2010

OUTLOOK AND POLICY IN 2011

INTERNATIONAL ECONOMIC OUTLOOK

As in 2010, the global economy is expected to experience a two-speed and uneven economic recovery in 2011 with the overall economic growth likely to be more moderate. The continued divergence in growth performance between the advanced economies and emerging market economies, reflects the continuing impact of the global financial crisis on the potential growth path for the former. These effects include structural problems related to high unemployment, weak fiscal positions and constrained credit conditions. To some extent, growth prospects in the advanced economies will be supported by recent policy stimulus in the US and Japan, underscoring the governments' concerns that growth in private sector demand may not be sufficiently strong to sustain economic activity. After experiencing above-trend growth in the previous year, the Asian economies are expected to continue to lead global growth although the momentum will moderate to a pace closer to their long-term averages as the base effect dissipates. While external demand for the region will improve at a slower pace in line with the moderation in the global economy, domestic economic activity in these economies will remain robust, underpinned by positive consumer and business sentiments, improving labour markets and favourable financing conditions.

An emerging feature of the global economy in the post-crisis period is that the global growth is increasingly dependent on the emerging economies. While the emerging economies account for about a third of global GDP, they have contributed more than two thirds of global growth in recent years (1990s: one-third), highlighting the growing importance of emerging economies as the new growth centres. In the recent period, changing growth dynamics have brought about new challenges to the emerging economies following the shift in global short-term capital flows from the advanced economies to the emerging market economies. This trend has been further accentuated by the series of quantitative easing measures in the advanced economies that have contributed to a surge in global liquidity. As the monetary policy normalisation or tightening in the emerging economies is expected to continue, it will contribute to the widening of interest rate differential between the advanced and the emerging economies. These large and persistent short-term capital inflows into emerging economies often also exert significant upward pressure on exchange rates and asset prices in these economies. At the same time, the tendency of these flows to reverse in response to global developments is also likely to create greater volatility in financial prices in the emerging economies. For the regional monetary authorities, the challenges in 2011 will revolve around how best to manage the capital flows while concurrently addressing the emerging inflationary pressures arising from high global commodity prices.

In the **US**, the prospects are for a continued expansion in economic activity, underpinned by a new round of fiscal policy stimulus, easy monetary conditions, and a gradual revival in private consumption. Private sector demand, particularly consumption, will be boosted by the implementation of a USD858 billion tax relief package (5.9% of GDP) announced in December 2010, which include a two-year extension of tax relief for all income levels, a one-year extension of unemployment benefits, and a one-year tax payroll holiday and the continuation of investment incentives. The expansionary fiscal policy would also be reinforced by the second round of quantitative easing involving the Fed's purchase of USD600 billion worth of Treasury bonds during the first half of 2011. In addition to the anticipated positive impact of these measures on private sector demand, the underlying private consumption is also expected to be supported by a gradual improvement in the job market, rising personal incomes, longer working hours and the higher equity prices that will contribute towards increasing the net worth of households.

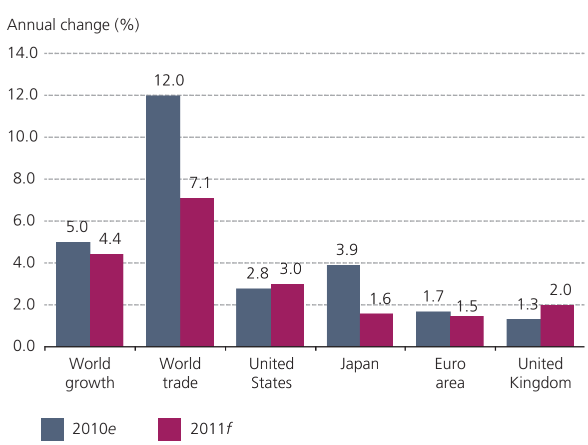
In the **euro area**, the economic growth is expected to continue albeit at an uneven and modest pace this year. While growth in the core economies such as Germany and France is projected to moderate amid a slower pace of improvement in external demand, robust private sector activity will likely sustain growth in these economies. In contrast, the growth prospects for the peripheral economies such as Greece and Ireland remain weak as domestic demand will be further impinged by fiscal austerity measures, high unemployment, fragile financial systems and tight credit conditions. Furthermore, the continued uncertainties surrounding the sovereign debt problems in the euro area will weigh on consumer and business sentiments, further restraining economic activity. In the **UK**, economic expansion is expected to remain modest as fiscal austerity measures weigh on domestic activity. The improvements in exports and industrial production are likely to continue, supported by a weak pound sterling. Amid an environment of rising inflationary pressures, private consumption is likely to be constrained by weak real income and job growth, tight credit conditions and low consumer confidence. For **Japan**, the export-dependent economy will continue to be supported by demand from the Asian region, particularly PR China. However, export growth is expected to slow during the year as the base effect dissipates and the impact of a strong yen takes effect. The fragile recovery in domestic demand will to some extent be supported by the ¥5 trillion stimulus package unveiled in November 2010, which includes job creation programmes, welfare spending and schemes to help small businesses and the construction sector. Nonetheless, domestic demand will be affected by continued deflation amid a strong yen.

The prospects of a gradual growth in the advanced economies coupled with a more moderate demand from the emerging economies are expected to slow the pace of expansion in **global trade** in 2011. Of significance, global trade will continue to be increasingly driven by the emerging economies, particularly Asia. In Asia, the changing global trade pattern will influence the global foreign investment pattern as multinational companies are likely to redirect resources to expand their operations rapidly in the fast growing economies. Intra-regional trade in Asia would remain strong, benefiting from the robust domestic demand in the region.

After an exceptionally strong recovery in the previous year, economic growth in the **Asian economies** is expected to return to a more normal pace in 2011. The expansion will be mainly driven by sustained strength of domestic demand while external demand is projected to register a slower pace of improvement in line with the moderation in the advanced economies. External demand may also be affected by the anticipated slower growth in the Chinese economy following a series of monetary and credit tightening measures introduced by the authorities to achieve a more sustainable overall growth momentum. Nevertheless, domestic demand will continue to be a key driver of growth in the region. Private consumption is expected to remain robust,

Chart 4.1

World Growth, World Trade and Growth in Major Advanced Economies (2010-2011)



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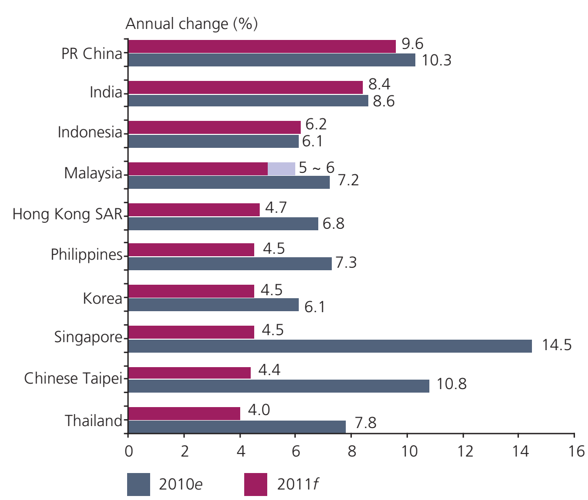
Source: International Monetary Fund and National Authorities

Chart 4.2

Regional Economies: Real GDP Growth



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Source: International Monetary Fund and National Authorities supported by buoyant consumer sentiments, better employment prospects, and favourable credit conditions. Large infrastructure development projects planned in several regional economies will also lend support to investment activities.

Global inflationary trends are expected to continue to diverge between the advanced and emerging economies. Underlying inflation is expected to remain subdued in the advanced economies, reflecting the economies' underutilised capacities and moderate demand conditions. Nevertheless, there is the risk that higher commodity prices will lead to higher headline inflation in these advanced economies. These inflationary pressures could be further exacerbated through the rising costs of imports resulting from higher inflation and appreciating currencies of key emerging market economies. For the emerging economies, inflationary pressures will remain a growing concern due to buoyant domestic demand, and the impact of rising global commodity prices. Commodity prices are expected to be on an upward trend, due to strong demand from emerging economies, adverse weather conditions and speculative activity in the commodity markets. In some economies, the appreciation of currencies has mitigated some of the inflationary pressures. Significant capital inflows into the emerging markets, however, may exert upward pressures on prices in the asset markets, thereby reinforcing the upside risk to the inflation outlook.

Despite improving global growth prospects, downside risks to growth remain. Growth in the advanced economies, particularly in the US and Japan, continue to be driven by policy stimulus amid heightened concerns over large fiscal deficits and increasing government debt of these economies. The lingering uncertainty regarding the sovereign debt problems in the euro area could have significant implications on the pace of fiscal expansion in the advanced economies, particularly in view of large refinancing needs of governments and the potential spikes in international borrowing costs. Notwithstanding the risk of early withdrawal of policy stimulus, the advanced economies continue to face persistent structural problems in the form of high unemployment, weak housing market and constrained credit conditions, highlighting the risk to the ability of private sector demand to drive overall growth.

Conversely, emerging economies are dealing with a different set of challenges to sustain their growth momentum. Given the continuing divergence in growth between the advanced and emerging economies amid ample global liquidity, significant capital inflows are expected to continue to flow to emerging economies. These large and volatile flows not only complicate the normalisation or tightening of monetary policy but also have the potential to create financial instability through the formation of price bubbles in the domestic asset markets. In addition, emerging economies are facing rising inflationary pressures associated with escalating commodity prices, resulting in the greater need to normalise monetary conditions, and in cases where domestic aggregate demand fuels inflationary pressures, to tighten their monetary stance. This could in turn attract more capital flows into these economies. Adding to the monetary policy uncertainty is the risk that rising food and fuel prices could erode the purchasing power of household incomes and cause a decline in discretionary spending, thereby affecting economic growth. The consequent monetary policy dilemma has encouraged a number of monetary authorities in emerging economies to rely on alternative policy tools such as macroprudential regulations, administrative measures and restrictions on capital inflows in order to manage the risks associated with these flows.

MALAYSIAN ECONOMY

Following the strong performance in 2010, the Malaysian economy is projected to grow at 5–6% in 2011, supported mainly by continued expansion in domestic demand. Whilst external demand is expected to moderate in 2011, the growth contribution of net exports would turn around to be positive amid a larger trade surplus on sustained commodity exports to the Asian region.

Domestic demand is expected to maintain a strong growth momentum, driven mainly by a robust expansion in private sector activity. Private consumption will be supported by favourable labour market conditions, higher disposable incomes and sustained consumer confidence. The employment situation is anticipated to improve, particularly with higher job creation in the domestic-oriented manufacturing and services sectors. The expectation for further increases in private sector salaries and continued high commodity prices will raise incomes of households. In addition, access to credit will also provide support to household spending in 2011. Private investment is expected to remain strong and contribute favourably to growth. This will be supported by capital spending by the domestic-oriented industries given the high levels of capacity utilisation and positive business confidence, as well as the implementation of key initiatives announced by the Government under the Economic Transformation Programme. Meanwhile, the public sector will remain supportive of growth, with higher capital spending projected in the second half of 2011. This is attributable mainly to the implementation of new projects and the acceleration of ongoing projects to promote private sector activity.

The Malaysian economy is projected to grow at 5 – 6% in 2011, supported mainly by continued expansion in domestic demand

All economic sectors are projected to expand firmly in 2011, supported mainly by the continued growth of domestic demand. The services and manufacturing sectors are expected to expand, albeit at a more moderate pace given the high statistical base of 2010. The services sector will remain the largest contributor to growth, driven by the domestic demand-oriented sub-sectors, particularly wholesale and retail trade, finance and insurance, and communication. The trade- and manufacturing-related sub-sectors, however, are expected to grow at a more moderate pace, in line with the expected moderation in external demand. A similar moderation in growth is also anticipated for the export-oriented industries in the manufacturing sector. In particular, the E&E cluster will experience a slower growth following the strong rebound in 2010. Nevertheless, growth in the domestic-oriented industries will continue to provide support to the manufacturing sector. In addition, growth in the primary sector is projected to strengthen, benefiting from the expected turnaround in industrial crop production amid high commodity prices, and higher natural gas output following the opening of two new gas fields. Further progress in on-going infrastructure projects and new projects due for implementation under the Economic Transformation Programme will provide the impetus for the construction sector.

Headline inflation is expected to average 2.5 – 3.5% in 2011, and will continue to be driven by supply factors. Global commodity prices is expected to rise on account of disruptions in supply due to adverse weather conditions, geopolitical developments, speculative activities and the strong demand from emerging economies. Domestically, while further adjustments to administered prices are expected in 2011, these adjustments are expected to be gradual. This will help to contain its overall impact on inflation. Meanwhile, the pressure on domestic prices from demand factors is expected to be modest.

On the external front, the larger trade surplus, together with the sustained services account surplus, is anticipated to contribute to a wider current account surplus (12.5% of GNI) in 2011. Gross exports are expected to expand at a more moderate pace, mainly on account of a high statistical base in 2010 and the slower growth in manufactured exports, in tandem with the projected moderation of global growth. Commodity exports, however, are expected to register robust growth, supported by higher prices and firm demand, particularly from the region. Meanwhile, growth in gross imports is projected to moderate significantly following a slowdown in the imports of intermediate goods, consistent with the more modest growth in manufactured exports. Consequently, a larger trade surplus will be recorded in 2011. The services account will continue to register a small surplus, driven by higher receipts from the travel account, while the income account deficit will be slightly smaller, due mainly to higher earnings by Malaysian companies investing abroad and lower repatriation of profits and dividends by foreign companies in Malaysia. For the financial account, gross inflows of foreign direct investment will likely increase further amid the favourable economic outlook, better corporate earnings and positive business confidence. Continued improvement in global FDI flows, together with the Government's

Potential Output of the Malaysian Economy

Potential output is the non-inflationary level of output that is consistent with the aggregate productive capacity of an economy. It provides an indication of the sustainable growth path of an economy based on available productive inputs, the level of technology and its overall efficiency. The growth in potential output is primarily determined by the expansion and non-inflationary utilisation of physical capital and the labour force, as well as total factor productivity (TFP) growth. TFP captures productivity increases arising from improvements in the utilisation of factor inputs.

Potential output of the Malaysian economy expanded by 4% in 2010, moderating from 5.3% and 4.2% in 2007 and 2008-2009 respectively. This is consistent with other country experiences[1], in which economic crises usually lead to lower potential output growth in the short term due to a slowdown in capital accumulation and the negative effects on labour. In most cases, TFP would also decline. In the case of the Malaysian economy, the initial slowdown in potential output growth was due mainly to slowing capital accumulation and TFP, while the subsequent moderation in potential output was primarily caused by slower growth in the labour force.

While potential output tends to be lower during recessions, actual output, however, usually witnesses a sharper decline, reflecting a relatively greater slowdown in overall demand vis-à-vis the productive capacity of the economy. This leads to the output gap[2] becoming negative, indicating spare capacity during a period of economic slowdown. As the economy recovers, the negative output gap gradually narrows. This was observed in 2010, in which the output gap of the Malaysian economy narrowed to -0.7% from -2.6% in 2009 as the economic recovery gathered strength.

Malaysia's output gap is projected to narrow further and turn slightly positive in 2011 given the sustained growth of the economy. Potential output growth is expected to return to its medium-term trend of about 5%, supported by a further expansion in the capital stock, the growing labour force and continued productivity improvements.

Table 1

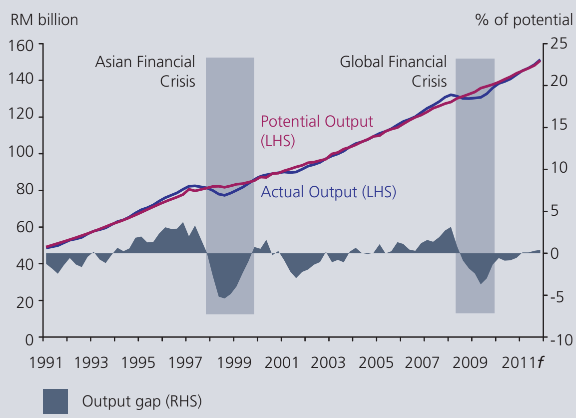
Actual Real GDP and Potential Output

Period	Actual Real GDP	Potential Output	Investment	Labour	Output Gap
	Annual change (%)				(% of potential output)
1993-1999	6.5	6.4	4.5	4.1	0.1
2000	8.9	4.8	25.7	4.4	0.5
2001	0.5	4.6	-2.1	1.5	-2.1
2002	5.4	4.1	0.6	1.9	-1.0
2003	5.8	5.9	2.8	3.6	-0.7
2004	6.8	5.4	3.6	1.0	0.2
2005	5.3	5.0	5.0	0.6	0.7
2006	5.8	5.7	7.5	2.1	0.8
2007	6.5	5.3	9.4	2.5	1.9
2008	4.7	4.2	0.7	1.3	0.3
2009	-1.7	4.2	-5.6	2.6	-2.6
2010e	7.2	4.0	9.4	2.5	-0.7

e Estimate

Chart 1

Actual and Potential GDP



f Forecast

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

[1] A good review of this can be found in Furceri, D. and A. Mourougane (2009), "The Effect of Financial Crises on Potential Output: New Empirical Evidence from OECD Countries", *OECD Economics Department Working Papers*, No. 699, OECD Publishing. doi: 10.1787/224126122024

[2] The output gap is the difference between the levels of actual and potential output and the gap is 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.

wide-ranging economic transformation projects, will support higher inflows of FDI into Malaysia. Direct investment abroad by Malaysian companies is anticipated to remain large as companies continue to seek new markets and business opportunities abroad.

While growth will be driven mainly by domestic demand in 2011, external demand will remain important given that the total trade in goods and services accounted for 176% of GDP in 2010. The growth projection of 5 – 6% is based on the expectation of moderate growth in the advanced economies and a return to more normal growth rates by the Asian economies. Nonetheless, there remains downside risks to global growth. Notwithstanding robust domestic demand, a rapid deterioration in external conditions could have significant adverse spill over effects on the overall economy through the investment and employment channels, whilst also affecting overall sentiments. Second, volatility in capital flows will continue to remain a policy challenge for the region, including Malaysia. In line with the regional economies, Malaysia has been receiving large inflows of portfolio investments since the second half of 2009. Malaysia has managed to effectively intermediate these flows given the strength and depth of the financial system and the wide range of monetary instruments available to the Central Bank. While this is currently the case, there needs to be vigilance on the potential risk of massive shifts in global liquidity flows that could overwhelm the financial markets in the emerging economies, including Malaysia. Going forward, significant volatility in two-way flows can be expected given the continued uncertainties in the international financial markets and the shifting global financial landscape. Third, higher-than-anticipated inflation would also present downside risks to the growth projection. Given the expectation for private consumption to contribute significantly to growth, sharper-than expected increases in food and fuel prices in particular, would pose a risk to the GDP growth momentum in 2011.

Domestic Demand Conditions

Domestic demand is projected to register a strong expansion of 6.7% in 2011, driven by robust private sector activity. In particular, private consumption is expected to continue to be a main contributor to growth supported mainly by the favourable labour market conditions, rising disposable income and sustained consumer confidence. Private investment will continue to be strong, especially in the second half of 2011, spurred by the favourable outlook for domestic-oriented industries and the overall positive business conditions. The public sector will remain supportive of growth. Of importance, public investment will be underpinned by the implementation of projects outlined in the Tenth Malaysia Plan (10MP) as well as higher capital spending by the NFPEs.

Strong expansion of domestic demand in 2011, driven by robust private sector activity

Private consumption will be the main contributor to domestic demand growth in 2011, with an expansion of 6.9%. The strong expansion in consumer spending is attributable to the favourable labour market conditions, higher disposable income and sustained consumer confidence. Amid a more moderate growth in external demand, gains in employment will be mainly supported by the continued strong expansion in domestic-oriented manufacturing and services sectors. The unemployment rate is projected to remain stable at 3.2% of the labour force in 2011. In addition to the improved employment situation, higher household incomes will also be underpinned by the expectation of further increases in private sector salaries by an average of 4.8% in 2011 and the continued high commodity prices, with the latter having a significant positive impact on the incomes of rural households.

Household spending will also be supported by continued access to credit. While the ratio of household debt to GDP was relatively high at 75.9% as at end-2010, the overall household balance sheet has remained sound. In particular, the ratio of debt to financial assets remained relatively unchanged at a level of 41.9% as at end-2010. Loan repayments across all types of household borrowings remained high, with the ratio of repayments to disbursements of household loans averaging at 85% in 2010

Table 4.1

Real GDP by Expenditure (2000=100)

	2010*p*	2011*f*	2010*p*	2011*f*
	Annual change (%)		Contribution to real GDP growth (percentage point)	
Domestic Demand[1]	**6.3**	**6.7**	**5.6**	**6.0**
Private sector expenditure	7.8	7.4	4.9	4.7
Consumption	6.6	6.9	3.6	3.7
Investment	13.8	9.7	1.4	1.0
Public sector expenditure	2.5	5.1	0.6	1.3
Consumption	0.1	7.2	0.0	1.0
Investment	5.5	2.7	0.6	0.3
Change in stocks			**4.9**	**-0.9**
Net exports of goods and services	**-24.2**	**2.3**	**-3.3**	**0.2**
Exports	9.8	2.7	10.5	3.0
Imports	14.7	2.8	13.8	2.8
Real Gross Domestic Product (GDP)	**7.2**	**5.0~6.0**	**7.2**	**5.0~6.0**

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

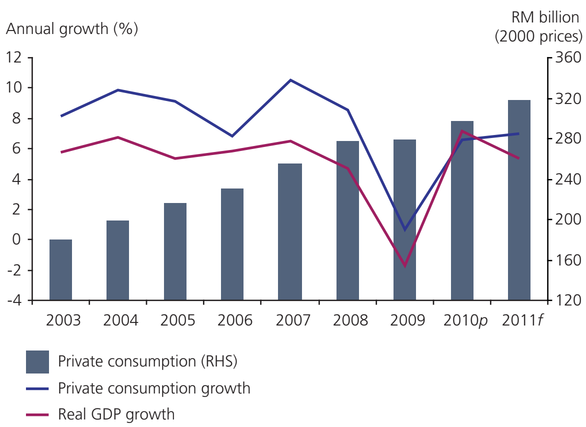
(2006-09: 87%). The non-performing loans ratio of the household sector continued to trend downwards, from 7.1% as at end-2006 to 2.3% as at end-2010. With the overall household balance sheet remaining sound and debt repayment capacity continuing to be intact at the aggregate level, financing conditions will continue to be supportive of household consumption in the near term.

Private investment is expected to register a growth of 9.7% in 2011, supported by capital spending in all economic sectors, particularly in the services, manufacturing and mining sectors. High investment activity will be sustained by positive business confidence, in line with the strengthening of domestic demand. Important initiatives announced by the Government in 2010 are also expected to weigh favourably on business confidence and outlook. In addition, the overall improvement in global FDI and consequently, higher FDI into Malaysia, will also contribute positively towards private investment growth.

In the services sector, capital spending is projected to increase further, especially among domestic-oriented firms, in tandem with higher domestic consumption as well as ongoing initiatives to improve the provision of existing services. Communication service providers are expected to enhance and expand the present broadband infrastructure and networks, driven by the anticipation of higher demand for broadband services. In the wholesale and retail trade industry, firms have indicated expansion plans through the establishment of new outlets. The financial services industry is also expected to undertake higher

Chart 4.3

Real GDP and Private Consumption



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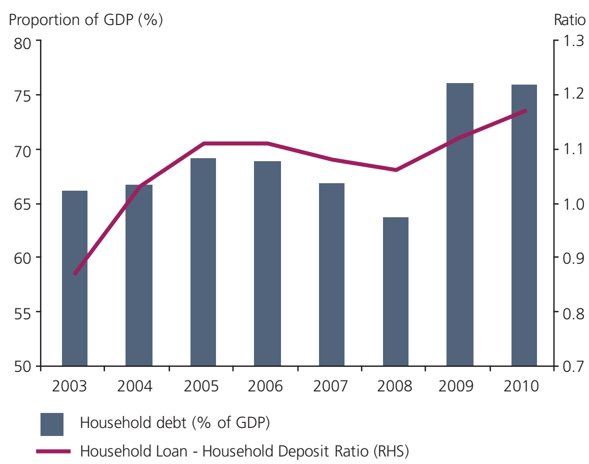
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 4.4

Household Debt Indicators



Source: Bank Negara Malaysia

capital expenditure, following the establishment of new operations by foreign licensees and business expansion by current institutions.

In addition, investment activities in the transportation and storage sector will be supported by the development of oil and gas-related storage and terminal facilities, as well as expansion in port infrastructure and air transportation, given the expectation of higher passenger demand and additional air routes.

Capital spending in the manufacturing sector is expected to remain resilient, as reflected by the higher level of approved investment projects in the sector in 2010. Higher investments were approved for the E&E, petroleum products and basic metal products segments. In particular, investment spending in the E&E segment is attributable to foreign manufacturers in the new growth area of renewable energy as well as hard disk drive components. Furthermore, high capacity utilisation rates will continue to promote capacity expansion activity by manufacturing firms in general, especially in the domestic-oriented industries.

Investment in other sectors is expected to register further improvements. In the mining sector, investment is anticipated to increase, supported by the expansion and upgrading of existing production facilities, development expenditure for new discoveries in the past few years, as well as exploration activities in the deepwater and marginal oil fields. In addition, new tax incentives that have improved project viability in the oil and gas industry will provide further impetus to exploration activity in the mining sector. In the construction sector, capital spending is also expected to increase on account of the implementation of new and ongoing infrastructure projects.

Public sector expenditure will reinforce the expansion of domestic demand in 2011, particularly, with higher public capital spending projected in the second half of the year. This is attributable mainly to the implementation of new projects and acceleration of ongoing projects to promote private sector activity.

Public consumption is projected to increase by 7.2% in 2011, due to higher expenditure on emoluments and supplies and services. Of importance, the expansion in supplies and services is in line with Government's new commitment under the 10MP to ensure the effective delivery of quality public services and proper maintenance of public assets.

Public investment is expected to remain supportive of growth in 2011 with an expansion of 2.7%. This is on account of higher Government capital spending driven by new projects planned under the ETP and 10MP as well as ongoing 9MP programmes. In the economics sector, a large proportion of development expenditure will be utilised to provide basic rural infrastructure, improve connectivity in urban public transport as well as to fund water supply and electrification projects. Substantial provision is also made to trade and industry sub-sector to promote higher domestic private investment activity. Education and healthcare sub-sectors are given priority in the social services sector to support the development of a skilled workforce and to enhance provision of affordable healthcare.

Investment by the non-financial public enterprises (NFPE) is also expected to rise, providing further support to public investment in 2011. Capital expenditure in the oil and gas sector will be the main contributor, largely on account of upstream activities for the development of marginal fields and deepwater explorations. Additionally, capital expenditure in the transport and utility sub-sectors will be focused on rail and airport expansion and the construction of new power plants respectively. Expenditure on the high speed broadband project is expected to make up the bulk of the investment in the communication sub-sector.

Sectoral Outlook

All economic sectors are projected to expand in 2011, to be supported mainly by the continued growth of domestic economic activity. From the high base of 2010, the services and manufacturing sectors are expected to expand at a more moderate pace in 2011, underpinned by the favourable growth in the domestic-dependent sub-sectors. Trade-related services and export-oriented manufacturing industries, however, will record slower growth, in line with the expected moderation in external demand. Growth in the primary sector is projected to strengthen, benefiting from the expected turnaround in the production of industrial crops amid high commodity prices, as well as higher output of natural gas. Further progress of on-going infrastructure projects and new projects due for implementation under the Economic Transformation Programme (ETP) will provide the impetus for the construction sector.

Steady expansion across all economic sectors in 2011, to be supported mainly by domestic demand

The **services** sector will remain the largest contributor to growth in 2011, with a projected growth rate of 5.9% (2010: 6.8%). All sub-sectors are expected to expand further, to be driven by sub-sectors that are dependent on domestic demand such as wholesale and retail trade, finance and insurance, and communication. Reflecting the slower external demand, the trade- and manufacturing-related sub-sectors are expected to grow at a more moderate pace.

The wholesale and retail trade sub-sector is expected to continue to register a robust performance, supported by higher private consumption amid favourable labour market conditions as well as the expansion of new retail stores and hypermarkets. The sub-sector is also expected to benefit from higher tourist arrivals, particularly from the high-income countries.

Table 4.2

Real GDP by Sector (2000=100)

	2010*p*	2011*f*
	Annual change (%)	
Agriculture	1.7	3.4
Mining & quarrying	0.2	2.0
Manufacturing	11.4	5.7
Construction	5.2	5.4
Services	6.8	5.9
Real Gross Domestic Product (GDP)	**7.2**	**5.0 ~ 6.0**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

Growth in the finance and insurance sub-sector is expected to remain strong, driven mainly by the finance segment, as bank lending would continue to grow in tandem with higher consumer spending and business expansion activity. The anticipated increase in capital market activity would contribute favourably to the fee-based income of banking institutions. In the insurance segment, growth is expected to emanate mainly from the life segment, in line with rising disposable income and improved public awareness on financial planning.

Similarly, outlook for the communication sub-sector is expected to remain robust. The telecommunication industry would be driven by the non-voice segment, as demand for mobile data is expected to benefit from the rising popularity and affordability of smartphones amid a proliferation of new devices and intensified competition among service providers. Growth will be further supported by wider roll-out of high-speed broadband (HSBB), wireless broadband services and continuous initiatives by the Government to promote the adoption of broadband services in the rural areas.

Growth in the trade-related sub-sectors is projected to be more moderate, reflective of the slower growth outlook of external demand. In the transport and storage sub-sector, the expected moderation in cargo-related services would be partly offset by the resilience in the passenger-related segment, in line with projected higher tourist arrivals and increased domestic tourism activities. Competitive airfares in the low-cost segment and aggressive expansion by domestic airlines would provide further support to growth.

The **manufacturing** sector is projected to grow at a more modest pace in 2011 given the high base in 2010. Slower expansion is expected in the export-oriented industries, in tandem with an environment of more moderate external demand. In particular, the E&E cluster will experience a slower growth after the sharp rebound in 2010. The anticipated slower growth will be in line with the trend in world semiconductor sales, but the cluster will continue to be supported by demand for products in the consumer and communications segments, particularly from within the region. In addition, implementation of investments in new areas, such as solar cell and light-emitting diodes (LED) manufacturing, is expected to benefit the cluster. Growth in the primary-related cluster will continue to be driven by global demand for chemical and off-estate products, particularly from within the region. In addition, the rubber products industry is expected to perform favourably, supported by the demand for gloves as well as automotive-related rubber products.

Growth in the domestic-oriented industries will continue to provide support to the manufacturing sector. The consumer-related cluster is expected to move in tandem with the continued growth of private consumption, particularly in the food- and transport-related industries. The construction-related cluster will be supported by the expected improvement in construction activity during the year. In addition, infrastructure projects in the region will continue to benefit the production of steel products.

The **agriculture** sector is expected to record a higher growth of 3.4% in 2011 due to a turnaround in the production of industrial crops. Palm oil output is projected to recover in the second half of the year in line with an expected normalisation of weather conditions during the period. Similarly, high rubber prices amid low global stocks and strong global demand will continue to encourage tapping activity during the year. Growth of the agriculture sector will also be supported by the sustained high production of food crops in line with the Government's efforts to invigorate the sector, including measures to promote high value-added agriculture activities.

The **mining** sector is projected to expand by 2% reflecting higher natural gas output with the opening of two new gas fields in offshore Terengganu and Sarawak. However, crude oil production is expected to decline further due to scheduled maintenance and the implementation of the Reservoir Management Plan to sustain long-term production.

Growth in the **construction** sector is expected to improve to 5.4% in 2011 (2010: 5.2%), supported by expansion across all sub-sectors. In particular, the civil engineering sub-sector is expected to benefit from the implementation of projects under various Government initiatives. Apart from further progress on on-going projects such as the construction of the Second Penang Bridge, double-track rail networks, LCCT, and oil and gas terminal in Sabah, the civil engineering sub-sector will also be supported by the implementation of new major projects such as the construction of power plants in Terengganu and Sabah as well as the Klang Valley LRT extension. The non-residential sub-sector will be driven by the on-going construction of purpose-built office and retail space and the public sector expenditure on the building and upgrading of schools, hospitals and clinics, while the continued growth in housing demand and favourable financing environment will support growth in the residential sub-sector.

Balance of Payments

On the external front, the current account surplus is expected to increase to RM100.7 billion or 12.5% of GNI in 2011. Higher commodity prices and firm domestic demand will continue to drive growth in gross exports and imports respectively, contributing to a bigger trade surplus. The services account is expected to register a small surplus on account of higher receipts from the travel account. On the financial account, foreign direct investment inflows are likely to increase further while direct investment abroad by Malaysian companies is projected to remain large as the economic outlook, particularly in the region, remains favourable.

Gross exports are expected to expand by 5.4%, a moderation from the high base in the previous year. Manufactured exports are projected to register more modest growth as E&E exports are expected to expand at a moderate pace in tandem with the slower growth of the global electronics industry. Given their relative strength in the computer segment, Malaysian producers are likely to reap limited benefits from the upgrade in the global electronics, driven by smartphones, tablets and other consumer electronic gadgets. Nonetheless, continued regional demand for audio-visuals, such as flat panel televisions and Blu-ray disc players/recorders will continue to support the sustained growth in exports of electrical products. In the non-E&E product segment, the increase in exports is expected to be driven by sustained regional demand for resource-based products, particularly chemicals, petroleum and rubber and higher commodity prices. Commodity exports are expected to continue to register robust growth, supported by higher prices and firm demand for commodities, particularly from the region.

Growth in gross imports is projected to moderate to 5.7% as imports of intermediate goods slow down in line with the more modest growth in manufactured exports. Nonetheless, both consumption and capital imports are expected to grow at sustained rates, supported by the resilient expansion of domestic private consumption and the strengthening of private investment.

The services account is expected to continue registering a small surplus of RM0.2 billion, driven by higher receipts from the travel account as tourist arrivals, particularly from the region are projected to increase amidst active promotional campaigns and increased access through the low-cost airline carriers. In the income account, the deficit is likely to be slightly smaller due mainly to higher earnings by Malaysian companies investing abroad and lower repatriation of profits and dividends by MNCs operating in Malaysia. The former is expected to be supported by stronger commodity prices and favourable economic outlook in the region, while the latter will be affected by the expected moderation in exports.

On the financial account, gross inflows of foreign direct investment (FDI) are expected to increase further in 2011 given the favourable economic outlook, better corporate earnings and rising business confidence. Further improvements in global FDI flows and the Government's wide-ranging economic transformation projects will lend additional support to inflows of FDI into Malaysia. The higher FDI is expected to remain broad based with flows being channelled mainly into the manufacturing, services as well as the oil and gas sectors. In the manufacturing sector, FDI will be in the form of both reinvestment by MNCs for capacity expansion and new investments in new growth areas and emerging technologies. Data from MIDA on approved foreign investment in the manufacturing sector shows that the bulk of the investments will be in industries such as E&E, petroleum products including petrochemicals, basic metal products as well as non-metallic mineral products that are likely to generate high value-added, utilise high technology and create higher skills. FDI in the

Table 4.3

Balance of Payments

	2010*p*	2011*f*
	RM billion	
Goods	136.6	144.3
Trade account	110.2	114.6
Exports (% annual change)	*15.6*	*5.4*
Imports (% annual change)	*21.7*	*5.7*
Services	0.9	0.2
Balance on goods and services	**137.4**	**144.6**
Income	-25.2	-23.7
Current transfers	-21.7	-20.2
Balance on current account	**90.5**	**100.7**
% of GNI	***12.2***	***12.5***
Capital account	-0.2	
Financial account	-21.9	
Balance on capital and financial accounts	**-22.1**	
Errors and omissions	-71.0	
of which:		
Foreign exchange revaluation loss	*-32.6*	
Overall balance	**-2.6**	

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

Table 4.4

External Trade

	2010*p*		2011*f*	
	RM billion	Annual change (%)	RM billion	Annual change (%)
Gross exports	**639.4**	**15.6**	**674.2**	**5.4**
of which:				
Manufactured	486.7	13.0	507.9	4.4
Agriculture	69.9	30.8	78.5	12.4
Minerals	72.8	23.4	78.6	8.0
Gross imports	**529.2**	**21.7**	**559.6**	**5.7**
of which:				
Capital goods	76.4	16.2	84.3	10.3
Intermediate goods	363.2	22.1	382.4	5.3
Consumption goods	34.6	10.1	37.5	8.4
Trade balance	**110.2**	**-6.9**	**114.6**	**4.0**

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

oil and gas sector will continue to be supported by rising prices and increasing demand as well as increased government incentives to the sector. Following further liberalisation of the services sector in 2009, FDI in the services sector is likely to flow into both the financial and non-financial services sub-sectors. Although the amount of foreign investments in the service sector could be relatively small when compared to the investments in the manufacturing sector, these investments are expected to generate higher employment opportunities in the managerial, professional and technical levels, in line with Government's objective of creating a quality workforce and higher income economy.

Direct investment abroad (DIA) by Malaysian companies is anticipated to remain large in 2011 as companies continue to seek new markets and business opportunities abroad. The large DIA is expected to be channelled mainly into the services, oil and gas as well as manufacturing sectors, focusing on regional and other emerging economies. While most of the DIA continues to be led by Government-linked companies, the private sector is also expected to continue to invest abroad by venturing into areas of their expertise and seeking opportunities in existing and new regions and markets. This will continue to benefit Malaysian companies through greater competitiveness arising from having better market access and greater economies of scale, thus, leading to a greater potential for higher repatriation of profits and dividends from investments abroad over the medium term.

Labour Market Outlook

Labour market conditions are expected to remain positive in 2011, with the continued expansion in employment stemming primarily from growth in the domestic-oriented sectors. Job creation will be led by the services sector, particularly in the distributive trade, finance and insurance, and communication sub-sectors. In the manufacturing sector, despite a more moderate growth in the export-oriented industries, gains in employment will be sustained, supported by the expansion in the consumer-related and construction-related clusters. The unemployment rate is projected to remain at 3.2% of the labour force in 2011. The positive employment outlook will underpin expectations of higher wages and income growth of households, supporting sentiments and private consumption activity during the year. Based on a survey conducted by Bank Negara Malaysia, most firms in the manufacturing, non-financial services and construction sectors are optimistic on the outlook for employment and expect further increases in salaries. The overall average salary increment in the private sector is expected to be 4.8% (2010: 4.5%), with an average increment of 3.1% and 5.5% in the manufacturing and non-manufacturing sectors, respectively.

Inflation Outlook

Headline inflation is expected to average 2.5 – 3.5% in 2011. Inflation will continue to be driven by supply factors, especially from higher global commodity prices and further adjustments to domestic administered prices. Demand pressures will be modest in line with the gradual improvements in domestic demand. The wider forecast range reflects greater uncertainty in the external and domestic environment, particularly on global food and energy prices, and the timing and magnitude of adjustments to administered prices by the Government.

Headline inflation is expected to increase, driven mainly by supply factors

On the supply side, global commodity prices are expected to increase on account of disruptions in supply due to adverse weather conditions, geopolitical developments, speculative activities and strong demand from emerging economies. For crude oil, the IMF WEO update in January 2011 projected prices to increase to an average of USD90 per barrel in 2011 (USD79.5 per barrel in 2010). The IMF projection was similar to the survey of analysts' forecasts by Bloomberg in early February 2011, which showed a median projection of close to USD90 per barrel. As demand from advanced economies is expected to remain low throughout 2011, the underlying demand for crude oil is mainly from emerging economies. Supply of crude oil, on the other hand, is expected to remain adequate for the year. In February 2011, the International Energy Agency (IEA) estimated the spare production capacity of the Organisation of the Petroleum Exporting Countries (OPEC) to amount to 4.7 million barrels per day, compared to only 2.3 million barrels per day during the peak of the oil price shock in 2008.

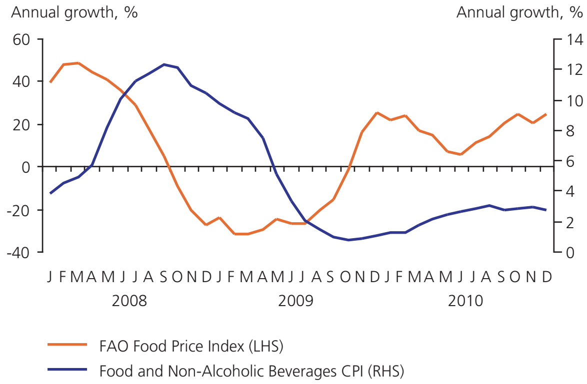
Global food prices in 2011 are expected to remain high as demand pressures remain elevated amidst robust economic growth and rising incomes, especially in emerging market economies such as China, India and Indonesia. Continued disruptions in supply from seasonal factors and adverse weather conditions would exert further upward pressure on prices. The November 2010 edition of the Food and Agriculture Organisation of the United Nation's (FAO[1]) Food Outlook anticipated that the recent rapid pace of increase in food prices will be temporary given that supplies of major food crops are expected to be more than adequate when reserves increase by the second half of 2011. For Malaysia, the impact of higher global food prices in 2010 would also be felt in 2011 as movements in global food prices are transmitted to domestic prices with a lag given that many of the food items in the CPI basket are administered by the Government.

Speculative demand for commodities could also intensify, as investors continue to search for higher returns amidst excess liquidity and low interest rates globally. This could drive up global commodities prices and increase their volatility. Better than expected growth in the advanced economies could also contribute to drive up prices further. Another source of uncertainty is the evolution of geopolitical developments in the Middle East and North Africa region, which could exert further upward pressures on global prices of commodities, especially crude oil.

On the whole, average inflation among Malaysia's key import source countries is expected to be higher in 2011. Prevailing slack capacity and subdued demand pressures from low consumption spending in advanced economies would, to some extent, soften inflationary pressures from these countries. However, strong domestic demand will likely see sustained price pressures in emerging market economies. This in turn would result in higher costs for imported inputs and consumer

Chart 4.5

Food and Non-Alcoholic Beverages CPI and FAO Food Price Index



Source: Department of Statistics Malaysia and FAO

goods from these economies, and exert additional pressure on domestic inflation.

Domestically, as part of the Government subsidy rationalisation programme, a series of adjustments to the prices of administered items is expected for 2011. The impact on overall inflation will depend on the timing and magnitude of these adjustments. However, the price adjustments are expected to be gradual, and this will help to contain the overall impact on inflation.

The pressure on domestic prices from demand factors is expected to be moderate and in line with the steady increase in domestic demand. Increases in wages, improvements in consumer and business sentiments, steady increase in private consumption, and the favourable monetary conditions will continue to support the consumption and investment activities of households and businesses. Consequently, the output gap will be narrowing, albeit at a measured pace, and could turn slightly positive in 2011 (*See white box on Potential Output of the Malaysian Economy*). While this could create upward pressure on prices, the extent of such price pressures are expected to be modest. Moreover, the overall price increases will also be balanced by the potential negative developments in the external sector.

A factor that has attenuated the upside pressure on prices is the appreciation of the ringgit's nominal effective exchange rate since 2010. Thus far, the appreciation has helped to soften the transmission of external price pressures to domestic inflation. However, excessive

[1] The FAO Food Price Index consists of a weighted average of 55 food commodities considered by FAO specialists as representing the international prices of food.

strengthening of the exchange rate can also lead to a misalignment of the exchange rate against economic fundamentals which would in turn have negative implications on the overall economy. Gradual and orderly adjustments in the exchange rate is important to allow for the corresponding adjustments to take place in the real economy.

MONETARY POLICY

Monetary policy in 2011 is expected to operate in an increasingly complex environment characterised by continued uneven global economic growth, high global liquidity, volatile capital flows, and elevated commodity prices. Compared to 2010, when monetary policy focused on preventing the risk of financial imbalances and sustaining economic growth, the upside risks to inflation have become increasingly visible in 2011. Monetary policy will thus continue to support the sustainable growth of the economy while managing the risks to inflation. Emphasis will also be placed on ensuring that monetary policy remains appropriate to avoid the build-up of financial imbalances.

Monetary policy will support sustainable growth of the economy while managing the risks to inflation

The Malaysian economy is expected to grow at 5 – 6% in 2011. The projected growth rates are consistent with the fundamentals of the Malaysian economy. Given the weaker external demand, domestic private demand will have an important role in driving economic growth. Both private consumption and investment are expected to maintain their growth momentum supported by an accommodative policy environment. However, a risk to this outlook is the increase in the inflation rate.

Inflation is expected to trend higher in 2011, driven mainly by commodity and energy prices which have increased sharply due to multiple external factors such as changes in global demand, adverse weather conditions, geopolitical developments, and, to a certain extent, speculative activity driven by ample global liquidity and the financialisation of the commodity markets. This will lead to higher domestic prices. While there is little that monetary policy can do about these "first-round" effects, vigilance needs to be accorded to assess whether such price pressures become entrenched and are reinforced by domestic factors. Under these circumstances, the degree of monetary accommodation may need to be adjusted to ensure that inflation does not increase to levels that will undermine economic activity and erode economic welfare.

Rising inflation may also result in real interest rates becoming negative. Apart from the importance of providing positive real returns on savings to depositors, low real interest rates could encourage excessive risk taking behaviour, the disintermediation of funds from safe assets, like deposits, into more risky investments in a search for higher yields, and potentially spur the build-up of excessive leverage. Such developments create imbalances that could undermine the long-term growth potential of the economy when they unwind, usually in a disorderly manner. In this regard, the stance of monetary policy should remain appropriate to avoid the build-up of financial imbalances. To the extent that such excessive risk taking behaviour or asset price escalations occur within specific segments of the market, other targeted instruments such as macro-prudential measures can be deployed to address such concerns.

Capital flows would pose another challenge to the management of monetary policy in 2011. Large shifts in global liquidity have resulted in significant capital flows into emerging economies, and in particular, into the Asian region. Due to their large size, these inflows have the potential to create sharp movements in the exchange rate. Such sharp movements within a short period of time would be detrimental to economic activity. Decision making by businesses in an environment of such uncertainty about the future pricing of goods and services as well as investments becomes highly challenging. Excessive flows can also lead to a sharp escalation in domestic asset prices, which, when these flows reverse, can then collapse, which will in turn create negative wealth effects. Such flows need careful monitoring and management.

Compared to previous episodes, Malaysia now has greater latitude in managing capital flows. First, the more diversified and developed financial system has helped to intermediate the capital flows. Second, the managed float regime has accorded the necessary flexibility for the exchange rate to adjust to changing conditions. Third, the Bank's ability to manage domestic liquidity has also improved significantly, supported by a wider range of instruments for its monetary operations and augmented by better surveillance and information systems. Fourth, the stronger fundamentals and a healthy level of international reserves also mean that the Bank has the buffers to preserve macroeconomic and financial stability if capital flows were to reverse. Fifth, closer cooperation among central banks in the region also enhances the Bank's ability to be pre-emptive in managing the risks emanating from capital flows.

FISCAL POLICY

Fiscal policy in 2011 is geared towards transforming the nation into a developed and high-income economy by continuing to focus on measures that facilitate and enable a higher level of private sector activity. These measures are guided by the strategies outlined in the 10th Malaysia Plan (10MP), 6 National Key Result Areas (NKRAs) and the 12 National Key Economic Areas (NKEAs). In particular, the 2011 Budget focuses on measures to reinvigorate private investment and boost domestic demand.

In facilitating private sector activities, the 2011 Budget outlined, among others, three key initiatives. First, the establishment of public-private partnership initiatives as a key mechanism to implement Government development projects through private sector funding. Second, the identification of several high-impact development projects to further attract private sector investment, such as Kuala Lumpur International Financial District (KLIFD) and Mass Rapid Transit (MRT). Third, the implementation of measures to enhance the sources of private sector financing, including measures to revitalise the capital market and venture capital industry. There are also measures to enhance efficient public delivery system in order to facilitate transactions between the private sector and Government agencies.

Acknowledging that human capital development is key to transforming Malaysia into a high-income economy, the Government is committed to developing and effectively managing human capital. This is achieved through measures to attract, motivate and retain talent, intensifying training programs and strengthening the quality of education at all levels. Among the announced measures were the introduction of the Industrial

Table 4.5

Federal Government Finance

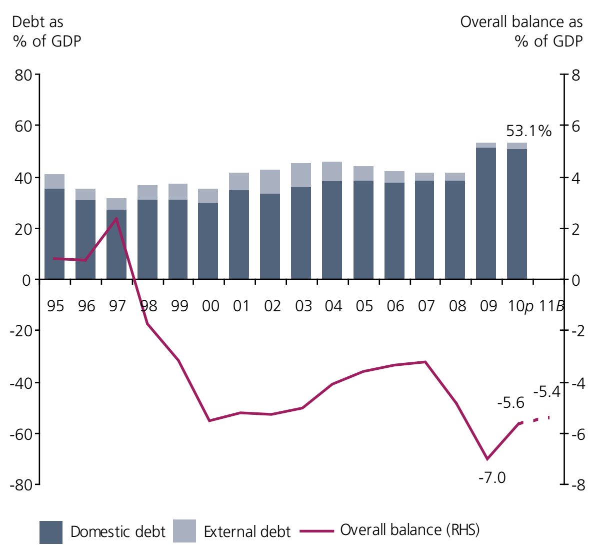
	RM billion		% change	
	2010*p*	2011*B*	2010*p*	2011*B*
Revenue	159.7	165.8	0.6	3.9
Total expenditure	204.4	212.0	-1.0	3.7
Operating expenditure	*151.6*	*162.8*	*-3.5*	*7.4*
Gross development expenditure	*52.8*	*49.2*	*6.6*	*-6.8*
Loan recoveries	1.5	0.7		
Overall balance	**-43.3**	**-45.5**		
% of GDP	**-5.6**	**-5.4**		
Sources of financing:				
Net domestic borrowing	36.5	-		
Net external borrowing	3.7	-		
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

Chart 4.6

Federal Government Fiscal Balance and Debt



p Preliminary
B Budget

Source: Ministry of Finance

Skills Enhancement Programme and 1Malaysia Training Programme. The Government will also establish a National Wage Consultation Council as the main platform for wage determination to ensure fair wages that commensurate with productivity. In promoting inclusive and equitable economic growth, the Government has also accorded importance to efforts in enhancing the welfare of Malaysians, particularly those from the disadvantaged groups. Hence, budgetary allocations continue to be directed towards providing resources to eradicate hardcore and urban poverty, assist the poor and vulnerable groups by increasing home ownership, enhancing the social safety net and expanding public health facilities.

For 2011, the Federal Government is expected to record a lower fiscal deficit of 5.4% of GDP (2010: 5.6% of GDP). Fiscal expenditure during the year is projected to be higher by 3.7% at RM212 billion (2010: RM204.4 billion) due to the Government reform initiatives and projects under the 9th and 10th Malaysia Plan. Nevertheless, the rising expenditure will be contained as the Government gradually reduces its direct role in the economy while encouraging the private sector to be the main driver of growth. Meanwhile, revenue collection is expected to be higher in 2011 on account of sustained economic performance and higher commodity prices. An increase in the service tax rate from 5% to 6%, as well as other measures related to the enhancement of the tax system, will also increase revenue collection. In terms of financing, the Government will continue to tap the domestic market,taking advantage of the low borrowing cost and ample liquidity.

In the medium term, the Federal Government fiscal deficit is expected to narrow further, consistent with the Government's commitment to a phased consolidation over the next five years, as outlined in the 10MP. Measures to transform the nation into a developed and high-income economy are expected to enhance future growth of the economy, thus providing support for the Government to strengthen its finances. Going forward, the challenge for fiscal policy centres on further consolidation of the fiscal deficit and maintaining a sustainable debt path, while playing a prudent facilitative role in the economy.