2012

OUTLOOK AND POLICY IN 2013

THE INTERNATIONAL ECONOMIC OUTLOOK

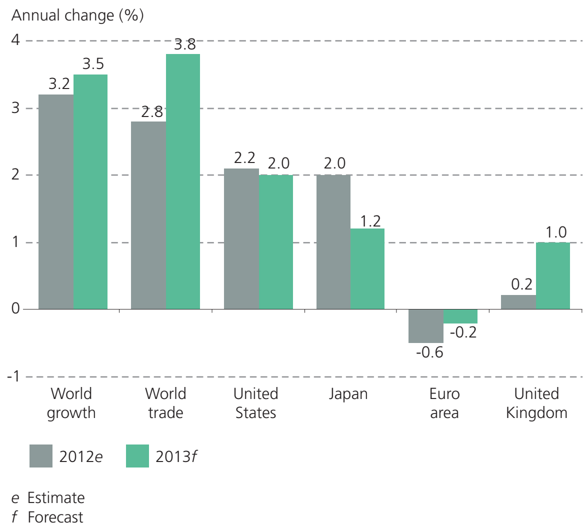
The global growth outlook is expected to improve in 2013. Financial and policy risks have receded compared to the situation over the recent two years. Policy measures introduced in the latter half of 2012 have reduced policy uncertainties and stress in the financial markets. In the advanced economies, the pace of recovery is likely to be weak, with the differential in national growth rates reflecting the degree of economic and financial stress in the individual economies. The outlook for the emerging economies is relatively more favourable, despite their vulnerability to external developments. For most of these economies, domestic demand remains the key driver of growth. Key to the trajectory of inflation will be the prices of commodities, in particular, oil and food crops. Overall, the pace of global growth would be contingent on the strength of the revival in private sector activity in the US, the commitment towards a credible and comprehensive set of crisis resolution policies in the euro area and the sustainability of domestic demand in the emerging economies.

Global growth is expected to improve in 2013

The **US** economy is expected to register modest growth, supported by an improvement in private demand which is expected to partially offset the ongoing fiscal consolidation. Consumption activity will remain a key driver of the private sector-led growth, supported by a recovery in the housing and labour markets. In the housing market, the improvements observed towards the second half of 2012 - in sales, construction starts and prices - are expected to continue in 2013 amid an accommodative interest rate environment. The positive developments in the housing market have already been translated into higher consumer confidence and employment, particularly in the construction sector. The labour market is benefiting from sustained job creation, although the degree of improvement will be constrained by prevailing structural weaknesses including the elevated long-term unemployment rate and the decline in the labour force participation rate. A significant development is the improvements in the household balance sheet and its effects on consumer confidence. By mid-2012, household net worth improved by 27% since 2009, bolstered by the recovery in house prices and the progress in deleveraging. Nevertheless, a faster pace of recovery of the economy continues to be constrained by the fiscal headwinds. Although the 'fiscal cliff' was partially averted following the agreement on 1 January 2013 to extend selected tax cuts and unemployment benefits, other measures, such as the expiration of payroll tax and sequester cuts, could dampen the pace of recovery.

Chart 4.1

World Growth, World Trade and Growth in Major Advanced Economies (2012-2013)



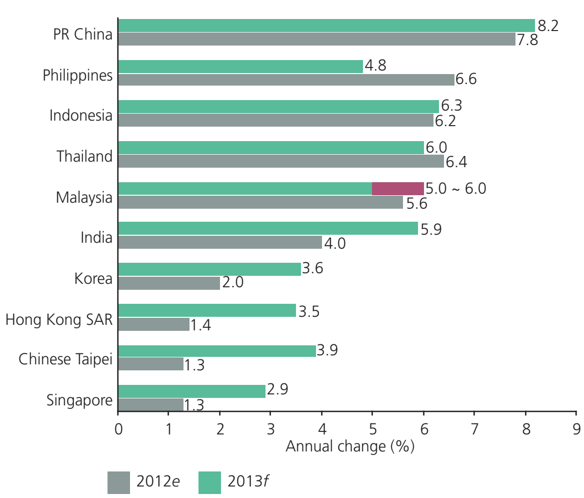
Source: International Monetary Fund and National Authorities

Economic activity in the **euro area** is expected to remain weak due to structural constraints and the continued fiscal consolidation. While tensions in the financial markets have receded, fragile growth still persists particularly in the crisis-affected economies due to the ongoing fiscal austerity measures and structural adjustments. The sustainability of the fiscal position of the crisis-affected economies in the euro area remains a major concern, with public debt ranging between 90% and 171% in 2012. Private sector activity is further undermined by the tight financing conditions and weak labour markets. Financial institutions continue to be affected by their exposure to crisis-affected economies, hampering the provision of credit to the real economy. Labour market conditions are particularly weak in the crisis-affected economies such as Spain and Greece, where unemployment rates are at 26.2% and 26.6% respectively in November 2012. At the regional level, policy decisions directed towards the strengthening of the euro area, including in the area of banking union and greater fiscal cooperation, will continue to influence financial markets, business sentiments and subsequently growth.

In **Japan,** economic growth is expected to moderate, reflecting the diminishing effects from reconstruction-related demand over the recent two years, amid protracted weakness in domestic activity. While the nation's export performance is expected to recover gradually, growth will be supported primarily by more monetary and fiscal stimulus. Of significance, the Bank of Japan's recently introduced price stability target of 2% and commitment towards more aggressive monetary easing is expected to support the efforts to overcome deflation and promote growth. In addition, the newly-elected Japanese government has introduced a ¥10 trillion stimulus package (2.5% of GDP), comprising mainly of public work

Chart 4.2

Regional Economies: Real GDP Growth



e Estimate
f Forecast

Source: International Monetary Fund and National Authorities

programmes and the provision of financial aid to businesses, which will cumulatively support the economic recovery. The growth trajectory, however, remains contingent upon the effective transmission of these policy measures to real economic activity.

The economic performance in **Asia** is likely to improve in 2013, driven mainly by resilient domestic demand and a modest strengthening in export demand, particularly from the region. Government-led infrastructure investment will likely underpin the strength in domestic demand, particularly in the ASEAN economies. These initiatives include private-public partnerships in the Philippines, major infrastructure projects in Indonesia and rail transport network expansion programmes in Thailand and Singapore. Consumption growth will continue to be buttressed by income growth amid favourable labour market conditions, continued access to financing and government policy support, such as the implementation of, and increases in, minimum wages in several of the regional economies. In the more open economies, growth will be lifted by the gradual increase in global demand as the external environment improves. The economic expansion in PR China is expected to remain robust, with domestic economic activity set to become stronger during the year. While the Chinese government remains committed to restructuring the economy through efforts to boost consumption, targeted investments, particularly in infrastructure projects, will continue to be a key contributor to growth in the near term.

Global inflation is expected to remain moderate in tandem with the modest improvement in global demand. In the advanced economies, underlying inflationary pressures are expected to be subdued, reflecting excess capacity and weak demand in these economies. There are, however, signs of demand-pull inflationary pressures in the emerging economies following the stronger domestic activity. Nevertheless, on the supply side, the risk of cost-push inflation is expected to remain restrained, given the expectations of modest increases in the prices of global commodities. There are, however, risks of periodic spikes in commodity prices as have been observed over the recent two years. In the oil market, an escalation of unrest in the Middle East and North Africa could lead to higher prices of crude

Post-Crisis Structural Changes in Global Growth Trends

Half a decade after the global financial crisis, the global economic environment remains confronted with challenges that are both structural and cyclical in nature. Economic activity in the advanced economies continues to be sluggish, as these economies deal with the legacy of excessive leverage, continued weaknesses in the labour markets and the challenge of reforming existing institutional frameworks. The emerging economies, however, are leading the global economic expansion, amid ongoing efforts in implementing structural reforms to accelerate the shift of the drivers of growth from exports towards domestic demand. These asymmetrical growth patterns are cumulatively contributing to the emergence of an increasingly multi-polar world which may have profound implications for economic relationships between nations and policies globally. This article aims to identify the structural changes that are driving global growth, with a special focus on Asia.

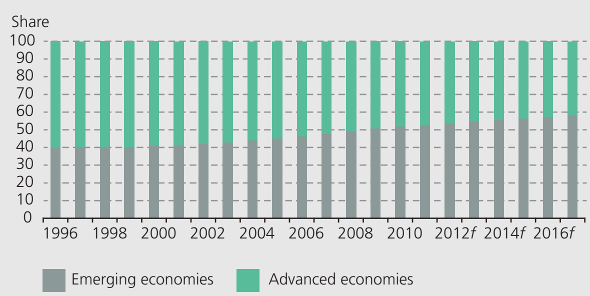
The Great Recession

In 2008-09, the global economy experienced the worst synchronised recession since World War II. Global output contracted by 2.2% while international trade activity weakened by 12% relative to 2005 levels. In response, the swift and aggressive countercyclical monetary and fiscal policy measures undertaken by both advanced and emerging economies managed to cushion the negative impact of the crisis and paved the way towards economic recovery in 2010.

While global output is gradually returning to the pre-crisis levels, the crisis exposed considerable structural weaknesses in the world economy, which are particularly acute in the advanced economies. In contrast, the emerging economies are exhibiting greater resilience and have accounted for more than three quarters of global growth between 2010 and 2012. Emerging economies' share of global growth also rose from 37% in 2000 to 49% in 2011 with a corresponding decline in the share of the advanced economies (Chart 1). Such heterogeneity in economic performance underscores the reshaping of the economic and financial landscape to a new global environment with multiple growth poles.

Chart 1

Share of Global GDP



f Forecast

Source: International Monetary Fund (IMF)

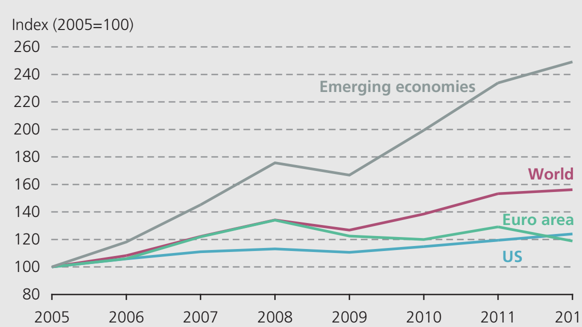
The Rise of a Multi-Polar World

Slow recovery in the advanced economies

In the past five years, growth in the advanced economies has averaged at a lower rate of 0.5% (2000-2007: 2.6%). The pace of increase in economic output in the major economies from pre-recession levels considerably lagged that of the emerging economies (Chart 2). The relatively muted growth prospects of these economies are attributable to several factors, namely private sector deleveraging, fiscal austerity, impaired financial intermediation and structural rigidities in the job market. These factors will be explored further in the next section.

Chart 2

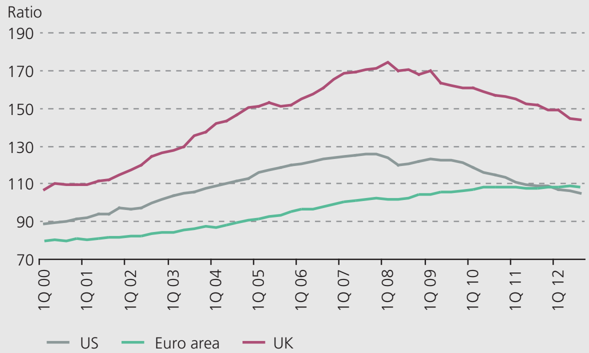
Economic Growth of Selected Major Economies since 2005



Source: Haver

Chart 3

Ratio of Household Debt to Personal Disposable Income



Source: Haver

1) *Continued deleveraging by private sector*

The most immediate constraint to a more robust economic recovery originates from the ongoing deleveraging process across most advanced economies. In the past two decades, several advanced economies experienced excessive debt growth which fuelled a prolonged consumption boom. Of significance, the rising trend of household indebtedness of several major economies was supported by a few key developments in the property and financial markets. The relaxation of mortgage underwriting rules in an environment of abundant liquidity allowed households with lower creditworthiness to purchase properties. Financial innovations also made it easier for homeowners to borrow on overvalued homes. The situation became unsustainable when falling house prices led to defaults, turning into a vicious cycle which cumulatively depressed aggregate demand. As a result, highly-indebted households have been forced to reduce debt and rebuild wealth positions that were severely affected by the negative equity in the housing market. A survey of past systemic crises has shown that in balance sheet recessions, the recovery process is often delayed and lengthy (Reinhart and Reinhart, 2010). Currently, household debt relative to personal income remains elevated by historical standards (Chart 3), indicating that the deleveraging process is still ongoing and would continue to inhibit private consumption activity.

2) *Fiscal austerity*

In response to the severe economic downturn, governments in the advanced economies undertook massive fiscal stimulus measures and provided support to troubled financial institutions through large-scale equity injections and debt guarantees. The deterioration of government finances was further compounded by the operation of automatic stabilisers such as higher expenditure on unemployment benefits and lower tax revenues. The IMF estimates that almost half of the public debt increase among advanced economies is attributable to automatic revenue losses, with another 17% being accounted for by the stimulus packages (Allen, 2012). As a result, the public debt of the advanced economies had escalated to very high levels after the crisis, reaching 105% of GDP in 2011 (2001: 72%), with a fiscal deficit of 4.7% of GDP (2001: +0.7%). Governments in the advanced economies are hence forced to cut spending and strengthen fiscal positions, thereby limiting the ability to further support economic recovery.

Beyond the immediate future, the restoration of sustainable fiscal positions remains challenging, due to other underlying structural impediments. In particular, unfavourable demographic trends of ageing population and rising dependency ratios will exert further strains on public finances. This will constrain the governments' ability to finance the increased public expenditure on healthcare and pension systems. In 2008, age-related spending such as health and pension expenditure averaged 13% of GDP in the advanced economies. By 2030, these expenditures are expected to increase further by as much as 4.5 percentage points to account for 17.5% of GDP, thereby placing further pressure on their fiscal positions (IMF, 2010).

3) *Impaired financial intermediation*

Financial institutions in the crisis-affected economies are also deleveraging to repair balance sheet positions that had impaired the banks' capacity to provide an adequate flow of credit to finance economic activity. The bursting of the housing bubbles caused an immediate and sizeable reduction in the value of bank assets as homeowners defaulted on mortgages and mortgage-based securities experienced a significant deterioration in value. Balance sheets were also affected by the diminishing value of sovereign paper holdings amid heightened fiscal sustainability concerns in several advanced economies. Compounding the situation is the tighter regulatory environment. In 2012, European banks underwent a recapitalisation exercise to raise capital buffers to 9% in core Tier 1 capital. The possible future implementation of more stringent requirements such as Basel III could indirectly tighten lending standards and increase borrowing costs for households, businesses and governments. While recent policy actions by central banks, such as the introduction of Operation Twist in the US and Outright Monetary Transactions in the euro area, have lowered the cost of short-term lending and somewhat eased funding strains, many challenges remain. European banks are estimated to still face a €400 billion shortfall in capital (4.5% of euro area's GDP). Insufficient provision of credit to the real economy may continue to be a major constraint to a full recovery.

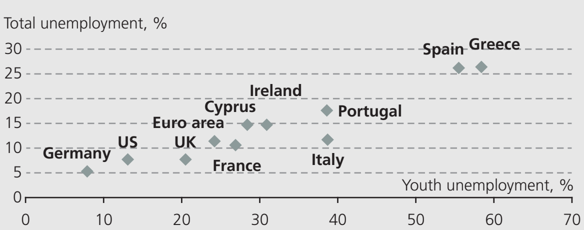
4) *Employment rigidities*
On the employment front, labour market conditions remain weak in most advanced economies. Of significance, the ongoing fiscal austerity in an increasingly uncertain economic environment have cumulatively dampened hiring rates and exacerbated the dislocation of workers from the labour market. In the US and UK, unemployment rates continue to hover around 8%, and in most euro area economies, the rate exceeds 11% (Chart 4). The slowdown in economic activity has had a disproportionate effect on workers in industries that were more affected by the crisis, such as construction and financial services. These job losses, however, are spreading to other sectors that were not directly implicated in the financial crisis such as the manufacturing sector, due in part, to weak consumer confidence and impaired credit flows to consumers.

The slower recovery in employment is also symptomatic of other trends that are structural in nature. Given the uncertain global environment, businesses are more cautious and increasingly opting to hire more temporary workers. Since the onset of the global crisis, part-time employment has increased in more than 60% of the advanced economies and temporary employment was higher in 25% of these economies (ILO, 2012). This is worsened by geographical mismatches; where workers with the desired skills are unable to accept employment in another geographic market, further contributing to the labour market rigidities and higher structural unemployment. In the US and UK, lower labour mobility also partly reflects the lingering effects of the collapse in the real estate market, where most individuals with negative equity mortgages are unable to relocate given the sharp fall in house prices.

The elevated long-term unemployment rates carry serious social and economic costs such as persistently high jobless claims, permanent loss of skills or hysteresis and an increased risk of social unrest and poverty. This has also affected the youth segment of the population more adversely than others. The ILO estimates that youth unemployment in the advanced economies has risen to almost 20% in 2012 from 11.7% in 2007. The situation is more severe in the economies that are in recession, such as Greece (55%), Spain (53%) and Portugal (39%). The exclusion of the young from the labour market may have detrimental effects on future employability and wage growth, especially when many young workers are currently employed in low productivity jobs.

Chart 4

Youth and Overall Unemployment Rates in Selected Advanced Economies

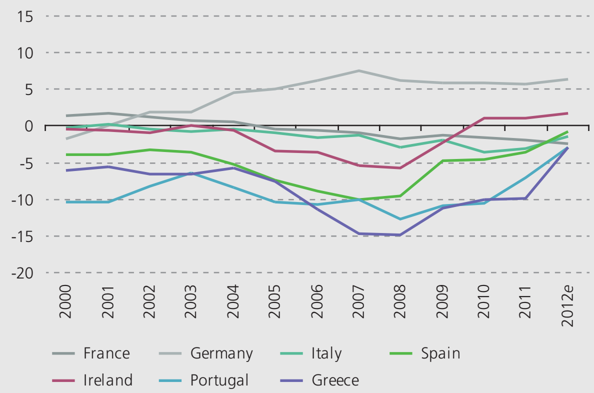


Source: National Authorities, Haver

The crisis has also highlighted other existing structural rigidities in the labour market which have significant bearing on the overall competitiveness of the advanced economies. Many advanced economies have high unit

Chart 5

Current Account Balance of Selected Euro Area Economies (% of GDP)



e Estimates

Source: International Monetary Fund (IMF), Eurostat

labour costs as a result of prevailing wage structures. This is not fully compensated with similar increases in productivity. Among the G7 economies, productivity growth (measured as the change in output per hour worked) has been on a weakening trend since 2005 before declining by 2.4% during the peak of the crisis in 2009. This is particularly acute in the euro area as the shift towards a monetary union has increased the importance of national competitiveness based on real factors such as unit labour costs. The difference in labour compensation and productivity has resulted in differing competitiveness among euro area economies, as reflected by the divergence of external imbalances within the region (Chart 5). In this respect, governments have been undertaking structural reforms in the product and labour markets to improve competitiveness, but the positive effects can only be observed in the real economy over the medium term. In the foreseeable future, the combination of slower economic activity and prolonged and deep weaknesses in the labour market will cause unemployment to remain high, depress income growth and create a huge strain on government finances.

Prospects for the emerging economies

Economic activity in emerging economies remains robust. The IMF projects that the emerging economies are expected to expand by an average of 6.0% annually over the next 5 years. In Asia, growth is increasingly underpinned by the rising strength in domestic demand, which contributed to more than two-thirds of the region's growth in 2011. The Asian economies have weathered the global economic upheaval relatively well compared to the advanced countries. In the immediate aftermath of the crisis, stimulus packages put in place by the authorities played a key role in mitigating the adverse impact of weaker global trade. In addition, policy and market reforms undertaken in response to the 1997/98 Asian financial crisis have enhanced the region's macroeconomic fundamentals and financial market resilience, which allowed for these countercyclical expansionary measures to be quickly transmitted to the real economy.

The experience from the global financial crisis provides several crucial insights to the region. Weakness in global demand has reinforced the need for ongoing economic reforms in Asia to reorient growth towards domestic demand. Beyond national borders, the crisis has also expedited efforts to advance greater intra-regional and inter-regional economic linkages. Given the prolonged nature of the current economic recovery, the growth challenge is premised upon efforts to generate and sustain new sources of growth whilst leveraging on existing favourable trends.

The sustainability of Asia's growth path going forward will also be underpinned by several structural factors. The **rapid expansion of the middle-class population** in Asia will contribute to a shift towards greater domestic consumption in regional economies. This transition is already underway, with private consumption contributing to almost half of Asia's growth in 2011. In Developing Asia[1], the share of the middle-class[2] population has doubled to 56% of total population in 2008 (1990: 21%).

[1] Developing Asia - Armenia, Azerbaijan, Bangladesh, Cambodia, People's Republic of China, Georgia, India, Indonesia, Kazakhstan, Kyrgyz Republic, Lao People's Democratic Republic, Malaysia, Mongolia, Nepal, Pakistan, the Philippines, Sri Lanka, Tajikistan, Thailand, Turkmenistan, Uzbekistan, Vietnam (ADB, 2010).

[2] Middle Class – population with expenditure of USD2-20/day.
High Class – population with expenditure >USD20/day (ADB, 2010).

By 2030, the middle-class population in developing Asia is expected to account for 42% of global expenditures, underscoring the region's evolving role as a significant consumer base for the global economy (Chun, 2010).

Furthermore, Asia is also experiencing an unprecedented rate of urbanisation and improvement in living standards. By 2025, more than 2 billion people in Asia, which accounts for half of the world's urban population, are expected to live in cities. This development is expected to contribute to the reorientation of regional economies towards stronger domestic-based growth. Furthermore, there will likely be more public investment initiatives to address the region's infrastructure needs. In particular, Asia's infrastructure investment needs are estimated at USD8 trillion for the period 2010-2020 (ADB, 2009).

On the international front, **closer economic linkages among the emerging economies** in the form of trade and investment flows will allow for greater diversification of markets, thereby reducing over-reliance on the advanced economies. The share of emerging East Asia's exports to advanced economies has been on a steady decline since 1990. Of significance, East Asia's[3] exports to G3 economies have fallen to 22% of total East Asian exports from 31% a decade earlier. This is largely attributed to the trend of rising intra-regional trade, which currently accounts for about half of Asia's total trade. Given the expected increase in consumption within the region itself, many Asian economies could leverage on this new international trade configuration to meet the greater domestic demand in the region. Foreign direct investment within the region has also grown in importance, expanding by 20% per annum over the past decade. This encouraging development is supported by the emergence of home-grown multinational firms as well as greater business opportunities in the region.

In Asia, the closer ties are also evident as authorities leverage on the existing intra-regional groupings and networks to foster greater collaboration and cooperation in key areas of interest. The reinforcement of alliances, such as the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) and ASEAN+3, highlight Asia's growing economic cooperation. Several regional countries have also established bilateral agreements to use domestic currencies for trade settlement and cross-border collateral agreements aimed at enhancing liquidity facilities to financial institutions. These have cumulatively contributed to the strengthening of economic and financial linkages within Asia.

Structural reforms have also been earnestly pursued. Regional governments are placing focus on promoting policies aimed at boosting household incomes and reducing precautionary savings. These include health insurance reforms and extended pension coverage and financial sector reforms to strengthen financial inclusion. In Asia, the enhancement of social safety net schemes such as the minimum wage has played a role in boosting the incomes of households with the highest propensity to consume and subsequently raise consumption activity.

Finally, the integration of **new global players** into the market will continue to reshape the global labour, consumption and production landscape. In the past few decades, new emerging regions have made significant strides towards establishing a more market-oriented economic system amid lower bureaucratic barriers to trade and investment activity. These reforms have taken strong root in Asia over the past decade. Emerging ASEAN nations such as Cambodia, Laos, Myanmar and Vietnam have undertaken deep and significant reforms which have facilitated the liberalisation of their domestic markets. While these four economies currently account for 9% of ASEAN's GDP (2011), growth has averaged 6.6% over the past 5 years, underlining the region's potential as a new consumption centre and investment base for investors. This would cumulatively elevate the Asian region's growth prospects.

[3] East Asian economies comprise of PR China, Hong Kong, Indonesia, Malaysia, the Philippines, Singapore, Korea, Chinese Taipei and Thailand.

A New Normal

The confluence of these developments suggests that the aftermath of this recent crisis is fundamentally different from previous crises. The global economy is currently navigating through a 'new normal'. Growth in advanced economies is expected to be weighed down by continued efforts to promote structural reforms and deleveraging by governments, financial institutions and consumers. Against these developments, the emerging economies, particularly those in Asia, will remain the key drivers of global growth, leveraging on favourable trends such as rising intra-regional trade and greater shift towards domestic demand-led growth. While these factors will play a crucial role in moderating the impact of lower demand in the advanced economies, the emerging economies are not fully insulated from the weaker external environment. In mid-2012, for example, domestic demand in Asia showed signs of moderation amid sustained weakness in the advanced economies. Taking all these factors together, while the global economy is expected to continue to improve, the recovery may face prolonged downside risks and remain unevenly distributed.

Looking further ahead, global structural trends such as continued urbanisation, technological advances and the changing demographics will also play a more prominent role in reshaping the global economic and financial landscape. Of significance, efforts to enhance economic resilience, flexibility and efficiency will be a key policy focus in most regions, particularly with regard to the allocation of scarce resources and the provision of sufficient infrastructure. Beyond the national borders, the 'new normal' requires policy perspectives to transcend cyclical and domestic considerations towards one that is pre-emptive and global in nature. In this respect, structural and institutional reforms will play an important role in creating more inclusive and sustainable growth.

References

Allen, M. (2012), 'Current Fiscal Problems of Advanced Economies', IMF Presentation to Joint Vienna Institute, Slide 6.

ASEAN Community in Figures 2011, ASEAN Secretariat, April 2012.

Asian Development Bank and Asian Development Bank Institute (2009), 'Infrastructure for a Seamless Asia', 4 (Tokyo: ADB/ADBI). Available from www.adbi.org/files/2009.08.31.book.infrastructure.seamless.asia.pdf.

Chun, N. (2010), 'Middle Class Size in the Past, Present, and Future: A Description of Trends in Asia', ADB Economic Working Paper Series No. 217, 10-23.

International Labour Organization (2012), World of Work Report 2012, 'Better Jobs for a Better Economy', 6.

International Monetary Fund (2010), 'From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies', IMF Fiscal Affairs Department, 12-15.

Reinhart, R. and Reinhart, V. (2010), 'After the Fall', National Bureau of Economic Research Working Paper 16334, 3.

oil. In addition, food prices are susceptible to fluctuations given the low inventory levels of staple grains in some key export markets and potential supply disruptions due to adverse weather conditions. Upside risks to commodity prices may also emanate from greater demand following rising financial flows into these markets.

Notwithstanding the improving global growth prospects, **downside risks** remain considerable. In the euro area, the policy measures undertaken in the latter part of 2012 have reduced acute crisis risks but the key fundamental constraints remain unresolved. The sovereign debt crisis in Europe could re-intensify if further progress on the crisis resolution plans and reform measures is not realised. A renewed rise in government borrowing costs could jeopardise the fragile recovery process and would set back the progress that has been made. In addition, sharper-than-expected fiscal consolidation in the crisis-affected economies could also weaken growth prospects in the near term.

Given the divergent growth prospects between the advanced and emerging economies, the latter faces a different set of challenges. First, the large-scale policy easing in major economies has created massive amounts of liquidity, which has subsequently spurred a global search-for-yield. Thus, the strong inflows of capital into the emerging economies are expected to continue. These inflows could result in macroeconomic and financial instability and might lead to excessive increases in exchange rates and asset prices in the recipient countries. Second, emerging economies could face higher inflationary pressures due to rising food and commodity prices. Upward pressures on prices could materialise in the event of supply disruptions arising from adverse weather conditions amid low inventories of selected food commodities. A confluence of these factors would pose challenges to policymakers in balancing the risks between growth and inflation, given the continued uncertainty in the global economic environment.

It should be noted that there is some upside potential to growth. In the US, a stronger-than-expected recovery in the housing market may support business and consumer sentiments, cumulatively leading to a strengthening of private sector-led growth. Credible progress in policy setting in Europe has contributed to a gradual improvement in financial market conditions, which could facilitate an improvement in economic activity in the region. A firmer recovery would benefit the rest of the world through stronger trade activity and greater economic certainty.

MALAYSIAN ECONOMY

The Malaysian economy is expected to remain on a steady growth path with an expansion of 5-6% in 2013. Economic activity will be anchored by the continued resilience of domestic demand, and supported by a gradual improvement in the external sector.

> The Malaysian economy is expected to remain on a steady growth trajectory of 5-6% in 2013

Domestic demand, which recorded the highest rate of expansion over the recent decade in 2012, is expected to remain the key driver of growth in 2013, albeit at a more moderate pace. Growth in public and private investment is expected to remain strong, following the exceptional growth in capital spending in 2012. Private investment is still expected to record a double-digit rate of growth, driven by the continued capacity expansion of the domestic-oriented firms, ongoing implementation of projects with long gestation periods and a gradual improvement in external demand. Private consumption is projected to grow at a more moderate rate in the second half of the year, but it will continue to be supported by sustained income growth and healthy labour market conditions. Public sector spending is also expected to record lower growth given the ongoing consolidation of the Government's fiscal position and as the role of the private sector gains greater significance.

In line with the pace of expansion in domestic demand, imports of capital and consumption goods are also expected to moderate. However, imports of intermediate goods are projected to turn around and record positive growth as the improvement in the global economic environment leads to an increase in manufacturing exports. In particular, non-electrical and electronics (non-E&E) exports are expected to benefit from the positive growth prospects of the regional economies. Electrical and electronics (E&E) exports, meanwhile, are expected to experience a smaller contraction following manufacturers' continued efforts to diversify their production line-up and shift into the fast-growing mobile telecommunication sub-segment. The rebound in manufactured exports, however, will be partially offset by lower commodity exports, due to the expected softening of commodity prices. Services exports are expected to be higher due to a stronger travel account in line with the promotional campaigns for the run-up to the Visit Malaysia Year 2014, while growth in services imports is expected to be slower given the lower volume of imports. Overall, with the gradual recovery in exports and lower import growth, net export of goods and services is expected to exert a lower negative contribution to real growth in 2013. Nevertheless, the growth of imports is expected to continue to outpace exports amid the continued deficit in the income account and in current transfers. The current account surplus, while still remaining large, is expected to narrow further in 2013.

Table 4.1

Real GDP by Expenditure (2005=100)

	2012*p*	2013*f*	2012*p*	2013*f*
	Annual change (%)		Contribution to growth (percentage point)	
Domestic Demand[1]	**10.6**	**8.1**	**9.2**	**7.3**
Private sector expenditure	10.7	9.1	6.8	6.0
Consumption	*7.7*	*7.1*	*3.8*	*3.6*
Investment	*22.0*	*15.6*	*3.0*	*2.4*
Public sector expenditure	10.3	5.4	2.4	1.3
Consumption	*5.0*	*3.6*	*0.7*	*0.5*
Investment	*17.1*	*7.5*	*1.7*	*0.8*
Change in stocks			**0.3**	**-0.2**
Net exports of goods and services	**-29.4**	**-19.1**	**-3.8**	**-1.7**
Exports	0.1	1.8	0.1	1.7
Imports	4.5	3.9	3.9	3.4
Real Gross Domestic Product (GDP)	**5.6**	**5.0 ~ 6.0**	**5.6**	**5.0 ~ 6.0**

[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

The underlying fundamentals of the economy are expected to remain strong, and will continue to support the growth prospects for the economy. Of importance, labour market conditions will remain favourable, with the unemployment rate projected to remain low at 3.1% of the labour force in 2013. In addition, the financial system continues to demonstrate resilience against the challenging external environment, with financial intermediation expected to continue to provide strong support to domestic economic activity. The strength of Malaysia's external position remains intact, with international reserves at healthy levels and external debt continuing to be low and within prudent limits.

Headline inflation is expected to average 2-3% in 2013. This inflation projection takes into account the expected higher global prices of selected food commodities and adjustments to domestic administered prices. Demand-driven price pressures are expected to be moderate. The wider forecast range reflects the greater uncertainty in the external and domestic developments.

Headline inflation is expected to average 2-3% in 2013

Nevertheless, given the challenging external environment, there remain risks to the growth outlook. As in 2012, the potential re-emergence of instability in the euro area and slower growth in Malaysia's major trading partners may affect the Malaysian economy. While pressures from global commodity prices have receded, upside risks from non-fundamental factors such as adverse weather conditions and geopolitical developments could push commodity prices higher and adversely affect the growth prospects of Malaysia's major trading partners. Potential upside to the domestic economy could emerge if the domestic recovery in the advanced economies turns out to be better than expected. In particular, a stronger-than-expected recovery in the housing market may contribute towards a better performance in the US economy.

Broad-based Expansion across All Sectors

On the supply side, all the major economic sectors are expected to record continued expansion in 2013. The services and manufacturing sectors are expected to be the key contributors to overall growth, driven by the continued resilience of domestic demand and supported by the gradual improvement in the global economic environment, which will augur well for international trade activity.

Consumption-related activities in the services sector such as retail trade, accommodation and restaurants will continue to be supported by private sector spending. Tourist arrivals are expected to rise in response to the promotional campaigns for the upcoming Visit Malaysia Year 2014. Growth in the finance and insurance sub-sector is projected to be sustained, reflecting continued robust demand for financing particularly by businesses.

Table 1

Real GDP by Sector (2005=100)

	2012*p*	2012*p*	2013*f*	2012*p*	2013*f*
	% of GDP[1]	Annual change (%)		Contribution to growth (percentage point)[1]	
Services	54.6	6.4	5.5	3.5	3.0
Manufacturing	24.9	4.8	4.9	1.2	1.2
Mining & quarrying	8.4	1.4	5.0	0.1	0.4
Agriculture	7.3	0.8	4.0	0.1	0.3
Construction	3.4	18.5	15.9	0.6	0.5
Real GDP	**100.0**	**5.6**	**5.0 ~ 6.0**	**5.6**	**5.0 ~ 6.0**

[1] Numbers do not 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 domestic-oriented industries within the manufacturing sector, in particular the consumer-related cluster, such as food and transportation, are likely to benefit from the continued growth of private consumption. The construction-related manufacturing cluster is also expected to perform well. Growth in the construction sector will be driven by the civil engineering sub-sector as the momentum of construction activity in the oil and gas, transportation and utilities sub-sectors is expected to remain strong.

The performance of the export-oriented manufacturing industries such as the E&E and primary-related clusters are expected to improve in tandem with the gradual recovery in the advanced economies and the sustained growth in the regional economies. The E&E cluster will continue to be supported by demand for products in the consumer and telecommunication segments. In the primary-related cluster, growth is projected to be supported by firm demand from the regional countries, particularly for resource-based products such as refined petroleum products, chemicals and chemical products as well as rubber products. The higher volume of trade and the better overall performance of the manufacturing sector will also benefit the trade- and manufacturing-related services sub-sectors, such as wholesale trade, transport and storage and utilities.

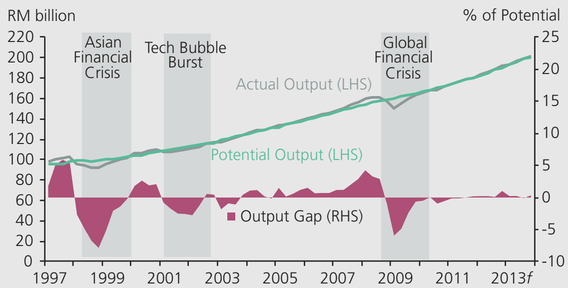
In the commodities sector, growth in agriculture and mining is expected to improve in 2013. The agriculture sector is expected to expand by 4% in 2013, supported by higher output of crude palm oil (CPO) and food commodities, especially livestock and vegetables. CPO production is expected to rise as yields improve with better weather conditions, supported by supply from newly maturing trees. The mining sector is expected to strengthen on higher production of natural gas, crude oil and condensates.

Potential Output of the Malaysian Economy

Potential output is an estimate of the highest level of output that an economy is capable of producing in a non-inflationary environment. It indicates the economy's sustainable growth path that is consistent with its available inputs for production – capital, labour and technology. When actual output is above potential output, the utilisation of productive inputs is high and inflationary pressures tend to build. Conversely, inflationary pressures usually abate when actual output falls below potential output.

Chart 1

Actual and Potential GDP



f Forecast

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

The latest estimates[1] indicate that Malaysia's potential output growth increased from a range of 4.5-5.0% in 2011 to 5.0-5.5% currently. Strong growth in both private and public investment in 2012 contributed to the robust pace of capital accumulation and, in turn, to the further expansion of potential output as the productive capacity of the economy was raised. Labour conditions also improved slightly as the labour force grew at a faster rate of 3.5% in 2012 (2011: 3%). The output gap, which captures deviations of actual output from potential output, remained close to zero. This indicates that the economy did not experience substantial price pressures, consistent with the stable inflation of 1.6% registered during the year.

In 2013, potential output is projected to continue growing within the 5.0-5.5% range, with the output gap remaining small. Potential output growth is expected to be driven by a growing labour force as well as an expansion in capital stock, due to sustained growth of private investment.

[1] Interested readers may refer to the technical note entitled 'Potential Output and the Output Gap in Malaysia' in the 2Q 2012 BNM Quarterly Bulletin (Pg. 59-65) for a detailed explanation of the methodology used to estimate potential output.

Domestic demand continues to anchor growth

Following the strong performance in 2012, domestic demand is expected to grow at the pace of 8.1% in 2013. Domestic demand is expected to remain the major contributor and driver of economic growth, supported mainly by private sector investment and consumption. Public sector spending, while remaining supportive of growth, is expected to increase at a more moderate rate in view of the Government's ongoing fiscal consolidation. Capital expansion by the public enterprises (PEs) will also provide support to public investment growth amid sustained Government development spending.

Private investment is expected to expand at a double-digit growth of 15.6% in 2013. Private investment will be underpinned by domestic consumption, the gradual recovery in external demand and the continued improvement in the investment climate. These favourable business conditions will continue to support the ongoing implementation of projects with long gestation periods. As observed in 2012, capital spending is again expected to be broad-based across sectors and regions.

Private sector spending remains resilient amid consolidation in the public sector

In the services sector, capital spending is projected to increase further, particularly in the domestic-oriented sectors. Firms in the retail trade and restaurants sub-sectors are expected to establish new outlets, while investments in the telecommunication and aviation segments will be driven by infrastructure upgrading and capacity expansion. Growth in residential investments is also expected to remain strong, supported by the construction of high-end residential properties and increasingly, activity in the mid-range residential property segment. Investment in the high value-added business services sub-sector, especially in engineering, architecture and IT services, is also expected to expand.

In the manufacturing sector, investment will be driven by the domestic-oriented and primary-related manufacturing clusters. Investment in the construction-related cluster, especially in steel and cement, will be driven by the demand from strong construction activity, while the expansion of firms in the consumer-related clusters, such as food and beverages and motor vehicles, will be underpinned by the steady growth of domestic consumption. In addition, regional demand and initiatives to deepen Malaysia's downstream petrochemical industry are expected to support the implementation of projects in the primary-related manufacturing cluster. Capacity expansion in the E&E industry will be supported by the gradual improvement in external demand and the diversification into new products and new growth areas, notably the medical devices industry and niche E&E components. Furthermore, initiatives by firms to automate and to invest in new machinery are expected to continue in 2013 as firms respond to rising costs and the implementation of the minimum wage policy. These developments are expected to spur the manufacturing industry into producing higher value-added goods.

The strong growth momentum in mining investment is expected to continue in 2013, underpinned by firm global energy prices, the ongoing construction of production facilities under existing projects and further supported by activity related to the exploration and survey of new fields. The implementation of upstream development projects such as the Gumusut-Kakap and Malikai deepwater and Kebabangan cluster fields will also benefit the civil engineering construction segment, particularly for the construction of production facilities and floating production storage and offloading vessels (FPSOs).

Oil and Gas Investments to Support Higher Production

The mining sector is projected to expand by 5% in 2013, due to a recovery in the production of natural gas, and supported by higher output of crude oil and condensates. The former is due to higher output of several gas fields offshore Sabah to meet the higher demand for liquefied natural gas (LNG) from PR China, while the latter is largely driven by the commencement of production from both marginal and new fields, such as Gumusut-Kakap in Sabah, and new wells in Sarawak and Terengganu.

Private Investment in Malaysia: Drivers and Sustainability

Introduction

Following Malaysia's steep decline in private investment during the 1997/98 Asian Financial Crisis, the gradual recovery of private investment had been punctuated by several episodes of global demand shocks. These included the bursting of the 'Tech Bubble' in 2001, the outbreak of the Severe Acute Respiratory Syndrome (SARS) epidemic in 2003, and more recently, the 2008/09 Global Financial Crisis (GFC). As a result, in contrast to the high average private investment of 22.9% of GDP during the 1990s, private investment had a more modest role in the economy in the period 2001-2011, averaging 11.8% of GDP.

Since the fourth quarter of 2011, however, private investment has emerged as a key contributor to growth. Following the strong growth of private investment in 2012 (22%), the share of private investment has risen to 15.5% of GDP in 2012. This strong growth momentum partly reflects the underlying shifts taking place in the Malaysian economy, particularly the strengthening of private consumption and the diversification of Malaysia's export structure. While private investment has benefited from this trend, it has also reinforced these structural shifts, contributing to the strengthening of domestic demand and further diversifying the sources of growth of the economy. Given the importance of private investment in raising the economy's productive capacity, accelerating technological progress and creating employment opportunities, this article aims to highlight the key drivers that have contributed to the rise of private investment. A broad assessment of its sustainability going forward and potential implications to growth is also explored.

Theoretical literature and empirical findings

Several frameworks that are available in the literature were used as references to determine the key drivers of private investment in Malaysia, namely: (i) The accelerator model; (ii) the expected profits model; (iii) the Jorgenson neoclassical model; and (iv) the Tobin's Q model[1]. Most of these models emphasise the importance of fundamental factors, such as demand, profitability, capacity utilisation and the cost of capital, in explaining private investment. More recent literature incorporate other determinants such as economic uncertainty and the availability of financing.

Empirical findings of the available literature show that output, profits and the level of capacity utilisation generally impact private investment positively. Furthermore, higher profitability and greater access to financing facilitate private investment through the availability of a higher level of funding. Similarly, higher interest rates and economic uncertainty can be expected to affect private investment negatively. High interest rates would also raise the cost of bank credit, and thus the cost of capital or the opportunity cost of retained earnings, while elevated levels of economic uncertainty may cause delays or even a reduction in investment.

Key determinants of private investment in Malaysia

In analysing the key determinants of private investment in Malaysia, a linear regression was estimated using a general-to-specific modelling strategy, with consideration being given to the major investment determinants that have been cited in the existing literature. Consistent with existing empirical findings, estimated results suggest that four major factors have a statistically significant impact on private investment, namely: (i) Profitability; (ii) the capacity utilisation rate[2]; (iii) the availability of financing; and (iv) the level of economic uncertainty.

---

[1] See Chenery (1952), Chirinko (1993), Serven and Solimano (1992), Jorgenson (1971) and Tobin (1969) for conventional models of investment and Guimaraes and Unteroberdoerster (2006) for analysis specific to the case of Malaysia.

[2] The capacity utilisation rate used was specific to the manufacturing sector.

(i) ***Company profitability***

Existing literature suggests that operating profits, the profits earned from firms' business operations, positively affect private investment. Empirical studies also show that previous or current profits are used as an indication of expected future profits[3], as profitability is a major incentive for investment and it also contributes to the availability of internal and external financing. In the case of Malaysia, firm-level data[4] reveals that the recent increase in private investment is positively associated with the strong company profitability in recent years, particularly in the resource-based and domestic-oriented industries[5]. In the resource-based industry, particularly in the oil and gas sector, high commodity prices have contributed to the significant increase in profitability, raising the expected rate of return on investment. Meanwhile, strong private consumption activity has raised profits in the domestic-oriented sectors, particularly in the services sector, such as the wholesale and retail, transportation and telecommunication sub-sectors, and the consumer-related cluster of the manufacturing sector.

(ii) ***Capacity utilisation rate***

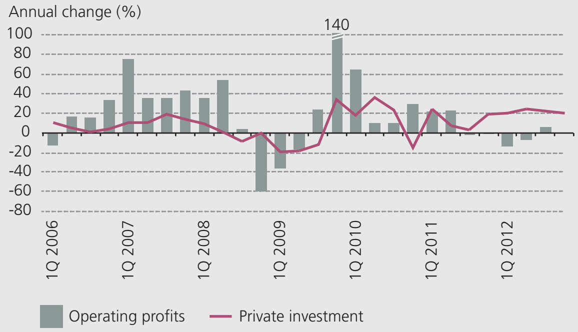
Similarly, the rate of capacity utilisation is found to exert a positive impact on private investment in Malaysia. In 2012, the capacity utilisation rate rose to 80.8% of installed capacity, higher than the average capacity utilisation rate of 76.9% in 2003-2007[6]. In line with the improvements in the capacity utilisation rate, manufacturing firms have embarked on capacity expansion to respond to the increased demand for their products (Chart 2). This was particularly evident in the domestic-oriented manufacturing sub-sectors, such as the consumer-oriented and construction-related manufacturing clusters, following the strengthening of domestic consumption and the rapid growth of construction-related activity respectively. In addition, the capacity utilisation rate has also remained high for firms in the primary-related manufacturing cluster, which has been supported by resilient regional demand.

(iii) ***Availability of financing***

Access to financing also exerts a positive and significant influence on private investment in Malaysia, as access to bank credit[7] enables firms to obtain the required financing for investment. This is

Chart 1

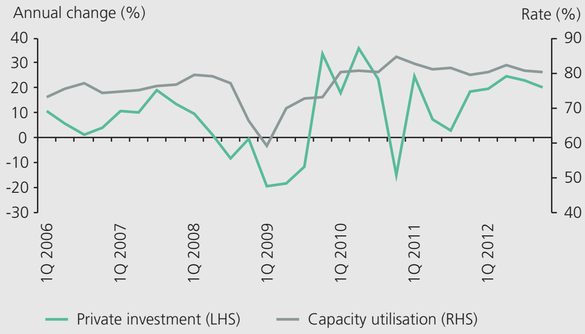
Operating Profits and Private Investment



Source: Bloomberg and Department of Statistics, Malaysia

Chart 2

Capacity Utilisation Rate and Private Investment



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

3 See Manjappa and Niranjan (2010).
4 Data from 250 companies listed on Bursa Malaysia and excludes firms classified as Public Enterprises in National Accounts statistics.
5 Resource-based industry refers to the mining, agriculture and primary-related manufacturing sectors, while domestic-oriented industry refers to the services and consumer-related manufacturing sectors.
6 2003-2007 was used as the reference period, taking into consideration data availability and the attempt to capture information from a relatively 'normal' period.
7 While it is acknowledged that firms, particularly large firms, also source funds from the capital markets, this study did not incorporate that data as it is highly volatile.

especially true for small and medium enterprises (SMEs), whereby bank credit is the main source of financing for their working capital and investment needs. In 2012, the financing environment remained supportive. While total credit disbursement for the year was 14.6%, credit disbursed to businesses registered a growth of 21.4% (2003-2007 average: 5.2%). Of significance, loans disbursed to SMEs expanded by 21% in 2012 (2004-2007 average: 13.1%), supported partly by various funds and programmes implemented by the authorities. The continued improvements in access to financing for businesses have also been reflected in Malaysia's favourable position in several international rankings measuring 'Ease of Access to Loans'. These include the World Bank's *Doing Business Report* (1st position for five consecutive years), and the World Economic Forum's *Global Competitiveness Report* (2012-2013: 8th position; 2010-2011: 10th position).

(iv)* *Economic uncertainty

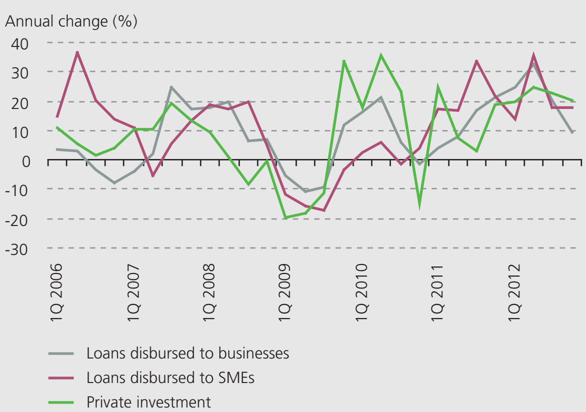
In recent quarters, private investment has also been supported by the greater economic certainty[8] prevailing in Malaysia (Chart 4). While economic uncertainty in the global economy has had an adverse impact on firms in the export sector, sustained domestic activity has generated relatively less economic uncertainty for domestic-oriented firms. Another contributing factor to greater economic certainty could be the ongoing efforts by the authorities to improve the business investment climate. In particular, various initiatives aimed at improving the ease of doing business and attracting quality investments in high value-added activity, have strengthened business sentiments and the domestic investment climate. These measures have also been reinforced by the implementation of the Economic Transformation Programme (ETP), which has provided greater policy clarity and investment opportunities for businesses.

The sustainability of private investment and its potential implications to growth

Going forward, several key underlying factors, such as favourable demand, financing conditions and the overall investment climate, are expected to continue to support private investment activity. The resilience in private consumption will also support capacity expansion in the domestic-oriented sectors, while continued efforts to enhance awareness of the access to financing and the advisory services available for SMEs will continue to facilitate investment activity by SMEs. Augmenting these favourable domestic factors, the gradual improvement in global growth prospects will also contribute towards improvements in

Chart 3

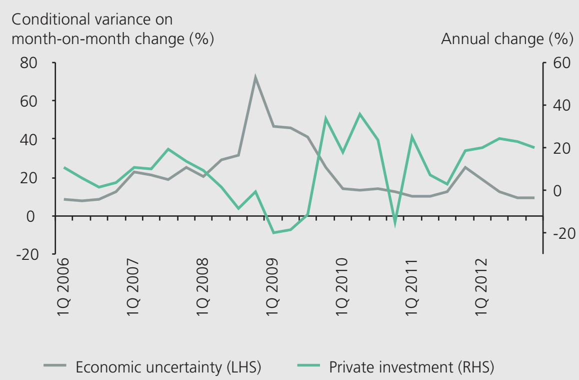
Loans Disbursed and Private Investment



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 4

Economic Uncertainty and Private Invesment



Source: FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI), Department of Statistics, Malaysia and Bank Negara Malaysia estimates

[8] Economic uncertainty was measured by a conditional variance derived from a Garch (1,1) model of monthly returns in the KLCI. The use of firm-level data such as stock returns volatility to proxy for uncertainty is common in existing literature since it captures uncertainty closely related to a firm's environment, i.e. asset returns capture the effects of relevant aspects of a firm's environment which investors deem important (see Leahy and Whited (1996)).

business confidence. The timely implementation of reforms, the catalytic projects under the ETP, and the continued provision and upgrading of infrastructure will also provide a boost to private investment.

The sustained growth in private investment is expected to benefit the Malaysian economy mainly through the acceleration in technological progress and the enhancements to the economy's productive capacity. In particular, sizeable investments in the oil and gas sector, in both the upstream exploration and development activity, and the deepening of the downstream petrochemical industry, are expected to result in technological progress which will contribute directly to raising Malaysia's growth potential. The implementation of major infrastructure projects, such as in public transportation, airports, ports and telecommunication, is also expected to indirectly enhance the productive capacity of the economy through improving connectivity, both within Malaysia and with the rest of the world. An encouraging development is the increase in research and development (R&D) spending (2011 estimate: 0.8% share to GDP; 2006: 0.6% share to GDP), which augurs well in terms of contributing towards higher value-added activities.

Conclusion

Private investment has strengthened, driven mainly by strong corporate profits, high capacity utilisation in the manufacturing sector, access to financing, and a favourable investment climate. Going forward, these fundamental factors are expected to continue, thereby providing strong support for future private investment. As the economy undergoes a transformation towards a high value-added, high-income economy, the implementation of investments that will accelerate technological progress and enhance the productive capacity of the economy will also be important in ensuring the sustainable growth of the Malaysian economy.

References

Chenery, H.B. (1952), 'Overcapacity and the Acceleration Principle', Econometrica, Vol. 20, No. 1.

Chirinko, R.S. (1993), 'Business Fixed Investment Spending: Modelling Strategy, Empirical Results, and Policy Implications', Journal of Econometric Literature, Vol. 31, pp. 1875-1911.

Guimaraes, R. and Unteroberdoerster, O. (2006), 'What's Driving Private Investment in Malaysia? Aggregate Trends and Firm Level Evidence', International Monetary Fund Working Paper No. 06/190.

Jorgenson, D.W. (1971), 'Econometric Studies of Investment Behaviour: A Survey', Journal of Economic Literature, Vol. 9, pp. 1111-1147.

Leahy, J.V. and Whited, T.M. (1996), 'The Effect of Uncertainty on Investment: Some Stylized Facts', Journal of Money, Credit and Banking, Vol. 28, No.1, pp. 64-83.

Manjappa, D.H. and Niranjan, R. (2010), 'Determinants of Investment Pattern in Indian Manufacturing Industries: A Panel Data Study', Indian Journal of Economics and Business, Vol 9, No. 1, pp. 219-232.

Serven, L. and Solimano, A. (1992), 'Private Investment and Macroeconomic Adjustment: A Survey', The World Bank Research Observer, Vol. 7, No. 1, pp. 1-35.

Tobin, J. (1969), 'A General Equilibrium Approach to Monetary Theory', Journal of Money, Credit and Banking, Vol. 1, pp. 15-29.

Growth in **private consumption** is expected to moderate but still remain strong in 2013, increasing by 7.1% (2012: 7.7%). This will be supported by the sustained growth in incomes, which is likely to benefit from the continued growth of the domestic-oriented sectors and the expected rebound in the export-oriented industries. The implementation of the minimum wage policy will also contribute to increase incomes. Softer commodity prices, however, are expected to weigh down on incomes and consumption spending, particularly among the rural households. Labour market conditions are projected to remain favourable. While the implementation of the minimum wage policy may lead to some adjustments by the affected firms to their workforce, overall employment conditions are expected to remain stable as the demand for labour remains strong. In particular, the expectation of an improvement in external demand conditions will support employment in the export-oriented sectors.

Government transfers to low- and middle-income households as announced under Budget 2013 will also provide support to household spending. These fiscal transfers include the RM500 assistance to households with a monthly income of RM3,000 and below (Bantuan Rakyat 1Malaysia or BR1M 2.0), the RM100 schooling assistance to primary and secondary school students and cash support to the armed forces.

Public expenditure is expected to moderate in 2013, in line with the Government's commitment to fiscal consolidation. Nonetheless, both public consumption and investment will remain supportive of growth. **Public consumption** is expected to record a positive growth of 3.6% in 2013, supported by the spending on emoluments and supplies and services.

Public investment is also expected to moderate in 2013 (7.5%). Federal Government development expenditure is expected to sustain, and a major portion of the expenditure will continue to be allocated to the economic sector, mainly to improve access and connectivity in both the urban and rural transportation infrastructure. Other key areas of development spending will be in the trade and industry sub-sector, such as upgrading of infrastructure facilities in industrial areas. Expenditure in the social services sector will continue to be channelled to the education and training sub-sectors.

Capital spending by the public enterprises (PEs) is expected to remain large, resulting in a steady growth in the overall public investment. Investments by PEs reflect the continued implementation of key infrastructure projects, particularly in the energy, transportation and communication sub-sectors. In the mining sector, capital spending will focus both on the upstream and downstream segments, particularly in the development of oil and gas fields. Investment in the transportation sub-sector will largely concentrate on the extension of rail-based public transport network as well as the continued fleet upgrading by the national airline. Capital spending in the utilities sub-sector will be mainly for the construction of the power plants in Janamanjung and Prai, while investment in the communication sub-sector is largely for further expansion of the coverage of High-Speed Broadband (HSBB) services.

The higher investment activity by both the private and public sectors are expected to provide longer term benefits to the economy through enhancing the future productive capacity and productivity of the overall economy.

Improvement in external demand

The global economic outlook is expected to improve in 2013. The better growth prospects for the regional economies are expected to provide strong support for Malaysia's exports. The subpar growth projection for the major advanced economies, however, is likely to constrain any further strengthening of international trade activity. Together with the softening of major commodity prices, Malaysia's gross exports of goods are expected to improve modestly by 1.4% in 2013.

External demand to improve as global economy recovers

The nascent recovery of manufactured exports, which was evident in the fourth quarter of 2012, is expected to continue, and will be supported mainly by non-E&E manufactured exports that are primarily demanded by the regional economies. In contrast, the growth of E&E exports will continue to be weighed down by the weakness in external

Variations in Household Propensity to Consume across Income Segments

Introduction

Private consumption was again a major driver of growth in 2012. Its robust performance of 7.7% was mainly supported by stable employment conditions and continued strong wage growth. However, at the micro level, there were also economic and policy developments that affected the incomes of different segments of households to varying degrees. The decline in crude palm oil prices in the second half of 2012 impacted the incomes of small-holders in that sector. Meanwhile, households earning less than RM3,000 per month benefited from a transfer of RM500 from the Government under Bantuan Rakyat 1Malaysia (BR1M).

To assess the aggregate effects of such developments on various income levels, it is necessary to identify: (1) Their magnitudes; and (2) the affected households and the likely change in their spending patterns. The latter requires knowledge of households' responsiveness to a change in income, which may vary according to the level of household income. This article highlights the diversity in households' propensity to consume from income, and the need to account for this heterogeneity while assessing the impact of income shocks.

Diversity in Household Consumption Behaviour across Income Segments

The literature posits that, in general, households aim to maintain a stable standard of living by avoiding excessive fluctuations in consumption in response to temporary changes in their income. Ideally, households would save more during periods of temporarily higher income and draw down on savings during periods of temporarily lower income. Alternatively, some households may access credit markets instead of drawing down from their savings. This concept, consumption smoothing, explains why temporary fluctuations in income are often observed to have less than proportionate effects on spending. In reality, despite the desire to smooth spending, households earning different income levels differ in their ability or willingness to do so. Lower income households are often less able to smooth expenditures and thus their spending behaviours display a higher sensitivity to fluctuations in income.

There are three main reasons underpinning this observation. Firstly, lower income households are often less able to save, mainly because this group tends to spend a higher share of total income on essential items such as food and utilities. The inability to accumulate sufficient savings results in their expenditures being more sensitive to changes in income. In the absence of credit, a drop in income will induce a household without savings to reduce its expenditures by an amount that corresponds to the decline in income, while a household with sufficient savings has the option of continuing to spend by using its savings. Secondly, within the context of imperfect credit market conditions, access to credit for lower income households is also more constrained, given the lower current and expected future incomes and the ability to secure collateral for borrowing. Households with limited access to credit, when faced with an adverse income shock, would have to reduce their expenditures by a greater magnitude compared to households who are able to borrow. Finally, studies have found that the spending behaviour across different income levels is also a function of the level of financial literacy. Lower income households with lower levels of financial literacy are less likely to purchase insurance, have a lower capacity to save and are more likely to undertake borrowing at a higher cost than necessary. These factors, taken together, would cumulatively inhibit the ability to smooth consumption against unanticipated income shocks, thus making expenditures of lower income households more sensitive to income shocks, relative to the higher income segments.

Empirical Evidence for Households in Malaysia

Consumption functions across income groups were estimated to capture the differing spending behaviour of households at various income levels. This was done using a cross-section of 21,641 households categorised into seven income brackets based on data from the 2009/2010 Household Expenditure Survey (HES). In the empirical specification, consumption was regressed on income, credit and wealth factors, and the life cycle stage of the households.

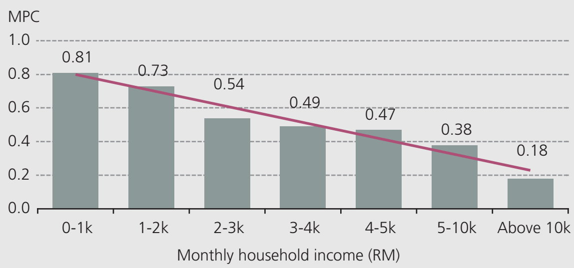
Chart 1 presents the main results, showing the estimated income elasticities vis-à-vis marginal propensity to consume (MPC) across income groups. Households earning less than RM1,000 per month will, on average, spend RM0.81 out of RM1 of additional income. This is much higher compared to the comparable estimate of RM0.18 for households earning more than RM10,000 per month.

Chart 2 shows the food-to-income ratio and household savings rate across income groups. The left panel shows a negative relationship between the food-to-income ratio, which proxies the extent to which income is spent on necessities, and income. The right panel shows a clear positive relationship between the ability/desire to save and income. The results support the *a priori* prediction that lower income households are more sensitive to income shocks. It is also consistent with the earlier hypothesis that lower income households tend to have lower savings as most of their expenditures are for necessities.

Overall, the significant differences in the MPCs across income segments suggest that applying the overall MPC across all income groups would not produce accurate results. This is illustrated in the assessment of the impact of BR1M, which disbursed RM500 to households earning less than RM3,000 per month in 2012. Two scenarios of the impact are computed. Scenario 1 uses the estimated MPC for each of the three income groups that received the RM500 payment. Scenario 2 uses a constant MPC of 0.51, the average across all income groups, for households

Chart 1

The MPC from Income across Income Groups



Source: Bank Negara Malaysia estimates based on HES 2009/2010, Department of Statistics, Malaysia

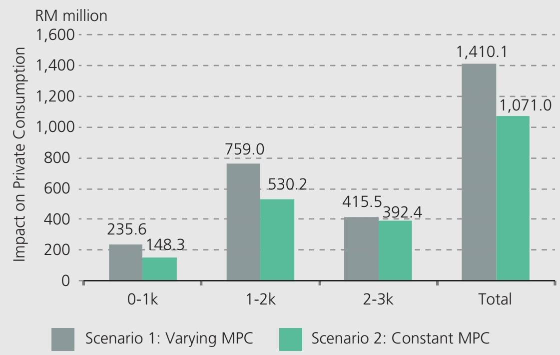
Chart 2

Spending and Saving Patterns across Income Groups

Source: Bank Negara Malaysia estimates based on HES 2009/2010, Department of Statistics, Malaysia in all three income groups. The difference in the estimated impact under both scenarios is shown in Chart 3[1]. The impact under Scenario 1, at RM1.4 billion, is larger compared to the RM1.1 billion estimate under Scenario 2 because the former is sensitive to the variations in the MPC across different income groups.

Chart 3

The Potential Impact of BR1M Using Varying and Constant MPCs



Source: Bank Negara Malaysia estimates based on HES 2009/2010, Department of Statistics, Malaysia

Conclusion

The empirical evidence indicates that households differ significantly in their consumption responses to income, with spending by lower income households being the most sensitive to income changes. This implies that recent policies such as 1Azam and BR1M, in addition to achieving their intended welfare objectives, have also generated an impact on aggregate private consumption. Looking ahead, as the country transitions to a high-income economy, the current policy framework needs to be complemented with a comprehensive social safety net system. Such an initiative will foster economic progress that is also inclusive.

[1] The estimates under both scenarios reflect only the direct impact of the policy on private consumption. There are also benefits from second-round effects through higher profits and employment in the consumption-related sectors which are abstracted from this example.

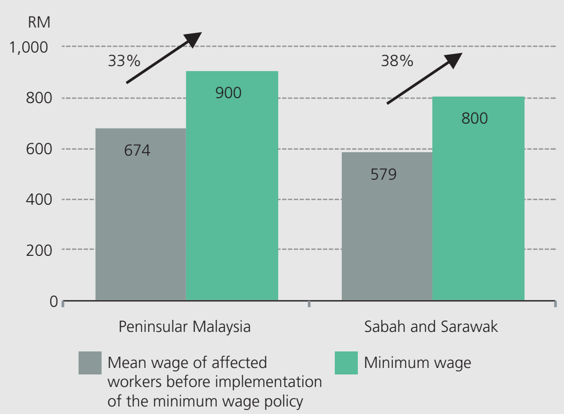
Potential Impact of the Minimum Wage Policy on the Malaysian Economy

Introduction

Malaysia implemented a minimum wage policy on 1 January 2013[1], thereby joining more than 150 other countries that already have minimum wage laws in place. The policy sets a minimum wage of RM900 per month (RM4.33 per hour) for Peninsular Malaysia and RM800 per month (RM3.85 per hour) for Sabah, Sarawak and the Federal Territory of Labuan, covering both the local and foreign workforce, except for domestic workers such as domestic helpers and gardeners. The minimum wage policy is intended to ensure that the basic needs of workers and their families are met, to reward and protect them from exploitation, and to incentivise firms to move up the value chain by investing in technology and boosting productivity[2].

Chart 1

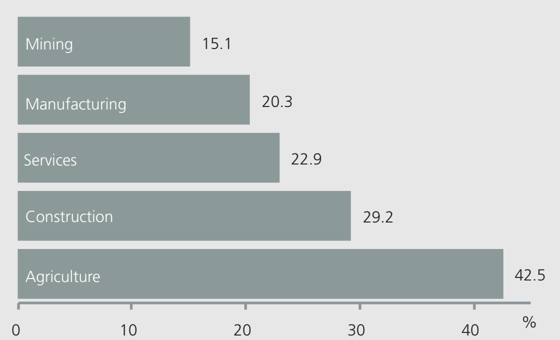
Wage Increases for Workers Affected by the Minimum Wage Policy



Source: Bank Negara Malaysia

Chart 2

Share of Workers Earning Below the Minimum Wage by Sector (Peninsular Malaysia)



Source: Bank Negara Malaysia

The minimum wage affects close to one-third of the workforce

The minimum wage policy is estimated to benefit about 27% of workers nationally[3]. On average, the affected workers in Peninsular Malaysia are expected to receive a 33% increase in wages, while those in East Malaysia would be given a 38% increment. By economic sector, the agriculture industry is expected to be the most affected, as 43% of workers in the sector received wages that were below the minimum wage prior to the implementation of the policy.

The minimum wage will improve worker welfare and facilitate transformation of the economy

The minimum wage policy is envisaged to have an important role in addressing inefficiencies in the labour market, and in improving the social welfare of low-paid workers. First, setting a minimum level for wages will alleviate labour market distortions and maximise the efficiency of labour usage in the economy. When wages are artificially suppressed below productivity levels, it would lead to low labour participation rates in the economy, as workers have less incentive to take part in the labour market. In some instances, wages have been suppressed at such low levels that local workers were displaced by low-waged foreign workers. In Malaysia, real wages have recorded a slower growth compared to real labour productivity

---

1 Note: For microenterprises, the implementation date is 1 July 2013. A total of 635 firms and members of selected associations that were due to implement the minimum wage on 1 January 2013 have been granted extensions. The deadline for microenterprises to send in their applications for extension is 1 April 2013.
2 Source: Ministry of Human Resources.
3 Source: Bank Negara Malaysia.

growth, especially in the manufacturing sector, where wages increased by 2.4% per annum over the decade while labour productivity expanded by 5.0% per year over the same period[4]. The higher wage levels following the implementation of the minimum wage policy are expected to encourage greater participation in the labour market and improve the utilisation of labour in the economy.

Second, the increase in the incomes of low-wage workers, to levels that would fulfil their basic needs, would improve the economic welfare of workers by raising their standards of living. From a macroeconomic perspective, the increase in wages would also raise consumption and support domestic demand, as low-income groups tend to have a higher marginal propensity to consume *(see box article on Variations in Household Propensity to Consume across Income Segments).*

Third, consistent with the Government's objective of transforming Malaysia into a high-income and high-productivity economy, the minimum wage policy provides incentives to both firms and workers to undertake productivity-enhancing measures. As the relative cost between capital and labour narrows, firms may be encouraged to invest in automation and newer technologies that could enhance production capacity, rather than rely on low-cost foreign labour. Firms may also be incentivised to provide training to enhance the skills and productivity of their employees. With lower reliance on low-cost unskilled labour, firms may in turn be encouraged to move up the value chain to be more competitive. For workers, the greater availability of jobs with higher wages and the potential for the acquisition of higher skills would encourage increased participation in industries that were previously avoided. These changes would facilitate the transformation of Malaysia into a high value-added, high-income economy.

Short-term adjustment costs to be contained

In the short run, the minimum wage policy may subject firms to higher costs, especially those that have been highly dependent on low-wage workers. This could result in adjustments through several possible means, including by absorbing the increased cost through a reduction in margins, increasing productivity, reducing the overall costs through improved efficiency, and reducing the amount of labour used. Firms may also pass on some of the increase in costs to consumers, although this may not be a feasible option in an environment where firms face strong market competition. For the more labour-intensive and financially-constrained firms, immediate adjustment to the policy may result in cost-cutting or, where applicable, cost-passing measures.

Several studies on the impact of the minimum wage policy in other countries find a small negative effect on employment, particularly for young and low-skilled workers. The magnitude of this effect varies across countries due to differences in labour market characteristics and the prevailing economic environment. For Malaysia, while there may be some risk of lower employment, this effect is expected to be transitory and contained, given the country's strong economic fundamentals. Demand for labour is expected to continue to increase in the current environment of sustained growth and low unemployment. Any adjustment to employment as a result of the minimum wage policy will likely be temporary, as dislocated workers would be reabsorbed into the workforce given the relatively tight labour market. Indeed, job vacancies have been on an increasing trend since 2004[5], while Malaysia's unemployment rate has remained consistently low, with a historical average of 3.3% over the recent two decades.

Malaysia's low and stable inflation, together with the healthy profit margins of firms, would further aid in mitigating the extent of the pass-through of costs to consumers. The magnitude of price increases would also be constrained by the extent of adjustments that are made by the larger firms, which are generally price leaders and tend to be less affected by the minimum wage policy.

[4] Source: The World Bank's Malaysia Economic Monitor, April 2012.
[5] Vacancies refer to the number of job postings on the JobsMalaysia portal, as reported by the Ministry of Human Resources.

Findings from a survey conducted by Bank Negara Malaysia[6] in May 2012 suggest that the impact of the minimum wage policy will be manageable. Over 90% of firms that would be affected indicated they would not retrench workers in response to the policy, while only 25% indicated a reduction in hiring. The survey also showed that about half of the firms that would be affected did not have plans to pass on the cost increase to consumers. More importantly, close to 50% of the firms that would be affected indicated they had plans to increase training to enhance labour efficiency, while 40% indicated they would expand automation as an option to offset the increase in the cost of labour. The results of the survey reaffirm the expectation that firms will be able to adapt to the minimum wage policy, at the aggregate level, through a number of adjustment mechanisms without experiencing any significant economic disruptions.

Conclusion

Over the medium to long term, the minimum wage policy is expected to have a positive impact on the Malaysian economy. The short-term costs and risks of the minimum wage policy on inflation are expected to be well-contained. The impact on business cost will likely be small, as the increase in wages could be mitigated through improvements in productivity. Given that low-wage households tend to have a higher marginal propensity to consume, the increase in the incomes of the affected workers can be expected to result in higher consumer spending and economic activity.

The minimum wage policy is envisaged to be a positive step towards encouraging a fairer wage structure, and in contributing towards the promotion of higher value-added economic activities and higher-skilled jobs. To achieve its objectives, the policy is further complemented by other productivity-enhancing measures, such as the provision of training to up-skill workers, improvements in the quality of education, and the facilitation of investment in automation and advanced technology. With government and institutional support, as well as proper supervision and enforcement, the minimum wage policy is well-positioned to realise its goals.

[6] Bank Negara Malaysia conducted a Minimum Wage survey in May 2012. A total of 232 firms responded.

demand for personal computers, as consumers' preferences shift to mobile telecommunication devices, and manufacturers undertake inventory adjustments following the weak demand in 2012. Nevertheless, the contraction in E&E exports is anticipated to moderate as manufacturers continue to diversify their production line-up and shift into the fast-growing mobile telecommunication sub-segment.

The contraction in commodity exports, which began last year, is expected to continue in 2013, due mainly to further decline in prices, particularly for crude palm oil (CPO) and liquefied natural gas (LNG). In addition, the slower growth in global demand for commodities, coupled with increased global supply is likely to weigh down on the growth of commodity exports.

Services exports, particularly transportation and travel services, are expected to improve in 2013. While transportation services will benefit from the anticipated higher exports volume, travel services will be buoyed by higher tourist arrivals in response to the campaigns for the Visit Malaysia Year 2014. Overall, exports of goods and services are projected to register a modest growth of 2% in 2013.

Gross imports of goods are projected to increase but at a more moderate pace of 5.7% in 2013. After registering a contraction in 2012, intermediate imports, which form the bulk of Malaysia's imports, are expected to turn around to increase in 2013 as manufacturers increase production to meet rising export orders and replenish inventories. The expanding domestic investment and consumption activity, while more moderate than in 2012, will continue to support the growth of gross imports in 2013. In particular, investment activity will continue to result in the demand for imports, particularly the imports of capital goods for the oil and gas, manufacturing and services sectors. As consumers continue to experience sustained income growth, imports of consumption goods are also expected to increase. Services imports are, however, expected to expand at a slower rate. Overall, the imports of goods and services are projected to expand by 5.4% in 2013.

The net outflows in the income account in 2013 are likely to be smaller, as Malaysian companies with investments in the mining, services and manufacturing sectors are expected to provide a higher contribution to income inflows, given the improving economic outlook in the region. Profits and dividends accruing to multinational corporations

Table 4.2

External Trade

	2012*p*	2013*f*
	Annual change (%)	
Gross exports *of which:*	**0.6**	**1.4**
Manufactures	3.1	4.1
Agriculture	-15.3	-13.1
Minerals	1.9	-0.5
Gross imports *of which:*	**5.9**	**5.7**
Capital goods	20.5	18.5
Intermediate goods	-3.4	1.9
Consumption goods	11.6	9.6
Trade balance	**-23.7**	**-26.1**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 4.3

Balance of Payments

	2012*p*	2013*f*
	RM billion	
Goods	125.2	102.3
Services	-13.4	-12.7
Balance on goods and services	**111.9**	**89.6**
Income	-33.7	-27.2
Current transfers	-18.2	-19.6
Balance on current account	**60.0**	**42.7**
% of GNI	***6.6***	***4.4***
Capital account	0.1	
Financial account	-22.5	
Balance on capital and financial accounts	**-22.5**	
Errors and omissions	-33.6	
of which:		
Foreign exchange revaluation loss	*-7.7*	
Overall balance	**3.9**	

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

Source: Department of Statistics, Malaysia and Bank Negara Malaysia operating in Malaysia are projected to be sustained following the recovery in manufactured exports.

With investment-related imports remaining strong, and exports registering a modest recovery, the current account surplus of the balance of payments in 2013 is projected to amount to RM42.7 billion or 4.4% of GNI. This lower current account surplus also reflects the continued, albeit lower, deficits in the services and income accounts.

Inflation Outlook

Headline inflation is expected to average 2-3% in 2013. The higher inflation projection takes into account the expectation for higher global prices of selected food commodities and adjustments to domestic administered prices. Demand-driven pressures on prices are expected to be moderate. The wider forecast range reflects the greater uncertainty in the external and domestic environment, particularly in terms of the movement in global food and energy prices, and the timing and magnitude of the adjustments to administered prices.

Externally, the key factors driving inflation will be the prices of selected food commodities, while crude oil prices and inflation in import partner economies are expected to remain relatively stable. The Food and Agriculture Organisation of the United Nations (FAO), in its November 2012 edition of the Food Outlook, projected that selected food prices, especially corn and wheat, will continue to remain high in 2013, due to adverse weather conditions and low stockpiles. The persistently high corn and wheat prices could translate into increases in domestic meat prices through high cost of animal feed.

Headline inflation is expected to be higher but to still remain modest

Average global crude oil prices are expected to moderate slightly in 2013, as the global supply of oil is expected to exceed demand. Demand for crude oil is projected to be higher in the emerging economies, especially in PR China, given the more favourable growth outlook in these economies. However, this would be offset, to some extent, by the lower demand in the advanced economies amid weak economic activity. Global oil supply, meanwhile, will continue to increase, lifted by the resumption of oil production in South Sudan and additional supply from new oil fields in Brazil. The January 2013 update of the IMF's World Economic Outlook (WEO) projected global crude oil to trade at an average[1] of USD100 per barrel in 2013, marginally lower than the average price of USD105 per barrel in 2012. Inflationary pressures emanating from Malaysia's key import partners are also expected to be contained in 2013. The higher inflation projected for the emerging economies, following sustained growth in domestic demand and adjustments to administered prices in these economies, will be offset by the lower inflation in the advanced economies. Prevailing economic slack and weak demand conditions are expected to result in subdued price pressures in the advanced economies. The more moderate external price pressures would provide producers with greater flexibility to manage their overall operating costs, without having to resort to raising retail prices significantly.

In the domestic economy, the Government is expected to move towards a system of more targeted subsidies that will result in a series of adjustments to the prices of administered items in 2013. The overall impact on inflation will depend on the timing and magnitude of these price adjustments. These adjustments, however, are expected to be small and gradual, and hence, would not have a significant impact on the overall price level. The impact of the implementation of the minimum wage policy on total costs of firms is also expected to be modest (see box article on Potential Impact of the Minimum Wage Policy on the Malaysian Economy).

Price pressures arising from demand factors are also expected to be contained, in line with the more moderate growth in domestic demand. Private consumption will be supported by the overall stable labour market conditions and Government transfers to selected households under the 2013 Budget. The output gap will narrow as the economy expands at a rate close to its potential growth (see box article on Potential Output of the Malaysian Economy). This will result in higher inflation in 2013, but to a modest extent in view of the sustained investments to expand capacity and some moderation in income due to lower commodity prices.

[1] Average price of Brent, Dubai and West Texas Intermediate (WTI) crude oil, equally weighted.

Upside risks to inflation arising from both external and domestic factors cannot be ruled out. Externally, global food and energy prices could rise significantly should disruptions to global supplies of commodities occur. A prolonged drought in key food-producing countries and a resurgence of geopolitical risks in the Middle East and North Africa (MENA) region could contribute to higher prices. Domestically, upside risks could also emanate from larger-than-expected adjustments to administered prices, especially should global crude oil prices increase significantly. There is also the risk of stronger demand-driven price pressures in the event of a better-than-expected recovery in the external sector. Despite these risks, Malaysia projects that inflation will remain modest given that any adjustments are not likely to be significant and will be paced over an extended period of time. This will minimise its effects on inflation, thus providing an environment of macroeconomic stability.

MONETARY POLICY

The monetary policy operating environment in 2013 will continue to be shaped by the uneven economic recovery in the world economy, the persistent volatility in the financial and commodities markets, the large capital flows and by developments in the domestic economy. The Malaysian economy entered 2013 from a position of strength, providing the foundation for the sustained expansion of domestic demand. Domestic inflation is expected to be higher, but will remain contained. While there are upside risks to inflation, arising from both external and domestic factors, inflation in the last quarter of 2012 and early 2013 has remained low, in the region of 1.2% to 1.3%. Monetary policy in 2013 will focus on addressing potential risks to inflation and growth.

Globally, growth is projected to improve in 2013. Notwithstanding the recent improvements, the economic performance of the advanced economies continues to be uneven, restrained by prevailing structural weaknesses and ongoing strains in public finances. Significant challenges remain in the implementation of policies to resolve the European sovereign debt crisis, and the fiscal situation in the US remains highly uncertain. In Asia, despite being affected by the external shocks, economic activity is expected to continue to expand, underpinned by resilient domestic demand and a gradual recovery in the external sector.

Monetary policy in 2013 will focus on addressing potential risks to inflation and growth

In 2013, the Malaysian economy is expected to expand within a range of 5-6%. Domestic demand will continue to be the anchor for growth, while the expected gradual recovery in the external sector will provide additional support to the economy. Private investment is likely to remain firm, led by continued capital spending in the domestic-oriented sectors, the ongoing implementation of infrastructure projects, and a gradual improvement in external demand. Private consumption is expected to grow at a more modest rate, supported by sustained income growth and stable employment conditions. Further consolidation of the Government's fiscal position is projected to lower the growth of public sector spending. The key risk to the growth outlook emanates from the external sector, as the strength of the recovery in the crisis-affected advanced economies continues to be a major source of uncertainty for the growth outlook.

Inflation is expected to trend higher, but remain moderate within a range of 2-3% in 2013. Upward supply pressures on inflation are expected to emanate mainly from higher global prices for selected food commodities, which will contribute towards higher domestic costs. While sustained domestic demand may exert some pressure on domestic prices, the impact is not expected to be significant, given the more moderate increase in consumption and investment. Continued investment by firms to expand their productive capacity will also contribute to containing price pressures. Nevertheless, there are risks that, if manifested, will have implications for inflation. This includes supply disruptions that could result in increases in key commodity prices. The impact on domestic inflation will depend on the extent to which firms are able to offset the higher costs through increases in productivity and efficiency, and the extent to which producers absorb the increases in costs.

These factors will be taken into consideration in the setting of an appropriate monetary policy stance. Based on the Monetary Policy Statement (MPS) issued by the Monetary Policy Committee (MPC) in March 2013, the prevailing level of the Overnight Policy Rate (OPR) is appropriate for the inflation and growth outlook. In addition to domestic conditions, the MPC has indicated that it will continue to carefully assess the global economic and financial developments and their implications on the overall outlook for inflation and growth of the Malaysian economy.

FISCAL POLICY

Fiscal policy in 2013 continues to focus on sustaining the growth momentum of the domestic economy in the near term and facilitating the long-term transformation of the economy, while ensuring the sustainability of public finances. Towards this end, efforts are being centred on maximising the efficiency of fiscal resources and strengthening fiscal management. Given the challenging external environment, supporting domestic demand remains a key priority for the public sector, with greater emphasis on enhancing the country's productive capacity, a critical lever in Malaysia's transition towards becoming a high-income nation. At the same time, fiscal reforms are underway to enhance policy flexibility and to ensure fiscal sustainability. Such reforms, while necessary, need to be implemented gradually and in an orderly manner to ensure that it does not result in economic dislocation.

Table 4.4

Federal Government Finance

	RM billion		% change	
	2012*p*	2013*B*	2012*p*	2013*B*
Revenue	207.9	208.7	12.1	0.4
Total expenditure	252.5	249.7	10.2	-1.1
Operating expenditure	*205.5*	*201.9*	*12.6*	*-1.8*
Gross development expenditure	*46.9*	*47.8*	*1.1*	*1.7*
Loan recoveries	2.6	1.0		
Overall balance	**-42.0**	**-40.0**		
% of GDP	**-4.5**	**-4.0**		
Sources of financing:				
Net domestic borrowing	43.3	-		
Net external borrowing	-0.1	-		
Realisable assets[1] and adjustments	-1.3	-		

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

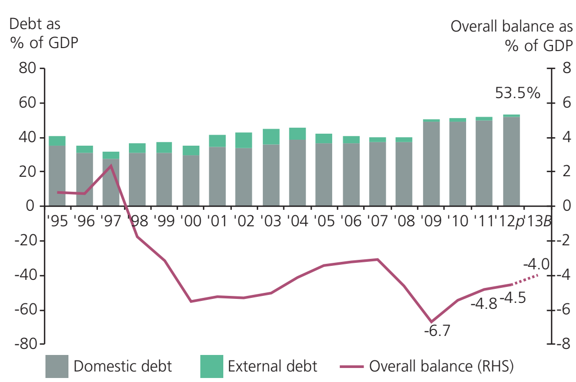
Source: Ministry of Finance

The Federal Government fiscal deficit is expected to consolidate further to 4% of GDP in 2013 from 4.5% of GDP in 2012. Revenue collection is expected to remain firm on account of stable corporate earnings amid resilient economic expansion and ongoing tax enhancement measures. Higher-than-expected revenue, as observed in the recent years, is expected to continue providing support to the fiscal consolidation plan. As the Government gradually reduces its role in the economy, total expenditure in 2013 is expected to be marginally reduced. The fiscal deficit will be primarily financed from domestic sources given the ample liquidity and high savings in the domestic economy.

In ensuring the efficient use of fiscal resources, the 2013 Budget continues to focus on enhancing the productive capacity of the domestic economy. Major initiatives to accelerate investment activity are being put in place with a greater focus on promoting higher value-added activity and quality investments by the private sector. Particular focus is dedicated to accelerating the growth of small and medium enterprises (SMEs). Provisions have been made to further enhance financing access for businesses, including incentives to encourage the issuances of retail bonds and

Chart 4.3

Federal Government Fiscal Balance and Debt



p Preliminary
B Budget

Source: Ministry of Finance

retail sukuks. Such issuances of retail bonds and retail sukuks would contribute to the deepening of the Malaysian capital market, while offering a wider choice of instruments to retail investors, including households. Special emphasis is also being accorded to human capital enhancement through promoting early childhood education, training, and research and development, in order to develop the desired competencies and enhance employability in a rapidly evolving economy.

The 2013 Budget also places importance on achieving inclusive growth in the course of economic transformation. More targeted socioeconomic spending is allocated, particularly for the poor, disadvantaged and under-served groups, to strengthen social safety nets. These include increasing the availability of affordable housing and promoting home ownership, expanding the social safety net and enhancing public health facilities.

Ongoing fiscal reforms include consolidating the fiscal deficit to the target of 3% of GDP by 2015, through a comprehensive review of the tax system, subsidy rationalisation and measures to increase spending efficiency. In 2012, the Long-Term Fiscal Sustainability Steering Committee, an inter-agency committee, was established to focus on strategies to reduce public sector indebtedness. Among the areas under review include the administration of civil servant housing loans. In the interim, the Federal Government is also leveraging on various technical assistance programmes provided by multilateral institutions to further enhance the standards of fiscal management in Malaysia, in line with international best practices. Moving forward, the gradual implementation of the ongoing public finance reforms will accord a greater degree of policy flexibility, which is particularly vital in an uncertain global environment.