

2015

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THE INTERNATIONAL ECONOMIC OUTLOOK

The global economy is expected to improve at a modest pace in 2016. The growth outlook, however, remains vulnerable to considerable downside risks arising from policy developments in the major economies, high uncertainty surrounding the direction of global commodity prices and abrupt financial market adjustments. Growth in the advanced economies is expected to proceed at a gradual and uneven pace. Even with highly accommodative monetary policies, the advanced economies are experiencing persistent economic slack stemming from unresolved structural issues and weakness in domestic demand. For the emerging economies, growth is projected to recover from the shock to external demand experienced in 2015. Nevertheless, the extent of the recovery will be contingent on several factors, including commodity price developments, financial market conditions and the ability of economies to contain rising domestic vulnerabilities. In this environment, global trade activity is expected to register only a modest improvement. The confluence of external and domestic headwinds will make 2016 a challenging year for policymakers globally.

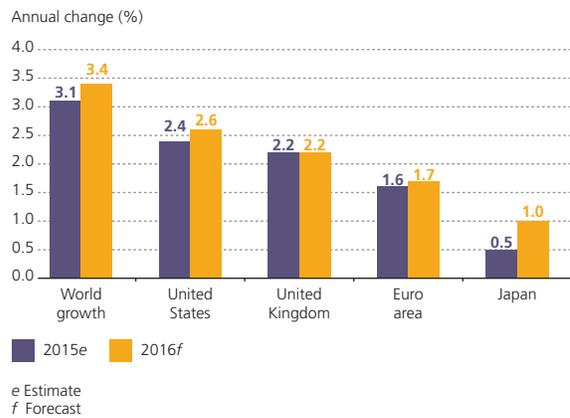
Global economy to improve in 2016 although considerable downside risks remain

Uneven growth momentum across major economies

The **US** economy is expected to remain on a steady growth path, underpinned by a continued expansion in private consumption. Private consumption, which accounts for about two-thirds of GDP, is projected to strengthen on account of favourable labour market conditions and improving household balance sheets. In particular, labour market slack is diminishing as evidenced from the declining trend in the number of part-time workers who would rather work full-time and the number of workers who are marginally-attached,

Chart 4.1

Growth: World and Major Advanced Economies (2015 - 2016)



Source: International Monetary Fund and National Authorities

including discouraged workers. The ongoing improvement in the labour market amid an environment of low energy prices will continue to support growth in real personal incomes, which have risen by an average of 4.1% in 2015 (2003-2007 average: 3%). These trends have positive spillovers to the housing market. House prices have shown continued improvement, following the recovery in housing demand amid diminishing supply. This provides support to home equity and has strengthened household balance sheets. The share of homeowners that have mortgage loans with a higher balance than the fair market value of their property is now less than half of what it was at its peak in the first quarter of 2012. Residential investment has also improved gradually, with single-family homebuilding continuing to trend up and multi-family construction remaining at a high level. Notwithstanding these positive trends, the strength of the recovery of the US economy will be weighed down by weakness in energy-related industries and to some extent, spillovers from developments in the financial markets and the external sector.

Growth in **PR China** is expected to moderate as domestic demand faces the immediate effects of the ongoing structural adjustments. While sustained growth in the services sector continues

to support the Chinese economy, this is expected to be offset by the slowdown in sectors with excess capacity, such as the industrial and property sectors. In addition, the potential re-emergence of financial market volatility may affect sentiment and poses downside risks to financial stability and growth. In view of these challenges, domestic policy is likely to remain accommodative to support growth. Thus far, Chinese policymakers have announced wide-ranging measures such as higher infrastructure investment, ensuring continued access to credit for viable sectors in the economy, and tax reductions on vehicle and house purchases.

In the **euro area**, while the gradual improvement in economic activity is expected to continue, the pace of recovery is likely to be uneven across the region. In the core economies, such as Germany and France, private consumption activity is anticipated to be driven by improvements in the labour market and favourable credit conditions. The unemployment rate has declined to 10.9% (2012 - 2014 average: 11.7%) while private sector credit growth is beginning to recover albeit at a gradual pace (2015: 0.7%; 2012-2014 average: -1.6%). However, the outlook for some of the crisis-affected economies remains fragile amid slow progress in structural reforms and reduction in public debt. Policy decisions involving

further structural and financial sector reforms, including deregulation of the labour markets, reduction of public debt and the completion of the banking union, will continue to be critical elements in promoting confidence and supporting a sustained economic recovery.

Economic activity in **Japan** is expected to expand at a very modest pace. Growth will be supported primarily by monetary and fiscal stimulus. Of significance, the Cabinet has approved a ¥3.5 trillion (0.7% of nominal GDP) supplementary budget to support domestic demand through enhanced welfare services, cash hand-outs to pensioners and accelerated reconstruction in areas devastated by the March 2011 earthquake and tsunami. The Bank of Japan has adopted increasingly aggressive monetary policy. The growth trajectory, however, remains contingent upon the effective transmission of these policy measures to real economic activity, the progress of structural reforms, the prospects for wage growth and increased capital expenditure.

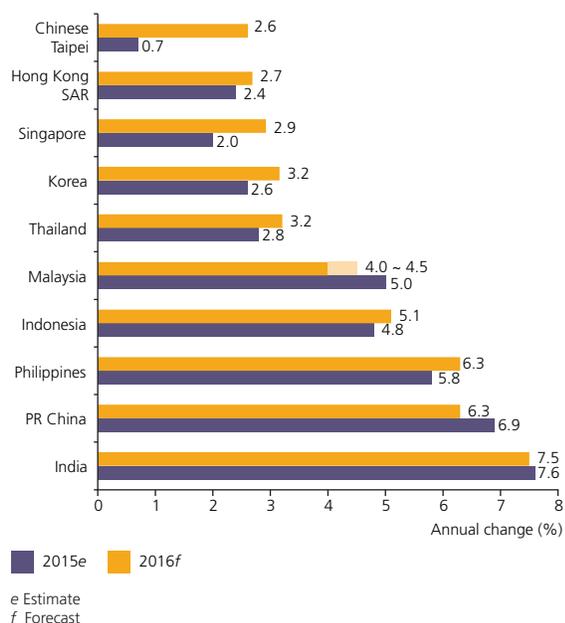
Economic growth in **Asia** is projected to improve in 2016, driven mainly by continued expansion in domestic demand and a modest recovery in external demand. In most Asian economies, growth is projected to be higher compared to 2015. Private consumption activity is likely to be underpinned by sustained income growth amid favourable labour market conditions, including increases in minimum wages in some of the regional economies. Infrastructure initiatives are expected to support the expansion in capital spending, particularly in the ASEAN economies. The implementation of additional fiscal measures in a number of Asian economies, including Chinese Taipei, Thailand, Indonesia and Korea, will also bolster domestic economic activity. The measures include financing support for small businesses, higher public investment and rebates to encourage purchases of durable consumer goods.

Global inflationary pressures to remain modest

Global inflation is expected to remain modest in 2016, reflecting weak supply and demand pressures. On the supply side, the risk of cost-push inflation is expected to remain restrained, given expectations for persistently low global commodity prices. In addition to the moderate growth in global demand, crude oil prices are expected to be weighed down by continued oversupply from both the Organisation of the Petroleum Exporting

Chart 4.2

Regional Economies: Real GDP Growth (2015 - 2016)



Source: International Monetary Fund and National Authorities

Countries (OPEC) and non-OPEC members, the restoration of oil supply from Iran following the cessation of economic sanctions and the lift of the ban on US oil exports. Food prices are also expected to remain moderate amid higher crop production and high inventories. For hard commodities, lower demand from several key economies, including PR China, will continue to exert downward pressure on prices, particularly for copper, nickel, zinc and iron ore.

Amid the modest outlook for global commodity prices, headline inflation rates are expected to remain below central banks' inflation targets in most advanced and emerging economies. In some of the advanced economies, underlying inflationary pressures are expected to be subdued, reflecting continued excess capacity and weak demand in these economies. Across the emerging economies, inflation is projected to exhibit diverging trends. While lower fuel prices are easing inflationary pressures in most emerging economies, several economies, including those in the Commonwealth of Independent States, Latin America and the Middle East, are projected to face a faster pace in price increases due to the removal of subsidies amid efforts to consolidate fiscal positions. Additionally, the effect may be exacerbated by imported inflation, mainly reflecting the impact of marked currency depreciations.

Downside risks remain elevated

The projected improvement in the global economy is subject to considerable **downside risks**, amid a highly challenging growth and policy environment.

While PR China's economic rebalancing is necessary for its transition towards a more sustainable growth model, the process faces challenges from domestic vulnerabilities, including high indebtedness and continued excess capacity in a few industrial sectors. Given PR China's rising importance in the global economy and extensive trade and financial linkages, a potential sharper-than-expected growth moderation in the Chinese economy would have significant spillover effects on global trade activity, investor sentiments and commodity prices.

Uncertainty surrounding key commodity prices will continue to affect growth prospects of several large economies. Crucially, a further downward adjustment in commodity prices will lead to a weaker-than-expected outlook for commodity-exporting countries while creating disinflationary pressures in several economies.

The sharp reaction of global financial markets to monetary policy shifts in the advanced economies in the past two years reflects the underlying fragility in the current phase of recovery and the overall financial risk-taking driven by a search for yield. Going forward, investors' behaviour will continue to be affected by the divergences in the monetary policies of the major economies. Bouts of heightened financial market volatility amid large shifts of global liquidity may potentially impact financing conditions and therefore weigh on growth prospects. Moreover, a further escalation of geopolitical tensions in several regions could materially affect sentiments and divert policymakers' focus from strengthening economic fundamentals.

For Asia, the high degree of uncertainty in the external environment will continue to generate high volatility in domestic financial and currency markets. Thus far, financial intermediation in most Asian economies has remained undisrupted. There is also ample room for policymakers to undertake countercyclical policies should the circumstances warrant it. This is due in part to policy measures put in place in the past decade to strengthen macroeconomic fundamentals and preserve financial stability. Going forward, Asia continues to face challenges from the domestic and external environments which require active recalibration of policies while maintaining efforts at structural reforms to support medium-term growth prospects.

THE MALAYSIAN ECONOMY

The international economic and financial landscape is likely to remain challenging and will be a key factor that will influence the prospects of the Malaysian economy in 2016. The strength of global economic growth and the trajectory of the global oil prices will have important implications for the growth of the Malaysian economy. The Malaysian economy also remains affected by growth prospects of its key trading partners, conditions in the financial markets and the state of investor and consumer confidence.

Nevertheless, Malaysia will face these challenges from a position of strength, afforded by the country's diversified structure, strong fundamentals and policy flexibility. Growth will continue to be anchored by domestic demand. Financial intermediation is expected to remain supportive of growth, underpinned by the strength of the financial institutions and the deep and well-developed financial markets. While subdued prices will continue to weigh on commodity exports, Malaysia's exports

are expected to be supported by the gradual improvement in the advanced economies and continued growth in the regional economies. The diversified nature of Malaysia's exports in terms of products and markets continues to accord resilience to Malaysia's trade performance.

The Malaysian economy is expected to grow by 4 – 4.5% in 2016

Overall, the Malaysian economy is expected to grow by 4 – 4.5% (2015: 5.0%). Domestic demand will continue to be the principal driver of growth, sustained primarily by private sector spending. The pace of expansion in domestic demand, however, is expected to be more moderate amid ongoing adjustments by consumers and investors to the challenging economic environment. Private consumption growth is projected to trend below its long-term average, as households continue to make expenditure adjustments in response to the lingering effects of the GST implementation, and changes in administered prices. Household spending will also be affected by weaker consumer sentiments due to the uncertain conditions in the labour and financial markets. These moderating effects, however, will be partially offset by continued growth in income, employment and some support from Government measures targeted at enhancing households' disposable income. In an environment of prolonged uncertainty and cautious business sentiments, private investment growth is projected to be less buoyant compared to its performance over the past five years, when it registered an average growth of 12.2%. Private sector capital spending is expected to be underpinned by the implementation of ongoing and new investment projects in the manufacturing and services sectors.

The current account of the balance of payments is projected to remain in a surplus position of about 1 – 2% of gross national income (GNI), largely from a sizeable surplus in the trade account. Benefitting from the measures introduced to ease travel from selected countries and targeted marketing and promotional efforts, tourist arrivals are expected to boost tourism income and contribute to a lower deficit in the services account.

Headline inflation is projected to be higher at 2.5 – 3.5% in 2016 (2015: 2.1%), due mainly to adjustments in the prices of several price-

administered items and the weak ringgit exchange rate. However, the impact of these cost factors on inflation will be mitigated by the low global energy and commodity prices, generally subdued global inflation, and more moderate domestic demand. The trajectory of inflation, however, could be more volatile as it is subject to uncertainties such as those relating to global growth, global oil prices and the ringgit exchange rate.

The projected growth of the Malaysian economy in 2016 is premised on expectations of a modest improvement in global growth and firm private sector spending domestically. It is recognised that **downside risks** to growth have heightened following the increase in uncertainties on both the global and domestic fronts. One of the key sources of risks to the growth forecast continues to be on the momentum of growth in PR China, as the country progresses with its economic rebalancing. While PR China remains one of Malaysia's main trading partners, the likelihood of a significant direct impact is limited as PR China accounts for only 13% of exports. Nonetheless, exports could also be affected indirectly should there be significant spillover effects from weaker regional trade and a further dampening of global commodity prices. Further compounding this challenging global economic environment are the continued uncertainties surrounding global oil prices and the high volatility in capital flows and financial markets. Domestically, the transmission and magnitude of these external shocks are a source of heightened uncertainty to the economy and financial system, particularly to the labour market, business sentiments and financial intermediation activities.

Past experience has demonstrated that Malaysia has the economic and financial adaptability to get through these challenging environments. Malaysia's strength rests on four factors, namely sound macroeconomic fundamentals, a diversified economic structure, a strong and well-developed financial system, and a robust policy toolkit. Macroeconomic fundamentals have been supported by a steady growth path between 4 – 6% for several years, with stable inflation and low unemployment. The external position is expected to remain favourable, underpinned by the continued surplus in the current account of the balance of payments, sustained FDI and healthy levels of international reserves.

Structural reforms undertaken over the years have endowed Malaysia with multiple sources of growth.

The economy continued to grow at a steady rate in 2015 despite sharp declines in commodity prices and more moderate Federal Government spending. The strength and depth of the financial sector is also another source of economic resilience. Financial shocks from volatile capital flows have been effectively and efficiently intermediated by the strong banking institutions as well as the deep and developed domestic financial markets. As a result, access to financing remains uninterrupted and continues to facilitate economic activity. The pre-emptive macroprudential measures to contain financial imbalances have provided ample space for effective policy-making. Importantly, past fiscal reforms have enabled the Government to remain firm in its commitment to fiscal consolidation. In addition, monetary policy has remained accommodative to support growth. Overall, policymakers in Malaysia have the capacity to undertake the necessary policy measures to manage further shocks to the economy.

Domestic demand continues to be the principal driver of growth

Domestic demand growth is projected to moderate to 4.3% in 2016 (2015: 5.1%). This is following the expectations that economic agents would continue

Table 4.1

Real GDP by Expenditure (2010=100)

	2015p	2016f	2015p	2016f
	Annual change (%)		Contribution to growth (percentage point)	
Domestic Demand¹	5.1	4.3	4.6	4.0
Private sector expenditure	6.1	5.2	4.2	3.6
<i>Consumption</i>	6.0	5.1	3.1	2.7
<i>Investment</i>	6.4	5.5	1.1	0.9
Public sector expenditure	2.1	1.6	0.5	0.4
<i>Consumption</i>	4.3	2.0	0.6	0.3
<i>Investment</i>	-1.0	1.1	-0.1	0.1
Change in Stocks			0.6	0.0
Net Exports of Goods and Services	-3.7	1.1	-0.3	0.1
Exports	0.7	3.2	0.5	2.3
Imports	1.3	3.4	0.8	2.2
Real Gross Domestic Product (GDP)	5.0	4.0~4.5	5.0	4.0~4.5

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

to make the necessary adjustments to manage the impact of higher consumer prices and greater uncertainties on the external fronts. Domestic demand, nevertheless, would remain as the anchor of growth, driven primarily by private sector spending. Reflecting the Government's commitment to fiscal consolidation, growth of public sector expenditure would remain moderate in 2016, but continue to be supportive of overall growth.

Private expenditure will remain as the key driver of growth, with continued support from the public sector

Reflecting largely the continued household adjustments to an environment of higher prices and greater uncertainty, **private consumption** growth is projected to moderate to 5.1% in 2016 (2015: 6.0%). Households are expected to continue making expenditure adjustments due to the higher cost of living arising from the implementation of the GST and changes in the administered prices of several goods and services. Additionally, household spending will be affected by weaker consumer sentiments due to uncertainty on labour market conditions, financial markets and ringgit performance. These adverse effects, however, will be partially offset by continued growth in income, employment and Government measures targeted to increase households' disposable income. These measures include reduction in employees' EPF contribution by three percentage points, higher Bantuan Rakyat 1Malaysia (BR1M) cash transfers and additional tax relief of RM2,000¹.

Private consumption will continue to expand despite households adjusting to higher cost of living

While growth in the first half of the year is expected to be more moderate, consumer spending is projected to register a gradual improvement as the impact of GST lapses. This improvement will be further lifted by the

¹ This tax relief is applicable to individual taxpayers with a monthly income of RM8,000 or below for the assessment year 2015.

Expansion in Key Economic Sectors

In 2016, key economic sectors are projected to expand at a more moderate pace. The services and manufacturing sectors would remain the key drivers of overall growth, while growth in the construction sector is expected to be sustained. Despite the lower oil and gas prices, growth in the mining sector will be supported by the introduction of new gas production capacity. The agriculture sector is expected to record a marginal contraction due to the lower yields caused by the El-Nino weather phenomenon.

Table 1

Real GDP by Kind of Economic Activity (2010=100)

	2015 ^p	2015 ^p	2016 ^f	2015 ^p	2016 ^f
	% of GDP		Annual change (%)	Contribution to growth (percentage point)	
Services	53.5	5.1	4.4	2.8	2.4
Manufacturing	23.0	4.9	4.1	1.1	0.9
Mining and quarrying	8.9	4.7	3.5	0.4	0.3
Agriculture	8.8	1.0	-0.3	0.1	0.0
Construction	4.4	8.2	7.9	0.3	0.3
Real GDP	100.0¹	5.0	4.0 ~ 4.5	5.0¹	4.0 ~ 4.5

¹ Figures may not necessarily add up due to rounding and exclusion of import duties component

^p Preliminary

^f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The services sector will continue to expand in 2016, albeit at a more moderate rate. Growth in consumption-related sub-sectors such as retail trade, food & beverages and accommodation is anticipated to moderate in tandem with slower growth of private consumption. In contrast, the information and communication sub-sector is expected to register robust growth as demand for data communications services remains strong. The transportation and storage sub-sector will continue to expand, benefiting from higher trade activity. The performance of the finance and insurance sub-sector is expected to remain weak, in line with the more moderate loan growth and slower capital market activity.

Growth in the manufacturing sector is expected to moderate in 2016 mainly due to slower expansion in the export-oriented industries. The expected softening in regional demand will affect the performance of the primary-related cluster. While the electronics and electrical (E&E) cluster will remain supportive of growth, the weakening demand from emerging market economies and the strength of the US dollar is likely to weigh down on global demand for electronic goods. Growth in the domestic-oriented industries is also expected to soften in line with weaker domestic demand conditions.

Growth momentum in the construction sector is projected to moderate slightly in 2016. In the residential sub-sector, the expansion is projected to remain modest amid weak housing approvals and property launches. Performance in the non-residential sub-sector is expected to be more moderate amid slower construction activity in the industrial and commercial property segments. The overall performance of the construction sector, however, will be supported by new and existing multi-year civil engineering projects, particularly in the transport and petrochemical segments.

In the commodity sector, agriculture production is expected to record a marginal contraction in 2016. This is largely due to lower palm oil yields following the hot and dry weather conditions brought about by the strong El Nino weather phenomenon. Growth in the mining sector will be supported by new gas production capacity from the Train 9 LNG production facility in Bintulu, Sarawak.

increase in the national minimum wage and the salary increment for civil servants effective July 2016. Consumption spending is also anticipated to be supported by higher crude palm oil and rubber prices, particularly spending by rural households.

The Malaysian labour market is expected to remain broadly stable. While the labour force will continue to grow in line with population growth, employment gains are expected to be moderate. Risks originate from weak sentiments among jobseekers and businesses, following the uncertainties surrounding global oil prices and global growth prospects. Nevertheless, moderate domestic demand and a gradually improving external sector are expected to remain supportive of the labour market. The unemployment rate may increase slightly but is expected to remain low at around 3.3 – 3.5% (2015: 3.2%). While the job market gradually adjusts to these conditions, wages will continue to grow in line with overall economic expansion. The Malaysian Employers Federation (MEF) annual survey reports that employers expect salary increments to average around 5.5% in 2016² (2015: 5.7%). Wage growth would likely be supported by robust wage growth in the export-oriented sectors, while wages in the domestic-oriented sectors will continue to expand moderately.

Private investment will be supported by ongoing and new investment projects, particularly in the manufacturing and services sectors

Given the continued environment of uncertainty and the cautious business sentiments, **private investment** growth is projected to trend below its long-term average and grow by 5.5% in 2016. The environment of continued low commodity prices would affect capital expenditure in the upstream mining sector, particularly investment related to activity involving marginal oil fields. Nonetheless, private sector capital spending will be supported by the implementation of ongoing

² Source: MEF Salary Survey Reports for Executives and Non-Executives 2015.

and new investment projects, particularly in the manufacturing and services sectors.

With the modest growth in demand from the advanced economies, investment in the manufacturing sector is expected to be driven by the expansion of capacity in the export-oriented manufacturing industries such as E&E and resource-based manufacturers. Furthermore, manufacturers are also expected to increase their capital spending to support the adoption of automation in order to increase efficiency and productivity, given the more competitive business environment.

In the services sector, investment would be driven by the continued implementation of existing capacity expansion projects, particularly in the tourism-related, transportation, healthcare and telecommunications sub-sectors. Specifically, investment in the telecommunications sub-sector will be driven by infrastructure expansion to cater for the growing nationwide demand for reliable and high-speed internet, including the 4G/LTE network expansion and fibre structures. Projects in the residential property segment, however, are expected to continue to expand at a more moderate pace as new housing approvals and launches remain modest.

Public sector expenditure to remain supportive of overall growth

Public consumption growth is expected to moderate to 2.0% in 2016, reflecting mainly the lower spending on supplies and services given the Government's commitment to more prudent spending under the current uncertain environment. However, public consumption will continue to contribute positively to overall growth, supported by the continued expansion in emoluments.

Public investment is projected to turn around to register a positive growth of 1.1%. While the Federal Government has announced a scale back in expenditure and reprioritisation of development projects, the total spending on fixed assets would still be higher in 2016 compared with the previous year. Public corporations, meanwhile, are expected to continue the positive investment momentum recorded in the second half of 2015,

Malaysia's Potential Output

Potential output can be described as the maximum output an economy can produce without exerting pressure on prices. The divergence of the actual output from its potential is the output gap, a useful indicator to assess the intensity of utilisation of an economy's resources. While it is unobserved and estimates tend to be sensitive to model specifications, the output gap is one of the indicators which is often used by policymakers to forecast inflation and make interest rate decisions.

In estimating Malaysia's potential output and output gap, Bank Negara Malaysia has adopted three broad approaches. These approaches include univariate models (Hodrick-Prescott (HP) filter and the univariate state space), the structural model (Cobb-Douglas production function) and multivariate models (Kalman filter and the model-based multivariate filter). All these approaches are used to obtain an average estimate of the output gap. As each of these models individually has its own strengths and limitations¹, the use of a combination of estimation methods allows for comparisons and cross-checking of the results.

Potential Output and Output Gap in 2015-2016

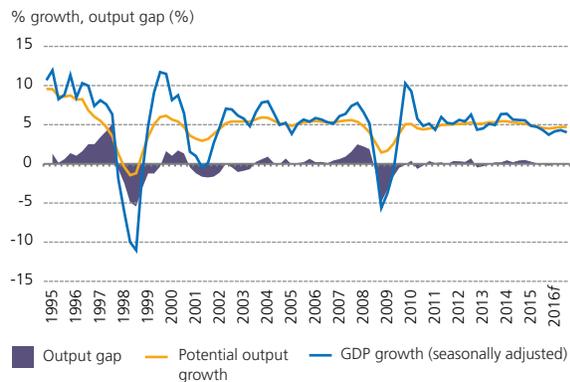
In 2015, Malaysia's output gap² narrowed to +0.21% (2014: +0.32%), with the potential growth also moderating to approximately 4.8%. While continued domestic investment and the broadly stable employment and labour participation rates (2015: 67.6%; 2014: 67.5%) remained supportive of potential output, global developments, namely declines in global oil prices, had a negative impact on the path of potential output³. In this regard, potential output growth was affected mainly through the investment channel, as firms in the oil and gas industry lowered their capital expenditure in response to the declines in oil prices resulting in a slower rate of capital accumulation. As the potential output growth moderated concurrently with the actual output (2015: 5%, 2014: 6%) the output gap narrowed during the year. Consistent with the narrower output gap, domestic inflation was at 2.1% (2014: 3.2%).

The output gap is forecast to be close to zero in 2016, with potential output expected to grow at approximately 4.6% (2015: 4.8%) (Chart 1). Continued capital accumulation, stable employment conditions and improvements in total factor productivity are expected to underpin the growth in potential output. While investments in the oil and gas industry are likely to remain weak in 2016, investments in the non-energy sectors are expected to continue in 2016 thus generating positive spillovers into the rest of the economy. In addition, labour participation rates are expected to be sustained in 2016 and therefore supportive of growth of potential output.

Demand pressure is expected to be contained. Aggregate demand is projected to grow at 4.3% compared to 5.1% in 2015, consistent with the

Chart 1

Output Gap, Potential and Actual Output Growth, 1995-2016f



f Forecast

Source: Bank Negara Malaysia estimates

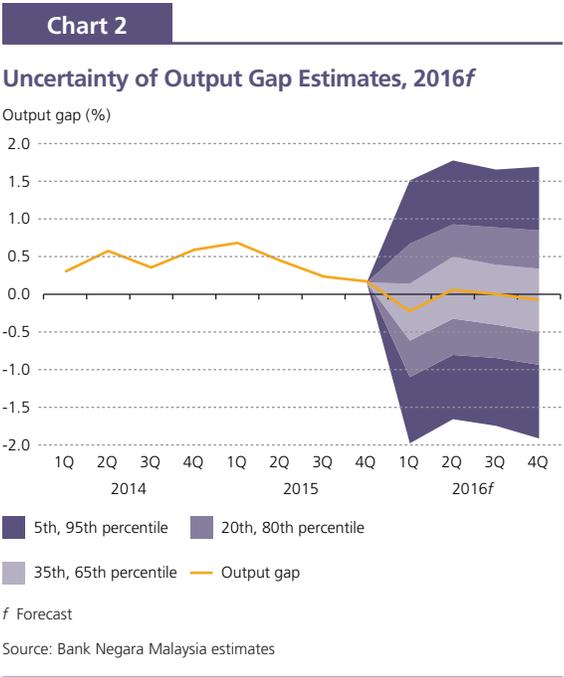
¹ Chuah L.L and Shahrier, N. A. (2014). Estimating Malaysia's Output Gap: Have we Closed the Gap?, Bank Negara Working Paper Series WP4/2014.

² The output gap is the average of the results obtained from five estimation methods, which include the Hodrick-Prescott (HP) filter, univariate state space (USS), Cobb-Douglas production function, multivariate Kalman filter (MVKF) and a model-based multivariate filter.

³ Studies have shown that oil price fluctuations could have broad consequences on economic activity. For example, see Jiménez-Rodríguez, R. and Sánchez, M. (2004). Oil Price Shocks and Real GDP Growth. Empirical Evidence for Some OECD Countries. ECB Working Paper Series, No. 362 / May 2004.

resources available in the economy. Inflation which is projected to increase slightly to 2.5 – 3.5% (2015: 2.1%), would be driven mainly by the adjustments of several price-administered items and the weak exchange rate. Domestic demand pressures are therefore not expected to be the main factor driving inflation.

Some uncertainty remains as shown in the dispersion of the fan chart (Chart 2). The output gap lies in the inner band of the fan chart which ranges from -0.46% to +0.34%. Given this uncertainty, information gathered from the industry is used as means to evaluate the model-based assessments. From the Bank’s surveys and engagement with businesses, firms in the export-oriented sectors generally expressed cautious optimism based on improvements in global conditions. Nonetheless, external risks such as the weakness of the ringgit and the slowdown in China will continue to weigh on firms’ business decisions. In view of this cautious outlook, firms are selective in their investment and hiring decisions and hence, will continue to invest only in areas important to their operations and hire workers critical for their production. Altogether, these information point to an outlook of moderate growth in both output and potential output in 2016.



after registering negative growth since 2014. This reflects the ongoing implementation of key infrastructure projects in diversified sectors, including in the utilities, transportation as well as the downstream oil and gas sectors.

External sector to remain resilient

In line with the projected improvement in external demand, Malaysia's export performance is likely to remain positive in 2016. Gross exports are forecast to expand by 2.4% in 2016, sustained by a modest improvement in demand from the advanced economies and continued growth in the regional economies. Subdued commodity prices will continue to weigh on Malaysia's exports but to a smaller extent than in 2015. The well-diversified nature of Malaysia's exports will continue to support the overall growth of exports.

The current account of the balance of payments will remain positive in 2016

With broad-based expansion in both E&E and non-E&E products, manufactured exports are projected to register a positive growth. E&E exports are likely to continue to benefit from the progressive diversification in the sector. Steady demand for semiconductors for a wide range of consumer and business applications in the fast growing industries, such as mobile devices, automotive and photosensitive sensors would likely bolster E&E export growth. Non-E&E exports will continue to expand, supported by sustained regional demand for resource-based products such as chemicals, petroleum and rubber products.

Persistent weakness in prices of mining products will affect commodity exports. This is expected to be further exacerbated by the softer overall global demand for commodities. However, the degree of decline in mining prices is unlikely to be as severe as in 2015, hence, the negative impact of lower commodity prices on exports will be smaller in 2016. Moreover, the crude palm oil (CPO) price is likely to inch higher, amid steady demand and lower supply due to lower yields caused by the El-Nino weather conditions. This will provide some support to commodity exports.

Gross import growth is projected to increase to 4.9% in 2016. Intermediate imports, which

form the bulk of Malaysia's imports, are expected to increase in tandem with firm production activity for exports and domestic consumption and investment. Continued expansion in domestic investment activity, particularly in the services and manufacturing sectors, is anticipated to contribute to the higher growth in capital imports. Growth in the intermediate and capital imports categories are likely to be higher, partially due to the relatively low base effect in 2015. Imports of consumption goods would register a more moderate growth, although imports of food and beverages, which are relatively inelastic in demand, will continue to drive the growth of consumption imports.

Given the sustained performance of manufactured exports and a continued surplus in the commodity trade balance, the overall trade balance in 2016 is expected to continue to record a surplus. The surplus will, however, be smaller in magnitude. As a large net exporter of LNG and CPO, the prices of these commodities will affect Malaysia's trade balance. The lower price of LNG will weigh on Malaysia's trade balance. The impact, however, will be partially mitigated by the improvement in CPO prices. With minimal corresponding imports for LNG and CPO, the contribution of these commodities to Malaysia's trade balance

Table 4.2

External Trade

	2015 ^p	2016 ^f
	Annual change (%)	
Gross exports	1.9	2.4
<i>of which:</i>		
Manufactures	6.5	5.6
Agriculture	-2.7	-3.8
Minerals	-20.6	-17.0
Gross imports	0.4	4.9
<i>of which:</i>		
Capital goods	0.0	8.9
Intermediate goods	-2.3	4.7
Consumption goods	24.1	3.0
Trade balance (RM billion)	94.6	79.5

^p Preliminary
^f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

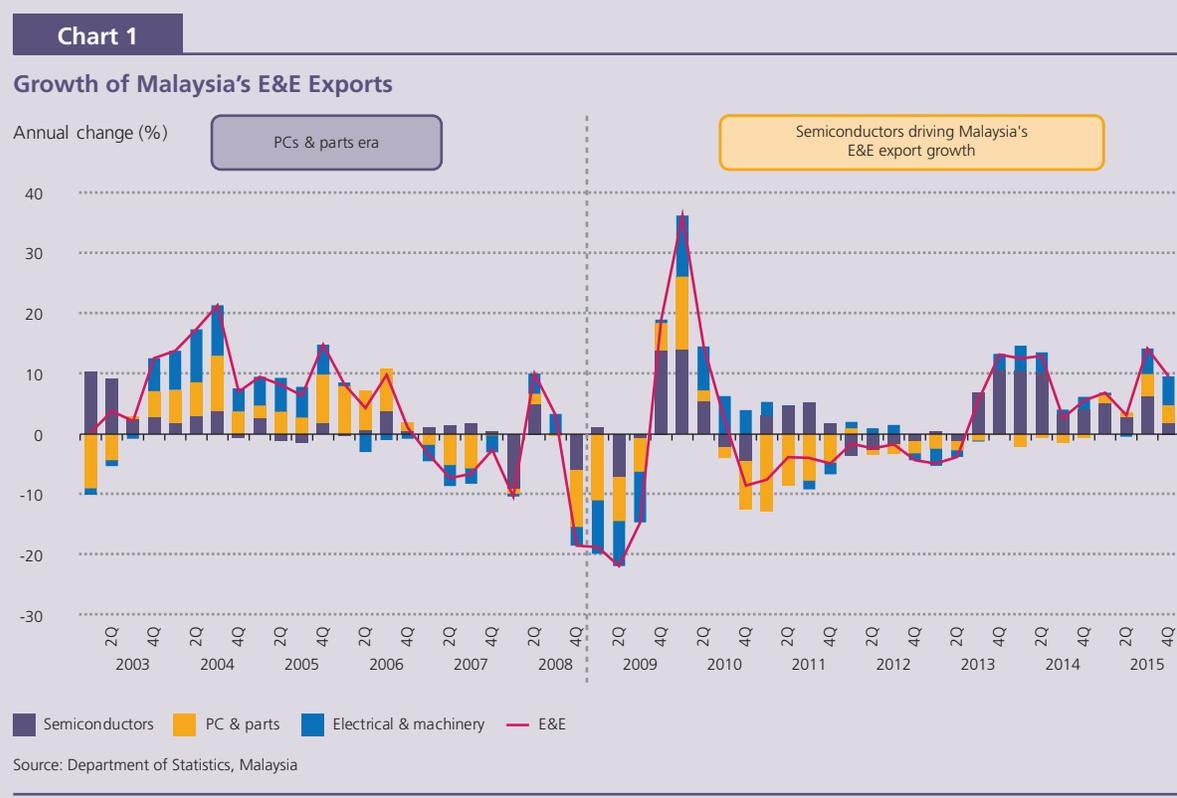
Shifting Shapes, Turning Tides: The Evolution of Malaysia's Electronics and Electrical (E&E) Industry

The global electronics and electrical (E&E) industry has experienced several transformations since the start of the new millennium. Firstly, post its ascension to the World Trade Organisation (WTO) in 2000, PR China has emerged as the world's largest E&E exporter, with aspirations to rapidly move up the value chain. Secondly, the progression towards more modern smart devices and wireless technology came to some extent at the expense of traditional personal computers (PCs) and parts manufacturers, which has been one of the industry's main drivers of growth until the Global Financial Crisis (GFC). Conversely, the increasing ubiquity and proliferation of electronics into all types of products, besides PCs and telecommunication equipment, have provided greater support for semiconductor manufacturers. Thirdly, the more diffused global E&E supply chain has also led to the increased competition among economies in attracting and retaining foreign direct investments (FDIs) from multinational companies (MNCs). Taken together, all these forces have prompted many participating economies and firms to recalibrate their strategies in the E&E industry.

Against this backdrop, Malaysia's E&E industry has had to adapt to the changing global environment to remain both relevant and competitive. In addition, the recent downturn in global commodity prices has drawn greater attention to the ability of Malaysia's E&E exports to mitigate the impact of the downturn in commodities and overall exports, whilst providing support to growth. These structural adjustments are observed in the on-going diversification of the local E&E industry away from PCs and parts into new emerging growth areas as well as products that are higher up in the value chain.

Shifting Shapes

From the early 2000s until the financial crisis in the advanced economies, Malaysia's E&E output and exports were mainly driven by products related to the PCs and parts industry (Chart 1). This ranged from testing and assembly services for integrated circuits (ICs) to the manufacturing of components. It can be observed that while the financial crisis caused a **cyclical weakness** in demand for electronic

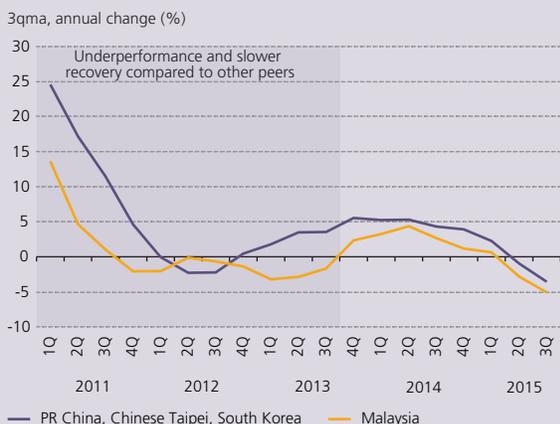


products, Malaysia's E&E export performance was further affected by a **structural shift** in consumer preferences away from PCs to smartphones and tablets. Combined with the prolonged weakness in demand from advanced economies after the financial crisis, Malaysia registered a much weaker recovery in E&E exports in 2012 and 2013 compared to its regional peers that are more involved in the fast-growing smart devices market (Chart 2).

Faced with this structural shift in the industry, many E&E manufacturing firms in Malaysia – both multinational and domestic – decisively moved towards diversifying away from the traditional PCs and parts segments into faster-growing and higher value-added segments. For example, many in the data processing semiconductor industry, especially data storage firms, have leveraged on the rising demand for cloud computing – arising from increasing internet-related activities – by increasing their involvement in the enterprise servers market. Another significant development is Malaysia's increasing involvement in automotive semiconductors (Chart 3). With continued robust demand for automotive sensors driven by safety and efficiency reasons, this industry is projected to experience long-term and stable growth compared to the smartphones and tablets segments. This will likely provide impetus for more sustained growth of Malaysia's semiconductor industry. These on-going E&E diversification efforts have enhanced Malaysia's ability to capitalise on the growth upturn in the advanced economies.

Chart 2

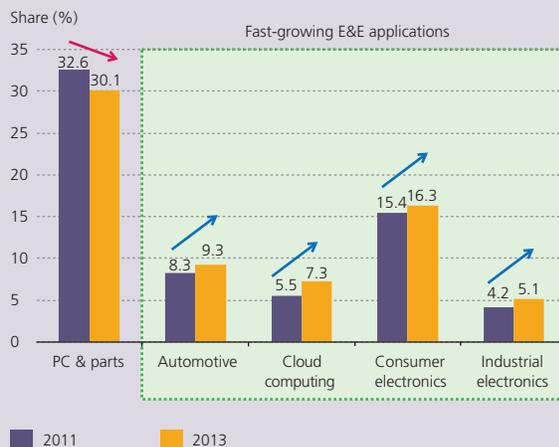
E&E Export Growth for the Major Asian Economies (in USD)



Source: Global Trade Atlas

Chart 3

Share of Malaysia's Total Semiconductor Sales



Source: Gartner Dataquest (December 2013) and Bank Negara Malaysia estimates

However, despite the encouraging tailwinds in the E&E industry, there remains room for further diversification of Malaysia's semiconductor product mix into other fast-growing segments. For example, in the coming years, the increasing pervasiveness of sensors and semiconductors in a great variety of industrial and consumer products, integrated by wireless technology and sophisticated software – known colloquially as the "Internet of Things (IoT)" – will provide a strong catalyst for the growth of Malaysia's E&E industry. While still at its infancy, the wide product coverage in the IoT space, ranging from wearables, common electrical appliances as well as bio-medical devices, represent exciting diversification opportunities for semiconductor players in Malaysia. In fact, many in the industry are already positioning themselves in this new growth area.

Recognising that public policy would need to act in concert with the E&E manufacturers to reap the most gains from this diversification process, the Government has launched, among others, the National IoT Strategic Roadmap and the National Aerospace Blueprint 2015-2020. These provide both the strategic spotlight and the framework to allocate public resources in support of greater entry into these new frontiers. The re-orientation of incentives and greater selectivity towards higher value-added investments further complement existing initiatives to spur more innovation-driven

operations in Malaysia. It is important for policymakers to conduct periodic re-assessments of existing incentives and policies to ensure that Malaysia catches the next technological wave early enough to derive significant economic benefits. Continuous collaboration with the private sector to identify and respond to emerging trends is necessary to maintain Malaysia's relevance in the global E&E value chain. Also, the National Exports Council (NEC) was created to spearhead policies that further enhance Malaysia's exports competitiveness, including that of the E&E industry.

Turning Tides?

While the adaptability in gaining a strategic foothold in new fast-growing market segments is vital in ensuring Malaysia's competitive edge in the E&E industry, it still needs to be complemented with measures that bolster its underlying fundamentals. The increased access to larger markets and the added attraction for FDIs provided by the Trans-Pacific Partnership Agreement (TPPA) are likely to draw focus on the ability of Malaysia's E&E industry to maximise its potential in an environment of increasing competition. This will require Malaysia to concurrently build on the progress made towards driving automation and to increase the supply of high-skilled talent. The latter is crucial in deepening Malaysia's presence in research and development (R&D) and design and development (D&D) activities, which is paramount given the increasing competition and limited space for growth in the lower value-added segments. Despite successes in incentivising major global E&E players to further increase their exposure in these high value-added activities in Malaysia through policy interventions, there is still some way to go before a critical mass of firms is achieved. While the transition up the value chain and higher productivity will likely exert pressures on those that are overly reliant on labour-intensive operations, the re-orientation of Malaysia's focus to more innovation-driven investments and activities is crucial in achieving a high value-added and high-income economy.

Current signs point towards a brighter future and a major role of the E&E industry in Malaysia's diversified economy provided the industry continues to undertake the necessary measures needed to further enhance its competitiveness. As more frequent technological disruptions become the norm, the ability to spot changing trends and to adapt accordingly will be an increasingly critical factor that affects the competitiveness of the economies involved in the E&E industry. With a major presence in the global value chain, Malaysia is strategically positioned to benefit from the positive developments in the industry.

will remain positive. At the same time, the modest improvement in global demand is likely to generate continued positive contribution to the export performance of manufactured products.

The services account is projected to record a narrower deficit. This is premised upon the expected improvement in tourist arrivals and higher tourist spending. The introduction of e-Visa for tourists from selected countries and the easing of travel requirements for tourists from China, coupled with intensified promotional efforts for targeted tourism industries such as medical, sports and Halal tourism, would attract more foreign tourists to Malaysia. Growth in services imports, however, will be driven by continued dependence on foreign service providers for transportation and other services such as business and professional services, in line with the expansion in trade and investment activities during the year.

In the primary income account, profits from Malaysian companies investing abroad are expected to be lower, mostly on account of the lower income of oil and gas companies, which accounted for more than a third of Malaysia's investment income abroad. Nevertheless, this is likely to be partially offset by continued profits from other overseas investments. Reflecting the sustained growth in manufactured exports, higher investment income is expected for the multinational corporations operating in Malaysia. Altogether, this will result in the deficit in the primary income account to increase in 2016. The continued deficit in the secondary income

account, meanwhile, is mainly attributable to higher expected outward remittances, which will more than offset the expected increase in inward remittances.

Overall, given a gradual improvement in exports, the net export of goods and services is projected to provide some support to real GDP growth in 2016. The current account surplus may be lower at RM19.1 billion or 1 – 2% of GNI, on account of lower goods surplus and wider income deficits.

The international economic and financial landscape is expected to remain challenging in 2016, with investor sentiments being affected by the downside risks to the global growth outlook. As a consequence, Malaysia will likely be confronted by continued sizeable two-way movements in capital flows, shaped by the large and volatile shifts in global liquidity. Despite these uncertainties, Malaysia's deep and developed financial markets remain well positioned to intermediate these highly volatile flows, thus ensuring that the functioning of the domestic financial markets continues to be orderly and supportive of the real economy. Malaysia's ability to withstand external shocks will also be further augmented by the availability of ample buffers, robust policy frameworks, economic adaptability and ample policy space.

INFLATION OUTLOOK

Headline inflation is projected to increase to 2.5 – 3.5% in 2016 (2015: 2.1%), due mainly to adjustments in the prices of several price-administered items and the weak ringgit exchange rate. However, the impact of these cost factors on inflation will be mitigated by the low global energy and commodity prices, generally subdued global inflation, and more moderate domestic demand. The trajectory of the inflation forecast, however, could be more volatile as it is subject to uncertainties in global oil prices and the ringgit exchange rate.

Several adjustments in administered prices have been undertaken since October 2015. These price adjustments include increases in intra-city highway toll charges, railway charges and a reduction in electricity tariff rebates. In addition, prices of cigarettes were increased by about 23% in November following the increase in excise duty on tobacco products. As most of

Table 4.3

Current Account of Balance of Payments¹

Item (Net)	2015 ^p	2016 ^f
	RM billion	
Goods	108.9	99.5
Services	-20.5	-19.2
Primary income	-32.2	-38.0
Secondary income	-22.2	-23.1
Current account balance	34.0	19.1
<i>% of GNI</i>	<i>3.0</i>	<i>1~2</i>

¹ The data are compiled in accordance with the Sixth Edition of Balance of Payments and International Investment Position Manual (BPM6) by the International Monetary Fund (IMF)

^p Preliminary

^f Forecast

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

these price adjustments were implemented towards the end of 2015, the inflationary impact will mostly be felt in 2016.

Inflationary pressures from adjustments to administered prices and the weaker ringgit exchange rate will be offset by low global energy and commodity prices

The weak ringgit exchange rate will likely contribute to higher inflationary pressures in 2016. Imported finished goods are likely to cost more. Imported raw and intermediate materials could also be more expensive, resulting in higher prices of locally manufactured goods. However, the overall impact of price increases due to the weaker ringgit exchange rate is not expected to be large as imported finished consumer goods excluding fuel only account for 7.2% of the CPI basket, while imported intermediate inputs only account for 20% of the gross output³.

In 2016, the IMF projects global oil prices to average at USD35 per barrel⁴ (average 2015: USD51 per barrel) as a result of the continued high global production amidst moderate growth in global demand. The large build-up in global inventories and the removal of sanctions on Iran would also contribute to the oil supply glut, exerting further downward pressures on global oil prices. The Food and Agriculture Organisation of the United Nations (FAO) projects global food prices to also continue trending lower in 2016 given favourable supply conditions amidst slower global demand. The projected low energy and commodity prices are expected to mitigate upward price pressures from the weak ringgit exchange rate. Domestic fuel prices, for example, are expected to remain low in 2016 as global oil prices will continue to be low. However, the extent of this offsetting impact from low global oil prices is not expected to be as large as in 2015, due to the more modest decline in global oil prices. Given the low global energy and commodity prices and subdued domestic demand in some of Malaysia's

major trading partner economies, imported inflation is also expected to remain low.

Inflationary pressures stemming from domestic demand factors are expected to be modest, given the slower expansion in household spending amidst more moderate real wage growth. The output gap is expected to be close to zero in 2016. With more moderate demand conditions, firms may hesitate to fully pass on the increase in costs from adjustments to administered prices and weak exchange rate to consumers.

The inflation outlook in 2016 is subject to two risks. First, the trajectory of inflation could be volatile and uncertain, arising mainly from the uncertainties surrounding the movements of global oil prices and the ringgit exchange rate. These uncertainties would affect inflation mainly through their impact on domestic fuel prices. Second, changes in ringgit exchange rate could also have varying implications on the prices of imported goods and services. The pass-through of exchange rate changes to domestic inflation remains highly uncertain and is dependent on the prevailing economic conditions and the behaviour of firms and households.

MONETARY POLICY

Monetary policy in 2016 will focus on ensuring monetary conditions remain supportive of the sustainable growth of the domestic economy with price stability. This is against a challenging policy environment, characterised by the expectation of more moderate domestic growth, higher headline inflation and a high degree of uncertainty in the global and domestic environment. In particular, there are downside risks to global growth, given weaknesses in both the advanced and emerging economies, the uncertainty surrounding the outlook for energy and commodity prices, and the expectation of continued volatility in the international financial markets. The implications of these developments on the domestic growth and inflation outlooks will be closely monitored during the year. In addition, monetary policy will also continue to consider the risk of financial imbalances.

Against a challenging global environment, the Malaysian economy is projected to expand at a more moderate pace of 4.0 - 4.5% in 2016, anchored by private sector-driven domestic demand. Headline inflation is expected to range

³ Estimated based on Input-Output Tables 2010 for Malaysia.

⁴ Average price of Dated Brent, West Texas Intermediate (WTI) and Dubai Fateh crude oil, equally weighted, as projected by the IMF Primary Commodity Price Forecast in February 2016.

between 2.5% and 3.5% in 2016. The higher inflation compared to 2015 will be driven mainly by upward adjustments in administered prices and the weak ringgit exchange rate, although this will be partly offset by the continued low global energy and commodity prices. The uncertainty around the path of the ringgit exchange rate and global energy prices, however, is a risk to the outlook for inflation. Nevertheless, underlying inflation is expected to remain relatively stable given the more moderate domestic demand conditions.

Monetary policy in 2016 will focus on ensuring monetary conditions remain supportive of sustainable economic growth with price stability

The baseline outlook for both domestic growth and inflation will be subject to risks during the year, given the high degree of uncertainty prevailing in the external and domestic environment. The focus of the Monetary Policy Committee would thus be to

ensure that the stance of monetary policy remains consistent with the achievement of price stability and sustainable growth given the evolving risks in the global and domestic economies. In addition, given the expectation of continued volatility in external flows, the Bank's monetary operations will be directed towards ensuring that domestic liquidity will continue to be sufficient in the financial system, in order to support the orderly functioning of the domestic financial markets.

FISCAL POLICY

Fiscal policy in 2016 will continue to focus on fiscal consolidation amid challenging external and domestic conditions. The 2016 Budget, tabled in October 2015, was recalibrated in January 2016 to incorporate the expected decline in global oil prices⁵, which would have an implication on the Government's revenue. The recalibration entails the implementation of prudent and pre-emptive measures to reprioritise Government spending. This is underpinned by cost-cutting measures in the Government's operating expenditure and reprioritisation of its development expenditure. Measures to broaden revenue sources⁶ were

Table 4.4

Federal Government Finance

	RM billion			% change		
	2015	2016 ^r		2015	2016 ^r	
Oil price	52	30	35			
Revenue	219.1	216.3	217.9	-0.7	-1.3	-0.5
Total expenditure	257.8	255.7	257.2	-0.5	-0.8	-0.2
<i>Operating expenditure</i>	217	210.7	211.2	-1.2	-2.9	-2.7
<i>Gross development expenditure</i>	40.8	45.0	46.0	3.2	10.4	12.8
Loan recoveries	1.5	0.8	0.8			
Overall balance	-37.2	-38.7	-38.5			
% of GDP	-3.2	-3.1	-3.1			
<i>Sources of financing:</i>						
Net domestic borrowing	38.9	-	-			
Net external borrowing	0.7	-	-			
Realisable assets ¹ and adjustments	-0.2	-	-			

¹ A negative (-) sign indicates a build-up in assets

^r Recalibration

Note: Numbers may not add up due to rounding

Source: Ministry of Finance, Malaysia

⁵ The assumption on global oil price was revised downward to between USD30 - USD35 per barrel (2016 Budget: USD48 per barrel).

⁶ These include redistribution and bidding of the telecommunications spectrum, strict duty enforcement on sales of cigarettes, liquors and imported vehicles in duty-free islands and streamlining the foreign worker levy system.

also introduced to further enhance the revenue collection. As a result, the Government fiscal deficit target for 2016 remained at 3.1% of GDP (2015: 3.2%) as announced in October 2015.

Despite the more challenging economic environment, the Government will continue to implement fiscal reform measures to further consolidate its fiscal position. This includes measures to rein in the growth of operating expenditures, which includes the rationalisation of subsidies and the reduction of non-critical spending on supplies and services, and asset purchases. The share of operating expenditure as a percentage of GDP is expected to decline to about 17% in 2016 compared to 18.8% in 2015. The implementation of the Goods and Services Tax (GST) has broadened the sources of income for the Government. This would help to mitigate the revenue loss from lower oil prices and reduce dependence on highly volatile commodity-based revenues. The contribution of oil-related revenue to total revenues has indeed declined to 21.5% in 2015 compared to 30% in 2014. This is expected to further decline to between 13% and 14% in 2016.

Fiscal resources in 2016 will be prioritised towards high impact infrastructure projects with larger multiplier effects⁷. This is also in line with the objectives of the Eleventh Malaysia

Plan (11th MP) that charts the development priorities of the Government for the next five years (2016-2020). Government expenditure will be channelled towards expanding connectivity and infrastructure, building an efficient public transportation system and enhancing technology and telecommunications, which would increase the productive capacity of the economy. Emphasis will continue to be accorded towards ensuring inclusive and sustainable growth through welfare enhancement. Socio-economic support to the lower- and middle-income segments will continue to be provided in order to sustain the capacity of these groups to cope with the rising cost of living⁸ and to support private consumption.

Over the medium term, sustaining fiscal reform would remain a key element of the Government's economic transformation agenda. The strengthening of public finances is one of the fundamental indicators of the resilience of the economy. A sound fiscal position provides the space for more effective counter-cyclical macroeconomic policy, and supports the Government's pursuit of nation-building initiatives. Towards this end, further enhancement of the Medium Term Fiscal Framework will be important to support the Fiscal Policy Committee in ensuring a sustainable and effective role of the Government's fiscal policy.

Table 4.5

Fiscal Adjustment Measures Announced in the 2016 Budget Recalibration

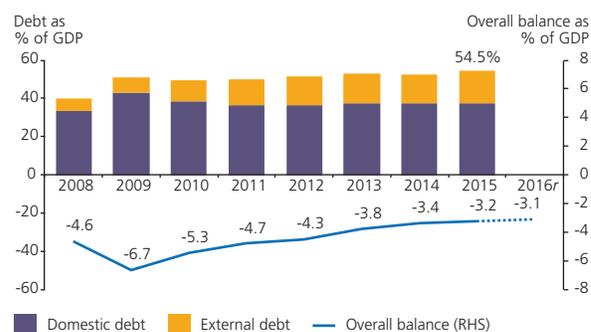
		RM billion
Expenditure optimisation measures		9.0*
1	2 – 5% scale down in supplies and services	1.7
2	Rationalisation of grants and transfers	1.0
3	Lower subsidy on LPG and diesel	1.0
4	Delay asset purchase	0.2
5	Reprioritisation of development expenditure	5.0

*Figure may not add up due to rounding
Source: Prime Minister's Speech on 28 January 2016

⁷ These include strategic investments such as Cyber City Centre, Aeropolis KLIA and Iskandar Malaysia.

Chart 4.3

Federal Government Fiscal Balance and Debt



r Recalibrated
Note: External debt refers to offshore borrowing and non-resident holdings of ringgit-denominated Government debt (MGS, Gil, T-bills, etc.)

Source: Ministry of Finance, Malaysia

⁸ These include the increase in the national minimum wage, increments in various fiscal transfers and income tax relief for the middle-income group. The Budget Recalibration further complements these measures with a temporary reduction of EPF employees' contribution and special tax relief for individual taxpayers with a monthly income of RM8,000 or below for the year of assessment 2015.

