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Outlook and Policy

Outlook and Policy

INTERNATIONAL ECONOMIC OUTLOOK IN 2008

While moderation is expected in the developed economies in 2008, the growth momentum is expected to be sustained in Asia and the other emerging economies. The growth outlook would be dependent on the length and depth of the US slowdown, and the extent of the impact from financial market turbulence. Inflation is expected to remain elevated following sustained high oil and food prices. While these developments will have an impact on the Asian regional economies, the growth in the region will continue to be supported by strong domestic demand and the high growth momentum in the large economies in the region. Overall, the expectation is for global growth to moderate, reflecting a less favourable environment in the major industrial economies and continued uncertainty in the global financial markets.

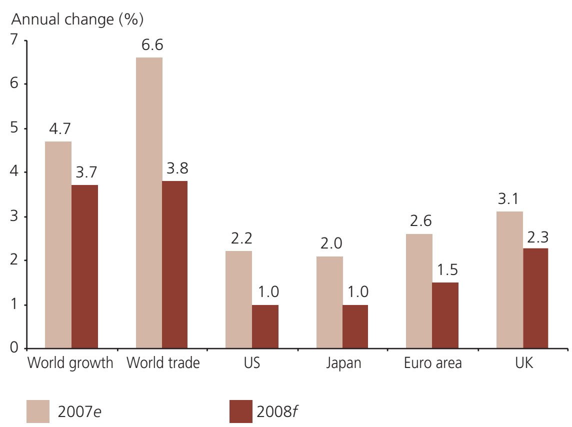
While moderation in growth is expected in the developed economies in 2008, growth is expected to remain strong in Asia and other emerging economies. However, the global growth outlook would be dependent on the length and depth of the US slowdown and the extent of the impact of the financial market turbulence

In the **US**, the prospects are for further weakening in the economy, with several indicators showing moderation across industrial activities, employment and consumption. The housing market correction is expected to continue as housing supply outstrips demand, while at the same time, household spending is likely to be affected by weakening labour market conditions. However, net exports are expected to lend some support with the weakness in the US dollar and the continued demand arising from the relatively stronger growth in the rest of the world. The risk to the outlook of growth of the US economy has increased significantly arising from uncertainties on the extent of the impact of the problems in the credit market and on the ability of the financial system to intermediate credit and its spillover effects on the broader economy. Constrained balance sheets and increasing risk aversion have already led to higher risk premiums and significant tightening of credit standards beyond housing loans, which would adversely impact the economy.

Nevertheless, policy responses that have been put in place are, however, expected to provide some support to the economy. These include aggressive easing by the Fed and the fiscal stimulus package announced. Possible resolution mechanisms are also being discussed to address the strains in the financial system.

Reflecting a further slowing of the US economy as well as some domestic developments in the euro economies, growth in the **euro area** is expected to expand at a slower pace. Slower export demand especially from the US and softer investment activity in construction amidst a broader slowdown in housing markets in several European economies are the major factors behind the more moderate prospects for growth in the

Chart 4.1
World Growth, World Trade and Growth in Major Industrial Countries (2007-2008)



e Estimate
f Forecast
Source: International Monetary Fund and Bank Negara Malaysia

euro area. However, consumption activity in the region will be supported by rising wages and lower unemployment rates. Furthermore, increasing integration of Central and Eastern Europe economies into the European Union would support growth amidst expansion of intra-EU trade. In addition to strong domestic demand and the presence of skilled labour amidst relatively low wages, ongoing economic restructuring and reform in the emerging European economies have attracted Western European companies to set up businesses and expand production chains in these economies.

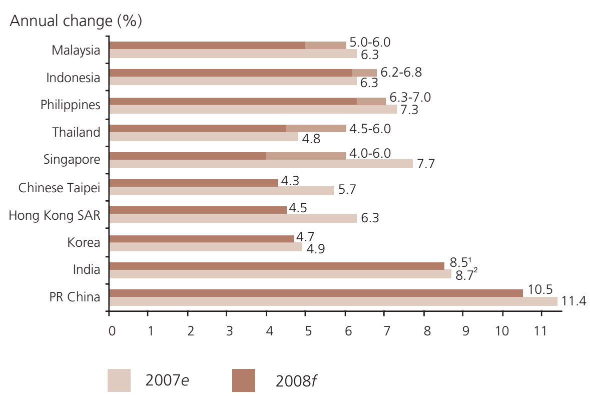
In contrast to the developments in the major developed economies, the growth momentum within the **Asian region** is expected to be relatively sustained in 2008. The slowdown in the US is likely to be mitigated by strong growth in PR China and India along with a vibrant economic expansion in commodity-exporting countries.

Prospects for **PR China**'s economy remains positive with continued high growth expected, despite a slight moderation in external demand and the effect of monetary tightening. Investment spending is likely to remain the main driver of growth for China, given the large need for infrastructure development and industrial upgrading. Private consumption is also expected to contribute more to economic activity as growth is gradually rebalanced from being investment-driven to being consumption-driven. Rising household income growth and living standards would support higher consumer activity as government efforts to redistribute growth to less developed regions take broader effect. However, export growth is likely to moderate in 2008 amidst slowing external demand and government efforts to reduce its current account surplus. There is, however, a rising concern on domestic inflation, attributed mainly to rising food prices and strong demand pressures.

India, which is increasingly becoming a driver of growth in the region, is also expected to register robust economic performance in 2008 supported mainly by investment and industrial expansion. Growth is also likely to be underpinned by strong consumer demand. Growth in the **Latin America** and the **Middle East** regions is also expected to remain strong, supported by strong domestic consumption benefiting from the high commodity and energy prices.

Meanwhile, the other **Asian regional economies** can be expected to experience some moderation in growth, reflecting the slowdown in external demand. However, the overall growth momentum is projected to be supported by strong domestic demand. Commodity prices are expected to remain relatively high, adding to the impetus for growth in several of the commodity-producing economies. Trends in the global semiconductor industry also suggest that a sustained albeit modest recovery can be expected as consumer electronics demand typically strengthens in a year coinciding with the Olympics. This would support electronics exports in several regional economies which are involved in this segment. Meanwhile, domestic demand is expected to play a central role in cushioning the impact of the moderation in external demand. Higher consumption activity is expected to remain supported by rising income levels and firm labour market conditions as seen in the generally low unemployment rates across the region. Implementation of infrastructure projects across the region is adding support to investment activity. In addition, flexibility in fiscal policy is expected as several regional economies have improved their fiscal positions over a number of years, while monetary policy remains accommodative for several of the regional economies. The substantial monetary easing undertaken in the Philippines, Thailand and Indonesia in 2007 would further stimulate growth in 2008.

Chart 4.2
Regional Countries: Real GDP Growth



e Estimate
f Forecast
1 Fiscal year 2007/2008
2 Fiscal year 2006/2007
Source: National authorities

In 2008, global and regional **inflation** is expected to remain elevated based on pass-through effects from higher commodity prices in the second half of 2007 and the expectation of continued high oil and food prices. Oil prices are expected to continue to be subject to pressures from sustained demand growth, supply constraints and potential supply-side shocks. While a significant softening of global growth may lead to some correction in commodity prices from the recent peak levels, underlying trends suggest that prices would remain elevated. Prices could also remain supported in the longer term with the emergence of commodities as a growing asset class for diversification and enhancing returns by fund managers. Therefore, inflationary pressures may persist while the risks to growth have increased. Against this backdrop, monetary policy actions are thus expected to vary based on country-specific conditions and the balance of risks to inflation and growth.

Notwithstanding these trends, several **risks** have increased the uncertainty on the global and regional outlook. In the event of a more protracted period of significantly below-trend growth of the US economy, accompanied by a sharper slowdown in other industrialised economies, there would be a larger impact on growth across the region as trade linkages to the developed economies remain strong. A further risk is the more severe impact from disruptions in the functioning of the financial markets and the financial intermediation process. Further adverse credit-constraining developments in the financial sector in several of the major economies could precipitate more widespread financial market volatility and damage business and consumer sentiment, while potentially prolonging the downturn in economic activity as more segments of financing activity are affected. However, in the event that there are larger than expected corrections in commodity prices, commodity-producing economies would be affected.

MALAYSIAN ECONOMY IN 2008

The outlook for the Malaysian economy in 2008 remains favourable. As a small and highly open economy, the outlook will be influenced by the current high degree of uncertainties in the global economic and financial environment, including the problems associated with the international credit markets and financial institutions. These uncertainties will have some impact on Malaysia, mainly through the trade and financial markets linkages.

The Malaysian economy is expected to remain on a steady growth path, expanding by 5 - 6% in 2008, supported by resilient domestic demand

The resilience of the Malaysian economy to weather a slowdown in the global economy has, however, strengthened over the years, due to a number of factors. First is the emergence of domestic demand as a key driver of growth. The strong economic growth of 6.3% in 2007 was achieved due to the robust expansion in domestic activities despite a moderation in external demand. Second, Malaysia's export markets are increasingly diversified, with almost 54% of total exports to the Asian (exclude Japan) economies (2001: 46.2%). Meanwhile, the share of Malaysia's exports to US has declined to 15.6% in 2007 from 20.2% in 2001. Thus, while global growth is expected to moderate in 2008 due mainly to slower growth in the US, and to a lesser extent, in Europe and Japan, the outlook for strong economic growth in the Asian region and other emerging economies would support the export sector. Third, as a commodity producer, Malaysia will continue to benefit from high prices of crude oil, palm oil and rubber. In addition, the strong base in the commodity sector would further strengthen the linkages with down-stream activities, including the resource-based industries which will continue to benefit from the robust domestic demand as well as demand from the regional economies.

Against this backdrop, the Malaysian economy is projected to expand by 5 – 6% in 2008. Domestic demand is expected to remain resilient, providing strong support to the economy. While consumer and business sentiments could be affected by the prospects of a sharper than expected global economic slowdown and uncertainties in the international financial markets, the major underlying factors supporting domestic private sector activities are expected to remain generally intact in 2008. Private consumption will be supported by the steady growth in income, firm labour market conditions, high commodity prices as well as a conducive financing environment. The diversified and high level of approved domestic and foreign direct investments for a number of years now, particularly in the manufacturing, services, and oil and gas sectors, indicate that private investment activity will remain robust in 2008. In addition, private investment will also benefit from measures implemented to further improve business environment, including the reduction in corporate tax rate, as well as intensification of implementation of projects under the Ninth Malaysia Plan (9MP) and the economic corridors. The public sector will continue to remain supportive of growth in facilitating the efficient implementation of these projects.

All sectors are projected to record strong growth in 2008, with the exception of the manufacturing sector for which growth is projected to moderate further to 1.8% (2007: 3.1%) in tandem with the weakness in external demand. The services sector will be supported by the resilient private consumption and a robust tourism sector, while the implementation of the 9MP projects as well as investment in the oil and gas sector would underpin the growth momentum in the construction sector. The agriculture and mining sectors will register stronger growth following expected higher production of palm oil and rubber, as well as crude oil respectively.

Global inflation, which is to remain elevated based on the expectation of continued high commodity and non-commodity prices, is expected to exert upward pressure on the domestic inflation. In particular, these developments are expected to have an impact on domestic food prices. However, the ability of producers to pass on cost increases into consumer prices would depend on the strength of consumption demand and to what extent consumers substitute from the more expensive goods into cheaper ones. In addition, softer global growth in 2008 could also contain the rise in global commodity prices. On balance, the average headline inflation rate for 2008 is expected to be in the range of 2.5 – 3%.

On the external front, the weaker demand for manufactured exports, particularly for the E&E products, will be partly offset by the relatively strong growth in exports of commodities and non-E&E manufactured products. The services account will continue to record a surplus supported by the higher tourism receipts expected in conjunction with the extension of Visit Malaysia Year campaign to August 2008. The surplus in the current account, therefore, is projected to remain high, albeit lower at 14.4% of GNI. The financial account is expected to remain favourable, supported mainly by the continued inflows of foreign direct investment. In addition, continued retention by the multinational corporations (MNCs) of a significant amount of their profits in Malaysia and new inflows of equity capital for acquisition of domestic businesses by foreign investors are also expected for 2008.

There is great uncertainty on the depth and length of the slowdown in the US economy, and its spillover effects on other developed economies as well as emerging market economies. The projection of economic growth of 5 – 6% for Malaysia in 2008 has, therefore, taken this into account and is based on the assumption that the US economy moderates to significantly below-trend growth during the year, based on the most recent available data. The projection also assumes that the policy measures undertaken by the US authorities would result in a less protracted slowdown in the US and thus, in the other major economies.

The downside risks remain, however, particularly on the possibilities of a more protracted and sharper slowdown in the US, accompanied by a substantial moderation of growth in other developed economies that would result in a more widespread spillover of heightened risk aversion by the international financial markets on the global economy. In this scenario, the domestic economy may be impacted to grow at a slower pace, nearer the lower end of the forecast range. Malaysia's strong underlying fundamentals, however, places the economy in a position of strength to meet any unexpected global developments. The authorities also have a range of policy options to respond in a timely manner as required to counter the downside risks should they emerge and thereby, promote domestic economic growth.

Domestic Demand Conditions

The major underlying factors that supported robust domestic demand in 2007 are expected to remain intact in 2008. The private sector will continue to drive domestic demand, particularly from consumption spending, while the public sector remains supportive of growth with the on-going

Table 4.1
Real GDP by Expenditure (2000=100)

	2007*p*	2008*f*	2007*p*	2008*f*
	Annual change (%)		Contribution to real GDP growth (percentage point)	
Domestic demand[1]	**10.5**	**5.6**	**8.8**	**4.9**
Private sector expenditure	11.8	6.5	7.1	4.1
Consumption	*11.7*	*6.5*	*5.7*	*3.3*
Investment	*12.3*	*6.3*	*1.4*	*0.8*
Public sector expenditure	7.2	3.5	1.7	0.8
Consumption	*6.4*	*6.0*	*0.8*	*0.8*
Investment	*8.0*	*0.5*	*0.9*	*0.1*
Change in stocks			**-2.6**	**1.8**
Net exports of goods and services	**0.9**	**-8.4**	**0.1**	**-1.3**
Exports	3.7	0.9	4.6	1.1
Imports	4.1	2.3	4.5	2.4
Real Gross Domestic Product (GDP)	**6.3**	**5 - 6**	**6.3**	**5 - 6**

Note: Figures may not necessarily add up due to rounding.
[1] Excluding stocks.
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

implementation of the 9MP projects. However, a sharper than expected slowdown in the US, moderating growth in the other developed economies and heightened uncertainties, could have an impact on domestic demand. Against this scenario, aggregate domestic demand would moderate to 5.6% in 2008.

Factors supporting robust domestic demand to remain intact in 2008, despite the less conducive external environment

Growth in **private consumption** expenditure is expected to moderate but remain high at 6.5% in 2008. Household spending will continue to be supported by the steady increase in disposable income and favourable employment prospects as the domestic labour market conditions are expected to remain firm during the year. Labour demand from most economic sectors would continue to be strong, especially from the services sectors which are typically labour-intensive. The manufacturing sector, however, is expected to record more moderate recruitment activities. Meanwhile, the implementation of the 9MP projects and various corridor projects would lead to higher new job creations across various job levels and industries, especially in construction; construction-related industries; and professional services. Consequently, the unemployment rate would remain low at 3.2% of labour force. In view of the firm labour market conditions, the overall private sector salary growth is projected to be sustained at 5.8%.

The positive impact of the upward salary adjustments for civil servants in July 2007 will continue into 2008, particularly in the first half-year. In addition, households in the rural area would continue to enjoy favourable income growth as commodity prices are expected to remain high in 2008. Other factors supporting private consumption growth include the relaxation of policy allowing for monthly withdrawal to cover mortgage repayments from the EPF Account 2 as well as the conducive financing environment with low and stable interest rates. Households' balance sheet is also expected to remain strong as reflected by stable debt levels and low non-performing loans for consumption credit and credit cards. In addition, the promotional events related to the Visit Malaysia Year 2007, which has been extended to August 2008, would continue to support domestic tourism and consumption activities.

Chart 4.3
Real GDP and Private Consumption

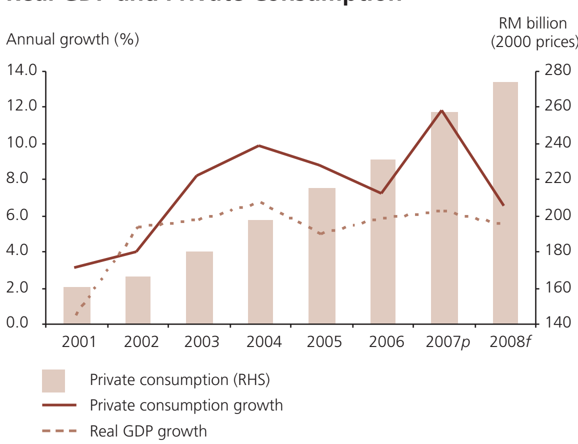


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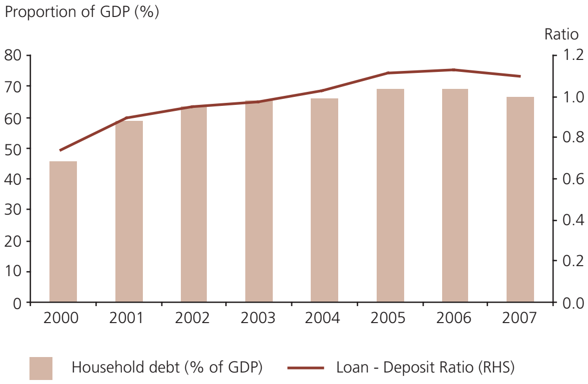
Chart 4.4
Household Debt Indicators



Private investment is expected to be sustained in 2008, albeit at a slower rate of expansion. The increased investment activity will be supported by the generally favourable business climate and pro-business initiatives implemented by the Government. In particular, the phased reduction in corporate income tax to 26% in 2008 and 25% in 2009 is expected to provide stimulus for private sector capital spending activities. In addition, implementation of projects under the 9MP and in the various economic corridor development plans are expected to be accelerated during the year, and would reinforce the private sector investment activities, especially in the construction sector. Capital spending in the manufacturing sector is expected to remain resilient, based on the high level of approved investment recorded in the recent two years. In 2006 – 2007, total investment approved by the Ministry of International Trade and Industry in the manufacturing sector amounted to RM105.9 billion. Meanwhile, continued fleet expansion programmes by the shipping and air services providers would be the main driver of capital spending in the services sector. In the mining sector, investment in the upstream oil and gas sector is expected to accelerate due to strong upstream exploration activities, particularly in the deepwater areas.

In terms of public sector expenditure, **public consumption** is expected to increase by 6% in 2008, mainly on account of higher expenditures on emoluments and supplies and services. Expenditure on supplies and services is expected to contribute to improve support facilities and public sector delivery system.

For **public investment** in 2008, Federal Government spending will remain high and mainly channelled towards improving the economic and social services sectors of the economy. The allocation for development expenditure in the economic sector is mainly for the implementation of infrastructure projects under the 9MP and the various economic corridors as well as to improve the agriculture sector. In the social services sector, the bulk of expenditure will be utilised for the provision of essential services such as education and health and development of affordable houses, emphasising improvements in human resource development and basic amenities. Capital outlays from the non-financial public enterprises will be higher in 2008, mainly in the oil and gas, and services sectors. Capital spending by PETRONAS in the upstream oil and gas sector is expected to increase due to intensification of exploration and production activities. Meanwhile, higher investment is expected for the enhancement of the communications network and provision of utility services.

Sectoral Outlook

On the production side, all economic sectors, except manufacturing, are projected to record high growth rates. Growth will continue to be driven by the services sector, with further impetus emanating from the construction, mining and agriculture sectors. The growth in the services sector will be underpinned by resilient private consumption and robust tourism activity, while public and private sector-driven investments would support the growth momentum in the construction sector. The manufacturing sector is, however, expected to record a more moderate expansion in an environment of weak external demand, especially from the United States. The robust domestic demand and growth of regional economies will, however, support growth in the domestic-oriented and selected resource-based industries and thus, partly mitigate the downside risks from the projected slowdown in the electronics and electrical (E&E) industry. In addition, higher production of crude oil as well as positive supply factors, such as recovery in the palm oil's yield cycle and improved weather conditions for rubber, will support growth in the mining and agriculture sectors respectively.

Table 4.2
Real GDP by Sector (2000=100)

	2007*p*	2008*f*
	Annual change (%)	
Agriculture	2.2	3.4
Mining & quarrying	3.2	6.0
Manufacturing	3.1	1.8
Construction	4.6	5.5
Services	9.7	7.7
Real Gross Domestic Product (GDP)	**6.3**	**5 - 6**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

The **services sector** is expected to sustain its strong growth momentum, expanding by 7.7%, contributing 4.1 percentage points to the overall GDP growth. As a result, the share of the services sector to GDP is expected to increase to 54.5% (2007: 53.4%).The strong growth in the sector will be supported by private consumption and tourism activity during the year, as well as the impetus from new growth areas. Activities in the new growth areas, such as Islamic finance, telecommunications, IT services, shared services and outsourcing (SSO) and professional services, are expected to gain further momentum during the year.

The services sector will remain the key driver of growth in 2008, and reinforced by higher growth in the construction and commodities sectors

The finance and insurance sub-sector would benefit from the anticipated sustained growth in bank lending and fee-based activity, in line with the expansion in domestic economic activity. Demand for financing is expected to be supported by healthy financial positions of households and businesses as well as the low interest rate environment. Growth would be further enhanced by the development in Islamic finance, with the entry of new Islamic banks and expected strong activity in the Islamic capital markets following the further implementation of initiatives to promote Malaysia as an International Islamic Financial Centre. The insurance segment, meanwhile, is expected to be supported by the expected recovery in motor insurance in tandem with higher car sales as well as demand for investment-linked and other savings-related insurance products for education and medical purposes.

The real estate and business services sub-sector is projected to continue its strong growth momentum. Increased property transactions in response to incentives announced in 2007, as well as new incentives that came into effect in 2008, including the withdrawal of EPF funds to repay monthly housing loan installments and the 50% stamp duty waiver for residential properties below RM250,000, should support real estate activity. The business services segment is projected to be enhanced by growth in IT services, as well as professional services following higher activities in the construction, and oil and gas sectors, as well as increased SSO activity.

The outlook for the transport and storage sub-sector remains favourable, led by the passenger transport segment. Liberalisation of the Kuala Lumpur-Singapore air route and commencement of new rail services in the Ipoh-Rawang route following the completion of the double-tracking project are positive factors that would attract more people to travel. The communication sub-sector is likely to be supported by the roll-out of new technologies such as the WiMax technology and mobile network portability, and innovations by new market entrants such as the mobile virtual network operators.

The final services segment is expected to continue on a firm expansion path in line with trends in private consumption. Of significance, the automotive segment is likely to see an improvement following the stabilisation in the second-hand car market, launching of new models and the upward salary adjustments for civil service. In addition, tourism activity is expected to intensify, with the Government aiming to achieve 22.5 million tourist arrivals during the year. As a result, this would support the wholesale and retail trade as well as the accommodation and restaurant sub-sectors.

The **manufacturing sector** is expected to record a modest growth of 1.8% (2007: 3.1%) due to the expected weak performance of the export oriented-industries in an environment of projected moderation of global economic growth. In particular, the E&E industry is expected to weaken further in view of the more sluggish US growth. Weaknesses in the US household and corporate sectors could adversely affect the computers and parts segment of the E&E industry, given that a large share of these products is exported to the US. Nevertheless, the impact is expected to be softened by sustained growth in the semiconductor segment led by demand emanating from the Asia-Pacific region. The Beijing Olympics 2008 as well as the expansion in mobile penetration in emerging markets are anticipated to generate strong demand for semiconductors.

In addition, the non-E&E industries, particularly domestic-oriented and selected resource-based industries that export mainly to the region, are expected to perform favourably during the year. Industries related to the construction sector, including fabricated metal are likely to see an improved performance supported by higher construction activity, while the transport equipment industry is expected to turn around to register a positive growth in tandem with the pick-up in sales of new motor vehicles during the year. Off-estate processing activity should strengthen following the recovery in production of palm oil and rubber. Meanwhile, growth in the chemicals and chemical products sector may be constrained by the rising raw material prices.

In the **agriculture sector**, growth is expected to strengthen to 3.4%, supported by the recovery in output of major industrial crops, namely palm oil and rubber. Amidst the biological yield up-cycle of palm trees, palm oil output is projected to trend higher to 16.25 million tonnes supported by the recovery in yields. Similarly, output of rubber is expected to record a positive growth assuming normal weather conditions would support both yields and tapping activities. The projected high prices are also expected to stimulate tapping activity during the year, especially among the smallholders. Growth in the agriculture sector is also likely to emanate from activity related to food crops, such as livestock and fisheries, due to improved rearing methods and expansion in deep-sea fishing.

The **mining sector** would continue to lend further support to economic growth, expanding by 6%. Production of crude oil (including condensates) is expected to increase by 7.2% to an average of 743,000 barrels per day, supported by the acceleration in output from the Kikeh deepwater oil field in Sabah. Output of natural gas is also expected to rise to fulfill demand from Korea and Japan, Malaysia's major LNG importers.

Prospects are for the **construction sector** to expand by 5.5%, led mainly by higher activity in the civil engineering sub-sector. The sub-sector is expected to benefit from activity related to implementation of projects under the 9MP as well as in the oil and gas sector. Growth would also be supported by the increased activity in the non-residential and residential sub-sectors. The former would be supported by demand for office space, particularly in the Klang Valley, while the latter is expected to benefit from the measures taken by the Government in 2007 to spur the residential sub-sector.

Balance of Payments

On the external front, in tandem with the slowdown in the global economy, both exports and imports are expected to record slower growth of 1.8% and 1.4% respectively in 2008. Nevertheless, the current account surplus is expected to remain high, at 14.4% of GNI. The large surplus in the **current account** will be supported mainly by a sustained high trade balance underpinned by strong exports of commodities and non-E&E products, and further reinforced by a continued surplus in the services account due to higher tourism receipts. Similarly, the financial account is expected to remain favourable, supported mainly by continued inflows of foreign direct investment (FDI).

The current account surplus is expected to be supported by a large trade balance and a surplus in the services account. The financial account will be underpinned by continued inflows of foreign direct investment

In tandem with the weaker external conditions, gross exports are expected to record a modest growth of 1.8%, due mainly to lower demand for manufactured exports, particularly E&E products. However, the relatively strong growth in exports of commodities, supported by higher prices of palm oil and crude oil, and the high demand for non-E&E products particularly from the Asian region, are expected to partly offset the impact.

Table 4.3
Balance of Payments

	2007*e*	2008*f*
	RM billion	
Goods	128.1	131.1
Trade account	100.3	104.2
Exports (% annual change)	*2.7*	*1.8*
Imports (% annual change)	*5.0*	*1.4*
Services	1.0	1.0
Balance on goods and services	**129.1**	**132.1**
Income	-13.7	-16.1
Current transfers	-16.1	-17.7
Balance on current account	**99.3**	**98.3**
% of GNI	**15.8**	**14.4**
Capital account	-0.1	
Financial account	-37.0	
Balance on capital and financial accounts	**-37.1**	
Errors and omissions	-16.9	
of which:		
Foreign exchange revaluation loss	*-5.6*	
Overall balance	**45.3**	

Note: Numbers may not necessarily add up due to rounding
e Estimate
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Manufactured exports are expected to decline by 1.6%, reflecting further softening in demand for E&E products, which is affected by the weakness in the US economy. The impact would be felt mainly in exports of computer and parts. However, sustained growth in semiconductor exports, led by demand from the Asia-Pacific region, is expected to partially offset the impact. Manufacturing exports will also be supported by growth in non-E&E exports including selected resource-based and metal products which are mainly to the region. Halal products are also expected to gain further momentum into the Middle-East market during the year.

Exports of **agricultural commodities** are expected to remain favourable, expanding by 23.7% in 2008, led mainly by higher receipts of palm oil and rubber. The growth in palm oil earnings is expected to be supported by higher prices, as well as a recovery in export volume. Similarly, rubber exports are expected to be lifted by higher prices and increase in export volume in line with the rise in rubber production and continued demand from the major importing countries.

Growth in **mineral exports** is expected to be higher at 10.3% (2007: 7.5%), reflecting expansion in both crude oil and LNG. The increase in crude oil exports would be driven by higher export volume in line with the increased production from the Kikeh field as well as high prices. LNG exports would be supported by continued demand from the major importing countries.

Growth in **gross imports** is expected to emanate from continued expansion in imports of capital and consumption goods. Capital imports are expected to strengthen (8.5%) in line with capacity expansion in the services, oil and gas and manufacturing sectors. Deliveries of new ships and aircraft to meet the firm demand for commodity exports and expansion in intra-regional travel respectively will lead to higher capital imports in the services industry. Continued development of new oil and gas fields and related infrastructure will also result in higher capital imports. Imports of consumption goods will be supported by growth in private consumption. In line with weaker performance of E&E sector, imports of intermediate goods (which constitute 69% of total imports) are expected to decline.

In 2008, the **services account** is expected to record another year of surplus, supported mainly by increased tourism receipts due to higher tourist arrivals following the extension of the Visit Malaysia Year campaign until end-August 2008. Tourist arrivals are expected to increase to 22.5 million visitors (2007: 21 million) thereby contributing towards a larger travel surplus. In addition to tourists from ASEAN countries,

Table 4.4
External Trade

	2007*p*		2008*f*	
	RM billion	Annual change (%)	RM billion	Annual change (%)
Gross exports	**605.2**	**2.7**	**616.2**	**1.8**
of which:				
Manufacturing	474.7	0.3	467.2	-1.6
Agriculture	52.4	24.4	64.8	23.7
Minerals	61.1	7.5	67.4	10.3
Gross imports	**504.8**	**5.0**	**512.0**	**1.4**
of which:				
Capital goods	69.9	7.2	75.9	8.5
Intermediate goods	358.8	6.9	355.5	-0.9
Consumption goods	28.9	3.6	29.9	3.3
Trade balance	**100.3**		**104.2**	

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia visitors from India, PR China and the Middle East markets are envisaged to increase further. The continued expansion in the SSO and ICT industries is expected to contribute to higher earnings from exports of computer and information services. Meanwhile, implementation of 9MP projects and the economic corridor developments as well as increased activities in the oil and gas sector would lead to increase in the demand for imported services, particularly the construction and professional services. Payments to foreign service providers in the areas related to communication and multimedia services are also expected to increase following rising demand for transmission services.

The **income account** deficit is projected to be at 2.4% of GNI. The deficit is attributable mainly to sustained large profits and dividends accruing to foreign multinationals (MNCs) from their investment in Malaysia, particularly in the oil and gas, services and manufacturing sectors. Meanwhile, profits and dividends accruing to Malaysian companies investing abroad are expected to remain high, mainly from the oil and gas, services, agriculture and utilities sectors.

The **financial account** is expected to be supported mainly by continued inflows of foreign funds for long-term investment. **Foreign direct investment** (FDI) is expected to emanate mainly from retained earnings of existing MNCs operating in Malaysia and new inflows of equity capital for acquisition of domestic businesses by foreign investors. The implementation of the new economic corridors is also expected to attract new inflows of FDI. FDI in the *manufacturing sector* is projected to remain sizeable, following the higher levels of foreign manufacturing projects approved by the Ministry of International Trade and Industry (MITI) in 2006 and 2007 (RM20.2 billion and RM33.4 billion respectively). The bulk of the approved projects is in high value-added E&E; petroleum products including petrolchemicals; basic metal products; paper and printing as well as chemicals and chemical products industries.

Foreign direct investment in the *services sector* will reflect mainly foreign investment in the finance and insurance; and real estate and business services sub-sectors following the progressive liberalisation and rapid development in the financial sector, particularly Islamic finance, as well as establishment of the SSO operations and MSC-status information technology companies in Malaysia by MNCs. Foreign participation in the wholesale and retail trade; and accommodation and restaurant sub-sectors will be in line with the continued expansion in the tourism sector. The focus on key development areas such as education, healthcare, logistics and tourism-related activity in the economic corridors are also likely to spur new inflows of FDI into the services sector. Given the sustained high energy prices and continued upstream production activities, FDI in the *oil and gas sector* is anticipated to remain large.

Meanwhile, **direct investment abroad** by established Malaysian companies is expected to be mainly via acquisition of substantial interest in businesses abroad, aimed at broadening market base and tapping into new opportunities as well as positioning themselves as regional and global players. These investments are projected to be broad based, with the bulk of the outflows channelled into the *services sector*, specifically the finance and insurance; real estate and business services; wholesale and retail trade; accommodation and restaurant; as well as utilities sub-sectors. Meanwhile, investment in the *oil and gas* and *construction sectors*, are expected to continue in view of the projected strong global demand for energy as well as fast paced infrastructure development in the region and Middle East.

Notwithstanding this, the expected global economic slowdown and increased uncertainty in the global financial markets may have some impact on the outlook for FDI flows and direct investment abroad by Malaysian companies.

Inflation Outlook for 2008

Headline inflation is expected to average 2.5 – 3% in 2008 (2007: 2%) reflecting the passthrough effects of global inflation, as well as continued strength of domestic demand. Despite the expected deceleration in global economic growth, favourable domestic demand conditions are expected to sustain overall economic activity at reasonably high levels, albeit below potential productive capacity. Consumption demand for goods and services by households is expected to be supported by expectations of stable employment conditions and positive growth in private sector wages. The salary adjustment in the public sector, higher income for rural communities due to the continued high commodity prices and the implementation of a withdrawal scheme from the Employees Provident Fund (EPF) for housing loan repayment, would all lend support to domestic consumption. The expected growth in private investment activity, the implementation of the Ninth Malaysia Plan and the new economic growth corridors will further augment domestic demand in 2008.

The period of high uncertainty surrounding global growth and inflation prospects that was evident from the second half of 2007 is expected to continue in 2008. As a small and highly open economy, Malaysia is not insulated from external price pressures or macroeconomic shocks. There are incipient signs that global price developments, especially the strong rise in the prices of commodities and higher inflation in Malaysia's major trading partners, have begun to exert upward pressure on domestic prices. The imported price component of the CPI recorded an upward trend, from increasing at 0.3% per annum in June 2007 to 1.5% per annum in December 2007. External price pressures are expected to continue to have a significant influence on domestic price developments in 2008.

There also remains considerable uncertainty with regard to global commodity prices, particularly for crude oil and food commodities. Global crude oil prices have remained elevated, staying within the USD90 - 100 per barrel range in the January - February 2008 period. Such developments are expected, as in the past, to have repercussion on global prices, both at the producer and the consumer level. Increased fuel costs have already contributed to higher freight charges and fares in the shipping and airline industries. Although domestic fuel prices are partly subsidised by the Government, the extent of high global crude oil prices feeding through the supply chain of other imported inputs and ultimately into consumer prices needs to be closely monitored.

Meanwhile, world food prices are also subject to both cyclical and structural developments. Data from the February 2008 edition of The Food and Agriculture Organisation of the United Nation's (FAO) Crop Prospect and Food Situation indicated that the ratio of global supply (existing stock and new production) of cereal, comprising of wheat, rice and coarse grains, relative to global utilization is on the decline, falling from 1.24 in the year 2005/06 to 1.20 in 2006/07, and to 1.19 in 2007/08. These developments reflect, in part, global supply constraints amidst strong demand from rising consumption, as well as new sources of demand, such as for the production of bio-fuels. This could have implications on feedstock costs, leading to higher meat, poultry and milk prices for consumers. Amid tight supply conditions, production disruptions arising from adverse weather conditions could also prolong the elevated and volatile food prices.

To some extent, the presence of administered prices and Government subsidies on imported food items could mitigate or delay the pass-through into domestic food prices. For food items that are not under any type of price controls, the non-food items, or intermediate goods such as animal feed, the pass-through would depend on the prevailing demand conditions, the elasticity of demand for that particular product, as well as the business strategies of the producers or distributors. The ability of the producers to pass on cost increases to consumer prices would depend greatly on the strength of consumption demand. It will also depend on the extent to which consumers substitute from more expensive goods into cheaper goods. Competition and fear of losing market share could act as a strong deterrent to indiscriminate price increases.

There is also further added uncertainty to the inflation outlook in terms of the potential for stronger wage demand by the private sector to affect a broader rise in the general price level. Private sector wages are expected to increase as demand for labor remains strong. At this stage, however, there is little evidence that labour costs will rise at a faster pace in 2008 than previously. As in the past, the steady stream of foreign skilled and unskilled workers is expected to augment the domestic work force to balance the demand for labor and hence attenuate wage pressures. In 2007, the number of migrant workers and expatriates employed in Malaysia increased significantly by 9.4% and 5.7% respectively (2006: 3% and -1.3%). Furthermore, the wage increases have generally been commensurate with improvements in labor productivity, in which case, the increase in unit labour cost could be relatively small and would not add substantially to inflation.

A factor counterbalancing the upside risks to price pressures is the weaker global economic outlook, which could lead to lower global commodity prices and hence, lower global inflation. The projections are for growth

Table 4.5
Average growth of salary increases for executives in the private sector

	2007	2008*f*
Hay Group	6.5	6.4
Tower Perrins	5.6	5.8
FMM	5.6	5.9
MEF	6.2	5.7
Watson Wyatt	5.6	5.6
Average	**5.9**	**5.9**

f Forecast

of the global economy to moderate to 3.7% this year (2007: 4.7%), with the less favourable environment in the advanced economies and continued uncertainty in the global financial markets. This may contain further increases in global commodity prices.

MONETARY POLICY IN 2008

In 2008, the external environment is expected to be more challenging as growth in the industrial economies is forecast to moderate, whilst price pressures could potentially stay elevated. Nevertheless, domestic demand is expected to support Malaysia's economic growth momentum. Malaysia's real GDP is expected to grow by 5 - 6% in 2008.

Price pressures in 2008 are expected to be stronger following the relatively benign domestic inflation environment of 2007. Headline inflation is expected to average between 2.5 - 3% driven by the pass-through of prices of inputs, as well as higher global prices of food, commodities and other raw materials. As at end-2007, the weighted inflation for the countries that are a major source of imports for Malaysia had risen to 3.6% per annum and it is trending upwards.

There are a number of factors that could help contain inflationary pressures in 2008. Competitive pressures and substitution by consumers from more expensive into less expensive goods could mitigate the ability of producers to pass on their costs into final consumer prices. Slower global growth could ease pressures on global food and commodity prices, as well as reduce inflation in Malaysia's import partner countries. Government policies to ensure the availability of essential goods would also contribute to reducing the cost of these goods. With the economy expected to operate below its potential, the presence of excess capacity should also have a dampening effect on prices. Slower demand may also ease labour cost pressures and wage increases are more likely to be reflective of improvements in productivity.

The conduct of monetary policy in 2008 will face a number of challenges. The balance of risks to inflation and growth would be more difficult to gauge given the high degree of uncertainty regarding the global macroeconomic and financial environment. The problems in global financial markets and the extent of their eventual impact on real economic activity in the US and to the global economy remains a source of great risk. The longer these problems persist, the more extended is the likely duration of their negative impact on the global economy. Risk aversion, credit constraints and negative wealth effects are likely to depress consumer and investor sentiment, resulting in a deeper and more protracted weakening of global demand. Although Malaysia's domestic economic fundamentals remain sound, Malaysia's highly open economy means that international developments will impact the domestic economy. With respect to inflation, uncertainties regarding the depth and length of slower global growth and the degree to which it will dampen commodity prices will influence the inflation outlook.

A second challenge is managing the more frequent, large and volatile capital flows and their impact on the exchange rate, domestic liquidity and asset prices. Rapidly changing market sentiments, the search for higher yields, and sudden shifts in risk premiums are factors driving such volatile flows. Large short-term inflows and outflows have at times contributed to highly volatile exchange rate movements which creates significant uncertainties for businesses and consumers in undertaking economic decisions thereby having a negative impact on the real economy. Also, the resulting increase in liquidity arising from large inflows could be inflationary and distort both financial and real asset prices in the domestic economy. Recognising that such flows will result in greater challenges in the conduct of monetary policy, Bank Negara Malaysia has increasingly broadened its range of instruments to manage the flows and enhanced the surveillance mechanisms to ensure that such flows do not disrupt the smooth functioning of the financial system and the economy.

In this uncertain environment, the focus of monetary policy in 2008 will be on sustaining the economic growth momentum while maintaining price stability in the medium to long term. In the formulation of monetary policy, the Bank will continue to be forward looking and will weigh the impact of new developments on growth and inflation. The Bank stands ready for a monetary policy response in the event the outlook for growth or inflation changes and the nature of the problem prompts a change in monetary policy. Concerning price stability, it is also important to note that not all sources of inflationary pressures warrant a monetary policy response. Monetary policy is foremost a demand management tool. As such, it has limited influence in terms of mitigating cost-push price pressures emanating from rising global prices of food and commodities. Moreover, other policies would also be more appropriate if the problem is structural or underpinned by supply driven factors.

Potential Output of the Malaysian Economy

Potential output is the trend level of output that is consistent with the aggregate productive capacity of the economy. It provides a clear determinant for the pace of sustainable growth based on its available productive inputs. 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, which captures productivity gains from improvements in factor inputs as well as overall economic efficiency.

The latest estimate for Malaysia shows that potential output grew at 6.4% in 2007, with the output gap[1] estimated at an average of -0.1% of potential output. The Malaysian economy was, therefore, characterised by balanced growth, with the small negative output gap suggesting that the economy was performing close to its potential with minimal demand-driven inflationary pressure. Growth was supported by continuous improvement in productivity and expansion of both capital stock and labour force during the year.

Table 1
Actual GDP and Potential Output

Period	Actual GDP	Potential Output	Investment	Labour	Output Gap
	(Annual change in %)				(% of potential output)
1993-1999	6.4	6.5	3.5	3.2	0.0
2000	8.9	4.0	25.6	4.3	2.2
2001	0.3	4.6	-2.1	1.6	-1.8
2002	4.4	3.9	0.6	3.5	-0.4
2003	5.5	6.0	2.8	3.6	-0.5
2004	7.2	5.5	3.6	4.0	0.7
2005	5.2	5.2	5.0	4.1	0.5
2006	5.9	6.3	7.9	2.2	0.1
2007*e*	6.3	6.4	9.2	2.0	-0.1

e Estimates

Overall, since the year 2000, Malaysia's economy has exhibited relatively balanced growth as shown by the output gap which was on average less than ±1% of potential output. The period corresponding to the Eighth Malaysia Plan (2001-2005) witnessed Malaysia's evolvement from capital-led growth in the 1990s to a productivity-driven growth (see chart 2). In line with the

[1] 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.

Chart 1
Actual and Potential GDP

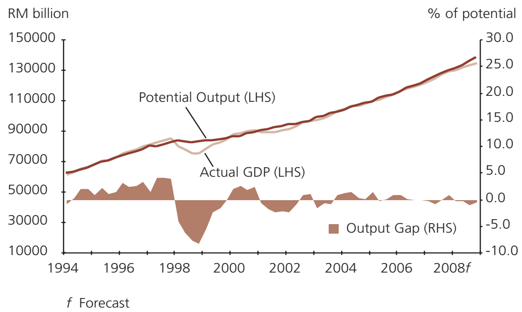
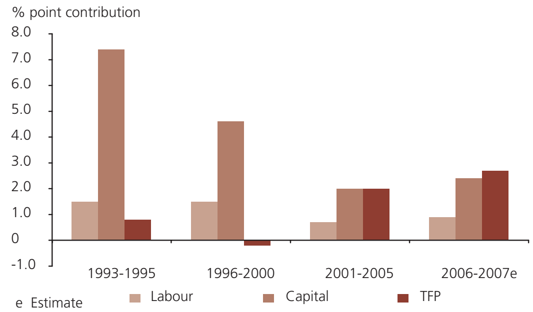


Chart 2
Factor contributions and TFP growth



strategies to increase productivity and competitiveness under the Ninth Malaysia Plan (2006-2010), it is expected that improving productivity levels through greater knowledge intensity of labour force as well as efficiency in the use of capital and technological progress will continue to enhance the contribution of TFP. Having suffered from a period of lacklustre investment climate since the Asian crisis, the pick-up in private investment activities since 2003 has contributed favourably to the growth of potential output. This trend for private investment activity is expected to be sustained in the future, given the strong domestic demand and the implementation of the Ninth Malaysia Plan projects.

Going forward, potential output of the economy is expected to grow above 6% in 2008 supported by the expansion of capital stock and the labour force. However, the output gap is expected to widen marginally following a modest moderation in actual output projected during the year.

Liberalisation of the Foreign Exchange Administration Rules

As a highly open economy, Malaysia has taken advantage of globalisation to sustain its growth momentum and diversify its economic structure. Efforts to strengthen its economic and financial relationships with the rest of the world has contributed to the high level of external trade, sustained level of foreign direct investment and an increase in overseas ventures by Malaysian corporations and financial institutions. Malaysia is committed to progressively liberalise the foreign exchange administration rules to continuously promote the competitiveness of the economy and taking into consideration that economic benefits of the liberalisation outweigh the risks and costs. The sequenced and gradual liberalisation approach that has been adopted has led to positive economic payoffs for the country through the reduction of the cost of doing business, enhancing the regulatory delivery system and facilitating the sound and healthy development of the domestic financial system.

In the early part of 2007, fifteen foreign exchange administration rules were liberalised and the details were reported in the Bank's Annual Report 2006. Subsequently, further liberalisation of the foreign exchange administration rules were announced to strengthen further the overall macroeconomic objective of enhancing Malaysia's competitiveness and promoting economic flexibility. The liberalised rules are as follows:

<table>
<tr><th>Objective</th><th>Rules liberalised</th></tr>
<tr><td>1. To reduce transaction cost, cost of doing business and enhancing business efficiency</td><td>• Effective 28 November 2007, a resident corporation with export earnings is free to pay another resident corporation in foreign currency for settlement of goods and services.
• Effective 1 October 2007,
(i) The individual reporting threshold for payment and receipts between residents and non-residents is increased to RM200,001 or its equivalent in foreign currency from the previous threshold of RM50,001 per transaction.
(ii) The registration requirements on the following were abolished:
➢ Forward foreign exchange contracts entered by residents;
➢ Ringgit-denominated loans extended by a resident to a non-resident for purchase or construction of immovable properties in Malaysia;
➢ Investment in foreign currency assets by residents;
➢ Foreign currency borrowing by resident corporations from:
– licensed onshore banks;
– non-residents; and
– another resident company within the same corporate group using proceeds from an Initial Public Offering on foreign stock exchanges; and
➢ Repayment of permitted foreign currency borrowing (without fixed schedule of repayments) or prepayment.
• Effective 1 January 2008, the requirement for submission of the following reports was also abolished:
(i) Overseas Account Statement (Statement OA) for accounts maintained by resident corporations with offshore banks; and
(ii) Inter-Company Account Statement (Statement IA) for accounts maintained by resident corporations with non-resident corporations.</td></tr>
<tr><td>2. To facilitate the development of Malaysia as an Islamic Financial Centre</td><td>• Effective 1 October 2007, unit trust and fund management companies are free to invest the total amount of Islamic funds under their management in foreign currency assets.

(Previously the limit for investment in foreign currency assets was up to 50% of the Net Asset Value or of total funds of residents with domestic ringgit borrowing).</td></tr>
<tr><td>3. To facilitate hedging and development of commodities futures market in Malaysia</td><td>• Effective 15 January 2008, the following flexibilities were granted to facilitate the transaction of the US dollar denominated crude palm oil futures contracts (USD FUPO) on Bursa Malaysia:</td></tr>
</table>

Objective	Rules liberalised
	(i) Exclude investments by residents in USD FUPO on Bursa Malaysia from the investment in foreign currency assets rule, if the contracts are settled in ringgit; and (ii) Allow commodity futures brokers licensed by Securities Commission to act as agents to licensed onshore banks to quote exchange rates to facilitate settlement of USD FUPO with Bursa Malaysia.
4. To support the development of new areas of economic growth	• Effective 24 September 2007, resident corporations approved under the Iskandar Development Region framework and biotechnology companies approved under the National Biotechnology Policy, are free to undertake the following: (i) To pay and receive payments in foreign currency, other than the currency of Israel, with residents; (ii) To borrow any amount of foreign currency from licensed onshore banks and non-residents; (iii) To invest any amount in foreign currency assets onshore and offshore; and (iv) To retain export proceeds offshore.
5. To enhance risk management flexibility for investment in ringgit assets by non-residents	• Effective 1 October 2007, the requirement for a non-resident to reinvest within 7 working days, the proceeds arising from the sale of ringgit assets prior to the maturity of the forward foreign exchange contract was abolished.

The remaining foreign exchange administration rules currently applicable to non-residents and residents are mainly for prudential purposes and will be progressively reviewed to continuously promote the competitiveness of the Malaysian economy. The rules can be broadly categorised into the following 6 main areas:

The explanatory notes are in the Annex.

FISCAL POLICY IN 2008

The 2008 Budget outlined wide-ranging tax and non-tax measures to enhance the nation's competitiveness, strengthen human capital development and ensure the well-being of all Malaysians. Fiscal policy in 2008 also focused on expediting the implementation of projects and programmes that had been identified under the Ninth Malaysia Plan.

In enhancing the nation's competitiveness, a more competitive tax regime coupled with initiatives to strengthen the efficiency of the public service delivery systems were among the key measures introduced. In the 2008 Budget, the Government reduced corporate income tax by two percentage points in two stages, to 26% for the 2008 assessment year and then to 25% in 2009, and introduced a single-tier tax system under which profits are only taxed at the company level and dividends received are exempted from tax. To promote the Islamic financial sector and Malaysia as an international Islamic financial centre, the Government introduced a number of measures, including tax incentives for existing stockbroking companies to set up Islamic stockbroking subsidiaries, exempt income tax on all fees related to Islamic fund management activities and including fees earned by non-resident consultants with expertise in Islamic finance, and tax deductions on the share of distributed profits for the takaful industry. As part of the Government commitment towards improving the public delivery system, the Special Taskforce to Facilitate Business (PEMUDAH) was established to formulate measures to improve public service by reviewing procedures and recommending alternative processes to reduce the administrative and regulatory cost of doing business in Malaysia.

The Federal Government's overall financial position is expected to strengthen further in 2008. The increase in the overall revenue from increased efficiency in revenue collection and the higher oil-related income, will accommodate the increased Federal Government expenditures, while reducing the budget deficit to 3.1% of GDP in 2008 (3.2% in 2007). The rise in emoluments after the increase in civil servant salaries in July 2007 accounts for part of the increase. In terms of development expenditure, special attention was given to both the economic and the social sectors in an effort to generate higher value-added economic growth, strengthen human capital development, and address socio-economic inequalities. The bulk of the development expenditure will, therefore, be channeled to the economic sectors (agriculture and infrastructure) and social sectors (education, training, health and housing). In terms of financing, the Government continues to finance the fiscal deficit from domestic sources, facilitated by the high domestic savings and ample domestic liquidity.

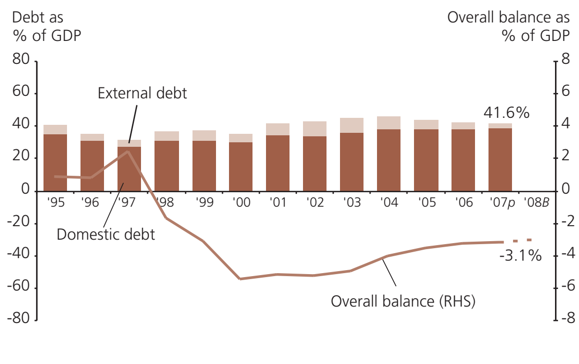
Table 4.6
Federal Government Finance

	RM billion		% change	
	2007*p*	2008*B*	2007*p*	2008*B*
Revenue	139.9	146.4*	13.2	4.7
Total expenditure	163.6	168.8	14.0	3.1
Operating expenditure	*123.1*	*128.8*	*14.3*	*4.6*
Gross development expenditure	*40.6*	*40.0*	*13.3*	*-1.4*
Loan recoveries	3.1	0.8		
Overall balance	**-20.7**	**-21.6**		
% of GDP	**-3.2**	**-3.1**		
Sources of financing:				
Net domestic borrowing	25.8	-		
Net external borrowing	-4.3	-		
Realisable assets[1] and adjustments	-0.8	-		

[1] A positive (+) sign indicates a drawdown in the accumulated realisable assets
p Preliminary
B Budget
* Revenue used are inclusive of potential tax losses arising from implementation of 2008 Budget measures
Note: Numbers may not add up due to rounding

Source: Ministry of Finance

Chart 4.5
Federal Government Fiscal Balance and Debt



p Preliminary
B Budget