Developments in the Malaysian Economy

HIGHLIGHTS

- **The Malaysian economy grew by 6.2% in the third quarter.**
- **Headline inflation declined to 3.8% due mainly to lower average domestic fuel prices. Core inflation remained stable at 2.5%.**
- **Current account balance widened to 3.7% of GNI due to a larger goods surplus, which offset the higher deficits in the income accounts.**

The Malaysian economy expanded by 6.2% in the third quarter of 2017

The Malaysian economy recorded a stronger growth of 6.2% in the third quarter of 2017 (2Q 2017: 5.8%). Private sector spending continued to be the main driver of growth. The external sector also contributed positively to growth, as real exports expanded at a faster pace (11.8%; 2Q 2017: 9.6%), supported by stronger demand from major trading partners. On a quarter-on-quarter seasonally-adjusted basis, the economy grew by 1.8% (2Q 2017: 1.3%).

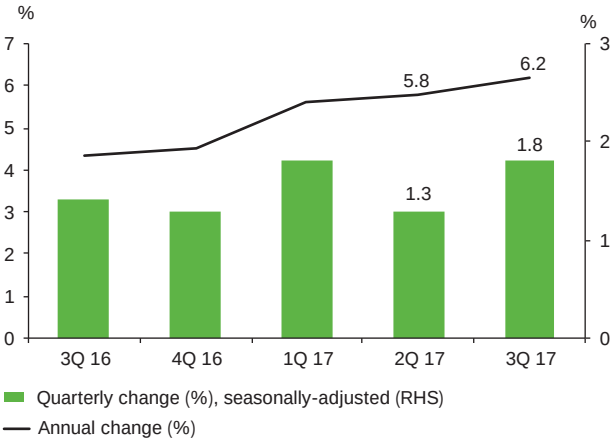
Domestic demand driven by the private sector

Domestic demand grew by 6.6% in the third quarter of the year (2Q 2017: 5.7%), supported by continued expansion in both private sector expenditure (7.3%; 2Q 2017: 7.2%) and public sector spending (4.1%; 2Q 2017: 0.2%).

Private consumption expanded by 7.2% (2Q 2017: 7.1%), underpinned by better labour market conditions. In particular, private sector wages were sustained amid stronger employment growth.

Stronger growth in 3Q 2017

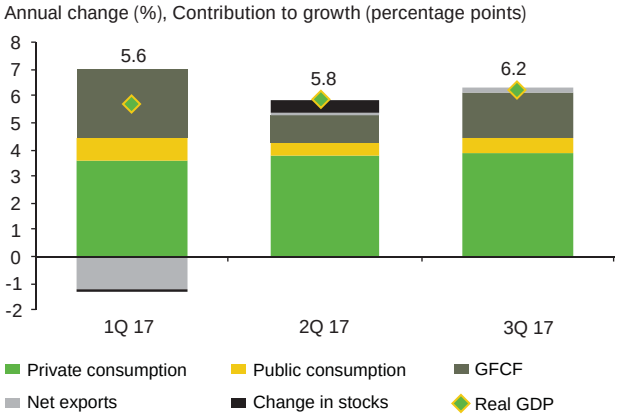
Chart 4: GDP Growth



Source: Department of Statistics, Malaysia

Private sector demand remained the key driver of growth

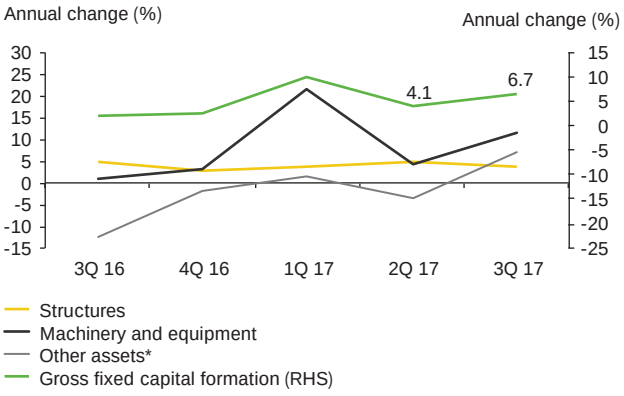
Chart 5: Contribution of Expenditure Components to GDP Growth



Source: Department of Statistics, Malaysia

Gross fixed capital formation expanded at a faster pace

Chart 6: GFCF Growth by Type of Assets



*Other assets include mineral exploration, research & development and capitalised planting

Source: Department of Statistics, Malaysia

Private investment registered a stronger growth of 7.9% (2Q 2017: 7.4%), mainly in the services and manufacturing sectors. Within the manufacturing sector, both export- and domestic-oriented sub-sectors undertook higher capital spending during the quarter. Business sentiments also remained above the optimism threshold, in line with favourable external and domestic demand conditions.

Public consumption expanded by 4.2% (2Q 2017: 3.3%) following faster growth in emoluments amid continued prudence in spending on supplies and services.

Public investment turned around to register positive growth of 4.1% during the quarter (2Q 2017: -5.0%). This was due to higher fixed assets spending by both the Federal Government and public corporations.

Gross fixed capital formation (GFCF) growth was higher at 6.7% (2Q 2017: 4.1%) driven by higher growth in private investment and the positive turnaround in public investment. By type of assets, capital spending on machinery and equipment improved to 11.5% (2Q 2017: 4.4%) while investment in structures moderated to 3.6% (2Q 2017: 5.1%). Investment in other types of assets was higher at 7.2% (2Q 2017: -3.7%).

Continued expansion across all economic sectors

On the supply side, growth was supported by continued expansion across all sectors.

The services sector registered a higher growth in the third quarter of 2017. Growth of the wholesale & retail trade sub-sector was supported by continued growth in household spending. The information and communication sub-sector remained strong, driven by higher demand for data communication services, while the transportation and storage sub-sector benefited from the robust trade activities.

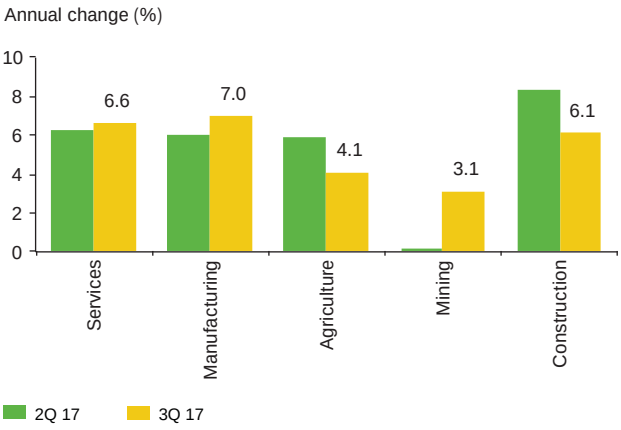
The manufacturing sector grew at a faster pace during the quarter, supported by broad-based improvements in both export- and domestic-oriented industries. Export-oriented industries benefitted from robust global demand for semiconductors and higher petroleum-related refinery activity. Domestic-oriented industries were supported by continued demand for food-related products and construction-related materials, in addition to stronger growth in transport equipment driven by auto parts and ship building activities.

Growth in the mining sector recorded stronger growth during the quarter, supported by higher natural gas production, particularly in Sabah and Sarawak. However, growth in the agriculture sector moderated, reflecting mainly lower rubber and CPO production due to adverse weather conditions.

Growth in the construction sector moderated during the quarter particularly due to lower non-residential activity in the commercial sub-segment.

Higher growth across most economic sectors

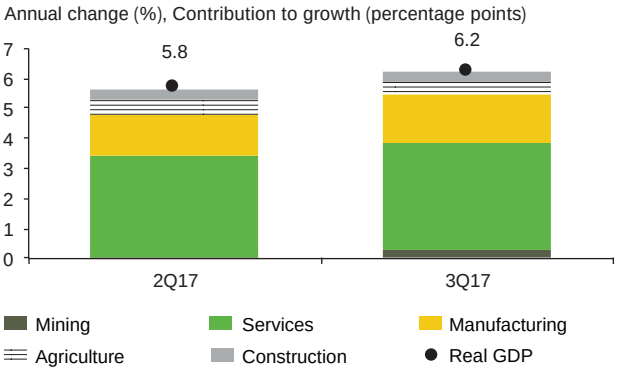
Chart 7: Growth by Sector



Source: Department of Statistics, Malaysia

Services and manufacturing sectors remained the key drivers of growth

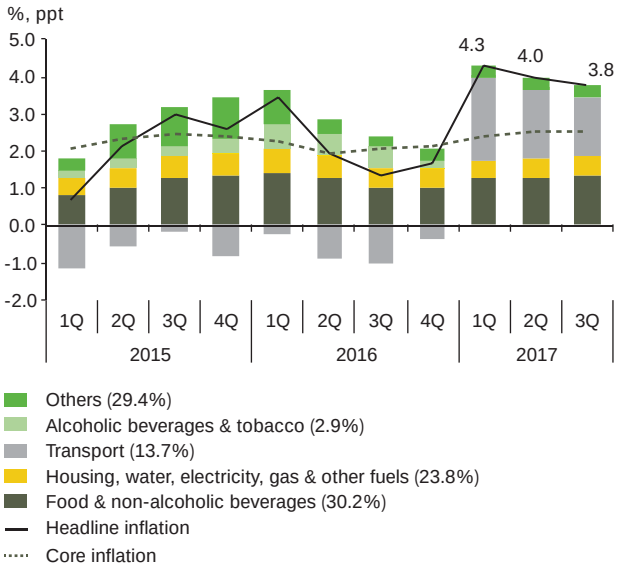
Chart 8: Real GDP by Economic Sector



Source: Department of Statistics, Malaysia

Lower inflation mainly reflected the decline in transport inflation

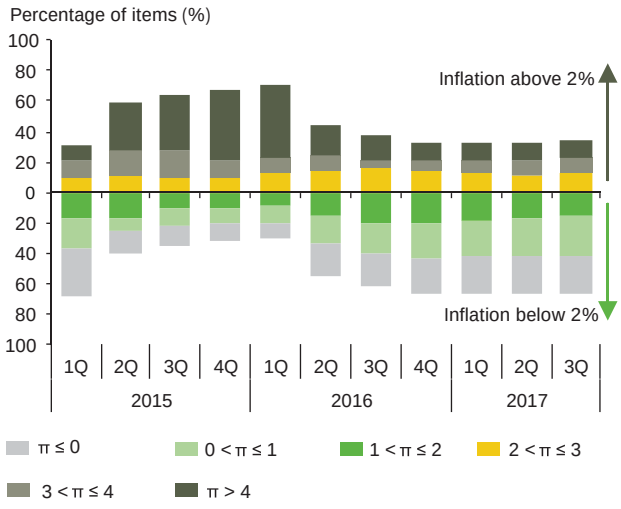
Chart 9: Headline Inflation



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

Inflation pervasiveness remained broadly stable

Chart 10: Inflation Pervasiveness



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

Headline inflation moderated due to lower *transport* inflation

Headline inflation[1] moderated to 3.8% in the third quarter of 2017 (2Q 2017: 4.0%) due mainly to lower ***transport*** inflation at 11.7% (2Q 2017: 13.4%). Although domestic fuel prices trended upward during the quarter due to rising global oil prices, domestic fuel prices averaged slightly lower compared to the previous quarter (RON95 petrol in 3Q 2017: RM2.09 per litre; 2Q 2017: RM2.10 per litre). The lapse in the impact from the upward adjustment of satellite TV charges also contributed to the lower inflation during the quarter. However, ***rental*** and ***non-durable household goods*** recorded higher inflation during the quarter. ***Rental*** inflation increased to 2.9% (2Q 2017: 2.7%), although the increase was limited to selected geographical areas and property types. Inflation for ***non-durable household goods*** also rose to 3.8% (2Q 2017: 1.8%) following the spillover of higher input costs.

Core inflation was stable at 2.5% during the quarter. The percentage of the CPI basket that registered inflation of more than 2% remained broadly unchanged (3Q 2017: 34%; 2Q 2017: 33%).

[1] As measured by the annual change in the Consumer Price Index (CPI).

Improving labour market conditions

Labour market conditions in the third quarter of 2017 were supportive of growth. Private sector wage growth was sustained at 7.3% (2Q 2017: 7.3%) while employment growth registered some improvements (2.0%; 2Q 2017: 1.8%). During the quarter, labour force expansion was relatively matched by net employment gains resulting in a stable unemployment rate of 3.4% (2Q 2017: 3.4%). Labour demand also improved as the number of vacancies posted on a major job search website increased to 68,794 positions in the third quarter (2Q 2017: 65,478 positions).

The sustained growth in private sector wages was driven by wage growth in the services and manufacturing sectors. Services sector wage growth rose to 5.9% (2Q 2017: 5.6%), supported by the strength in the ICT and transportation and storage sub-sector. Manufacturing wages remained in double-digit territory for the second consecutive quarter, growing by 10.6% (2Q 2017: 11.2%).

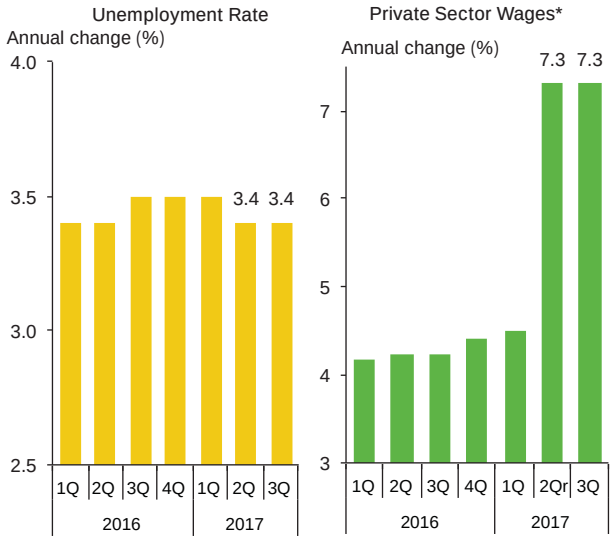
Robust external sector performance

In the third quarter of 2017, gross exports expanded at a faster pace of 22.1% (2Q 2017: 20.5%). The robust performance reflected mainly the strength of manufactured exports which continued to register double-digit growth. As export growth outpaced import growth, the trade surplus widened to RM26.7 billion (2Q 2017: RM24.1 billion).

The strong manufactured export growth was supported by higher demand from most of Malaysia's key trading partners, particularly regional economies, the EU and US. Of significance, the sustained strong global demand for semiconductors continued to benefit E&E exports.

Stable unemployment rate and sustained wage growth

Chart 11: Labour Market Indicators

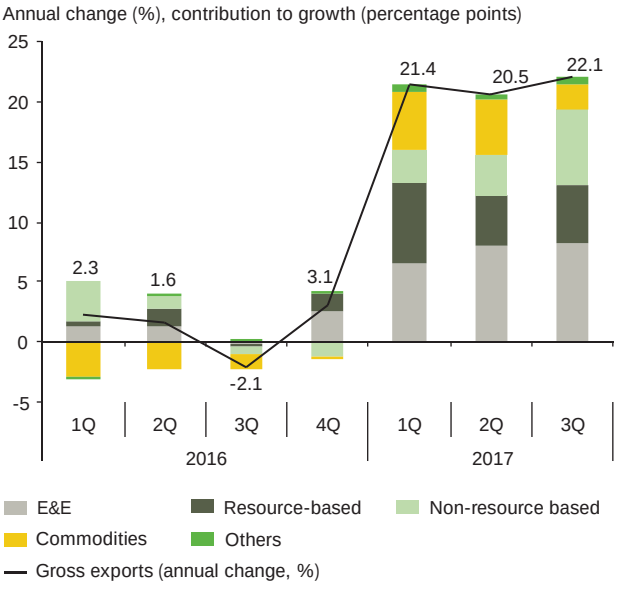


*Private sector wages is derived from the salaries and wages data published in the Monthly Manufacturing Statistics and Quarterly Services Statistics by the Department of Statistics, Malaysia. It covers 62% of total employment.
r Revised

Source: Department of Statistics, Malaysia

Export growth driven mainly by manufactured exports

Chart 12: Gross Exports by Products

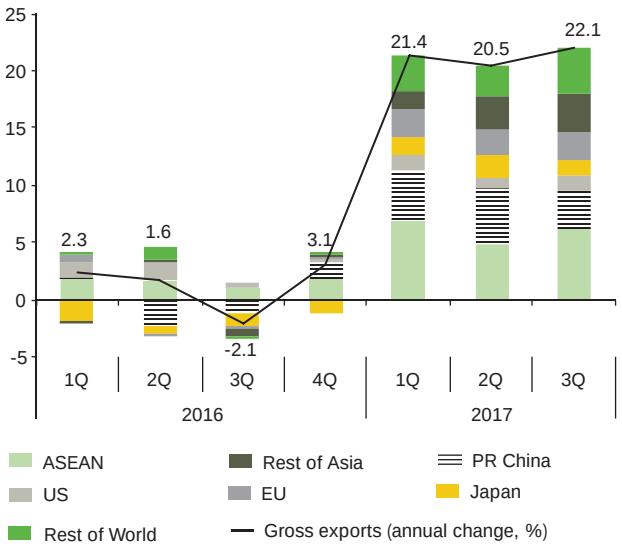


Source: Department of Statistics, Malaysia

Export growth was also broad-based across markets

Chart 13: Gross Exports by Markets

Annual change (%), Contribution to growth (percentage points)

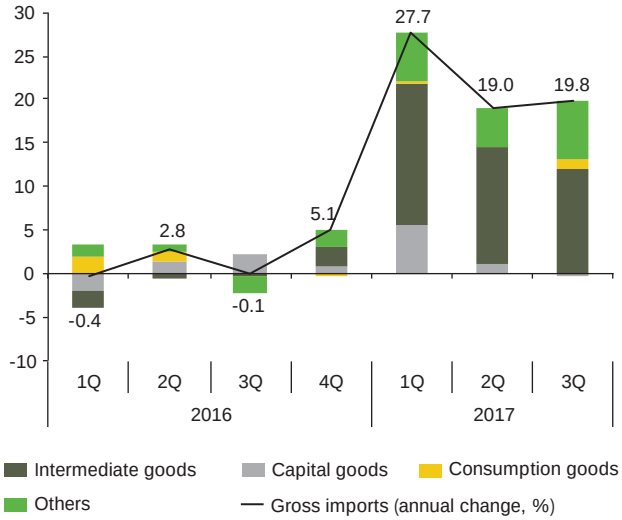


Source: Department of Statistics, Malaysia

Strong imports, particularly in intermediate and imports for re-exports

Chart 14: Gross Imports by Products

Annual change (%), Contributionto growth (percentage points)



Source: Department of Statistics, Malaysia

Resource-based manufactured exports also expanded faster, driven mainly by stronger exports of petroleum products to the region. Growth of non-resource based manufactured exports accelerated, largely on account of higher exports of metals and machinery and equipment. Commodity exports moderated due mainly to slower growth in CPO output and a contraction in crude petroleum production.

Gross import growth remained strong (3Q 2017: 19.8%; 2Q 2017: 19.0%), on account of continued strength in intermediate imports and higher growth in imports of consumption and goods for re-exports. This was in line with strong manufacturing export performance and continued strength in domestic demand. Growth in capital imports was flat reflecting mainly a high base effect arising from the delivery of a large liquefied natural gas vessel in July 2016. Excluding this delivery, capital imports expanded at a faster pace, in tandem with higher investment activity in the manufacturing and services sectors.

Current account surplus widened

The current account surplus widened to RM12.5 billion in the third quarter of 2017 (2Q 2017: RM9.6 billion) accounting for 3.7% of GNI (2Q 2017: 3.0% of GNI). This was due primarily to a larger goods surplus which offset the higher deficits in the income accounts and sustained deficit in the services account.

The goods surplus widened to RM31.7 billion[2] in 3Q 2017 (2Q 2017: RM27.0 billion), as exports grew at a faster pace, while intermediate and capital imports moderated from the second quarter of 2017. The deficit in the services account was broadly sustained at RM4.9 billion (2Q 2017: -RM5.0 billion). The travel account registered a bigger surplus of RM9.2 billion, supported by higher tourist arrivals and spending amid major sporting events held during the quarter. This improvement was partly offset by a larger deficit in construction services (3Q 2017: -RM3.3 billion; 2Q 2017: -RM2.4 billion), reflecting mainly lower receipts due to the near completion of construction projects in Qatar and India.

The higher deficit in the primary income account in 3Q 2017 (-RM8.6 billion; 2Q 2017: -RM8.2 billion) was largely attributable to lower income generated by Malaysian firms investing abroad (RM11.4 billion; 2Q 2017: RM12.4 billion). Income earned by foreign investors in Malaysia remained sizeable (-RM18.9 billion; 2Q 2017: -RM19.4 billion).

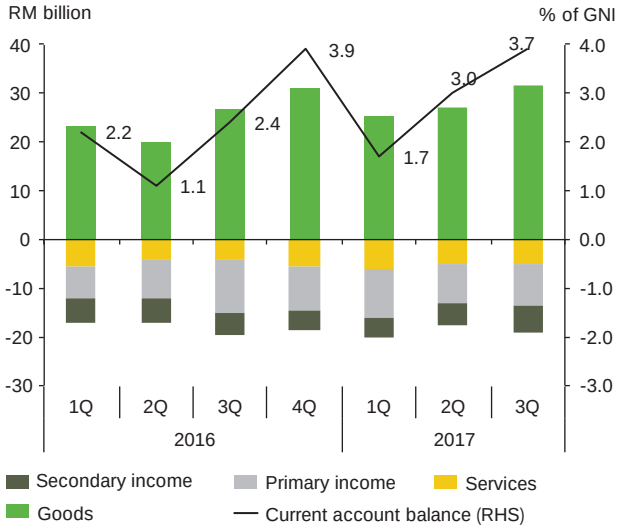
The deficit in the secondary income account was larger at RM5.7 billion (2Q 2017: -RM4.2 billion). Outward remittances amounted to RM9.5 billion (2Q 2017: -RM8.7 billion) driven by foreign worker remittances while inward remittances were lower (RM3.8 billion; 2Q 2017: RM4.4 billion).

Financial account recorded net outflows

In the third quarter of 2017, the financial account registered a net outflow of RM1.2 billion (2Q 2017: net inflow of RM7.3 billion), as higher inflows of long-term foreign direct investments (FDI) and sustained foreign inflows into domestic portfolio assets were offset by portfolio investments abroad by residents and outflows arising from banks' liquidity and treasury management operations.

Higher current account surplus

Chart 15: Current account balance

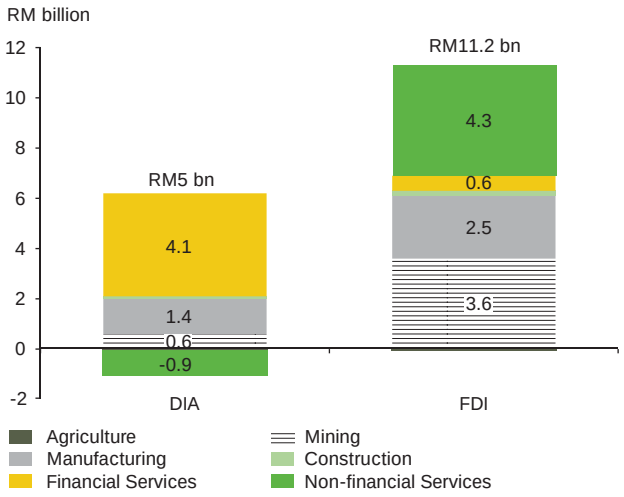


Source: Department of Statistics, Malaysia

[2] The 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.

DIA channeled mainly into financial services sub-sector while FDI was broad-based across sectors

Chart 16: Net Direct Investment Flows by Sector

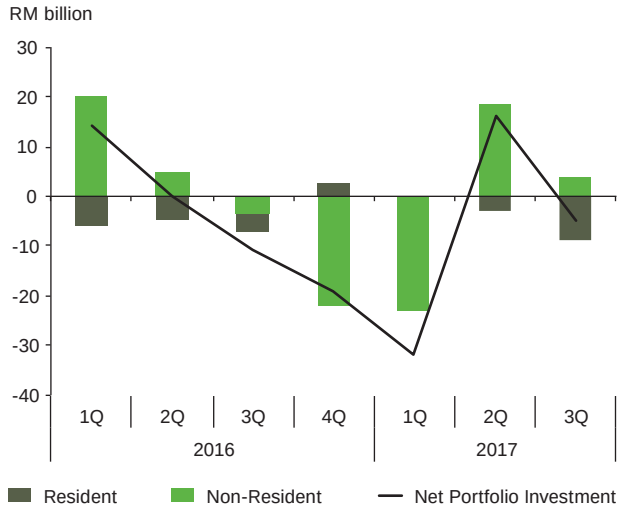


Note: For DIA, positive values refer to net outflows while negative values refer to net inflows

Source: Department of Statistics, Malaysia

Net outfows in portfolio investment account contributed by residents

Chart 17: Portfolio Investments by Residency



Source: Department of Statistics, Malaysia

The direct investment account turned around to register a net inflow of RM6.2 billion (2Q 2017: net outflow of RM7.1 billion), as FDI inflows more than offset outflows of direct investments abroad (DIA) during the quarter. FDI increased to RM11.2 billion (2Q 2017: net inflow of RM8.3 billion), due mainly to higher injections of equity capital and reinvestment of earnings from parent companies. FDI inflows were channeled mainly into the *real estate activities* sub-sector, followed by the *mining* and *manufacturing* sectors. DIA by Malaysian companies declined to RM5 billion (2Q 2017: net outflow of RM15.4 billion), on account of lower capital injections and earnings retained by subsidiaries abroad for reinvestment. DIA outflows were channeled mainly into the *financial services* sub-sector and the *manufacturing* sector.

The portfolio investment account registered a net outflow of RM5.1 billion (2Q 2017: net inflow of RM16 billion). Portfolio investments by non-residents recorded a net inflow of RM3.7 billion (2Q 2017: net inflow of RM18.8 billion). Sustained strong export growth and better-than-expected economic performance continued to attract foreign investors into the domestic financial markets. However, these inflows were partially offset by maturities of Malaysian Government Securities (MGS) and Government Investment Issues (GII) during the quarter. Resident portfolio investments registered a higher net outflow of RM8.8 billion (2Q 2017: net outflow of RM2.8 billion), due to the continued investments in both equity and debt securities abroad by domestic fund managers and financial institutions.

The other investment account recorded larger net outflows of RM3.3 billion (2Q 2017: net outflow of RM1.3 billion), due mainly to the maturity of currency and deposits placed by foreign financial institutions in the domestic banking system.

Following these developments, the overall balance of payments registered a surplus of RM2.9 billion in the third quarter (2Q 2017: a surplus of RM2.7 billion). Errors and omissions, which includes the revaluation changes on reserves, amounted to -RM8.5 billion or -1.9% of total trade.

Manageable external debt

Malaysia's external debt edged lower to RM873.8 billion, equivalent to USD204.7 billion or 65.0% of GDP as at end-September 2017 (end-June 2017: RM877.5 billion or USD202.3 billion). The lower external debt largely reflects the repayment of maturing interbank borrowing and valuation effects following the strengthening of the ringgit against selected major and regional currencies during the third quarter. These more than offset the increase, in particular, in non-resident (NR) holdings of domestic debt securities and deposits, as well as other debt liabilities.

Malaysia's external debt remains manageable given its currency and maturity profiles, as well as the availability of large external assets. More than one-third of total external debt is denominated in ringgit (34.0%), mainly in the form of NR holdings of domestic debt securities and in ringgit deposits in domestic banking institutions. As such, these liabilities are not subjected to valuation changes from the fluctuations in the ringgit exchange rate.

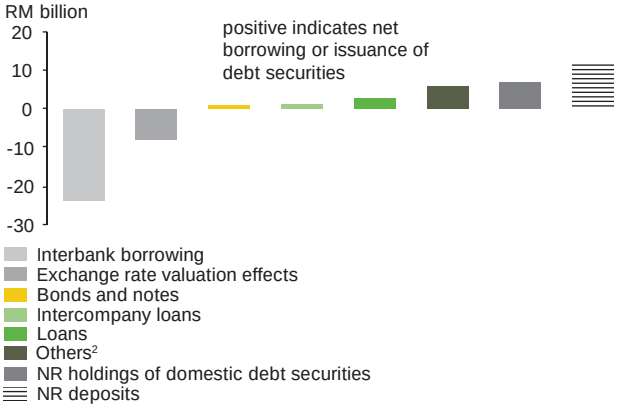
The remaining external debt of RM577.0 billion (66.0%) is denominated in foreign currency (FC) and accounted mostly by banking institutions and corporates (97.1% of total FC borrowings). These are subject to prudential liquidity management practices and hedging requirements. The bulk of these obligations are offshore borrowings, raised mainly to expand productive capacity and to better manage financial resources within corporate groups. As at end-September 2017, the offshore borrowing remained low at 36.8% of GDP compared to 60.0% of GDP during the Asian Financial Crisis.

Of the total FC-denominated external debt (inclusive of valuation effects), more than one-third (or amounting to RM204.7 billion) is accounted by interbank borrowing and FC deposits in the domestic banking system. This largely reflects the banks' intragroup liquidity management and placements of deposits from foreign parent entities, which are subjected to prudent liquidity management practices. Among these are internal limits on funding and maturity mismatches. This is then followed by long-term bonds and notes issued offshore which amounted to RM161.6 billion as at end-September 2017, primarily to finance asset acquisitions abroad that will generate future income. The intercompany loans are typically on flexible and concessionary terms, such as no fixed repayment schedule or low interest rate.

From a maturity perspective, more than half of the total external debt is skewed towards medium- to long-term tenure (56% of total external debt), suggesting limited rollover risks. It is important to note that the progressive liberalisation of foreign exchange administration rules has also resulted in greater decentralisation of the country's international reserves. This is reflected in the increasing acquisition of assets abroad by resident banks and corporates. In particular, banks and corporates hold around three-quarters of Malaysia's external assets (as at end-3Q 2017: RM1.3 trillion), which can also be drawn upon to meet their external debt obligations (as at end-3Q 2017: RM664.5 billion), without creating a claim on international reserves. As at 31 October 2017, international reserves is 1.1 times the short-term external debt and is sufficient to finance 7.6 months of retained imports.

Lower external debt in 3Q 2017

Chart 18: Changes in External Debt
Net Change[1]: -RM3.7 billion

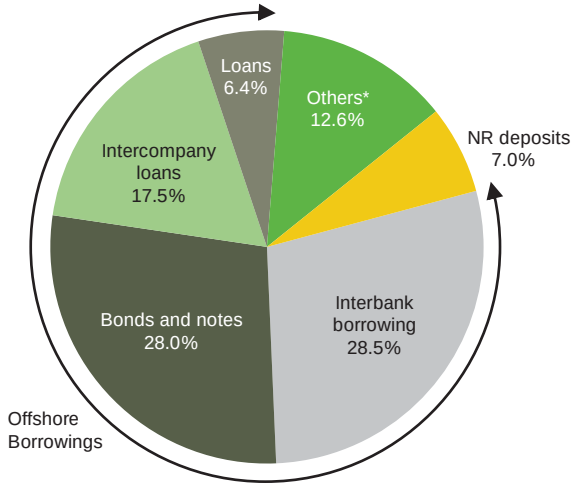


[1]Changes in individual debt instruments exclude exchange rate valuation effects
[2]Comprises trade credits, IMF allocation of SDRs and other debt liabilities
Note: NR refers to non-residents

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

About half of FC-denominated debt subjected to prudent liquidity management practices and flexible terms

Chart 19: Breakdown of Foreign Currency-Denominated External Debt (% of Share)



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

Source: Bank Negara Malaysia

Box Article 1

Rethinking Investment Incentives

Authors: Mohd Shazwan Shuhaimen, Nurul Hana Ahmad Ghazali, Kevin Wong Tho Foo, Loke Po Ling and Sarah Syamimi Mohd Suhaimi

HIGHLIGHTS

- **While FDI was a game-changer in transforming the Malaysian economy in the past, there is mounting evidence that the net benefits have been narrowing in recent periods.**
- **The total cost of incentives used to attract FDI has been significant, and there are indications its effectiveness is waning.**
- **There is room to improve the existing investment incentives framework and landscape such that Malaysia continues to attract quality investments with greater economic spillovers going forward.**

Introduction

Malaysia's longstanding appeal as a preferred destination for foreign direct investment (FDI) has been supported by a conducive investment climate, modern infrastructure and attractive incentives. While these investments have benefited the economy in the past, there is growing evidence to suggest that the net benefits have plateaued in recent years amid substantial costs to attract them in an increasingly competitive environment. The diminishing net benefits, together with a changing global environment necessitates a rethink of the investments that would safeguard Malaysia's future-readiness, and the incentives designed to attract these investments. This article assesses the benefits and costs of FDI and the effectiveness of the current investment incentives framework in attracting investments. The article also discusses potential areas for reforms that would enhance positive economic spillovers from FDI.

Overview of FDI in Malaysia

Investment is a key driver in expanding productive capacity for the sustainable future growth of the economy. In Malaysia, investment activity has grown by almost tenfold over the last 35 years, with foreign affiliates[1] (hereby known as FDI) playing a large role in this achievement. Between 2010 and 2015, FDI accounted for almost 40% of nominal gross fixed capital formation.

While Malaysia has received FDI since the turn of the 20th century, the rapid industrialisation in the 1970-80s witnessed the influx of multinational corporations (MNCs) particularly in the manufacturing and mining sectors (Chart 1). Shaped by both external developments and domestic policies, such as the liberalisation of foreign equity ownership requirements in the services sector post-2008, FDI has become increasingly broad-based. There is now greater global presence in the services sector, mainly in the finance and insurance, wholesale and retail as well as transportation and communication sub-sectors (Chart 2). The presence of MNCs in the investment landscape reflects Malaysia's appeal as an attractive business destination, underpinned by pro-business policies, an educated workforce, well-developed infrastructure and an array of competitive investment incentives. In fact, Malaysia is one of the main profit centres for FDI in the region, with average returns[2] of 12.9% between 2010 and 2016 (Chart 3).

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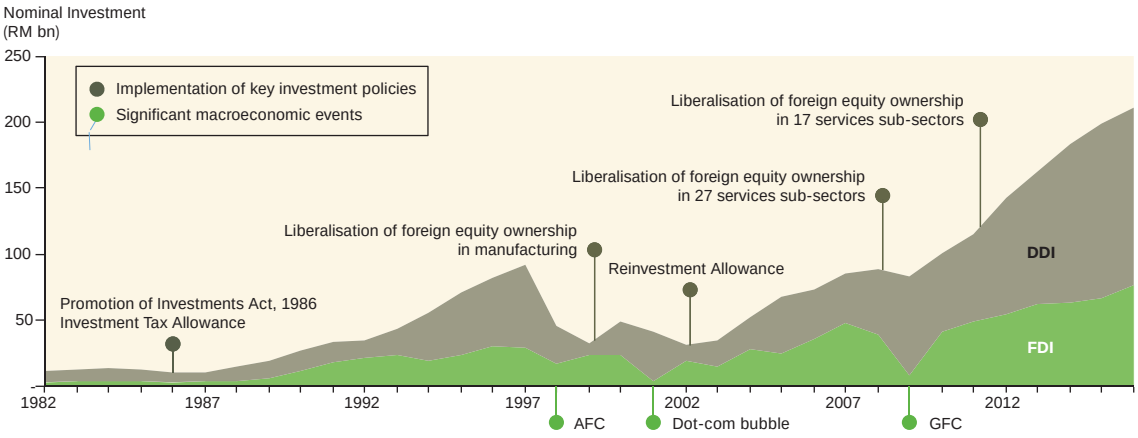
[1] A 'foreign affiliate' is defined as an enterprise operating in Malaysia with more than 50% of its equity owned by a foreign company. This concept differs from the Fifth Edition of the Balance of Payments Manual by the International Monetary Fund, which suggests a foreign equity ownership of at least 10% to be defined as FDI.

[2] Returns are measured by FDI investment income (comprising dividends, retained earnings and interest income) over the stock of outstanding FDI. For a detailed discussion on the divergence in the rate of returns between FDI and direct investment abroad by Malaysian corporations (DIA), please refer to the BNM Annual Report 2016 Box Article 'Payoffs from Going Global: Assessing the Returns from Malaysia's Direct Investment Abroad'.

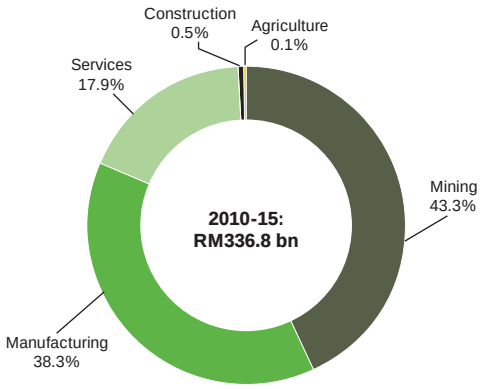
Chart 1: The landscape of investment in Malaysia and policy implementation



Note: DDI refers to investment by domestic private corporations

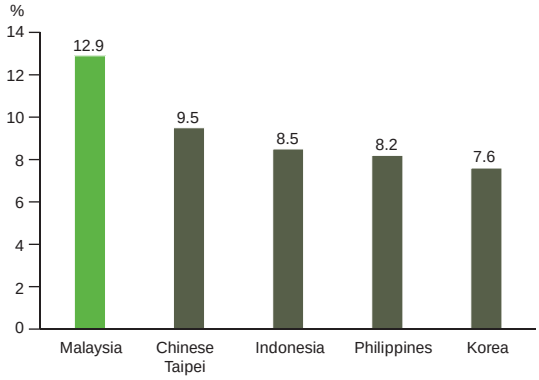
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Chart 2: Gross Fixed Capital Formation of Foreign Affiliates (FDI) by Sector



Source: Department of Statistics, Malaysia

Chart 3: FDI Returns (Average: 2010-2016)



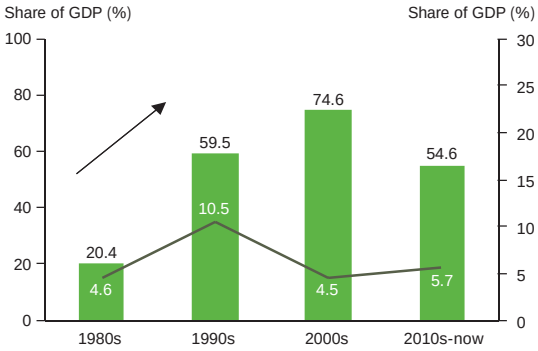
Source: Department of Statistics, Malaysia, Haver Analytics and Bank Negara Malaysia estimates

Assessing the benefits and costs of FDI

The presence of FDI was indeed a game-changer in transforming the Malaysian economy. FDI has been an important catalyst for manufactured exports, job creation and productivity. For example, the increase in FDI to 10.5% of GDP in the 1990s brought a corresponding rise in the share of manufactured exports (Chart 4). In 2015, exports generated by FDI firms amounted to RM290.2 billion or 35.5% of total exports of goods and services during the year. The rise in FDI has also been associated with greater employment opportunities, with FDI firms hiring about 848,000 workers or 5.8% of total employment in 2015 (Chart 5). Value added per worker in FDI firms is about three times higher than the national average (Chart 6).

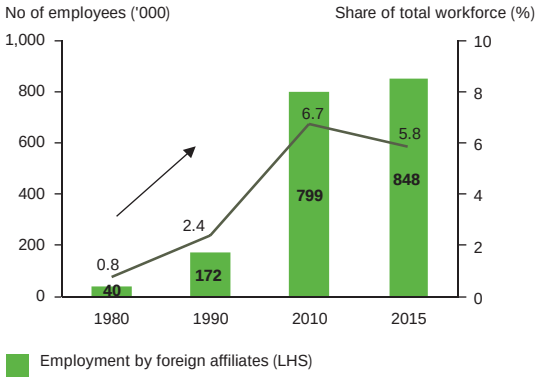
In recent years, however, there is evidence that the net benefits have been narrowing. While FDI has helped create jobs in the economy, the dependency on foreign workers and inputs needs to be addressed. Estimates indicate that among FDI manufacturing firms, as a proportion of total employment, the hiring of locals has declined from 74% share in 2011 to 68% share in 2014 amid greater hiring of low-skilled foreign workers (Chart 7). High dependence on foreign workers erodes the benefits of FDI by substituting employment away from Malaysians and dampening wage growth, particularly affecting low-income earners (bottom 40% or B40 of households). In terms of intermediate input, growth of domestic value added in

Chart 4: Manufactured Exports & FDI



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

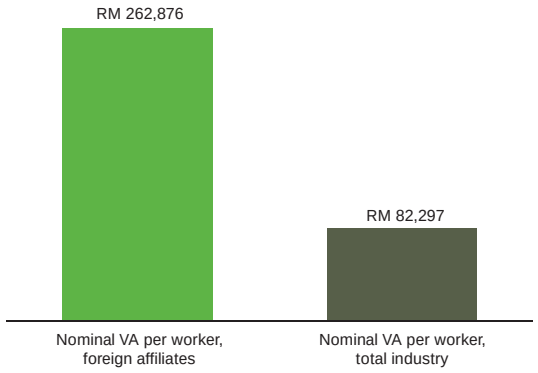
Chart 5: Employment by FDI Firms



Note: Employment by foreign affiliates was proxied for 1980 and 1990.

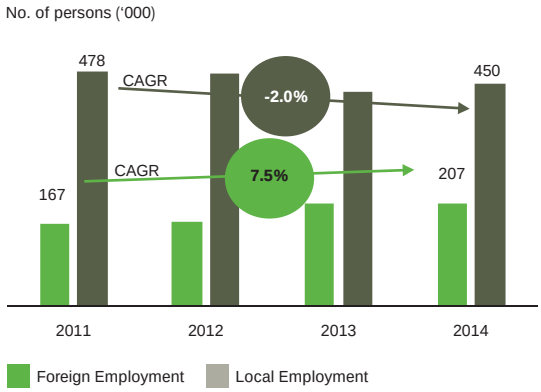
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Chart 6: Labour Productivity: Value Added (VA) per worker (2015)



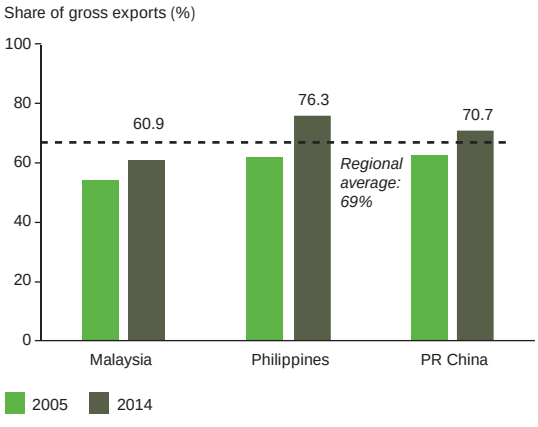
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Chart 7: Employment in Manufacturing FDI Firms



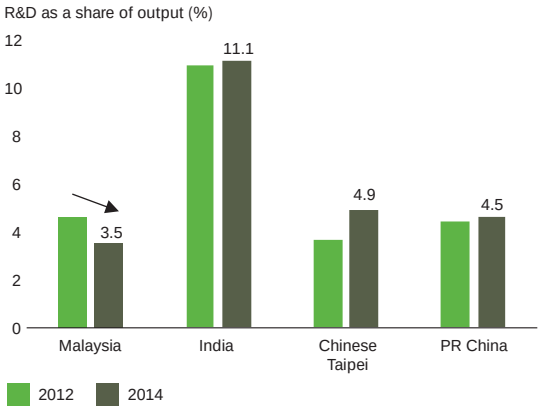
Source: Ministry of Home Affairs and Bank Negara Malaysia estimates

Chart 8: Domestic Content in Gross Exports



Source: OECD

Chart 9: R&D Spending by US FDI Companies



Source: OECD

gross exports has stagnated relative to the regional economies (Chart 8). This indicates continued heavy dependence on imported inputs and foreign services (e.g. logistics), which reflects the slow development of deeper backward linkages and value creation among domestic suppliers and service providers. Further, the prevalence of labour-intensive production methods impedes adoption of technology, such as automation, and hence Malaysia's progress in moving up the production value chain. Technology transfer has plateaued, evidenced by the lower spending on R&D by the US MNCs in Malaysia relative to other countries in the region (Chart 9). The diminishing net benefits can also be observed at the firm level, based on a recent study conducted by the Bank (Refer to Sub-Box: Case Study on Selected MNCs). Therefore, resulting distortions created by the continued heavy reliance on foreign inputs, including wage and price distortions, inhibit the efficient functioning of market mechanisms in the Malaysian economy.

There are also high costs associated with attracting investments. The Government has deployed numerous incentives to attract investments as well as to encourage certain desired economic spillovers and activities. In 2010-2015, FDI made up close to 60% of the value of manufacturing investments that were given incentives. These incentives are mainly in the form of corporate tax exemptions, tax allowances for capital expenditure and financial assistance such as training and R&D grants. As tax exemptions and allowances reduce the corporate tax paid by firms, the cost of such incentives is quantified in terms of tax foregone. Estimated by comparing the gross operating surpluses of corporates against the corporate tax revenue collected in the manufacturing sector, the cost of incentives ranged between RM10-15 billion annually over the past five years. This is equivalent to 0.8-1.3% of GDP or 6.0-8.9% of Government tax revenue.

Foreign firms have also benefitted from the liberal foreign exchange administration policies and prevailing regulations on foreign workers. Non-residents are free to invest in ringgit assets in Malaysia, and are also free to remit divestment proceeds, profits, dividends or any income arising from these investments. The Bank's estimates suggest that up to 60% of dividends declared by FDI firms have been repatriated to their home country and shareholders abroad. The resulting outflows are likely to be even higher if repatriations in other forms are incorporated, such as charges imposed by head office for inter-company lending, royalty payments and outsourcing arrangement fees.

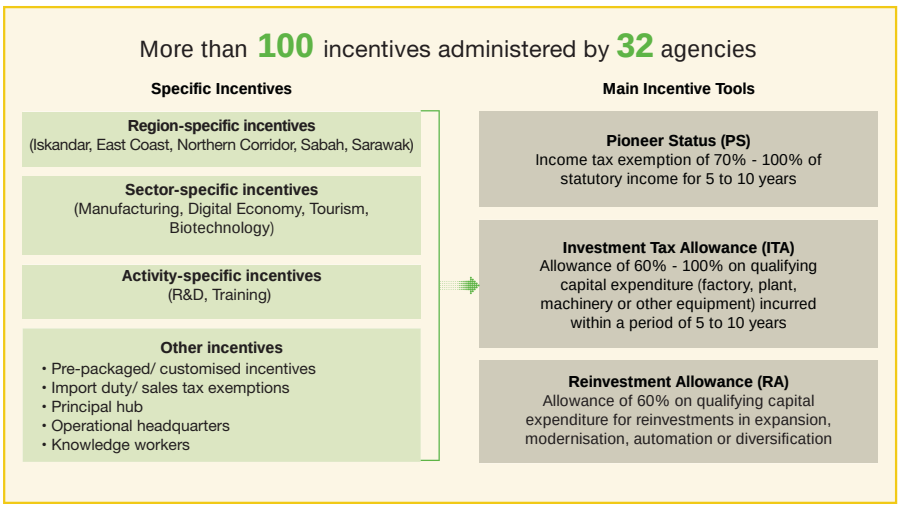
The Bank's estimates also show that MNCs directly employ 7% of all registered foreign workers. While this is a small proportion relative to local firms, it does not take into account the induced hiring of foreign workers by the domestic suppliers and service providers that are supporting these MNCs. As a result, the overall reliance on foreign workers within the manufacturing sector has led to large remittance outflows which have doubled in the past 15 years.

Effectiveness of current incentives landscape

Malaysia presently offers more than 100 different types of incentives to promote investment in the economy. These are disbursed in three main forms: Pioneer Status, Investment Tax Allowance and Reinvestment Allowance. One long-established incentive is the Pioneer Status, which provides corporate tax exemption for selected activities and products as published in a 'promoted list' accompanying the Promotion of Investments Act 1986. The promoted list has since become a guidepost among Investment Promotion Agencies (IPAs) in attracting investments and offering of incentives through the fulfilment of stipulated conditions. However, given its broad scope as well as the fast-changing global environment, in its current form the list risks obsolescence and may not adequately account for new growth areas, evolving business models and activities with higher economic complexity[3].

The fragmented nature of Malaysia's investment promotion landscape is also an area that can be improved. There are presently a total of 32 IPAs operating at the national, regional and state levels, each with their own objectives and criteria in assessing prospective investments, approving incentives and monitoring the results of investments. Recognising these challenges, the Government has reaffirmed the role of the Malaysian Investment Development Authority (MIDA) as the sole agency responsible to manage investments and incentive approvals for the country as a whole. Given its vast expertise, MIDA should be entrusted and emancipated with autonomy and authority in respect of other IPAs, thereby improving coordination and consistency in the investment promotion framework, including the monitoring of economic spillovers from investments.

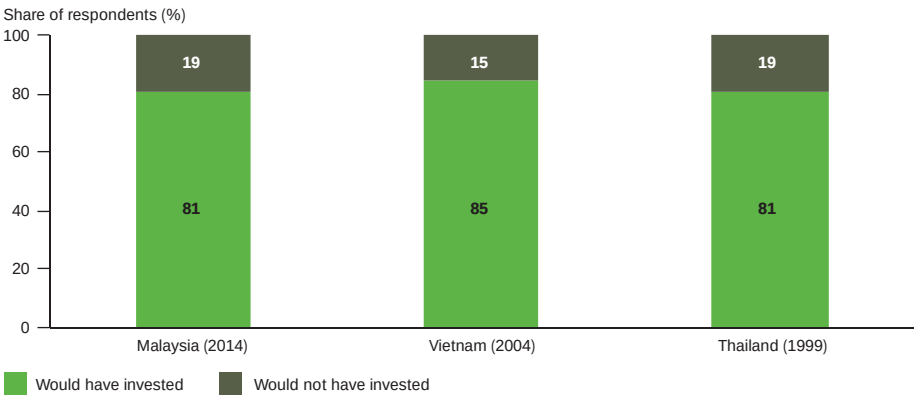
Diagram 1: Fragmentation of Incentives Landscape



Source: MIDA, state, sectoral and regional investment promotion agencies (IPAs), PwC "Doing Business in Malaysia 2017"

At the same time, there is growing evidence to suggest that the effectiveness of the current incentive instruments in attracting FDI may be diminished by growing regional competition and reforms in the international regulatory environment. As countries compete against each to attract FDI, they tend to offer similar incentive packages. This gives MNCs the upper hand in negotiating for even more generous incentives, leading to a 'race to the bottom'. A study by the World Bank has shown that competition for investments through tax-based incentives leads to tax competition and downward pressure on tax rates among regional peers[4]. In a separate study by the World Bank, four out of five firms surveyed in Malaysia indicated they would have still invested even if incentives were not provided. Also referred to as the 'redundancy ratio', the proportion of investments that would have occurred without incentives is similarly high in the regional economies such as Thailand and Vietnam (Chart 10). Nevertheless, the study on Malaysia, which covers about 200 firms, would yield greater insights from wider sampling and more granular firm-level indicators. Furthermore, practical experience suggests that for certain industries, the competition for FDI among countries is fierce and in a number of instances, the attractiveness of incentives offered could be the deciding factor in locating investments. On a wider scale, growing awareness of base erosion and profit shifting (BEPS) places greater international scrutiny on investment incentives, with the objective of discouraging potential harmful tax practices globally.

Chart 10: Redundancy Ratios of Investment Incentives in Selected Asian Economies



Source: The World Bank Facility for Investment Climate Advisory Services

[3] Economic and Product Complexity Indices are as published in "The Atlas of Economic Complexity," Center for International Development at Harvard University, http://www.atlas.cid.harvard.edu . In this article, "higher economic complexity" refers to products with Product Complexity Index higher than Malaysia's 2015 Economic Complexity Index of 1.08.

[4] World Bank, 2015; Klemm and Van Parys, 2012.

Policy considerations on rethinking the investment incentives framework

The highly-dynamic global environment and emergence of global trends such as technological disruptions, rapid urbanisation and climate change necessitate a rethink of the existing investments that would prepare the Malaysian economy for the future. In particular, prospective investments should exhibit desirable characteristics that would raise overall economic complexity, create high-value jobs, deepen linkages within the domestic supply chain and create new industrial clusters. These positive spillovers should be monitored comprehensively and reported on a timely basis.

A principles-based approach would ensure a more nimble and flexible evaluation of such characteristics in prospective investments, compared to a relatively static promoted list. Principles, which may be used to assess the quality of prospective investments include, among others, investments that are 'innovation and productivity driven', generates 'quality employment' and exhibit 'high economic complexity'. In this instance, only investments that adhere to these principles would be considered for incentives. The incentives should also be time-bound and tied to performance- and outcome-based indicators, such as R&D and technological intensity, creation of skilled jobs and ranking on the Product Complexity Index (see footnote 3).

In this regard, MIDA has implemented a new cost-benefit analysis (CBA) module in the evaluation of prospective manufacturing projects. The new CBA module is more holistic as it takes into account both the quantitative and qualitative cost and benefit aspects of the investment proposal and is benchmarked against international best practices. This provides for a more comprehensive and realistic assessment of the investment's intended benefit to the economy, thereby enhancing the incentives evaluation process to become more effective and performance-driven. MIDA is also in the process of designing a new generation of the promoted list. The new list would align promotional efforts of IPAs to attract investments in new and emerging economic activities, encourage an ecosystem approach by developing the supply chain and supporting clusters within each industry as well as provide greater clarity among investors.

There is further scope to review the type of instruments through which incentives are disbursed to ensure that benefits from investments materialise. A recent study by the World Bank states that incentives which lower the cost of investment (such as capital allowances) are less prone to profit shifting strategies as they are not contingent upon profitability[5], as compared to profit-based incentives (such as corporate income tax exemptions). At the same time, incentive instruments should also cater towards changing investor preferences, beyond tax considerations. Pivoting away from tax-based instruments, existing incentives may be complemented with lower personal income tax for highly-skilled knowledge workers, higher R&D and automation grants, and greater access to technology parks and co-working spaces.

Regardless, investment incentives should complement and should not detract from the importance of ensuring that the fundamental investment climate in Malaysia is attractive to quality investments. A conducive investment ecosystem includes elements beyond investment incentives. These include having world-class infrastructure and connectivity, efficient public service delivery and a dynamic education system which would produce a skilled workforce that is capable of undertaking high value-added activities.

Conclusion

A holistic review of the investment promotion strategy, instruments and landscape is critical in attracting quality investments going forward. More targeted, relevant and effective incentive instruments would ensure that the desired investments are attracted to Malaysia and that positive economic spillovers from these investments are maximised. It should be acknowledged, however, that investment incentives are one part of the investment landscape, and the review of incentives should be complemented with the enhancement of business enablers, such as infrastructure, public service delivery and talent. With all these in place, it is envisaged that Malaysia would stand the best chance to become a future-ready economy, and maximise the intended benefits for all Malaysians.

[5] World Bank, 2017.

Sub-Box: Case Study on Selected MNCs

Author: Loke Po Ling, Sarah Syamimi Mohd Suhaimi

Bank Negara Malaysia conducted a study on a sample of six MNCs in the E&E industry, which are also recipients of investment incentives, to assess their contributions to the domestic economy. These MNCs are among the largest manufacturers in Malaysia, with a combined revenue averaging RM63 billion per annum (9.7% of total manufacturing sales)[6]. The study shows that while these investments have generated benefits on an aggregate basis, the extent of positive spillovers have been offset by leakages at various stages of production. These leakages include the use of imported inputs, employment of foreign labour and tax foregone. The following are the key findings from the study:

1. **On an aggregate basis, the MNCs contributed positively to the domestic economy.** In the period 2013-2015, the six MNCs invested RM1.2 billion per year and generated average annual exports of RM46 billion (6.1% of total gross exports). After taking into account gross imports, these MNCs registered a trade surplus of RM16.5 billion (USD4.8 billion). These MNCs employed around 48,000 Malaysians, with a total wage bill of RM3.3 billion per year. They also collectively engaged with about 5,700 local suppliers, resulting in an overall spending on domestic inputs and services amounting to RM13.3 billion per annum.

2. **However, these positive spillovers have been offset by leakages and the degree of net benefits varies across firms.** Despite significant contributions to the gross exports of the country, spillovers generated by the sample MNCs to the domestic economy are limited by their high dependence on imported inputs and foreign services, which averages RM40 billion per annum. Consequently, net conversion of foreign currency into ringgit arising from trade only accounts for 36% of trade surplus at RM6.0 billion (USD1.75 billion). In addition, some of these MNCs register much lower net conversion of foreign currency into ringgit than the industry average[7].

3. While some firms have transitioned towards higher value added activity, **many continued to focus on low-cost business models with limited innovation capabilities.**
   - The six MNCs directly employ about 12,000 foreign workers, representing 20% of their total workforce, resulting in remittance outflows of RM0.8 billion[8] per year. Among the assembly operators, the share of foreign workers was as high as 48% of their workforce.
   - Jobs that are skewed towards the low-paying, lower-skill categories comprises 37% of total workforce. Among the assembly operators, this category could be as high as 60% share.
   - R&D intensity[9] is also relatively low, with most firms spending less than 2% of their revenue on R&D activity. Only one firm reported an R&D intensity of above 30%.

4. **The cost of investment incentives provided to the surveyed MNCs, in the form of tax foregone, is sizeable at an average of RM0.6 billion per annum.** This is equivalent to about 0.4% of Government tax revenue. Due to the incentives, these MNCs enjoy an average effective tax rate of 7.4%, significantly lower than the national corporate tax rate of 25% in 2015. This does not include other fiscal costs in the form of customs and duty exemptions, as well as subsidised rates for domestic resources[10].

It is important to note that while these findings should not be generalised to represent the E&E industry as whole, evidence does suggest that for some firms, the intended benefits are not commensurate with the associated leakages.

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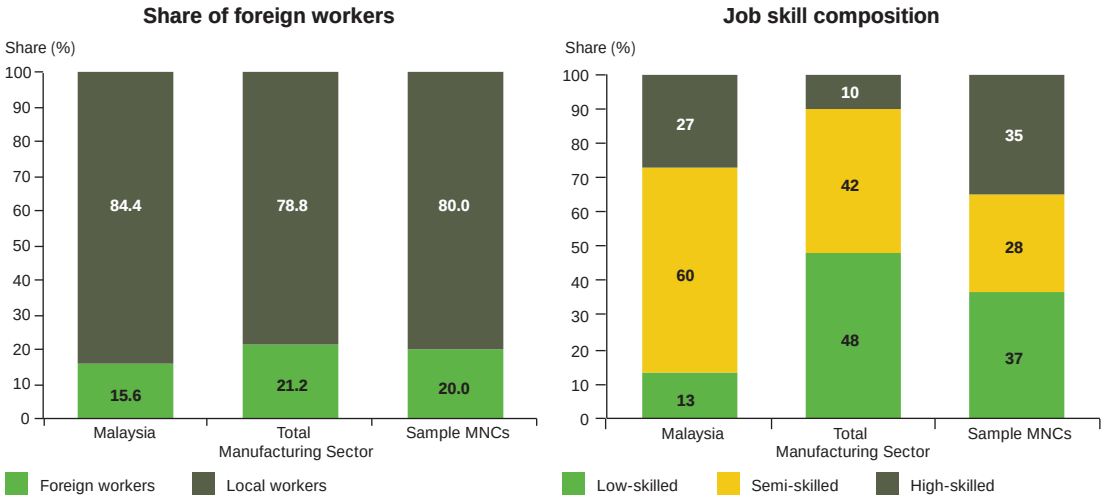
[6] Data is based on 3-year average (2013-2015) to take into account data availability for all firms at the time of the survey.
[7] Refers to net foreign currency flows over net exports. The average net conversion for a group of 184 E&E companies is 56% of trade surplus.
[8] Upper limit based on assumptions that 20% of wages accrue to foreign workers, in line with proportion of employment, and that wages are fully repatriated.
[9] R&D intensity is estimated using R&D spending as a proportion of value added. As a global benchmark, R&D intensity among electronics manufacturers is 25%-35% (McKinsey, 2012).
[10] Subsidised domestic resources include electricity tariff, basic food necessities and transportation. Since May 1997, the Government, through PETRONAS, subsidised a cumulative amount of RM241.4 billion in terms of revenue foregone from the supply of gas to Peninsular Malaysia's power and non-power sectors (PETRONAS, 2016).

Chart 11: Composition of Employment in Surveyed MNCs



Source: Annual Manufacturing Survey (2015) Department of Statistics, Malaysia and firm-level survey

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Box Article 2

Imbalances in the Property Market

Authors: Cheah Su Ling, Stefanie Almeida, Muhamad Shukri, Lim Le Sze

HIGHLIGHTS

- **Supply-demand imbalances in the property market have increased since 2015.**
- **Unsold residential properties are at a decade-high, with the majority of unsold units being in the above RM250,000 price category.**
- **The oversupply of office space and shopping complexes in the major states will be exacerbated by incoming supply, potentially becoming more severe than during the Asian Financial Crisis.**

Introduction: Property market imbalances have increased

In Bank Negara Malaysia's 2015 Annual Report[1], the risks of property market imbalances in Malaysia were highlighted. Since then, the supply-demand imbalances in the residential and commercial property segments have increased. This article is aimed at providing an update on recent developments and to highlight existing and potential actions that may be taken to mitigate the risks.

Residential Market: Total unsold residential properties currently stand at a decade-high, primarily on account of the mismatch between the prices of new housing launches and what the households can afford to pay

In 1Q 2017, total unsold[2] residential properties stood at 130,690[3] units, the highest in a decade (Chart 1). This is close to double the historical average of 72,239 units per year between 2004 and 2016. About 83% of the total unsold units were in the above RM250,000 price category (Chart 2). 61% of total unsold units were high-rise properties, out of which 89% were priced above RM250,000. Johor has the largest share of unsold residential units (27% of total unsold properties in Malaysia), followed by Selangor (21%), Kuala Lumpur (14%) and Penang (8%).

The large number of unsold properties is due to the mismatch between the prices of new launches and households' affordability[4]. Over the period 2016 to 1Q 2017, only 21% of new launches were for houses priced below RM250,000. This is insufficient to match the income affordability profile of about 35% of households in Malaysia (Chart 3). Secondly, the mismatch was exacerbated by the slower increase in median household incomes (CAGR 2012-2016: 9.6%) relative to median house prices (15.6%). These factors have resulted in median house prices in Malaysia being 5.0 times annual median household income in 2016, rendering house prices "seriously unaffordable"[5] in Malaysia. The housing affordability issue is even more acute in certain states, with house prices being "severely unaffordable" in Sabah and Penang (median multiple of 5.5). Such a wide disparity between the supply and demand of affordable homes has worsened the imbalances in the housing market.

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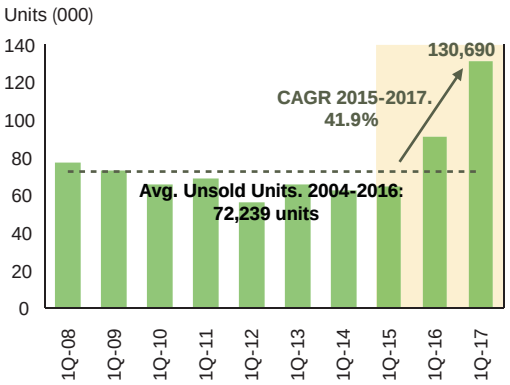
[1] Bank Negara Malaysia 2015 Annual Report box article "Assessing Demand-Supply Conditions in the Malaysian Property Market".
[2] Total unsold residential properties include unsold properties that have been completed (overhang) and unsold properties currently under construction (Source: National Property Information Centre).
[3] The figure includes small office/home office (SOHO) and serviced apartments (Source: NAPIC).
[4] For a more in-depth discussion on the topic, please refer to the Bank Negara Malaysia 2016 Annual Report box article "Demystifying the Affordable Housing Issue in Malaysia".
[5] Affordability thresholds are based on the Median Multiple approach by Demographia International (2017)

Chart 1: 130,690 unsold residential units, the highest in the decade

Total Unsold* Residential Properties

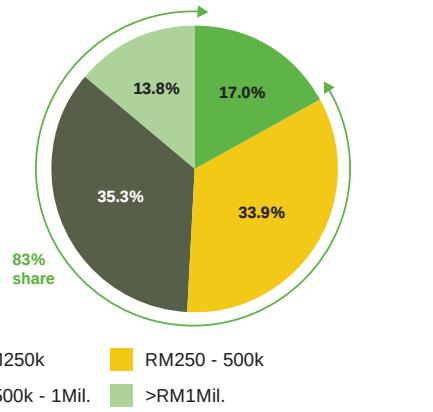


Note: *Includes overhang and unsold residential properties under construction. Includes Small Office/Home Office and serviced apartments

Source: National Property Information Centre

Chart 2: 83% of unsold residential units were in the above RM 250,000 category

Unsold* Residential Properties by Price Categories



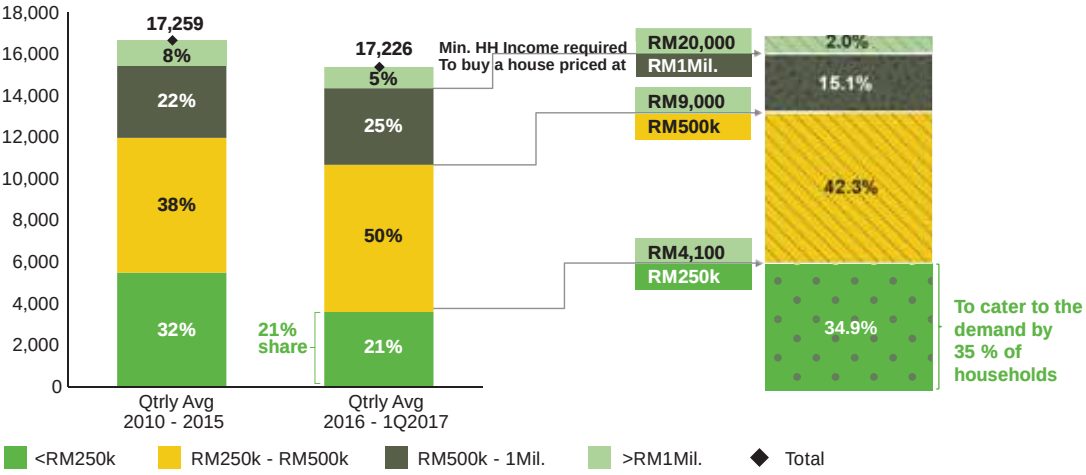
Note: *Includes overhang and unsold properties under construction, as well as Small Office/Home Office (SOHO) and serviced apartments.

Source: National Property Information Centre

Chart 3: 21% of new launches are for units priced below RM250,000. This is insufficient to cater to the demand by 35% of households

New residential launches by price category

Percentage of households and minimum gross household income required to purchase houses in the respective price segments



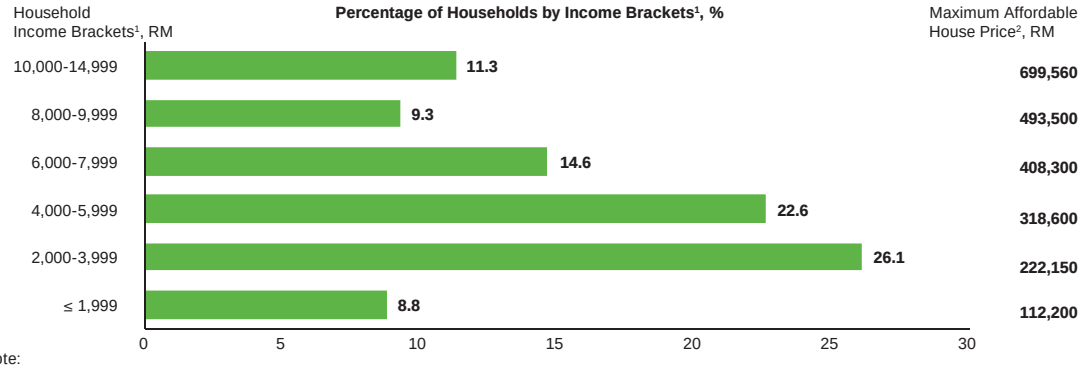
Note:
1. The above assumes households will purchase a house at the maximum price given their income levels.
2 Derived using the Housing Cost Burden Approach, in which a house is deemed affordable if the monthly housing repayment cost do not exceed 30% of household income. Estimates are based on prevailing interest rates and 35 year mortgage tenure.
3. Based on the 2016 Household Income and Expenditure Survey (HIES). Estimates for households earning above RM9,000 and RM20,000 are based on the HIES (2014), due to the lack of granular data at the point of analysis.
4. Data on new residential launches presented above uses final figures up to 1Q 2017. 2Q 2017 figures have not been included as they are preliminary, hence subject to revision.

Source: National Property Information Centre, Department of Statistics, Malaysia, Bank Negara Malaysia estimates

There are unsold residential units within the affordable price range of below RM250,000 (17% share). Several factors hamper the take-up of these properties. Firstly, this reflects the unattractive location of some affordable housing projects due to factors such as distance from work places and low transport connectivity. Secondly, the unsold affordable homes may reflect households' preference towards landed properties over high-rise properties. Thirdly, applicant registries maintained by providers of affordable housing may comprise many non-creditworthy[6] applicants, resulting in delays in the allocation of affordable homes.

[6] Applicants who do not have the financial means to even buy an affordable home.

Information Box: Housing Affordability by Income Levels



Note:
1 Based on the Household Income and Basic Amenities Survey Report 2016. Households earning RM15,000 and above account for 7.1% of total Malaysian households.
2 Estimates of maximum affordable house price is derived based on the upper-end of each income bracket, using the Housing Cost Burden Approach, in which a house is deemed affordable if the monthly housing repayment cost do not exceed 30% of household income. Estimates are based on prevailing interest rates and 35 year mortgage tenure.

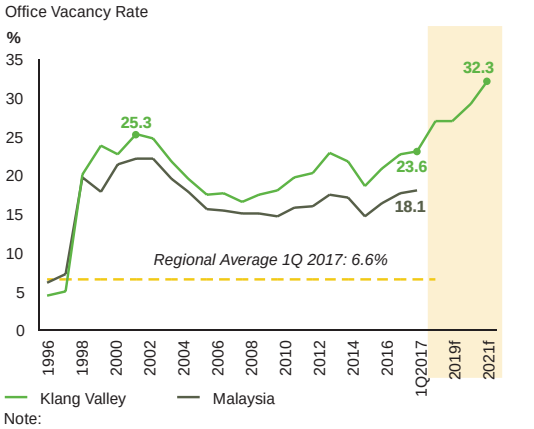
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Office Space: Incoming supply could exacerbate the glut in the Klang Valley

Since 1Q 2015, the office vacancy rate in the Klang Valley has increased steadily from 20.9% to 23.6% in 1Q 2017. This is higher than the national average of 18.1%, and more than three times the regional average of 6.6%[7] (Chart 4).

The incoming supply of 38 million square feet (msf) of office space could exacerbate the glut. The office vacancy rate is projected to reach an all-time high of 32%[8] by 2021, far surpassing levels[9] recorded during the Asian Financial Crisis. In other words, if current supply-demand dynamics persist, 1-in-3 offices in Klang Valley could be vacant in 2021. Total incoming supply could potentially be higher if future phases of the ongoing large development projects[10] are taken into account. This may result in further downward pressure on office rentals, which are already the lowest[11] in the region.

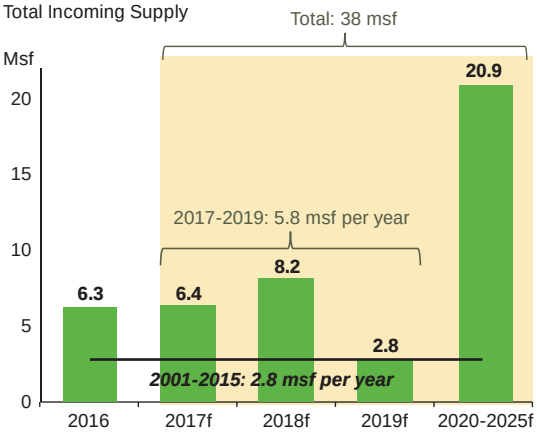
Chart 4: About 1-in-3 offices in Klang Valley projected to be vacant by 2021



Note:
1 Shaded area represents estimates of office vacancy rates going forward. For projects in the planning stage, new supply is assumed to enter the market by 2020 (45%) and 2021 (55%).
2 Regional average refers to the simple average for Hong Kong SAR, Beijing, Singapore, Shanghai, Seoul and Bangkok in 1Q 2017

Source: National Property Information Centre, Jones Lang Wootton, Jones Lang LaSalle and Bank Negara Malaysia estimates

Chart 5: Annual incoming supply from 2017-2019 to more than double the past 15 years



Note:
1 Shaded area represents estimates of incoming supply going forward. For projects in the planning stage, new supply is assumed to enter the market by 2020 (45%) and 2021 (55%).

Source: National Property Information Centre, Jones Lang Wootton and Bank Negara Malaysia estimates

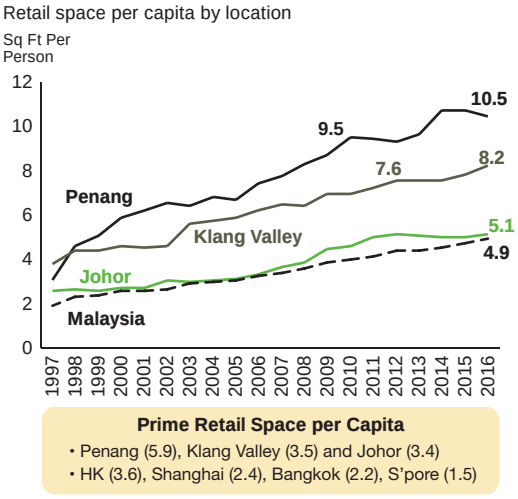
[7] Refers to prime office buildings. Corresponding vacancy rate is 22.6% in 1Q 2017 in the Klang Valley (Source: JLW).
[8] Projections assume all 38 msf of new supply enter the market by 2021, new demand of 2.6msf per year and GDP growth of 5.0-5.5%. Projections for new demand of office space are consistent with similar periods of economic growth during 2004-2016.
[9] Vacancy rate of 5.1% (1997), 20.1% (1998) and historical peak of 25.3% (2001).
[10] Tun Razak Exchange and Bukit Bintang City Centre.
[11] Monthly rents of prime offices in Kuala Lumpur (RM5.30 psf) are lower compared to Manila (RM7.40), Bangkok (RM11.10), Singapore (RM24.80) and Hong Kong (RM 85.00) (Source: Knight Frank Research).

Shopping Complexes: Large incoming supply to aggravate the oversupply across Klang Valley, Penang and Johor

Total retail space in the major states has increased sharply over the years. In 2016, Penang had the highest retail space per capita in the country (10.5 sq ft per person), followed by Klang Valley (8.2) and Johor (5.1). In higher-income regional cities such as Hong Kong SAR and Singapore, prime retail space per capita is only 3.6 and 1.5 respectively (Chart 6).

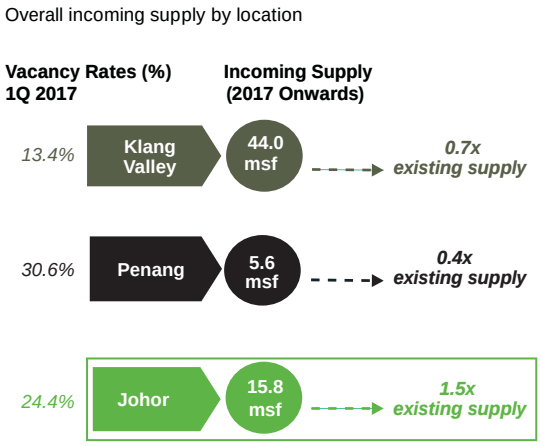
The incoming supply of 140 new shopping complexes by 2021 across the Klang Valley, Penang and Johor is expected to worsen the oversupply going forward (Chart 7). While Penang currently has the highest prime retail space per capita, it will be overtaken by Johor by 2018. The large incoming supply of 15.8 million square feet of retail space in Johor will be 1.5 times the existing supply.

Chart 6: Retail space per capita in key Malaysian states has increased sharply over the years, and is considerably higher than regional peers



Source: National Property Information Centre, Department of Statistics, Malaysia, Savills Research and Bank Negara Malaysia Estimates

Chart 7: Incoming supply of 140 shopping complexes in Klang Valley, Penang and Johor to worsen the oversupply situation going forward



Note: msf – million square feet

Source: National Property Information Centre, Jones Lang Wootton and Bank Negara Malaysia Estimates

Severe property market imbalances can pose risks to macroeconomic and financial stability

History has shown that excesses in the property market can pose risks to the wider economy. According to the IMF (2003), historically, housing booms have been followed by busts about 40% of the time, with housing busts being associated with longer economic downturns and larger output losses[12] compared to equity price busts. Given that there are imbalances in both the residential and commercial property markets in Malaysia, this is a source of concern as the property sector has linkages to more than 120 industries, collectively accounting for 10% of GDP and employing 1.4 million Malaysians.

Malaysia's own experience during the Asian Financial Crisis demonstrated that sharp corrections in the property market can have severe repercussions on the wider economy (Chart 8). In the years leading up to the Asian Financial Crisis, the Malaysian economy experienced a period of strong growth (1992-96: 9.6%). This fuelled exuberance in the property market, resulting in an increase in property prices and overdevelopment across the different property segments. This encouraged an increase in lending by banks to households for the purchase of properties and developers to fund the development of new projects. The ensuing construction frenzy also demanded large amounts of imports, which worsened

[12] On average, output loss following a housing bust was 8% of the level based on average growth rates before the bust (equity price bust: 4%), and lasted about 4 years (equity price bust: 1.5 years).

the current account of the Balance of Payments. When the crisis[13] struck and the property market crashed in 1998, projects were abandoned as developers' debt-servicing capacity weakened. Banks suffered losses as non-performing loans to the property sector doubled, resulting in a credit crunch. Spillovers to other industries then resulted in widespread layoffs and a severe economic recession. A similar story unfolded in Spain, Ireland and the US during the Global Financial Crisis – in these cases, large fiscal stimulus and bailouts had also strained the governments' balance sheets.

Chart 8: A vulnerable property sector poses risks to the economy



Source: Bank Negara Malaysia

The banking system has remained supportive of house financing, while becoming more cautious in the commercial property segment

Banks continue to play an important role in providing financing to house buyers, with more than 70% of all housing loans being given to first-time buyers. In the first nine months of 2017, RM121.6 billion of new housing loans were approved by banks, benefitting close to 300,000 borrowers. Of this, 60% were channelled for the purchase of houses priced below RM500,000.

With respect to the commercial property sector, banks have become more cautious in lending to this segment due to the oversupply situation, as shown by the lower loan approval rates for the construction and purchase of commercial properties. The banks' current exposure to the commercial property segment remains small, accounting for 5.1% of total bank loans.

These developments have reinforced the importance of existing micro- and macro-prudential regulations, such as the broad property sector concentration limit and single customer exposure limit as a means to ensure bank exposures to the overall property sector and individual property-related companies remain within prudent limits. Furthermore, current loan-to-value (LTV) ratio limits[14] also remain relevant to discourage speculative activity that drives up house prices and exacerbates the housing affordability problem. The Bank has also intensified monitoring of the banks' underwriting and credit risk management practices, particularly those related to the commercial property sector. In some instances, banks are required to enhance internal processes to ensure that related risks are effectively mitigated.

Overall, banks are assessed to be able to withstand a slowdown in the property segment as: (i) total loan exposures to segments with acute oversupply (i.e. commercial property and high-end high-rise residential) only account for 8% of total bank lending; and (ii) impaired loans ratio for the commercial property and housing segments remains low and stable at 1.2% and 1.1% respectively. Internal stress test simulations done on large corporate borrowers also indicate that banks' excess capital is sufficient to withstand potential credit losses from exposures to these borrowers, including large property developers.

[13] During the pre-AFC period (1992-96), property-related credit grew by 26%, construction activity by 14.8%, while house prices increased by 11.2%. During the AFC, real GDP contracted by 7.4% in 1998 (1997: 7.3%) with an increase in unemployment rate to 3.2% (1997: 2.5%). Private investment declined by 55.2% (1997:+9.4%), construction activity by 6.7% while fiscal deficit increased to 1.8% of GDP (1997: +2.4%). During the post-AFC period, there were continued weaknesses in house prices (1999-2003: 2.2%), fiscal balance (-4.8% of GDP), unemployment rate (3.4%), private investment (-4.1%) and construction activity (0.7%).

[14] LTV ratio limit of 70% on the third and above housing loans of individuals and 60% on all housing loans of non-individuals.

Policy considerations need to go beyond financial regulatory measures

A multi-faceted approach should be considered to address the imbalances in the property market (Table 1) as the effect of regulatory constraints on lending is limited. This is because developers also fund their projects using internal funds and proceeds from capital market issuances. There is a need for all parties, from the Federal and state governments, to property developers, to act in a concerted manner to manage the imbalances in the property market.

Table 1: Reducing Supply-Demand Imbalances in the Property Market

Issue	Segment	Policy Options	Details
High level of unsold residential properties	All price ranges	Encourage rental market	• Develop a strong rental market by enacting the Residential Tenancy Act and establish a Tenancy Tribunal to safeguard the rights of both tenants and landlords[15]
	Affordable housing	Increase efficiency in provision of affordable homes	• Establish a single entity for affordable housing to accelerate the rebalancing of supply towards the affordable range • Ensure that the development of new projects are in decent locations with good transport connectivity
		Increase efficiency in allocation of affordable homes	• Ensure applicant registries are regularly updated, verified and filtered to prioritise credit worthy households • Direct ineligible applicants to rental housing
Large incoming supply of commercial properties	Office and shopping complexes	Managing new incoming supply	• Commercial viability of any new project must be thoroughly assessed before it is commissioned. • Developers to be cognisant of current and future demand conditions: – Cannibalising effects on tenants and customers (from new malls and offices) – High costs of living – Rising e-commerce market
High vacancy rate and low rental rates in existing buildings		Repurposing vacant commercial buildings	• Vacant commercial spaces in prime locations could be repurposed into economically meaningful assets: – Corporate housing, en-bloc rental accommodation – Art centres – Indoor parks
		Increasing demand for existing space	• Intensify efforts to attract foreign companies to set up businesses and to expand their footprint in Malaysia • Encourage occupancy by start-ups by giving rental rebates

Conclusion

Over the past decade, property-related investments have risen significantly (2016: 25% share of total investments; 2005: 18%). Currently, the property market is characterised by an oversupply of non-affordable housing and idle commercial space, and conversely, an undersupply of affordable homes. This situation could worsen if the current supply-demand conditions persist. Within the country, Johor is poised to have the largest property market imbalances (highest number of unsold residential properties and potentially the largest excess supply of retail space). As such, it is timely for all parties to act now to mitigate any potential risks to macroeconomic and financial stability.

[15] Globally, governments have safeguarded the rights of tenants and landlords by enacting specific legislations such as Tenancy Act (Australia and New Zealand) or have incorporated these qualities into their Federal Law (Germany).

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