

Potential Output in the Malaysian Economy

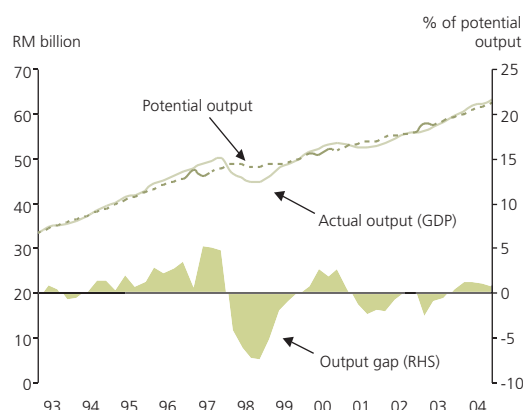
Potential output is defined as the level of output that is consistent with the productive capacity of an economy. Conceptually, the level of potential output is determined by the growth of non-inflationary trend levels of physical capital and the labour force as well as the rate of technological advancement. The output gap – the difference between actual output and the trend level of potential output – is a measure of the cyclical deviation from the non-inflationary trend of output. Knowledge on potential output and the output gap, together with other relevant information would help policymakers in making an assessment on the current position of an economy in the economic cycle, as well as indicating the latent growth path of the economy in the long term.

Potential output and the output gap are however not directly observable concepts. Nonetheless, by using a production function approach and using information regarding the existing physical capital stock and employment levels, estimates of potential output and the output gap for Malaysia can be obtained. It should be emphasised that these estimates alone do not provide an exhaustive perspective of the state of an economy, such as the extent of inflationary pressure. This is especially true for a structurally dynamic economy such as Malaysia.

Table 1
Actual GDP and Potential Output

Period	Actual GDP	Potential Output	Investment	Labour	Output Gap
	(Annual change in %)				(% of potential output)
1994-1998	9.2	8.0	14.1	3.9	2.3
1998	-7.4	3.0	-43.0	-2.1	-6.3
1999	6.1	1.3	-6.5	3.7	-2.0
2000	8.9	4.5	25.7	4.3	2.2
2001	0.3	3.8	-2.8	1.3	-1.2
2002	4.1	3.5	0.3	1.9	-0.7
2003	5.3	5.5	2.7	3.6	-0.9
2004	7.1	5.0	3.1	3.4	1.1

Graph 1
Actual and Potential Output



The latest estimates indicate that the Malaysian economy in 2004 was operating slightly above potential amidst the strong global economic growth, with the output gap estimated at 1.1% of potential output. A similar trend was observed during the previous global upswing in 2000. On the whole however, the deviations of actual from potential output have been modest since 1998, as illustrated in Graph 1, with growth in the Malaysian economy remaining in line with the growth of its potential capacity.

Prior to 1997, potential output of Malaysia grew at a rapid rate, with an average of 8% annually for the period of 1994 to 1997. The pronounced downturn in 1998 and following structural adjustments however altered the productive capacity of the economy. The potential growth path was affected and potential output growth subsequently slowed down during the recovery period as spare capacity within the economy was used up. Since 2000 however, the potential growth path began to improve and by 2004, potential output was growing at a rate of 5% annually, an almost fourfold increase compared to the low of 1999, as shown in Table 1 and Graph 1.

Given that steps have been taken to improve the contribution of productivity to growth, the current momentum in the expansion of productive capacity is expected to persist, resulting in further enhancement in potential output growth. This suggests that the potential growth path of the Malaysia economy is expected to continue to improve in the near future.