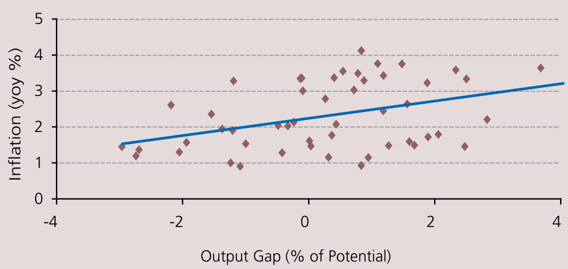
Potential Output of the Malaysian Economy

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

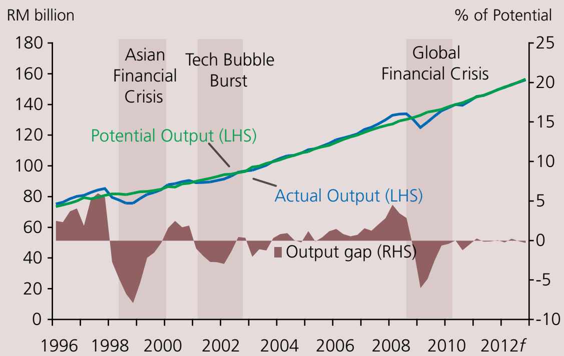


Note: Observations from 1Q 1995 to 3Q 2011, excluding periods with supply shocks

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

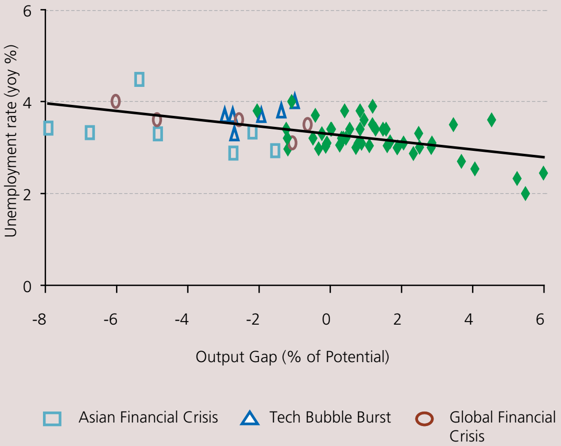
Since 1995, Malaysia has experienced periodic cycles of positive and negative output gaps. Of significance, Malaysia experienced three episodes of large negative output gaps, namely during the Asian Financial Crisis (AFC), the bursting of the tech bubble in 2001-2002 and the recent financial crisis in 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%.