Review and Outlook for the Malaysian Economy

2013 ECONOMIC REVIEW

Global economy strengthened in the second half of 2013

Global economy strengthened in the second half of 2013 bringing the full year growth to 3.0% from 3.2% in 2012. Advanced economies accounted for much of the pickup, although the pace of recovery was modest as policy uncertainties and structural constraints continued to weigh on overall demand.

US, a major impulse to global growth

A major impulse to global growth was from the United States ("US"), where there were some upside surprise from strong export growth particularly in regard to petroleum products, faster pace of inventory accumulation, consumer spending picked-up, and decline in household debt relative to disposable income which raised household net worth above its long-term average.

The euro area finally emerged from recession

The euro area finally emerged from recession with growth being in positive since the second quarter of 2013 after a long period of output decline. The turnaround could be attributed partly to less fiscal drag and some impetus from private domestic demand for the first time since 2010. National and collective policy actions have contributed to this positive turn of events. Yet the legacy of the crisis reflected by high unemployment, weak private and public balance sheets, contracting credit, large debt burden and longer-term impediments to growth are issues that needs addressing, thus raising concern about the strength and durability of the recovery.

Japan, favourable scenario

In Japan, while private consumption and public spending remained robust, GDP growth slowed in the second half of 2013 on slow recovery of exports and a surge in import demand due to sustained high energy imports and strong domestic demand.

Developing Asia rose moderately

Growth in developing Asia rose moderately. Growth picked up slightly in the second half of 2013. The weaker cyclical momentum in comparison with that in the advanced economies reflects the opposite effects of two forces on growth. Export growth increased supported by stronger activity in advanced economies and by currency depreciation. Fiscal policies were broadly neutral. Yet weaknesses in investment continued, with external funding and domestic financial conditions increasingly tightened. Supply-side and other structural constraints on investment and potential output such as infrastructure bottlenecks remained the key issues in some economies which are expected to remain in effect through much of 2014.

Domestic demand in developing Asia affected by the prolonged weakness in external demand

Domestic demand in developing Asia were affected by the prolonged weakness in external demand. In a number of emerging economies, growth was influenced by policy measures introduced to manage domestic vulnerabilities. The shift in market expectations for reduction in monetary accommodation in the US towards the second half of 2013 led to large capital flow reversals from the emerging economies. Thus, global inflation slowed, reflecting the moderate demand conditions in many economies and lower non-energy commodity prices. Overall, however, emerging market and developing economies continue to contribute more than two-thirds of global growth.

China enjoyed stable growth, while India was affected by cyclical and structural issues

China witnessed a high and stable economic growth of 7.7% in 2013, added with subdued inflation and a smaller current account surplus. Both the monetary and fiscal policies remained limited. In India, a spell of global financial turbulence caused capital outflows and pressure on the exchange rate. But strong policy measures stabilised the currency, rebuilt reserves, and narrowed the excessive current account deficit. Yet growth moderated to 4.4% in 2013 affected by persistent inflation, fiscal imbalances, bottleneck to investment, and inefficiencies that require structural reform.

Developments in the ASEAN economies were uneven

Developments in the Association of Southeast Asian Nations ("ASEAN") economies were uneven. Indonesia's growth was influenced by subdued investor sentiment and higher borrowing costs, although the currency depreciation since mid-2013 did provide some lift to exports. Thailand is being clouded by the political situation which weakened private demand and delayed public investment. Malaysia and the Philippines are on a more positive trajectory with favourable growth in 2013.

Malaysian economy continued to expand

Despite weaknesses on the external front and subdued public investment, the Malaysian economy continued to expand in 2013 by 4.7%, driven by the continued strong growth in domestic demand.

Private consumption is the key growth driver

Private consumption rose at the similar pace in 2012 by 7.6% and contributed the most of the GDP growth in 2013. Expansion in consumption spending was supported by low unemployment rate of 3.1%; better average real wages which rose by an estimated 0.9% in 2013; positive effects from the national minimum wage that came into effect in January 2013; widespread cash transfers to low- and middle-income households from the government and increases in public sector wages, bonuses, and pensions; and continued access to financing for creditworthy borrowers.

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Public consumption was supported by expenditure on supplies and services

Public consumption recorded a higher growth of 6.3% in 2013. Growth was supported by higher expenditure on supplies and services. Meanwhile, expenditure on emoluments was sustained.

Investment moderated, but continued to support private sector capital expenditure

Although the pace of investment moderated from the exceptionally strong growth in 2012, yet it continued to support private sector capital expenditure. Gross fixed capital formation ("GFCF") grew at a slower pace of 8.2% in 2013, following a robust growth of 19.9% in 2012. Growth in GFCF was supported by investment in structures which grew by 11.1%, reflected by all construction sub-sectors. Also, moderate gains from investments in machinery and equipment, up 5.1% provided the necessary impetus to GFCF despite the decline in imports of machinery for manufacturing in 2013 by 2.9% as well as imports of office equipment down by 8.7% and imports of locomotives which plunged by 96.9%.

Private investment in the services sector

The pace of growth in private investment by 13.6% was driven by capital spending from both the domestic and foreign investors. Focus areas were in the mining, services and manufacturing sectors. Services investment made up 48% share of private investment in 2013 were underpinned by capital spending in both the domestic and export-oriented services sub-sectors. Investments in the domestic-oriented services sector mainly focused on distributive trade, telecommunication and private healthcare sub-sectors, while investments in the export-oriented sub-sectors focused on expansion and upgrading of ports and petroleum storage terminals. Dwellings investment, proxy for residential construction work continued to remain strong.

Mining investment

Mining investment remained strong in 2013 from the continued capital spending in major upstream projects, like the Gumusut-Kakap deepwater field, Enhanced Oil Recovery of the Tapis oil field and the Berantai and Balai marginal fields. In the manufacturing sector, investments were undertaken in both the export-oriented industries such as the E&E and medical devices, and the domestic-oriented industries, particularly in food manufacturing. This expansion reflected improving business sentiment following the gradual improvement in external demand and sustained strong domestic consumption.

Public investment recorded a small positive growth

Public investment registered a small positive growth of 0.7% following the decline in the Federal Government development expenditure. It was offset by higher capital expenditure by the public enterprises, which was channelled mainly into the oil and gas, transportation and energy sectors. The key areas were Sabah Ammonia-Urea Plant, Sabah-Sarawak Gas Pipeline and Kinabalu Non-Associated Gas (NAG) upstream development; investment in the transportation sub-sector that was supported by the construction of the MY Rapid Transit ("MRT") and further work on the Light Rapid Transit ("LRT") extension; and investment in the utilities sub-sector that includes the building of power plants such as Tanjung Bin and Janamanjung. The Federal Government's development expenditure in the economic sector focused on transportation; trade and industry especially upgrading infrastructure facilities in industrial areas.

Services sector remained the largest contributor to growth

Services sector grew by 5.9% in 2013 and remained the largest contributor to growth by 3.2 percentage points to the overall GDP growth. Growth came largely from the sub-sectors that caters for domestic demand. Amongst them are the wholesale and retail trade sub-sector which benefitted strongly from the continued strengthening from the households' retail spending. Another key area is from the communication sub-sector which grew robustly from continued demand for data communication services. Performance from the transport and storage sub-sector was sustained amid strong growth in passenger travel. Meanwhile, growth in the finance and insurance sub-sector moderated following lower interest rate margins and insurance premiums.

Manufacturing was supported by domestic activities and exports

Manufacturing sector expanded by 3.4% primarily supported by the continued strength in the domestic-oriented industries and better performance of the export-oriented industries in the second half of 2013. Improved production in the export-oriented industries was due to stronger exports in both the E&E and primary-clusters, amid a gradual recovery in the global economy. Domestic-oriented industries recorded sustained growth, mainly driven by robust private consumption and resilient construction activity.

Construction sector remained strong

Growth remained strong in the construction sector, up 10.9% supported by robust activity in the residential and civil engineering sub-sectors. Strong activities in the residential sub-sector was reinforced by the construction of high-end and high-rise properties in the Klang Valley, Penang and Johor. Civil-engineering sub-sector enjoyed from the activities in infrastructure and oil and gas-related projects such as Tanjung Bin and Janamanjung power plants, MRT, Sabah Oil and Gas Terminal, Sabah-Sarawak Gas Pipeline and the Kebabangan Oil and Gas project.

Agriculture activities supported by CPO output and food commodities

Agriculture growth was strong, up 2.1% largely supported by higher CPO output on the back of better yields amid favourable weather conditions. Meanwhile, production of food commodities such as livestock, vegetables and fisheries also improved in 2013 in view of the efforts to increase food security and also the ongoing efforts to further improve the agro-food and aquaculture industries.

Maintenance work affected crude oil output and hence mining sector

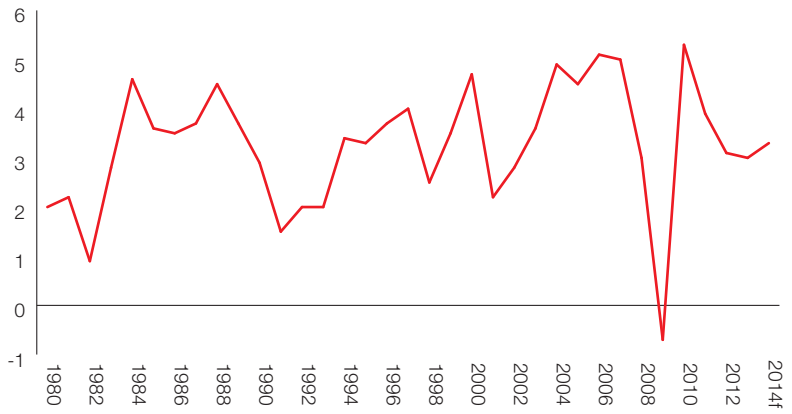
Mining sector posted a slower growth of 0.5% in 2013 as a result of lower crude oil production amid maintenance works that occurred in the later half of the year. Output of natural gas, however, recorded stronger growth during the year, driven by higher demand from East Asia for electricity generation as well as commencement of higher production from marginal and new fields.

2014 ECONOMIC PROSPECTS

Global activity is expected to improve

Global activity is expected to improve in 2014, projected to grow by 3.2%. Advanced economies are gaining momentum and driving the global growth momentum. Once stalled cylinders of the economic engine of growth like investment and trade are starting to ignite again. Growth impulse will continue to come mainly from advanced economies, although their recoveries remain uneven.

Chart 1: Global Growth (y/y %)



US should continue to expand at a moderate pace

With supportive monetary conditions and a smaller drag from fiscal consolidation, the outlook of the United States ("US") economic growth should continue to expand at a moderate pace, projected to grow by 2.2% - 2.4%. Although the unusually harsh winter weather weighed on activity in 1Q2014, growth is expected to rebound over the rest of the year driven by moderate growth in residential investment, bouncing back from a very low levels and given substantial pent-up demand for housing. Personal consumption is poised to be solid, added with a pickup in non-residential fixed-investment growth as consumer and business confidence improves. Growth will also be supported by less fiscal drag, thanks in part to the Bipartisan Budget Act, which replaced some of the automatic spending cuts in fiscal years 2014 and 2015 with back-loaded savings. Debt limit has been suspended until March 2015, reducing the uncertainty that has characterised fiscal policy in the past few years.

Risks to the US economy comes from both external and domestic

Risks to the US economy comes from both external and domestic. External issues are like prolonged sluggishness in the euro area would weigh on the US growth especially if the deflation dynamics take hold. A slowdown in emerging market economies could also pose a risk. Domestic concerns are issues like private domestic demand losing momentum if long-term yields rise faster than expected without an associated improvement in the outlook; fiscal sustainability over the medium term; continued downward trend in the labour force participation rate than could further dent potential output; and earlier-than-expected tightening of monetary policy.

Modest improvement in euro

The euro are is expected to improve modestly in 2014 by 0.8% - 1.0%. Recovery will be uneven across countries and sectors. Growth will largely come from export led although domestic demand has stabilised and turned positive in France, Spain and Germany. Despite some rebalancing within the euro area, current account balances have improved asymmetrically, with persistent surpluses in some core economies and shrinking external balances in deficit economies.

Downside risks still dominates in euro

Inflation remains very low, while unemployment and debt are high. Low investment, persistent output gaps, tight credit, political uncertainty, policy reversal, effects from tighter financial conditions in the US, external shocks like disappointing growth from emerging economies and financial fragmentation in the euro area are other risk issues that will weigh on the recovery. Private investment is yet to revive strongly across the region. Risks remain from incomplete reforms and external factors. In the stressed euro area economies, growth is projected to remain weak and fragile as high debt

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and financial fragmentation hold back domestic demand. Stronger growth in Germany for instance, will be affected by stagnant or declining output elsewhere. Accommodative monetary policy, completion of financial sector reforms, and structural reforms are critical.

Japanese growth envisaged to be moderate

Growth is envisaged to moderate in 2014 to 1.4%- 1.6% as fiscal policy weighs on its economic activity. Positive effect of the recently approved stimulus measures is envisaged to be more than offset by the negative impact of the consumption tax hike and the waning of reconstruction spending and past stimulus measures. Monetary support is poised to ensure the financial conditions remain accommodative. Inflation is projected to rise temporarily following the consumption tax hike. And the Government plans to restore the nation's global competitiveness by possibly changing in areas like labour, investment and agriculture, amongst others.

One of the biggest challenge is to address the issue of ageing population

One of the biggest challenge is to address the issue of ageing population, especially with the highest life expectancy in the world, but the retirement age is just 65 and is difficult to support the retired people. Hence, the likely policy is to raise old people's labour participation, increase the proportion of women in the workforce by making it easier for them to manage both private and professional lives, expand the use of robots in production, in order to reduce the impact of ageing population on the economy, and reduce the corporate tax rate to below 30 percent over several years from 2015.

Reform in China and India will be the key in shaping the outlook of developing Asia region

While advanced economies growth momentum picked up, the improvement was tempered by moderate growth in the People's Republic of China ("PRC") as it continued to shift towards more balanced growth. The US policy shift may bring further volatility in the financial markets. But the tightening of global liquidity can be mitigated by accommodative monetary policy in the euro area and Japan. These, together with the reforms from the region's two largest economies that is the PRC and India will be the key in shaping the outlook of the region in 2014. As reform gathers pace, growth in the PRC in 2014 is projected to hover around 7.3% -7.5%. In contrast, India's outlook depends on its ability to successfully implement structural reforms and spark stronger growth. If successful, reform in India may accelerate economic growth in 2014 to 4.7% - 4.9%.

Risks to the outlook of developing Asia have eased

Although the policy makers in developing Asia can manage the risks, yet there are three key areas that needs close monitoring. First, another shock to global financial markets from the changes in US monetary policy cannot be ruled out. Second, the data remains mixed on the recovery in advanced economies, leaving the possibility that demand for developing Asia's exports may be softer than projected. Finally, a sharper-than-expected slowdown cannot be ruled out for PRC if its curbs credit expansion in an abrupt or excessive manner, thus weighing on the economic growth of its trading partner.

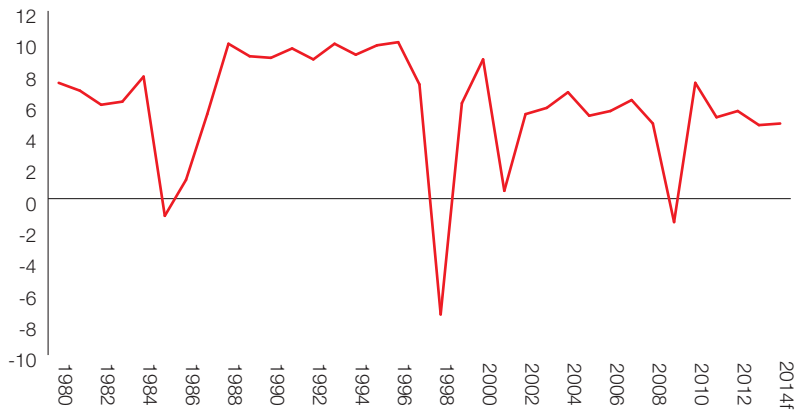
Uneven ASEAN economic performance

Political disruptions which began in the second half of 2013 in Thailand is expected to cloud the outlook in 2014 before rebounding in 2015. This, together with policy deficiencies that have prompted calls to improve the design and implementation of public programs will weigh 2014 growth, projected to hover between 2.0% - 2.2%. Indonesia's growth will depend on the stabilisation policies rolled out in the second half of 2013 and that parliamentary elections in April and presidential elections in July go smoothly, forecasted to grow between 5.7% - 5.9%. Malaysia's growth will lean on the outcome of major industrial countries and world trade as the rising inflation and fiscal tightening will moderate domestic demand. Growth is projected between 4.8% - 5.1%. Philippines growth will remain strong coming from rehabilitation and reconstruction in areas hit by natural disasters although inflation is forecast to pick up but will remain within the central bank's target range. Growth is projected between 5.8%- 6.1% in 2014. The challenge is to translate solid economic growth into poverty reduction by generating more and better jobs.

Trade is expected to support Malaysia's growth

The economy is expected to grow at a steady path in 2014, likely to expand between 4.8% -5.1%. Growth will be supported by better performance from the external sector amid some moderation in domestic demand. As a trading nation with exports equivalent to 83% of GDP, improvement in the economies of major industrial countries and world trade will bode well for Malaysia exports, projected to grow by 5.6%-5.8% in 2014. In particular will be the exports from electronics and electrical ("E&E") that will benefit from higher demand from the advanced economies. Also, non-E&E exports will be sustained by regional demand for resource-based products. Commodity exports is projected to register a small positive growth after two consecutive years of contraction. Services exports will be higher from stronger travel account supported by Visit Malaysia Year 2014.

Chart 2: Malaysia's Economic Growth (y/y %)



Private investment will remain as the other growth driver

Domestic demand will continue to play an important role in driving the economic growth, but at a more moderate pace in view of continued public sector consolidation. In particular, private investment will remain strong for the fifth consecutive year supported by the ongoing implementation of multi-year projects, improvement in external demand, sustained improvements in the investment climate and healthy capital spending in the services, manufacturing and mining sectors. It is projected to grow by 12.2% -12.6% in 2014.

Strong public investment

Underpinned by public enterprises' ("PEs") investment and Federal Government development expenditure, public investment is poised to remain strong, projected to grow by 2.7%-2.9%. PEs investments reflects the continued implementation of key infrastructure projects, particularly oil and gas, utility and transportation. The Federal Government development expenditure focuses on improving access and connectivity in urban and rural transportation infrastructure. Social services sector emphasis will be on education, training and healthcare.

Moderate growth in private consumption

Private consumption is projected to grow moderately between 6.7% - 6.9% in 2014 after two consecutive years of strong growth, partly due to higher inflation and greater uncertainty. But healthy labour market conditions and sustained income growth are expected to provide support to private consumption. Implementation of the minimum wage policy by some will also support wages, albeit to a lesser extent compared to 2013. Household credit growth will be slower in 2014 due to the series of measures implemented by Bank Negara in 2013. Impact of these measures on private consumption is expected to be marginal as creditworthy households will continue to have access to credit.

Public consumption is anticipated to record lower growth

Public consumption is anticipated to record lower growth, following the ongoing consolidation of the Government's fiscal position. Growth in 2014 is forecasted to hover between 2.8% - 3.0%. More moderate expenditure is also expected on supplies and services as well as emoluments.

Imports to increase at a stronger pace

Imports is projected to increase at a stronger pace in 2014 by 8.6% - 8.9%. In particular, imports of intermediate goods which form the bulk of the total imports is envisaged to rise in 2014, largely due to stronger manufacturing production to meet higher export orders. In addition, the continued expansion of domestic investment and consumption activity will continue to support the imports of capital and consumption goods, respectively.

Headline inflation is projected increase due mainly to domestic cost factors

Headline inflation is on the upward pressure in 2014, projected to hover between 2.8% - 3.1% largely due to domestic cost factors. It includes the recent price adjustments arising from subsidy rationalisation and the spillover effects of these adjustments on the prices of other goods and services. Higher cost pressures will be partly contained by subdued external price pressures, given the expectations of lower global food and energy prices. Continued expansion in domestic capacity and a moderate domestic demand outlook would help to lessen the cost pressures. Upside risks to inflation includes stronger domestic demand arising from better-than-expected external demand, a significant rise in global commodity prices and excessive wage increases leading to second-round effects. These risks, however, are assessed to be relatively low.

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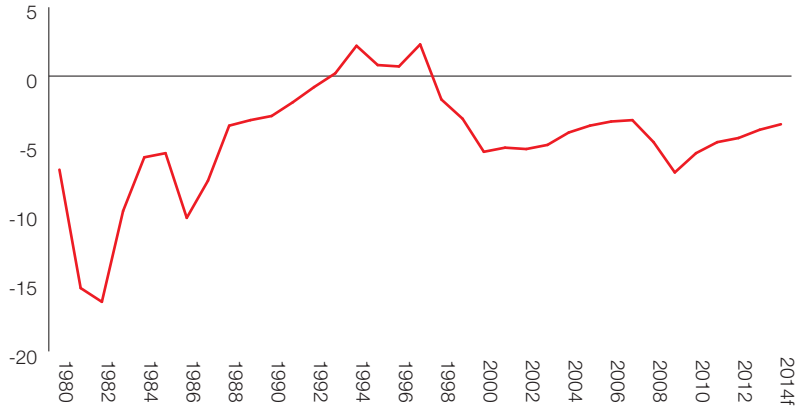
Narrowing fiscal deficit

Fiscal policy is aimed towards strengthening the fiscal position, while ensuring continued support for domestic growth and the protection of the well-being of the society. Given the challenging domestic and external environment, fiscal reforms are being pursued gradually without undermining economic growth. At the same time, fiscal resources will be directed towards key economic sectors to accelerate the shift towards a high value added, high-income economy. Fiscal deficit is expected to be at 3.5% of GDP in 2014.

Chart 3: Fiscal Balance % GDP



Healthy labour market

Labour market is envisaged to stay healthy with the unemployment rate projected to hover around 2.9% -3.1%. Employment growth is expected to remain above the post-Global Financial Crisis average of 3%, but to moderate from a strong growth of 4.8% in 2013. The demand for labour will be supported by the improvement in global economic conditions, particularly benefitting the export-oriented industries, and the sustained expansion in domestic economic activity.

Monetary policy will aim to support the sustainable growth

Monetary policy will aim to support the sustainable growth while mitigating any potential vulnerabilities arising from inflation and financial imbalances. The economy is expected to continue on a steady growth path, supported by better performance in the external sector amid some moderation in domestic demand. Compared to 2013, inflation is projected to be higher. Nevertheless, the higher inflation will largely be due to cost factors, with the underlying inflation expected to remain contained. The continued low global and domestic interest rate environment would also make it important to be vigilant to the build-up of financial imbalances.