2011

# OUTLOOK AND POLICY IN 2012

## INTERNATIONAL ECONOMIC OUTLOOK

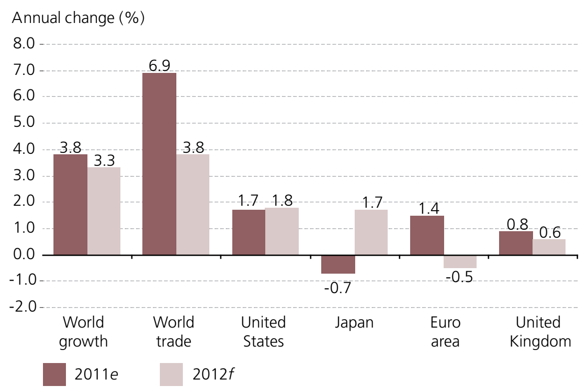
The global economic recovery, which began in the second half of 2009, is expected to slow in 2012 largely due to the ongoing sovereign debt issues in the advanced economies. Growth in these economies would be largely constrained by fiscal consolidation and private sector deleveraging following impairment of balance sheet of financial institutions. The extent of the moderation in global growth is largely contingent on how the debt crisis evolves and the nature and timeliness of the policy actions in restoring market confidence. In particular, given Europe's integration with the rest of the world, the spillover from the sovereign debt crisis will affect growth in both the advanced and emerging economies to varying degrees, through both trade and financial channels. Reflecting the weaker growth outlook and sentiments, global trade activity is expected to moderate, with a larger impact on the more open economies. In addition, continued volatility in international financial markets will have implications for global credit conditions through cross-border exposures to European banks, particularly to the banks that have weak balance sheets. Following the large and unprecedented policy stimulus measures taken during the global financial crisis, fiscal and monetary authorities in the advanced economies now have less policy space to fully mitigate the impact of these adverse developments on growth, thus reinforcing the expectations of a slower growth this year.

Global growth to moderate in 2012 amid increased downside risks, emerging particularly from the advanced economies

The growth prospects of the **advanced economies** are therefore expected to remain subdued. While the recovery in private sector activity is expected to proceed at a gradual pace, economic growth will be constrained by negative spillovers from the sovereign debt problems in the euro area. This will occur mainly through tighter credit conditions for households and businesses as banks embark on further deleveraging driven by continued financial market uncertainty and new regulatory requirements. In addition, fiscal consolidation measures will be a further factor affecting growth as the authorities attempt to restore fiscal credibility in view of high deficits and debt levels. For several European economies in particular, the pressure for further fiscal austerity is stronger as these economies face large gross financing needs during the year amid elevated sovereign bond yields. Furthermore, persistent crisis-related structural weaknesses, including impaired balance sheets of financial institutions, high unemployment and sluggish housing markets will continue to weigh on the fragile growth prospects.

Chart 4.1

**World Growth, World Trade and Growth in Major Advanced Economies (2011-2012)**




*e* Estimate
*f* Forecast

Source: International Monetary Fund and National Authorities

In the **US**, the prospects are for a moderate recovery in economic activity, underpinned by a modest revival of private sector demand amid very loose monetary conditions. Private consumption is expected to expand, supported by job creation in the private sector and the extension of the payroll tax holiday and unemployment benefits. Nevertheless, the progress continues to lack the momentum witnessed in previous recoveries due to the unresolved structural issues facing the economy. While employment is expected to improve, there are still approximately six million workers that had lost their jobs since the start of the recession and have yet to regain employment. Long-term unemployment is still unusually high as approximately 40 percent of the unemployed have been jobless for more than 10 months. This highlights the challenges faced by job seekers in finding suitable employment opportunities in the current economic environment. Some progress has been made in improving household balance sheets but deleveraging efforts are expected to continue as household debt remains high at 110% of disposable income (peak in 3Q 2007: 127%). The housing market remains sluggish due to tight credit conditions, weak income growth and subdued sentiments. The persistent excess supply of vacant houses, driven largely by foreclosures, will continue to constrain price increases, limiting new construction activity. Fiscal policy is expected to be a factor affecting growth due to the waning of fiscal stimulus that was implemented during the financial crisis and exacerbated by caps on discretionary spending.

With the **euro area** being the epicentre of the ongoing sovereign debt crisis, growth in that region is expected to be subdued. Economic activity in the core economies, including Germany and France, is expected to slow amid a moderation in external demand. Private sector activity is likely to be restrained by weaker consumer and business sentiments. Financing conditions could tighten as banks in the region might deleverage to meet the new core Tier 1 capital ratio of 9% by mid-2012. For the euro area economies experiencing fiscal sustainability concerns, namely Greece, Portugal, Spain and Italy, growth prospects remain fragile with domestic demand being further constrained by fiscal austerity measures, high unemployment, and weak bank lending.

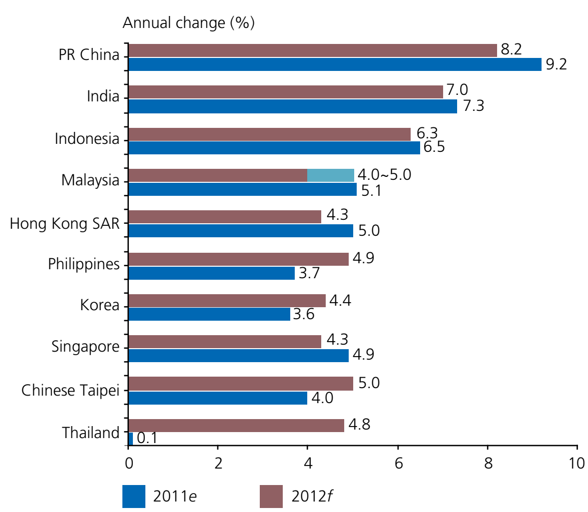
The **Japanese** economy is expected to rebound from the negative growth in 2011, due mainly to reconstruction spending. The government has approved a few supplementary budgets in 2011 to focus on measures for recovery and reconstruction from the natural disasters. This is complemented by the approval of a special account of ¥3.8 trillion in the FY2012 Budget. Growth, however, will be restrained by slowing global demand and the persistent strength in yen.

In view of the deterioration in the external environment, growth in the emerging economies will continue to moderate from the highs seen in 2010. In addition, growth of domestic demand is also expected to slow. More cautious private sector sentiments amid high uncertainties in the global economic and financial environment would restrain domestic activity as both firms and consumers reduce their spending. For a number of Asian economies, earlier policy measures to prevent overheating, rapid growth in credit and excessive increases in property prices have reined in demand to a more sustainable level. Emerging economies could also be adversely affected by the large quantity of liquidity being injected by the advanced economies and the consequent low interest rate environment which will continue to spur investors' search for yields. The implication is that many emerging economies will continue to experience large capital flows and significant volatility in their financial markets.

With global growth slowing, several governments in Asia have introduced measures to support

**Chart 4.2**

**Regional Economies: Real GDP Growth**




*e* Estimate
*f* Forecast

Source: International Monetary Fund and National Authorities economic activity in their economies. Monetary authorities in the region have also shifted their monetary policy focus from addressing inflation to preserving growth.

In **Asia**, the growth momentum is expected to moderate in view of the weaker external demand outlook and to a certain extent, and for certain economies it is on account of the lagged impact from the previous policy measures. The deterioration in export performance stems mainly from slower demand from the advanced economies, particularly the European Union, which accounts for 23% of final demand for Asia's exports. Slower export growth is expected to have a larger adverse effect on the more open economies, but resilient domestic demand would continue to support growth across the region. Targeted fiscal support in some regional countries such as the Philippines, Indonesia and Korea, and reconstruction spending in Thailand are expected to mitigate some of the impact of the external weaknesses.

**Global inflation** is expected to moderate in tandem with lower food and energy prices and the slowdown in the global economic activity. Both headline and core inflation in the advanced economies are expected to remain subdued as a consequence of moderation in commodity prices, excess capacity and weak demand in these economies. In the emerging economies, including those in Asia, cost-push inflationary pressures are also expected to moderate, with lower core inflation rates amid slower growth. Commodity prices are generally expected to ease, due mainly to lower global demand and improved supplies. Nevertheless, there is the risk that the continuation of political unrest in the Middle East and North Africa could lead to further disruptions of oil supplies, leading to higher oil prices. In addition, given the low level of stocks in some agricultural markets, particularly for grains, food prices are vulnerable to supply disruptions caused by adverse weather conditions. The easy monetary conditions globally may also prompt demand for commodities as an asset class, which could pressure prices higher.

Several **downside risks** have emerged which significantly raise the prospect of challenging global economic and financial conditions going forward. The risks from the sovereign debt crisis in the euro area could have significant ramifications on the global economy. Concerns over fiscal sustainability and other economic uncertainties are likely to contribute to continued heightened global financial market volatility and greater investor risk aversion. For several of the affected economies in Europe, some concerns revolve around the elevated international borrowing costs which could potentially pose a risk to fiscal sustainability given the large government refinancing needs during the year. Impairment of bank balance sheets and the reduced availability of credit are expected to continue to be a factor affecting growth. In addition, commitments by fiscal authorities to lower deficits and debt ratios in many of the advanced economies may also serve to further weaken growth in these economies. The implementation of needed structural reforms would enhance the flexibility and competitiveness of euro area economies, but could also lead to lower growth in the near to medium term.

The emerging economies face the risk of spillovers from the problems in the advanced economies through both the trade and financial channels. In addition, sudden reversals of capital flows may not only result in tighter domestic credit conditions but could also pose risk to financial stability. On the inflation front, the risk that the emerging economies could face renewed inflationary pressures due to higher food and commodity prices cannot be discounted given the potential for geopolitical and weather-related disruptions of supplies. In addition, China and India, the largest economies in the region, face risks that could lead to lower growth during 2012. Less favourable growth in these major economies, especially China, would have a negative impact on trading partners in Asia.

Notwithstanding the high downside risks, there have been tentative signs of improvement in the global economic and financial environment in the beginning of 2012, which could provide some upside potential to the global outlook. In the US, a stronger recovery could take place if the recent positive developments in the labour market picks up further. In addition, with the recent progress made in alleviating the risks of a disorderly default in Greece, market sentiments may improve further if continuous efforts are made to stem the contagion of the sovereign debt crisis. This would allow a gradual recovery in financial conditions

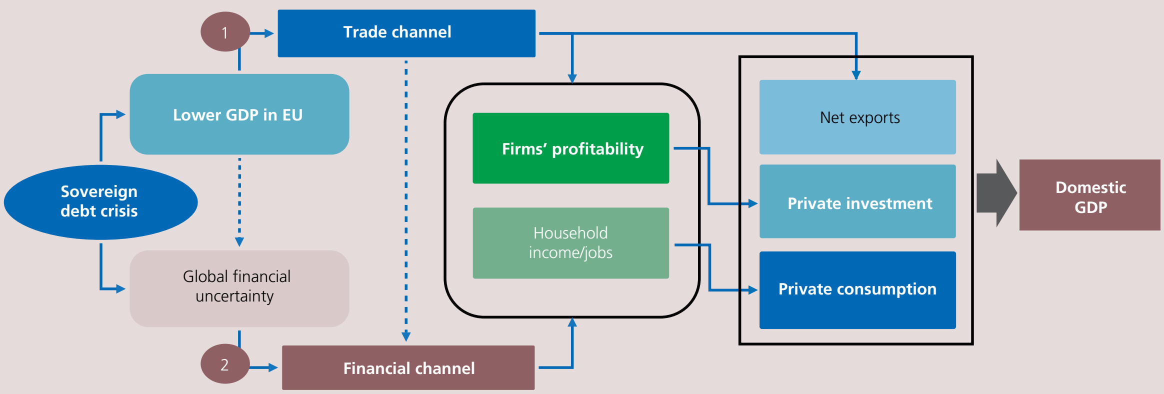
## Impact of the European Sovereign Debt Crisis on Malaysia

### Introduction

The European sovereign debt crisis poses a key risk to the global economy, as its potential escalation may have significant spillover effects on the real economy and the financial markets. The transmission of the impact of the Euro debt crisis to the Malaysian economy is through two major channels, namely the trade and financial flows (Chart 1). While Malaysia faces downside risks to growth from such external shocks, the resilience of the economy has improved steadily over the years. This is attributable mainly to the country's sound macroeconomic fundamentals, more resilient economic structure, stronger and more developed financial system, and the efficacy and flexibility of its macroeconomic policies.

**Chart 1**

**Transmission of the European Sovereign Debt Crisis to Malaysia**




### Channels of Transmission to the Malaysian Economy

On the real sector side, Malaysia is exposed to the Euro debt crisis mainly through the trade channel, with potential subsequent spillover effects on private investment and consumption spending. In 2011, Malaysia's direct exports to EU[1] accounted for a relatively small share of 10.4% of total exports (2000: 13.7%). A more complete assessment of trade exposure, however, has to include indirect exports, in particular, exports of intermediate goods that are processed and subsequently exported to EU (Chart 2). Based on an analysis of intermediate goods flowing from Malaysia to the East Asian economies (Chart 3), which are then processed and exported worldwide, the indirect exposure to EU is estimated to be around 3.8% of Malaysia's total exports in 2011[2]. This brings the overall exposure to EU to approximately 14.2% of total exports[3]. The main products exported to EU are E&E manufactures, particularly semiconductors, and computers and parts. The types of goods exported, however, have become more diversified to include more commodity and resource-based manufactured products such as rubber gloves and chemical and chemical products (Chart 4). These changes reduce the nation's vulnerability as exports become less dependent on any specific product.

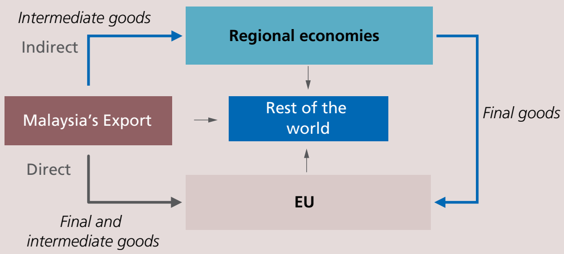
[1] EU includes all 27 countries in the union.

[2] The method assessed intermediate goods exports to EA8 economies, which are processed and then exported globally, with a smaller share of the goods going to the EU. This method only provides an estimate of the indirect exposure for the purpose of analysis.

[3] Other studies have shown similar results. For example, Pula and Peltonen (2009) argued that based on an updated 2006 Asian Input-Output table, Malaysia's total exposure to EU15 (a smaller group of European countries) is estimated to be 9%.

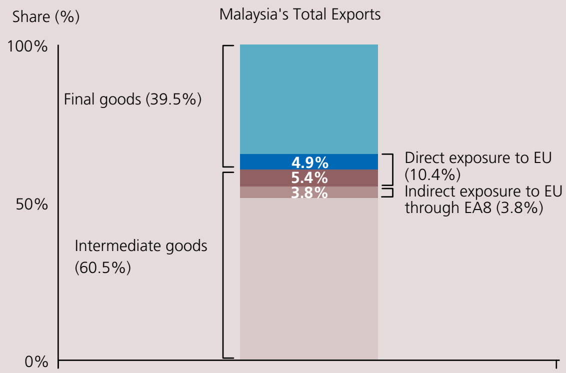
## Chart 2

### Direct and Indirect Linkage in Malaysia's Exports, an Illustrative Example




## Chart 3

### Exposure of Malaysia's Exports to EU

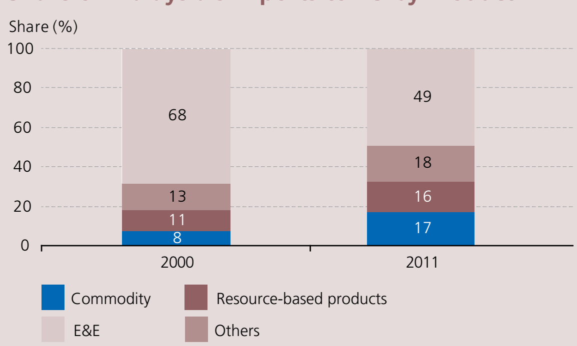



Note: EU includes all 27 countries in the union;
EA8 includes PR China, Hong Kong SAR, Singapore, Korea, Chinese Taipei, Philippines, Thailand, and Indonesia;
Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

## Chart 4

### Share of Malaysia's Exports to EU by Product




Source: Department of Statistics, Malaysia and Bank Negara Malaysia

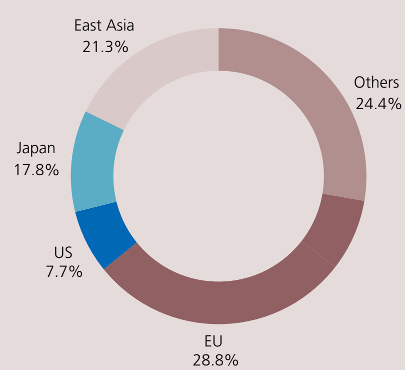
Shocks to trade may also spill over to other demand components. If such spillover effects materialise, they would have an impact on production activity and capacity utilisation rates, and may prompt businesses to delay investments in new capacity and products. Naturally, the manufacturing export-oriented industries, which account for about 30% of total private investment spending in 2011, will likely be the most affected. More directly, foreign direct investment (FDI) may also be affected, particularly by firms with direct linkages with the EU, and with other major trading partners of Malaysia that are also affected by the crisis. On average, net FDI flows from the EU accounts for about 29% of total net FDI flows into Malaysia between 2008 and 2011 (Chart 5).

Furthermore, firms may undertake cost-cutting measures, including shorter working hours, wage cuts, or even retrenchments. Thus, household consumption spending may be affected by the resultant loss in income, especially among workers in the export-oriented manufacturing sector (about 12.2% of total employment) and in the trade-related services sector, such as transportation services (4.8% of total employment). Ultimately, the magnitude of the spillover impact would depend largely on the size of shock to the trade channel. However, given

## Chart 5

### Cumulative Flows of Net Foreign Direct Investment by Blocks of Countries

**2008-2011 (RM91.2 billion)**




Source: Department of Statistics, Malaysia

Malaysia's diversified trade structure, any shock to Malaysia's overall trade arising from the EU would have a limited impact on the economy.

On the financial side, the impact from the European sovereign debt crisis will be transmitted mainly via increased uncertainty and volatility in the global financial markets, and the attendant rise in deleveraging activity, particularly among European financial institutions. Due to the close correlation that exists across markets and across asset classes, the heightened uncertainty in global financial markets may lead to significant volatility in the movement of cross-border capital. Uncertainty in the financial markets could affect not only confidence and subsequently domestic spending, but may also dampen fund-raising activity of businesses. At the same time, the weaker capital positions of some European banks create concerns that deleveraging by these institutions may restrain the availability of credit, including trade credit.

Malaysia, however, is somewhat insulated from the deleveraging by European banks. In Malaysia, all foreign banks are locally-incorporated subsidiaries with dedicated capital committed to the Malaysian operations as required under the Malaysian banking legislations. These subsidiaries are funded domestically, well-capitalised and are subject to the same standards of rigorous supervision and regulation that Bank Negara Malaysia imposes on domestic-owned banks. Given the strong and consistent financial performance and sustainable returns of the Malaysian operations of the locally-incorporated European banks, a material scale back of Malaysian operations as a result of deleveraging by the European parent banks is unlikely. Even in the unlikely event of a wide-scale retreat of European banks from the Malaysian market, domestic intermediation activity would continue to be well-supported by the domestic-owned and non-European banks in Malaysia that are well-capitalised and have strong liquidity positions. A more detailed exposition of the impact of external developments on the Malaysian financial system can be found in *Managing Contagion from External Developments* from Chapter 1 of Bank Negara Malaysia's Financial Stability and Payment Systems Report 2011.

**Resilience of the Malaysian Economy**

Malaysia's resilience and capacity to withstand the Euro debt crisis, and other potential external shocks from its major trading partners, have steadily improved over the years. Malaysia's strength could be broadly classified into four broad areas, namely sound macroeconomic fundamentals, more resilient economic structure, stronger and more developed financial system, and greater policy efficacy and flexibility.

The economy has been on a steady growth path, in an environment of low and stable inflation, while the financial system is now more developed with improved regulatory and supervisory structures. The external position remains favourable, with a sustained current account surplus and a high level of international reserves providing the buffer against the volatility in global financial flows.

Moreover, the economic structure has grown to become more resilient. Trade has become more diversified both in terms of products and markets. Malaysia's reliance on trade with the advanced economies including the EU is now smaller. The direction of trade has shifted progressively towards the regional economies, reflecting robust final demand amid the rising affluence of a large and expanding middle-class population in Asia. As a result, Malaysia's trade with the East Asian economies has surpassed that with the advanced economies, accounting for 47% of total exports in 2011 (2000: 40.2%). In terms of product mix, Malaysia's exports have also become more diversified, as its dependence on E&E exports has declined, with higher exports of commodities and non-E&E manufactured products. At the same time, domestic demand has been an anchor of growth in the Malaysian economy for the past few years, especially household consumption spending, benefiting from the steady increase in incomes and continued access to financing. These healthy fundamentals and a more resilient economic structure, therefore, place the economy in a better position to endure external shocks to the economy.

The financial system is also on a stronger footing. The domestic financial markets are deeper and broader, and the range of counterparties have over the years become more diversified, which means that financial shocks such as volatile capital flows can be absorbed more effectively. Having a broad range of instruments for monetary operations has also increased the efficiency of domestic liquidity management. Greater exchange rate flexibility through the managed float regime and high external reserves provide the necessary flexibility to adjust to external shocks. In addition, intensified supervision and a strengthened regulatory framework have ensured that financial globalisation and openness do not undermine the stability of the domestic financial system. Of significance, Malaysian banking system has remained resilient, supported by strong financial buffers even during the peak of the Global Financial Crisis. Given the prudent levels of capitalisation, a stable ringgit deposit-based funding structure, and limited exposure to European counterparties, Malaysian banking institutions are well-positioned to withstand potential shocks emanating from the more challenging external environment.

More importantly, unlike the crisis-affected countries, there are no domestic imbalances to constrain the transmission of policy impulses. Inflation is low, while household debt is still at a manageable level. Impaired loans of businesses have been on a declining trend. There is, therefore, flexibility to implement counter-cyclical policies to manage potential shocks coming from the external environment.

**Conclusion**

The European sovereign debt crisis poses a key downside risk to domestic growth prospect. Thus far, the impact on the domestic economy has been manageable. While Malaysia continues to face risks from potential escalation of the Euro debt crisis, the economy has sufficient buffers against shocks emanating from the external environment. Sound macroeconomic fundamentals, a resilient economic structure, a stronger and more developed financial system and the authorities' ability to implement policies effectively and efficiently are expected to put Malaysia in a good position to manage potential external shocks to the economy. Nevertheless, given the possible scale and intensity of the shocks from Europe, domestic policy makers are in a high state of vigilance in monitoring and assessing the situation. In this respect, closer cooperation among regional authorities will contribute to efforts to improve regional surveillance and monitoring systems against potential shocks, in particular, from volatile capital flows into the region. Malaysia has been active in promoting policy surveillance and coordination with other regional economies to further strengthen the country's and the region's defense mechanisms against external shocks.

and hence, facilitate a faster recovery of economic activity. Emerging economies would stand to benefit from a stronger recovery in demand from the advanced countries. For economies in Asia, a better external environment would support the favourable domestic fundamentals in elevating growth prospects across the region.

## MALAYSIAN ECONOMY

Amid the more challenging external environment, Malaysia's economy is projected to experience a steady pace of growth of 4 – 5% in 2012. Domestic demand is expected to remain resilient and will continue to be the anchor for growth. Following the strong expansion in 2011, the growth of both private consumption and investment is projected to soften in 2012, as both income and capital expenditure in the external-related sectors of the economy are affected by the slower global growth. Nevertheless, some measures announced in the 2012 Budget are expected to provide support to private consumption. These include the one-off financial assistance to low- and middle-income groups and the higher increment of public sector wages. Private investment will be supported by continued investment by domestic-oriented industries and the ongoing implementation of projects under the Economic Transformation Programme (ETP). The public sector will remain supportive of growth in 2012, with higher capital expenditure by both the Federal Government and the non-financial public enterprises (NFPEs). The implementation of the Special Stimulus Package through Private Financing Initiative that was announced in the 2012 Budget would also provide further impetus to real activity during the year.

On the supply side, most sectors will continue to expand in 2012. Nevertheless, the slower growth in global demand may adversely affect export-oriented industries in the manufacturing sector as well as trade-related industries in the services sector. The performance of domestic-oriented industries, on the other hand, is expected to remain firm, benefiting from resilient domestic demand conditions. In particular, the construction sector is projected to record a stronger growth, supported by the implementation of major infrastructure projects and the Special Stimulus Package. Growth in the mining sector is also expected to strengthen. However, the agriculture sector is likely to register a more moderate growth mostly on account of lower growth of both palm oil and natural rubber following the strong performance seen in 2011.

Amidst a more challenging external environment in 2012, the Malaysian economy is expected to experience a steady pace of growth of 4 – 5%, anchored by sustained expansion in domestic demand

Headline inflation is expected to moderate in 2012, averaging between 2.5 - 3.0%. The lower inflation projection reflects the moderation in global commodity prices and the weaker global growth outlook. Domestically, more modest growth in domestic demand would also restrain price pressures. In the absence of significant adjustments to administered prices, domestic inflation would remain contained.

On the external front, the current account surplus is projected to remain large at RM109.5 billion or 12.2% of gross national income (GNI). Although gross exports are expected to record a slower growth in 2012, the trade account surplus will remain large. This is due to the anticipated slower growth in gross imports in tandem with the weaker demand for manufactured exports and moderate growth in private domestic demand. Deficits in the services and income accounts are also projected to narrow further in 2012. On the financial account, capital flows are likely to remain volatile, amid heightened global uncertainty.

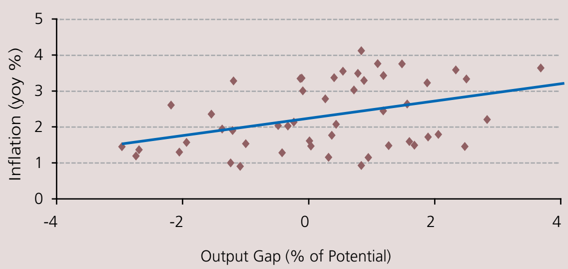
Despite the moderation in economic growth in 2012, the underlying fundamentals of the economy is expected to continue to remain strong, with the unemployment rate projected to remain low at 3.2% of the labour force. Financial stability is expected to remain intact, underpinned by well-capitalised financial institutions which will continue to provide support for financial intermediation in the economy. Given the comfortable level of reserves and relatively low external debt, Malaysia is well

## Potential Output of the Malaysian Economy

Potential output is the maximum level of output (or production capacity) that an economy can sustain without generating inflationary pressures. The level of potential output, and correspondingly the output gap[1], is one of the important factors in policy considerations relating to Bank Negara Malaysia's core mandate of maintaining low and stable inflation for sustainable economic growth. When actual output is above its potential level (positive output gap), the economy is experiencing high resource utilisation. This usually corresponds to tight labour market conditions and increased wage pressures, and thus higher inflation (Chart 1). Conversely, the economy has surplus capacity when actual output is below its potential level (negative output gap). This in turn is generally associated with higher unemployment and lower inflationary pressures.

**Chart 1**

**Positive Output Gap Corresponds with Higher Inflation**

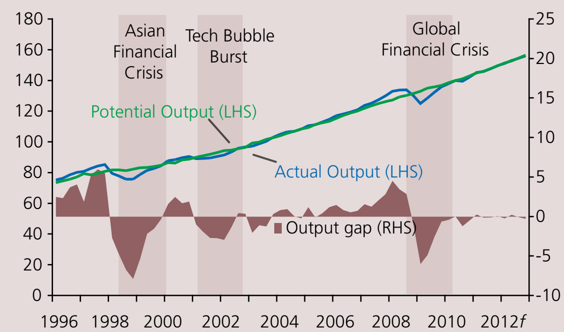



Note: Observations from 1Q 1995 to 3Q 2011, excluding periods with supply shocks

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

**Chart 2**

**Actual and Potential GDP**




*f* Forecast

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

Since 1995, Malaysia has experienced periodic cycles of positive and negative output gaps. Of significance, Malaysia experienced three episodes of large negative output gaps, namely during the Asian Financial Crisis (AFC), the bursting of the tech bubble in 2001-2002 and the recent financial crisis in the advanced economies (Chart 2). During these periods, unemployment was higher (Chart 3) and capital accumulation was lower, as the contraction in both domestic and external demand caused actual output to fall significantly below the productive capacity of the economy. It is noted that though lower inflation is normally seen alongside negative output gaps, this was only witnessed during the 2001-2002 period. Despite negative output gaps, the economy experienced higher inflation during the AFC and the recent crisis. This can be mainly attributed to the large depreciation in the exchange rate[2] during the former episode and the sharp increase in global commodity prices during the recent global crisis. Nonetheless, in all three episodes, the negative output gap narrowed with improving demand as the economy recovered. Within two years, output converged back to the level of potential output and unemployment declined.

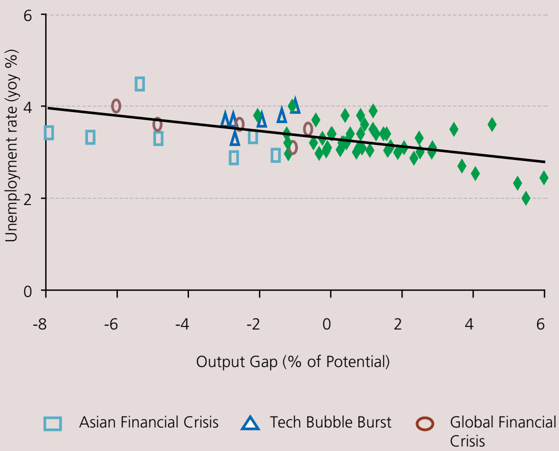
---

[1] The output gap is the difference between the levels of actual and potential output, and is generally measured as a percentage of potential output. A positive output gap indicates that actual output is above potential output, while a negative output gap indicates the reverse.

[2] A depreciation in the exchange rate typically leads to higher import prices which can result in increased inflationary pressures.

**Chart 3**

**Malaysia experienced three episodes when the negative output gaps were large and unemployment rates increased during 1995-2011**




Note: Observations from 1Q 1995 to 3Q 2011

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

**Table 1**

**Actual Real GDP and Potential Output**

| Period | Actual Real GDP | Potential Output | Output Gap |
|---|---|---|---|
| | Annual change (%) | | (% of Potential Output) |
| 1996 | 10.0 | 7.1 | 3.2 |
| 1997 | 7.3 | 5.8 | 4.6 |
| 1998 | -7.4 | 2.7 | -5.6 |
| 1999 | 6.1 | 2.5 | -2.3 |
| 2000 | 8.9 | 4.3 | 1.9 |
| 2001 | 0.5 | 4.6 | -2.1 |
| 2002 | 5.4 | 4.1 | -0.9 |
| 2003 | 5.8 | 6.0 | -1.0 |
| 2004 | 6.8 | 5.3 | 0.4 |
| 2005 | 5.3 | 5.0 | 0.7 |
| 2006 | 5.8 | 5.6 | 0.9 |
| 2007 | 6.5 | 5.4 | 1.9 |
| 2008 | 4.8 | 4.3 | 2.4 |
| 2009 | -1.6 | 4.3 | -3.5 |
| 2010 | 7.2 | 4.0 | -0.5 |
| 2011e | 5.1 | 4.6 | 0.0 |

*e* Estimate

In 2011, the analysis of potential output and the output gap revealed three key observations. First, latest estimates indicate that the Malaysian economy was operating close to its potential despite the challenging external economic environment. In tandem, labour market conditions were favourable while inflation remained manageable. Second, the higher inflation of 3.2% (historical average of 2.9%) was largely attributable to increases in global food and fuel prices. Third, although potential output grew at a faster pace of 4.6% in 2011 (2010: 4%), it remained below the 2000-2010 average of 4.8%. In this regard, continuous improvements in productivity, higher private investment to sustain capital stock accumulation, and continued job creation especially for high-skilled workers would be important for supporting a higher growth in potential output.

Going forward, despite concerns on the fragility of the global economy, the Malaysian economy is projected to continue growing close to its potential. Over the medium term, potential output is estimated to return to its trend growth rate of about 5%.

positioned to manage volatile capital flows under the current environment of continued volatility in the international financial markets.

The GDP growth projection of between 4 – 5% in 2012 is premised upon the expectation of a moderation in global growth and the timely and full implementation of measures announced in the 2012 Budget. Several risks, however, remain. These risks include a deterioration in the eurozone sovereign debt crisis, and much slower growth in our major trading partners. Should growth in the advanced economies turn out to be stronger than expected, there is some upside potential to domestic growth in 2012. It should also be noted that the authorities have sufficient policy flexibilities and tools to support the domestic economy and manage the international challenges, should conditions warrant it.

### Domestic Demand Conditions

Domestic demand will continue to be the main driver of growth in 2012, with the rate of expansion remaining resilient at 6.6%. The weaker global growth outlook is likely to affect both income and capital expenditure in the external-related sectors of the economy, thus constraining the overall momentum in private consumption and investment. The public sector is expected to remain supportive of growth, driven by higher capital expenditure by both the Federal Government and the NFPEs.

## Domestic demand to anchor growth in 2012

**Private consumption** will remain strong in 2012. The slight moderation of consumer expenditure is mainly attributed to moderating income in the private sector. Overall labour market conditions are expected to soften but not significantly so, and job creation will continue, especially in the domestic-oriented sectors. However, the lower demand for exports, particularly from the advanced economies, is expected to weigh down more on employment and wages in the export-oriented industries and the trade-related services sectors. In addition, the expected moderation of rubber and crude palm oil prices during the year may also adversely affect the incomes of smallholders.

**Table 4.1**

**Real GDP by Expenditure (2000=100)**

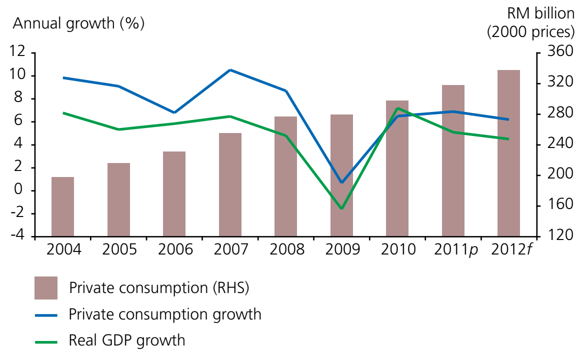
| | 2011*p* | 2012*f* | 2011*p* | 2012*f* |
|---|---|---|---|---|
| | Annual change (%) | | Contribution to real GDP growth (percentage point) | |
| **Domestic Demand[1]** | **8.2** | **6.6** | **7.2** | **6.0** |
| Private sector expenditure | 8.2 | 6.6 | 5.2 | 4.4 |
| Consumption | 6.9 | 6.2 | 3.7 | 3.4 |
| Investment | 14.4 | 8.3 | 1.6 | 1.0 |
| Public sector expenditure | 8.2 | 6.7 | 2.0 | 1.7 |
| Consumption | 16.8 | 0.2 | 2.2 | 0.0 |
| Investment | -2.4 | 16.2 | -0.3 | 1.6 |
| **Change in stocks** | | | **-0.7** | **-1.5** |
| **Net exports of goods and services** | **-14.4** | **-1.4** | **-1.4** | **-0.1** |
| Exports | 3.7 | 1.4 | 4.0 | 1.5 |
| Imports | 5.4 | 1.6 | 5.4 | 1.6 |
| **Real Gross Domestic Product (GDP)** | **5.1** | **4.0~5.0** | **5.1** | **4.0~5.0** |

[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

However, the higher salary increment for the civil servants under the improved Malaysian Remuneration System or *Sistem Saraan Malaysia (SSM)*, and the temporary income support initiatives that were announced in the

**Chart 4.3**

**Real GDP and Private Consumption**

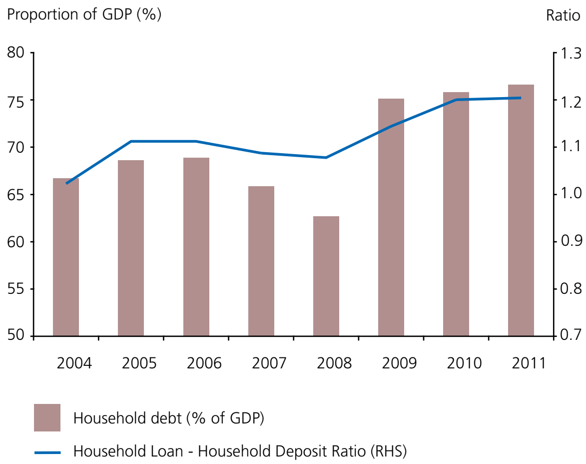



*p* Preliminary
*f* Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

**Chart 4.4**

**Household Debt Indicators**




Source: Bank Negara Malaysia

2012 Budget will provide support to private consumption. The latter include the RM500 assistance to households with a monthly income of RM3,000 and below, RM100 schooling assistance to all primary and secondary students from Year 1 to Form 5 and the book voucher worth RM200 to all Malaysian students in Form 6 and institutions of tertiary education. Households also continue to have access to credit markets, especially for the purchase of durable assets, supported by more sustainable financing and accommodative monetary conditions.

**Private investment** is expected to expand further in 2012, albeit at a more moderate pace. Continued investment by domestic-oriented industries is expected to mitigate the anticipated moderation in investment by export-oriented industries. The ongoing implementation of projects under the ETP will also augment private investment activity.

Investment in the manufacturing sector is expected to be the most affected by the external developments. Despite the large amount of investment approved in 2010 and 2011, some companies, especially in the export-oriented sub-sector, can be expected to delay their investment plans due to the increased uncertainty about global prospects. Some capital spending projects, nevertheless, will continue, especially in the resource-based industries such as basic metal products and chemicals, and in new growth areas encompassing renewable energy and advanced E&E products, such as light-emitting diodes (LEDs) and test equipment.

In the services sector, capital expenditure will be supported by the consumer-oriented business segments, including distributive trade and communications. Businesses in the communications sub-sector are expected to add new capacity for mobile networks and data transmission, while those in the wholesale and retail trade sub-sector are expected to further expand their operations with strategically-located new outlets. The liberalisation of several services sub-sectors under the ETP will also contribute to higher investment activity in the services sector.

Investment in other sectors is also expected to support private investment growth. Capital spending in the mining sector is expected to be lifted by exploration and development activities in the deepwater and marginal oil fields, supported by recent incentives targeted to spur investment in the oil and gas sector. Construction sector investment is also expected to benefit from the implementation of infrastructure projects identified in the 10th Malaysia Plan (10MP) and ETP.

**Public consumption** is projected to register a small positive growth in 2012. This is mainly on account of a significant moderation in the expenditure on supplies and services as the Government is expected to continue with its consolidation efforts. In addition, it is assumed that the Government, in view of the higher salary increment to the civil servants under the improved SSM during the year, will not be making further bonus payments in 2012.

After contracting marginally in 2011 on account of slower implementation of new 10MP projects, **public investment** is expected to expand significantly in 2012. Growth will be supported by higher Federal Government development expenditure and NFPEs' investments in the mining and transportation sectors. A major portion of the Federal Government's development expenditure will be allocated to the economics sector, mainly to improve the public transportation system and infrastructure. Funds will be channeled towards expanding the capacity of KTM Komuter services, on-going construction of double-tracking projects and provision of clean water and electricity. Expenditure in the social services sector will involve spending for education and training to meet the demand for a skilled and knowledgeable workforce. The additional impetus to growth in public investment is expected to come from the implementation of a Special Stimulus Package through the Private Financing Initiative that was announced in the 2012 Budget. Several public projects will be implemented under this initiative, such as the upgrading and maintenance of schools, upgrading hospitals, flood mitigation programme, and the construction of public housing. The bulk of the budgeted amount (RM6 billion) will be spent in 2012.

Capital spending by NFPEs in the mining sector will focus on the upstream and downstream segments, in activities such as the development of new oil and gas fields and enhanced oil recovery projects. In the transportation sector, the Light Rail Transit line extension project, fleet expansion, and airport construction are expected to be major drivers of investments. Capital expenditure in the utility and communication sectors will reflect the construction of new power plants and continued efforts to expand the coverage of the High-Speed Broadband (HSBB).

**Sectoral Outlook**

In 2012, most sectors are expected to continue to grow but at a more moderate pace as the uncertain global outlook is expected to weigh on industries directly exposed to external demand. These include the trade-related industries in the services sector, and the export-oriented industries within the manufacturing sector. Nevertheless, the performance of domestic-oriented industries is expected to remain firm, benefiting from resilient domestic demand conditions. In particular, the construction sector is expected to perform well, supported by the implementation of major infrastructure projects. Growth in the mining sector is expected to strengthen, while the agriculture sector is expected to register a more moderate growth.

The **services** sector is projected to continue to drive growth in 2012. Growth will be supported by consumer-related sub-sectors, which is likely to cushion the effects of slower trade-related activity during the year. In the wholesale and retail trade sub-sector, growth will be led by the retail segment, in line with the trend in private consumption. However, growth in the wholesale trade segment is expected to be lower, amidst slowing trade-related activity. Growth in the finance and insurance sub-sector is expected to remain firm, supported by bank lending activity. In the insurance segment, growth is expected to emanate from the general insurance business, following favourable motor vehicle sales and the implementation of the new motor cover framework which will enhance efficiency in the motor insurance and takaful sector. Growth in the communication sub-sector is projected to be sustained, amidst margin compression resulting from rising competition among service providers. Growth will be supported by the expected launch of advanced wireless technology, the ongoing widening of the High-Speed Broadband (HSBB) infrastructure and Government initiatives to promote broadband services nationwide. Growth in the transport and storage sub-sector is anticipated to moderate, amidst the uncertain external outlook.

## Most sectors will continue to expand in 2012

The **manufacturing** sector is expected to grow at a slower pace due to the anticipated slower activity in the export-oriented industries. The E&E cluster will be particularly vulnerable to sluggish growth in the advanced economies as it would adversely affect demand for personal computers and semiconductors. Nevertheless, this will be partially offset by demand for

**Table 4.2**

**Real GDP by Sector (2000=100)**

| | 2011*p* | 2012*f* |
|---|---|---|
| | Annual change (%) | |
| Agriculture | 5.6 | 3.8 |
| Mining & quarrying | -5.7 | 0.6 |
| Manufacturing | 4.5 | 3.9 |
| Construction | 3.5 | 6.6 |
| Services | 6.8 | 5.1 |
| **Real Gross Domestic Product (GDP)** | **5.1** | **4.0 ~ 5.0** |

*p* Preliminary
*f* Forecast

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

products in the communications sub-segment, and normalisation of the global E&E supply chain following the natural disaster in Japan. The cluster will also be supported by new growth areas such as the renewable energy and light-emitting diode (LED) industries. The primary-related cluster is also projected to moderate. However, growth for the cluster is expected to be supported by firm demand from regional countries, particularly for resource-based products such as refined petroleum products, chemicals and chemical products as well as rubber products. Notwithstanding the weakness in the export-oriented industries, growth in the domestic-oriented industries will continue to provide support to the manufacturing sector. In particular, the performance of the consumer-related cluster is expected to improve in tandem with the trend in private consumption and recovery in the automotive segment, which was affected by supply chain disruptions in 2011. Construction-related manufacturing industries are expected to move in tandem with the broad construction sector but outlook for the cluster remains constrained by the weaker external demand for its products.

The **construction** sector is anticipated to record a stronger growth, driven by the civil engineering sub-sector. Growth will be contributed mainly by the launch of key infrastructure projects such as the Sungai Buloh-Kajang MRT line and the Government's Special Stimulus Package. Continued progress in existing projects such as the Second Penang Bridge, Ipoh-Padang Besar double track, KLIA 2 and the extension of the Kelana Jaya and Ampang LRT lines will lend further support to growth. Growth in the non-residential sub-sector is expected to be sustained, owing to public sector expenditure on hospitals and schools. In contrast, the residential sub-sector is projected to grow at a slower pace as developers shift focus to mass market housing from the high-end segment.

The **mining** sector is projected to improve, recording a positive growth rate in 2012. This reflects the higher production of natural gas, driven largely by strong demand from Japan for electricity generation. Output of crude oil is expected to remain subdued amidst maturing fields and delays in the commencement of production of some new fields. However, measures such as the enhanced oil recovery and tax incentives to promote production from marginal fields are anticipated to contribute favourably to oil production in the longer term.

Growth in the **agriculture** sector is expected to be more moderate, caused mainly by lower growth of both palm oil and natural rubber following the strong performance seen in 2011 and the moderation in commodity prices. Growth will be supported by food production, namely fish and poultry, amid ongoing efforts to improve productivity as outlined in the National Agro-Food Policy 2011-2020.

**Balance of Payments**

The protracted slow growth in the global economy and persistent uncertainty in the international financial markets are expected to continue to affect trade activities and capital flows in Malaysia in 2012. Both exports and imports are expected to record a slower growth in 2012. Nevertheless, the current account surplus is expected to remain large at RM109.5 billion or 12.2% of GNI, supported by a sustained large surplus in the trade account and smaller deficits in the services and income accounts. On the financial account, long-term capital flows are likely to moderate, but short-term capital flows could be higher and more volatile amid heightened global economic uncertainty.

Current account surplus is expected to remain large with a sustained trade surplus and smaller services deficits

Growth in **gross exports** is expected to be slower due mainly to the weaker performance in commodities. The moderation in commodity exports reflects largely the price effect, a trend that was already prevalent in the fourth quarter of 2011. Export prices for LNG, however, are expected to be higher due to sustained demand from major importing countries. Manufactured exports would be supported by non-E&E (electronics and electrical) exports including resource-based and metal products, which are mainly determined by regional demand. While demand for E&E products is expected to

**Table 4.3**

**Balance of Payments**

| | 2011*p* | 2012*f* |
|---|---|---|
| | RM billion | |
| Goods | 149.4 | 155.6 |
| Trade account | 120.3 | 125.6 |
| *Exports (% annual change)* | *8.7* | *3.2* |
| *Imports (% annual change)* | *8.6* | *3.0* |
| Services | -8.4 | -6.2 |
| **Balance on goods and services** | **141.0** | **149.4** |
| Income | -22.0 | -19.4 |
| Current transfers | -21.1 | -20.5 |
| **Balance on current account** | **97.9** | **109.5** |
| ***% of GNI*** | ***11.8*** | ***12.2*** |
| Capital account | -0.2 | |
| Financial account | 15.5 | |
| **Balance on capital and financial accounts** | **15.3** | |
| Errors and omissions | -18.5 | |
| *of which:* | | |
| *Foreign exchange revaluation gain* | *7.6* | |
| **Overall balance** | **94.7** | |

*p* Preliminary
*f* Forecast
Note: Numbers may not necessarily add up due to rounding
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

remain sluggish, the contraction in E&E exports is expected to be smaller because the E&E production is expected to rebound from the low production base in 2011, which was affected by supply disruptions. E&E demand will also be supported by the growing level of semiconductor content embedded in a wide range of consumer and business applications.

In tandem with the weaker demand for manufactured exports and slower domestic economic activity, growth in **gross imports** is also expected to be slower in 2012. Growth of intermediate imports is projected to moderate as manufacturers reduce production in line with the declining export orders. Slower growth in capital imports is attributable mainly to the moderation in investment by export-oriented industries. Imports of consumption goods would be smaller due to more cautious consumer spending and the relatively high-base effect in 2011 is also likely to be a contributing factor to this trend.

**Table 4.4**

**External Trade**

| | 2011*p* | 2012*f* |
|---|---|---|
| | Annual change (%) | |
| **Gross exports** | **8.7** | **3.2** |
| *of which:* | | |
| Manufactured | 3.4 | 4.5 |
| Agriculture | 32.9 | -9.3 |
| Minerals | 20.3 | 6.1 |
| **Gross imports** | **8.6** | **3.0** |
| *of which:* | | |
| Capital goods | 9.7 | 6.8 |
| Intermediate goods | 5.4 | 2.5 |
| Consumption goods | 19.0 | 3.7 |
| **Trade balance** | **9.4** | **4.4** |

*p* Preliminary
*f* Forecast
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The deficit in the **services account** is projected to narrow in 2012. Net payments for transportation are expected to be smaller in line with the lower volume of trade. Net travel receipts would be slightly higher on account of a modest growth in tourist arrivals. Outflows in the **income account** are expected to be smaller, reflecting mainly the lower investment income accruing to foreign direct investors from investments in Malaysia, particularly in the manufacturing, oil and gas and services sectors.

Capital flows in the financial account are expected to moderate as FDI and DIA activity may be affected by global slowdown and uncertainty

On the financial account, gross inflows of **FDI** are anticipated to moderate in 2012. FDI inflows, which began to soften in the second half of 2011, are expected to moderate further in 2012, reflecting weak external demand and greater uncertainty in the global economic environment. While there has been higher levels of foreign manufacturing projects approved by the Malaysian Investment Development Authority (MIDA) in 2010 and 2011 (RM29.1 billion and RM34.1 billion respectively), investments in the manufacturing sector may moderate as foreign firms are expected to turn more cautious following the heightened uncertainty in the global economy. However, FDI into new growth areas such as renewable energy, and advanced E&E products such as light-emitting diodes and test equipment, is expected to continue given the growing global interest in green technology. Foreign investments in the oil and gas sector are also projected to remain firm, supported by increased government incentives to the sector. In addition, the liberalisation of several services sub-sectors under the ETP will also contribute to further inflows of FDI into the services sector.

The trend in **direct investment abroad (DIA)** by Malaysian companies is likely to mirror that of the FDI, although by a lesser degree. This is mainly attributed to the diversified profile of overseas investment in terms of economic activity as well as the investment destination. DIA is projected to be channeled mainly into the services and oil and gas sectors, with a continued focus on high-growth markets in the region. Despite the highly challenging global economic conditions, Malaysian companies are anticipated to continue venturing abroad to seek access to new and larger markets. Over the medium term, this regional and global expansion will contribute in creating more competitive and globalised Malaysian companies.

**Labour Market Outlook**

Labour market conditions are expected to soften in 2012, amid the slower economic activity. Job creation is projected to be concentrated in the domestic-oriented sectors, particularly in the services and construction sectors, as domestic demand is expected to remain firm. Employment in the export-oriented sectors may be affected by the weakening external demand.

The unemployment rate is projected to increase to 3.2% of the labour force in 2012 (2011: 3.1%). Income growth in 2012 will be affected by the cautious economic outlook, which affects firms' decisions on salary increments and bonus payments. Nevertheless, the expected implementation of a minimum wage policy during the year would provide some support to low-income workers, while the higher salary increment for the civil servants under the improved Malaysian Remuneration System or *Sistem Saraan Malaysia* (SSM) would support public sector incomes.

## Labour market conditions may soften in 2012

**Inflation Outlook**

Headline inflation is expected to moderate in 2012, averaging between 2.5 - 3.0%. The lower inflation projection reflects moderation of global commodity prices for 2012 as a whole and slower global inflation precipitated in part, by the weaker global growth outlook. Domestically, the moderation in growth of domestic demand would also restrain price pressures. In the absence of significant adjustments to administered prices, the pressure on domestic inflation would remain contained.

Global commodity prices are expected to remain elevated in 2012. For food commodities, the Food and Agriculture Organisation of the United Nations (FAO), in its November 2011 edition of Food Outlook, projected that food prices would remain below the February 2011 peak, but would continue to be high and volatile. Despite the global slowdown, demand for high-protein food from countries experiencing sustained growth would continue to be strong. In terms of supply, while there are expectations of an improvement in production, particularly for cereals, there is also a higher probability that bad weather conditions could adversely affect production. The Intergovernmental Panel on Climate Change (IPCC) projected a high likelihood of warm spells on a global scale. High costs of inputs, such as fertilisers and energy would also continue to exert upward pressure on food prices.

Crude oil prices are expected to remain volatile in 2012, but the levels would be restrained by the slower growth of the global economy. The deterioration in global growth prospects prompted the International Energy Agency (IEA) to trim its 2012 projections for oil demand growth to 0.8 million barrels per day (mb/d) from an earlier forecast of 1.1 mb/d. Conversely, despite the higher output target announced by the Organisation of the Petroleum Exporting Countries (OPEC), geopolitical tensions in the MENA region have raised uncertainties over oil supply. This could keep oil prices high throughout 2012. The IMF's World Economic Outlook (WEO) update in January 2012 projected crude oil to trade at an average[1] of USD99 per barrel in 2012, slightly lower than the 2011 average price of USD104.

Inflationary pressures among Malaysia's key import partners are expected to be modest in 2012 in line with weaker global growth and lower global commodity prices. Weak consumer confidence, prevailing economic slack and subdued demand pressures would keep inflationary pressures muted in the advanced economies. The January 2012 update of the WEO projected a lower inflation of 1.6% for the advanced economies (2011: 2.7%). Price pressures are also expected to be moderate in the emerging economies in line with the stable domestic demand in these economies. The emerging and developing economies are expected to register a lower inflation of 6.2% in 2012 (2011: 7.2%). The reduced pressure from external prices could provide greater flexibility for producers to align prices with the more moderate domestic demand.

Price pressures arising from demand factors are expected to be contained as the growth of both private consumption and investment are projected to soften. However, the upward revision of public sector wages and other measures announced in the 2012 Budget would continue to support household consumption spending in 2012. Overall, the economy is expected to operate slightly below its potential *(See white box on Potential Output of the Malaysian Economy).* Firms would be able to accommodate the demand as production capacity had expanded following high investment in previous years.

There are, however, upside risks to inflation from both the external and domestic factors. Externally, there is potential for upward bias in global commodity prices. First, if global growth is stronger than expected, the corresponding expansion in global demand for commodities could exert significant upward pressure on prices, as production may not be able to adjust quickly enough to meet the unexpected surge in demand. Second, geopolitical risk to oil supply could intensify further and escalate the upward pressure on oil prices. Third, the surplus liquidity that is flooding the major financial markets, and the resulting search for higher yields, could spill over to the commodity markets. The low interest rate environment, and possible weakness in the US dollar could prompt more speculative investment in commodities, further driving up prices. While recognising these risks, the dominant assumption is that slower global growth would restrain increases in commodity prices.

Aside from the external factors, there are also potential upside risks from domestic supply factors. Potential supply disruptions could keep food prices elevated. High vegetables, fruits and fish prices may persist due to labour shortages and adverse weather conditions. Meat prices could remain elevated if higher global corn prices lead to more expensive feed. There could also be possible adjustments to administered prices if global commodity prices are higher than expected.

## MONETARY POLICY

Monetary policy in 2012 will continue to operate in a complex global environment characterised by slower growth, rising uncertainties and increased volatility in the financial and commodities markets amid high liquidity in the international monetary system. The Malaysian economy entered 2012 with increasing downside risks to growth amid softening inflationary pressures domestically. Monetary policy in 2012 will focus on ensuring the sustainability of economic growth in an environment of price stability. Emphasis will also be placed on ensuring monetary policy remains appropriate to avoid the build-up of financial imbalances.

There are increased downside risk to global growth from the ongoing uncertainties and weaknesses in the advanced economies. Growth in the advanced economies continues to be constrained by prevailing structural weaknesses, ongoing strains in public finances and impaired financial intermediation. The Asian growth

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

momentum is likely to moderate due to weak external demand from advanced economies. Key engines of growth within the region, such as China, have also showed signs of moderating growth. As a small and highly open economy, Malaysia will not be insulated from these external developments and is likely to experience some moderation in real activity, particularly in the export-oriented industries.

## Monetary policy in 2012 will focus on ensuring the sustainability of economic growth in an environment of price stability

Despite the highly challenging external environment, the fundamentals supporting the economy remain intact. The Malaysian economy is expected to remain resilient and to grow within the range of 4 - 5% in 2012. Domestic demand will continue to be the anchor for growth. Private sector economic activity will be sustained, underpinned by stable employment conditions and a favourable outlook for the domestic- oriented sectors. This will be further reinforced by public sector spending and investment via the ETP and policy initiatives announced during the 2012 Budget such as the one-off financial assistance to low and middle income groups, upgrading of schools, hospitals and basic rural infrastructure and the construction of public housing.

Inflation is expected to moderate in 2012. Demand pressures on inflation should be contained. In terms of supply pressures, slowing global demand is expected to relieve some of the pressure on the international prices of key commodities. Nevertheless, there remains upside risks to inflation. Adverse geo-political developments, irregular weather patterns and the ample global liquidity which could prompt the financialisation of commodity markets could result in large swings in global food and energy prices, and keep prices elevated. Some of the increase in global cost pressures could be transmitted to the prices of domestic goods and services.

At the current level of the Overnight Policy Rate (OPR), monetary conditions remain supportive of economic activity. This is evident in the retail lending rates to businesses and households which are still below pre-crisis levels, and the sustained financing growth of 12.5% in 2011. However, should the global economy enter a new phase of even weaker growth during the course of 2012 and adversely affect the outlook for the Malaysian economy, the Monetary Policy Committee (MPC) at Bank Negara Malaysia has the flexibility to respond to adjust the degree of monetary accommodation. Any consideration for further monetary stimulus, however, will be weighed carefully by the MPC against the potential upside risks to inflation, as well as the build-up of financial imbalances that could adversely affect macroeconomic and financial stability in the medium to long-run.

Liquidity in the international monetary system has risen significantly in recent years following the unprecedented scale of monetary policy easing by central banks in the major advanced economies. Large shifts of this liquidity have resulted in significant inflows and equally large outflows of portfolio investments to and from emerging economies, including Malaysia. These large movements in portfolio flows could raise short-term exchange rate volatility, creating risks for the economy and financial system, and disrupting international trade and investment activity. The surges in inflows could also lead to a build-up of liquidity in the domestic financial system, giving rise to distortions that eventually result in excessive growth of leverage and misalignment of asset prices.

Malaysia is in a strong position to manage these challenges. First, the more developed and diversified financial system is better able to intermediate the large volume of capital flows. Second, the managed float regime currently adopted by the Bank also allows the exchange rate to flexibly adjust to changing conditions. Third, the Bank has sufficient international reserves to attenuate volatility in the foreign exchange market to prevent extreme currency movements that may cause severe dislocations in financial markets and the overall economy. Fourth, the Bank's ability to manage domestic liquidity has also improved significantly, supported by a wider range of instruments for monetary

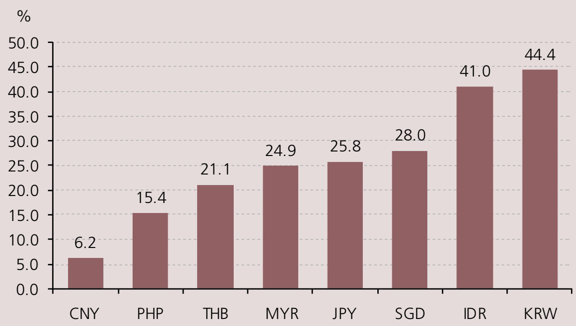
## Impact of Ringgit Appreciation on Import Prices and Inflation

### Introduction

The ringgit and other Asian currencies have been on a broad appreciating trend since early 2009 amid the nascent global economic recovery and improvements in the global financial markets. As market sentiments and risk appetites improved against a background of increased global liquidity, portfolio inflows to Asia rose significantly and regional currencies appreciated between 6.2% and 44.4% relative to the US dollar between March 2009 and July 2011 (Chart 1). At the same time, the fast pace of the economic recovery in the region over the course of 2010 and 2011 coincided with a gradual build-up of inflationary pressures following sustained increases in global commodity prices and rising domestic demand amid global supply disruptions. Given the heightened inflationary risks during the period, a pertinent issue is whether the currency appreciation would dampen some of the effects of the global cost-push factors on inflation by lowering the local-currency price of imports.

Chart 1

Performance of Regional Currencies Against US Dollar (March 2009 - July 2011)




Source: Bank Negara Malaysia

The relationship between the exchange rate and inflation is highly complex and it involves interactions through a number of transmission channels in the economy, including trade, domestic demand, expectations of households and businesses, financial markets, liquidity and monetary conditions, and the costs of production. This article discusses the role of exchange rate appreciation in containing the costs of imported inputs and final consumption goods and consequently, consumer prices. In summary, consistent with the findings in the literature, the pass-through from ringgit appreciation to import prices was found to be partial and incomplete. An even smaller pass-through to consumer prices was also observed. Given the weak relationship between the exchange rate and inflation, care must be exercised on the role that is attributed to the exchange rate in mitigating cost-push inflation from abroad.

### The transmission of exchange rate changes to consumer prices

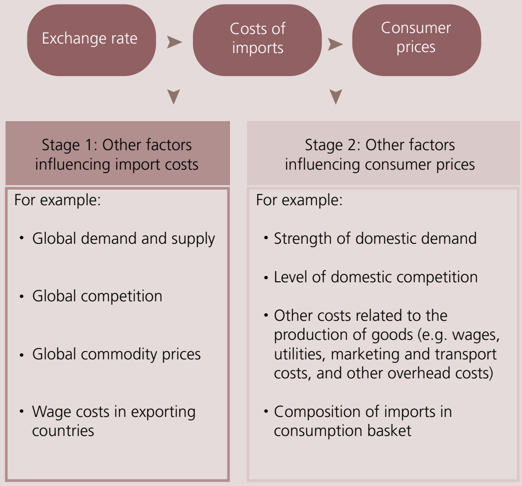
In general, exchange rate movements may have an effect on inflation through imports. The impact of exchange rate movements on consumer prices can be observed in two stages, namely from the exchange rate impact to import prices, and subsequently from import prices to consumer prices. At the first stage, changes in the exchange rate may be reflected through import prices that are paid by importers[1]. In the absence of other influences, the hypothesis is that a ringgit appreciation against the US dollar would lower import costs in ringgit terms for Malaysian importers, assuming US dollar was

[1] These may include imports of raw materials, intermediate goods and final goods.

used for trade settlement. While the exchange rate could be an important consideration, there are other factors that could influence the prices of imports. These include global demand and supply conditions, global competition, prices of global commodities and production costs in the exporting countries.

Chart 2

**Transmission of Exchange Rate Changes to Consumer Prices through the Cost of Production Channel**




Source: Bank Negara Malaysia

At the second stage, the changes in import prices would feed into the overall cost of domestic production and eventually determine the final prices paid by consumers. The degree of pass-through from import prices to consumer prices depends essentially on the share of imported inputs and goods in overall production and distribution. In general, the smaller the proportion of imported inputs and goods into overall production and distribution, the smaller the impact on consumer prices. Beyond cost considerations, factors such as the strength of domestic demand and the extent of market competition could also influence the decision by firms to pass-on cost savings from cheaper imported prices.

**The transmission of exchange rate changes to consumer prices in Malaysia is partial and incomplete**

For Malaysia, the impact of exchange rate changes on import prices and subsequently on consumer prices was estimated using monthly observations from July 2005 to mid-2011[2]. Our estimation suggests that exchange rate movements are statistically significant in influencing import prices[3]. A 10% Nominal Effective Exchange Rate[4] (NEER) appreciation lowers import prices by between 1-3% within four months. This suggests that while ringgit appreciation can lower import prices, the degree of pass-through is relatively smaller than the magnitude of ringgit appreciation. The result also indicates that

[2] The model is developed on the basis that the effect of exchange rate movements on consumer prices is transmitted in two stages. At the first stage, import prices are determined by the costs of production in the exporting country, global demand conditions and the nominal effective exchange rates (NEER), in which the degree of exchange rate pass-through to import prices is given by the NEER coefficient. At the second stage, consumer prices are determined by import prices, the output gap and lagged inflation. The import price coefficient would reflect the degree of pass-through to consumer prices.

[3] Imported goods are assumed to go through local production and distribution channels once they arrive in Malaysia. As a small economy, Malaysian importers are assumed to be price-takers; hence all imports are priced in foreign currency. This is not an extreme assumption as the bulk of our imports are denominated in USD, EUR and JPY in 2011.

[4] NEER is the weighted average of home country's currency against the currencies of major trading partners.

global demand is a more important factor in influencing import prices in Malaysia, whereby a 10% increase in global demand would increase import prices by 1-5%. At the second stage, the impact of changes in import prices on consumer prices was found to be even lower. A 10% decrease in import prices would lower domestic inflation by 0.5% within 6 months. This estimate also suggests that domestic demand conditions are more important in influencing consumer prices. Combining the results for stage 1 and stage 2, the research outcome suggests that a 10% appreciation of the ringgit results in a fall of only 0.05-0.15% in consumer prices.

The finding that the impact of an exchange rate appreciation is greater on import prices than on consumer prices suggests that although ringgit appreciation can lower import prices, producers may not necessarily pass on these savings completely to consumers. An important caveat to this finding, however, is that the evidence of low pass-through reflects the average outcome across a range of different episodes. The degree of pass-through may vary across time in response to different shocks. For example, an extreme appreciation of the ringgit could erode export competitiveness, which in turn could reduce incomes and weaken domestic demand.

The findings from Malaysian data are broadly consistent with similar studies conducted elsewhere. Exchange rate appreciations are found to only partially reduce import costs, whereas the pass-through is even lower from import costs to consumer prices. Campa and Goldberg (2006) found that the consumer price index is less sensitive to exchange rate changes than import prices. For Organisation for Economic Co-operation and Development (OECD) countries, in the long run (about four quarters), a 10% depreciation of local currency leads to an average of 6% increase in import prices and 2% increase in consumer prices. For the United States, a 10% depreciation in the US dollar leads to an average of 4% increase in import prices and 0.1% increase in consumer prices. Ca'Zorzi, Hahn and Sanchez (2007) also found that the exchange rate pass-through to be lower on consumer prices than import prices. For selected Asian countries, the study found that exchange rate pass-through to import prices was between 0.12% and 0.78% within four quarters, while the pass-through from exchange rate to consumer prices was between 0.01% and 0.19%, also within four quarters. The paper also found that countries with low average inflation experienced lower levels of exchange rate pass-through than countries with higher average inflation. Mihaljek and Klau (2008) estimated a sample of 14 emerging economies and found that exchange rate pass-through to inflation was below 0.3% and that there has been a general declining trend across emerging economies since the 1980s[5]. Importantly, Mihaljek and Klau also found that there is an asymmetric effect of the impact of exchange rate movements on inflation. Exchange rate depreciations seems to have a significant and stronger effect on inflation than appreciations in Korea, Malaysia, Mexico, Poland and Turkey. Conversely, appreciations seems to have a significant and stronger effect on inflation in Philippines, Brazil and Hungary. Other countries in their sample[6] however, do not display the presence of asymmetric effects of exchange rate movements on inflation.

**Price rigidity and local currency pricing as sources of partial and incomplete exchange rate pass-through**

There are several explanations for the partial and incomplete pass-through from exchange rate changes to consumer prices. These can be broadly categorised as rigidity in price adjustments, increasingly globalised production chain, the importance of distribution costs, firms changing profit margins, local currency pricing, magnitude of exchange rate changes and country-specific factors.

1. **Rigidity in price adjustments.** It is often observed that firms do not instantaneously adjust prices in response to changes in business conditions. More importantly, price adjustments are often seen to be asymmetric between price increases and price decreases, with less likelihood for firms to revise prices downward. Consequently, while an exchange rate appreciation may lower import costs and the overall cost of productions, these costs savings are not fully translated into lower prices

[5] The decline in exchange rate pass-through to inflation across emerging economies since 1980 coincides with lower levels and volatility of domestic inflation and foreign prices.
[6] Other countries refer to Thailand, South Africa, Chile, Peru and Czech Republic.

for consumers. There were various explanations for such observations, including the existence of pre-existing contracts to ensure stable prices, the high cost of frequently adjusting prices and the association of prices as a signal for quality and exclusivity.

2. **Increasingly globalised production chain.** There are now more goods being produced through multiple stages of production that are located in different countries. As a result, the final goods being produced embody input costs in various currencies that do not necessarily move in tandem. This means that a fall in cost from a bilateral appreciation against one particular currency may be offset by a rise in cost from a bilateral depreciation against another currency. As a result, the net impact of exchange rate movements on final goods' prices was limited.

3. **Distribution costs.** For some goods that are imported from abroad, the production costs may include a proportionately larger domestic cost component such as transportation, marketing, wholesaling and retailing. For example, a study by Feenstra (1998) illustrated that a Barbie doll shipped from PR China to the United States cost about USD2, where it sold for about USD10[7]. The relatively insignificant cost of imports in the overall cost structure reduces the price sensitivity to the impact of exchange rate changes.

4. **Firms changing profit margins.** In practice, many goods and services are traded in imperfectly competitive markets that allow producers to charge prices based on margins over costs. Producers may respond to exchange rate fluctuations by adjusting their profit margins instead of prices, which reduces the sensitivity of consumer prices to exchange rate changes.

5. **Local currency pricing.** International business strategies may also result in producers absorbing the impact of exchange rate variations. Cross-border product differentiations, market segmentations and competition have led many producers to price products based on the specific conditions in each market. This would reduce import and consumer price sensitivity to exchange rate changes.

6. **Magnitude of exchange rate changes.** Large changes in exchange rates may have more significant impact on pass-through to import prices and consumer prices than smaller exchange rate changes.

7. **Malaysia-specific factors.** The low pass-through could be attributed to the inherent characteristics of the domestic Consumer Price Index (CPI), which is compiled based on the expenditure pattern of the average household in Malaysia.

    a. *CPI captures many goods that are not traded internationally.* Many items that are captured in the computation of the CPI are not traded internationally. For example, services like car wash, haircuts and other specialised services are determined entirely by domestic conditions and do not necessarily respond directly to external developments. While there are some imported inputs in the services category, the contribution to the overall cost of production is relatively small. Services components account for about 47.5% of the CPI basket in Malaysia.

    b. *Limited direct import of final goods.* For Malaysia, direct imports of final goods only accounts for 15.9% of the overall CPI basket. Hence, the direct impact of exchange rate changes on consumer prices is often not pervasive and is limited to selected items. Prices for some of these imported items, such as petroleum products, were also subject to the Government's administered price mechanism, which would further limit the overall sensitivity of prices to

[7] Source: "The Exchange Rate–Consumer Price Puzzle", FRBSF Economic Letter, 2006

exchange rate movements. While the gradual removal of price controls and Government subsidies on these products could potentially increase the degree of pass-through, the actual impact should not be overstated given that even countries with few price controls have low exchange rate pass-through.

**Policy Implications and Conclusion**

Empirical evidence suggests that there is only a relatively small reduction in import costs as the ringgit appreciates. Producers, in turn, do not entirely pass on these cost savings to consumers. This insensitivity of the CPI to exchange rate movements implies a rather limited role for the exchange rate in mitigating the impact of imported inflation. Although the finding is consistent with other studies in the literature, an important qualifier is that the period of coverage corresponds to the environment of relatively stable inflation and orderly ringgit appreciation. As noted, the magnitude of the exchange rate changes is important in terms of determining its impact on import prices and consumer prices. An extremely strong currency appreciation could erode competitiveness, which in turn reduces incomes and weaken domestic demand. Conversely, a very strong depreciation could exert upward inflationary pressure on consumer prices as rising import prices become unbearable for importers, who would in turn pass on this rise in import cost to consumers. In this regard, the importance of orderly two-way adjustment in the currency should remain an important policy objective for the central bank in a small open economy.

operations, including the use of the Statutory Reserve Requirement (SRR) which provides more longer-term sterilisation of liquidity. This has been augmented by better surveillance and information systems. Fifth, closer cooperation among central banks in the region also enhances the Bank's ability to manage the risks emanating from capital flows.

## FISCAL POLICY

Fiscal policy in 2012 is geared towards stimulating domestic economic activity and providing support to the economic transformation plan. A key challenge for the Government in 2012 is to continue providing support to domestic demand amid the weakening external sector while ensuring that the fiscal position remains sustainable. In this regard, greater emphasis has been placed in the 2012 Budget on generating growth through private sector investment and consumption. Timely implementation of the Government's reform initiatives under the National Key Result Areas (NKRAs), National Key Economic Areas (NKEAs) and Strategic Reform Initiatives (SRIs) is also a major focus of the Government.

As part of the Government's efforts to accelerate investment, several major initiatives were outlined in the 2012 Budget. First, the enhancement of the existing public-private partnership (PPP) initiative to undertake development projects through private sector funding. Towards this end, RM2.5 billion is allocated in the 2012 Budget under the PPP Facilitation Fund to assist the private sector in initiating various catalytic projects. Second, the introduction of various tax incentives to facilitate the development of high-impact projects in targeted sectors. These incentives are provided for projects in Kuala Lumpur International Financial District (KLIFD), Iskandar Development Region (IDR) and other regional corridors which are expected to have large multiplier effects on economic activity. The third initiative involves attracting foreign investments and participation in the economy through further liberalisation of the 17 services sub-sectors that allow up to 100% foreign ownership. This initiative is expected to enhance the competitiveness of the domestic services sector which has been identified as one of the key drivers of economic growth.

**Table 4.5**

**Federal Government Finance**

| | RM billion | | % change | |
|---|---|---|---|---|
| | 2011*p* | 2012*B* | 2011*p* | 2012*B* |
| Revenue | 185.4 | 186.9 | 16.1 | 0.8 |
| Total expenditure | 229.0 | 230.8 | 12.0 | 0.8 |
| *Operating expenditure* | *182.6* | *181.6* | *20.4* | *-0.6* |
| *Gross development expenditure* | *46.4* | *49.2* | *-12.1* | *6.1* |
| Loan recoveries | 1.1 | 0.9 | | |
| **Overall balance** | **-42.5** | **-43.0** | | |
| **% of GDP** | **-5.0** | **-4.7** | | |
| *Sources of financing:* | | | | |
| Net domestic borrowing | 45.1 | - | | |
| Net external borrowing | 0.5 | - | | |
| Realisable assets[1] and adjustments | -3.1 | - | | |

[1] A positive (+) sign indicates a drawdown in the accumulated realisable assets
*p* Preliminary
*B* Budget
Note: Numbers may not add up due to rounding

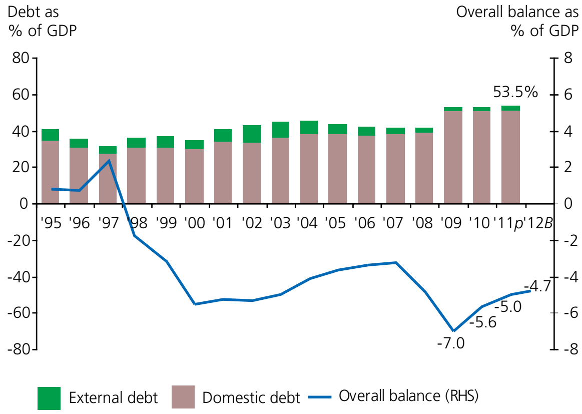
Source: Ministry of Finance

In line with the Government's transformation initiatives under NKRAs, the 2012 Budget also emphasises further developing human capital and enhancing rural development. Both areas are critical to Malaysia becoming a high-income nation that is based on inclusive and sustainable fundamentals. In terms of developing human capital, priority is given to enhancing the quality of education. Among the measures announced are the establishment of several funds to promote creativity and innovation, and the introduction of various tax incentives to encourage greater participation of the private sector in areas related to building talent and enhancing the quality of education. The Rural Transformation Programme was introduced to attract investment and thus create new employment opportunities in the rural areas. The programme also includes assisting small-scale rural entrepreneurs to reach a wider market to distribute their products.

Priority is also placed on the implementation of programmes to improve the socio-economic well-being of Malaysians, particularly those in the lower income groups. The Government has provided financial assistance programmes such as the cash assistance of RM500 to households

**Chart 4.5**

**Federal Government Fiscal Balance and Debt**




*p* Preliminary
*B* Budget

Source: Ministry of Finance

with monthly income of less than RM3,000 and introduced the SARA 1Malaysia scheme. Apart from improving the well being of the rakyat, these measures also act as a catalyst for growth as they will contribute towards supporting private consumption. Given the expectation of continued high global commodity prices and the impact on cost of living, a total amount of RM33.2 billion was allocated for various forms of subsidies, assistance and incentives. Incentives were provided for programmes aimed at increasing food production such as rice, meat, vegetable and fruits. In addition, several policy measures to stimulate home ownership were also announced, including the 1Malaysia People's Housing Scheme (PRIMA) introduced to develop affordable and quality housing for the middle-income group.

The Federal Government fiscal deficit is expected to narrow further from 5.0% in 2011 to 4.7% of GDP in 2012. Revenue collection is expected to improve to RM186.9 billion, supported by better tax administration and higher compliance in tax submission and collection. Total expenditure continues to remain supportive of growth with an allocation of RM181.6 billion for operating expenditure and RM49.2 billion for development expenditure. Development expenditure will be channeled for projects and programmes under the second rolling plan (RP2) of the 10MP including transformation initiatives under the NKRAs, NKEAs and SRIs. The Government will continue to finance the fiscal deficit from domestic sources, mainly through the issuances of Malaysian Government Securities (MGS) and Government Investment Issues (GII), given the high domestic savings and the ample liquidity in the financial system.

Moving forward, the Government continues to face the challenging task of striking a balance between fiscal consolidation and the need to support initiatives to transform the country into a high-income economy. In the medium-term, the Government will remain committed to fiscal consolidation. A successful implementation of the ETP and all other reform initiatives are expected to ensure sustainable growth which will enhance tax revenues, thus contributing to the efforts to strengthen the fiscal position of the Government.