Malaysia's
Financial Services Cluster

Final Report

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Disclosure:
Ahmad Shariff is a Malaysian national and has worked in the financial services sector.

Introduction

Malaysia is situated in South-Asia, on the shores of the South China Sea, just above the equator. The country is separated into two major regions—Peninsular Malaysia and Malaysian Borneo. It borders Indonesia, Thailand, Philippines, Singapore, and Brunei.

The British first established outposts in what is now Malaysia in the late 1700s, and subsequently maintained a presence in the territory. While the Japanese occupied the region during World War II, and the British Empire regained control in 1945. Following a prolonged campaign led by the United Malays National Organization, independence from the Empire was achieved in 1957. The Federation of Malaysia came into being in 1963.[1]

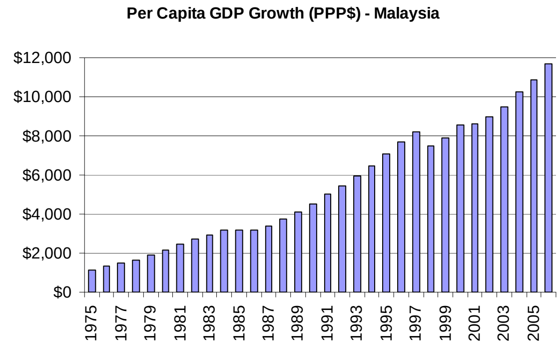
Currently, the government is a parliamentary democracy and constitutional monarchy, modeled after the British system. In 2004, the population was 50.4% Malay, 23.7% Chinese, 11% indigenous, 7.1% Indian, and 7.8% classified as others. The country's religious makeup was 60.4% Muslim, 19.2% Buddhist, 9.1% Christian, and 6.3% Hindu in 2004. While Malay is the official language, more than seven other languages are also spoken by the population of 25.3 million.

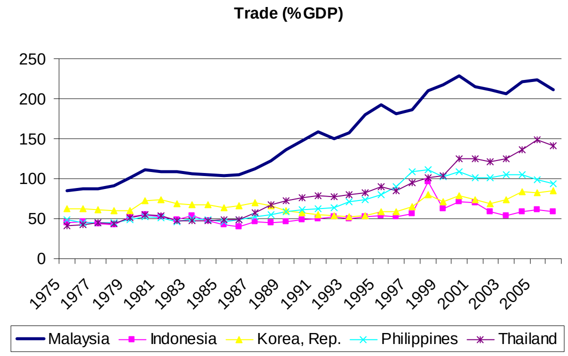
Economic History

Since independence in 1957, Malaysia has been transformed from a rural economy to a middle-income country, which appears well on its way toward its long-term goal of achieving developed country income levels. Since 1975, per capita GDP (PPP$) has increased by a factor of 10. Over the past 30 years, Malaysia has emerged as one of the world's foremost trading nations, with trade standing at over 200% of GDP, led by strong growth in manufacturing, particularly in electronics. The incidence of poverty has declined dramatically, and other social indicators have improved over the period. The Malaysian government has actively supported economic development through a series of long-term economic strategies, aimed first at growth and national unity, then on strategies for rapid industrialization and development. These policies have evolved considerably over time, in line with the changing structure of

[1] EIU, Malaysia—Country Report, February 2008

Malaysia's economy, competition from abroad, and the changing nature and needs of the global marketplace.





1957-1970: At the time of independence in 1957, Malaysia was a rural agricultural and commodity-based economy, concentrated in the cultivation of rubber and extraction of tin, which accounted for about 70 percent of exports and 36 percent of total employment.[2] In this context, one of the legacies of British rule and the British East India Company was that Malaysia had long been highly dependent on exports as an economic engine.

The new government began by initiating economic and development policies aimed at modernizing agricultural practices and diversifying crops, and industrial policies focused on import substitution and government investment. These policies were successful in increasing agricultural output and creating basic industries focused on the extractive sector. By the end of the 1960s, palm oil and timber had emerged as major cash crops. Oil was also discovered near the Sarawak peninsula, which soon became a major source of government revenue.[3]

Growth performance averaged 6.5% from 1960 to 1969, with real GDP almost doubling over the decade.[4] Despite some progress, the incidence of poverty remained significant by the late 1960s, and the income distribution remained highly inequitable, particularly across ethnic groups. These tensions between ethnic Malays and wealthy minorities, particularly those of Chinese and Indian origin, led to

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[2] "Recent Economic History", Economic Planning Unit, Government of Malaysia, http://www.epu.jpm.my/new%20folder/recenteconomichistory.htm
[3] "Recent Economic History", Economic Planning Unit, Government of Malaysia, http://www.epu.jpm.my/new%20folder/recenteconomichistory.htm
[4] Team analysis based on WDI

worsening socio-political dynamics. These tensions were largely responsible for Singapore's secession from the Union in 1965, and would lead to civil unrest throughout the 1960s, culminating in mass riots across the country in 1969.

1970-1991: Largely in response to mounting ethnic tensions and related political instability, the government initiated the first in a series of ambitious long-term socio-economic development strategies in 1970, known as the New Economic Policy (NEP). The NEP's primary objectives were to promote growth and national unity, by focusing on (1) reducing poverty, and (2) restructuring society. At the outset, the explicit focus of the NEP was not to maximize growth, but to increase national unity and overcome ethnic and religious divisions. Much of the focus was on increasing the participation of the Bumiputera ethnic group, composed of ethnic Malays and indigenous peoples. The government explicitly acknowledged at the outset that the NEP would give unity priority over growth, sacrificing some degree of economic performance in favor of political objectives.[5]

The NEP initially focused on a mixed model of export promotion in competitive manufactures (e.g., electrical devices and later electronics, textiles, and food), buttressed by import substitution for industries focused on domestic consumption. In this context, free trade zones were created to support production for export. Foreign and domestic exporters also received subsidies and/or other policy incentives to produce—e.g., tax concessions and duty-free imports of inputs.[6] This policy was supported by heavy government investment, financed largely by oil and gas revenues and deficit spending.[7]

Economic performance improved significantly from 1970 to 1979, with real GDP growth averaging over 14% and output almost quintupling over the decade.[8] However, deficit spending led to

[5] "Malaysia: 30 Years of Poverty Reduction, Growth, and Racial Harmony", Ministry of Economic Planning, Government of Malaysia
[6] Drabble, John H.; "The Economic History of Malaysia", University of Sydney, Australia; http://eh.net/encyclopedia/article/drabble.malaysia
[7] "Malaysia—An Economy Transformed", Department of Foreign Affairs and Trade, Government of Australia and Monash University, 2005, www.dfat.gov.au/eau
[8] Analysis based on data collected from the World Bank, World Development Indicators Database, www.worldbank.org

increasing indebtedness—e.g., the external debt to GNI ratio doubled from 1970 to 1979. [9] In 1973, the central bank moved away from a fixed exchange rate regime to a managed float, which allowed the government to influence the value of the ringgit, often with the implicit aim of promoting export competitiveness.[10] By the late 1970s, a global recession and a collapse in commodity prices led to a severe economic downturn in Malaysia, punctuated by twin fiscal and current account deficits.

By the 1980s, growth had slowed considerably. The government began to focus more of its efforts on supporting higher-value added manufacturing sectors, particularly in electronics (e.g., semiconductors). Structural reforms were aimed at reducing public expenditure and promoting private sector-led growth through deregulation and privatization. As part of this process, the government focused on developing the infrastructure and basic services necessary for supporting investment and growth, including by investing more funds in public utilities and education.

By 1987, manufacturing overtook agriculture as the main engine of growth.[11] By the early 1990s, the government began to focus on the next stage of development, by concentrating on the development of a modern industrial economy, taking its cue from the extraordinary successes of other newly-industrializing Asian economies.

1991-2006: In 1991, the New Development Policy (NDP) was launched as a successor to the NEP, along with Vision 2020, which set the goal of reaching developed economy status over the next 29 years—a goal that would require an eight-fold increase in per capita income over the period.[12] While the NDP, like its predecessor the NEP, officially aimed at promoting "balanced development", its orientation was decidedly more pro-market. The promotion of private sector-led growth and the development of

[9] Analysis based on data collected from the World Bank, World Development Indicators Database, www.worldbank.org

[10] "Malaysian Capital Controls: Macroeconomics and Institutions", IMF Working Paper, 2006

[11] "Malaysia—An Economy Transformed", Department of Foreign Affairs and Trade, Government of Australia and Monash University, 2005, www.dfat.gov.au/eau

[12] "Malaysia—An Economy Transformed", Department of Foreign Affairs and Trade, Government of Australia and Monash University, 2005, www.dfat.gov.au/eau

human resource capacity were among its main pillars.[13] The government began to reduce its intervention in the economy, including by initiating a large scale privatization program.

The early 1990s were an era of strong performance for Malaysia, with GDP growing at over 8.5 percent per year, and the incidence of poverty falling from 16.5 to 6.1 percent from 1991 to 1997.[14] This period saw the emergence of high technology manufacturing as a globally competitive export industry. In this context, FDI and other capital flows also increased dramatically during the early to mid 1990s.

In 1998, the Asian Financial Crisis had a devastating impact on many economies in the region. While Malaysia fared well relative to some of its neighbors, the economy suffered a severe setback in terms of output performance, which was not fully overcome for several years. This underscored many of the vulnerabilities faced by the Malaysian economy, particularly the susceptibility of such an open economy to both changes in global economic performance and shifting capital flows.

Today: Today, Malaysia is a vibrant manufacturing-based economy, characterized by strong growth performance (reaching over 6 percent in 2006), low inflation, and external surpluses. [15] This performance is underpinned by prudent macroeconomic polices, which have improved dramatically since the Asian Financial Crisis. Currently, life expectancy at birth is 73 years, and infant mortality stands at 16.4 deaths per 1000 live births, which compares well with both other countries in the region, as well as others at a similar level of development.[16]

Regarding trade policy, Malaysia is currently characterized by low average tariffs and limited incidence of non-tariff barriers. Malaysia is a founding member of the Association of South East Asian Nations (ASEAN) Free Trade Area, and most tariffs among original member states were scrapped in 2007. Trade now stands at over 200 percent of GDP, making Malaysia the world's fourth most open

[13] "Malaysia: 30 Years of Poverty Reduction, Growth, and Racial Harmony", Ministry of Economic Planning, Government of Malaysia

[14] "Recent Economic History", Economic Planning Unit, Government of Malaysia, http://www.epu.jpm.my/new%20folder/recenteconomichistory.htm

[15] IMF—2006 Article IV Consultation with Malaysia, Public Information Notice, March 2007, http://www.imf.org/external/np/sec/pn/2007/pn0734.htm

[16] 2008 CIA World Factbook.

economy by this measure, behind Luxembourg, Hong Kong, and Singapore in 2002.[17] This has supported the country's export-oriented growth strategy, particularly in the hi-tech manufacturing sector. Malaysia was the world's fifth largest exporter of semiconductors in 2003.[18] However, tariff peaks and specific trade restrictions remain in some areas—e.g., the importation of finished automobiles is prohibited.[19] While this overall openness is certainly a function of prudent policies, it is also due to necessity, as many of the country's manufactures have a high intermediate input content.

Regarding macroeconomic management, the government shifted from a pegged exchange rate regime that was introduced during the Asian crisis, to a managed float linked to a basket of currencies in 2005.[20] This has provided greater flexibility regarding both monetary and fiscal policy, and reduced the economy's vulnerability to shocks. However, by many estimates, the ringgit remains undervalued.[21] In this context, allowing the currency to reflect its fundamental value would expose export sectors to greater competition and support productivity enhancing investments in capital intensive industries.

Fiscal management has improved, and fiscal deficits have been declining since 2001, reaching a record low of 3.5% of GDP in 2007.[22] However, this improvement in performance comes in the context of rising oil and gas prices, and government expenditure has actually been increasing since 2005. While government financing needs appear modest at present, growing reliance on oil and gas revenues may pose problems in the future. Lower non-priority expenditures (e.g., in supporting government-linked companies) would also free up capital for critical infrastructure and development expenditure in the short term, and help to provide scope for counter-cyclical policies in the event of a downturn.

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[17] "Malaysia—An Economy Transformed", Department of Foreign Affairs and Trade, Government of Australia and Monash University, 2005, www.dfat.gov.au/eau

[18] "Malaysia—An Economy Transformed", Department of Foreign Affairs and Trade, Government of Australia and Monash University, 2005, www.dfat.gov.au/eau

[19] "Malaysia—An Economy Transformed", Department of Foreign Affairs and Trade, Government of Australia and Monash University, 2005, www.dfat.gov.au/eau

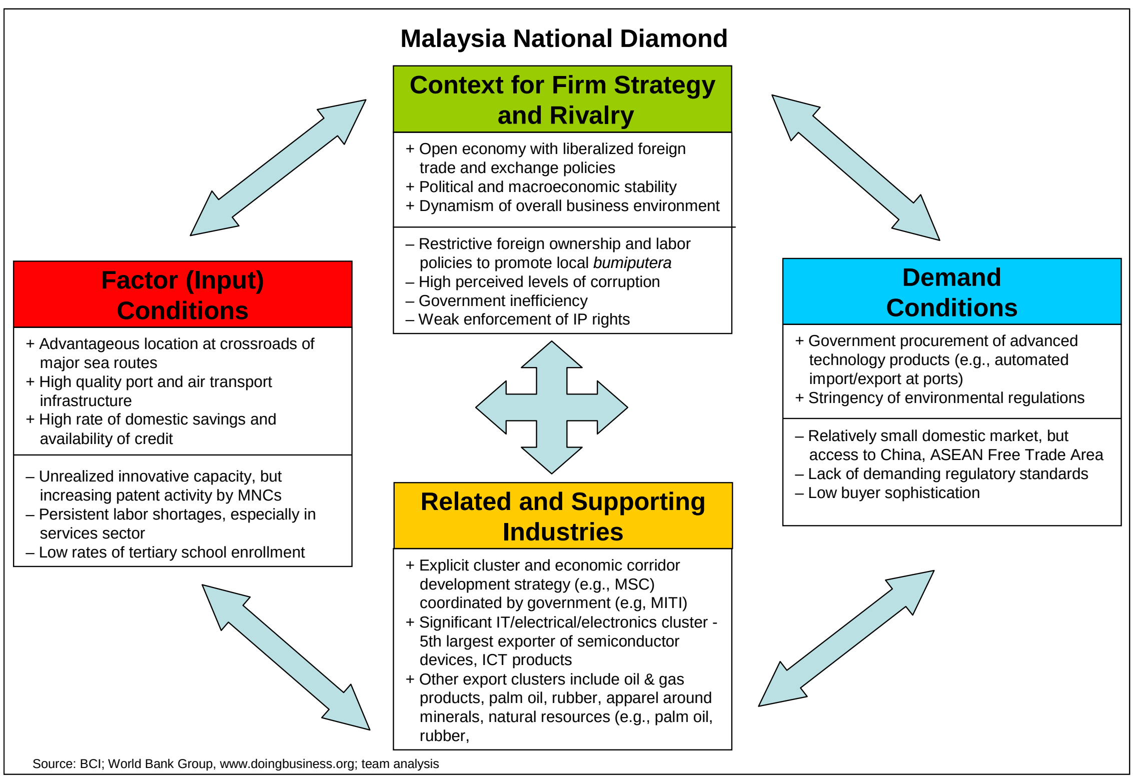
[20] EIU, "Malaysia—Country Forecast", February 2008

[21] IMF—2006 Article IV Consultation with Malaysia, Public Information Notice, March 2007, http://www.imf.org/external/np/sec/pn/2007/pn0734.htm

[22] "Malaysia—Country Forecast", EIU, February 2008

The National Business Environment

Malaysia's business environment generally compares favorably with other Asian countries. It ranks 21st on the 2007-2008 Global Competitiveness Index, behind Singapore (#7), Korea (#11), Hong Kong SAR (#12), Taiwain (#14), but ahead of Thailand (#28), Indonesia (#54), Vietnam (#68), and the Philippines (#71). (GCR 2007-2008) Malaysia's macroeconomic conditions and economic policies have also made the country one of the highest ranked in terms of the speed at which it is upgrading its competitiveness. According to the GCR, Malaysia ranks 2nd among middle-income countries and 3rd out of all countries in its dynamism. (Porter, GCR 69-70). The following text and figures summarize Malaysia's factor conditions, the context for firm rivalry and strategy, important industries and the state of cluster development, and demand conditions.



Business Competitiveness Index Rankings for Malaysia, 2007

Relative Strengths		Relative Weaknesses	
Government procurement of adv. tech. products	3 ⇧	Property rights	51 ⇩
Quality of math and science education	10 ⇧	Cellular telephones per capita	37
Cooperation in labor-employer relations	10	Absence of trade barriers	36
Quality of port infrastructure	12	Quality of telephone/fax infrastructure	34
Quality of primary education	12 ⇧	Low business costs of corruption	31
Company spending on research & development	12 ⇧	Freedom from corruption	30
Control of international distribution	13 ⇧	Patents per capita	28
Air transport infrastructure quality	13 ⇧	Effectiveness of antitrust policy	27
Extent of staff training	14 ⇧	Quality of electricity supply	26
Ease of access to loans	14 ⇧	Financial market sophistication	26

Source: Institute for Strategy & Competitiveness, BCI

Note: Arrows indicate a change of 5 or more ranks since 2001

Factor Conditions. Malaysia's location and natural endowments offer distinct advantages. Sitting at a crossroads of major sea routes that connect the Far East to South Asia, the Middle East and Europe, Malaysia benefits tremendously from its openness to foreign trade and investment. Malaysia is self-sufficient in important natural resources, including gas and oil, and has a good climate for the production of various crops, including oil palm and rubber. Malaysia's natural beauty, as well as political and macroeconomic stability, have also made it an increasingly popular destination for tourists from Europe, Japan, and North America.

At independence, Malaysia inherited relatively well-developed but unevenly distributed infrastructure and transportation networks. In the ensuing years, the government committed significant investments in expanding its highways, railroads, seaports, and airports. The government has been particularly astute at applying state-of-the-art technology to improve the flow of trade. Automated cargo import and export procedures cut down delivery times through the Kuala Lumpur International Airport (KLIA) and Malaysia's seven international ports and eight domestic ports. The government has also actively encouraged development of modern modes of communications such as satellite telecommunications and the Internet.

In 2001, Malaysia ranked 60th in terms of Innovation Capability according to UNCTAD's 2005 World Investment Report. This placed Malaysia in the middle-category of Medium Innovation Capability, but it remained behind other Asian economies such as Japan (11th), Korea (19th), Singapore (26th), and Thailand (54th). (UNCTAD 2005) Patent activity in Malaysia has increased more recently. The number of U.S-registered patents increased from 42 in 2000 to 158 in 2007, reflecting a CAGR of 18%. International patenting registration in the U.S. fell at a CAGR of -.02% over the same period; registration by non-U.S. entities increased overall by only 0.89% CAGR. Most of Malaysia's institutional U.S. patent holders, however, are not local firms, but multi-national corporations involved in the country's booming semi-conductor industry, including Agilent Technologies, Intel, National Semiconductor Corporation, and Motorola. (USPTO)

Malaysia's workforce is young and moderately well educated, but labor shortages are persistent. Due to rapid expansion of all sectors of the national economy, all types of workers are in high demand, especially skilled labor in the manufacturing sector and well-trained professionals in the services sector. Not surprisingly, the 10 million strong workforce now includes a large number of foreign workers: officially 2 million, but likely closer to 3 million if one includes illegal immigrants from high-unemployment Indonesia and other neighboring countries. (EIU World Investment Service) The government plans to reduce this dependency on foreign labor by discontinuing work permits (outside the construction and manufacturing industries) for unskilled workers after five years and of skilled workers after ten years. The steps, if carried out, are expected to significantly raise production costs due to the expenses of importing skilled and specialized workers. (EIU World Investment Service)

The Malaysian government is trying to develop better education at all levels, as it wants to retain and attract new skill-intensive industries and services to the country. The quality of primary education, as well as math and science schools, is high – 12th and 10th in the world according to the Business Competitiveness Index (GCR 2007-2008); however, Malaysia ranks 82nd out of 172 countries on the combined primary, secondary, and tertiary enrollment percentage. (UNDP) Tertiary enrollment has been of particular concern due to its importance to higher-value and services clusters. At 32.01%, Malaysia ranks 61st in terms of tertiary enrollment – behind Korea (2nd), Japan (32nd), and Thailand (45th). (UNESCO)

Context for Firm Strategy and Rivalry. Malaysia is ranked 24th out of 178 economies in the Ease of Doing Business rankings. It is among the top five in the world for protecting investors (#4) and getting credit (#3) – the latter mark higher than even Singapore. It is, however, in the bottom 20% of countries for time and number of procedures to get a license to build a warehouse. (World Bank Group 2008) Such inefficient government bureaucracy is cited by the GCR as Malaysia's most problematic factor for doing business. (GCR 2007-2008) In February 2007, Malaysia's government announced the creation of Pemudah, a public-private task force to review and improve public service delivery systems and the ease of doing business in the country generally.

Ease of Doing Business Rankings
in Malaysia and Neighboring Countries, 2008

Metrics	Singapore	Hong Kong	Thailand	Malaysia	Korea	Vietnam	Indonesia	Philippines
Starting a Business	9	13	36	74	110	97	168	144
Dealing with Licenses	5	60	12	105	22	63	99	77
Employing Workers	1	23	49	43	131	84	153	122
Registering Property	13	58	20	67	68	38	121	86
Getting Credit	7	2	36	3	36	48	68	97
Protecting Investors	2	3	33	4	64	165	51	141
Paying Taxes	2	3	89	56	106	128	110	126
Trading Across Borders	1	3	50	21	13	63	41	57
Enforcing Contracts	4	1	26	63	10	40	141	113
Closing a Business	2	15	44	54	11	121	136	147
Ease of Doing Business	**1**	**4**	**15**	**24**	**30**	**91**	**123**	**133**

Better ← → **Worse**

Source: World Bank Group, www.doingbusiness.org; Global Competitiveness Report 2008

Like many countries in the Asian Pacific region, Malaysia faces serious perceived levels of domestic corruption. Despite the enactment of anti-corruption legislation and establishment of an Anti-Corruption Agency, the country ranked 43rd on Transparency International's Corruption Perceptions Index in 2007. It placed 8th out of 32 countries in the region – ahead of many of its low- and middle-income neighbors, but still behind New Zealand, Singapore, Australia, Hong Kong, Japan, Macao, and Taiwan. Malaysia has signed but not yet ratified the UN Convention against Corruption.

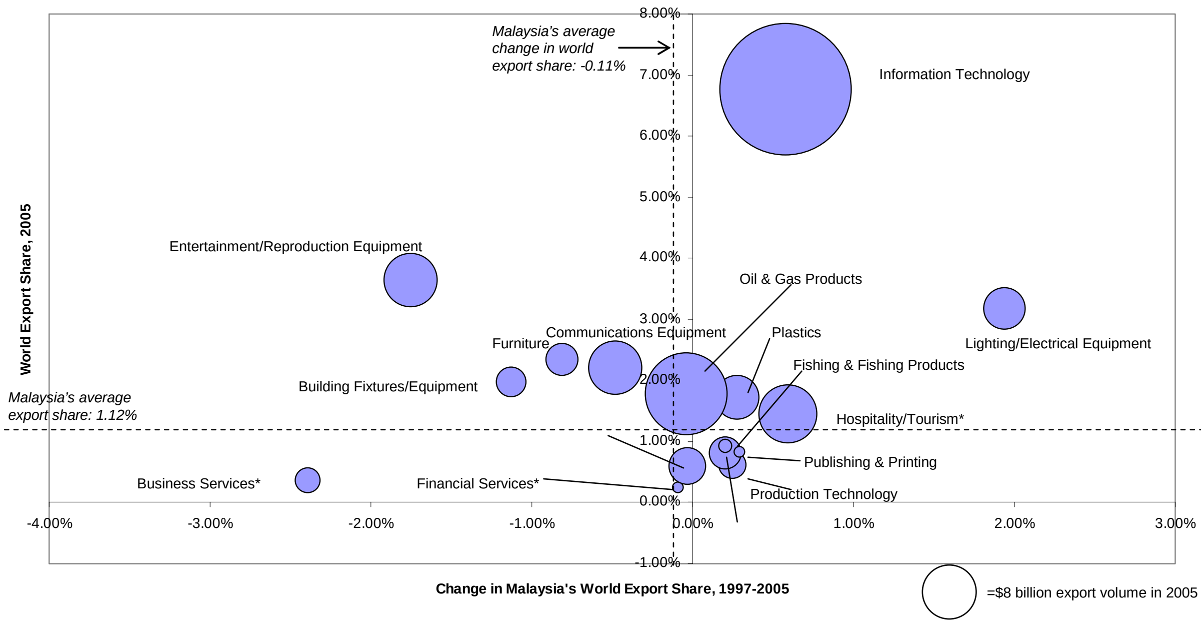
Rooting out corruption in Malaysia may be more difficult than neighboring countries because of its program of affirmative action. Enshrined in Article 153 of the constitution, *bumiputera* promotion policies make preferential treatment the law of the land, even in the awarding of government contracts and jobs. In practice, the well-off and well-connected receive the largest portion of benefits, which include admission to public educational institutions, qualifications for public scholarships, and restrictions on foreign ownership. The resulting economic distortions in the property, labor, and stock markets inhibit growth and deter both foreign and domestic investment. (U.S. State Department)

Malaysia’s protection of intellectual property rights is weak and inconsistent. Malaysia has extensive and progressive legislation in the field of intellectual property rights protection. Malaysia is a member of the World Intellectual Property Organization (WIPO), Paris Convention, Berne Convention and signatory to the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS). (MSC) However, Malaysia's track record in enforcement of IP rights has been far from satisfactory. Piracy-related costs to industry due to the manufacture of counterfeit products and medicines are estimated at nearly $200 million annually. (Heritage) Consequently, property rights is one of just three ranked areas in the GCR in which Malaysia has lost ground over the last seven years, and the only one that has dropped more than five ranks. (WEF; ISC)

Related and Supporting Industries. In recent years, Malaysia’s government has promoted regional economic corridors and worked to develop certain higher-value clusters. The Malaysian Industrial Development Authority (MIDA) is the government’s principal agency for the promotion foreign investment and the coordination of industrial development, and Malaysia External Trade Development Corporation (MATRADE) is responsible for promoting Malaysian products and exploiting market opportunities overseas. Both MIDA and MATRADE advise Malaysia’s Minister of International Trade and Industry (MITI) and constitute the chief Institutions For Collaboration (IFCs) coordinating cluster development and general business environment improvements.

As previously noted, the country has achieved considerable success in developing its electronics sector, on the basis of heavy foreign investment in projects like the Multimedia Super Corridor (MSC). Malaysia is now the world's 5th largest exporter of semiconductor devices, electrical goods, and other information and communication technology (ICT) products. (ISC) Prime Minister Abdullah recently unveiled a series of development schemes, modeled after the MSC, for several regions that have had trouble attracting business investment. As the following graph illustrates, other major Malaysian export clusters include oil, natural gas, tourism, fishing, and palm oil.

Malaysia's Export Performance for Selected Clusters, 1997-2005



* Export performance data range is more limited: Financial Services (1999-2004); Business Services (1997-2004); Hospitality/Tourism (1997-2004)
Note: Selections represent major clusters by export value in 2005, as well as smaller clusters experiencing significant change over period
Source: Prof. Michael E. Porter, International Cluster Competitiveness Project, Institute for Strategy & Competitiveness; underlying data from UNCTAD, IMF

Demand Conditions. Although Malaysia remains a middle-income country with a relatively small domestic market, the country benefits from the size, dynamism, and growth of its neighborhood. Malaysia is a founding member of the Association of South East Asian Nations (ASEAN) Free Trade Area, and most tariffs among original member states were scrapped in 2007. (EIU World Investment Service).

Malaysia financial services cluster

History. The Malaysian financial services cluster can be traced back to the establishment of the Malaysian central bank, Bank Negara Malaysia (BNM) in 1959. As the regulatory agency for the financial industry BNM also acted as a focal point of the nascent sector. Prior to independence in 1957 the banking system was dominated by three British banks, starting with Standard Chartered Bank which opened in 1875[23]. The focus of the British colonial banking system was to facilitate the booming rubber and tin production from the end of the 19th century up to the Second World War. The 1960's saw rapid expansion of the Malaysian finance sector with the establishment of a number of locally-owned banks, mostly owned by local Chinese merchants, which catered to the needs of local businesses. It was also in this period that a capital market was established with the opening of the Malayan Stock Exchange in 1960[24] as well as the establishment of Malaysian based insurance companies. As the Malaysian economy began to diversify away from commodity and agriculture into export-led manufacturing activity, the financial services cluster also developed to service the increasingly sophisticated demand of local businesses. The 1970's saw the emergence of the merchant banking and other non-banking financial institutions.

Supplementing the equity market, the Malaysian bond market emerged in the 1970's when the government began issuing local currency bonds to finance development expenditure (Ibrahim & Wong, 2006). The Malaysian Securities Commission, a dedicated capital market regulator was established in 1993 while two independent rating agencies were established in 1990 and 1995. To complement the local currency finance sector the Labuan Offshore Financial Centre was established in 1990, attracting a number of offshore banks, insurance and finance firms. The sophistication of the capital markets also increased steeply with the introduction of the Kuala Lumpur Options and Financial Futures Exchange in 1995 (Ong, 1999).

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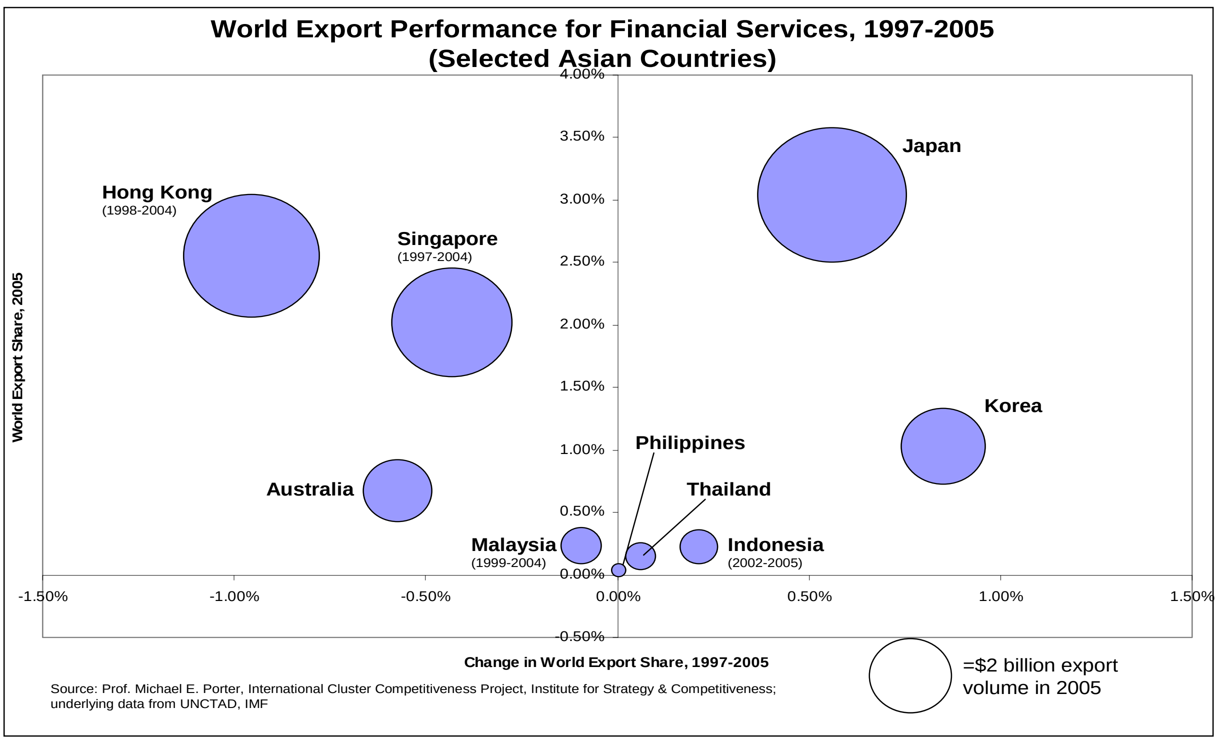
[23] Standard Chartered Bank Malaysia website http://www.standardchartered.com.my/home/aboutus.html
[24] Bursa Malays website http://www.klse.com.my/website/bm/about_us/the_organisation/history.html

In the aftermath of the Asian financial crisis, the Malaysian government initiated a regulatory consolidation of the financial system, including by increasing bank reserve requirements. By 1999, 71 locally-owned banks had consolidated into 30 larger institutions. In 2002, further consolidation was undertaken, resulting in the survival of 10 domestic banking groups, all larger and better capitalized than their predecessors (Zamani, 2006).

Performance of the Malaysian financial services cluster. The Malaysian financial services cluster is large and diversified, with several distinct and well established sub-clusters. Broadly we can map the cluster under five activities: banks, insurance, asset management, offshore financial services, and development finance. While the cluster is large in terms of its contribution to GDP, at 10% in 2006 (Bank Negara, 2007), the cluster is largely domestically focused, and has only a modest traded component as illustrated below.



While its export intensity appears to be quite modest (with the exception of the Islamic finance sub-cluster), the financial services sector is a crucial part of the Malaysian economy, in particular in its role in supporting Malaysian firms competing regionally and internationally. In fact, if the high trade share of the Malaysian economy is taken into account, it seems fair to argue that the financial services sector is, in fact, intrinsically linked to significant international flows of goods and services. This is further illustrated by the fact that Malaysia's banking sector assets are sizeable when compared against its regional peers while its equity market capitalization is a healthy 151% of GDP (EIU, 2007). Another measure of the importance of the Malaysian financial services cluster is the relatively high proportion of financing provided by the sector, at 56% of GDP (EIU, 2007). In this context, the cluster appears to be both successful, dynamic, and to display significant potential for growth.

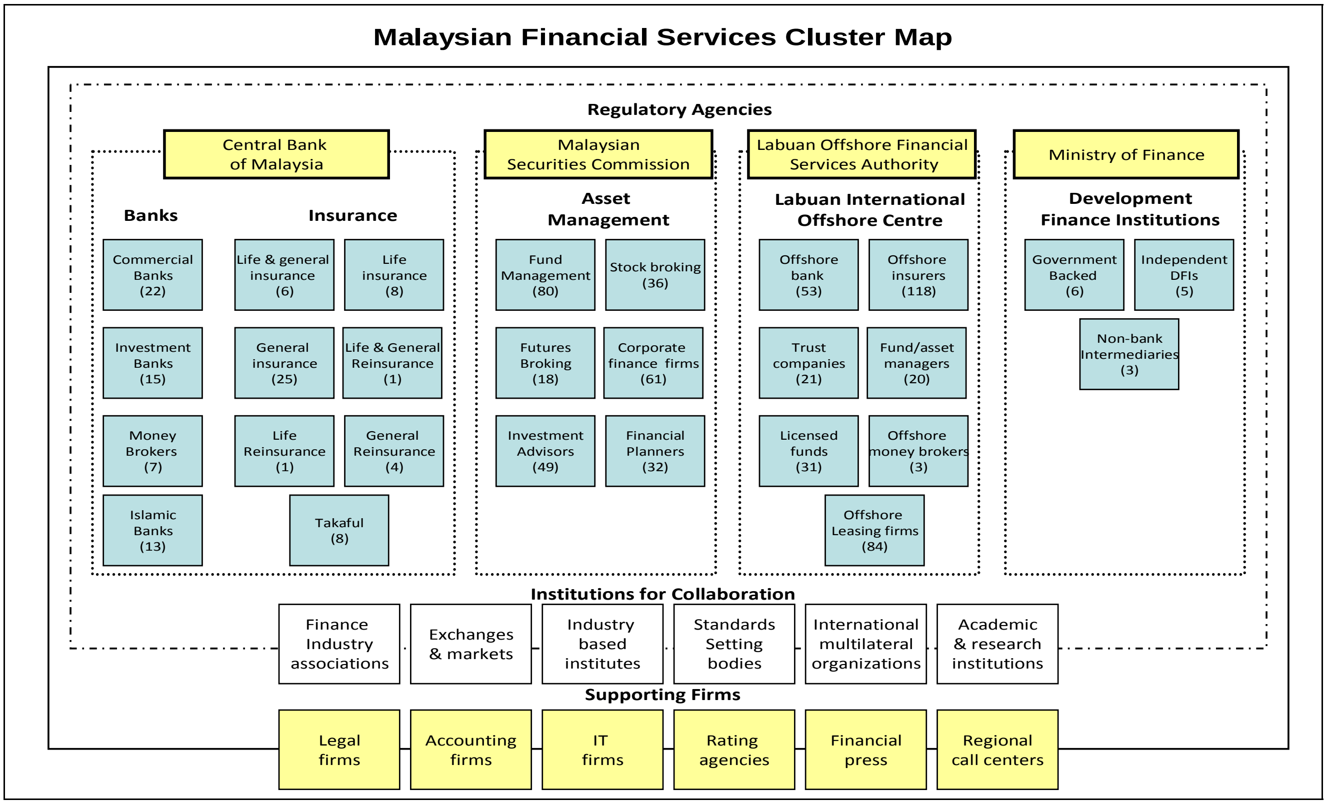
Comparative size of financial services sectors[25]

	Malaysia	Singapore	Indonesia	South Korea	Hong Kong	UK	USA
Total banking sector assets (US$ bn)	314.3	339.1	189.6	1,040.2	1,371.8	2,544.1	8,050.3
Equity market capitalization (% of GDP)	150.92	290.69	37.42	116.89	1264.22	159.86	148.30
Capital raised by initial public offerings (% of GDP)	0.21	3.65	0.09	0.33	0.02	2.37	0.41
Domestic financial sector and corporate debt issues outstanding (% of GDP)	55.74	17.58	1.96	62.64	12.82	16.11	121.90
Int. financial sector and corporate debt issues outstanding (% of GDP)	18.29	33.78	2.83	11.02	34.07	79.09	33.47

The banking sub-cluster is serviced by four types of institutions: 1) commercial banks, 2) investment banks, 3) Islamic banks, and 4) money brokers. Commercial banks (including Islamic banks) are by far the largest players accounting for 96% of banking system assets followed by investment banks and money brokers. Malaysia's commercial banking market consists of 9 domestic bank groups and 13 foreign owned banks while the Islamic sector has and 10 locally-owned banks and 3 foreign-owned institutions. As an alternative system, the Islamic banking sub-cluster has been growing steadily since its introduction in 1983 and is currently operating in parallel with the conventional sector (the Islamic finance sub-cluster is considered in greater detail in the next section). There are currently 15 investment

[25] Economist Intelligence Unit Country Finance reports 2007

banks in Malaysia, which is the result of consolidation between different entities such as the merchant banks, broking firms and discount houses which operated separately previously. The framework for the creation of this consolidation into investment banks was announced by BNM in March 2005.



The Government continues to encourage further consolidation of the banking sector. Foreign investors are allowed to own up to a 30% share equity share in domestic banks (100% in banks classified as foreign owned). The banking system's capital strength remains strong from the improvements in the level of capitalization, profitability, and asset quality. The risk-weighted capital ratio of the banking system stood at 12.9% at end-June 2006, and has been hovering above 12% since 1999.

Insurance. In line with consolidation elsewhere, the insurance industry in Malaysia has also been consolidated in recent years. As of March 2008, there were 25 general insurance companies, 8 life insurance companies, 6 life and general insurance companies[26], and 8 takaful (Islamic insurance) companies[27]. In addition, there are 6 reinsurance companies operating in Malaysia. In 2006 the total insurance gross premium represented 4.5 % of GNP, whilst in 1990, it represented only 2.9 % of GNP[28]. Life insurance premiums grew by 15.1 % CAGR in the last 16 years while general insurance premiums grew by 10.4 %, CAGR during the same period. The presence of a 12,100 member network of professional insurance agents helped the industry to grow. In 1990 there were only 2,091 such professionals.

Asset management. As at end-2005, funds under management in Malaysia amounted to RM127.2 billion (USD34.6 billion), and the industry was dominated by 5 major fund management companies, which together account for 69% of the total funds under management, although there are some 80 licensed fund management firms operating today. In 2005, unit trust funds, which totaled RM99.9 billion (US$27.2 billion), were the main source of funds under management. The unit trust and fund management industries are governed by the Securities Commission (Amendment) Act, 2000, the Securities Industry Act of 1983 as well as Circulars and Directives issued to investment management and unit trust companies. Both these industries are regulated and supervised by the Securities Commission.

Labuan International Offshore Centre. The domestic banking system in Malaysia is supplemented by an international offshore financial centre (IOFC) in Labuan, Malaysia which hosts over 330 different finance firms. The IOFC provides a full range of financial services from offshore banking, insurance, fund management and trust companies, leasing and financial exchange. Labuan IOFC operates under the supervision of the Labuan Offshore Financial Services Authority (LOFSA), and is governed by the Labuan Offshore Financial Services Authority Act, 1996.

Development Finance Institutions. Other participants in the Malaysian financial services cluster are development finance institutions (DFIs) specializing in the provision of medium and long term finance to develop strategic sectors of the economy, such as agriculture, infrastructure development, small

[26] Annual report , bank Negara 2007
[27] Bank Negara Malaysia Website -
[28] Bank Negara Annual Report 2007

and medium enterprises, shipping and high-technology industries. There are currently 6 Government-backed DFIs (mostly export credit agencies, agriculture development banks and infrastructure development banks), 5 independent DFIs and 3 non-bank intermediaries (national provident funds and national unit trust agency).

Supporting clusters. The success of Malaysia's financial services sector is also explained by the existence of a large number of established supporting firms, themselves operating in clusters. These include a large number of professional firms, in particular legal and accounting firms which are of international standing and recognized internationally. These firms have benefited from the strong colonial legacy of the well regarded English common law system and the English Company law framework as well as internationally based accounting standards. Another key support cluster is the large number of local and international IT firms which help to support the financial serves sector. Many international IT firms such as Accenture, SAP and Microsoft have a significant presence in Malaysia, having been attracted to the country's large pool of well educated and multilingual college graduates. Other supporting clusters are the financial press (4 daily financial newspapers), rating agencies (2 credit rating agencies) and a number of regional call and backroom operations of international banks (HSBC, Citigroup and ABN Amro) in Malaysia, again leveraging on Malaysia multiethnic and well educated workforce.

Institutions for collaboration (IFCs). Given the long history of the Malaysia finance sector and the presence of many participating firms, there are a number of key IFCs in the form of industry association. Almost all the main sub-segments of the cluster have active and well organized industry associations, which act as a collaborative platform as well as representing the interest of its members, many of which have been in existence since the 1970's. The biggest among them include the Association of Banks Malaysia, Institute of Banks Malaysia, The Malaysian Insurance Institute and the Association of Islamic Banking Institutions Malaysia. The existence of a large number of universities and training institutes has also helped to spur the growth of the financial services cluster by producing over 40,000 graduates annually, many of them joining the finance services industry. Among these academic institutions are University Malaya, National University of Malaysia, International Islamic University Malaysia, Institute of Banking and Finance Malaysia and University Putra Malaysia.

Other key IFCs include the stock exchange and financial market bodies (Kuala Lumpur Stock Exchange, Kuala Lumpur Commodities Exchange). With a market capitalization of US$324 billion at the end of 2007, the Malaysian stock market is among the largest in the region. Malaysia also has a large number of listed companies with 986 companies quoted in Malaysia, making it the largest market in this respect in Asia. These factors have enabled the capital market to offer scale in terms of access to liquidity and growth and maintain its status as a leading emerging market for investors.

Other IFCs include international multilateral organizations such as the Asia Development Bank, Islamic Financial Services Board, Islamic Development Bank and the South East Asian Central Banks Research and Training Centre which also act as collaborative platforms for the Malaysian financial service industry.

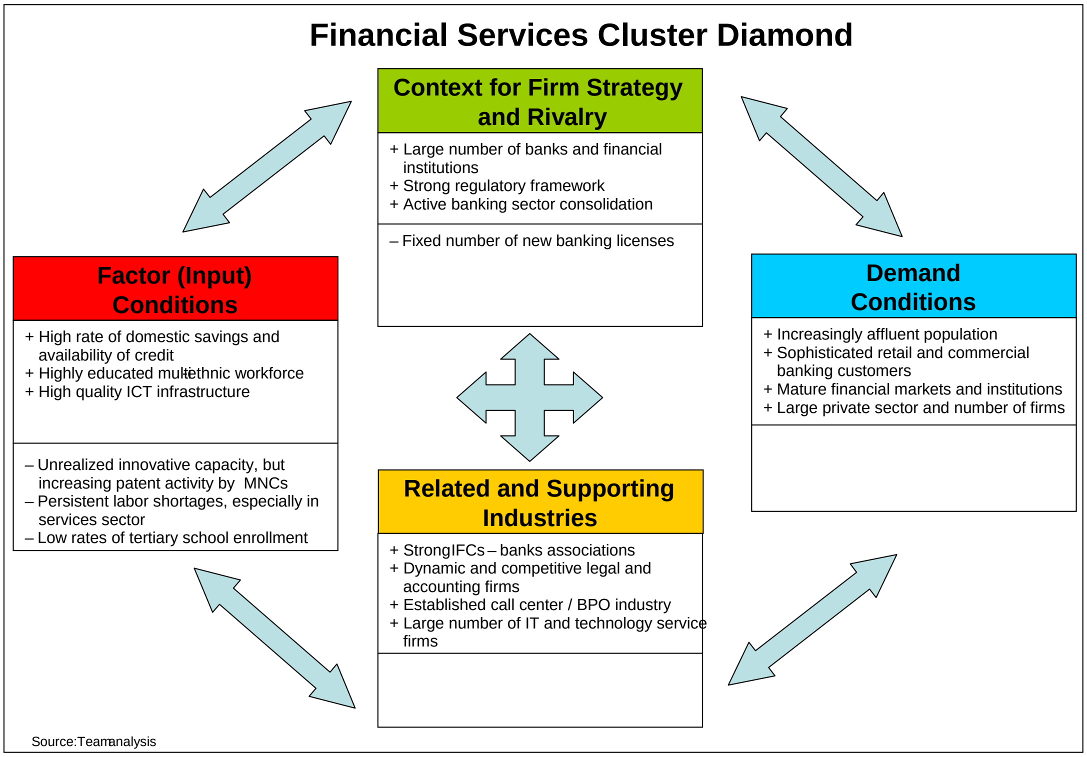
The cluster diamond. Malaysia's financial cluster diamond can be described as generally attractive with visible strength in terms of its factor conditions and related and supporting industries while the context for firm strategy and rivalry and demand conditions have some constraints that will need to be resolved for the cluster to develop further.

Factor conditions. The cluster has strong advantages in terms of factor conditions such as Malaysia's well educated and multilingual workforce, the existence of developed physical and technological infrastructure in Malaysia as well as the high level of domestic savings and investment rates. The existence of reputable and credible legal, accounting and regulatory frame work and systems are also major advantages that the cluster enjoys. In terms of the factor condition weaknesses, the most evident are the relatively low levels of innovation and research capacity, and the increasingly tight labor market.

Context for firm strategy and rivalry. Malaysia has benefited from the high level of competition within the financial service cluster, spurred by the large number of firms and numerous specialized sub-clusters. This has been achieved in spite of the ongoing consolidation in the industry, which has led to larger and better capitalized financial institutions. Undoubtedly, the sector has also gained significant competitive advantage relative to its regional peers from the credible and competent regulatory framework provided by Bank Negara and the Securities Commission, which are both well regarded by local and international market participants. Nonetheless it is within this context of a very tightly regulated industry that the cluster is also at a disadvantage. In particular the tightly controlled licensing process and limited market access for new foreign participants is likely to contribute to a less than dynamic market environment in the long run.

Demand conditions. Malaysia's relatively high income level, coupled with high levels of education, and supported by high savings rates, has lead to an abundant supply of domestic liquidity. This has allowed for the development of sophisticated products and a competitive banking and financial market. Meanwhile Malaysia's large and established corporate sector, with over 980 listed companies as well as the government's own active support in the banking and capital markets, has also supported the cluster's development.

Related and supporting industries. The cluster's broad range of activities with a multitude of sub-clusters has also benefited from the existence of many active IFCs, including large industry associations, academic and research institutions, as well as multilateral agencies and standard setting bodies, which have all helped to provide platforms for cluster development.



Malaysian Islamic finance cluster. The Islamic finance sub-cluster in Malaysia is one of the most competitive segments of the financial services industry in Malaysia, with significant growth potential given its role as the most developed Islamic finance market in the world (The Banker, 2007). The Malaysian Islamic finance cluster has, from its inception, had a significant regional and international presence, either through the participation of Malaysian Islamic finance firms in international banking and capital markets, or from its role as one of the global hubs of Islamic capital markets. This leading position is not only the result of its first mover advantage, but also attributable to several key factors, including:

i. *Supportive Government policies*. The Government of Malaysia has played a key role in promoting Islamic finance by facilitating necessary policy changes (in particular through amending tax and banking laws) as well as establishing key institutions in support of the Islamic finance cluster.

ii. *Effective regulatory framework by the Central Bank and capital markets regulator*. Bank Negara Malaysia has been successful in fostering a conducive environment for the development of the Islamic finance cluster by establishing of a liquid and efficient Islamic inter-bank market to facilitate the liquidity needs of Islamic banks.

iii. *Sophisticated and strong domestic demand with many competitive firms in the market*. With their increasing affluence, Malaysia's large and growing middle-class Muslim population has been a key driver of demand for Islamic financial services and products.

iv. *Established network of Institutions for Collaboration (IFCs)*. The existence of a number of IFCs facilitated new product innovation and established the prudential and accounting standards necessary for the Malaysia Islamic finance cluster to gain international credibility and competitive positioning.

Background. Islamic finance is defined as the provision of all banking and financial services in compliance with Islamic laws or the *Sharia.* In its most general application, Islamic Finance products and services would entail the strict avoidance from all elements of interest, as was uncertainty and speculation in its transactions. Another feature of Islamic finance is its adherence to the avoidance of all transactions relating to prohibited activities under the *Sharia* such as gambling, the production and sale of tobacco, alcohol and pornography (Nazim Ali 2007). In fact Islam encourages productive economic and capitalistic activity, with trade and commerce being emphasized as key components of any social system. The scope of Islamic Finance is therefore wide ranging and covers all aspects of financial services, including retail and commercial banking, capital markets as well as insurance services.

Global Islamic Finance Industry. The provision of Islamic Finance services and institutions is a relatively new phenomenon and has only been established in its modern form in the last 40 years with the first modern Islamic Finance institution in the world being established in Malaysia in 1963 in the form of the *Pilgrimage Fund Board*[29]. In the Middle East the first modern Islamic Finance institution was *Dubai Islamic Bank*, established in 1975[30].

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[29] Bank Negara Malaysia website - http://www.bnm.gov.my

[30] Bank Negara Malaysia website - http://www.bnm.gov.my

The industry has however seen rapid growth, primarily driven by the demand for *Sharia* complaint financial services from the estimated 1.6 billion Muslims worldwide, with global Islamic Financial assets currently estimated at over $500 billion. While this remains a small fraction of the global financial asset base (estimated at over $72 trillion in 2007) (the Banker, 2007), Islamic Finance is one of the fastest growing sub-sectors of financial services, having grown by between 15 to 20% annually in the last 10 years[31]. According to a 2007 survey by industry publication *The Banker*, there are now 525 licensed Islamic finance institutions operating in 47 countries. In terms of Islamic Finance assets, the top three countries in 2007 were Iran ($155 billion), Saudi Arabia ($69 billion), and Malaysia ($65 billion). From a mere niche market, Islamic finance has emerged as the fastest growing segment of financial services in Muslim countries, representing over 37% of all banking assets in Kuwait, over 31% in Saudi Arabia over 25% in Pakistan and over 12% in Malaysia.

Malaysian Islamic Finance cluster. Malaysia has benefited from being a first mover in the Islamic Finance industry with the creation of a parallel Islamic Finance system within its financial services sector facilitated through legislation in 1983 of the *Islamic Banking Act 1983*. The act created the first ever Islamic Finance regulatory framework in the world. This paved the way for the creation of *Bank Islam Berhad* in 1983, the first *Sharia* complaint commercial bank in Malaysia. The Islamic banking segment is the fastest growing sub segment of the Malaysian finance industry, with its assets growing by over 17% per year over the last seven years, with financing from this sub-segment growing at over 21% over the same period. As of December 2007, there were a total of 35 financial institutions operating within the Malaysian Islamic Finance cluster and licensed as official financial institutions by the Central bank. These include 11 Islamic banks, 7 commercial banks with Islamic banking windows, 3 international Islamic banks, 6 investment banks and 8 Islamic insurance or *takaful* companies. In addition there are also other non-banking Islamic finance institution operating in Malaysia, including 29 Islamic asset management companies, and 2 Islamic stock broking firms.

[31] KPMG Publication "Growth and Diversification in Islamic Finance" 2007

The Islamic finance cluster is also one of the most liberalized sub-segments of the Malaysian financial services sector, with 3 new full banking licenses being awarded to foreign Islamic finance institutions, and 2 new asset management licenses being awarded to international asset management firms over the last 5 years. This is notable for as these are the only new banking licenses having been granted in the Malaysian financial industry in the last 15 years.

Malaysia is the largest Islamic capital market internationally, with over two thirds[32] of the outstanding *sukuk* issues globally being traded there. New *sukuk* issuance in Malaysia amounted to $4.5 billion, or 50.3% out of a total of $9.1 billion of new bond issues in 2007[33].

Apart from the firms directly involved in this sub-sector Malaysia is also home to some of the key Institutions for Collaboration (IFCs) in this global industry. This includes leading academic institutions the *International Islamic University Malaysia* (IIUM), the *International Centre for Education in Islamic Finance* (INCEIF), and the *Malaysian Institute of Islamic Understanding*. These institutions play a critical role in developing Islamic finance internationally through their development of new Islamic finance products and services. Another important group is the *Sharia* advisory boards. Malaysia recently became the first country to establish a national level independent *Sharia* advisory board. Malaysia is also home to the *Islamic Financial Services Board* (IFSB), the international standard setting body for Islamic banks. The presence of these international organizations has helped to position the Malaysian Islamic finance cluster as a leading player in this global industry.

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[32] Amadou Sy, *Malaysia: An Islamic Capital Market Hub,* IMF Survey Magazine, IMF. September 2007
[33] Bank Negara Malaysia Annual Report 2007, Kuala Lumpur

Strategic Issues and Recommendations

At the country level, given Malaysia's factor endowments and level of development, it is clear that export-oriented growth should continue to be a critical pillar of the economic strategy. However, as noted earlier, the country's extreme openness to trade and capital flows poses difficulties with respect to macroeconomic management and policies. In this context, there are several steps that the government should undertake to reduce vulnerabilities, spur growth, and improve the business environment, including:

- Maintain prudent fiscal and monetary policies. The government should target low fiscal deficits in order to reduce external financing needs and risks of financing shortfalls, particularly if should oil and gas prices fall in the future. Greater exchange rate flexibility would also help to reduce vulnerabilities with respect to economic shocks, as well as increase long-term investor confidence. While much progress has been made since the Asia crisis, particularly given the shift from a US dollar peg in 2005 to a managed float, the ringgit appears to be undervalued. Allowing the currency to reflect its fundamental value would expose export sectors to greater competition and support productivity enhancing investments in capital intensive industries.
- Broaden the country's sources of economic activity, including by diversifying exports, to reduce external vulnerabilities and promote growth. The government should provide supportive conditions that would facilitate innovation and the expansion and diversification of clusters. In particular, as income increases, the government should continue to support the growth of domestic demand and private-sector led investment through a reduction in government activity, which crowds out private investment.
- Focus on higher value-added activities. As Malaysia moves closer to its Vision 2020 goal of developed country status, wages will continue to rise, further reducing its competitive advantage in low-cost manufacturing. Competition from other low-cost manufacturers will continue to intensify (e.g., China, India, other ASEAN). One of the major weaknesses of the Malaysian economy stems from a shortage of skilled labor and the inflexibility of the labor market, which is often cited by

investors and foreign companies as an issue that discourages investment. The government should continue to invest aggressively in human capital and research and development, as well as increase labor market flexibility (e.g., reduce employment restrictions on foreign nationals).

- <u>Increase the country's attractiveness as a destination for FDI</u>: Surrounded by increasingly competitive countries, Malaysia must avoid discriminating against foreign investment or ownership. In this context, the investment environment would become more attractive by reducing restrictions on foreign ownership. The government has already done so in the manufacturing sector, and it must now undertake similar measures in the services sector.
- <u>Increase innovative capacity and IP enforcement</u>: In the short term, Malaysia should dramatically improve the enforcement of existing IP laws and the independence of the courts which handle disputes. Considering that most of Malaysia's innovation is led by foreign actors, in a long term perspective, the government should encourage collaboration among universities, research institutions, and investors to promote research and development.
- <u>The government should address inefficient procedures and corruption through independent, public-private partnerships</u>: The government should ensure that the appropriate agencies have the resources, legitimacy, and sufficiently skilled management to continue its detailed assessment of the regulatory environment, and set clear and measurable targets for improving licensing, registration, and other basic business activity.

At the cluster level, while the steps suggested above will yield benefits, there are several additional recommendations for strengthening the competitiveness of the financial services industry in Malaysia:

- Make the development of Malaysia's Islamic Financial Center central to the overall finance cluster's strategy: Malaysia should continue to leverage this globally competitive sub-cluster to improve its competitiveness in the financial services segment globally. This can be achieved by relaxing the licensing barriers and encouraging foreign participation in order to increase competition and develop further financial market sophistication/competence.

- Encourage greater product development through a supportive policy framework, by further leveling the playing field for Islamic finance transactions, mainly in the area of tax liberalization and attracting foreign professionals to Malaysia. Product and service innovation can also be achieved by encouraging local Islamic banks to expand overseas and compete in regional/international markets.
- Reduce regulator involvement in driving the industry. Firms within the cluster should be allowed to drive the development of the sector based on commercial insights. Allowing for a competitive framework would encourage greater innovation, which will spur further cluster growth and development.

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