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The Growing Economic Divide: Assessing Malaysia's Emerging K-Shaped Economy

Executive Summary

- Malaysia's economic outlook remains broadly resilient, supported by sustained domestic fundamentals, improving external demand, a recovery in global technology cycles and continued investment activity. The economy is expected to maintain steady growth momentum in 2026, underpinned by several structural growth drivers, including the semiconductor upcycle, artificial intelligence (AI)-related investments, data centre expansion, supply chain diversification and ongoing infrastructure development. Key macroeconomic indicators, including exports, industrial production and investment activity, continue to suggest that Malaysia remains well-positioned amid a challenging global environment characterised by geopolitical uncertainties, trade fragmentation and elevated cost pressures.

- However, beneath the headline resilience lies an increasingly uneven economic recovery. While aggregate indicators remain constructive, the underlying composition of growth suggests that the benefits of economic expansion are becoming more concentrated among selected sectors, firms and households. This emerging divergence raises the possibility that Malaysia may gradually exhibit characteristics of a K-shaped economy, where different segments of the economy experience significantly different trajectories despite operating within the same macroeconomic environment.

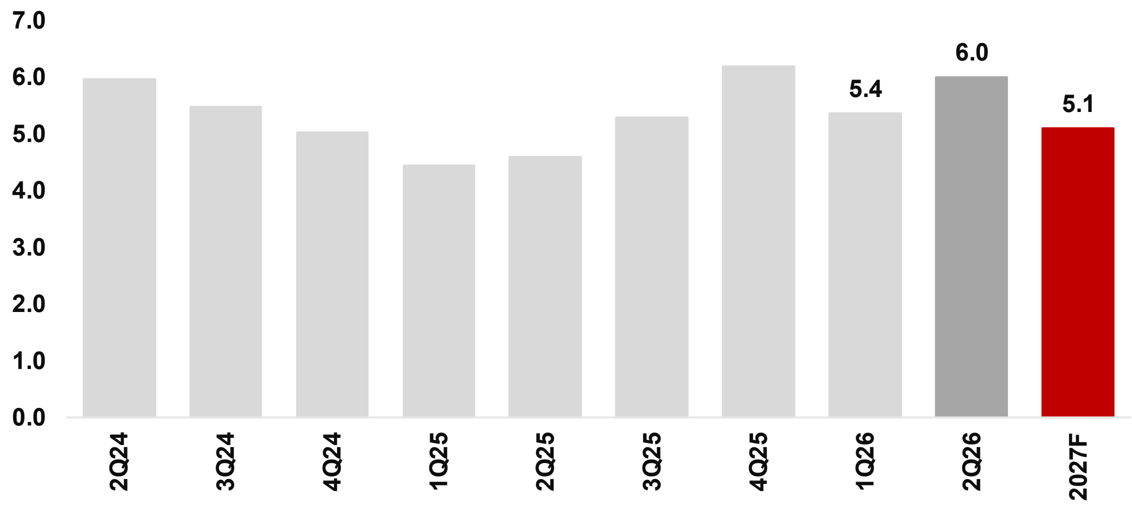
- The upward trajectory of the K is increasingly visible among technology-intensive, export-oriented and investment-driven sectors. Industries linked to global supply chain restructuring, semiconductor demand, AI infrastructure, digitalisation and high-value manufacturing continue to benefit from strong external demand and capital inflows. These sectors generally possess stronger balance sheets, higher productivity, greater pricing power and better access to financing. Large corporates, multinational corporations (MNCs) and government-linked companies (GLCs) remain relatively well-positioned to capitalise on these structural opportunities.

- Conversely, the downward trajectory of the K reflects growing challenges among domestic-oriented sectors, particularly smaller businesses and lower-income households. Small and medium enterprises (SMEs), traditional manufacturing firms and selected consumer-facing industries continue to face a more challenging operating environment due to persistent cost pressures, labour constraints, cautious household spending and limited ability to pass through higher input costs. The impact of rising living expenses has also become increasingly differentiated across income groups, with lower-income households experiencing greater pressure on disposable income and discretionary consumption.

- The divergence is increasingly visible through demand-side and supply-side dynamics. On the demand side, external demand and investment-related activities have remained relatively strong, while domestic consumption recovery has been uneven. Although aggregate private consumption remains resilient, spending patterns indicate a growing divide between higher-income households that continue to support discretionary consumption and lower-income segments that remain focused on essential expenditure. This divergence has important implications for businesses that depend heavily on mass-market consumption.
- On the supply side, Malaysia's economic transformation is creating a widening productivity gap between industries. Technology-driven sectors are benefiting from automation, digitalisation and foreign direct investment, allowing them to achieve stronger productivity gains and competitiveness. Meanwhile, lower-productivity sectors, particularly labour-intensive industries and smaller firms, face increasing challenges from rising operating costs, wage pressures and structural changes in the economy. Without improvements in productivity and business adaptation, these sectors risk falling further behind.
- Overall, Malaysia's key economic challenge in 2026 may not be the absence of growth, but rather the uneven distribution of that growth. A K-shaped economy, if it becomes more pronounced, could reshape the risk landscape by creating a widening gap between economic winners and vulnerable segments.

Malaysia Economic Outlook 2026: Resilient Growth Amid Uneven Recovery

Chart 1: Real GDP, y-o-y %



Sources: DOSM, CEIC Data, Bank Islam

Table 1: Countries with Food Export Bans during the Russia-Ukraine War

Economy	2Q25	3Q25	4Q25	1Q26	2Q26	2025	2026
GDP (by expenditure)	**4.6**	**5.3**	**6.2**	**5.4**	**6.0**	**5.2**	**5.1**
Final Consumption Expenditure	**5.5**	**5.4**	**5.8**	**4.6**	**5.2**	**5.3**	**4.8**
-Private Consumption	5.1	5.8	5.6	4.7	4.8	5.3	4.8
-Public Consumption	5.7	5.8	6.6	4.1	7.6	5.3	5.0
Gross Fixed Capital Formation (GFCF)	**12.0**	**7.4**	**9.3**	**7.3**	**4.6**	**9.6**	**5.4**
-Private Investment	11.7	7.4	9.2	7.8	4.3	9.4	5.5
-Public Investment	13.5	7.5	9.5	5.3	6.3	10.3	5.0
Net Exports of Good and Services	**-58.3**	**32.2**	**-32.9**	**13.5**	**168.5**	**-15.6**	**22.1**
-Exports	4.5	4.6	6.3	5.2	17.0	4.9	8.8
-Imports	7.9	3.0	9.0	4.6	13.9	6.3	8.1
GDP (by economic activity)	**4.6**	**5.3**	**6.2**	**5.4**	**6.0**	**5.2**	**5.1**
-Agriculture	2.5	0.2	5.7	2.6	-3.7	2.2	-1.0
-Mining & Quarrying	-5.2	9.4	1.4	-2.1	9.2	0.6	3.1
-Manufacturing	3.7	4.1	6.0	5.9	7.3	4.5	6.2
-Construction	12.1	11.7	10.9	7.7	6.5	12.2	6.8
-Services	5.1	5.3	6.2	5.6	5.9	5.4	5.4

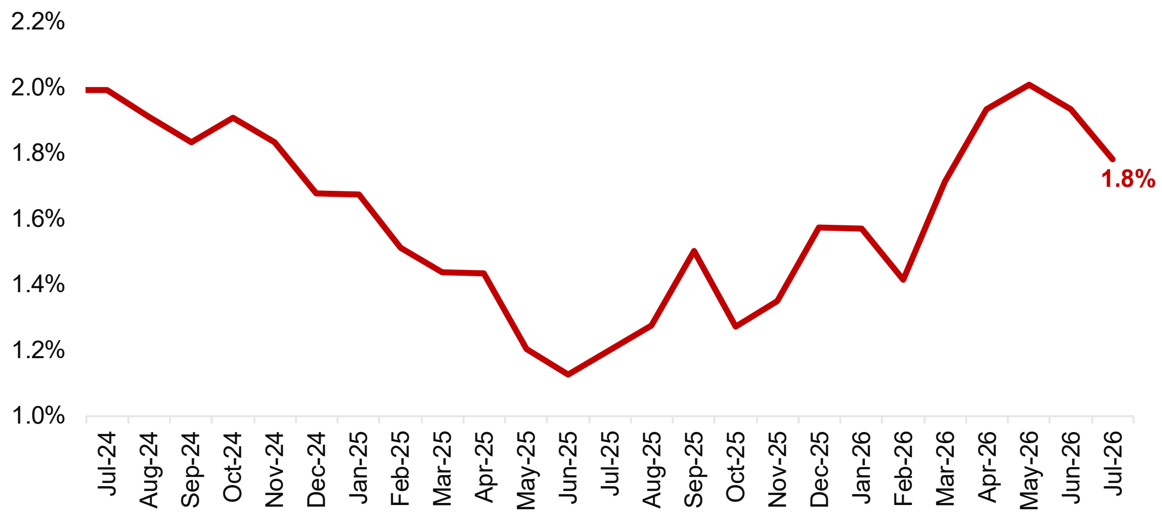
Sources: DOSM, CEIC Data, Bank Islam

- Malaysia enters 2026 from a position of relative macroeconomic strength. Despite a global environment characterised by persistent geopolitical tensions, elevated trade policy uncertainty and an increasingly fragmented global trading system, the domestic economy continues to demonstrate resilience. Growth remains supported by improving external demand with net exports increasing sharply by 168.5% y-o-y in 2Q26, driven by stronger export growth of 17.0%, alongside sustained domestic demand. Export performance continued to benefit from robust demand for E&E products, supported by the ongoing AI-driven investment cycle and global technology expansion.

- While the pace of growth may moderate from the post-pandemic rebound, the economy is expected to remain on a stable expansion path, with real GDP projected to grow by 5.1% in 2026 (2025: 5.2%), broadly in line with its long-term potential.

- Unlike previous growth cycles, however, the current expansion is becoming increasingly selective. Economic momentum is no longer driven by broad-based improvements across all sectors, but rather by a smaller number of industries benefiting from structural shifts in the global economy. Malaysia's integration into global semiconductor supply chains, the rapid expansion of artificial intelligence (AI) infrastructure, rising digital investment and continued inflows of foreign direct investment have created powerful growth engines that are reshaping the country's economic landscape. These sectors continue to attract capital, generate high-value employment and stimulate investment, reinforcing their role as key drivers of medium-term growth.

Chart 2: Consumer Price Index (CPI), y-o-y %

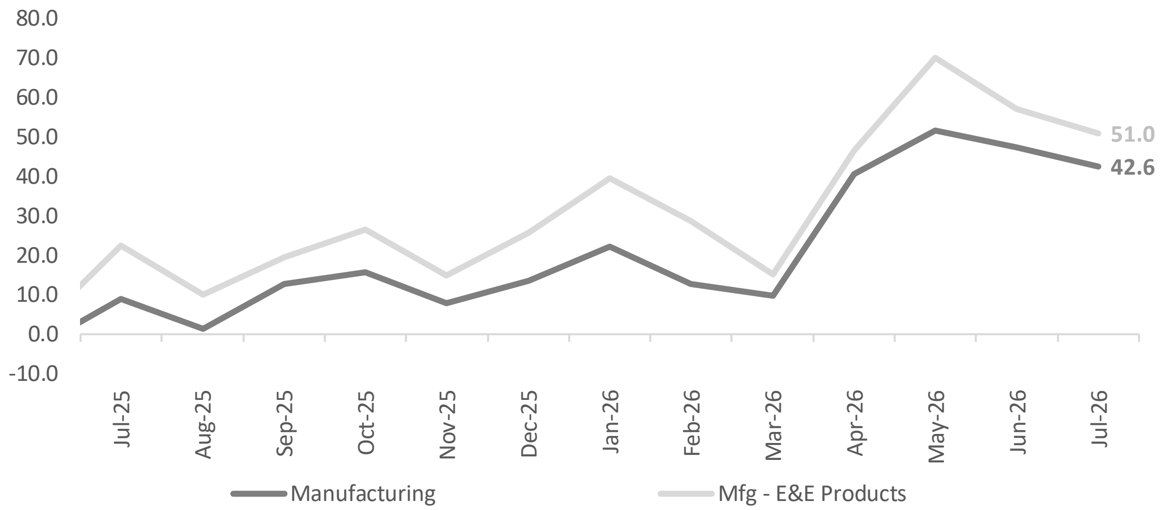


Sources: DOSM, CEIC Data, Bank Islam

- At the same time, domestic economic conditions remain supported by relatively stable labour market fundamentals, ongoing tourism recovery, public infrastructure spending and gradual improvements in household income. Inflation has moderated from previous peaks, allowing monetary policy to remain broadly accommodative while providing households and businesses with greater certainty over financing costs. The combination of easing inflationary pressures and stable financing conditions should continue to support domestic demand throughout 2026.

- Nevertheless, these favourable macroeconomic conditions increasingly mask a widening divergence beneath the surface. Aggregate indicators continue to portray a healthy economy, yet the distribution of growth across sectors, businesses and households has become progressively more uneven.

Chart 3: E&E Remains the Main Driver of Manufacturing Exports, y-o-y %



Sources: DOSM, CEIC Data, Bank Islam

Chart 4: Export-Oriented Production Continues to Outperform Domestic-Oriented Industries, y-o-y %

Sources: DOSM, CEIC Data, Bank Islam

- Export-oriented manufacturers are benefiting from recovering global electronics demand, while many businesses serving the domestic market continue to experience softer sales growth. Investment activity remains robust, but much of the expansion is concentrated in high-value sectors such as semiconductor manufacturing, AI-related infrastructure, data centres and renewable energy. These investments generate substantial economic value but often involve relatively capital-intensive production processes with limited immediate spillovers to the broader SME ecosystem.

- This growing concentration of growth is consistent with broader structural changes taking place across the global economy. Technological transformation is increasingly rewarding firms with greater innovation capacity, stronger productivity and higher digital adoption. Businesses capable of integrating automation, artificial intelligence and advanced manufacturing technologies are becoming more competitive, while firms operating under traditional business models face rising cost pressures and narrower profit margins. Consequently, the benefits of economic expansion are becoming increasingly concentrated among sectors with stronger productivity growth and greater access to capital.

- The divergence is also becoming evident from the demand side of the economy. External demand has emerged as one of the principal engines of growth, supported by recovering global electronics demand and continued supply chain diversification. Meanwhile, investment spending remains buoyant due to large-scale infrastructure projects and private sector commitments in technology-related industries. By contrast, household consumption, while still expanding, has become increasingly differentiated across income groups. Higher-income households continue to support discretionary spending, particularly in travel, hospitality, premium retail and financial services, whereas lower- and middle-income households remain more cautious as a larger share of disposable income is absorbed by essential expenditures such as housing, food, transportation, healthcare and education.

- These differences in spending behaviour are beginning to influence business performance across industries. Consumer-facing sectors targeting mass-market spending are experiencing more moderate growth than businesses serving higher-income consumers or export markets. Retailers, food and beverage operators and smaller service providers increasingly report a more price-sensitive customer base, while premium retail and tourism-related activities continue to demonstrate stronger resilience. Consequently, headline private consumption figures increasingly conceal significant differences in underlying consumer behaviour.

- A similar divergence is emerging on the supply side. Manufacturing output has benefited from stronger production in electrical and electronics products, machinery and other high-value export industries, contributing to improvements in industrial production and manufacturing activity. However, several traditional manufacturing segments continue to face structural challenges arising from rising labour costs, foreign worker shortages, increasing compliance requirements and slower productivity improvements. Many smaller firms remain constrained by limited economies of scale and lower technological adoption, reducing their ability to compete effectively within an increasingly digital and automated economy.

- These structural differences are reshaping corporate financing demand. Larger corporations and multinational enterprises continue to expand investment capacity, supported by healthier balance sheets, stronger access to capital markets and greater participation in high-growth industries. Conversely, many SMEs remain more cautious, reflecting weaker domestic demand, tighter operating margins and greater uncertainty regarding future business conditions. Recent banking data indicate that working capital financing growth has increasingly been supported by larger corporates and government-linked companies, while financing demand among SMEs has softened. This shift may represent one of the earliest indications that economic divergence is beginning to influence financing behaviour within the banking system.

- The implications of these developments extend beyond short-term economic performance. Historically, Malaysia's business cycles have largely reflected cyclical fluctuations in external demand, commodity prices and domestic consumption. The current cycle appears different. Increasingly, structural factors - including technological transformation, AI adoption, global supply chain realignment, demographic change and the transition towards higher-value industries - are becoming the principal determinants of growth. These structural shifts create substantial opportunities for sectors able to adapt, but simultaneously widen the gap between firms and industries with differing levels of competitiveness and productivity.

- For policymakers, this evolving landscape presents a more complex policy challenge. Conventional macroeconomic management remains important in maintaining overall economic stability, but aggregate policy measures alone may become less effective in addressing increasingly uneven growth outcomes. Structural reforms aimed at improving productivity, accelerating digital adoption, strengthening SME competitiveness and enhancing workforce skills will play a progressively larger role in ensuring that economic gains are more broadly shared across businesses and households.

Understanding Malaysia's Emerging K-Shaped Economy

"The economy appears healthy. Exports are expanding, industrial production is recovering, investment commitments remain robust and labour market conditions continue to support domestic demand. Yet many businesses continue to report weaker sales, SMEs remain cautious in expanding operations and households continue to adjust their spending in response to rising living costs. How can these seemingly contradictory developments occur simultaneously?"

The answer lies in the increasingly uneven distribution of economic growth.

- Malaysia's economy has traditionally experienced relatively synchronised business cycles, where periods of expansion generally lifted most sectors, businesses and households, albeit to varying degrees. During economic downturns, the reverse also tended to hold true, with broad-based weakness affecting much of the economy. Aggregate indicators such as GDP, employment and industrial production therefore served as reliable proxies for overall economic conditions.

- The current economic landscape appears increasingly different. While headline macroeconomic indicators continue to point towards a resilient economy, the underlying drivers of growth have become progressively more concentrated within selected industries, firms and income groups. Instead of a broad-based recovery where economic gains are shared relatively evenly, evidence suggests that different segments of the economy are now following distinctly different trajectories.

- This phenomenon is commonly described as a K-shaped economy, where one group of sectors, firms and households continues to experience improving economic conditions while another faces slower growth or increasing financial pressure. Importantly, a K-shaped economy does not imply that the overall economy is weak. Rather, it suggests that aggregate growth increasingly conceals widening disparities beneath the surface.

- For Malaysia, the emergence of K-shaped characteristics is less the result of a traditional cyclical slowdown than of a series of structural transformations reshaping both the global and domestic economy. Technological disruption, artificial intelligence, global supply chain realignment, demographic change, evolving consumer behaviour and geopolitical fragmentation are collectively creating new winners and losers. These forces influence industries differently depending on their productivity, technological readiness, exposure to international markets and ability to adapt to structural change.

- Consequently, the central issue facing policymakers and financial institutions is no longer whether the economy is expanding, but whether economic gains are being distributed broadly enough to sustain balanced growth across households, businesses and regions.

Evidence of Malaysia's Emerging K-Shaped Economy: Divergence Across Demand and Supply

- While Malaysia's headline economic indicators continue to reflect resilience, a closer examination reveals increasing divergence across different segments of the economy. Growth remains positive, but the underlying sources of growth have become increasingly concentrated among selected sectors, businesses and income groups. This divergence is visible from both the demand and supply sides of the economy, suggesting that the current expansion is becoming less uniform than previous economic cycles.

- The emergence of these differences does not imply a broad-based economic weakness. Instead, it highlights a structural transition where sectors with stronger exposure to global growth engines, technology adoption and investment cycles are advancing more rapidly, while businesses dependent on domestic consumption, traditional production models and lower productivity activities face greater challenges.

Demand-Side Divergence: External and Investment-Led Growth Versus Uneven Domestic Consumption

- One of the clearest manifestations of Malaysia's emerging economic divergence is the uneven performance among different sources of aggregate demand.

- Traditionally, Malaysia's growth model has relied on a combination of domestic consumption, investment and external trade. However, the current expansion is increasingly being supported by external demand and investment activities, while domestic consumption recovery remains more differentiated across households and industries.

- Export Sector benefiting from global technology recovery. Malaysia's export sector has emerged as one of the key beneficiaries of the global technology recovery cycle. The improvement in global semiconductor demand, particularly related to:

  - ✓ Artificial intelligence applications
  - ✓ Data centre expansion
  - ✓ High-performance computing
  - ✓ Cloud infrastructure
  - ✓ Advanced electronics

has supported Malaysia's electrical and electronics (E&E) sector.

- Malaysia's position within the regional semiconductor ecosystem has strengthened as multinational corporations continue diversifying supply chains beyond traditional manufacturing locations. Penang, Johor and parts of Selangor have benefited from new investment commitments linked to semiconductor assembly, testing, data infrastructure and advanced manufacturing.

- This has created a positive cycle:

Foreign investment inflows → Higher industrial activity → Demand for skilled labour → Higher productivity and wages → Further investment attraction

- However, the benefits of this cycle are not evenly distributed. The technology-driven export recovery primarily benefits large manufacturers, multinational corporations (MNCs), specialized suppliers, skilled workers, and regions with established industrial ecosystems. The spillover effects on smaller domestic-oriented businesses remain more limited.

Industrial Production Recovery Masks Sectoral Divergence

- Industrial production indicators have shown improving momentum, supported by stronger manufacturing activity. However, the headline improvement masks significant differences across industries.

- Industries benefiting from structural demand:

Beneficiary Industries	Detail
Electrical & Electronics (E&E)	The semiconductor upcycle continues to provide support as demand shifts towards AI-related applications and advanced computing
Machinery and equipment	Investment in automation and digital infrastructure supports demand
Medical devices	Malaysia's established manufacturing ecosystem continues attracting global investment
Renewable energy and utilities	Energy transition and data centre expansion create new investment opportunities

- Industries facing structural pressure:

Challenged Industries	Detail
Labour-intensive manufacturing	Challenges include rising wage costs, foreign worker constraints, and increasing competition from lower-cost producers
Furniture and selected consumer manufacturing	Affected by weaker external demand, changing global supply chains, and reduced competitiveness
Small-scale manufacturers	Many face difficulties investing in automation due to limited financial resources, weaker profitability, and smaller operating scale

- This creates an important distinction: Manufacturing is recovering, but not all manufacturers are benefiting equally.

Household Demand: Resilient Consumption but Unequal Purchasing Power

- Private consumption remains an important pillar of Malaysia's economy. However, household behaviour increasingly reflects differences in income resilience.

- The moderation in inflation from previous peaks has provided some relief, but the cumulative impact of higher living costs continues to influence household spending decisions. For many households, particularly lower- and middle-income groups, the adjustment has been significant.

- A larger share of income is allocated towards:

  - ✓ food
  - ✓ housing
  - ✓ transportation
  - ✓ healthcare
  - ✓ education
  - ✓ utilities

  This reduces discretionary spending capacity. As a result, consumption patterns are becoming increasingly divided.

- **The Upward Consumption Segment**: Higher income households continue demonstrating stronger resilience due to:

  - ✓ Higher savings buffers
  - ✓ Stronger wage growth
  - ✓ Greater financial flexibility

  This supports premium retail, travel, hospitality, lifestyle services, and investment-related activities.

- **The Pressured Consumption Segment**: Lower-income households remain more cautious. Businesses affected include:

  - ✓ Mass-market retail
  - ✓ restaurants
  - ✓ small traders
  - ✓ selected consumer services

The implication is significant: A strong consumption headline may conceal weakness among specific business segments that depend heavily on lower-income consumers. For banks, this matters because many SMEs operate precisely within these affected segments.

Investment Divergence: Strong Capital Formation but Concentrated Benefits

- Investment remains one of Malaysia's strongest growth drivers. Large investment commitments in:

  - ✓ data centres
  - ✓ semiconductor manufacturing
  - ✓ digital infrastructure
  - ✓ energy transition
  - ✓ transport infrastructure

  have strengthened Malaysia's medium-term growth prospects. However, investment intensity is becoming increasingly concentrated.

- Large firms benefit from:

  - ✓ access to capital
  - ✓ technical expertise
  - ✓ international networks
  - ✓ government incentives

- Smaller firms often face greater difficulty participating due to:

  - ✓ Limited financing capacity
  - ✓ Technology gaps
  - ✓ Shortage of skilled workers

  Therefore, while aggregate investments indicators remain positive, the distribution of investment benefits remains uneven.

The Emerging Corporate Divide: Large Corporates Versus SMEs

- Investment remains one of Malaysia's strongest growth drivers. Large investment commitments in: Perhaps the most important evidence of a K-shaped economy from a banking perspective is the divergence between large corporates and SMEs. Large corporations and GLCs continue to demonstrate stronger confidence, supported by:

  - ✓ healthier balance sheets
  - ✓ stronger access to financing
  - ✓ exposure to infrastructure and investment projects
  - ✓ participation in export-oriented industries

- Meanwhile, SMEs face a more challenging operating environment. Key pressures include:

  1. Higher operating costs - Including:
     - ➢ wages
     - ➢ utilities
     - ➢ raw materials
     - ➢ compliance costs

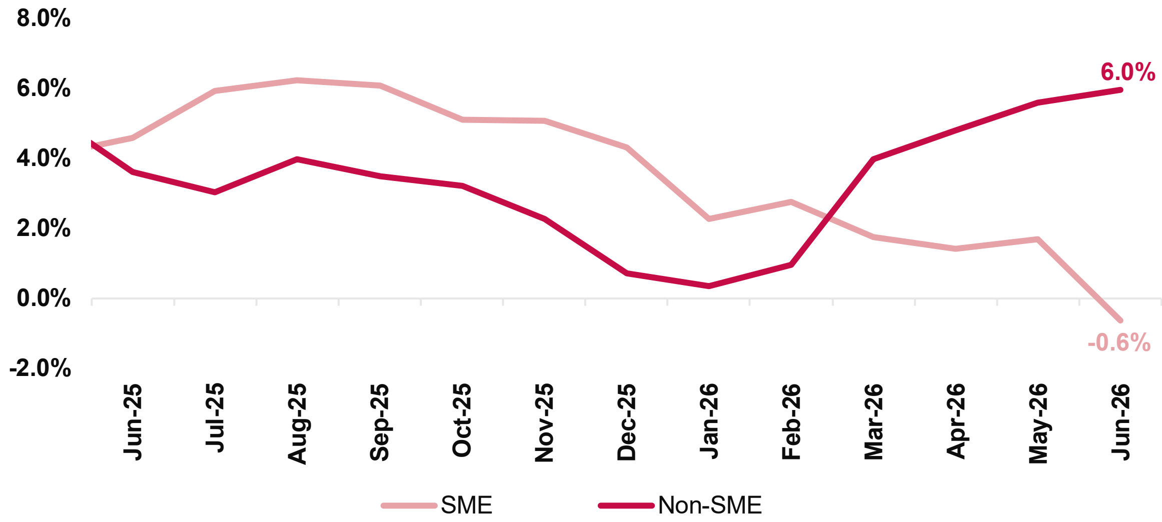
  2. Softer domestic demand- Particularly affecting:
     - ➢ retail
     - ➢ food services
     - ➢ small traders
     - ➢ domestic services

  3. Limited pricing power - Many SMEs operate in highly competitive markets and cannot fully pass through cost increases.

  4. Financing caution - Businesses facing uncertain demand are less willing to expand capacity or increase working capital requirements.

- Recent banking data provide an early indication that economic divergence is beginning to translate into financing behaviour. While overall financing conditions remain stable, the composition of financing growth has become increasingly differentiated.

Chart 5: Financing for Working Capital - SMEs VS Non-SMEs, y-o-y %



Sources: BNM, CEIC Data, Bank Islam

- Working capital financing trends show stronger support from:
  - ✓ Large corporates
  - ✓ Government-linked companies
  - ✓ Investment-related businesses

- Conversely, SME financing growth has weakened, reflecting more cautious business expansion. This pattern is consistent with the broader economic narrative:
  - ➢ Stronger firms continue investing and borrowing
  - ➢ More vulnerable firms become defensive and preserve liquidity

The K-Shaped Economy: A Growing Divide Rather Than a Broad Downturn

- Taken together, evidence from exports, industrial production, consumption patterns, investment and financing behaviour suggests that Malaysia is experiencing a more differentiated economic recovery.

- The divide is increasingly visible:

Upward Side of K	Downward Side of K
Semiconductor	**Traditional manufacturing**
AI infrastructure	**Low-productivity SMEs**
Data centres	**Small domestic businesses**
Export manufacturers	**Consumer-facing SMEs**
Skilled workers	**Lower-skilled workers**
Large corporates	**Smaller firms**
High-income households	**Vulnerable households**

- The key message is not that one group is expanding while another is collapsing. Rather, the gap between economic winners and laggards is becoming wider. For policymakers, the challenge is ensuring that structural transformation creates broader economic participation.

Conclusion

- Malaysia's economy continues to demonstrate resilience despite an increasingly complex global environment. The country's integration into global technology supply chains, sustained investment activity and supportive domestic demand provide a solid foundation for medium-term growth. However, the nature of that growth is changing. Rather than broad-based expansion across all sectors, firms and households, structural transformation is creating increasingly differentiated outcomes. High-value manufacturing, technology-intensive industries and export-oriented businesses continue to outperform, while selected domestic-oriented sectors and SMEs face greater adjustment pressures. This report argues that these developments represent the emergence of structural economic divergence, with Malaysia displaying growing characteristics of a K-shaped economy.