2013

OUTLOOK AND POLICY IN 2014

THE INTERNATIONAL ECONOMIC OUTLOOK

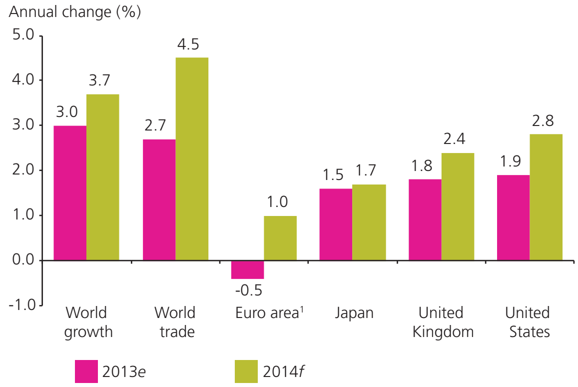
The gradual improvement in the global economy experienced in 2013 is expected to continue in 2014. Global growth will be supported by a broader economic recovery in the advanced economies and sustained growth in the emerging economies. Continued improvements in the advanced economies will have positive spillovers on the rest of the world, in particular on economies with extensive trade linkages. Nevertheless, the pace of recovery is expected to remain moderate, with global economic activity expanding below the average growth rate observed over 2000-2007.

Global growth to improve in 2014, supported by a broader economic recovery in the advanced economies and sustained growth in the emerging economies

A contributing factor underlying this trend is the remaining structural issues in the advanced economies, in particular the high structural unemployment and weak financing activity amid ongoing fiscal consolidation and deleveraging activity. In this environment, emerging economies are transitioning towards a more moderate pace of growth due in part to the policy stance that has been adopted to address domestic risks such as strong credit growth and rising property prices. The emerging economies also face the challenge of managing external risks. In particular, the policy normalisation in the major advanced economies will have spillovers on the international financial markets given the significant inter-linkages in the international financial system. The primary concern is on the pace and magnitude of capital flow reversals and the risks of contagion for the small open economies, and the attendant impact of these developments on the momentum of the global recovery.

Chart 4.1

World Growth, World Trade and Growth in Major Advanced Economies (2013-2014)



[1] Refers to EU-17
e Estimate
f Forecast
Source: International Monetary Fund and National Authorities

The **US** economic recovery is expected to be sustained by continued improvement in the private sector, and further supported by lower fiscal constraints. The pace of fiscal consolidation is anticipated to slow in the near term, as the recent US budget agreement has increased the discretionary government spending limits and removed the risk of a government shutdown over the next two years. This is expected to lead to improved sentiments, with positive spillovers on the private sector. Of significance, capital spending could gain momentum, supported by rising business confidence and more accommodative lending conditions. The average age of equipment and software is also at a record high, indicating that the long-overdue replacement cycle could materialise this year. Similarly, investment in the housing market is expected to improve, driven by higher demand and low inventory. On the housing sector, increasing prices will further reduce the number of the so-called underwater mortgages[1], contributing to better household balance sheets and increase households' labour mobility.

[1] Underwater mortgages refers to mortgages of homeowners that have come to exceed the value of their homes as a result of the significant decline in house prices during the 2007-2009 recession

The recovery of household wealth through higher equity and real estate values has already translated into improving consumer confidence, and lifting consumer spending. Private consumption will also be supported by improvements in the labour market and lower debt. After four years of deleveraging from about 122% of disposable income in the first quarter of 2009, household debt has declined to 100.3% in the fourth quarter of 2013, below the 2000-2005 average of 100.7%. Notwithstanding these positive trends, the strength of the recovery will be weighed down by post-crisis structural weaknesses. The labour market continues to experience declining labour participation rates and elevated long-term unemployment levels. High income inequality and subdued wage growth will also weigh on the pace of expansion.

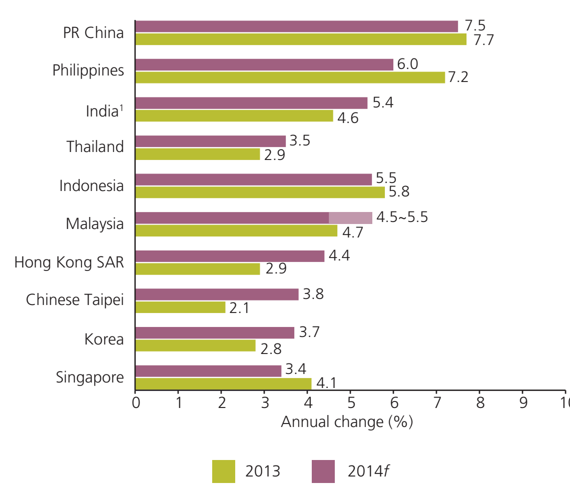
In the **euro area**, while the gradual improvement in economic activity is expected to continue, the pace of recovery is likely to be subdued and uneven across the region. The strength of domestic demand, particularly in the crisis-affected economies, remains suppressed by weak labour market conditions, financial fragmentation and the ongoing adjustments in private and public sector balance sheets. While the unemployment rate is stabilising, the rate remains elevated at historical highs, with significant divergences across countries, ranging from 5.3% in Germany to more than 25% in Greece and Spain. Nevertheless, government consumption is expected to register a smaller contraction amid a slower pace of fiscal consolidation. The euro area external sector is, however, gaining further momentum in line with the improving global economic environment. Amid a still-fragile growth outlook, policy decisions to undertake further structural and financial sector reforms, including deregulation of the labour markets, reduction of public debt and the creation of a banking union, will continue to be critical elements in promoting confidence and supporting a sustained economic recovery.

Economic activity in **Japan** is expected to be underpinned by the continuation of the stimulative policies of 2013, thus sustaining positive sentiments in the economy. The introduction of the ¥18.6 trillion fiscal stimulus package in December 2013 will mitigate some of the adverse impact from the scheduled increase in consumption tax in April 2014. On the external front, export performance will benefit from the global economic recovery. Prospects for a stronger and sustained recovery depend, however, upon the progress of structural reforms, positive wage growth and increased capital expenditure.

The overall growth momentum in **Asia** is expected to be sustained, supported by the gradual improvement in external demand. However, the degree of improvement in exports could vary across the region. In some of the advanced Asian economies, export growth is projected to strengthen, benefitting from improved demand for consumer electronic products and industrial machineries, in line with the recovery in the advanced economies. Commodity exporters are, however, likely to experience more muted export performance as improvements in export volume may be offset by lower commodity prices. While domestic demand remains a key driver of growth in most of the ASEAN economies, the strength of economic activity is contingent on several country-specific factors. In a number of these economies, private consumption and private investment activities could be affected by rising costs and inflation. Growth in PR China will expand at a more moderate pace amid efforts to rebalance the economy towards a more sustainable, consumption-driven growth model. The pursuit of reforms in key areas such as financial liberalisation, fiscal and social reforms remains a top policy priority for the government in 2014.

Chart 4.2

Regional Economies: Real GDP Gowth



f Forecast
¹ Refers to fiscal year

Source: International Monetary Fund and National Authorities

Global inflation is expected to be moderate, in line with lower price pressures in the commodity markets following improved supply conditions. The increase of energy production in the US and the expected easing of geopolitical risks in the Middle East would reduce supply constraints of crude oil, thus exerting downward pressure on prices. Similarly, food prices are expected to fall on account of increased crop production. The inflation outlook is, however, expected to vary between the advanced and emerging economies. In most of the advanced economies, persistent negative output gaps and slow wage growth will limit price increases. In contrast, some Asian economies are projected to experience higher cost-push inflation in an environment of tightening labour market conditions.

Notwithstanding the improved outlook, the global economy continues to face **downside risks**. A key concern is the continued economic slack in the advanced economies despite the recent improvement in growth. Unemployment rates remain elevated relative to pre-crisis levels in many advanced economies while spare capacity continues to be sizeable in several economies, reducing the prospect of higher investment growth. Amid low inflation, prolonged weak growth may expose some economies to the risk of deflation. Fiscal uncertainties also continued to linger, particularly in the advanced economies. In the US, there still remain fiscal challenges, such as a more permanent solution to the debt-ceiling limit and structural deficits arising from higher mandatory expenditures. In the euro area, while fiscal austerity has resulted in a narrowing of budget deficits, these measures have adversely affected private sector activity and hence, overall growth. Furthermore, public debt remains high, limiting the room for policy support to the economy.

Amid these global developments, the emerging economies face a relatively different set of domestic risks. Financial imbalances have been a key concern following the strong increase in credit and asset prices. This has led to high household debt levels in many emerging economies, including those in Asia. In PR China, financial risks arise from the rapid growth in shadow banking activity, a growing source of financing for property and infrastructure investments. A few emerging economies are also experiencing twin deficits. In particular, current account positions turned into deficits in some countries as a weak recovery in external demand was accompanied by strong domestic growth that boosted imports. A rising trend in public debt levels, coupled with fiscal deficits, was observed in several of these economies in large part due to the result of fiscal stimulus implemented during the global recession in 2008-2009. Furthermore, some emerging economies also face structural challenges such as supply bottlenecks, rising income inequality and over-reliance on the traditional sources of growth.

Given the improving growth outlook in the advanced economies, the gradual normalisation of monetary policy will be inevitable, as evidenced by the recent scale-back of quantitative easing (QE) in the US. The unprecedented scale of QE undertaken since 2009 suggests that the reversal is likely to reverberate across the global financial markets and pose a significant challenge to policymakers. Against the backdrop of heightened volatility in global portfolio flows, concerns over domestic factors in the emerging economies could exacerbate negative investor sentiments and lead to a disorderly reversal of capital flows. This, in turn, raises the risk of disruptions to credit intermediation and disproportionate corrections in asset prices. While there appears to be increasing country differentiation based on the assessment of strengths and weaknesses of each economy, contagion risks have risen. The increasing inter-linkages in the global financial system have led to a swift transmission of financial shocks across markets, regions and asset classes, in particular during the period of a simultaneous rise in risk aversion which could trigger herd behaviour. However, it is noteworthy that while global policy spillovers will pose significant challenges to the region, many Asian economies continue to exhibit resilience, underpinned by strong fundamentals following the decade of reforms after the Asian Financial Crisis. The more flexible exchange rates, higher foreign exchange reserves and more developed financial systems have significantly improved Asia's resilience to withstand external shocks and preserve macroeconomic and financial stability (More discussion on this can be found in the box article `Spillovers of Quantitative Easing on Asia´ in Chapter 2).

THE MALAYSIAN ECONOMY

Overview
The Malaysian economy is expected to remain on a steady growth path in 2014, expanding by 4.5%-5.5% (2013: 4.7%). The growth momentum will be supported by better performance in the external sector amid some moderation in domestic demand.

The Malaysian economy is expected to remain on a steady growth trajectory of 4.5%-5.5% in 2014

Domestic demand will remain the key driver of growth, albeit at a more moderate pace, reflecting the continued public sector consolidation. Private investment is forecast to register robust growth for the fifth consecutive year, driven by the ongoing implementation of multi-year projects and the improvement in external demand. Private consumption will be underpinned by healthy labour market conditions and sustained income growth. Nonetheless, household spending is expected to moderate towards its long-term trend growth, reflecting in part the impact of the higher inflation. Public consumption is anticipated to record lower growth, following the ongoing consolidation of the Government's fiscal position, while public investment is projected to register a higher growth, supported by both Government and public enterprise capital spending.

In line with the improvement in external demand, Malaysia's export performance across most product categories is expected to pick up in 2014. Electronics and electrical (E&E) exports will benefit from higher demand from the advanced economies while exports of non-E&E will be sustained by regional demand for resource-based products. Gross export performance is expected to be further supported by a small positive growth in commodity exports following two consecutive years of contraction. Services exports is expected to be higher due to the stronger travel account, which will be supported by Visit Malaysia Year 2014. At the same time, gross imports is projected to increase at a faster pace, driven mainly by higher intermediate imports. With import growth remaining robust, the current account surplus of the balance of payments is projected to narrow in 2014. Nevertheless, as exports improve, net exports of goods and services is expected to exert a lower negative contribution to real growth in 2014.

Headline inflation is expected to average 3%-4% in 2014 (2013: 2.1%) due mainly to domestic cost factors. These include the recent price adjustments arising from subsidy rationalisation and the spillover effects of these adjustments on the prices of other goods and services. The higher cost pressures, however, will be partly contained by subdued external price pressures, given the expectations of lower global food and energy prices. Continued expansion in domestic capacity and a moderation in domestic demand would also contribute towards attenuating the cost pressures.

Notwithstanding the moderation in domestic demand, the underlying fundamentals of the Malaysian economy remain strong. Growth will be driven by the private sector across a diversified range of economic activities. Of importance, employment remains strong and incomes are rising. The financial system is resilient, with financial intermediation expected to provide continued support to investment and consumption activity. In addition, the strength of Malaysia's external position remains intact, with international reserves at healthy levels and external debt within prudent limits.

While the central outlook for the Malaysian economy assumes a gradual improvement in external demand, downside risks to global growth remain. These downside risks could affect the performance of the Malaysian economy in 2014. In the advanced economies, excess capacity in the labour and product markets remains, while fiscal uncertainties may affect the pace of recovery. Emerging economies may also experience slower-than-expected domestic demand amid policy measures to address domestic risks arising from high growth in credit and asset prices. As in 2013, volatility in global financial markets could contribute to the potential re-emergence of large and volatile capital flows. It should be noted that past experience has demonstrated Malaysia's ability to withstand volatile capital flows. For example, following intense deleveraging at the height of the crisis in the advanced economies, Malaysia experienced capital reversals by non-residents amounting to RM113.4 billion between second quarter 2008 and second quarter 2009, without disruptions

Higher Growth amid Expansion in All Economic Sectors

On the supply side, all economic sectors are expected to register positive growth in 2014. Key drivers to overall growth will be the services and manufacturing sectors, which will benefit from the improvement in the global economic environment despite more moderate growth in domestic demand.

Table 1

Real GDP by Sector (2005=100)

	2013*p*	2013*p*	2014*f*	2013*p*	2014*f*
	% of GDP[1]	Annual change (%)		Contribution to growth (percentage point)[1]	
Services	55.2	5.9	6.2	3.2	3.4
Manufacturing	24.5	3.4	3.5	0.8	0.9
Mining and quarrying	8.1	0.5	1.6	0.0	0.1
Agriculture	7.1	2.1	3.8	0.2	0.3
Construction	3.7	10.9	10.0	0.4	0.4
Real GDP	**100.0**	**4.7**	**4.5 ~ 5.5**	**4.7**	**4.5 ~ 5.5**

[1] Figures may not necessarily add up due to rounding and exclusion of import duties component

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The services sector is projected to continue on a firm expansion path in 2014. Growth will be mainly supported by production-related activities such as wholesale, transport and storage amid a pick-up in external trade activity. Consumption-related activities including retail trade, and accommodation and restaurants will be supported by household spending, albeit at a more moderate rate. Nonetheless, higher tourist arrivals, in conjunction with Visit Malaysia Year 2014, will provide support to growth. In the finance and insurance sub-sector, growth is projected to improve due mainly to higher growth in the insurance segment. The finance segment will be supported by continued demand for financing, particularly from businesses.

The outlook for the manufacturing sector is also favourable, led by the export-oriented industries, which are expected to record higher growth, in line with the improvement in external demand (see `Performance of the Manufacturing Sector to Improve, Driven by the E&E and Primary-related Clusters´).

However, growth in the domestic-oriented industries, in particular the consumer-related cluster such as transport equipment and food and beverage, is expected to be lower than in 2013 in line with the more moderate domestic demand. The construction-related cluster will remain supported by the continued implementation of various construction projects.

The construction sector is expected to continue recording high growth, albeit at a more moderate pace in 2014, as the completion of several large civil engineering projects will more than offset the progress in existing projects in the transport, utility, and oil and gas sectors. Although several highway and power plant projects are expected to commence in 2014, these projects are not expected to provide significant support to overall growth in the construction sector in 2014.

In the commodity sector, growth in agriculture is expected to improve on account of higher production of palm oil as both yields and the number of matured palm trees increase. Growth will also be supported by food commodities, especially livestock and fisheries. Better performance is projected in the mining sector due to higher crude oil and natural gas production from deepwater and marginal fields; and enhanced oil recovery.

to the financial intermediation process. Malaysia's well-developed capital markets, resilient external position and strong banking system will continue to provide the country with the capacity and policy flexibility to absorb the volatility in capital flows. The economy could, however, also register stronger growth performance if the pace of global recovery exceeds expectations.

Domestic demand continues to anchor growth

Domestic demand is expected to grow at a more moderate pace of 6.9% in 2014 (2013: 7.6%), reflecting the ongoing public sector consolidation. Domestic demand will be supported by investment and private consumption.

Private domestic demand to anchor growth amid lower public expenditure

Private investment growth is expected to remain robust at 12.6% in 2014, the fifth consecutive year of double-digit growth. The projected growth rate is higher than the 2000-2012 average growth of 8.8%. Insights gained from the Bank's survey with businesses suggest that investments will be broad-based and geographically diverse, supported by the improvement in external demand and continued expansion in domestic consumption. Sustained improvements in the investment climate will also attract new investments and support the ongoing implementation of projects with long gestation periods. These include projects under the Economic Transformation Programme (ETP) and the development of regional economic corridors.

In the services sector, private investment is expected to be driven by investments in the domestic-oriented sectors. Capital spending in the healthcare and education sectors is expected to be lifted by increasing demand, in line with the development of Malaysia as a medical and education hub. Investments in the telecommunication and aviation segments will be supported by infrastructure upgrading and capacity expansion, while hotels and retail investments will expand, underpinned by domestic spending and tourism activities.

Table 4.1

Real GDP by Expenditure (2005=100)

	2013*p*	2014*f*	2013*p*	2014*f*
	Annual change (%)		Contribution to growth (percentage point)	
Domestic Demand[1]	**7.6**	**6.9**	**6.9**	**6.4**
Private sector expenditure	9.0	8.3	5.9	5.7
Consumption	*7.6*	*6.9*	*3.8*	*3.6*
Investment	*13.6*	*12.6*	*2.1*	*2.1*
Public sector expenditure	3.7	2.9	0.9	0.7
Consumption	*6.3*	*3.0*	*0.8*	*0.4*
Investment	*0.7*	*2.9*	*0.1*	*0.3*
Change in Stocks			**-0.2**	**-0.5**
Net Exports of Goods and Services	**-22.9**	**-10.3**	**-2.0**	**-0.6**
Exports	-0.3	2.1		
Imports	1.9	3.1		
Real Gross Domestic Product (GDP)	**4.7**	**4.5 ~ 5.5**	**4.7**	**4.5 ~ 5.5**

[1] Excluding stocks
p Preliminary
f Forecast
Note: Figures may not necessarily add up due to rounding
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Investment in the residential property segment is also expected to remain firm, supported by the construction of mid-range residential properties. This is in line with private developers' and Government measures taken to meet rising demand for affordable housing by low- and middle-income earners.

Capital spending in the manufacturing sector is also projected to increase in 2014, driven by higher investments in the E&E sector and sustained investments in the domestic-oriented manufacturing clusters. The recovery in external demand is expected to support investments in new technology in the E&E sector, while continued diversification into new growth areas, such as medical equipment, optics and solar will further contribute to the recovery in manufacturing investments. In addition, investments in the construction-related cluster, especially in steel and cement will continue to be channelled towards meeting the demand from the implementation of existing construction projects. Furthermore, as announced under

Budget 2014, the RM120 million integrated package allocated by the Government to SMEs will allow firms to upgrade capacity and invest in mechanisation and new technology in the face of higher costs. This is expected to facilitate improvements in productivity and the shift of SMEs towards higher value-added activity.

Investment in the mining sector will be sustained by the ongoing construction of production facilities under existing deepwater projects and investments in marginal fields. In addition, firm energy prices will continue to underpin exploration and discoveries of new fields.

Private consumption is expected to grow by 6.9% in 2014 (2013: 7.6%). This moderation towards its long-run average of 6.6% (1990-2013) is after two consecutive years of strong growth. The more moderate growth in household spending follows a period of higher prices and greater uncertainty. Nevertheless, favourable income prospects are expected to provide support to private consumption going forward. Wage growth in the export-oriented sectors is expected to improve as the sector benefits from the better performance in the external sector. Wages in the domestic-oriented sectors are expected to remain stable. The implementation of the minimum wage policy by some companies will also support wages, albeit to a lesser extent compared to 2013. In addition, targeted Government transfers to low- and middle-income households are expected to partially mitigate the impact of higher prices on household spending.

The labour market is expected to remain supportive of private consumption, with the unemployment rate projected to remain stable at 3.1% (2013: 3.1%). Employment growth is expected to remain above the post-Global Financial Crisis (GFC) average of 3%, but to moderate from a strong growth of 4.8% in 2013. The demand for labour will be supported by the improvement in global economic conditions, particularly benefitting the export-oriented industries, and the sustained expansion in domestic economic activity.

Growth in household credit is expected to be slower in 2014, in part due to the series of measures implemented by the Bank in 2013. Nonetheless, the impact of these measures on private consumption growth is expected to be marginal as creditworthy households will continue to have access to credit.

Public sector spending is expected to moderate in 2014, in line with the Government's continued commitment to fiscal consolidation. **Public consumption** is expected to record a slower growth of 3%, reflecting more moderate expenditure on supplies and services; and emoluments.

Public investment will register higher growth of 2.9%, underpinned by public enterprises' (PEs) investment and Federal Government development expenditure. Investments by PEs reflect the continued implementation of key infrastructure projects, particularly in the oil and gas, utility and transportation sub-sectors. The Federal Government development expenditure will be channelled mainly towards improving access and connectivity in urban and rural transportation infrastructure. In the social services sector, expenditure will be channelled primarily to the education, training and healthcare sub-sectors.

Improvement in external demand

In line with the improvement in external demand, Malaysia's export performance is expected to pick up in 2014. Gross exports is forecast to expand by 5.8% in 2014 amid an improvement in demand from the advanced economies and sustained growth in the regional economies.

External demand to improve as global economic activity continues to expand

The growth in manufactured exports is expected to improve in 2014, driven by both E&E exports and non-E&E exports. E&E exports is expected to expand at a modest pace in 2014, supported by the improvement in investment activity in the US, in particular corporate spending on IT-related equipment. In addition, while the personal computers sub-segment remains important, manufacturers are increasingly diversifying their product mix to cater to the fast-growing mobile devices and automotive sub-segments. Non-E&E exports is expected to continue to expand, supported by sustained regional demand for resource-based products and re-exports of petroleum products following the continued expansion in petroleum

Evolving Household Balance Sheets and Implications for Private Consumption

Introduction

The household balance sheet in Malaysia has evolved significantly over the recent decade. The size of the balance sheet has grown substantially over the years, as reflected in rising household assets and debt. The composition of the balance sheet has also changed, with higher holdings of financial and property assets. This article explores the changing structure of the household balance sheet and discusses the key drivers behind it. It also examines the effects of these changes on private consumption and outlines the policy implications going forward.

The Evolving Nature of the Household Balance Sheet[1]

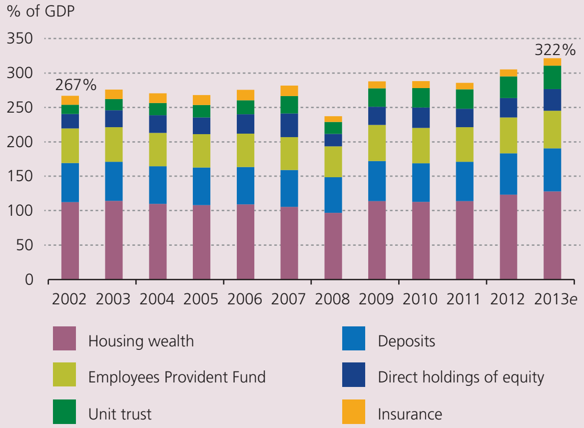
The household balance sheet provides a snapshot of assets and liabilities, and reflects households' financial health. Assets reflect resources for future spending, and can be both liquid[2] (for example deposits, unit trust funds and direct investments in the stock market) and relatively illiquid (for example housing wealth[3] and mandatory contributions to the Employees Provident Fund). Household debt represents liabilities that need to be repaid in the future, comprising of loans to purchase property and securities, and to finance consumption[4].

Two key trends in Malaysia's household balance sheet can be observed. First, the size of the balance sheet has grown since 2002. Total household assets grew at an average annual rate of 10.4% from 2003-2013 to 321.6% of GDP at end-2013, while household debt grew annually by 12.7% to 86.8% of GDP at end-2013 (Chart 1 and 2). In level terms, household assets continue to exceed debt by 3.7 times. This trend is mainly attributable to rising household income, which facilitates asset accumulation through an increase in savings and borrowings.

Second, the composition of household assets has become more diversified. While the level of deposits continues to grow, its share of total assets has been on a moderating trend. At the same time, the accumulation of assets in unit trust funds and equities has been on the rise (Chart 3). This trend

Chart 1

Composition of Household Assets

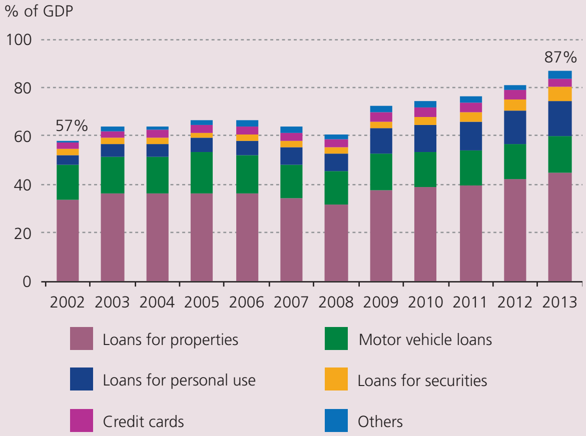


e Estimate, housing wealth data is only available up to 3Q 2013

Source: Bank Negara Malaysia estimates

Chart 2

Composition of Household Debt



Source: Bank Negara Malaysia

[1] Only domestic assets and liabilities are included in the analysis. This is due to the unavailability of a breakdown by economic agents in the International Investment Position statistics on holdings of assets abroad and external liabilities.

[2] Liquid assets are assets that can be converted into cash quickly and with minimal loss of value.

[3] Housing wealth is estimated by multiplying the average national house price with the total number of residential properties excluding unsold units.

[4] Loans for consumption comprise of motor vehicle loans, personal loans and credit card facilities.

not only reflects more developed domestic financial markets offering a wider range of products and services, but is also attributable to households' growing financial sophistication and improving awareness of alternative savings instruments. Housing wealth, meanwhile, continues to be the largest component of household assets[5].

From a distributional perspective, much of this wealth accumulation can be accounted for by higher-income households who are able to save a larger proportion of their income. Chart 4 illustrates the distribution of households by income groups and proxies of asset ownership based on flow data across income brackets[6]. Relative to lower-income households, those with monthly income above RM5,000 (accounts for a share of 33.7% of total households) assume a larger share of spending that is channelled to the accumulation of financial assets (65.8%) and earnings from rental income[7] (60.1%).

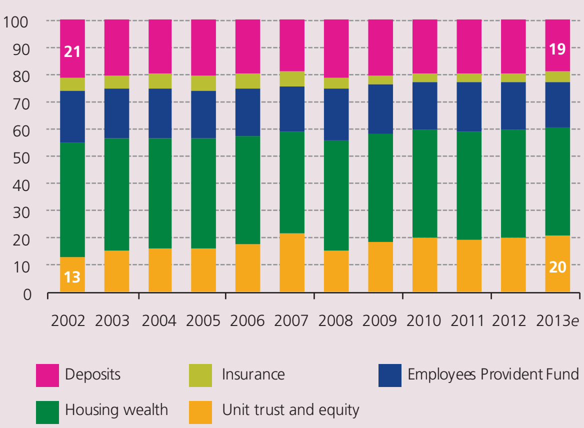
The Implications for Private Consumption

The changing size and structure of the household balance sheet has important implications for private consumption. On the assets side, the accumulation of property and financial assets has enabled Malaysian households to benefit from the recent asset price increases, supporting private consumption. Conceptually, asset prices affect spending by asset-owning households through three main channels (Skudelny, 2009). First, households are able to sell their assets to finance spending. This channel is stronger for more liquid financial assets, in which capital gains can be realised more quickly. Second, when assets serve as retirement savings, an appreciation in the value of these assets reduces the perceived need to save at present to finance future spending. Finally, assets can serve as collateral, enabling households to borrow against the value of the asset. While the three channels benefit asset owners, higher asset prices, particularly for property, increases the need for debt accumulation among house buyers. This reduces the disposable income of these households going forward, which may partially offset the positive wealth effect on private consumption.

On the liabilities side, borrowings to finance consumption have allowed households to adjust their spending patterns. Households with access to credit can borrow to facilitate purchases of durable goods as well as

Chart 3

Total Household Assets by Components

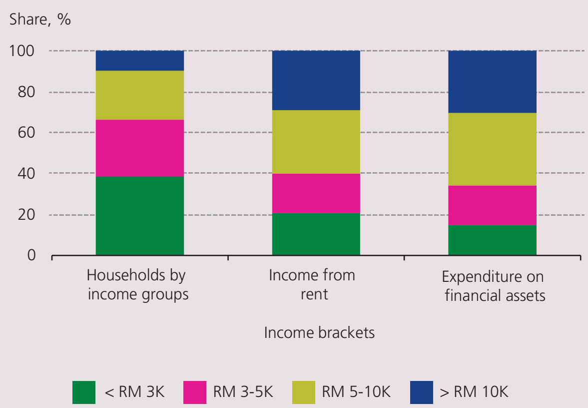


e Estimate, housing wealth data is only available up to 3Q 2013

Source: Bank Negara Malaysia estimates

Chart 4

Income from Rent and Expenditure on the Accumulation of Financial Assets Across Income Brackets



Source: Household Expenditure Survey 2009/10 and Household Income Survey 2012, Department of Statistics, Malaysia

5 For household liabilities, loans for the purchase of properties remain the largest component. Personal loans accounted for an increasing share since 2002, although its growth moderated in 2013. Refer to the Financial Stability and Payment Systems Report 2013 for a detailed analysis of household liabilities.

6 Statistics on stocks of household assets by income groups are not available.

7 Rental income, however, constitutes only a small fraction of total income for all income brackets.

to support consumption during times of lower income. Nonetheless, a portion of income must be devoted to the repayment of debt going forward. Consumption is not increased permanently but rather brought forward, hence limiting future increases in consumption. The sustainability of private consumption thus requires that households' future repayment capacities are in line with their debt obligations.

To understand the role of these channels for private consumption, an aggregate consumption function for the Malaysian economy was estimated[8]. The determinants considered are income, housing wealth, financial wealth[9], consumption credit disbursements and repayments. The contribution of each determinant to private consumption is quantified and illustrated in Chart 5.

The findings show that income is the most important driver of private consumption, accounting for an average of 67.4% of private consumption growth during the period. This result reflects the fact that private consumption has been consistently supported by stable labour market conditions and sustained income growth. Since 2005, housing and financial wealth have been supportive of private consumption, accounting for 14.5% and 13.7% of private consumption growth, respectively. The contributions have increased in the post-global financial crisis period. Consumption credit disbursements, while on average playing a small role, contributed significantly to private consumption during certain periods[10]. This reflects the fact that consumption credit cannot permanently increase spending, but rather helps households redistribute consumption over time or purchase durable goods[11].

The econometric findings relate to aggregate private consumption. Across income groups, the determinants of private consumption are likely to differ. Income likely contributes a larger share to private consumption growth for lower-income households, given that they have higher marginal propensities to consume

Table 1

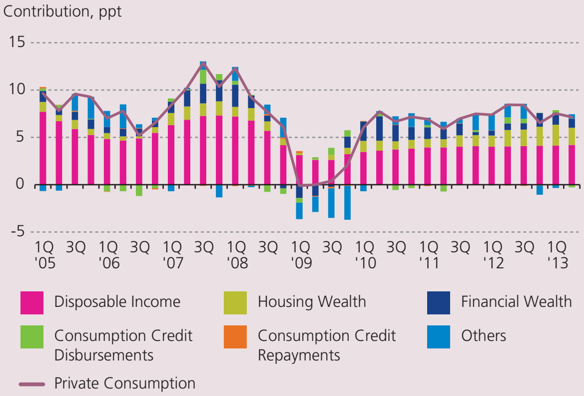
Average Contribution of the Determinants of Private Consumption Growth (2005-2Q 2013)

Determinant	Contribution (%)
Disposable income	67.4
Housing wealth	14.5
Financial wealth	13.7
Consumption credit disbursements	0.3
Consumption credit repayments	-0.2
Others	4.3

Source: Bank Negara Malaysia estimates

Chart 5

Drivers of Private Consumption Growth



Source: Bank Negara Malaysia estimates

[8] An error correction model (ECM) was used. Housing and financial wealth are estimated as the value of wealth net of the outstanding value of loans used to purchase them (e.g. financial wealth minus loans outstanding for the purchase of securities).

[9] Financial wealth refers to household holdings of unit trust funds. Direct holdings of equities are excluded due to the unavailability of reliable quarterly data.

[10] For example, between 2Q and 4Q 2009, consumption credit disbursements contributed an average of 0.6ppt. to overall private consumption growth of 1.0%. This coincided with the reductions in the Overnight Policy Rate by the Bank to support the economic recovery during this period.

[11] Loan repayments do not have a significant impact on private consumption in this model. This likely reflects the fact that there have been no episodes of widespread deleveraging on household balance sheets in the sample period. Repayments are expected to adversely affect consumption during such a deleveraging episode. For example, Dynan (2012) found that highly-leveraged homeowners in the United States experienced larger falls in consumption between 2007 and 2009, after accounting for the wealth effects of lower house prices.

(Murugasu, Ang and Tng, 2013). Improving the distribution of household income is thus likely to support overall private consumption. Meanwhile, wealth effects are probably larger for high-income households as they tend to hold more housing and financial assets.

Policy Implications

The findings suggest that balance sheet developments have become an increasingly important consideration for policy analysis for two key reasons. First, asset price movements have an important effect on household spending. For example, a reversal of the asset price gains in recent years is likely to reduce wealth, which may cause households to scale back on their spending. Thus, policy would need to focus on the sustainability of asset prices and the spillovers to the economy. This effect is, however, partially mitigated by the fact that a larger proportion of housing and financial wealth is held by higher-income households with larger savings buffers. Households with monthly income above RM5,000 save approximately a fifth of their income and are better able to support their consumption amid adverse asset price movements. Nonetheless, ensuring that asset prices are reflective of economic fundamentals remains a policy priority, given the potentially significant adverse implications of sharp corrections in asset prices for macroeconomic and financial stability.

Second, changes in household income may now pose significant implications for the real economy and financial stability. It not only affects households' ability to consume in a given period, but also to service their debt obligations. For example, if an income earner of an indebted household becomes unemployed, the household may be forced to further cut back on spending to manage debt repayments or face default. These concerns are, however, partially alleviated by holdings of assets. Liquid financial assets of households are 1.6 times outstanding debt, sufficient to cover their liabilities in the event of income shocks. In addition, 52% of the household debt is utilised for property purchases, and hence, is backed by physical assets. From a distributional perspective, however, the Bank continues to closely monitor lending to lower-income households. Households earning below RM3,000 a month have higher leverage positions than those in other income groups and hence are more susceptible to income shocks. The policy imperative, therefore, is to continue to ensure that households only borrow within their means.

Taking all these into consideration, the Government and the Bank have undertaken pre-emptive policies to prevent household balance sheets from becoming a source of systemic risk. In the 2014 Budget, the Government raised the real property gains tax (RPGT) and the minimum price of properties that can be purchased by foreigners. These measures are aimed at curbing speculation and ensuring that property prices grow in line with fundamentals. The Bank has also introduced macroprudential measures in stages since 2010, to prevent excessive household indebtedness and to ensure responsible lending practices. These measures are part of a broader trend of more active use of macroprudential policies to manage risks related to financial imbalances and excessive leverage. PR China, Chinese Taipei, Hong Kong SAR, Singapore and Indonesia have introduced macroprudential measures to manage either property prices or mitigate unsustainable increases in household indebtedness.

Conclusion

The household balance sheet has evolved over the recent decade. It has grown in size, both in terms of assets and debt, and has become more diversified. These developments have helped to support private consumption in recent years. Going forward, the household balance sheet will continue to evolve and have implications on household welfare, private consumption and economic growth. Nonetheless, it is recognised that over-leveraging which is not commensurate with income will make households more vulnerable to adverse shocks, and subsequently, pose a risk to household spending and sustainable growth. Therefore, there is a need to continuously evaluate financial developments and undertake pre-emptive action to mitigate the build-up of imbalances when appropriate.

References

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Performance of the Manufacturing Sector to Improve, Driven by the E&E and Primary-related Clusters

The improvement in external demand amid the recovery in global growth is expected to benefit the manufacturing sector. This is particularly relevant to the export-oriented industries, consisting of the E&E and primary-related clusters, which together account for 80% of the manufacturing output in Malaysia. In the E&E cluster, growth will be driven mainly by higher demand for semiconductors, especially for final use in mobile devices, tablets and automobiles. Amid the positive growth performance of semiconductors in recent years and underperformance of the personal computers and parts segment following the GFC, semiconductors have now become the largest contributor to Malaysia's E&E exports, accounting for a 39.7% share of total E&E exports (2006: 31.1% share). Growth is further supported by the primary-related cluster, underpinned by sustained regional demand for chemicals, refined petroleum and rubber products.

storage capacity (see `Re-export Activity Providing Growing Support to Malaysia's Trade´).

Export performance will also be supported by a small positive growth in commodity exports following two consecutive years of contraction. The better performance of commodity exports will be underpinned by the improvement in global demand for commodities and a smaller decline in commodity prices. The smaller decline in prices is attributed to higher crude palm oil (CPO) price that will partially offset the lower prices of liquefied natural gas (LNG), crude oil and rubber.

Gross imports is projected to increase at a stronger pace of 8.9% in 2014. Intermediate imports, which form the bulk of Malaysia's imports, is expected to rise in 2014 as manufacturers increase production to meet higher export orders. In addition, the continued expansion of domestic investment and consumption activity will continue to support the imports of capital and consumption goods, respectively.

In the services account, the projected smaller deficit will be supported by the increase in tourist arrivals and higher tourist spending in conjunction with Visit Malaysia Year 2014. Growth in imports, nonetheless, will be driven by continued payments for transportation and other services, in line with the expansion in trade and investment activity during the year.

In the income account, income from Malaysian companies abroad is expected to increase given the improving global economic outlook. Nevertheless, it is likely to be surpassed by profits and dividends accrued to multinational corporations operating in Malaysia following the recovery in manufactured exports. Net outflows in the income account, therefore, is likely to be sustained in 2014.

Overall, with the gradual recovery in exports, net exports of goods and services will exert a lower negative contribution to real growth in 2014. Nevertheless, with import growth remaining robust, and exports registering a modest recovery, the current account surplus of the balance of payments in 2014 is projected to narrow to RM30.8 billion or 3% of GNI.

Table 4.2

External Trade

	2013*p*	2014*f*
	Annual change (%)	
Gross exports *of which:*	**2.4**	**5.8**
Manufactures	5.7	7.2
Agriculture	-17.0	8.5
Minerals	3.8	-4.1
Gross imports *of which:*	**7.0**	**8.9**
Capital goods	2.8	7.2
Intermediate goods	4.3	6.0
Consumption goods	8.7	8.5
Trade balance	**-26.4**	**-22.7**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Re-export Activity Providing Growing Support to Malaysia's Trade

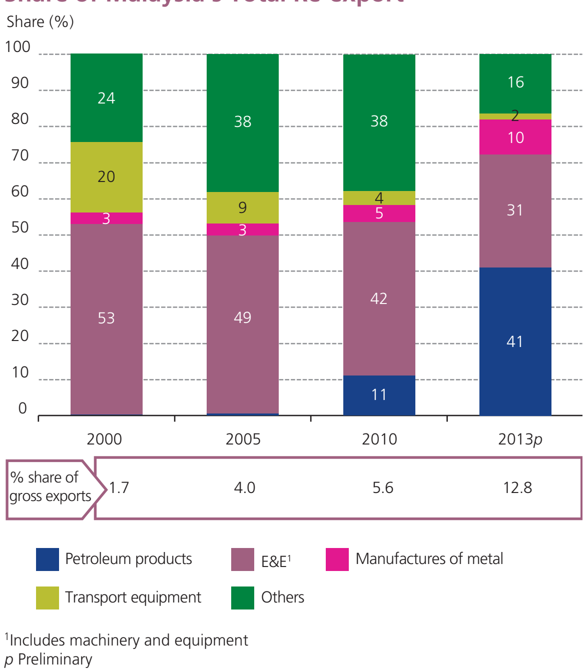
A notable development in Malaysia's trade structure in recent years is the increase in re-export activity. In essence, goods are considered as re-exports if the goods are exported out of the country in the same form as when they were originally imported, without undergoing any major transformation. Goods for re-export are recorded in the Customs merchandise trade figures for both exports and imports. However, some of these items are excluded from the goods account compilation in the Balance of Payments (BoP) statistics. These include goods that are imported and then exported without involving a change in ownership.

Re-export activity has been a feature of Malaysia's trade for several decades, but it used to account for only a small share of total exports. The strong growth of Malaysia's re-export activity in the more recent period has been largely attributable to the rapid increase in re-export of petroleum products. This reflects the ongoing expansion of petroleum storage capacity, as Malaysia positions itself as a regional oil storage and trading hub, as planned under the Economic Transformation Programme (ETP). Subsequently, the share of re-exports to total gross exports has more than doubled, increasing to 12.8% in 2013 from 5.6% in 2010.

By composition, the share of re-exports of petroleum products has grown significantly in recent years given the expansion in storage capacity. Currently, it constitutes the largest share of Malaysia's total re-exports, surpassing E&E re-exports. In addition, increasing warehousing activity for metal in Johor has also resulted in the rising share of re-exports of manufactures of metal.

Chart 1

Share of Malaysia's Total Re-export



[1]Includes machinery and equipment
p Preliminary
Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

Re-export activity has positive spillover effects on the economy. First, it increases the value-add of other related industries, including the transportation and storage services sub-sectors, manufacturing and construction sectors. Second, it contributes to the creation of mid- to high-skilled jobs, such as engineers and operators in the respective fields, resulting in higher employment and hence consumption activity. Third, the growth of re-export activity has a direct positive impact on net exports of services and investment in storage terminals and port infrastructure. For Malaysia, the positive spillovers of re-export activity to the economy is still small but is expected to increase rapidly going forward. At this point, most of the activity remains centred around warehousing services and other supporting or add-on services based on customers' requirements, such as heating and blending.

The strong growth of re-export of petroleum products is expected to continue, supported by further capacity expansion in petroleum storage terminals. This will further increase the contribution of re-exports to Malaysia's growth in the years ahead.

Table 4.3

Balance of Payments

	2013*p*	2014*f*
	RM billion	
Goods	102.7	93.7
Services	-15.0	-11.9
Balance on goods and services	**87.6**	**81.8**
Primary income	-35.2	-34.9
Secondary income	-15.2	-16.0
Balance on current account	**37.3**	**30.8**
% of GNI	***3.9***	***3.0***
Capital account	-0.0	
Financial account	-15.0	
Balance on capital and financial accounts	**-15.1**	
Errors and omissions	-7.5	
of which:		
Foreign exchange revaluation gains	*18.6*	
Overall balance	**14.6**	

Note: Figures may not necessarily add up due to rounding
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Inflation Outlook

Headline inflation is projected to average 3%-4% in 2014 (2013: 2.1%) due mainly to domestic cost factors. These include the recent price adjustments arising from subsidy rationalisation and the spillover effects of these adjustments on the prices of other goods and services. The higher cost pressures, however, will be partly contained by subdued external price pressures, given the expectations of lower global food and energy prices. Continued expansion in domestic capacity and a moderation in domestic demand would also help to attenuate the cost pressures. Upside risks to inflation include stronger domestic demand arising from better-than-expected external demand, a significant rise in global commodity prices and excessive wage increases leading to second-round effects. These risks, however, are assessed to be relatively low.

Externally, global inflation will remain subdued due to the prevalence of excess productive capacity and adequate supply of commodities to meet the expected increase in global demand. The Food and Agriculture Organisation of the United Nations (FAO)[2] projected lower global food prices in 2014, as the production of major food items, such as corn and wheat, is expected to increase significantly. Global crude oil prices are expected to remain stable, to average at USD103.70 per barrel in 2014[3] (2013: USD104 per barrel). The unprecedented supply of shale oil and the increase in its production in the US, as well as stable production of crude oil by other major oil producers will be sufficient to accommodate the expansion in demand for oil. In addition, the easing of geopolitical risks in the Middle East will also reduce the risk of crude oil supply disruptions. In line with the subdued global commodity prices, inflationary pressures originating from Malaysia's key import partners are also expected to be modest. The more moderate external price pressures would help to alleviate the pressure on domestic production costs.

Headline inflation to be driven by domestic cost factors

Domestically, the upward adjustments to the prices of petroleum products and sugar, as well as higher excise duties on tobacco products, in the later part of 2013, together with the recent increase in electricity tariffs in January, will contribute to higher inflation in 2014. While these adjustments may also have some spillover effects on the prices of other goods and services, the magnitude of the spillovers is expected to be contained given that these adjustments were implemented during a period of low inflation and moderate demand conditions. The pressure on prices from domestic demand factors is also expected to be modest due to a slower increase in household spending and the slower real wage growth. Thus, while the economy is expected to grow at close to its potential (see box article on `Estimating Malaysia's Potential Output´), it is not expected to result in significant domestic price pressures.

However, the upside risks to inflation remain. A better-than-expected recovery in the external demand would lead to stronger domestic demand. This could lead to higher demand-driven

[2] November 2013 Food Outlook

[3] Average price of Brent, Dubai and West Texas Intermediate (WTI) crude oil, equally weighted, as projected by the International Monetary Fund (IMF) in the January 2014 World Economic Outlook.

Estimating Malaysia's Potential Output

Potential output reflects the productive capacity of the economy. It is the maximum amount of goods and services an economy can produce over the long term without exerting downward or upward pressure on prices. The output gap is a measure of the difference between the actual output of the economy and its potential output. Policymakers closely monitor the potential output and output gap for two main reasons. First, the estimates of potential growth not only inform policymakers of the long-term sustainable growth rate of the economy but also the underlying drivers of growth. Second, the output gap reflects the extent to which economic resources are being overutilised or underutilised, and therefore, provides insights into demand-driven inflationary trends. For example, a negative output gap suggests that there is slack in the economy and price pressures will be weak on account of the weak demand conditions. Conversely, with a positive output gap, the economy is operating above its potential. If this condition persists, the prevailing excessive demand will exert upward price pressure on factors of production and subsequently cause an increase in the general price level.

This article highlights three different approaches of assessing Malaysia's potential output and output gap[1] (Table 1). These approaches comprise of statistically-based filtering methods, macroeconomic model-based multivariate filter methods and structural methods. The approaches complement the existing estimation method using the production function approach, and have further improved the understanding of the relationships between potential output, output gap and economic activity.

Table 1

Various Methods in Estimating the Output Gap

Estimation Methods	
Univariate	Linear Trend
	Univariate State Space
	Hodrick-Prescott
Multivariate	Multivariate Kalman Filter (MVKF)
	Multivariate Filter (MV)
Structural	Structural Vector Autoregression (SVAR)
	Cobb-Douglas production function (CDPF)

In the past, potential output was estimated through mechanistic linear trends which assume that the potential output grows at a constant rate through time. Increasingly, estimation techniques have advanced to use more sophisticated approaches which incorporate economic relationships, and thus are able to capture the dynamics and drivers of potential output. The macroeconomic model-based multivariate filter establishes more robust linkages between the estimated potential output and output gap with other key macroeconomic variables, including inflation and the non-accelerated inflation rate of unemployment (NAIRU). The structural vector autoregression (SVAR) approach allows price shocks to be decomposed into demand- and supply-side shocks which would have important policy implications. Meanwhile, the Cobb-Douglas production function (CDPF) approach allows growth to be decomposed into contributions from the various factors of production. Notwithstanding the progress that has been made, estimating the potential output and the output gap remains challenging as it cannot be directly observed and it can change significantly when an economy experiences structural changes.

Each competing model is different conceptually and will therefore produce different results. Nonetheless, the various estimation results can be used for cross-checking and therefore, contribute to more rigorous understanding of the economy's potential output and output gap.

Estimates of the Malaysian Economy's Potential Output

Based on the three different approaches, the potential output growth is estimated to be in the range of 4.7% to 5.1% in 2013 (a simple average of 4.9%) and to range between 4.6% to 5% in 2014 (a simple average of 4.8%) (Chart 1). Based on the projected economic growth, the output gap is estimated to be a small positive of 0.3% and 0.5% in 2013 and 2014, respectively.

[1] An in-depth discussion of the various estimation techniques can be found in the forthcoming BNM Working Paper on Estimating Malaysia's Potential Output.

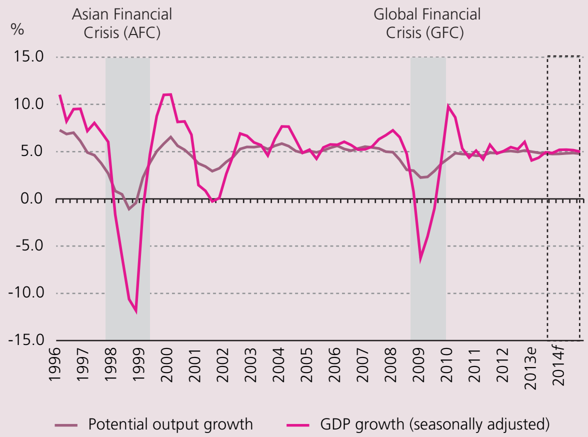
In terms of the quarterly time profile, both the univariate (Chart 2) and multivariate filters[2] (Chart 3) indicate that the economy registered a small negative output gap in the first two quarters of 2013, which turned marginally positive in the third quarter of the year. This small positive output gap is likely to persist in 2014. The estimates produced by filtered-based methods appear to give a plausible representation of Malaysia's historical business cycle and remain close to the range of the structural model estimates[3]. In particular, both filters estimated large positive output gaps during the periods leading up to the Asian Financial Crisis (AFC) and the Global Financial Crisis (GFC) and negative output gaps during the crises. These trends are further supported by the comparable output gap profiles from the structural models, namely the production function approach and the SVAR model (Chart 4).

In terms of the drivers of growth, the production function approach suggests that potential output in 2014 will continue to be supported by firm private investment and favourable labour market conditions.

While output gap profiles for the filter-based and the structural models remain broadly similar, the

Chart 1

GDP and Potential Output Growth, 1996-2014*f*

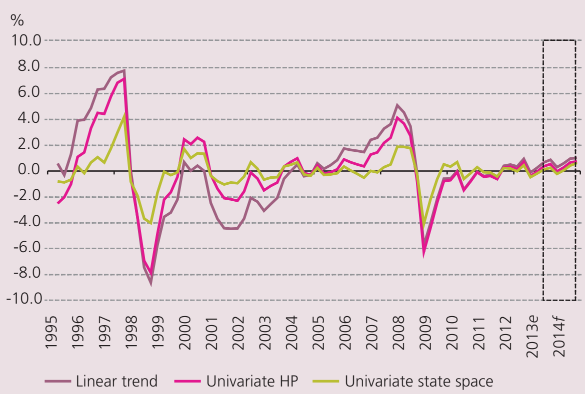


e Estimates
f Forecast

Source: Bank Negara Malaysia estimates

Chart 2

Univariate Filter Output Gap Estimates, 1995-2014*f*

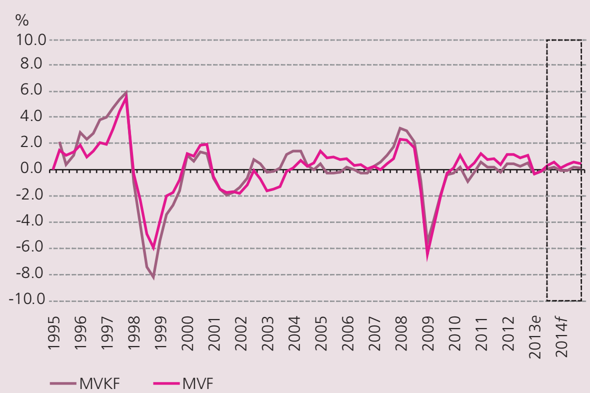


e Estimate
f Forecast

Source: Bank Negara Malaysia estimates

Chart 3

Multivariate Filter Output Gap Estimates, 1995-2014*f*



e Estimate
f Forecast

Source: Bank Negara Malaysia estimates

[2] Multivariate Kalman filter exploits the information on the excess demand in the labour market which is used as a proxy for demand in the product market. On the other hand, the multivariate filter, which takes into account the interaction between price, output, unemployment and capacity utilisation, improves further the estimation of the potential output.

[3] When the sample is truncated in 2008, the out-of sample forecast produced by the model-based multivariate filter for Malaysia show that the profile of the gap estimates remained consistent with the full-sample estimates. Benes et al conducted ex-post forecasting exercises for numerous countries and they found that the multivariate filter performs well relative to a random walk (see Benes, J. et al. (2010). *Estimating Potential Output with a Multivariate Filter*, IMF Working Paper, WP/10/285).

size of the output gap estimated by the two classes of models differs[4]. The univariate and multivariate filtered-based models estimate the output gap to be in smaller range compared with the structural models (0.04%-0.7% and 0.4%-1.3%, respectively) (Table 2). This is attributable to the key differences in how the two classes of models are specified. By construction, estimates from the structural models are governed by the theoretical relationship between the level of labour, capital and technology advancement in the economy. Of importance, in generating the estimates, the magnitude of the inter-linkages between these variables is assumed to be unchanged across time. The structural model hence, provides a good estimate of the economy's potential output over a longer run horizon. However, it may overestimate the output gap in the short-run as it does not explicitly account for the recent changes occurring in the economy. In contrast, the filter-based models combine the information from the latest underlying trend and the theoretical relationship among the macroeconomic variables. For example, the multivariate filter-based models generate the output gap estimates by capturing the latest trends from macroeconomic variables such as inflation, capacity utilisation and unemployment. To ensure consistency, information about the trend trajectory from these variables is linked together with a set of conditional relationship backed by economic theory such as Phillips curve that relates the output gap to inflation; a dynamic version of the Okun's law that relates unemployment and output gap; and a capacity utilisation equation that links capacity utilisation rates to the output gap. In other words, by construction, the filter-based models are more adept at picking up the recent short-run dynamics that are taking place in the economy. In this instance, it is likely that the potential output has been lifted by the robust growth of investment in recent years.

Table 2

Output Gap Estimates, 2014*f*

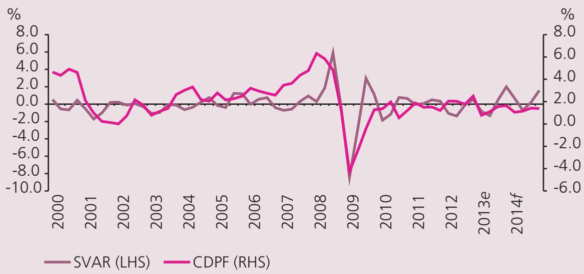
Estimation Methods	Range (%)
Univariate	0.2 - 0.7
Multivariate	0.04 - 0.4
Structural	0.4 - 1.3

f Forecast

Source: Bank Negara Malaysia estimates

Chart 4

Structural Models' Estimates of Output Gap, 2000-2014*f*



e Estimate
f Forecast

Source: Bank Negara Malaysia estimates

Conclusion

Although the estimated size of the output gap differs across models, the output gap profiles remain broadly similar and all point towards the economy operating close to its potential level in 2013 and into 2014. Going forward, the evolution of the potential output will be determined both by the structural features of the economy and the economic environment in which the economy operates. While the increases in the quantity of capital and labour may raise potential output, sustainable long-term growth critically depends on the quality of capital and labour as well as how efficiently these factors are used. Total factor productivity, which is associated with technological innovations and knowledge, will also be important in determining the country's long-term potential growth. Thus the successful creation of an ecosystem that promotes competition, skills, knowledge and innovation will play a key role in ensuring that productivity gains are reaped.

[4] For example, in the case of New Zealand, Claus et al. indicate a greater amplitude of output gaps from structural VARs and the Kalman filter than of those from the HP and HP multivariate filter (see Claus, I. et al, (2000). *The Output Gap: Measurement, Comparisons and Assessment,* Reserve Bank of New Zealand Research Paper, no. 44). In contrast Mc Morrow and Röger find that the HP filter generates larger output gaps than the Kalman filter in the EU countries (see Mc Morrow K, and Röger, W. (2001). *Potential Output: Measurement Methods, ``New´´ Economy Influences and Scenarios for 2001-2010,* ECFIN Economic Paper, no. 150).

inflationary pressures that in turn could translate into higher spillovers across the economy. Global food and energy prices could also rise significantly should there be disruptions to the global supply of commodities, contributing to higher input costs and imported inflationary pressures. There is also the risk of second-round effects on inflation should inflation expectations increase disproportionately, accompanied by excessive wage increases that are not reflective of the improvements in productivity. However, based on available information, the current assessment is that the probability of these risks manifesting themselves is relatively low.

MONETARY POLICY OUTLOOK

Monetary policy in 2014 will aim to support the sustainable growth of the Malaysian economy while mitigating any potential vulnerabilities arising from inflation and financial imbalances. The Malaysian economy is expected to continue on a steady growth path, supported by better performance in the external sector amid some moderation in domestic demand. Compared to 2013, inflation is projected to be higher. Nevertheless, the higher inflation will largely be due to cost factors, with the underlying inflation expected to remain contained. The continued low global and domestic interest rate environment would also make it important to be vigilant to the build-up of financial imbalances.

The global economy is expected to continue to improve in 2014, underpinned by a broader recovery in the advanced economies amid sustained growth in the emerging economies. The improvements in the advanced economies will have positive spillover effects on the rest of the world and provide support to the emerging economies as they transition towards a more moderate pace of growth in domestic demand. Nevertheless, there remains uncertainty surrounding the global macroeconomic and financial environment. In the advanced economies, key concerns are the significant economic slack and the impact of fiscal consolidation on the pace of recovery. Emerging economies face the challenge of managing external risks. The monetary policy transition in the advanced economies could heighten volatility in exchange rates, financial markets and capital flows, that may in turn, become destabilising to the growth prospects in these economies. Emerging economies may also experience a moderation in domestic demand as policy measures are taken to address domestic risks.

The Malaysian economy is projected to grow between 4.5%-5.5% in 2014. Domestic demand will continue to be the anchor for growth, but it will grow at a more moderate pace. Private investment is projected to continue to register robust growth, while private consumption is expected to moderate to its long-term trend growth. Public sector spending is also projected to expand at a slower pace. Nevertheless, the economy is expected to benefit from the gradual recovery in the advanced economies. Employment prospects are expected to remain favourable. Key risks to the growth outlook over the near- to medium-term emanate mainly from the external sector, arising from the downside risks to global growth. The economy could also experience stronger growth should the pace of global recovery exceed expectations.

Price pressures are expected to be stronger in 2014, following the relatively benign inflation environment throughout most of 2013. Headline inflation is expected to average between 3%-4% in 2014, due mainly to domestic cost factors. The higher cost pressures will be partly contained by the subdued external price pressures, continued expansion in domestic capacity and the more moderate rate of expansion in domestic demand. There is, however, a risk that higher global commodity prices and stronger-than-expected demand conditions could put an upward pressure on inflation. Rising inflationary expectations and excessive wage increases, if they occur, would also pose upside risks to inflation. However, these risks are assessed to be contained at this juncture.

Given the nature of the factors behind the increase in inflation, monetary policy is not the best policy tool to manage the situation. Being a demand management tool, there is less reliance on monetary policy to deal with cost-push inflationary pressures. There is greater reliance on other policies, such as measures to expand domestic capacity, improve the distribution channels and promote market efficiency and competitiveness. Nevertheless, higher cost-push inflation could lead to inflation expectations becoming unanchored and could, in turn, lead to wage growth that is not consistent with productivity growth. This could create conditions for a more significant increase in inflation. Recognising these risks, monetary surveillance will remain focused on identifying signs that inflation is becoming more pervasive and persistent, where a monetary policy response would become more appropriate.

Given the prolonged period of relatively low international and domestic interest rates, such a situation could encourage excessive risk-taking. The consequent build-up of excessive leverage and asset price misalignment could undermine macroeconomic and financial stability should these imbalances unwind in a disorderly manner. To the extent that such excessive risk-taking behaviour or asset price escalations occur within specific segments of the economy, other targeted policy instruments such as macroprudential measures would be deployed to address the risks. Such measures are, however, complementary in nature and not a substitute for interest rate policy.

Large shifts in global liquidity and capital flows are expected as central banks in some of the advanced economies continue to reduce their degree of monetary accommodation. This could heighten currency and financial market volatility in emerging economies, including in this region, and influence domestic monetary and financial conditions. The building of buffers and the continuous strengthening of fundamentals over the years has improved the resilience of the Malaysian economy and financial system to external shocks. This resilience is vital in ensuring that episodes of capital outflows do not lead to unintended excessive tightening of monetary conditions. Importantly is that the monetary and financing conditions do not become destabilising and continue to be supportive of the economy.

FISCAL POLICY OUTLOOK

Fiscal policy in 2014 is aimed towards strengthening the fiscal position, while ensuring continued support for domestic growth and the protection of the well-being of the society. Given the challenging domestic and external environment, fiscal reforms are being pursued gradually without undermining economic growth. At the same time, fiscal resources will be directed towards key economic sectors to accelerate the shift towards a high value-added, high-income economy.

The Federal Government fiscal deficit is expected to be rationalised further to 3.5% of GDP in 2014 from 3.9% of GDP in 2013, underpinned by sustained revenue expansion and more efficient spending. Given the path of fiscal consolidation, the Government is expected to remain on track in meeting its fiscal deficit target of 3% of GDP by 2015 and a balanced budget by 2020. The implementation of expenditure reforms would be key to reducing the fiscal deficit moving forward. Of importance is the restructuring of subsidies towards achieving fiscal sustainability. Such transition would lead to a more efficient allocation of resources in the economy.

Table 4.4

Federal Government Finance

	RM billion		% change	
	2013*p*	2014*B*	2013*p*	2014*B*
Revenue	213.4	224.1	2.6	5.0
Total expenditure	253.5	262.2	0.4	3.4
Operating expenditure	*211.3*	*217.7*	*2.8*	*3.0*
Gross development expenditure	*42.2*	*44.5*	*-10.1*	*5.4*
Loan recoveries	1.5	0.9		
Overall balance	**-38.6**	**-37.1**		
% of GDP	**-3.9**	**-3.5**		
Sources of financing:				
Net domestic borrowing	39.5	-		
Net external borrowing	-0.2	-		
Realisable assets[1] and adjustments	-0.7	-		

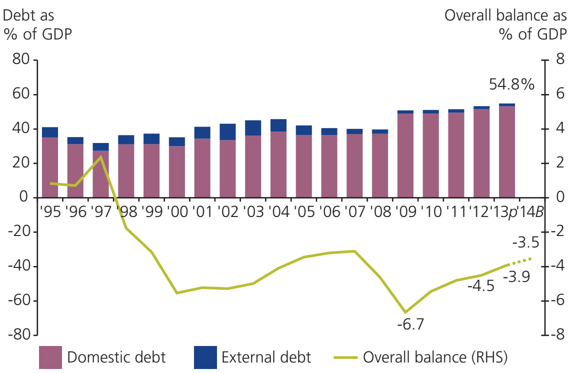
[1] A negative (-) sign indicates a build-up in assets
p Preliminary
B Budget
Note: Numbers may not add up due to rounding

Source: Ministry of Finance, Malaysia

Fiscal resources in 2014 are being prioritised towards high-impact investment projects undertaken in collaboration with the private sector. These include, among others, the ongoing MRT project, expansion of broadband infrastructure and acceleration of the development of regional economic corridors. The investment in public infrastructure will enhance mobility, connectivity and promote development nationwide, which would also further enhance productivity in the economy. Higher value-added activities, particularly in the agricultural and logistics sectors, will be encouraged to promote greater participation in the global supply chain. Incentives to improve productivity of small and medium enterprises are aimed at enhancing business competitiveness. Efforts to develop human capital will be strengthened through high quality training programmes and the implementation of the Malaysia Education Blueprint 2013-2025. The enhancement of the quality of talent is critical

Chart 4.3

Federal Government Fiscal Balance and Debt



p Preliminary
B Budget

Source: Ministry of Finance, Malaysia

to accelerating Malaysia's progress towards being a high-income nation. Measures to promote affordable housing, quality healthcare services, security and public order, and environmental conservation will help to improve the quality of life and well-being of society.

In June 2013, the Fiscal Policy Committee (FPC) was established to serve as the central policy-making committee for the formulation and implementation of fiscal strategies and giving due consideration to their impact on overall macroeconomy. The objective is to have in place a holistic fiscal framework and the institutional mechanism for the successful implementation of reforms, including shifting towards a more broad-based tax system through the introduction of the Goods and Services Tax in April 2015 to ensure fiscal sustainability into the future.