3Q 2017 Quarterly Bulletin.
[12] For a more detailed account, refer to Box Article on 'Low-Skilled Foreign Workers and Its Distortions to the Economy'.

(iii) Costs and Leakages to the Economy

These concerns are especially stark when taking into account the cost of attracting foreign investments into the country. Over the years, the Government has deployed broad-based investment incentives to develop strategic industries and encourage desired economic activities. As previously estimated by Bank Negara Malaysia, the cost of incentives ranged between RM10 billion to RM15 billion annually, over the past five years, and account for up to approximately 9% of total Government tax revenue. These resources could have been channelled to improve public infrastructure and services, which are critical components in attracting and facilitating investments in the first place. There also appears to be a mismatch between the investments the country is receiving, and new growth areas in which the nation should be cultivating. For example, there is emerging evidence of increasing FDI in less productive sectors such as real estate and property development, particularly in segments in which policymakers have identified imbalances. FDI in the real estate and construction sector has risen in terms of share, from an average of 6.3% of annual FDI flows in 2010-2015, to 19.1% in 2016 and 2017. Industrial engagements suggest these investments are channelled mainly in the higher-end property segments. Other leakages include low domestic spillovers due to the high rate of income repatriation by foreign companies and high remittances from foreign workers, both of which are structural factors which weigh on Malaysia's current account balance.

Furthermore, the prevalence of fiscal incentives as a means to attract investment has come under scrutiny by international organisations, amid concerns of a 'race to the bottom' and wide-ranging changes in the regulatory environment aiming to discourage harmful tax practices. This also gives multinational companies the upper hand when it comes to deciding on an investment destination, and puts pressure on Governments to give in to the other immediate demands of industry, at the cost of strategic policy direction.

V. Policy Implications: A New Framework for Thinking about Investments

In the current highly-dynamic and complex economic environment, there is little room for complacency. Globalisation and technological disruption is rapidly changing consumer preferences, industrial trends, and business models. A fresh approach is needed, and policymakers must adapt to a new framework for thinking about investments. While traditionally, policymakers tended to place more emphasis on FDI, Malaysia is facing an interesting turning point. Aside from ensuring FDI remains an important contributor to economic development, we must also consider strategies to maximise backward and forward spillovers from DIA. These are challenging mandates but they are not insurmountable. The way forward lies in undertaking a rethinking of the national investment strategy and adopting a new approach to the cost and benefit analysis framework for both inward and outward investments. There also needs to be greater clarity in the direction of labour policy, particularly with regard to the role of low-skilled foreign workers in the economy. Communication on the Government's strategy on foreign workers need to be enhanced, alongside ease of obtaining information about current regulations, and offer clearly defined timelines on the gradual implementation of future regulations. At the highest level, however, policymakers have to agree on how Malaysia's DIA and FDI can best fit into global industrial trends and strategise accordingly, as regional countries such as PR China and Singapore have done.

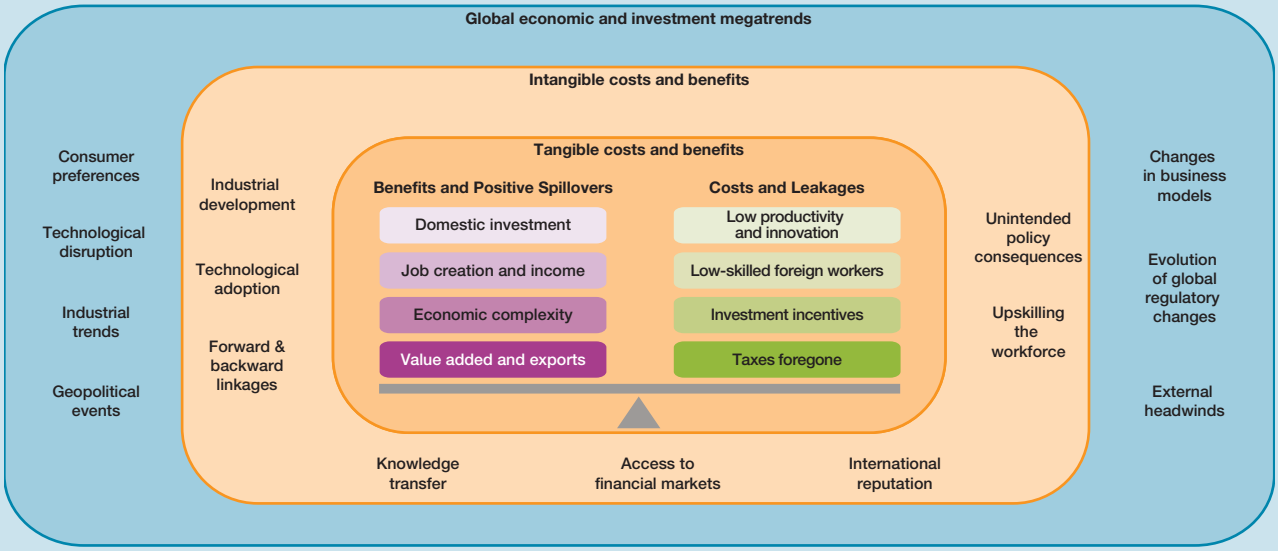
Towards this end, a broad framework in assessing the net benefits of both DIA and FDI is envisioned, combining quantitative and qualitative perspectives, and an overarching backdrop of rapidly-changing global economic, industrial, and technological trends (Illustration 1). Costs and benefits associated with both FDI and DIA includes measurable impacts such as investment, exports, value added, employment, and associated costs such as tax revenue foregone and investment income payments. We also take into consideration the less tangible benefits and costs associated with DIA and FDI, particularly the benefits brought about by technological adoption, development of industrial clusters, and potential distortions to industrial behaviour from previous regulatory barriers.

This new framework in weighing costs and benefits highlights several policy implications. Firstly, the effectiveness of the current strategy to attract investments needs to be reflected upon. Regulations must spur investors to innovate, adopt new technologies, and serve emerging consumer preferences and industrial trends. FDI and prospective

investments should deepen linkages in the domestic supply chain and build new value clusters. These investments should also exhibit desirable characteristics such as high-skilled job creation, and lift economic complexity and product sophistication[13]. Towards this end, a rethinking of the investment incentives framework is called for[14]. The decision on whether or not to award investment incentives should strike a balance between a nimble and flexible principles-based approach and a more decisive, performance- and outcome-based approach. Incentives awarded should be time-bound and tied to indicators on innovation, productivity, quality employment, and economic complexity. Malaysia cannot continue to rely on low-cost strategies to attract foreign investments, in an environment of increasing competition from other countries around the region.

Illustration 1: An Aspirational Cost-Benefit Analysis Framework

Considerations for investments must be broader than immediate impacts and profitability



Note: The indicators mentioned in the above framework are by no means exhaustive and serve as an illustrative example of a comprehensive perspective to assess the costs and benefits of both DIA and FDI.

Secondly and perhaps more challenging to achieve is the objective of maximising domestic spillovers from DIA. Efforts to promote two-way flows from investment activities and promote backward and forward linkages in the domestic economy must be strengthened. Part of this effort includes optimising the performance of Malaysian companies investing abroad. Korea, for example, facilitates local companies and SMEs in venturing abroad by offering investment consultancy services, which provides pertinent context on the social and political backgrounds of countries in which companies invest in. Through investment promotion agencies, the Government provides advisory services in terms of laws and regulations, and common challenges faced by foreign firms entering these markets. These services aim to reduce the incidence of companies falling into legal and regulatory pitfalls which could have been avoided, and prepare them for sector-specific challenges. Strategic and transparent communication of investment plans, particularly among GLCs and national institutional investors, would also be beneficial given the important roles that these companies play in the Malaysian economy. As discussed, a more dynamic investment incentives framework is needed to support this objective, coupled with more effective monitoring and enforcement to ensure performance measures are achieved, in line with investment approvals requirements and FEA regulations. This is complicated by the fact that domestic spillovers resulting from DIA activities may not be readily quantifiable due to data limitations and current frameworks for assessing the viability of investments abroad. Thus, a list of clear, principles-based requirements to complement quantitative indicators is warranted to comprehensively assess the

[13] For a more detailed account, refer to Box Article on 'Complexity and Growth: Malaysia's Position and Policy Implications'.
[14] For a more detailed account, refer to Box Article on 'Rethinking Investment Incentives' in BNM's 3Q 2017 Quarterly Bulletin.

likely financial and economic impact of investments abroad by domestic companies. Adoption of these policies will require implementation in a highly coordinated and cohesive manner to maximise the effectiveness of institutional support for DIA.

Finally, industry associations could also play a more constructive role in policy dialogue, either through providing industrial insights to national agencies, or by participating in policy ideation. Firms operating in the Malaysian economy must do so with a view of building a more facilitative industrial ecosystem, enhancing the functioning of domestic labour markets and continuously improving productivity. Initiatives by the Government such as the recently-introduced Employment Insurance System is necessary to enhance the flexibility of the labour market and encourage more efficient channelling of private savings. It has been observed that given the deep preponderance for low-cost models, there have often been strong industry pushback to Government-initiated reforms to lift labour or industrial standards. Corporate buy-in and meaningful participation is crucial in ensuring these key economic reform initiatives are implemented successfully. It is important to keep in mind that investments and economic progress in the economy must ultimately benefit the people and bring not only economic development, but also social progress.

Conclusion and Future Areas for Research

In summary, DIA has proven advantageous for certain domestic corporations, with some evidence of domestic spillovers in selected sectors. However, evidence of wide-ranging economic benefits of DIA have been inconclusive. On FDI, while the benefits to the economy are clearer, they are by no means constant or automatic. There is evidence that the net benefits to the economy is decreasing, amid the high costs of attracting foreign investments. Investment policy needs to be recalibrated such that the country does not rely solely on cost-pull factors to attract foreign investments, and to minimise economic leakages. The policy framework on investment needs to be reconsidered for both DIA and FDI, to ensure the country remains on track in its aspiration towards becoming a high-income nation. This would require that the country continues to invest in infrastructure and human capital and remove domestic impediments, so that it is always well positioned to ride the next wave of technological disruption and global economic megatrends. Going forward, a more concerted effort is needed to better quantify and assess the costs and benefits of both FDI and DIA. This includes conducting more research on the less-explored area of domestic complementarities of DIA, improving information collection and compilation methods to better quantify and take into account intangible impacts, and instituting greater discipline in enforcing a more comprehensive cost-benefit analysis framework which focuses on the wider impact of these investments. These policy tweaks to enhance backward linkages and spillovers from DIA and FDI are important, and they are a complementary effort in the long-run pursuit of efficient and functioning markets and high-quality infrastructure. Enhanced coordination between Government agencies and improved collaboration between the public and private sectors are necessary to strengthen the attractiveness of the domestic investment ecosystem for the sustainable long-term prospects of the Malaysian economy.

Case Study on Top Resident Investors

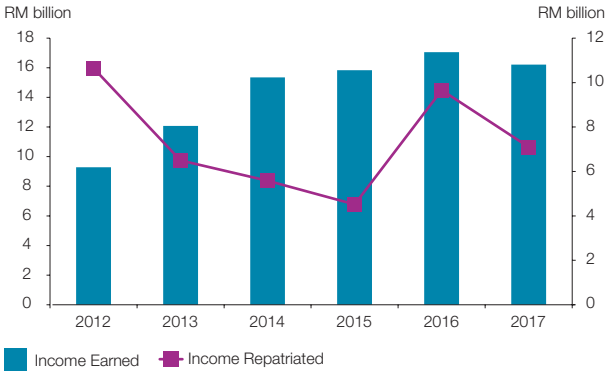
A series of industrial engagements and surveys on large DIA firms comprising of 52 companies which contributed to 60% of the total outstanding DIA stock as at 1H 2017[1] were conducted. The survey was aimed not only to gain insights into the financial performance of Malaysia's DIA but also to assess the intangible benefits of DIA to the domestic economy.

Moderate repatriation of financial returns

- Despite a challenging global economic environment, income on DIA remained stable for the past 6 years since 2012 reflecting the resilience of these investments. Of the DIA income earned, 51% (RM44.0 billion)[2] was repatriated with roughly equal share between GLCs and private companies. The remaining 49% (RM41.8 billion)[3] of DIA income retained overseas were used for reinvestment or paying off borrowings. Minimal conversion into ringgit is observed[4] from the repatriated income as it is generally kept in foreign currency to be re-channelled into new investments abroad, effectively leaving marginal amount for domestic utilisation.
- The moderate growth in investment income is also reflective of the relatively early stage of Malaysian DIA. Initially, DIA was mostly undertaken via greenfield ventures in which the payback periods were relatively long, ranging between three and 18 years. Following long gestation periods, some DIA started to yield return only recently. Over time, Malaysian corporates with increasing maturity started to undertake overseas expansion via brownfield ventures with shorter payback period ranging between three to five years.

Chart 1: Income Earned and Repatriated

Relatively stable income from DIA



Source: Bank Negara Malaysia

DIA has more apparent benefits in selected industries, as some sectors have benefited from technology transfer

- DIA can potentially expedite the technology transfer to Malaysia, especially in Malaysia's fledgling renewable energy sector. Acquisition of two brownfield projects in the United Kingdom and Turkey by the national power company can spur the development of Malaysia's own solar and wind power generation through technology transfer from global energy players. This is in line with the national strategy to develop renewable sources of energy as outlined in the Green Technology Master Plan Malaysia 2017-2030.
- Similarly, DIA in the leisure and hospitality sector has helped to develop a unique world class theme park in Malaysia through the participation of international producers and distributors of motion pictures. This bodes well for Malaysia's efforts to boost the tourism industry.

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[1] For the purpose of this article, companies incorporated in Wilayah Persekutuan Labuan are classified as non-residents, in line with treatment under FEA regulations.
[2] Figure excludes income earned by financial institutions and FEA treatment of Labuan as non-resident.
[3] Source: Bank Negara Malaysia.
[4] Source: Feedback from surveyed companies.

DIA not yet a catalyst for Malaysian exports

- While it is often acknowledged that DIA should facilitate greater market access, contribution to Malaysian exports via DIA has yet to be a reality. Only the plantation sector recorded some DIA related exports of equipment, machineries and fertiliser amounting to RM121 million between 2014 and 2016[5]. This amount is negligible compared to total exports from the country of RM2,330 billion in the corresponding period[6]. From this perspective, DIA has failed to spur Malaysian exports.

DIA in infrastructure projects abroad promotes Malaysia's brand and goodwill

- The success of Malaysian companies undertaking large scale overseas projects such as highways, power plants, and residential and commercial projects help to establish and elevate Malaysian corporates' reputation abroad. As at March 2017, Malaysia's corporates successfully completed 866 international projects with a combined value of RM92 billion and there are 55 projects still in the pipeline worth RM25 billion[7].

DIA benefits yet to be fully realised

- DIA flows are generally one way, as even repatriated income would be ploughed back into new investments, thus permanently impairing domestic liquidity in the process. There needs to be not only higher repatriation of DIA income but more importantly its conversion into ringgit should increase to replenish domestic liquidity and contribute towards more balanced flows in the onshore foreign exchange market. Based on anecdotal evidence, despite our GLCs and private companies undertaking large scale projects and huge investments overseas, the country's exports are yet to show a corresponding improvement due to DIA activities.

[5] Source: Feedback from surveyed companies.
[6] Source: Department of Statistics. Malaysia.
[7] Source: Construction Industry Development Board.

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