

2014

OUTLOOK AND POLICY IN 2015

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### THE INTERNATIONAL ECONOMIC OUTLOOK

The global economy is expected to continue expanding at a moderate pace in 2015, with increasing divergence in the growth momentum among the major economies. Global growth will be supported by gradual but uneven improvements in the advanced economies and sustained growth in most emerging economies. While growth in the US is projected to gather momentum amid higher private sector spending, economic activity in the euro area and Japan will remain weighed down by structural weaknesses. In PR China, growth is projected to continue to moderate towards a more sustainable path, as policymakers continue to undertake structural reforms to rebalance the key drivers of the economy. Nevertheless, growth prospects in most emerging economies are expected to be sustained by the continued expansion in domestic demand and the gradual improvement in external demand, following the recovery in several advanced economies. In addition, the low global crude oil prices are expected to provide additional lift to global growth. Lower inflation and higher disposable incomes will support higher consumer spending, while lower production costs could encourage further business investment in non-energy-related sectors, particularly in industries with already high capacity utilisation rates.

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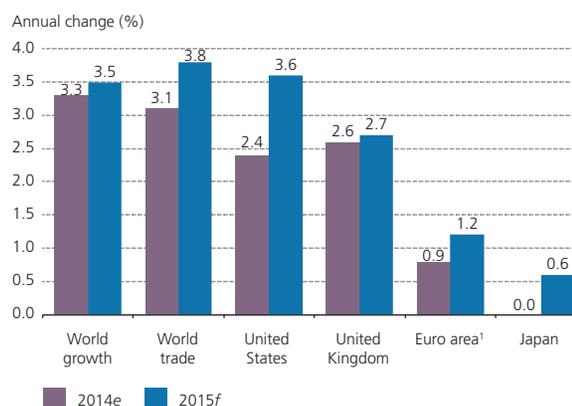
Global economy to remain on a moderate growth path in 2015, with increasing divergence in growth momentum among major economies

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Nevertheless, there remain downside risks to the global growth outlook. The prolonged weakness in domestic demand and persistence of disinflation or even deflation in several major advanced economies, together with adverse geopolitical developments, could have spillovers on global trade activity. Uncertainty over commodity price movements could also affect the growth prospects of the commodity-producing emerging economies.

Chart 4.1

#### World Growth, World Trade and Growth in Major Advanced Economies (2014-2015)



<sup>1</sup> Refers to EU-18  
e Estimate  
f Forecast

Source: International Monetary Fund and National Authorities

These, together with uncertainty arising from the potential divergence of monetary policy stance in the major advanced economies, could result in heightened volatility and potential disruptions in the international financial markets. Of significance, large and volatile shifts in global liquidity could have implications on the financial markets and growth prospects of the emerging economies.

#### Uneven growth performances across major economies

In the **US**, economic recovery is expected to become more entrenched, underpinned by a continued expansion in private sector demand and lower fiscal headwinds. Private consumption is projected to strengthen on account of improving household balance sheets and favourable labour market conditions. Of significance, job creation has been more broad-based. While some degree of labour market slack remains, it is expected to gradually diminish, as reflected by the ongoing decline in the unemployment rate and the lower number of involuntary part-time workers. The low energy prices will also provide further impetus to private consumption through lower inflation and higher disposable income. On the investment front, non-residential capital expenditure will be supported by rising new orders and higher capacity

utilisation rates, which have already exceeded pre-crisis levels (December 2014: 79.4% of total capacity; 2003-2007 average: 78.9%). Although mining investment will be weighed down by the lower crude oil prices, this is expected to be offset by higher investment in the other industries amid lower production costs and improving demand. Fiscal headwinds are projected to moderate amid a slower pace of fiscal consolidation in the near term. Possible fiscal challenges have broadly been alleviated, as the US Congress had passed a funding package for most federal agencies through Fiscal Year 2015, thus removing the possibility of a government shutdown. Nevertheless, the pace of economic expansion in the US could be affected by adverse spillovers arising from weaker-than-expected growth in several other major economies and the reversal of earlier US dollar weakness. Of significance, lower export performance and corporate earnings could affect the strength of investment activity.

In contrast, growth in the **euro area** is expected to remain subdued in 2015. Private consumption activity is anticipated to grow at a modest pace, as employment and real wage growth remain weak. Investment activity will likely remain low amid ample spare capacity, weak business sentiments amid persistent geopolitical developments, the modest implementation of structural reforms, and still unfavourable although improving financing conditions. Nevertheless, a broadly neutral fiscal stance, together with the introduction of the European Fund for Strategic Investments, could provide some support to investment activity going forward. Domestic demand may also benefit from the highly accommodative monetary policy stance, particularly following the implementation of the expanded asset purchase programme of EUR60 billion per month by the European Central Bank (ECB). On the external front, trade activity is expected to be supported in part by a gradual strengthening of external demand and the depreciation of the euro.

Economic activity in **Japan** is also expected to remain subdued in 2015. While export performance will continue to be supported by improving external demand and the weak yen, the lingering effects from the consumption tax increase in April 2014 could continue to limit the strength of domestic private sector recovery. Nevertheless, the postponement of the second consumption tax increase from 2015 to 2017 will likely mitigate further weakness in domestic

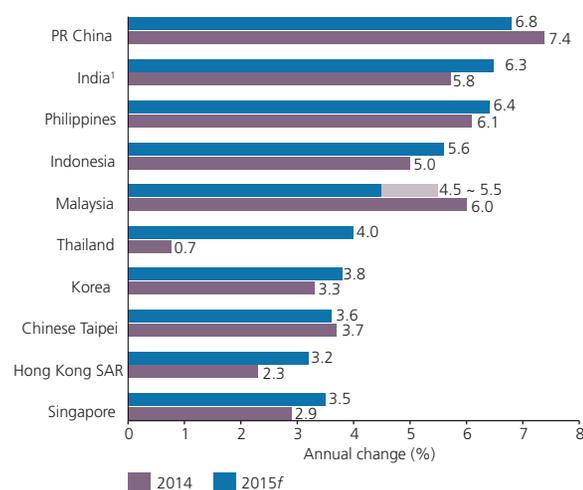
economic activity. Over the longer term, higher wage growth and further structural reforms aimed towards raising productivity and improving fiscal sustainability remain vital to the growth prospects.

In **PR China**, economic activity is expected to continue to trend towards a more sustainable growth path amid the implementation of further structural reforms to rebalance the key drivers of the economy. The pace of growth moderation is, nevertheless, expected to remain gradual. Of significance, the Chinese policymakers continue to have ample policy space to support overall growth, particularly through targeted measures to key productive sectors as well as accelerated infrastructure and rural development, and to mitigate potential risks confronting the Chinese economy.

In **Asia**, growth is expected to be sustained in 2015, supported by the continued expansion in domestic activity and improving external demand. Of significance, capital spending, particularly on infrastructure development, will continue to support the expansion in domestic demand. In the external sector, the improving growth prospects of several advanced economies, particularly the US, will continue to benefit Asia's export performance. Nevertheless, the degree of improvement will vary across economies based on their trade exposure, especially to the US and

Chart 4.2

Regional Economies: Real GDP Growth



<sup>1</sup> For India, GDP data and forecast are presented on a fiscal year basis

f Forecast

Source: International Monetary Fund, Asian Development Bank and National Authorities

PR China. For the major commodity exporters in the region, the lift from improving external demand could also be partly mitigated by the low commodity prices. Overall, the Asian region is projected to remain an important driver of global economy activity, contributing to over 50% of global growth in 2015.

### **Global inflationary pressures to remain modest**

Global inflationary pressures are expected to remain modest in 2015, reflecting the persistence of low commodity prices amid favourable supply conditions and weak demand from several key economies. Given the moderate growth outlook for the global economy, the persistence of low inflation will provide further support to consumer spending.

In the global commodities markets, crude oil prices are likely to remain subdued on account of ample supply from both the Organisation of the Petroleum Exporting Countries (OPEC) and non-OPEC producers. Food prices are also projected to remain moderate amid higher crop production. For hard commodities, improved supply conditions and lower demand from several key economies, such as PR China, are likely to continue to exert downward pressures on prices, particularly for iron ore and copper.

Amid the subdued outlook for global commodity prices, headline inflation is expected to continue to trend below central banks' inflation targets in most advanced and emerging economies. Of significance, in the euro area, persistently low commodity prices amid a persistent negative output gap and subdued wage growth could increase the risk of protracted deflation. In contrast, for several advanced economies, such as the US, the potential for improving wage growth amid the further narrowing of economic slack could dampen the downward pressures on overall inflation. In Asia, the subdued commodity price outlook will help to contain price pressures emanating from improving domestic demand and further price adjustments in a few economies.

### **Downside risks to global growth remain**

There, however, remain several downside risks to the global growth outlook in 2015. Despite highly accommodative monetary policies, prolonged economic slack and unresolved structural issues in several advanced economies could lead to weaker-than-expected growth momentum in these economies, with adverse

spillovers on global trade activity. The possibility for weaker-than-expected growth momentum in these economies could be further exacerbated by the persistence of disinflation or even deflation amid low commodity prices. While recent episodes of geopolitical developments have not resulted in sizeable disruptions to production, an increase in adverse geopolitical developments, particularly in the euro area, Eastern Europe and the Middle East, could affect global sentiments and dampen the strength of overall global growth. In addition, uncertainties over commodity price movements could have implications on the growth prospects of commodity-producing emerging economies.

### **Overall policy mix to remain supportive of growth**

Monetary policy is expected to remain accommodative across regions. Nevertheless, amid the uneven growth outlook, the monetary policy stance in the major advanced economies could potentially diverge in 2015. In the euro area and Japan, the ECB and the Bank of Japan will continue to increase the degree of monetary accommodation through further asset purchases. In contrast, as the recovery in the US economy becomes more entrenched, the Federal Reserve (Fed) could begin normalising interest rates from the current low levels in 2015. There will, however, remain considerable uncertainty over the timing and pace of interest rate normalisation in the US, as policy adjustments by the Fed will depend on the actual turnout of economic and financial developments, as well as the balance of risks emanating from strengthening economic conditions and downward pressures on inflation emanating from lower energy prices.

The uncertainty over the timing and pace of monetary policy adjustments by the major advanced economies will likely lead to large and volatile shifts in global liquidity. The emerging economies, particularly Asia given the region's high degree of financial interconnectedness, will remain susceptible to the bouts of heightened financial market volatility. Of significance, as the Asian region was a major recipient of capital inflows during the earlier periods of asset purchases by central banks in the major advanced economies, Asia will continue to be vulnerable to large and sudden capital flow reversals. Nevertheless, the Asian economies are expected to remain resilient, with little disruption to financial intermediation, supported by the continued implementation of policy measures to strengthen macroeconomic fundamentals and address areas of vulnerabilities over the years.

In addition, the prioritisation of reforms to address infrastructure constraints, accelerate urbanisation, expand social safety nets and advance human capital development will further enhance the competitiveness and strengthen the medium-term growth potential of Asia. Furthermore, amid increasing focus on the quality of growth in the region, successful implementation of such policies will yield significant benefits in terms of the prospects for sustainable growth in Asia and the improvements in the economic welfare of its people.

## THE MALAYSIAN ECONOMY

### Overview

The international economic and financial landscape has become more challenging since late 2014 and into 2015. Beyond the sharp decline in commodity prices, the growth momentum in several major economies is also weaker than earlier expectations. Different growth momentums could lead to divergent monetary policy stances in the major economies, precipitating volatility in capital flows. Against this backdrop, the international financial markets are likely to remain volatile during the year.

As a highly open economy, Malaysia's economic outlook will be affected by these developments. Export growth is projected to be lower due to the low commodity prices. At the same time, uncertainties regarding the strength of global economic outlook and the sharp decline in the global oil prices have raised concerns on the country's fiscal and balance of payments positions. These developments have affected market sentiments and resulted in greater volatility in the capital markets in late 2014 and early 2015.

Although the commodity sector is an important contributor to production, exports and employment, the highly diversified structure of the Malaysian economy provides a buffer against the consequences of the sharp decline in global oil prices. Domestic economic activity and employment are expected to be sustained by the continued growth of the services, manufacturing and construction sectors, which together accounts for almost 84% of GDP. While the Government's fiscal position will be affected, the impact is mitigated by the fact that the dependency of the Government on oil-related revenue has declined over the years following efforts to broaden the revenue base. Importantly, the pre-emptive measures announced by the Government on 20 January 2015, which involved

both revenue enhancement and expenditure rationalisation measures, will contain the impact of the external developments on the overall fiscal position.

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## Despite facing significant external shocks, the Malaysian economy is expected to remain on a steady growth path of 4.5 – 5.5% in 2015

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A positive development for Malaysia's exports in 2015 is the expected improvement in the US economy and the sustained growth of regional economies. Lower energy prices are expected to provide a lift to consumption and investment spending in net oil-importing economies such as the US, PR China and regional economies which are Malaysia's key trading partners. In addition, the global demand for mobile devices, tablets and automotive sensors continues to be strong. These developments are expected to drive Malaysia's manufactured exports (77% of total exports), in particular electronics and electrical (E&E) and non-resource based exports. The more diverse nature of exports in terms of products and markets will help sustain a surplus in the current account balance. The balance of payments position is therefore, expected to remain resilient, with the current account balance remaining positive.

Overall, the Malaysian economy is projected to register a steady growth of 4.5 – 5.5% in 2015 (2014: 6.0%), supported mainly by a sustained expansion in domestic demand amid strong domestic fundamentals and a resilient export sector. Domestic demand will continue to anchor growth in 2015, driven by private sector spending. Private consumption is forecasted to record a more moderate growth during the year, after registering five consecutive years of above-average growth rates since the financial crisis in the advanced economies. While household spending is expected to be affected by the implementation of the Goods and Services Tax (GST) in April and lower earnings in the commodity-related sectors, its impact will, however, be partially offset by Government measures to assist targeted groups, the additional disposable incomes from lower fuel prices and the favourable labour market conditions. Similarly, after three consecutive years of double-digit growth, private investment is expected

to moderate due mainly to lower investment in the mining sector following weak global crude oil prices. Nevertheless, private investment growth will be supported by on-going and new investments in the manufacturing and services sectors as firms benefit from the continued global recovery and lower cost of inputs. Public sector spending, in particular public investment, is expected to improve amidst higher spending on fixed assets, particularly by the public enterprises. In 2015, the contribution to growth from the Government is expected to remain modest.

On the external front, the current account of the balance of payments is projected to remain in a surplus position of about RM21.4 billion or 2 - 3% of gross national income (GNI). Even though gross exports are expected to record slower growth amid lower commodity prices, the improvement in economic activity in several advanced economies and sustained growth of regional economies will lend support to manufactured exports. At the same time, a stronger travel account in conjunction with 'Malaysia - Year of Festivals 2015' tourism promotion is expected to provide a lift to the services account. Gross imports are projected to increase at a faster pace as intermediate imports remain strong. After registering a negative growth in 2014, capital imports are expected to recover, reflecting continued investment activity which will improve Malaysia's productive capacity and export competitiveness in the medium- and long-term.

Headline inflation is expected to average 2 - 3% in 2015 (2014: 3.2%) due mainly to lower energy and food prices. The decline in global oil prices would lead to lower domestic fuel prices through the managed float fuel pricing mechanism. The subdued external price pressures would also mitigate increases in the cost of imports stemming partly from the recent ringgit depreciation, thereby reducing overall imported inflation. These would partly offset some of the impact from the implementation of the GST on 1 April 2015. While there is a risk that the monthly inflation trajectory could be subject to the volatility in global oil prices, the underlying inflation is expected to remain relatively stable.

While the latest projection is for a gradual improvement to global growth in 2015 relative to 2014, there are several **downside risks** to the growth outlook. In the advanced economies, the implementation of much needed structural reforms will determine the strength of economic

recovery in the immediate term and the sustainability of the recovery over the longer term. A sharper-than-expected slowdown in PR China poses downside risks to global growth and trade. In addition, the uneven growth prospects are raising the possibility of a divergence in the monetary policies of the major central banks. Such a development could result in sizeable global liquidity shifts and contribute to greater volatility in global financial markets and capital flows. The sharp decline in the price of oil and the uncertainty over its future price path, coupled with the attendant effects on the prices of other commodities, further compounds the challenging global environment.

In the event that some of these risks materialise, the Malaysian economy would be adversely affected, but its strong underlying fundamentals would act as a buffer to mitigate the impact. The economy is well-diversified, inflation is low, and the balance of payments position is resilient. At the same time, labour market conditions remain healthy, with an unemployment rate of 3%. In addition, financial system stability is intact, supported by financial institutions that have strong capitalisation levels and sound risk management practices. This will allow financial intermediation to continue and provide support to economic activity in the event of an external shock. The deeper and more matured financial markets and the strong banking system have also increased Malaysia's resilience to bouts of capital flow volatility. On the external front, the long-term prospects for FDI remain positive while Malaysia's external debt remains manageable, with a debt profile that is skewed towards the medium- and longer-term tenures. A significant share of the external debt is also ringgit-denominated, which reduces the impact of foreign exchange fluctuations. This, together with ample international reserves will further accord the policymakers with flexibility to manage these external risks. The combination of these factors will cumulatively also enable a more effective policy response to mitigate the impact of any external shocks on domestic demand and growth.

### **Domestic demand continues to underpin growth**

**Domestic demand** is expected to register a sustained growth of 6.0% in 2015 (2014: 6.0%), anchored by private sector expenditure. Private sector spending is expected to remain resilient amid an improvement in public expenditure growth.

## Expansion in All Economic Sectors

In 2015, all economic sectors are expected to expand, albeit at a more moderate pace. The services and manufacturing sectors would remain as key drivers of overall growth, benefiting from the resilience of domestic demand. Growth in the mining sector is projected to be sustained amid rising output from a new oil field. Weighed down by lower commodity prices, the agriculture sector is expected to record lower but still positive growth.

**Table 1**

### Real GDP by Kind of Economic Activity (2005=100)

	2014 <sup>p</sup>	2014 <sup>p</sup>	2015 <sup>f</sup>	2014 <sup>p</sup>	2015 <sup>f</sup>
	% of GDP	Annual change (%)		Contribution to growth (percentage point)	
Services	55.3	6.3	5.6	3.5	3.1
Manufacturing	24.6	6.2	4.9	1.5	1.2
Mining and quarrying	7.9	3.1	3.0	0.3	0.2
Agriculture	6.9	2.6	0.3	0.2	0.0
Construction	3.9	11.6	10.3	0.4	0.4
<b>Real GDP</b>	<b>100.0<sup>1</sup></b>	<b>6.0</b>	<b>4.5 ~ 5.5</b>	<b>6.0<sup>1</sup></b>	<b>4.5 ~ 5.5</b>

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

<sup>p</sup> Preliminary  
<sup>f</sup> Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The services sector is projected to remain as the largest contributor to growth in 2015. Growth in consumption-related activities such as retail trade, accommodation and restaurants will be supported by household spending. Higher tourist arrivals, in conjunction with the 'Malaysia - Year of Festivals 2015' tourism promotion, will further support growth. The communication sub-sector will continue to register robust growth, driven by strong demand for data services amidst higher usage of mobile devices, particularly smartphones. The continued expansion in trade-related activity will support growth in production-related services such as wholesale, transport and storage. In the finance and insurance sub-sector, growth is projected to be sustained, supported by stable demand for financing, particularly from businesses, and higher fee income from capital market activity.

The manufacturing sector is expected to continue to expand in 2015 despite slower growth in key clusters. While the lower oil prices will affect the production of petroleum-related products, growth in the export-oriented cluster will be supported by the sustained demand for Malaysia's E&E goods. Growth in the consumer- and construction-related clusters will remain supported by the favourable domestic demand conditions.

The construction sector is expected to continue to record high growth, albeit at a more moderate pace in 2015. After several years of robust growth, activity in the residential sub-sector is expected to increase at a more moderate pace due to lower housing approvals and property launches. Nonetheless, growth in the non-residential sub-sector is projected to be sustained, amid higher construction activity for industrial and commercial buildings. New and existing multi-year civil engineering projects, particularly in the transport and utility segments, will continue to provide additional support to the sector.

In the commodity sector, agriculture production is expected to record a marginal positive growth, in tandem with the lower commodity prices. In addition, production of palm oil will be affected by the lagged impact of the dry weather conditions which occurred in early 2014. Growth in the mining sector is expected to be sustained, supported by oil production from the new Gumusut Kakap field offshore Sabah.

The projected GDP growth in 2015 points to the economy operating close to its potential output. While the estimated positive output gap of 0.39% suggests that the economy would be operating slightly above its potential, the gap is relatively modest and is not expected to put a strain on resources within the economy<sup>1</sup>.

## Private expenditure is expected to remain resilient amid an improvement in public expenditure

After registering five consecutive years of above-average growth rates following the crisis in the advanced economies, **private consumption** is projected to grow by 6.0% in 2015 (2014: 7.1%). The implementation of the GST in April 2015 may have some effect on household spending. This will, however, be partially offset by the Government's measures to assist targeted groups, the additional household disposable income from lower fuel prices, and the favourable labour market conditions. The targeted Government assistance to low- and middle-income groups is expected to provide support to private consumption. These include the higher amount of *Bantuan Rakyat 1Malaysia (BR1M)* cash transfers, the RM100 cash assistance programme to primary and secondary school students, and the *Baucar Buku 1Malaysia (BB1M)* for Malaysian students in higher learning institutions. The reduction of individual income tax rates by one to three percentage points with the implementation of the GST is also expected to increase the household disposable income. The lower fuel prices will support household spending in two ways: through savings from paying lower prices for fuel and from lower inflation. All these factors are expected to raise disposable income and consequently, support consumption spending.

Overall wage growth is also expected to remain favourable. In particular, the latest Malaysian Employers Federation's survey suggests a slightly higher forecast for salary increment of 5.8% in 2015 (2014: 5.4%). Although workers in the agriculture and mining sectors will experience lower earnings, they account for a relatively small share of total employment (about 13%). Wages

<sup>1</sup> For details of the output gap, refer to the White Box on the 'Estimating Malaysia's Potential Output'.

Table 4.1

### Real GDP by Expenditure (2005=100)

	2014 <sub>p</sub>	2015 <sub>f</sub>	2014 <sub>p</sub>	2015 <sub>f</sub>
	Annual change (%)		Contribution to growth (percentage point)	
<b>Domestic Demand<sup>1</sup></b>	<b>6.0</b>	<b>6.0</b>	<b>5.6</b>	<b>5.6</b>
Private sector expenditure	8.0	6.7	5.5	4.7
<i>Consumption</i>	7.1	6.0	3.7	3.2
<i>Investment</i>	11.0	9.0	1.8	1.6
Public sector expenditure	0.2	3.7	0.1	0.9
<i>Consumption</i>	4.4	2.7	0.6	0.4
<i>Investment</i>	-4.9	5.1	-0.5	0.5
<b>Change in Stocks</b>			<b>-0.9</b>	<b>0.1</b>
<b>Net Exports of Goods and Services</b>	<b>19.7</b>	<b>-7.8</b>	<b>1.4</b>	<b>-0.6</b>
Exports	5.1	3.0	4.6	2.6
Imports	3.9	4.0	3.2	3.2
<b>Real Gross Domestic Product (GDP)</b>	<b>6.0</b>	<b>4.5~5.5</b>	<b>6.0</b>	<b>4.5~5.5</b>

<sup>1</sup> Excluding stocks

<sub>p</sub> Preliminary

<sub>f</sub> Forecast

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

in selected export-oriented industries, particularly the non-resource-based manufacturing sectors, are projected to improve in line with continued export growth. Growth of wages in the domestic-oriented sectors is also expected to be sustained given the favourable domestic demand conditions.

In addition, employment conditions remain favourable, with sustained demand for labour in the domestic-oriented services sectors. In 2015, the unemployment rate is projected to remain stable at 3.0% (2014: 2.9%).

After three years of strong double-digit growth, **private investment** is expected to expand by 9.0% in 2015. Private sector capital spending will continue to be supported by on-going projects and a steady inflow of new investments, particularly in the manufacturing and services sectors. In addition, measures to strengthen private investment, as outlined by the Government in the 2015 Budget and the Prime Minister's Special Address in January 2015, are expected to provide support to investment by local firms, including the SMEs.

## Estimating Malaysia's Potential Output

### Introduction

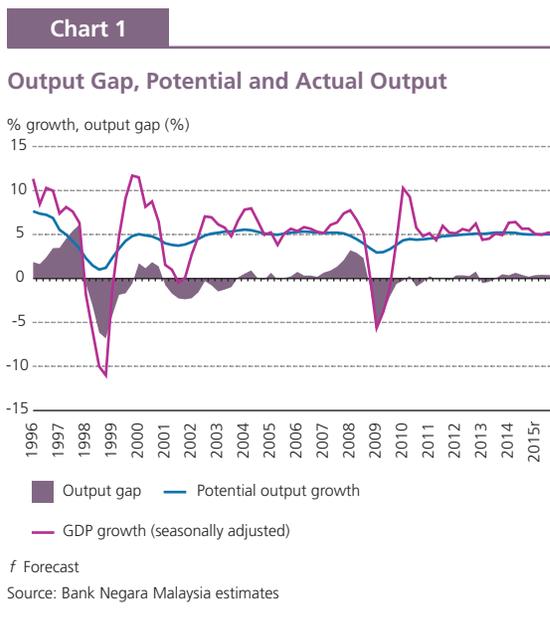
Potential output refers to the concept of maximum productive capacity of an economy without exerting pressure on prices. Another important concept is the difference between an economy's potential output and its actual output, known as the output gap. The output gap is a useful gauge of the intensity of utilisation of an economy's resources and is often used by policy makers as one of the indicators to forecast inflation and make interest rate decisions. Nevertheless, estimating a country's output gap can be challenging as it is not directly observable and is sensitive to model specifications. Structural changes in the economy further compound the difficulty to make estimates.

In estimating Malaysia's potential output and output gap, Bank Negara Malaysia has adopted three broad approaches. These approaches include univariate models (linear trend, Hodrick-Prescott (HP) filter and the univariate state space), structural models (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 limitations (see Chuah and Shahrier, 2014)<sup>1</sup>, the use of a combination of estimation methods allows for comparisons and cross-checking of the results, hence providing a better understanding of the robustness of the output gap estimates.

### Malaysia's Output Gap in 2014-2015

Based on the Bank's estimates, Malaysia's potential output grew by approximately 5.1% in 2014. As growth in actual output was relatively strong in 2014, the average output gap derived from the three broad approaches is estimated to be +0.41%. Continued private and public sector investment activity (gross fixed capital formation: 8.5% in 2013; 4.7% in 2014) as well as high labour participation (67.5%; 2013: 67%) during the year contributed to the expansion of the productive capacity in the economy.

Although the Malaysian economy registered a positive output gap of +0.41% in 2014, this did not necessarily signal an overheating of the economy. Not only was the gap relatively small, its duration was also relatively short (Chart 1). Demand pressures that were a contributing factor to the positive output gap, dissipated during the second half of the year (aggregate demand 1H 2014: 6.6%; 2H 2014: 5.4%).

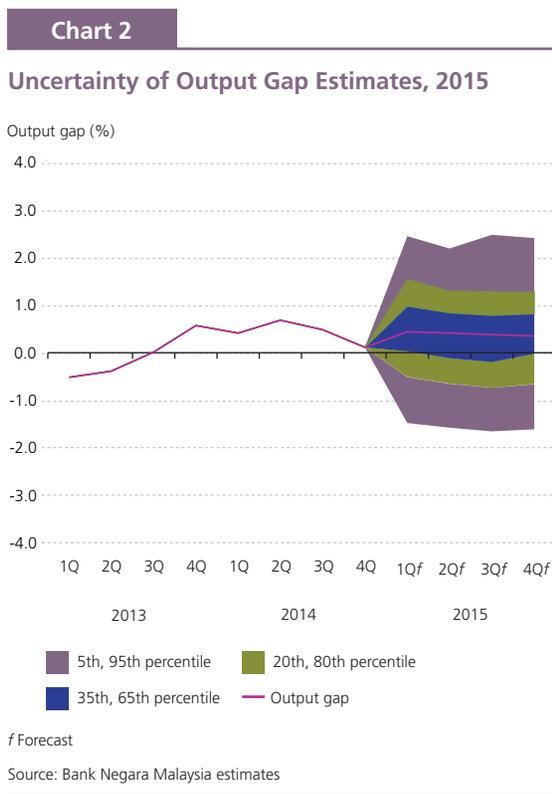


<sup>1</sup> Details of the models are discussed in the paper by Chuah and Shahrier (2014), Estimating Malaysia's Output Gap: Have We Closed the Gap?, *Bank Negara Working Paper Series WP4/2014*.

Capacity utilisation in the manufacturing sector was below 80%<sup>2</sup> (78.5%; 2013: 79.2%), indicating the availability of ample capacity in the economy to absorb any excess demand. In addition, wage pressures remained moderate. A survey by the Malaysian Employer Federation (MEF) on the salaries of Executives and Non-Executives showed that average wages increased by 5.4% in 2014 (2013: 6.6%). While inflation was higher in 2014 (3.2%; 2013: 2.1%), it was mainly driven by shocks to domestic costs.

In 2015, the potential output growth is estimated to be approximately 5% with the output gap estimated to be +0.39%. The pace of economic activity is expected to be consistent with the resources available in the economy. The estimated output gap, which is slightly smaller than the one in 2014, suggests that demand pressures will remain contained.

The fan chart (Chart 2) aims to capture the uncertainty in the output gap estimates, arising particularly from potential measurement errors. The estimated output gap lies within the inner band of the fan chart, which ranges between -0.08% to +0.85%. Given this uncertainty, information gathered from the industry is used to corroborate the model-based assessments of the output gap. From the Bank's engagements with the industry, firms have indicated that demand conditions will remain stable in 2015. While some domestic-oriented firms project a modest growth in sales, there are downside risks to these projections. In general, the electrical and electronic (E&E) firms are more optimistic about demand conditions as these firms expect to benefit from the strengthening US economy. However, export-oriented firms in other sectors expect demand to be stable. In terms of wages, firms are not expected to raise wages beyond the normal 5-6% yearly increments. The labour market remains balanced, with no apparent labour shortages, except potentially in the construction sector.



<sup>2</sup> In 2007/08 when there was a significant buildup in output gap, the capacity utilisation rate was 80.6%.

The moderation in private investment growth from the previous year is mainly attributable to the mining sector. The decline in global oil prices is expected to affect upstream oil and gas projects, particularly in the enhanced oil recovery (EOR) and marginal oilfield activity. The impact will, however, be partially mitigated by the implementation of projects that have already been contracted out and existing long-gestation projects such as deepwater exploration.

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### Private investment is expected to be driven by the continued expansion in export-oriented manufacturing activity

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In line with the continued expansion in domestic-oriented activity, investment growth in the services sector is projected to be driven by the inflow of new projects and the continued implementation of existing investment, particularly in the tourism-related, transportation and business-related sub-sectors. The residential property segment will continue to expand, albeit at a slower pace, and will be mainly concentrated in the mass-market and affordable housing segments.

In the manufacturing sector, investment is expected to be driven by the continued expansion in export-oriented activity, amidst the gradual improvement in external demand. This is also reflected in the significantly higher total manufacturing investment approvals in 2014 (RM71.9 billion), relative to the level of investment approvals in the previous year (2013: RM52.1 billion). The increase in investment approvals points towards robust investment activity for 2015 and beyond, particularly in the E&E and refined petroleum and petrochemical products sub-sectors.

**Public consumption** is projected to expand by 2.7% in 2015, reflecting sustained growth in emoluments amid lower spending on supplies and services following the Government's expenditure rationalisation measures.

**Public investment** will turn around to register a positive growth of 5.1%. While capital spending by both the public enterprises (PEs) and the Federal Government is expected to increase in 2015, the larger contribution will come from PEs. Investments by PEs reflect the continued

implementation of key infrastructure projects, particularly in the utility and transportation sub-sectors. These investments will provide additional support to public investment amid lower but still-sizable capital spending in the oil and gas sector. The Federal Government's development expenditure will be channeled mainly towards improving access and connectivity of urban public transport and rural infrastructure. In the social services sector, expenditure will be channeled primarily to the healthcare and housing sub-sectors.

### External sector to remain resilient

As Malaysia is a highly open economy and a commodity exporter, its performance would be affected by the lower commodity prices and the weaker growth momentum in several major economies. However, the diversity of Malaysia's exports in terms of products and markets would mitigate some of these impacts and provide support to the overall export growth.

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### Despite the negative terms of trade shock, the current account of the balance of payments will remain positive in 2015

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In 2015, the growth of gross exports is projected to moderate to 1.5% due mainly to lower commodity exports. Commodity exports, which constitute 23% of Malaysia's total exports, will be weighed down by lower prices of crude oil, liquefied natural gas (LNG) and crude palm oil (CPO). Nevertheless, the decline in CPO prices is not expected to be as severe as the decline in oil prices, given the projected lower supply of CPO following the dry weather conditions in first half of 2014, and the higher demand arising from the mandatory palm oil-based blending of biodiesel in several countries. In addition, LNG prices will also be supported by continued demand from the regional economies.

Malaysia's manufactured products stand to benefit from the improvement in economic activity in several of the advanced economies and the sustained growth in Asia. These manufactured exports, which comprise 77% of Malaysia's total exports, are diverse in terms of products and markets, and are expected to remain resilient in this challenging external environment.

## The Impact of Lower Commodity Prices on the Malaysian Economy

### Lower crude oil and commodity prices present a challenging economic environment

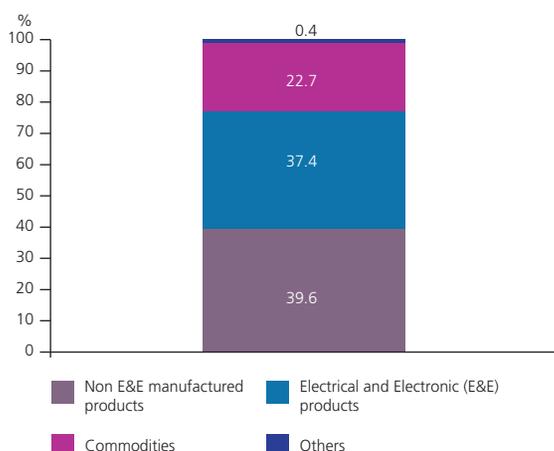
Following nearly four years of relative stability, crude oil prices have experienced a sharp decline since the second half of 2014<sup>1</sup>. The decline is expected to also lower the prices of other major commodities, including crude palm oil (CPO) and liquefied natural gas (LNG). As the commodity sector (agriculture and mining) accounts for almost a quarter of exports and around 15% of production, the decline in prices will have an impact on the Malaysian economy. Nevertheless, the transformation of the Malaysian economy over the recent decade towards one that is more diversified and developed, has enhanced the country's economic resilience. This article seeks to provide an overview of the likely impact of lower commodity prices on the Malaysian economy in terms of exports, the current account of the balance of payments, domestic demand, employment, production, the fiscal position and the overall impact to growth prospects.

### The current account balance will narrow but remain in surplus, supported by Malaysia's diverse trade structure

Commodity exports, including that of crude oil, liquefied natural gas (LNG) and crude palm oil (CPO), constitute 23% of total exports in Malaysia. While the sharp decline in commodity prices will have implications for overall exports, the impact is mitigated by Malaysia's diverse export structure in terms of both products and markets (Chart 1 and Chart 2). Manufactured products comprise 77% of gross exports, and will benefit from the improvement in global growth<sup>2</sup>. In particular, stronger growth momentum in the US as well as the continued expansion in PR China and regional economies will support external trade, as these economies are a significant source of final demand for Malaysia's products<sup>3</sup>. This diversity in Malaysia's exports will thus cushion the fall in commodity exports and ensure continued, although more moderate, expansion in **gross exports** in 2015.

Chart 1

Malaysia's Exports by Major Products (2014)

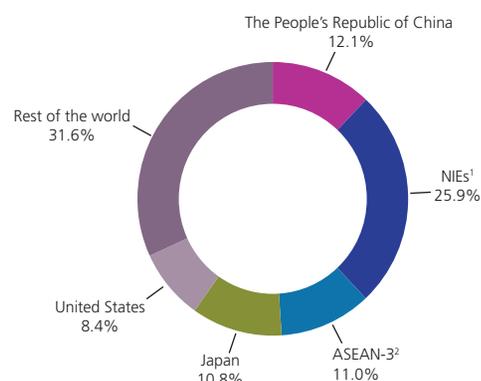


Note: Numbers do not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

Chart 2

Malaysia's Exports by Trading Partners (2014)



<sup>1</sup> NIEs refers to Singapore, Hong Kong SAR, Chinese Taipei and Korea  
<sup>2</sup> ASEAN-3 refers to Thailand, Indonesia and the Philippines

Note: Numbers do not necessarily add up due to rounding

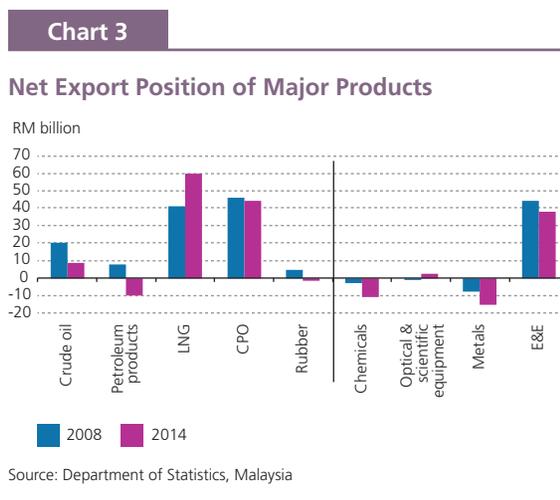
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

<sup>1</sup> The price of Brent crude declined by 52.5% from mid-June 2014 to end-December 2014, reaching a five-year low of USD47 per barrel on 13 January 2015. This is mainly a reflection of persistent oversupply of crude oil in the global markets, accompanied by some slowing in demand growth.

<sup>2</sup> The decline in commodity prices comes at an opportune time for the global economy, as it helps to partially offset weaker-than-expected growth momentum in several major economies. Although the effects will be uneven with selected major commodity exporters being adversely affected, the lower commodity prices are a net positive and will provide some support to economic activity and the global recovery.

<sup>3</sup> The US and PR China accounted for 17.7% and 9.9%, respectively, of the foreign final demand for Malaysia's goods and services in 2009, making them the two largest sources of foreign final demand for Malaysia (BNM estimates based on latest available OECD-WTO Trade in Value Added database).

In terms of the trade balance, as a large net exporter of LNG and CPO, the lower prices of these commodities will weigh on the trade position in 2015 (Chart 3). However, the net export position of both commodities will remain positive as the imports of LNG and CPO are minimal. In terms of oil, although Malaysia will receive less proceeds from exports of crude oil, the trade position will also benefit from the lower cost of imported petroleum products. The improvement in global growth will also provide support to manufactured exports and the overall trade position. Therefore, while lower commodity prices will contribute to a narrower **trade and current account balance** in 2015, both are expected to remain in a surplus position.



**Domestic demand will remain resilient, as households and non-oil and gas enterprises will benefit from lower prices and costs**

In terms of **domestic demand**, the private sector is expected to benefit from lower commodity prices and remain the key driver of economic growth in 2015. For households, lower fuel prices will lead to additional disposable income and support **private consumption**. BNM estimates suggest that the lower pump prices, if sustained, would translate to a total annual savings of RM7.5 billion<sup>4</sup> on fuel expenditure by households. This is expected to outweigh the effect of lower incomes in the commodity sector, which constitutes just 13% of total **employment**<sup>5</sup>.

For businesses, while **total investment** in the mining sector, which accounts for 19% of investment in the economy, will be affected, overall capital spending in Malaysia is broad-based (Chart 4) and is expected to remain resilient. Investment plans in the services and manufacturing sectors, which contributed 76% of total investment in 2013, are expected to continue as firms will benefit from the continued global recovery and lower costs of inputs. Thus, domestic investment is expected to remain resilient.

Similarly, in terms of **production**, the commodity sector accounted for only 15% of real<sup>6</sup> GDP in 2014. The services and manufacturing sectors, which accounted for 80% of GDP (Chart 5), will continue to support the growth momentum going forward. Therefore, although selected segments of the economy will be affected by lower commodity prices, **overall growth** is projected to remain within the 4.5-5.5% range in 2015.

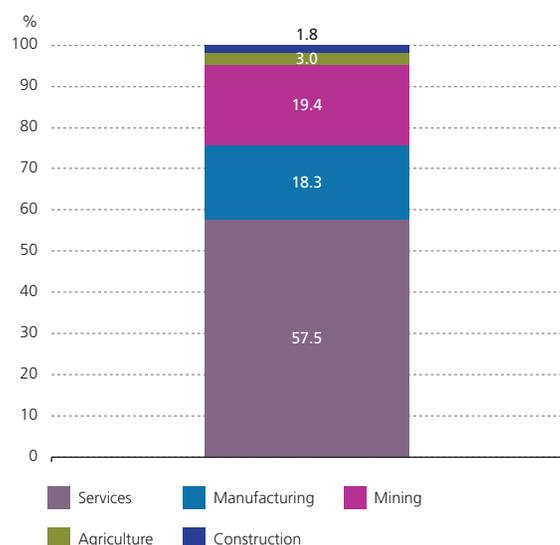
<sup>4</sup> Based on the savings to households under the managed float pricing mechanism assuming a USD40 per barrel decline in crude oil prices. If 40% of savings are spent, this will lead to an additional RM3 billion in household spending.

<sup>5</sup> This is compared to 61% and 17% in the services and manufacturing sectors, respectively.

<sup>6</sup> At constant 2005 prices.

Chart 4

Total Investment by Sector (2013)\*



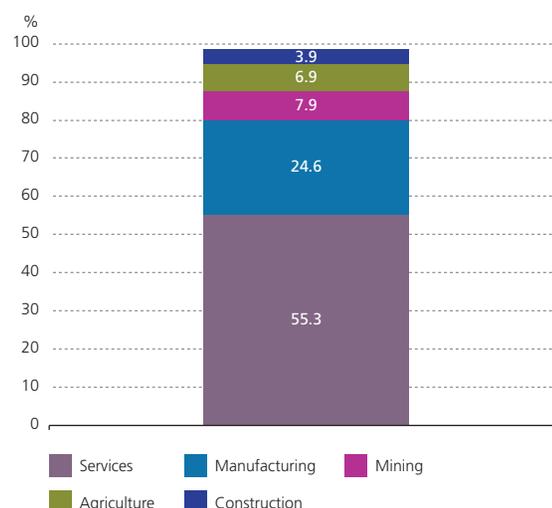
\* Figures for 2014 will be released by the Department of Statistics, Malaysia in June 2015

Note: Numbers do not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

Chart 5

Real GDP\* by Kind of Economic Activity for Malaysia (2014)



\*At constant 2005 prices

Note: Numbers do not necessarily add up due to rounding and the exclusion of import duties component

Source: Department of Statistics, Malaysia

### The fiscal position will be affected but the impact is being proactively managed

In terms of the **fiscal position**, a persistent decline in crude oil prices will result in lower oil-related revenues. Nonetheless, proactive measures designed to diversify fiscal revenues undertaken over the last few years, together with the pre-emptive measures that were announced on 20 January 2015 will ensure that the overall impact on the fiscal position will be contained and manageable.

Chief among the measures are reforms to broaden and diversify sources of Government revenue as well as reduce the dependency on oil revenue<sup>7</sup>. In this regard, the contribution of oil revenue to total Government revenue has been on a declining trend from its peak of around 41.3% in 2009<sup>8</sup> to 30.0% in 2014. This reflects the increased contribution of non-oil revenue in tandem with the sustained economic growth and the efforts by the Inland Revenue Board to further improve tax compliance and collections. The increase in the contribution of non-oil revenue is expected to continue going forward given the GST implementation in April. Besides the revenue enhancement measures, the Government has also undertaken expenditure rationalisation, underpinned by the transition to the managed float pricing mechanism for the price of RON95 fuel. This transition will reduce the subsidy burden of the Government, help raise efficiency and support the long-term sustainability of not only the fiscal position but overall growth prospects (See Box Article on *Price Reforms: Motivation, Impact and Mitigating Measures*).

Importantly, recognising the high likelihood of lower oil-related revenue in 2015, the Government, on 20 January 2015, announced pre-emptive revenue enhancement and expenditure reprioritisation measures to ensure that the fiscal deficit will remain on a consolidation path despite the challenging

<sup>7</sup> A comprehensive enhancement to tax administration has been underway since 2011. These include: (i) Programmes to increase tax awareness and compliance amongst tax payers, reduce tax arrears and broaden the tax base, as well as the provision of online tax services such as e-Filing, e-Register and e-Payment; and (ii) Monthly industrial engagements with businesses to increase tax compliance while expanding audit investigations.

<sup>8</sup> The higher share of oil-related revenue in 2009 is due in part to lower non-oil-related revenue due to the economic slowdown arising from the financial crisis in the advanced economies.

environment. Going forward, the Government has the policy space to undertake further adjustments if the need arises, to achieve the medium-term objective of a balanced budget by 2020. Nonetheless, the adjustments will be undertaken with due consideration to overall growth prospects of the economy.

#### **Financial market conditions are expected to remain orderly despite heightened volatility**

In the **financial markets**, expectations of interest rate normalisation by the Federal Reserve amidst the recovery in the US economy, and concerns on the global growth outlook have led to capital flow reversals from the emerging markets. This, in turn, has led to a depreciation of emerging market currencies against the US dollar. In addition, concerns over the potential impact of lower commodity prices on commodity-exporting economies have resulted in a larger adjustment in their exchange rates, including that of the ringgit.

Notwithstanding the capital reversals and the impact on the ringgit, the domestic financial markets have remained orderly. The recent outflows have been limited to Bank Negara Monetary Notes (BNMNs) and the equity market. The ability to manage the outflows by unwinding instruments such as the BNMNs ensured that the domestic bond market was not significantly impacted. This has allowed domestic bond yields, particularly long-term yields, across tenures to remain relatively stable despite the volatility of capital flows. There was no disruption in financial intermediation, with financing to the economy continuing uninterrupted.

Going forward, Malaysia remains well positioned to ensure that further bouts of financial market volatility do not spill over to the real economy. Malaysia has in the past experienced similar magnitudes of capital outflows and BNM has managed these episodes. The ability to navigate these challenges stems from having an ample reserves buffer, greater policy flexibility, a wider range of policy tools, a strong banking system and well-developed financial markets to intermediate volatile capital flows. In addition, the large domestic investor base, particularly the well-diversified institutional investors, has the capacity to support the market in the event of liquidation by non-resident investors. These conditions will ensure the continued orderly functioning of domestic financial markets, and ultimately, a financial system that is supportive of the real economy.

#### **The Malaysian economy is expected to remain resilient in 2015 despite the challenging external environment**

The decline in the prices of major commodities will have implications for economies across the world. As a small and open economy, this development will impact Malaysia. However, as the Malaysian economy is well-diversified and has sound economic fundamentals, the economy has the resilience to weather this shock. Nonetheless, policymakers will continue to monitor these developments and remain vigilant to emerging risks in the global and domestic environment. In the event of more severe shocks to the economy, policymakers have the policy space and the ability to undertake the necessary adjustments.

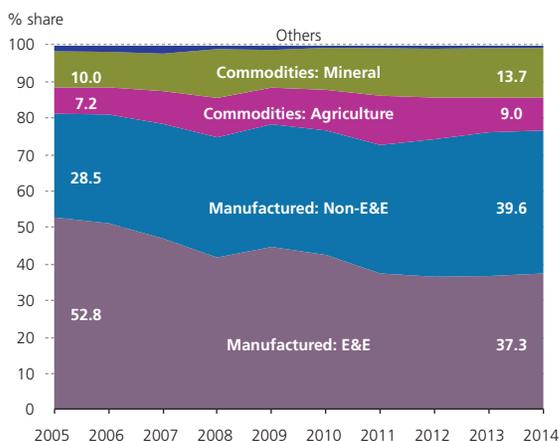
The expected improvement in manufactured exports in 2015 will be driven mainly by the E&E sector. E&E exports will be supported by an improvement in private sector activity in the US, in particular continued investment growth amid high capacity utilisation rates. In addition, the semiconductor industry is expected to remain resilient with the global semiconductor sales continuing to record steady growth, driven by sustained demand for smart devices. These positive trends augur well for semiconductor exports as Malaysia's E&E firms have ventured into industries with fast growing

global demand, such as mobile devices, tablets and automotive sensors. Non-E&E exports will continue to expand, albeit at a more moderate pace, supported by sustained regional demand. The moderate growth of non-E&E exports is expected to emanate mainly from the resource-based products, particularly chemicals, petroleum and rubber products.

Gross import growth is projected to increase to 6.0% in 2015, driven by the continued growth in intermediate imports and domestic demand. Intermediate imports, which form the

Chart 4.3

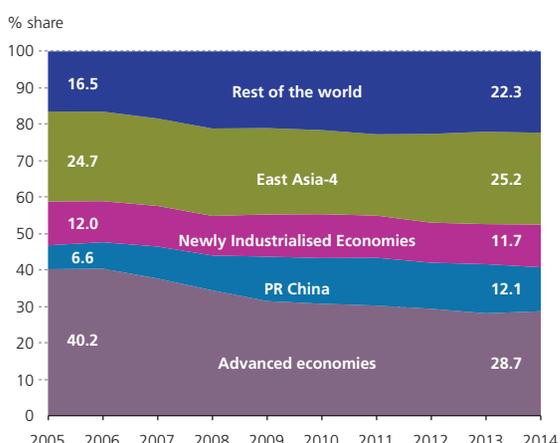
Export by Products



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 4.4

Export by Markets



Note: Advanced economies include US, EU28 and Japan; Newly Industrialised Economies include Hong Kong, Chinese Taipei and Korea while East Asia-4 include Singapore, Thailand, Philippines and Indonesia

Source: Department of Statistics, Malaysia

bulk of Malaysia's gross imports, are expected to expand further, amid the continued expansion in manufacturing activity to meet the improved global demand. In addition, capital imports are expected to grow at a faster pace, driven mainly by the ongoing investment projects, a steady inflow of new large private sector projects, and the continued implementation of key infrastructure projects. The slightly higher growth of consumption imports reflects the continued growth in food and beverages imports, which account for the largest share of consumption imports, and are relatively inelastic in demand.

The trade balance in 2015 is expected to narrow but remain in a surplus position, supported by the improvement in manufactured exports and a continued surplus in the commodity trade balance. While crude oil exports will be affected by the lower crude oil prices, the impact on the trade balance will be partially mitigated by the lower cost of imported petroleum products. Given that Malaysia is a large net exporter of LNG and CPO, the projected lower prices of these two commodities will weigh on the commodity trade surplus. Based on past trends, the price decline of LNG and CPO will not be as significant as the decline in crude oil prices. Furthermore, exports of these two commodities have minimal corresponding imports, lending support to Malaysia's position as a net commodity exporter. At the same time, net exports of E&E will be supported by the continued expansion in global demand.

In the services account, the projected narrower deficit will be mainly supported by the recovery in tourist arrivals and higher tourist spending amid 'Malaysia - Year of Festivals 2015' promotion and the intensification of other tourism promotional activities. Nevertheless, growth in services imports will be driven by continued payments for transportation and other services, in line with the expansion in trade and investment activity during the year.

Table 4.2

External Trade

	2014 <sup>p</sup>	2015 <sup>f</sup>
	Annual change (%)	
<b>Gross exports</b>	<b>6.4</b>	<b>1.5</b>
of which:		
Manufactures	7.3	8.4
Agriculture	0.6	-10.8
Minerals	7.3	-30.4
<b>Gross imports</b>	<b>5.3</b>	<b>6.0</b>
of which:		
Capital goods	-2.1	10.0
Intermediate goods	7.6	6.8
Consumption goods	5.7	6.8
<b>Trade balance (RM billion)</b>	<b>83.1</b>	<b>53.6</b>

<sup>p</sup> Preliminary  
<sup>f</sup> Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

In the income account, profits from Malaysian companies investing abroad are expected to be sustained. The lower income from oil and gas companies, which constituted more than a third of Malaysia's investment income abroad, will be partially offset by an improvement in profits from other overseas investments by Malaysian companies, amidst a modest improvement in global demand and lower costs of oil-related inputs. Nevertheless, this will likely be surpassed by the higher profits and dividends accrued to multinational corporations operating in Malaysia in line with the expected improvements in manufactured exports. As a result, net outflows in the primary income account are likely to increase in 2015. The continued deficit in the secondary income account is expected to be driven by lower inward remittances amid sustained outward remittances.

Overall, given a more moderate growth of exports and robust imports, net exports of goods and services will turn around to register a small negative contribution to real GDP growth in 2015. Alongside a wider income deficit, the current account surplus of the balance of payments in 2015 is projected to be lower at RM21.4 billion or 2 - 3% of GNI. This lower current account surplus also reflects a narrowing of the savings-investment gap.

Table 4.3

## Balance of Payments

	2014 <sup>p</sup>	2015 <sup>f</sup>
	RM billion	
Goods	125.1	94.2
Services	-20.5	-16.4
<b>Balance on goods and services</b>	<b>104.5</b>	<b>77.8</b>
Primary income	-37.4	-38.0
Secondary income	-17.6	-18.5
<b>Balance on current account</b>	<b>49.5</b>	<b>21.4</b>
<b>% of GNI</b>	<b>4.8</b>	<b>2-3</b>
Capital account	0.3	
Financial account	-76.5	
<b>Balance on capital and financial accounts</b>	<b>-76.2</b>	
Errors and omissions	-9.8	
<i>of which:</i>		
<i>Foreign exchange revaluation gains</i>	7.6	
<b>Overall balance</b>	<b>-36.5</b>	

<sup>p</sup> Preliminary

<sup>f</sup> Forecast

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

### Strength and flexibility to withstand external shocks

Amid continued uncertainty in the global financial markets, Malaysia will continue to experience volatile two-way capital flows. Nevertheless, the financial system is well-positioned to intermediate these flows given the country's deep, developed and liberalised financial markets, thus reducing its impact on the economy. Malaysia will continue to receive steady inflows of long-term capital as FDI prospects remain positive, driven by its strong economic fundamentals and international competitiveness, as attested by the various global competitiveness rankings. The positive outlook for FDI is reflected in the increase in foreign manufacturing investment approvals in 2014 (RM39.6 billion; 2013: RM30.5 billion), mainly in non-resource based industries.

Malaysia's external debt is expected to remain manageable. The potential for sizable foreign exchange revaluation changes would be mitigated as more than 40% of the external debt is denominated in ringgit. In particular, risks associated with exchange rate fluctuations are minimal for the private sector corporations as their external borrowings are largely hedged, either naturally through foreign currency earnings, or through the use of financial instruments. The maturity profile of Malaysia's external debt is expected to remain healthy, with more than half of the external debt being in the medium- and long-term tenures. The short-term external debt would continue to be manageable. Although banking institutions account for more than half of the short-term external debt, this constitutes a small share of banks' total funding. Furthermore, external debt liabilities of banking institutions mainly reflect centralised foreign currency liquidity management operations. In addition, the extension of trade credits to resident companies and short-term intercompany loans are largely backed by export earnings.

Although there are improvements in the global economy, 2015 will nevertheless be a challenging year given the risks facing the global economy. In this uncertain environment, Malaysia's strong fundamentals will enable the economy to weather any adverse developments in the external sector. Should global and economic conditions turn out to be more favourable than expected, these same strong fundamentals will allow Malaysia to benefit from these developments and experience higher growth.

## INFLATION OUTLOOK

Headline inflation is projected to be lower at 2 - 3% in 2015 (2014: 3.2%), due mainly to lower energy and food prices. In particular, the decline in global oil prices would lead to lower domestic fuel prices through the managed float fuel pricing mechanism. The subdued external price pressures would also mitigate increases in the cost of imports stemming from the recent ringgit depreciation, thereby moderating imported inflation. These would partly offset some of the impact from the implementation of the GST on 1 April 2015. While headline inflation is expected to be lower in 2015, there is the possibility that the inflation rate could be subject to the volatility in global oil prices given the now market-based pricing of domestic fuel products. However, underlying inflation is still expected to remain relatively stable.

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### Lower energy and commodity prices are expected to partly offset the impact of the GST on inflation

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External price pressures are projected to remain weak, reflecting mainly lower global energy and food prices. The Food and Agriculture Organisation of the United Nations (FAO) projects global food prices to trend lower in 2015 given ample supply, particularly for cereals and oil crops, amid favourable weather conditions in the major producing countries. For oil, the IMF projects global prices to average lower at USD51 per barrel<sup>2</sup>, after experiencing a sharp decline from the peak of USD108 per barrel in June 2014, to reach an average of USD61 per barrel in December 2014. Excess supply, supported by continued high global production amid modest growth in global demand, is projected to maintain lower oil prices in 2015. The large build-up in global oil inventories would also contribute to the downward pressures on oil prices. The downward pressures would also be exacerbated by the unwinding of financial investments in the commodity markets, especially

in oil, amid expectations for interest rate normalisation in the US and a stronger dollar. While excess supply would keep oil prices low compared to the previous year, the trajectory could become uncertain as the market reacts to incoming news and developments surrounding global oil supply and demand conditions. Given the lower commodity prices and subdued domestic demand in some of Malaysia's major trading partner economies, inflationary pressures emanating from the external sector are therefore expected to be low.

Domestically, although the implementation of the GST will result in higher prices for some goods and services, the extent of the inflationary impact will be contained by two factors. First, basic necessities such as fresh food and utilities are zero-rated or exempted from the GST<sup>3</sup>, hence reducing the extent of overall price increases. Second, some items such as clothing and electrical appliances are already subjected to the same or higher tax rates under the Sales and Services Tax (SST). With the GST replacing SST, prices of some of these items should remain relatively stable.

The implementation of the managed float fuel pricing mechanism since December 2014 allows for the pass-through of lower global oil prices to the domestic fuel prices. Given the expectation for global oil prices to remain low, this would contribute to lower domestic inflation in 2015. Inflationary pressures stemming from domestic demand factors are also expected to be modest following more moderate growth in household spending and relatively stable wage growth. While the economy is projected to operate slightly above its potential, the positive output gap is relatively small and therefore, is not expected to exert significant upward pressures on domestic prices.

However, there is a risk that the inflation trajectory during the year could be subject to some degree of volatility. This stems largely from the uncertainty surrounding the direction of global oil prices, which would have a direct influence on the inflation dynamics in Malaysia through its impact on domestic fuel prices. Excluding the volatile fuel prices and the one-off impact of the GST, the underlying inflation is, however, expected to remain relatively stable.

<sup>2</sup> Average price of Dated Brent, West Texas Intermediate (WTI) and Dubai Fateh crude oil, equally weighted, as projected by the International Monetary Fund (IMF) in the January 2015 World Economic Outlook.

<sup>3</sup> Based on the Bank's internal estimates, only 50% of the CPI basket is subject to the 6% GST, while 30% is zero-rated and the remaining 20% is exempted from the GST.

## Price Reforms: Motivation, Impact and Mitigating Measures

### Introduction

In Malaysia and several other developing economies, subsidies and price controls have been an important feature of the policy toolkit. However, as economies become more developed, the costs of maintaining such policies increasingly outweigh their benefits. As a consequence, many developing economies have embarked on subsidy rationalisation and price reforms. This box article provides a background on price controls and subsidies, the importance of price reforms and the impact of such reforms. It also discusses the various mitigating measures that will be implemented to ensure that price reforms will lead to a more sustainable and inclusive growth for the Malaysian economy.

### Background

One of the key aims of economic policy is to ensure sustainable and inclusive growth. An efficient allocation of resources is critical to the smooth functioning of a competitive economy, and this is often achieved through price signals<sup>1</sup>. However, markets by themselves will not guarantee inclusive growth where the benefits from growth and development are widely enjoyed by all levels of society. Market failures or inefficiencies could also arise when the price mechanism fails to account for the social costs and benefits of producing and consuming certain types of goods<sup>2</sup>, especially public goods such as defence, education and healthcare. Therefore, government measures, such as the provision of subsidies and price controls<sup>3</sup>, could in some cases be necessary for improving welfare and ensuring inclusiveness.

It has been conventionally argued that subsidies and price controls introduce distortions in the allocation of resources and have long-term adverse effects on economic efficiency. However, as with any economic policy, the costs must be weighed against the potential benefits. Where a substantial part of the population is living in poverty, especially in economies at early stages of development, widespread government measures such as price controls and subsidies ensure that the prices of key necessities remain stable and affordable for the intended target group<sup>4</sup>. Similarly, when most industries are at an infancy stage, subsidies and price controls provide the necessary initial support to compete, remain viable and grow into established industries. Hence, despite distortions to prices and resource allocation, these policies can enhance long-term sustainability and inclusiveness of economic growth.

As an economy develops, the costs of subsidies and price controls will steadily outweigh their benefits<sup>5</sup>. With growing incomes, more households would progress from low- to middle- or high-income brackets. Blanket subsidies or price controls would thus be subject to leakages, as those that do not belong in the vulnerable groups will continue to receive assistance. Artificially low prices also encourage wastage and overconsumption, and hence, a misallocation of resources. Importantly, as industries progress to a more mature stage, price distortions could inhibit the incentives to improve productivity, to innovate and achieve greater product sophistication, to adopt higher technological intensity and to move to higher value-added activities. Subsidies and price controls could thus pose an obstacle to economic development. Hence, as economies develop, the nature and rationale for subsidies and price controls often need to evolve toward more targeted and time-bound assistance, and less of a blanket subsidy.

<sup>1</sup> In a market economy, scarce resources will command higher prices than abundant resources. As a result, producers and consumers will use scarce resources for only higher-valued purposes, ensuring an efficient allocation of these scarce resources.

<sup>2</sup> An example of such a market failure is pollution. As the costs of pollution are widespread, and not confined to the individuals directly involved, an absence of government intervention will result in excessive pollution.

<sup>3</sup> For the purpose of this box article, a subsidy is broadly defined as any government action that lowers either the cost of production or the price of consumption, while price control refers to any government regulation that establishes a maximum or a minimum price to be charged for specific goods and services.

<sup>4</sup> While it is economically and socially desirable to target subsidies to selected groups, the costly and complex task of identifying recipients and distributing the benefits could justify an initial widespread intervention (blanket subsidy) in economies at early stages of development.

<sup>5</sup> There are exceptions. It is widely accepted that subsidies and/or government involvement in areas where market failures exist is justifiable. For example, government measures to ensure adequate provision of education and healthcare are often necessary to reap their widespread benefits. A similar case can be made for public goods such as defence and infrastructure.

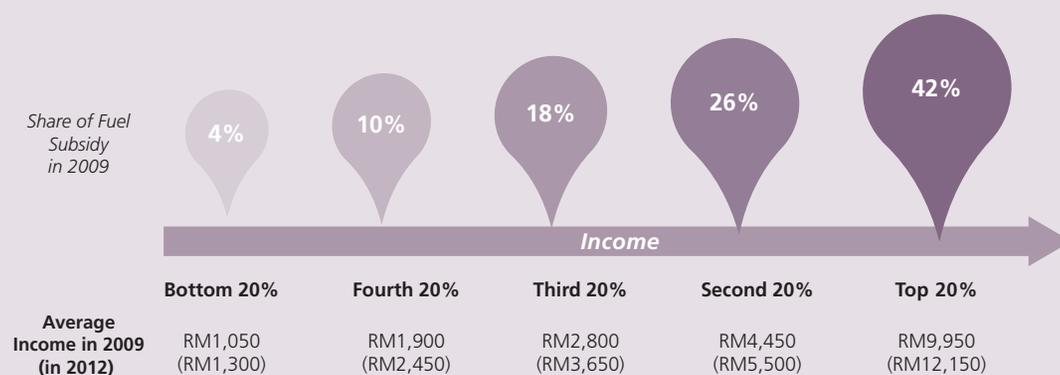
### Subsidies and Price Controls: The Need for Reform

In Malaysia, subsidies and price controls have long been a feature of the economy. In 2009, subsidies and price controls were present in a range of products, including petrol, natural gas, electricity, cooking oil, sugar, toll charges and bus fares, which account for about a fifth of the CPI basket. At earlier stages of development, these policies helped to provide some degree of stability to the prices of domestic goods and supported the development of infant industries. Nevertheless, as Malaysia transitions to a high-income economy<sup>6</sup>, the economic costs of subsidies and price controls far outweigh the benefits of such measures for a number of reasons.

First, most subsidies in Malaysia are blanket in nature, and hence, become more regressive as the economy develops. In a middle- or high-income economy, the benefits of most blanket subsidies will accrue more to the more affluent groups, especially if these groups consume larger quantities of the subsidised items. For example, in the case of the fuel subsidy in Malaysia, the benefits are enjoyed disproportionately by high-income households, who consume a larger amount of fuel as they are more likely to own multiple vehicles with larger engine capacities. It is estimated that the bottom 20% of households in Malaysia only receive 4% of the fuel subsidy, while the richest 20% receive 42% of the subsidy (Chart 1). Thus, the blanket subsidy has become a less effective tool in ensuring the benefits of low fuel prices are widespread and inclusive<sup>7</sup>.

Chart 1

Share of Fuel Subsidy Received by Each Income Group



Source: Household Expenditure Survey 2009/10 and Household Income and Basic Amenities Surveys 2009 and 2012, Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Second, subsidies and price controls result in price distortions by artificially depressing the prices of key goods and services in the economy. This could distort both consumption and production decisions in a number of ways, and hence, lead to a misallocation of resources in an economy. Key among these distortions is an overconsumption of the subsidised or price-controlled items by both households and firms. To illustrate, petrol consumption per capita in Malaysia has increased over the last decade and is higher than in other regional economies (Table 1)<sup>8</sup>. Coupled with a moderating trend in production (Chart 2), this has contributed to Malaysia becoming a net importer of crude oil and refined petroleum products in 2014.

From a structural perspective, subsidies and price controls could also hinder incentives to improve productivity and efficiency, thus holding back long-term development. Subsidies and price controls would result in an overreliance on cheap inputs by firms, which could lead firms to being trapped in

<sup>6</sup> Other developing economies that have undertaken price and subsidy reforms, in most cases for fuel and/or electricity, include Chile, Brazil, the Philippines, Turkey, India and Indonesia.

<sup>7</sup> The situation is worse if the impact of illegal fuel smuggling is considered.

<sup>8</sup> Overall petroleum product usage has grown at 3.0% annually on average over the last 10 years.

low-cost, energy-intensive sectors. This would reduce incentives to improve productivity, undertake research and development (R&D) or to innovate and move up the value chain, thereby impeding these firms' international competitiveness. Price reforms are thus needed to counter these effects. This is evidenced by findings from a survey by Bank Negara Malaysia that suggest that the majority of firms in Malaysia would adopt productivity-enhancing measures to manage rising costs following the upward fuel price adjustment in September 2013 (Chart 3).

**Table 1**

**Road Sector Petrol Consumption Per Capita (2000-2011)**

Country	Average 2000-2005	Average 2006-2011
	<i>(kg of oil equivalent)</i>	
United States	1,270	1,170
Japan	347	335
<b>Malaysia</b>	<b>279</b>	<b>294</b>
United Kingdom	340	259
Euro area	254	191
Singapore	163	173
Korea	151	155
Thailand	81	74
Indonesia	53	71
The People's Republic of China	31	46
Philippines	34	29
India	7	10

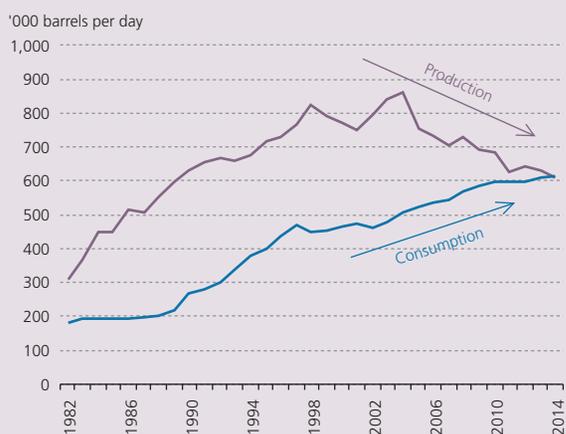
Source: World Development Indicators, World Bank

Specifically, for industries that are required to maintain low prices through price controls, they would become uncompetitive when costs rise and hence, would be less inclined to undertake quality enhancements. In extreme cases where prices are set at an artificially low level, revenue would be insufficient to incentivise firms to produce adequate output to meet demand. This could create shortages and black market transactions, as observed in the cement and steel industry in Malaysia in the past (Thillainathan, 2009). These effects are often reversed when industries are deregulated, underscoring the need for such reforms. For example, after the reforms of the electricity industry in Chile in the 1980s and 1990s, the industry experienced improved efficiency in generation and transmission, higher investment, more competitive prices and greater quality of services, particularly in rural areas (Pollitt, 2004).

In addition, maintaining subsidies and price controls also leads to challenges for public policy decision-making. Despite rising costs, it is often politically difficult to undertake upward adjustments of prices. As a result, prices of the controlled products are often left unchanged

**Chart 2**

**Production\* and Consumption of Oil in Malaysia**



\*Refers to crude oil and refinery gains

Source: US Energy Information Administration and PETRONAS

**Chart 3**

**Survey Findings on Firms' Response to the Increase in Domestic Fuel Prices**



Based on responses by 62 firms in the manufacturing and services sectors

Source: Bank Negara Malaysia Quarterly Survey 3Q 2013

for extended periods until significant increases in costs render these prices unsustainable. Eventually, this will result in large price hikes that would not only lead to large economic dislocation but also socioeconomic pressures<sup>9</sup>.

Finally, subsidies and in certain cases price controls, also impose a burden on the government. Attempting to keep prices of resources low amid rising global market prices and overconsumption by households and firms will ultimately weigh on the fiscal position of the government. For Malaysia, subsidies on retail petrol alone accounted for RM23.5 billion<sup>10</sup> or 2.4% of GDP in 2013, higher than some regional economies<sup>11</sup>. This figure also does not account for the cost of implicit subsidies in terms of revenue foregone by public enterprises and the Government under price controls, such as the provision of natural gas below market prices to electricity generation companies to enable lower electricity tariffs. Ultimately, this reduces the funds available for the Government to spend on other key development areas that would significantly benefit the nation over the long term, such as infrastructure, health, education and social protection.

Thus, price reforms have the potential to benefit the Malaysian economy in the short and long term. For both households and firms, it is an important transition away from the regressive blanket assistance towards a more targeted support system. In the medium to long term, it not only reduces wastage but encourages productivity enhancements and further progress up the value chain, creating high-income knowledge-intensive jobs. It frees up resources for the Government to finance critical public spending on social protection, education, healthcare and infrastructure. A review of the literature by the IMF (2013) finds that subsidy reforms boost competitiveness over the long term by stimulating private investment, encouraging productivity-enhancing public spending and promoting efficient use of scarce resources. In summary, price reforms are a critical part of the overall strategy during the transition to a high productivity and high value-added economy, supporting the creation of more high-income jobs in Malaysia.

### Price Reforms: Timing and Impact

It has been recognised that reforms have a higher chance of success if they are undertaken gradually and in an environment of growth and stability (IMF, 2013). Under such circumstances, households and firms are in a better position to adjust to higher prices and costs, and are able to undertake the necessary changes without creating large disruptions in economic activity. With this in mind, the Government has gradually lifted price controls and undertaken several price adjustments over the last several years<sup>12</sup>. More recently, the Government implemented additional price adjustments and introduced the managed float pricing mechanism for fuel, against a backdrop of steady growth prospects for the economy. The environment of lower global crude oil prices hence provided an opportune time to undertake this reform without the need for a price increase.

Nonetheless, it is acknowledged that price reforms have led to an increase in costs for households and firms. The challenges of managing these costs will continue, with movements in global commodity prices having a more direct effect on domestic cost conditions. While external price pressures are expected to remain subdued in 2015, the upward pressure on domestic costs could increase in the event of higher global commodity prices going forward. For households, in the absence of subsidies and price controls, an increase in the cost of living would have a disproportionate impact on vulnerable groups such as low-income groups, middle-income urban households, young working adults and senior citizens. These groups, particularly those with low savings, could face financial hardship. Firms, particularly small and medium enterprises, need to also cope with volatile costs and might find it difficult to pass on the additional costs to their customers

<sup>9</sup> These pressures have been observed in response to actual or attempted price adjustments in developing economies, such as Indonesia in 2012, India in 2010 and Jordan in the late 1980s and early 2000s (World Economic Forum, 2013).

<sup>10</sup> Based on the 2015 Budget speech.

<sup>11</sup> Based on the International Energy Agency statistics, total fuel subsidy in 2013, expressed as a percentage of GDP is 0.2% in PR China, 0.9% in Thailand, 2.5% in India and 3.3% in Indonesia.

<sup>12</sup> These include adjustments to the prices of fuel, electricity, sugar and other price-controlled items.

in order to remain competitive. Greater uncertainty on future costs and prices could also affect firms' investment and hiring decisions.

Therefore, a key policy thrust is to ensure that short- and long-term measures are earnestly implemented to partially mitigate the adverse effects of price reforms. The Government has undertaken targeted short-term measures, which include financial aid to support vulnerable households and firms in undertaking adjustments. Crucially, the Government has also enacted the Price Control and Anti-Profiteering Act 2011 to reduce profiteering<sup>13</sup> by businesses and firms. Efforts are currently geared towards strengthening enforcement of the Act to monitor and take action against errant parties. To this end, there have also been initiatives to promote awareness of consumer rights and of prices of goods through the media and online tools for price comparison. This will ensure that consumer activism can play a greater role in preventing excessive price hikes. Bank Negara Malaysia, through its monetary policy, remains vigilant on factors that could contribute to excessive inflationary pressures at the economy-wide level.

Price reforms must be complemented with measures to assist vulnerable groups, so as to achieve growth that is both sustainable and inclusive. To this end, a comprehensive social protection system<sup>14</sup> that covers social assistance, social insurance and human capital development programmes is being formulated to replace the regressive blanket assistance. The system will be targeted, sustainable and, most importantly, will help build the capacity of its recipients. This system will therefore not only provide short-term support to vulnerable households but would provide the opportunity to increase earnings by enhancing skills and capabilities. Such a system is a common feature in the advanced economies. For firms, specific incentives and grants will continue to be provided to encourage productivity improvements and innovation. Such assistance will support firms in adjusting to higher cost and facilitate the movement up the value chain into more sophisticated, technology-intensive and profitable ventures.

In addition, in a more deregulated pricing environment, the Government's role will evolve, from one that sets prices and provides subsidies to one that shapes regulations to foster a well-functioning and competitive market. Measures such as the introduction of the Competition Act 2010 and the establishment of Malaysian Competition Commission (MyCC) would promote effective competition and deter anti-competitive behaviour among firms. Well-developed regulation and enforcement can protect consumers and enable them to benefit from a wider range of better quality goods and services at affordable prices. These efforts to promote competition are consistent with the Strategic Reform Initiative (SRI) on Competition, Standards and Liberalisation<sup>15</sup>, which has made considerable progress, contributing to improvements in Malaysia's business environment.

Taken together, these measures will enhance the ability of the economy to adjust to cost and price fluctuations, thus making it more resilient to shocks. As with all policies, the key success factor will be clear communication, consistent monitoring, effective implementation and enforcement, and continuous policy improvements.

### Conclusion

Price reforms are a critical component of Malaysia's objective of achieving inclusive and sustainable growth as it evolves into a high-income economy. To support inclusiveness, the regressive blanket subsidies and price controls will be replaced by a more targeted social protection system that can provide sustainable support to households that are in need of such assistance. In enhancing growth sustainability, price reforms will incentivise firms to increase productivity, undertake innovation and

<sup>13</sup> Based on the Price Control and Anti-Profiteering Act 2011, profiteering refers to the act of making unreasonably high profit, after taking into consideration factors such as cost of production, supply and demand conditions and any tax imposition.

<sup>14</sup> Social assistance includes cash transfers, food stamps and targeted subsidies; social insurance includes insurance for disability, unemployment, health and other risks; human capital programmes include training and upskilling as well as public education and healthcare.

<sup>15</sup> Based on the Economic Transformation Programme Annual Report 2013.

move up the value chain, and avoid overreliance on cheap subsidised inputs. At the same time, the savings from the reforms create an opportunity for the Government to undertake more productive spending on infrastructure, healthcare and education. Consequently, Malaysia will benefit from a more productive and inclusive economy, more opportunities for the creation of high-skilled high-income jobs, greater access to higher quality goods and services, and an enhanced flexibility to manage shocks. Thus, while there are short-term challenges to manage, price reforms will ultimately place the economy on a more sustainable and inclusive growth path.

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## MONETARY POLICY

Monetary policy in 2015 will focus on ensuring steady growth of the Malaysian economy amid contained risks to inflation. The operating environment for monetary policy will be shaped by a number of factors including external developments that would affect the overall outlook for the domestic economy. These include the considerable downside risks to the global growth prospects, the implications of a changed outlook for commodity prices, and the potential divergence in the monetary policies of the major economies. Notwithstanding these external developments, the Malaysian economy is expected to remain on a steady growth path of 4.5 - 5.5%, supported by a sustained expansion of domestic demand and a resilient export sector. Headline inflation will be lower during the year given the significant decline in commodity prices. In addition to these developments, monetary policy will also consider the potential risk of financial imbalances that may have medium-term implications for the Malaysian economy.

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### Monetary policy in 2015 will focus on ensuring steady growth of the Malaysian economy amid contained risks to inflation

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Global growth is expected to improve moderately in 2015 but will remain uneven, with considerable downside risks. Although growth in the US is expected to improve and growth in many Asian economies will be sustained, the growth momentum in a number of key major economies is weaker than earlier expected. While overall supportive of global growth, the decline in commodity prices has also raised concerns over the growth prospects for net commodity exporters. The magnitude and timing of monetary policy shifts in the major economies are also uncertain. Against this backdrop, international financial markets are expected to continue to be volatile during the year.

The Malaysian economy is expected to grow by 4.5 - 5.5% in 2015. Domestic demand will continue to anchor growth. Private

consumption will be supported by higher disposable income from lower fuel prices and favourable labour market conditions. After three years of double-digit growth, growth in private investment is expected to moderate due mainly to lower investment in the mining sector as a result of the weak global crude oil prices. Nevertheless, private investment growth will be supported by on-going and new investment plans in the manufacturing and services sectors as firms benefit from the continued global recovery and lower cost of inputs. The export sector is expected to remain resilient, with the continued growth in manufactured exports, mitigating the impact of lower commodity prices on commodity exports. Against a backdrop of continued uncertainty in the global economic and financial landscape, the key risks to the growth outlook for the Malaysian economy will therefore emanate mainly from the external environment.

The risks to the inflation outlook are assessed to be relatively contained going forward. Headline inflation is projected to be lower at 2 - 3% in 2015, largely reflecting the impact of lower global oil prices on domestic fuel prices and the lower imported inflation, which are expected to partly offset some of the impact of the GST on inflation. Going forward, the inflation rate could be subject to the volatility in global oil prices. Nevertheless, underlying inflation is expected to remain contained amid the stable domestic demand conditions.

Given the uncertain global economic outlook and the potential divergence in the monetary policies of the major economies, large shifts in capital flows can be expected to continue in 2015. Together with other emerging economies, Malaysia is also expected to experience volatile capital flows. However, the availability of a wide range of policy instruments, policy flexibility and sufficient buffers have improved Malaysia's ability to manage these volatile capital flows. In addition, a strong banking system and well-developed financial markets will be able to absorb and intermediate swings in capital flows without disruptions to financial intermediation or dislocations to underlying economic activities. Most importantly, monetary and financial conditions are expected to remain accommodative and supportive of real economic activity.

## FISCAL POLICY

Fiscal policy in 2015 will focus on strengthening fiscal management amid the challenging environment of low global energy prices. The expected lower oil-related revenues as a result of a sharp decline in global oil prices since late 2014 had prompted the Government to introduce pre-emptive fiscal adjustment measures and revise the fiscal deficit target from 3% of GDP to 3.2% of GDP. These measures are intended to maintain the Government's commitment to fiscal consolidation while recognising the need to ensure a pro-growth environment in the economy.

Following the fiscal reforms, the reliance on oil-related revenue has declined from 41% in 2009 to 30% in 2014. This is a reflection of the measures undertaken to diversify the sources of revenue, especially enhancements to the tax and customs administration and compliance. The implementation of the GST will further support the diversification of the sources of revenue. In addition, expenditure rationalisation measures encompassing fuel subsidy reforms and the scaling-down of discretionary spending will moderate the growth in operating expenditure. In the aftermath of the December 2014 floods, the Government also announced flood assistance measures which include financial aid for flood victims, as well as rebuilding and flood prevention efforts.

**Table 4.4**

### Federal Government Finance

	RM billion		% change	
	2014	2015 <sup>r</sup>	2014	2015 <sup>r</sup>
Revenue	220.6	222.9	3.4	1.0
Total expenditure	259.1	260.9	2.2	0.7
<i>Operating expenditure</i>	219.6	212.4	3.9	-3.3
<i>Gross development expenditure</i>	39.5	48.5	-6.4	22.8
Loan recovery	1.1	1.0		
<b>Overall balance</b>	<b>-37.4</b>	<b>-37.0</b>		
<b>% of GDP</b>	<b>-3.5</b>	<b>-3.2</b>		
<i>Sources of financing:</i>				
Net domestic borrowing	37.6	-		
Net external borrowing	-0.4	-		
Realisable assets <sup>1</sup> and adjustments	0.2	-		

<sup>1</sup> A negative (-) sign indicates a build-up in assets  
<sup>r</sup> Revised

Note: Numbers may not add up due to rounding

Source: Ministry of Finance, Malaysia

**Table 4.5**

### Pre-emptive Fiscal Adjustment Measures Announced on 20 January 2015

		RM billion
<b>Revenue Enhancement Measures</b>		<b>1.4</b>
1	Additional GST revenue from higher-than-expected number of registrants	1.0
2	Additional dividend from Government Linked Companies, Government Linked Investment Companies and other agencies	0.4
<b>Expenditure Optimisation Measures (Operating Expenditure)</b>		<b>5.5</b>
1	Optimisation of spending on supplies & services	1.6
2	Postponement of National Service Programme (PLKN)	0.4
3	Rationalisation of grants & transfers to statutory bodies, public enterprises and trust funds, especially those with consistent revenues and high reserves	3.2
4	Reschedule purchases of non-critical assets	0.3
<b>Total Savings</b>		<b>6.9</b>

Source: Prime Minister's speech on 20 January 2015

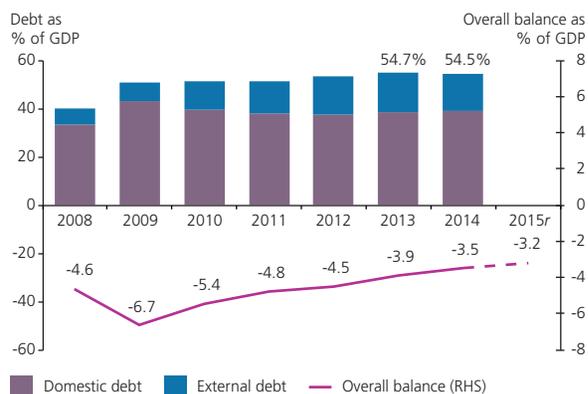
In the 2015 Budget, fiscal resources had been strategically prioritised towards infrastructure projects with larger multiplier effects, investments to enhance future productive capacity and programmes for capacity building. These include public infrastructure projects such as highways, railways and urban public transport as well as incentives to accelerate technology- and knowledge-based investments by the private sector<sup>4</sup>. To cultivate a competent and productive labour force, human capital development efforts continue to emphasise education, up-skilling, industrial training and entrepreneurship programmes.

Emphasis is also accorded to inclusive growth, particularly in ensuring the quality of life and a balanced development of urban and rural

<sup>4</sup> To encourage investment projects based on technology, innovation and knowledge, the Government introduced specialised incentive packages and research funds such as the Research Incentive Scheme for Enterprises (RISE) and Public Private Research Network.

Chart 4.5

Federal Government Fiscal Balance and Debt



<sup>r</sup> Revised

Source: Ministry of Finance, Malaysia

areas. Socio-economic support to underserved groups also continues to be provided through various forms of assistance including affordable housing schemes and fiscal transfers for the lower-income and less fortunate groups<sup>5</sup>. These measures provide support to increase private consumption spending.

Going forward, in facing the uncertain environment, the Government has indicated its commitment to ensuring that the fiscal consolidation plan remains on track towards achieving a balanced budget over the medium-term. Nevertheless, in pursuing the fiscal reform agenda, equally important is to ensure that the economic transformation initiatives to transition Malaysia into a high-income economy will stay on course.

<sup>5</sup> Examples of affordable housing schemes include the *Perumahan Rakyat 1Malaysia* and *Program Perumahan Rakyat* while fiscal transfers include, among others, the *Bantuan Rakyat 1Malaysia* and welfare assistance programmes for poor households and disabled groups.

## The New Reference Rate Framework

On 2 January 2015, the Base Rate (BR) replaced the Base Lending Rate (BLR) as the main reference rate for new retail floating-rate loans and financing facilities. This article discusses the general role of a reference rate, the motivation for the replacement of the BLR, the key features and benefits of the new BR framework and the transition from the BLR to the BR. The article concludes by providing an overview of the current reference rate landscape under the BR.

### (i) Roles of a reference rate

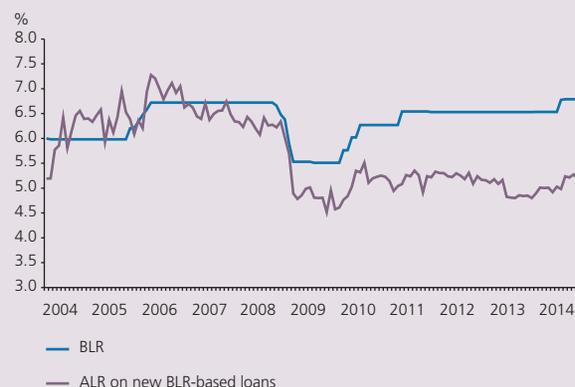
A reference rate constitutes a key component of the lending rate on a floating-rate loan. In general, a reference rate serves three important roles. First, as a reference rate is typically linked to the bank's cost of funds, it forms the basis for the pricing of loans. Second, it allows banks to vary floating lending rates to reflect changes in their funding costs that could arise from changes in central bank policies and general market funding conditions. Third, it ensures that changes in monetary policy are transmitted to borrowers and thereby influence decisions related to consumption, investment and debt.

### (ii) Motivation for a new reference rate

Since its introduction in 1983, the BLR served as the main reference rate on floating-rate loans in Malaysia. In recent times, however, the BLR appeared to have become less meaningful as a basis for pricing, as retail lending rates on new loans were being offered at substantial discounts to the BLR (Chart 1). A survey of housing loan rates across major commercial banks in 2013 indicated that these loans were offered at between 2.0% and 2.5% below the BLR<sup>1</sup>. In addition to the cost of funds and the Statutory Reserve Requirement (SRR), the BLR also included the cost of managing liquidity risk, profit margins and operating costs (Chart 2). The inclusion of these components had made changes in the BLR less transparent. This contributed to an asymmetry in BLR adjustments to changes in the monetary policy and resulted in instances of the BLR not fully adjusting to reductions in the Overnight Policy Rate (OPR). For example, following the cumulative 150 basis points OPR reduction in 2008 and 2009, the BLR adjusted downwards by only 121 basis points. In contrast, when the OPR was subsequently increased by 100 basis points, the BLR adjusted fully. The incomplete pass-through to repayments of existing borrowers reduced the effectiveness of a key channel of monetary policy transmission to the economy. Uneven monetary policy pass-through was also observed between new and existing loans when the OPR was increased, as the competition among banks for new loans ensured that these loans were more competitively priced. The BLR also appeared less sensitive to changes in funding costs arising from factors such as market conditions that were unrelated

Chart 1

Commercial Banks: BLR and ALR on New BLR-based Loans



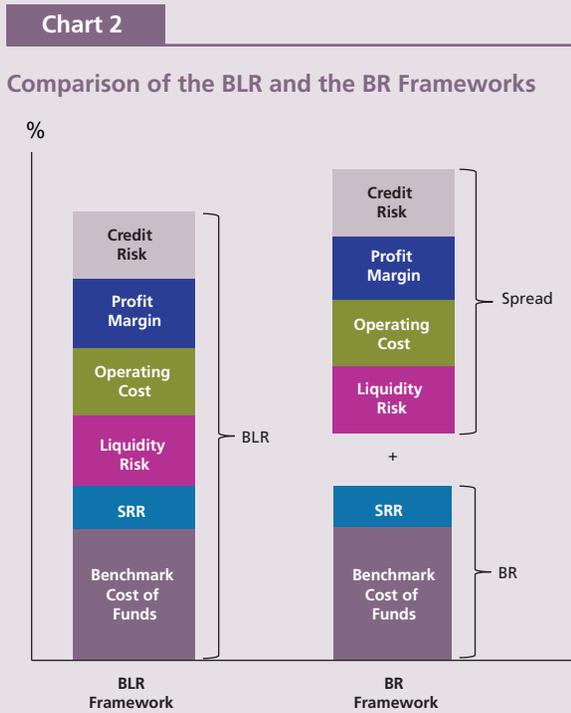
Source: Bank Negara Malaysia

<sup>1</sup> This observation of negative spread is not unique to Malaysia, and in recent years appears to be a common occurrence in countries with a base lending rate framework.

to changes in monetary policy. These shortcomings have motivated the need for a new reference rate framework that would allow banks to effectively manage interest rate risk, that is fair and transparent to borrowers, and that facilitates effective monetary policy transmission.

**(iii) Key features and benefits of the Base Rate framework**

The BR replaced the BLR as a basis for the pricing of new retail loans tied to a reference rate. Unlike the BLR, the BR is a cost of funds based reference rate<sup>2</sup>. Accordingly, the BR is determined only by the SRR and a financial institution’s funding costs (Chart 2). In terms of the latter, financial institutions have been given the flexibility in choosing the appropriate benchmark money market or financial market rate to reflect the funding costs associated with making the loan. Other components of loan pricing such as borrower credit risk, liquidity risk premiums, operating costs and profit margins are reflected in the spread above the reference rate, which will remain fixed throughout the life of the loan<sup>3</sup>.



Source: Bank Negara Malaysia

The new BR is expected to benefit borrowers and financial institutions, while facilitating a more effective transmission of monetary policy changes to the economy. A key aspect of the BR is that it is more transparent and fair to borrowers. Unlike the BLR which allowed changes in factors other than those related to the funding costs to be reflected in the lending rate after the loan has been contracted, the lending rate of a BR-based loan will vary only in response to changes in funding costs. As the funding costs are referenced off money and financial market rates that are readily visible<sup>4</sup> to borrowers, there will be an increase in the transparency of changes to the BR.

<sup>2</sup> A cross-country survey of loan pricing practices indicates that the use of reference rates is common practice. In general, there are two types of reference rates – base lending rate and cost of funds based reference rate. Both share a strong link to the cost of funds. A base lending rate, however, allows for other elements such as the profit margin and operating costs to be included in the reference rate, while with the cost of funds framework, the reference rate comprises only the cost of funds – all other components are included in the spread on top of the reference rate.

<sup>3</sup> The pricing of the spread can only change if the loan is restructured due to a severe deterioration of borrower credit risk which impairs the ability to meet the repayment obligation.

<sup>4</sup> For example, the Kuala Lumpur Interbank Offered Rate (KLIBOR) is published in most major local newspapers, as well as on Reuters and Bloomberg.

For financial institutions, the BR enables the lending rate on existing loans to adjust to changes in market funding conditions. This would support their management of market interest rate exposures. The BR is also expected to provide financial institutions with a meaningful basis for pricing floating-rate loans, as it reflects the relevant benchmark cost of funds for making the loan. An important consequence of this is that financial institutions will not have the incentive to price loans below the BR as it will not be profitable to contract the loan below their benchmark cost of funds, while all other non-cost components are priced as a positive spread over the BR. The introduction of a new reference rate framework will also promote greater discipline in banks' pricing practices. Under the BR, all non-cost factors in loan pricing, including the risk premiums, are fixed throughout the life of the loan. As such, the new framework incentivises banks to effectively price and manage these risks.

For most financial institutions, floating-rate loans are benchmarked off a short-term money market rate. Changes in these rates in response to monetary policy adjustments have typically been symmetric, regardless of the direction of policy. Thus, unlike the BLR which did not always adjust equally to increases and reductions in the OPR, changes in the OPR will be reflected symmetrically in the BR. In addition, the BR is also likely to facilitate a more even transmission of changes in market funding conditions to both new and existing loans. This will enhance the effectiveness of monetary policy changes in influencing spending and borrowing decisions, and consequently, better influence the economy in the intended direction.

As the new framework entails a shift towards benchmarking retail lending rates against rates that are driven by market forces, the risk of transmitting financial market volatilities to the borrower during a crisis period may also increase. To mitigate this, banks can price such a risk into the liquidity spread. Additionally, under such circumstances, Bank Negara Malaysia would also conduct its monetary operations to manage volatility in domestic money markets. These mitigating factors will ensure that there will not be an excessive transfer of bank funding cost risk to borrowers during periods of high financial market stress.

#### **(iv) Transition from the Base Lending Rate to the Base Rate**

Existing floating-rate loans which were granted prior to 2 January 2015 will continue to remain priced against the BLR. To ensure that borrowers with existing BLR-based loans are not worse off than new borrowers with loans referenced to the BR, any future adjustments to the BLR shall be tied directly to the changes in the BR. As such, financial institutions are required to display both their BRs and BLRs at all branches and websites.

It is important to note that the implementation of the BR does not represent a change in the monetary policy stance. As such, the proposed changes should not affect the overall level of lending rates for retail loans in the economy<sup>5</sup>, as the quoted BR and borrower-specific spread reflect the financial institutions' existing loan pricing practices. The shift to the new framework is to strengthen the link between retail lending rates and the reference rates that financial institutions use to manage the risk of future changes to funding costs incurred in providing the loans (Chart 3).

#### **(v) Reference rate landscape under the Base Rate**

Under the new BR, financial institutions are given the flexibility in choosing the appropriate benchmark money market or financial market rate to appropriately reflect the cost associated with making the loan. As at 2 January 2015, floating-rate loans for most financial institutions are benchmarked off the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR)<sup>6</sup>. Besides the KLIBOR, a few banks opted to use a composite funding cost approach as the benchmark to determine the BR. The composite funding cost

<sup>5</sup> Notwithstanding any changes in monetary policy and market funding conditions, new floating retail lending rates under the BR should not differ from current effective lending rates under the BLR framework, under the assumption that all risks associated with the loan are appropriately accounted for.

<sup>6</sup> The reason for choosing the KLIBOR reflects a number of factors. When presented with a lending opportunity, the 3-month KLIBOR is the marginal cost of raising new funds in the wholesale market through interbank borrowing or corporate deposits. The 3-month KLIBOR is also the standard reference for financial contracts and the settlement of hedging instruments such as the interest rate swaps and KLIBOR futures, which are used by banks to manage interest rate risks. The choice of the KLIBOR will also increase the transparency in the movements of the BR, as the KLIBOR is an observable market rate that is published on a daily basis.

reflects the average cost of raising new funds through a variety of instruments including retail deposits and wholesale funding. The difference in BR methodologies has several implications for borrowers.

First, compared to the BLRs that were relatively uniform across banks, it is likely that there would now be some divergence in BRs across financial institutions. Upon introduction, the BRs of banks ranged between 3.20% - 4.25%. At the onset, this disparity may appear to favour banks offering lower BRs as their loans could be perceived as being less costly by borrowers. Nevertheless, it is important for borrowers to compare the effective lending rate, which also includes risk premiums, operating costs and profit margins, rather than just the level of the BR alone. In this regard, a survey of the effective lending rates on housing loans across the banking system following the implementation of the BR framework suggests that the effective rates charged by various banks remain highly competitive despite the differences in the BRs. To facilitate comparison and assist borrowers in making an informed financial decision, Bank Negara Malaysia requires banks to publish the effective lending rate of a standard housing loan product<sup>7</sup> offered to the most credit-worthy customer.

**Chart 3**

**Comparison of Quoted Lending Rates under the Base Lending Rate (BLR) Framework and Base Rate (BR) Framework**



\* For illustrative purposes, the BLR is assumed to be 6.85%, while the BR is assumed to be 3.80%.  
 \*\*Effective lending rate under both the BLR framework and the BR Framework is assumed to be similar, under the assumption that all risks are appropriately accounted for.

Source: Bank Negara Malaysia

Second, two BRs derived using different methodologies can be expected to respond with varying degrees to OPR changes. While KLIBOR-based loans are likely to change almost completely, the composite funding cost approach is expected to adjust by a lesser extent due to the insensitivity of savings and current account deposits which pay minimal or no interest. This diversity in BR computation can cater to borrowers with varying needs and risk appetites. BR loans tied to the composite funding cost will provide borrowers with greater stability of repayments even when the OPR changes. On the other hand, borrowers of BR loans tied to the KLIBOR are likely to experience greater variability in repayments, but would benefit from a larger decrease in repayments should the OPR be reduced.

As the BR reflects changes in market funding conditions, it may entail more frequent changes compared to the BLR. Consequently, to reduce the volatility of the BR to small changes in market funding conditions, most banks are adopting a buffer, whereby only permanent increases or reductions in funding costs beyond a certain threshold would trigger a revision of the BR. For most banks, this threshold ranges between 5 – 10 basis points. Nevertheless, any adjustment to the stance of monetary policy will warrant an immediate review of the BR to ensure swift transmission to borrowers.

<sup>7</sup> A standard housing loan product is defined as a 30-year loan with a principle value of RM350,000 and without a lock-in period.

In conclusion, the new reference rate is a further step towards a more mature financial landscape in the country. Going forward, the inherent flexibility of the framework allows reference rates to evolve as borrowers become more sophisticated in choosing products that suit their individual appetite for risk. Financial institutions will be able to offer a range of products based on different reference rates to manage changes in their funding composition and strategies, as well as the different elements of risks. Bank Negara Malaysia will closely monitor the implementation of the BR mechanism to ensure that it achieves its intended objectives of increasing the transparency of loan pricing and improving the efficiency of monetary policy transmission.

