

Malaysia Macro View

Investor Trip Notes – Edging Closer towards Rate Normalization

We met policymakers and private sector economists from rating agencies in KL on April 1st. This note summarizes the key takeaways from the meetings.

- **Upside risks to export forecasts amidst domestic resilience** — BNM's wider 4.5-5.5% GDP forecast for 2014 should not be construed as a downgrade, with a higher probability of staying in the upper half of that range. Vs 2013, the global recovery is seen as "more forthcoming" if still uneven and official export forecasts could be revised upwards. Domestically, cuts in public investments could be offset by resilience in private investments, especially manufacturing FDI. Consumption has been resilient despite fiscal consolidation and debt service burdens, reflecting the firm labor market and possible front loading ahead of GST in Apr 2015.
- **Second round effect inflation risks closely watched amidst extended cost normalization** — BNM's 3-4% inflation forecast for 2014 already incorporates a broad range of RON95 price hike assumptions. While core inflation and internal surveys of price expectation have edged up, BNM does not see inflation as becoming more pervasive at this stage, while wage pressures are also mitigated by limited collective wage bargaining pressures. Nonetheless, amidst an extended period of cost normalization, private consumption growth above 7% or better than expected exports may prompt a re-assessment of demand pull pressures.
- **Rate normalization to resume once growth uncertainties subside** — Monetary policy is still viewed as "accommodative". Inflation need not be the only trigger, as second round effects could be mitigated by better communication strategy and non-monetary measures, e.g. price reduction campaigns. An equally important trigger could be concern over financial imbalances. Whilst targeted macroprudential measures have tackled pockets of imbalances, a reduction in growth uncertainties could spur excessive risk taking, on top of demand-pull inflation pressures. Simulations had shown debt service burdens would not be a constraint of higher interest rates. That said, private sector economists saw at most 25-50bps of hikes in 2H14, likely preceded by a SRR hike to raise the cost of funds and lending rates.
- **Fiscal reforms and deficit targets on track** — There was consensus that 6% GST implementation in Apr 2015 would go ahead as planned and would add RM3bn in revenues in 2015 and RM7-9bn in 2016, after taking into account loss of sales and service tax revenues. Delays in highway toll price hikes should not have a material impact on the 2014 Budget and were, in any case, viewed as unimportant relative to GST and subsidy cuts in RON95, which would be achieved via a combination of gradual price hikes (likely in 2Q14 or 3Q14) and reducing volumes. Policymakers remained confident of meeting the 2014 deficit target of 3.5% of GDP, helped by continued administrative efficiencies to increase the tax revenue share of GDP, rising oil production levels amidst new oil field discoveries, and expenditure cuts.

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Upside Risks to Export Forecasts amidst Domestic Resilience

Policymakers' assessment of the global economy is one of continued if uneven improvement, though they do see a recovery as more forthcoming compared to last year when Malaysia's exports saw 6-7 consecutive months of negative growth last year, necessitating a downward revision in forecasts. Since 4Q13 however, exports rebounded, though policymakers remain cautious.

The prognosis for advanced economy growth looks to be pointing up. The outlook for the US has improved, with less fiscal uncertainty, which could in turn lift capex and help Malaysia's exports – policymakers noted that Malaysia's exports to the US are more in finished goods rather than intermediate exports. Meanwhile Europe's economy is coming up from a low base, which should still be positive for Malaysia's exports – recent exports to Europe, mainly in electronics and semiconductors, have already done very well. Even in Japan where the impact of the consumption tax hike is still unclear, policymakers think growth momentum could be sustained – in any case, Malaysia's trade with Japan has diminished in recent times, especially in terms of finished goods, though Japan remains a top export destination due to LNG exports after the Fukushima nuclear disaster.

Instead, there was much greater concern over China, with its much slower growth projections of 7-7.5%, exuberant credit growth, and pervasive shadow banking. While efforts to engineer a soft landing for the Chinese economy are making progress, policymakers think that any negative surprises from China will likely hit Malaysia less from the financial channel and more from the trade angle – policymakers noted that regardless of whether Malaysia's exports to China are for China's domestic demand or intermediate good exports for processing, China remains Malaysia's largest trade partner, not to mention the inevitable indirect impacts of slower Chinese growth on demand from Malaysia's other trade partners.

Overall, with the improved external outlook, policymakers think Malaysia's baseline growth this year would still be better than in 2013, though the recent widening of the official forecast range to 4.5-5.5% from 5-5.5% was an acknowledgment of the downside risks and should thus not be seen as a downgrade. We suspect policymakers' base case scenario remains for growth to materialize in the upper half of the expanded forecast range, still higher than the 4.7% growth in 2013. With commodity price trends pointing towards a positive GDP deflator this year of around 2-3%, nominal GDP growth could come in at 7-8%.

Policymakers think exports for example could surprise on the upside, especially as IMF global growth forecasts could be upgraded. The gross exports forecast of 5.8% now looks too conservative after double-digit growth in the last quarter. While Malaysia's export outlook remains dependent on E&E, semiconductor sales have been improving amidst E&E inventory re-stocking, while capacity has expanded after the increased manufacturing investment approvals in the last three years, especially towards higher value-added activities. Meanwhile commodity prices have turned out better than expected in CPO and Tapis oil for example, which have translated into export revenues. Nonetheless there remains the risk of volatility in the external outlook in 2H14.

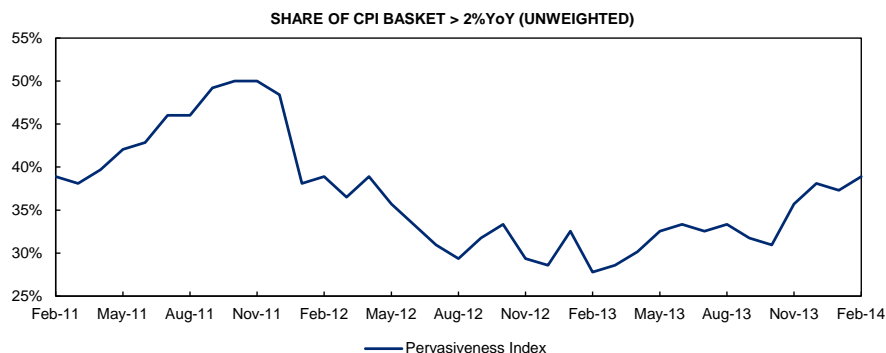
Domestic demand is expected to be anchored by private investments which are expected to remain sustained, especially given the pipeline of projects with long gestation periods – evidence of which is already in the BoP FDI figures which hit a record RM38.8bn in 2013 as well as record MIDA investment approvals. While FDI in solar has moderated, other segments like medical devices and sensors have been increasing and these investments have become more geographically-diversified. This should help offset the cuts in public spending as fiscal consolidation comes through, and should keep growth primarily domestically-driven despite some reshuffling in growth drivers.

Policymakers did not seem particularly pessimistic on the outlook for private consumption. Private sector economists also expressed some surprise at the resilience of private consumption in weathering fiscal consolidation, perhaps due to continued access to credit from NBFIs (which have slowed but not as much as expected) as well as the still solid labour market, though the significance of frontloaded consumption ahead of the GST was unclear. With official 2014 household income growth projections coming in at 5-6% (2013: 6%) vs inflation of about 3-4%, policymakers still expect positive real income growth this year, helped by the continued low unemployment rate of 3.1-3.2% – and firm commodity prices fueling consumption for about 500,000 rural households. Nonetheless, with subsidy rationalization working in the opposite direction, policymakers seemed skeptical about whether private consumption growth could sustain the above 7% growth rates of recent years – in fact, **private consumption growth above 7% despite subsidy rationalization could be interpreted as a sign of excessive demand which may warrant a policy response.**

Risks of Second Round Effects in Inflation Closely Watched amidst Extended Cost Normalization

For now, policymakers continue to see inflation as primarily supply side-driven and not yet pervasive. While policymakers' preferred measure of core inflation (excluding administered price components) has also been edging up, they appear to be paying more attention to a pervasiveness index measuring the (unweighted) number of categories in the CPI basket registering price increases beyond 2%. The pervasiveness index still has not shown that prices are increasing beyond the immediate impact of recent administered price adjustments. Going forward, the official 3-4% inflation forecast already incorporates a variety of fuel price hike scenarios. While BNM's surveys of inflation expectations (which have yet to be made public) have edged up as expected, policymakers are yet to be convinced of second round effects.

Figure 1. Pervasiveness Index



Source: CEIC, Citi Research

Higher inflation expectations need not necessarily translate into more pervasive price pressures and a wage price spiral. Policymakers noted that Malaysia's current unemployment rate of 3.1% remains above the non-accelerating inflation rate of unemployment (NAIRU) is 2.7%, leaving little room for wages to escalate. While there have been some demands for higher wages, these are unlikely to be entertained – not only is collective wage bargaining relatively uncommon in Malaysia, there have already been big adjustments from the minimum wage and GLC wage hikes in 2013, which should have diffused some of the wage pressures in 2014. Even if demand picks up, this can likely be met and cost pressures alleviated with capacity expansions from previous investments. Policymakers see the output gap forecast of 0.5% of potential output (2013: 0.3%) as still relatively low and would be much concerned if it breached the 1% mark.

While the inflation pressures this time will likely be less acute vs the 2007-2008 inflation spike, policymakers noted the extended period of subsidy cuts and GST hike suggest high inflation could be more persistent – possibly about two years – given upcoming GST implementation next year which could have a first round inflation impact of about 1-1.3% (Citi: 1-1.4%). Policymakers emphasized that communication and track record will be key to managing inflation expectations in this long period of cost normalization.

Nonetheless even if policymakers are reluctant to hike rates, the politically-sensitive nature of inflation necessitates the use of non-monetary measures The government has implemented a number of non-monetary measures, including the improvement of distribution channels to ensure that there are sufficient channels to bring goods to market; 1Malaysia stores which receive heavy government assistance and thus receive an implicit subsidy on their fixed costs in addition to economies of scale; and “farmer's markets” which aim to cut out the middlemen (which the media has tarred as “traitor” profiteers) and sell directly to consumers. Prices have also been listed on the Internet to fight profiteering, while the Competition Commission has been busy keeping anti-competitive behavior in check. **Ultimately however, while these can complement monetary tightening, they are not a substitute.**

Concern over Financial Imbalances Could Trigger Rate Normalization Once Growth Uncertainties Subside

Overall, with inflation still manageable for now, we sensed financial imbalances may be the larger consideration for the interest rate outlook. Policymakers monitor credit growth especially to households and the property segment – not just in terms of headline credit growth but also quality and risk segment. The rate normalization cycle which commenced in 2010 had been interrupted due to the poor global growth outlook. The still low rates thus continued to fuel credit growth – interest rate hikes however were seen as a blunt instrument in responding to pockets of financial imbalances, so policymakers leaned on more targeted macroprudential measures. However macroprudential measures are not a cure-all - if rates are kept too low for too long, imbalances would continue to emerge. **Low financial returns on savings would also fuel excessive risk taking, especially when confidence over the growth outlook improves.**

Policymakers' concerns over non-bank lending have eased somewhat, especially as the Financial Services Act has placed the NBFIs under BNM's supervisory purview. While NBFIs have fueled personal lending, the salary deduction scheme for civil servants has ensured low delinquency rates. Nonetheless lower income groups remain highly leveraged – while leverage for those earning below RM3,000/month has stabilized at seven times annual income,

there should be scope to go down further. However policymakers emphasized that these groups are not a risk to financial stability, as the probability of default remains manageable.

However policymakers think housing price growth at 12% is still quite strong and that housing affordability – which is fueling household debt – can be improved further. There seemed to be a view that more draconian measures taken in Hong Kong and Singapore were not necessary for now, and policymakers preferred to lean on supply-side measures to bring down house prices – private sector economists noted that BNM's property measures in the late 1990s had been blamed for the property downturn, which could explain greater caution amongst policymakers on this front today. Property interest groups have been very active in lobbying against more cooling measures.

Some private sector economists were concerned about a brewing property bubble, especially in the luxury segment but spreading to the middle market segment. While there were relatively few transactions above RM1mn by foreigners, these are still setting new price benchmarks for the market. Vacancy rates are rising even for landed property and are even worse for condominiums. Policymakers noted that the growth in borrowers with more than three housing loans have moderated and account for just 3% of borrowers now, though these borrowers still buy a large number of assets in urban areas.

Importantly, policymakers continue to describe monetary policy as accommodative and identified global growth uncertainty as the main constraint to rate normalization for now. If growth uncertainties subside, this could spur excessive risk taking if interest rates remained too low, while a pick up in demand growth amidst a tight labour market would also intensify demand pull inflation pressures. Under such circumstances, a resumption of rate normalization that had started in 2010 would be warranted.

Policymakers stressed that debt service burdens will not be a constraint on policy rate action. While 70% of housing loans are on a floating rate basis, most car loans and personal financing and credit card loans on fixed rate basis, such that on aggregate only 50-55% of household debt is on floating. Simulations have suggested manageable increases in debt service ratios in the event of rate hikes, with a 50bp rate hike leading to less than a RM100 increase in affordable housing loan repayments. The IMF had earlier estimated that a 200bps hike in the OPR would raise aggregate debt service ratios by 4% (to 48%), and just 0.5% once higher interest income of savers were included.

While confident that rate hikes were a matter of time, private sector economists saw at most 25-50bps of hikes in 2H14, possibly preceded by a SRR hike to raise the cost of funds and lending rates. Some thought 50bps of hikes were out of the question to accommodate borrowers as policymakers may be concerned that the domestic demand shock could be larger than expected. Under the new interest rate framework, SRR hikes would lead to higher lending rates even without an OPR hike as loans are priced to the cost of funds. The 2008 experience with fuel price hikes could also have imparted the lesson to policymakers that a gradualist approach is more acceptable as growth should not be sacrificed to temper inflation, even if the theory recommends a larger rate hike.

Policymakers were not keen to identify long term equilibrium neutral rates, stressing that monetary policy is not mechanistic. Some private sector economists however noted that the IMF's computation of equilibrium OPR appears to be 3.25%.

Some private sector economists thought that Fed Chairwoman Yellen's comments on maintaining easy monetary policy may have given policymakers reason to pause. However policymakers stressed that monetary policy had to be assessed in totality and not just with respect to Fed actions. Policymakers noted that the financial system has managed Taper-related outflows so far quite well – about 20% of the inflows that came in since QE1 flowed out in May-Aug last year – and that while policymakers can do little over the bouts of volatility from outflows, interest rates should not be used to manage capital outflows.

Fiscal Reforms and Deficit Targets on Track

While fiscal revenues saw a shortfall in 2013, the even larger shortfall in operating expenditure allowed the government to beat its 4% of GDP fiscal deficit target. Policymakers noted that the RM2.93bn Supplementary Budget for 2013 was to clean up the 2013 accounts and have already been taken fully into account. The main reason for the expenditure shortfall was because an expenditure allocation for interest payment was not used in the end. Policymakers attributed the revenue shortfall to corporate income taxes as GDP growth softened, though this was mitigated by the continued impact of administrative efficiencies that raised the tax revenue to GDP ratio, and policymakers still expect further gains from e-filing, corporatization of tax departments, as well as anti-money laundering and anti-smuggling measures. GST implementation was also expected to increase the willingness of companies to list revenues for future tax collections, which would help with the tax compliance issues.

With the GST already tabled in Parliament and royal assent likely to be granted by June, there was strong consensus that GST implementation would go ahead as planned as PM Najib has gone too far to backtrack now, having announced a firm implementation date and already spent more than RM300mn educating the public on the GST. Private sector economists thought that the timing is perfect for GST implementation and cost normalization as not only are external and commodity price pressures currently limited, Najib's position within UMNO also appears secure currently – further delays may let slip this opportunity. Concerns that Najib's dwindling popularity might force a rethink of GST were dismissed – having gone so far in, backtracking now could cause far more political damage to him than going ahead with its implementation. GST implementation early on in his current term of premiership would also make more political sense than later when elections are looming. But perhaps most reassuring for markets, it may simply be that Najib genuinely does care about Malaysia's sovereign ratings and is aware that any backtracking could validate the downgrade by Fitch last year and destroy any credibility he has with ratings agencies.

Policymakers estimate that the net revenue increase from GST in 2015, netting off the sales and service tax reductions as well as the 1%pt individual income tax cut, could be around RM3bn. Revenue gains in the following year is expected to be around RM7-9bn or about 3% of GDP. Policymakers noted that some SMEs earning under RM500,000/year in revenues which were eligible for GST exemption were offering to come on board willingly as the documentation involved would facilitate claims. Offsetting these gains however would be an additional one-off RM300 GST offset transfer for those eligible for BR1M handouts next year as well as a corporate income tax cut in 2016.

Policymakers reiterated confidence in bringing the fiscal deficit down to the 3.5% target this year and 3% next year, before eventually balancing the Budget by 2020 – which, policymakers noted, the World Bank thinks is achievable. Some

private sector economists noted that the government usually beats its revenue estimates by at least around RM10bn, only to be forced to spend the revenue overshoot on appeasing the population – current political circumstance suggests this may not be necessary this time, though the chances of revenue overshoot remain unclear. Policymakers were also confident that public debt would not breach the self-imposed 55% of GDP ceiling and would stabilize in the near-term at 54% as the deficit gets smaller and GDP rises.

Policymakers thought there was likely less scope for upward revisions to the oil revenue forecasts as the oil price assumption of US\$110/bbl is already close to the current price of US\$115/bbl, though Ukraine-related troubles could provide some potential for upside, especially if the gas supply from is cut.

Oil production levels could however rise to 600,000 bpd as new marginal oil fields come onstream (2013: 570,000 bpd). Oil production will be capped at 600,000 bpd for sustainability purposes to avoid running down the oil reserves. Policymakers want to ensure that there are always 22 years of reserves for oil and 37 years of reserves for gas – current oil production rates should allow reserves to last 28 years. As the oil recovery ratio is 1:1, higher production would necessitate a search for new replacement oil reserves. While there have been new deepwater oil fields found off the coast of Sabah, sometimes these do not produce as much oil as expected. Nonetheless policymakers emphasized the need to diversify revenue sources and reduce the oil revenue share, which has come down to 31% in 2013 from 32% the previous year.

The contribution from downstream activities such as RAPID could also provide additional revenue for Petronas to pay its dividend to the government. Policymakers noted that despite statements from Petronas seeking to shift to a dividend payout plan of 30% of net income, the dividends are a policy number and ultimately lie within the government's sphere of control.

While revenue overshoots remain uncertain as always, the government has far more direct control over expenditure. The government is trying to cut back on non-productive spending, including travel and entertainment spending as well as utility bills (which are to be cut by 5%). Some private sector economists saw scope for cuts in supplies and subsidies as well as fuel subsidies and were positively surprised at the complete removal of the sugar subsidy, which they thought opens the door to killing other subsidies later.

Policymakers were careful to emphasize that political capital should not be spent recklessly to accelerate subsidy rationalization. Policymakers noted that the most important targets were subsidies for fuel, sugar, and electricity. Everything else, including the absorption of highway toll increase (which had already been budgeted for), was minor and subsidies amounting to less than RM500mn were seen as not worth rationalizing.

Economists were divided on the timing of further RON95 price hikes. Some thought it would have to be in 2Q14 if the fiscal targets were to be met while others thought 2H14 more likely but acknowledged it seemed too close to GST implementation in Apr 2015. Policymakers for their part suggested price hikes could be done mid-year to the Budget 2015 date, with many options to mitigate the spillovers. However, policymakers appeared to suggest that this could be subject to political strategy – should RON95 price hikes threaten to jeopardize GST implementation, the government would likely sacrifice the former for the latter.

Rather than relying exclusively on price hikes, fuel subsidy reductions would also rely on reducing volumes via cutting leakages. While the current model has been one combining subsidy reductions and targeted cash transfers, there were some policymakers who thought perhaps fuel price hikes were not the only option. While skeptical of fixed rate subsidies like that in Indonesia, they emphasized trying to cap leakages via controls on volumes rather than just prices, perhaps limiting car-owners earning a certain amount of income to some volume of subsidized fuel, which would eliminate smuggling into Thailand and Indonesia as well as into domestic industries – while not a new idea, technology has certainly improved to the point where it would be much easier to keep track of individual fuel usage unlike in the past.

While acknowledging that cost normalization would take a toll on growth, policymakers stressed that this was a necessary step to reduce the reliance on artificially cheap inputs. Policymakers think cost normalization will not be an impediment to attracting FDI and that the corporate sector should be capable of absorbing the higher costs as corporate surpluses are still large relative to wages. Nonetheless policymakers did produce the caveat that the cost normalization time table could be revisited should an external crisis that threatens growth materialize – however should growth remain around 4.5-5.5%, cost normalization should go ahead as planned.

Apart from subsidies, fiscal consolidation would have a bigger impact on development expenditure. Policymakers emphasized that the government would try to move towards open tenders which would yield more value for money. ETP projects – which are supposed to be more than 90% private sector-driven – are not expected to be hit hard.

The government is opting for a hybrid approach towards financing big ticket but viable projects. In a case where the government is unable to fund the full cost of a project, future projected revenue streams from the project would finance the bulk of capital expenditure, with the government funding the rest.

With the second MRT line coming online after 2017, there may be some near-term increases in government guarantees, though some existing guarantees would also expire. Policymakers emphasized again that government guarantees are only given for strategic projects like the MRT to help reduce costs and are closely monitored on a quarterly basis, with the option of rescheduling if necessary to avoid having to make good on the guarantees. New and future borrowings of guaranteed firms require government approval and the government began imposing a guarantee fee in 2012, which policymakers stressed was not risk-related but rather to create a fund to provision for guarantees. In the case of the MRT, the government intends to use property-related activities along the line to support future earnings, i.e. the MTR model in Hong Kong.

Policymakers see a shift in financing from MGS to GII as supporting Malaysia's efforts to position itself as an international Islamic financial centre – international issuances are seen as mainly for benchmarking purposes. While there has been some criticism that GII holders hold to maturity and thus render the GII market illiquid, policymakers noted that post-Lehman, the hold to maturity was seen to be a good thing as it reduced portfolio outflow volatility. The GII investor base is predominantly local, though there is also some participation by Middle Eastern investment funds.

Current Account Now a Lesser Worry

Policymakers agreed with our assessment that the recent surge in intermediate good imports are largely for processing into exports. They also noted however that re-exports are becoming more prominent in the import figures, thus making it difficult to draw strong conclusions on the CA from the merchandise trade figures.

Policymakers reiterated that projects with high import content and low multipliers are being deferred, though there was little clarity on which projects these were. Policymakers did offer however that the much maligned 100-storey Wawasan Merdeka project has been largely secured for rental with a vacancy rate of only 20% and an imported component of only RM1bn. Policymakers noted that there was scope to avoid the bunching up of projects with high import content to avoid CA pressures, although this is not necessary for now. Policymakers stressed that they were not going to rely on a weaker MYR to stabilize the CA surplus. With the recovery in exports, policymakers see the CA surplus as sustainable, even if it narrows to about 3% of GDP in 2014. Going forward, the CA surplus should be boosted by marginal oil field production which is about 60% gas and 40% oil.

Policymakers seem comfortable with the level of FX reserves notwithstanding the recent decline. Policymakers noted that Malaysia has a lot of ODI especially in oil and gas – with external projects to be financed as well as Tapering-related outflows, it should be no surprise that the reserves took a hit. Policymakers noted that it is costly to hold such high reserves – at some point, US\$140bn could be excessive – and that assessments of reserve adequacy must take into account the nature of the flows.

The run rate of portfolio outflows from EPF amount to about 2.5% of GDP, but this can be reduced if the CA comes under pressure. While there had previously been less emphasis on KWAP and EPF to invest outside of Malaysia, after 2005 there was increasingly the sense that the two funds had grown too large – EPF assets for example amounted to about 60% of GDP. Where major pension funds once gave very good returns of close to 10% a year, now they are increasingly squeezed, with returns now around 7%. In an effort to meet the public's high expectations set by their own past outperformance, these funds now need to invest outside the country and the quota will likely only increase over time.

Overall, policymakers see the CA adjustment as healthy as it is driven by commodity price normalization and investments rather than consumption. Policymakers noted that investments have been diversified geographically and sectorally and have not been concentrated excessively in property.

Medium-Term Growth Themes

Policymakers noted that the government has fully bought into the New Economic Model and its aspirations of high income and inclusiveness. With regard to raising incomes, many projects such as the MRT and RAPID are on track – the key thing now is execution.

The government aims as part of its economic agenda to raise wages as a share of GDP, which has already risen from about 29% before 2008 to 33% as of 2012. The government will have to achieve a more equitable distribution of wealth without eroding competitiveness, which will likely require productivity increases. Policymakers noted however that they are not targeting, say, the UK's wage share of GDP which is around 54% as the UK has much higher taxes – the

wage share is only about 44% after tax. However a wage share of about 40% which is close to Singapore's level is seen as a more desirable target. Based on current forecasts and taking into account initiatives, policymakers think the wage share will rise to 37% by 2020.

Malaysia, Singapore, and Thailand are currently driving the AEC forward and overall implementation has reached about 80%, which is where Malaysia stands as well. Policymakers acknowledged that 100% implementation is unlikely by Dec 2015, but 90% would be seen as good progress. Policymakers noted the approach adopted by ASEAN would be very pragmatic, such that countries that are ready can move forward first, while others like Indonesia can be allowed to move later.

Integration with Singapore would help growth diversify away from the Klang Valley. Each growth corridor is supposed to focus on the value proposition of its location and Iskandar's is seen as being a hinterland for Singapore. The government is currently trying to get more Singapore companies involved as co-developers in Iskandar, the latest being the high tech park by Ascendas. Iskandar is also seen as complementary to the Singapore government's push to attract more FDI – firms can for example locate their regional HQs in Singapore but place their production in Iskandar. Policymakers did not seem overly concerned on oversupply in Iskandar.

Policymakers stressed that Malaysia was not interested in attracting labour-intensive industries which would necessitate importing foreign labour from Indonesia and Bangladesh for example. Some private sector economists noted that automation in response to higher costs will likely be a long-term phenomenon and can only begin when such labour-intensive firms fall into decline, which has not happened yet.

As to Malaysia's stance on joining the TPP, policymakers stressed that this will depend on whether Malaysia can enter on its own terms and that the benefits must be clear. Based on the current language, policymakers noted that the TPP will not work for Malaysia as the country will not be a net beneficiary. The government is currently in negotiations, with the key areas including (1) government procurement limits, (2) state-owned enterprises, (3) intellectual property (4), and investor dispute resolution mechanisms which are currently too punitive.

Policymakers acknowledged that Malaysia's manufacturing sector has underperformed, primarily due to a poor product mix as well as cyclical factors. While there has been progress in moving towards tablets and smartphones, policymakers think about 50% of E&E manufacturing is still related to the sunset PC industry, though their industry checks do suggest a smaller exposure.

Appendix A-1

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