SUMMARY

Economic Environment

1. Malaysia's strong overall economic performance during the period under review was led by pragmatic economic management and appropriately calibrated macroeconomic policies. The economy continued to undergo a significant external rebalancing due to a decline in external surpluses, while policies continue to ensure sustainable and inclusive growth in order to turn Malaysia into a high income country by 2020. Despite a slowdown in total factor productivity (TFP) growth during 2008-12, Malaysia remains externally competitive with its comparative advantage seemingly shifting from electrical goods and electronics manufacturing towards processed commodities and natural gas.

2. Malaysia's economy recovered rapidly from contraction in 2009 and moved towards more sustainable and moderate growth rates as, *inter alia*, the engines of growth shifted markedly from export-oriented manufacturing to domestic services. Robust domestic demand offset external weakness and fuelled growth at an annual average rate of 4.1% (2009-12). Malaysia's low inflation rate rose steeply from 2009 to 2011 due to temporary supply-side and cost-related factors, before falling in 2012 to below its 2010 level of 1.7%, one of the lowest in the Asia-Pacific region. In addition, its low official unemployment rate has further declined to 3% in 2012.

3. During the period under review, a slightly accommodative monetary policy continued to strike the right balance between supporting growth and keeping inflation in check. The benchmark interest rate at 3% has remained unchanged since May 2011, resisting a renewed trend among regional peers toward lowering rates. In 2011 and 2012, the real effective exchange rate of the ringgit fluctuated narrowly after a strong appreciation between September 2009 and April 2010. In line with its various capital markets and financial-sector development plans, Malaysia has relaxed or abolished several foreign-exchange policies. Its fiscal deficit declined gradually from 6.7% of GDP in 2009 to 4.5% in 2012 while Government debt is estimated to have risen to just below the self-imposed ceiling of 55% of GDP. Plans for fiscal consolidation, tax reform, and expenditure rationalization are under way. Several key initiatives have been implemented to improve public finances, including the resumption of subsidy rationalization. The long-awaited goods and services tax (GST) is to be implemented by April 2015.

4. Despite a significant narrowing, the trade and current account balances remain in surplus. Malaysia's adequate foreign exchange reserves rose steadily between 2009 and 2011, after which they evolved around a relatively flat trend; as of 15 November 2013, they were US$136.7 billion (9.7 months of imports, 3.7 times the short-term external debt). External debt (short-term) rose steadily during the period under review (except for 2012).

5. Malaysia's economy remains strongly outward-oriented, with trade in goods and services accounting for 162.4% of GDP. Although relatively well diversified, a considerable proportion of its foreign trade is increasingly intra-regional (Asia-Pacific); the share of commodities in total trade rose, but manufactures remain the main traded goods.

6. Between 2008 and 2012 Malaysia's FDI stock rose by 58.8%, the same pace as its equally important stock of direct investment abroad, and continued to be mainly directed to manufacturing and services activities. The EU and Singapore remained the main FDI stockholders. FDI inflows eased somewhat in 2012, reflecting the uncertain global economic outlook and the diminishing appeal of Malaysia as a base for labour-intensive industries.

7. Malaysia has undertaken a major liberalization effort in its services sector since 2009, removing or reducing restrictions on foreign equity participation in a swathe of services subsectors. While a full list of remaining FDI caps across all sectors of the economy was not available, FDI limits were identified in the context of this Review in: fisheries, energy, telecommunications, telecommunications, and air and maritime transport. Foreign participation in public-private partnership projects may only be considered in certain cases. The investment environment remains affected to a certain extent by policies favourable to the *bumiputera* community and Malaysians in general.

Trade Policy Framework

8. The direction of Malaysia's trade policy remains focused on ensuring that Malaysia becomes a self-reliant and industrialized nation by 2020. Emphasis is, *inter alia*, being placed on integrating Malaysian companies into global value chains and developing commercial ties with new markets. There have been no changes to the institutions responsible for trade policy formulation since 2010. Various new trade-related laws have entered into force: the Quarantine and Inspection Services Act, the Strategic Trade Act, the Competition Act and the Price Control and Anti-Profiteering Act.

9. Malaysia continues to negotiate new regional trade agreements (RTAs) both bilaterally and together with its ASEAN partners. Seven new RTAs entered into force for Malaysia during the review period. Three are ASEAN RTAs with third countries (Australia and New Zealand, India, and Korea), and four are bilateral agreements (with Chile, India, New Zealand, and Australia). Malaysia has signed and ratified the Trade Preferential System of the Organization of the Islamic Conference (TPS-OIC) and the Developing Eight Preferential Tariff Arrangement (D8-PTA); these are expected to enter into force imminently. Malaysia is in the process of negotiating RTAs with Turkey, the European Union, and the European Free Trade Association. It is a participant in the Trans-Pacific Partnership (TPP) negotiations as well as in the ASEAN Regional Economic Partnership (RCEP) negotiations.

10. At the ASEAN level, efforts are focused on achieving an ASEAN economic community by 2015; three new ASEAN agreements entered into force over the review period: the ASEAN Trade in Goods Agreement (ATIGA); the ASEAN Comprehensive Investment Agreement (ACIA) and the ASEAN Agreement on Customs in 2012. Additionally, there has been further liberalization within ASEAN with respect to trade in services, financial services, and air transport. ASEAN Regional Comprehensive Partnership negotiations are on-going.

11. During the period under review, Malaysia was not involved in any new WTO dispute settlement cases either as complainant or respondent. It has maintained a consistent flow of notifications to the WTO, although notifications are outstanding in a few areas, while in a few others (e.g. tariff-rate quotas, domestic support in agriculture) there have been relatively long submission gaps. Reforms undertaken since 2010 to improve the business environment in Malaysia have included cutting processing times for dealing with customs permits; eliminating and simplifying licensing requirements; and reducing the time required for the approval of construction permits. Additionally, a National Policy on the Development and Implementation of Regulations, issued in 2013, requires federal government entities to follow certain steps in developing regulations affecting business, trade, and investment. A National Committee on Investments (NCI) was established in 2010 to assess and approve investment projects in a more swift and streamlined fashion, and in the same year the Malaysia Corporate Identity (MyCoID) scheme was introduced to simplify business interactions with multiple government agencies.

Trade Policy Developments

12. The tariff remains one of the main trade policy instruments, albeit a minor source of tax revenue (1.3% of total tax revenue in 2012). Following the adoption of the HS 2012 tariff nomenclature, Malaysia's customs tariff was streamlined by reducing the number of its tariff lines (by 9.3%). The tariff involves a multiplicity of rates (19 *ad valorem*, 19 specific, 11 compound, 2 alternate duties), whose number remains virtually unchanged since 2009. As a result of unilateral tariff cuts during the period under review the average applied MFN tariff rate dropped from 7.4% in 2009 to 5.6% (2013). Tariff dispersion was reduced, though tariff escalation remains pronounced. Tariff rates continue to range from zero to 90%, although non-*ad valorem* tariffs tend to conceal much higher peak rates; 80% of rates were 10% or below in 2013. While more than 80% of tariff rates are bound, the average gap appears to have risen to at least 10 percentage points between applied and bound MFN rates, thus allowing considerable leeway for raising applied tariffs, though this does not seem to have occurred during the period under review. The gap between the simple average applied MFN tariff rate and the average preferential rate on imports from different preferential or FTA trading partners was also reduced.

13. Trade facilitation was strengthened by, *inter alia*, further shifting customs clearance from clearance-based controls to post-clearance audit controls; Malaysia's ease of trading across borders remains highly ranked in international comparisons.

14. Import prohibitions are maintained mostly for national security, religious, and environmental reasons. A considerable portion of Malaysia's tariff lines remain subject to import licensing, most of which is non-automatic and continues being used as a tool of trade and industrial policy for, *inter alia*, regulating the flow of imports and promoting selected strategic industries. Although Malaysia's recourse to anti-dumping action dropped markedly, with no case initiated from 2007 to 2011, in 2012 investigations were launched on imports of steel wire rod, biaxially oriented polypropylene film, and hot rolled coils, virtually all of Asian origin.

15. Export taxes (1.5% of total tax revenue in 2012) and/or restrictions, which are applied to certain goods (e.g. timber, crude palm oil), continue to, *inter alia*, discourage exports of certain commodities and essential goods and reduce their domestic prices, thereby ensuring adequate domestic supplies and assisting downstream processing of the products concerned. Exports of price-controlled essential goods (i.e. wheat flour, diesel, petrol RON 95, liquefied petroleum gas, sugar, and cooking oil), four of which are subsidized, are prohibited unless approval is granted. Import duty exemptions or drawbacks for intermediate goods used in the production of exports are in place so that the import duties do not feed through to become implicit taxes on exports. Support is available for exports of certain fresh and dried fruits, fresh and dried flowers, ornamental plants and ornamental fish, and manufactures, in the form of statutory income tax exemption ranging from 10% to 50% of the value of increased exports depending, *inter alia*, on the activity, value-added and/or ownership. Similar exemption of statutory income tax equivalent to 50% of the value of increased export is available to companies in selected services sectors. Other support measures remain in place, such as export processing zones involving local content requirements (since 2011), concessionary credits, insurance, and guarantees, as well as government-sponsored promotion and marketing assistance.

16. Measures involving grants, tax concessions, and low-interest loans continue to support production and trade of various agricultural and manufactured products, and encourage SMEs, R&D, and environmental-protection activities. The Malaysian economy remains one of the most highly subsidized in the region and the world. A reform aimed at rationalizing the subsidies regime on gasoline, cooking gas, electricity, and road tolls was launched but has accomplished little so far; renewed emphasis was placed on these efforts in October 2013.

17. Standards improvement and development activities remain among Malaysia's priorities for achieving developed-nation status by 2020. During the period under review the share of compulsory Malaysian standards and standards aligned with international standards continued to rise. Regulatory and institutional improvements were undertaken in the area of SPS. Further emphasis has been placed, *inter alia*, on halal certification and biosafety issues.

18. State involvement in the economy persists in numerous areas (e.g. oil, gas, key strategic utilities, and services) although competition challenges for government-linked companies (GLCs) were intensified due to several developments. Efforts to improve their productivity seem to have borne fruit in some cases. Preferential government procurement procedures and expanded countertrade/offset requirements continue to be used as an instrument of industrial policy to favour locally owned businesses; international tenders are invited only if goods and services are not available locally. GLCs, which are not governed by the public sector's procurement rules and regulations, are encouraged to purchase from locally owned businesses. Malaysia became an observer to the WTO Agreement on Government Procurement in 2012, and efforts were undertaken to improve transparency and "integrity pacts" in its procurement procedures.

19. During the period under review significant changes were brought to the legal and institutional framework governing competition policy, which also covers GLCs, but not certain anti-competitive practices, agreements or activities covered by their individual legislation (e.g. energy and communications). Price and supply controls over essential goods and services were reinforced, while sugar price subsidies were abolished and those on petrol were reduced. Consumer protection was strengthened in several areas (advertisements, personal data protection, credit sales, consumer redress). Substantial progress was made in further improving the regulatory framework of corporate governance by, *inter alia*, raising standards in this area.

20. Malaysia strengthened its intellectual property regime through significant amendments to its patent, industrial designs, copyright and trade mark laws and/or regulations, and expanding its international commitments. Its proactive enforcement approach was intensified with new initiatives (e.g. Basket of Brands (BOB) scheme).

Sectoral Policy Developments

21. The contribution of agriculture (including forestry and fisheries) remains at around one tenth of GDP. However, continuous adoption of new technologies has enhanced its TFP growth, while the self-sufficiency ratio for major agricultural products remained largely stable during the review period. The new agricultural policy supports the development of the agri-food industry with emphasis being placed, *inter alia*, on promoting biotechnology as well as high value agriculture. Malaysia continues to maintain a relatively liberal trade regime for agriculture with generally low applied MFN tariffs averaging 2.9% (WTO definition) in 2013. However, peak non-*ad valorem* tariff rates maintained almost exclusively on certain agricultural products continue to allow for higher tariff protection (*ad valorem* equivalents up to 1,439.2% for alcoholic beverages, tobacco refuse). Tariff-rate quotas related to multilateral agricultural market-access commitments with in-quota rates ranging from zero (round cabbages) to 25%, and out-of-quota rates from 20% to 90% (round cabbages), remain in place. The Government also implements measures to support the domestic processing of certain agricultural products (e.g. through non-automatic export licensing and export duties) as well as to promote exports (e.g. through corporate tax relief); export duties on crude palm oil were considerably reduced to improve its export competitiveness and reduce domestic stocks. Malaysia continues to provide increasing amounts of product-specific support (i.e. price support to paddy rice) and general support (e.g. fertilizer subsidies, and soft loans) mainly focused on rice-related activities. Rice is a strategic crop for which the authorities revised their approach by ensuring the availability, accessibility, and affordability rather than self-sufficiency. It remains the sole item subject to the import monopoly of the firm Padiberas Nasional Berhad (BERNAS), non-automatic import/export licensing, and price and supply controls. Fish production targets have been largely exceeded, despite the use of precautionary measures, such as the limitation on licences issue. A fisheries input control regime and certain resource enhancement and environmental-sustainability measures are in place. Domestic support for fisheries has included additional diesel fuel subsidies (until end May 2011 for trawlers above 70 GRT).

22. The contribution of mining (including fuels) and quarrying to GDP dropped slightly to 10.4% in 2012. Mining products remain subject to relatively high tariff protection, ranging from zero to 50% (portland cement), export licensing, and export taxes, thereby assisting downstream processing.

23. During the review period, efforts were made to reduce Malaysia's dependence on oil and gas and to cope with rising energy demand by increasing the share of renewable sources in the total primary energy supply. However, in spite of these efforts, the contribution of renewable energy remains negligible. Some action was also taken to improve energy efficiency. Energy subsidization for all consumers remains a major and long-standing fiscal, budgetary, developmental, environmental, and thereby political issue. State involvement in the oil, gas and electricity sectors persists, with government-linked company PETRONAS remaining the biggest contributor to the government budget. It allows, *inter alia*, for subsidization of power generators through a government-imposed low natural gas price, a pass-through element that is intended to benefit the end users. Furthermore, electricity tariffs vary depending on the category of users and their consumption, thus allowing for cross-subsidization among different consumer groups; for example, average tariffs for commercial and agricultural activities are higher than those charged to industrial and residential consumers.

24. Whereas manufacturing's share of GDP decreased slightly over the review period, its share of employment remained relatively stable. Manufacturing ranks 3rd behind construction and services in terms of TFP growth. With the notable exception of automotive products, manufacturing remains relatively open to both trade and foreign investment. Since 2009, Malaysia's average applied MFN tariff on imports of industrial products has dropped from 8% to 6.2% (2013) due to nomenclature changes. This level is more than double the average tariff level affecting agricultural products (WTO definition). Preferential treatment for locally produced goods in government procurement contracts, export licensing and export taxes on principal commodities, corporate tax exemptions for exports, and several tax and non-tax incentives for production and trade continue to support manufacturing activities. The automotive sector remains protected by an average applied MFN tariff of 17.3%, the highest of all HS sections, although tariffs on imports from ASEAN member countries were reduced to zero in 2010. Non-tariff measures such as the gazetted price system and the import licensing system of "approved permits" remain in place; the latter should be eliminated in the near future (2015, 2020). In

addition, an array of tax measures are still in use (e.g., high excise duties affecting disproportionately large vehicles, targeted excise duty exemption on sales of "national cars", and reduction on domestically assembled four-wheel-drive vehicles, and enhanced tax exemptions on statutory income from exports), as well as non-tax measures (soft loans and grants) within the framework of the National Automotive Policy.

25. The services sector continues to be a very dynamic segment of the economy, with annual growth averaging 5.9% over 2009-12. In 2012, it accounted for just over 50% of GDP and employment, and attracted the biggest share of the economy's approved investments. The Government has continued to autonomously liberalize foreign equity restrictions in a swathe of services sectors; in 2012 it commenced implementation of partial or complete lifting of foreign equity restrictions in 17 services subsectors, under 6 sectors: professional services; communications services; distribution services; educational services; environmental services; and health-related and social services. Over the review period Malaysia has undertaken comprehensive modernization and streamlining of its financial services legislation. New laws have removed the caps on foreign direct investment in the banking and insurance sectors. The issuing of insurance and banking licences is now based on prudential and the "best interest of Malaysia" criteria. Malaysia is seeking to promote itself as a centre for Islamic finance, health care, and education services, as well as a transportation hub for both air transport and shipping.

Outlook

26. Malaysia's economic fundamentals remain, by and large, sound. Despite its impressive rebound from the global financial crisis, Malaysia's economy remains vulnerable to exogenous shocks to global growth or risk aversion through international trade, commodity prices, and financial channels. Equitable and sustainable growth depends on implementing diversification and improved total factor productivity - enhancing structural reforms especially those aimed at addressing fiscal consolidation, tax reform and expenditure rationalization concerns. These and related reforms would increase the flexibility of the Malaysian economy and its ability to respond to growing external competition.