

Outlook and Policy in 2018

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Outlook and Policy in 2018

THE INTERNATIONAL ECONOMIC OUTLOOK

Synchronous uptrend in growth for most major economies in 2018

The global economy is forecast to expand at a faster pace in 2018, building on the strong positive momentum from the previous year. Growth will be driven primarily by private consumption and further lifted by investment activity in the advanced economies. In Asia, trade activity will continue to expand, albeit at a more moderate pace compared to 2017. This outlook will be further lifted by policy support, both on the monetary and fiscal fronts. Although global monetary policy is likely to continue on a path of gradual normalisation, financing conditions should remain relatively accommodative. Furthermore, additional spending on infrastructure in economies such as Thailand, Korea and the Philippines should provide impetus to regional growth. Given the broadly positive outlook, the assessment is for the trajectory of the current expansion to be sustained.

The strength of investments in the advanced economies is likely to persist through 2018. Business sentiment remains buoyant and profits have been strong in the improved global demand environment. Economic data showed that the need to upgrade existing capital stock remains. In addition, the recently passed Tax Cuts and Jobs Act in the US is likely to encourage further investment in the near term, as businesses benefit from corporate tax cuts and increased deductions for capital spending. In PR China, ongoing policy reforms to rebalance the economy are expected to lead to more moderate growth. Nevertheless, economies in the Asian region will, through trade channels, continue to benefit from the domestic demand strength in the advanced economies.

Growth in other emerging economies from Asia, Middle East, and Latin America is also projected to pick up. For commodity exporters, higher prices, notably for crude oil, will support a rebound in domestic demand following several years of below-trend growth. Furthermore, activity in several economies is projected to recover from the negative impact of reform policies in 2016 and 2017, with an example being India in the aftermath of demonetisation and GST implementation.

Risks to the global growth outlook are poised to become more broadly balanced. This is in contrast to the high prevalence of downside risks assessed in the past few years. On the upside, in the advanced economies, there is potential for investments to pick up further, and wages to rise as labour markets tighten. This would have positive bearing on both business and household spending, and generate more spillovers to the global economy through trade. In addition, the US administration's recent plans to increase spending on disaster relief and infrastructure in the 2018-19 fiscal years may also lend some upside risk to the outlook. Nevertheless, some downside risks from 2017 remain. Firstly, there is uncertainty regarding the impact of synchronised monetary policy normalisation across major economies. The global economy is shifting away from unprecedented levels of accommodative monetary conditions. Financial markets may correct abruptly if policy actions become misaligned from investors' expectations. Secondly, inward-looking trade policies remain a threat to global trade. Risks emerge mainly from protectionist measures by the US administration, and uncertainty in Europe amid pending new UK-EU trade agreements and the formation of key governments. Finally, geopolitical risks in relation to domestic conflicts, terrorism attacks and territorial disputes remain, which could affect sentiments in the global financial markets and dampen economic activity.

THE MALAYSIAN ECONOMY

In this positive environment, Malaysia is projected to remain firmly on a steady growth path to grow by 5.5% – 6.0% (2017: 5.9%).

The Malaysian economy is projected to expand by 5.5% - 6.0% in 2018

Malaysia's strong economic fundamentals, diversified structure and inherent dynamism have always been key factors to deliver economic growth. For 2018, growth prospects are further lifted by strengthening global economic conditions. Growth will be underpinned by continued expansion in private sector activity. The strong growth momentum will also be supported by the continued positive spillovers from the external sector to the domestic economic activity. Malaysia's trade performance will benefit from favourable global demand, exposure to the global technology cycle and new export production capacity. On the domestic front, continued income and employment growth will sustain household spending, amid the continuation of Government measures and improving consumer sentiments. Private investment activity is also projected to be sustained by capital spending for ongoing and new projects amid elevated business sentiments. On the other hand, public sector spending is expected to moderate given the continuation of fiscal consolidation efforts and the near completion of several major projects by public corporations.

The economic outlook is also characterised by some upside risks emanating from both external and domestic factors. Stronger-than-expected global demand will improve the prospects for export-oriented industries. This can translate into higher revenue

and profits for businesses and higher income for households, further reinforcing business and consumer sentiments. The potential increase in minimum wage and faster-than-expected pickup in existing and new production facilities in various industries including oil & gas, resource-based manufacturing and E&E will also support the better growth outlook. Nonetheless, downside risks to growth remain. Unfavourable monetary and regulatory policy shifts in the advanced economies, rising trade protectionism by major trading partners and a sharper-than-expected growth moderation in PR China, on the other hand, may impact the strength of Malaysia's exports to the major trading partners. A re-emergence of volatile commodity prices or abrupt corrections in the international financial markets could also weigh down sentiments, dampening the strength of domestic economic activity.

Malaysia remains well positioned to weather these headwinds should the downside risks materialise. Past experiences have demonstrated that Malaysia has the economic and financial adaptability to manage these risks. The strategic policy imperatives and structural reforms that were undertaken over the years have endowed the Malaysian economy with multiple sources of growth, ample buffers and robust policy frameworks. Going forward, the positive economic environment will provide policymakers with ample policy space to continue with the necessary reforms. The domestic financial markets are resilient and well positioned to intermediate large swings of capital flows in the event of heightened financial market volatility, thus preserving orderly market conditions that are supportive of the real economy. Fundamentally, policymakers have the tools, capacity and flexibility to undertake the necessary measures to steer the economy on a steady growth path.

Domestic Demand Remains the Anchor of Growth

In 2018, the Malaysian economy is projected to expand by 5.5% – 6.0%. Private sector expenditure will remain the key driver of growth, underpinned mainly by continued growth in wages and employment, business optimism and favourable demand. Public sector expenditure is expected to decline due to the contraction in public investment amid more moderate growth in public consumption. The external sector is expected to benefit from better global growth, and is likely to generate positive spillovers to domestic economic activity.

Private consumption growth is projected to remain sustained at 7.2% in 2018. The key factors that will support consumption spending during the year include continued growth in employment and income, lower inflation, and improving sentiments. In particular, robust export performance is expected to support wages in the export-oriented industries amid continued growth in domestic economic activity. The continued Government measures will also increase household disposable income in 2018. These measures include the

Table 1

Real GDP by Expenditure (2010=100)

	2017p	2017p	2018f	2017p	2018f
	% of GDP	Annual change (%)		Contribution to growth (percentage point)	
Domestic Demand¹	92.2	6.5	5.7	6.0	5.3
Private sector expenditure	71.2	7.5	7.6	5.3	5.4
<i>Consumption</i>	53.7	7.0	7.2	3.7	3.8
<i>Investment</i>	17.4	9.3	9.1	1.6	1.6
Public sector expenditure	21.0	3.3	-0.9	0.7	-0.2
<i>Consumption</i>	13.0	5.4	0.6	0.7	0.1
<i>Investment</i>	8.0	0.1	-3.2	0.0	-0.3
Change in Stocks	0.0			0.0	0.0
Net Exports of Goods and Services	7.8	-1.1	5.5	-0.1	0.4
Exports	72.9	9.6	8.8	6.7	6.4
Imports	65.1	11.0	9.1	6.8	5.9
Real Gross Domestic Product (GDP)	100.0	5.9	5.5 ~ 6.0	5.9	5.5 ~ 6.0

¹ Excluding stocks

p Preliminary

f Forecast

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

continuation of *Bantuan Rakyat 1Malaysia* cash transfers, individual income tax reduction by two percentage points on taxable income between RM20,000 to RM70,000 per annum, and the special payment to all civil servants and retirees.

In 2018, labour market conditions are expected to remain favourable and supportive of growth. This is underpinned by continued strong economic activity and improving hiring sentiments. Employment is expected to remain expansionary, and job growth will be sufficiently robust to absorb new entrants into the labour force. As such, unemployment rate is expected to be relatively unchanged (3.2% - 3.5%; 2017p: 3.4%). Effective 1 January 2018, Malaysia has implemented the Employment Insurance System (EIS) and the Employers Undertaking (EU). These would be followed with a review of the minimum wage later in the year. While these reforms may entail some short-term adjustments, these measures are necessary to put Malaysia's labour market on a more competitive, resilient and flexible path going forward.

Private investment growth is projected to be sustained at 9.1% in 2018, supported by ongoing and new capital spending in both the manufacturing and services sectors, and strengthened by continued positive business sentiments. Mining investment, while remaining moderate, is estimated to exert a lesser drag to growth following the improvement in commodity prices. Investments in the export-oriented industries (for example, the E&E and resource-based industries) would continue to benefit from the expected expansion in global growth. By type of asset, investments in machinery and equipment (M&E) are expected to receive further impetus from the recent Government measures to encourage automation and innovation. Investments in structures would be supported mainly by ongoing multi-year projects in the broad property sector.

Public consumption is expected to register a marginal expansion of 0.6% in 2018 on account of more moderate growth in emoluments amid prudent spending on supplies and services. This is in line with the Government's commitment to reprioritise and rationalise non-critical expenditure.

Public investment is projected to decline by 3.2% due to lower capital spending by public corporations following the near completion of large-scale projects. Investment by the General Government is expected to increase, reflecting mainly higher investment to improve public infrastructure and transportation network.

Continued Expansion across All Economic Sectors

All economic sectors are projected to expand in 2018. The services and manufacturing sectors remain the key drivers to overall growth.

Table 1

Real GDP by Sector (2010=100)

	2017p	2017p	2018f	2017p	2018f
	% of GDP ¹	Annual change (%)		Contribution to growth (ppt)	
Services	54.4	6.2	6.1	3.4	3.3
Manufacturing	23.0	6.0	5.9	1.4	1.4
Mining and quarrying	8.4	1.1	1.8	0.1	0.2
Agriculture	8.2	7.2	3.6	0.6	0.3
Construction	4.6	6.7	7.3	0.3	0.3
Real GDP	100.0¹	5.9	5.5 ~ 6.0	5.9¹	5.5 ~ 6.0

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

p Preliminary

f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The **services** sector is expected to record sustained expansion. The *wholesale and retail trade, food & beverages* and *accommodation sub-sectors* are anticipated to benefit from favourable labour market conditions. Similarly, growth in the *information and communication* sub-sector is expected to remain strong, reflecting sustained demand for telecommunication and computer services. In the *transport and storage* sub-sector, growth will be driven by continued strength in trade activity.

Growth in the **manufacturing** sector is projected to be sustained. In the export-oriented industries, growth will be supported mainly by continued demand for chemical-related products in the primary-related cluster. Production of E&E products will be sustained, in line with the expected normalisation in global semiconductors demand. Growth will also be supported by new production capacity in the resource-based industries such as petrochemicals and rubber gloves. In the domestic-oriented industries, growth will be driven by higher production of construction-related materials for new and on-going infrastructure projects as well as continued strength in demand for food-related products.

The **construction** sector is expected to record a stronger growth. This will be driven primarily by large new and existing multi-year civil engineering projects. These projects are mainly in the transportation and utilities segment.

In the commodities sector, the **mining** sector is projected to register higher growth, reflecting the continued pickup of natural gas production from the new gas fields and production facilities. The **agriculture** sector is expected to register a more moderate growth. This mainly reflects the normalisation in crude palm oil production growth following the exceptional post-El Niño rebound in 2017.

Potential Output and the Output Gap of the Malaysian Economy

Potential output is the maximum level of output that an economy can produce given its existing resources – comprising capital, labour and technology – without generating inflationary pressures. Output beyond this potential indicates the possible presence of inflationary pressures, while the converse reflects disinflationary pressures. Given the Bank's objective of maintaining price stability¹, the potential output, and the level of actual output in relation to potential (also known as the output gap²), are important indicators of inflation.

The Bank estimates that Malaysia's potential output expanded by 5.4% in 2017 (2016: 5.3%; 2010-2015 average: 5.0%), following higher capital expenditure in the private and public sectors. The faster pace of capital expansion was in line with higher demand for existing resources, as robust global growth resulted in spillovers to the domestic economy. The stronger demand conditions were reflected in higher capacity utilisation in the manufacturing sector during the year (average MIER capacity utilisation rate in 2017: 82.6%; 2016: 77.5%).

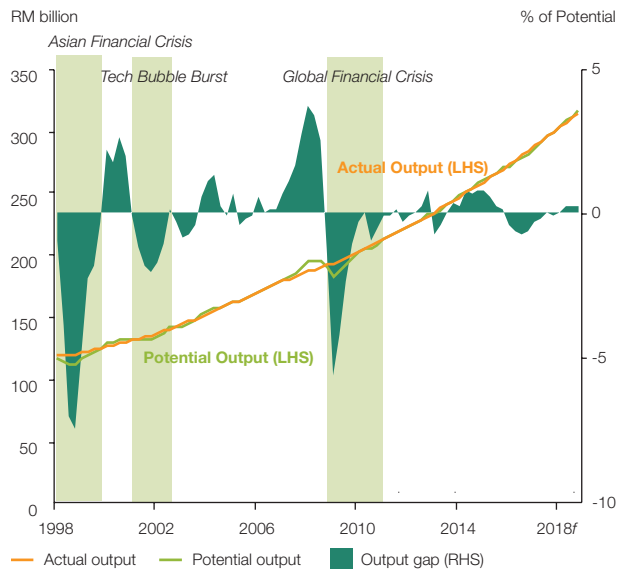
Despite faster GDP growth (2017: 5.9%; 2016: 4.2%), the output gap remained negligible during the year (2016: -0.6%), as the faster growth was accompanied by concurrent improvements in potential output. The increase in inflation to 3.7% (2016: 2.1%) in 2017 was mostly accounted for by cost factors (in particular, higher domestic fuel prices and the recovery in global commodity prices) and is expected to moderate going forward.

Looking ahead, the output gap is expected to turn marginally positive in 2018, in line with the continued growth momentum within the economy. Continued growth in the labour force and capital deepening will, however, result in an increase in potential output, thereby mitigating the build-up of demand-driven inflationary pressures.

Over the longer time horizon, there are ongoing policy measures that will boost potential output and hence sustain economic growth at a higher level. Some of these policies aim to boost labour force participation and encourage more efficient utilisation of capital. For example, these include policies to increase the participation of women in the workforce and to promote sharing economy activities that will unlock previously idle assets. In addition, Government initiatives to accelerate the development of the digital economy will increase productivity. Among others, this includes the implementation of the Digital Free Trade Zone (DFTZ), which will provide a consolidated digital platform for Small and Medium Enterprises (SMEs) to gain access to global markets. Such reforms will secure the long-term sustainability and quality of growth for the Malaysian economy.

Chart 1: Actual and Potential Output

Output gap to turn marginally positive in 2018



Year	Annual Growth in Potential Output (%)
2016	5.3
2017e	5.4
2018f	5.0 - 5.5

e Estimate
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

¹ Central Bank of Malaysia Act 2009.

² More formally, the output gap is defined as $\frac{(\text{Actual output} - \text{Potential output})}{\text{Potential output}} \times 100\%$

EXTERNAL SECTOR

Malaysia's exports and current account surplus to remain firm in 2018

The external sector is projected to remain resilient amid further strengthening in the global economy in 2018. Malaysia's export performance will be supported by favourable demand from major trading partners, continued expansion in the global technology upcycle and broadly sustained commodity prices. Gross exports and gross imports are projected to grow at above-average trends, albeit at a more sustainable pace of 8.4% and 8.6%, respectively. Amid continued strength in trade activity, the goods surplus of the current account is expected to increase. Deficits in the services and income accounts, however, will continue to weigh on the current account balance. Overall, Malaysia's current account balance is expected to register a surplus of 2.0 - 3.0% of GNI.

Exports to benefit from favourable external demand

Malaysia's gross export growth will be supported by demand from Malaysia's key trading partners, such as the US, EU and regional economies. Broad-based improvement in forward looking indicators such as business confidence indices of major trading partners, manufacturing production indices in the advanced and

regional economies and the US Technology Pulse index suggest continued strength of manufactured exports in the early quarters of 2018. In particular, continued investments in the advanced economies will lend support to the global electronics upcycle as the boost from smartphone demand eases. Malaysia's semiconductor exports (2017: 19.0% share of gross exports) will strongly benefit from the increasing pervasiveness of semiconductors used in automobiles and consumer electronics such as connected devices and smart appliances. Insights from the Bank's regional economic surveillance suggest that exports of semiconductors for the automotive market is likely to remain firm on account of rising semiconductor content per vehicle and growing demand for advanced vehicle safety, infotainment and comfort systems. For non-E&E exports such as petroleum, chemical and metal products, growth will be supported by steady demand from most regional countries. PR China's (2017: 13.5% share of gross exports) rebalancing efforts, however, may weigh down export of these products.

Increase in domestic productive capacity to support export growth

Capacity expansions particularly in the export-oriented manufacturing and mining sectors are also expected to support export growth. Of note would be the commencement of several approved investments, including the relocation of a sizeable E&E production line to Malaysia, which will contribute to the exports of high-value wireless communication chips. Firms in the resource-based manufacturing industries, such as petrochemicals and rubber gloves, have announced operationalisation of new manufacturing plants. The anticipated pickup in crude oil and LNG production from existing and recently commenced facilities will also provide some support to commodity export volume growth. Arising from these developments, growth in Malaysia's manufacturing exports is expected to remain at above-average trend, although the pace is expected to ease. In tandem with the performance in manufacturing exports, imports of intermediate inputs will continue to expand to cater for export-oriented manufacturing production.

Imports supported by continued expansion in domestic demand

Imports of intermediate inputs for domestic production¹ will be supported by sustained private sector spending.

Table 4.1

External Trade			
	2012-2016 average	2017 ^p	2018 ^f
	Annual change (%)		
Gross exports	2.5	18.9	8.4
<i>of which:</i>			
Manufactured	5.0	18.9	9.5
Agriculture	-5.4	10.9	3.5
Minerals	-5.7	23.9	3.7
Gross imports	4.1	19.9	8.6
<i>of which:</i>			
Capital goods	4.9	15.3	3.4
Intermediate goods	0.8	20.0	5.8
Consumption goods	10.5	6.1	2.5
Trade balance (RM billion)	85.9	97.2	104.2

^p Preliminary
^f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

¹ Using the 2010 input-output tables published by the Department of Statistics, Malaysia, 51.7% share of total gross imports are intended for domestic use.

Similarly, consumption imports will also expand, reflecting steady household demand for imported apparel, food and beverages. The decline in capital spending by public corporations, however, will partly weigh on capital imports as major projects are near completion. The moderation in capital import growth also reflects the high base in 2017, on account of the delivery of an oil and gas platform in the first quarter of 2017.

More moderate commodity price growth

Export prices of major commodities are expected to diverge in 2018, after the synchronous and strong rebound in 2017. Mineral prices will continue to increase, but at a smaller magnitude compared to 2017. The relatively smaller price increase will contribute to slower crude oil export growth. Similarly, slower increase in LNG price will also result in a more moderate expansion in LNG exports. In contrast, major agriculture export prices, particularly crude palm oil (CPO) is likely to decline reflecting elevated inventory levels as the recovery in CPO output continues post-El Niño. The slower growth in commodity prices will also be reflected in the lower exports of resource-based manufactured exports (e.g. petrochemicals and oleochemicals) and intermediate imports (e.g. fuel and lubricants) which use these raw commodities as feedstock.

On balance, Malaysia's export outlook will remain firm, supported by continued strength in export volumes amid a moderation in export price growth. Of importance, while the pace of overall export and import expansion is expected to moderate, it continues to

exceed the recent five-year average performance. Consequently, the goods surplus in the Balance of Payments is forecast to rise to RM120.5 billion.

The services account is projected to record a marginally higher deficit of RM23.2 billion, owing to higher net transport payments, as local firms continue to rely on foreign freight providers to transport goods. In addition, payments for professional and technical services are also expected to rise as firms engage in foreign expertise to facilitate construction of high-end commercial projects and civil engineering projects which use complex technologies. The travel account, which is the largest services account in surplus, will increase on expectations of higher tourist arrivals and rising per capita spending. Tourism Malaysia targets tourist arrivals to edge up to 33.1 million in 2018, from 25.9 million in 2017.

The income accounts are also projected to record a wider deficit. The primary income deficit will increase to RM39.1 billion as locally-incorporated multinational corporations are expected to continue to earn sizeable profits, especially in the manufacturing sector, in tandem with improved global demand. This will more than offset the increase in income accrued to Malaysian firms investing abroad, particularly in the mining sector which accounts for more than one-third of investment income receipts. The secondary income account is expected to register a larger deficit of RM19.3 billion due to higher outward remittances by foreign workers.

INFLATION OUTLOOK

Headline inflation to moderate in 2018 due mainly to a smaller contribution from global cost factors

Headline inflation is expected to average between 2.0% – 3.0% in 2018 (2017: 3.7%). While global energy and commodity prices are expected to trend higher in 2018, the higher base in 2017 will result in a smaller contribution to headline inflation. In addition, a stronger ringgit exchange rate compared to 2017 will partially offset the impact of higher global energy and commodity prices. It will also contain increases in import costs. Given the dependency of domestic inflation on the trajectory of global oil prices, there remains a high degree of uncertainty surrounding the inflation projection. Underlying inflation, as measured by core inflation, is also expected to moderate in

Table 4.2

Current Account of Balance of Payments ¹		
Item (Net)	2017 ^p	2018 ^f
	RM billion	
Goods	118.1	120.5
Services	-23.1	-23.2
Primary income	-36.1	-39.1
Secondary income	-18.6	-19.3
Current account balance	40.3	38.9
% of GNI	3.1	2.0 ~ 3.0

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

^p Preliminary

^f Forecast

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

2018, due to smaller cost pass-through to retail prices compared to the previous year. Inflationary pressures from domestic demand factors will be contained by improving labour productivity and ongoing investments for capacity expansion.

Global oil prices are expected to be higher in 2018 supported by continued tightness in the global oil market as the global oil output cuts agreement between Organization of the Petroleum Exporting Countries (OPEC) and several non-OPEC producers, notably Russia, has been extended to end-2018. Oil prices will also be supported by higher global oil demand amid improvements in global economic growth. The IMF projects crude oil prices to average at USD60 per barrel in 2018², an 11.7% increase compared to 2017 (2017: +23.1%). While the higher global oil prices will lead to higher domestic fuel prices in 2018, the higher base of domestic fuel prices in 2017 and a stronger ringgit exchange rate in 2018 could result in a smaller contribution of domestic fuel prices to domestic headline inflation.

Similar to global oil prices, other external cost factors are also expected to register some increases. Higher global demand for food amid sufficient supply is expected to lead to slight increases in food prices during the year. In addition, the weighted inflation rate of Malaysia's import partners is projected to increase slightly in 2018, following the continued cyclical recovery in global demand. However, in some major economies, the risks of higher-than-expected inflation remain due to the tighter labour market conditions, which may lead to accelerations in wage growth and hence, inflationary pressures.

These smaller increases in external cost factors, combined with a stronger ringgit exchange rate are expected to result in a relatively subdued cost environment for firms. Against the backdrop of sustained growth in domestic demand, however, some firms that have not fully passed on the higher costs faced in previous years could continue to raise retail prices in 2018. Nevertheless, the extent of such increases in prices is expected to be smaller. The Bank's Regional Economic Surveillance (RES) team reports that amid stronger competition, firms

are finding it more challenging to pass on higher costs to retail prices as consumers are now more price-sensitive.

Continued expansion in demand conditions is expected to lead to a marginally positive output gap in 2018. However, price pressures arising from demand factors are expected to be limited, contained by improving labour productivity and ongoing investments for capacity expansion. In the labour market, the unemployment rate is expected to remain relatively stable as the high employment growth will be matched by the expansion in the labour force. In addition, wage growth is expected to remain stable. The Malaysian Employers Federation (MEF)³ reports that employers expect salary increments to average at approximately 5.5% in 2018 (2017: 5.5%). The tightness in capital stock seen in 2017 is also not expected to persist, following the expansion in firms' productive capacity. Private investment grew by 9.3% in 2017 (2016: 4.3%) and is expected to be sustained in 2018, further expanding firms' productive capacity.

The inflation outlook is, however, subject to two key risks. Externally, stronger-than-anticipated increase in global oil prices could lead to headline inflation averaging higher. Global oil price movements remain uncertain, subject to geopolitical risks and developments in the US shale oil industry. Domestically, stronger-than-expected growth in demand could support larger cost pass-through to prices, and risk stronger demand-driven price pressures.

MONETARY POLICY

Monetary policy in 2018 will focus on ensuring the sustainable growth of the Malaysian economy with price stability

The global economy is seeing stronger growth prospects compared to a year ago. Growth is expected to continue to be broad-based, entrenched and synchronised across regions. The stronger global economic activity will be underpinned by more robust investments in the

² The IMF projection was published in IMF World Economic Outlook in January 2018. The price is the average price of Dated Brent, West Texas Intermediate (WTI) and Dubai Fateh crude oil, equally weighted.

³ Refers to the MEF Salary Survey for Executives and Non Executives 2017. The salary increment figures used are simple averages of employers' expectations of salary increments for both executives and non-executives.

advanced economies. Asian economies, including Malaysia, will continue to benefit from sustained strength in global trade even as it is projected to moderate from the strong growth recorded in 2017.

At this juncture, upside potential to the global growth outlook marks a distinction from past years, which had been dominated by downside risks. The considerable improvement in the upside potential is influenced mainly by the prospects of higher wage growth in the advanced economies and greater positive spillovers from stronger growth in the advanced economies to the global economy through trade. However, the potential upsurge of uncertainties surrounding geopolitical developments, repercussions from trade tensions, global oil and commodity prices, and shifts in capital flows amid ongoing monetary policy normalisation in the major economies weigh on the outlook. A key concern is that the international financial markets could experience renewed volatility, which may be triggered by a deviation from the expected path of monetary policy normalisation in the advanced economies, escalation of geopolitical risks and correction in overvalued financial assets globally. Overall, taking all these factors into account, risks to the global growth outlook are now balanced.

The Malaysian economy is expected to experience sustained growth momentum in 2018 within the range of 5.5% - 6.0%, after the remarkable pace of economic expansion in 2017. Domestic demand will continue to drive growth, underpinned by favourable income and employment conditions, and new and ongoing infrastructure projects and capital spending. Export growth will moderate⁴, but remain above long-term averages⁵. The domestic economy will continue to benefit from positive spillovers from the external sector, particularly given ongoing investments by firms to expand their productive capacity in meeting the global demand.

Improving consumer and business sentiments also provide indication of more robust private expenditure growth. However, it is also important to note that consumer sentiments have yet to reach

the optimism threshold⁶, and this may weigh on the outlook for private consumption. The subdued consumer sentiments may in part be a reflection of the distributional issues of growth and income, which need to be addressed by structural policies. The Monetary Policy Committee (MPC), however, is cognisant of the importance of monitoring how monetary policy actions could interact with such issues. On balance, given the optimism on the global growth outlook and sustained domestic demand, the overall outlook is for domestic growth to remain firmly on a steady growth path.

Headline inflation is projected to average lower, within the range of 2.0% – 3.0% in 2018. The lower inflation compared to 2017 is due mainly to a smaller contribution from global energy and commodity prices. A stronger ringgit exchange rate compared to 2017 will also mitigate import costs. Inflationary pressure from domestic demand factors will be contained by improving labour productivity and ongoing investments for capacity expansion. The inflation outlook, however, depends on the trajectory of global oil prices, which remains highly uncertain.

Given the continuing positive macroeconomic outlook and firm growth path, the MPC decided to normalise the degree of monetary accommodation at the January 2018 MPC meeting. The MPC raised the Overnight Policy Rate (OPR) by 25 basis points to 3.25%. This is aligned with the focus of monetary policy for the year, which is to ensure that the monetary policy stance is appropriate for sustainable growth prospects moving forward. The MPC also recognises the need to prevent the build-up of risks that could arise from interest rates being too low for a prolonged period of time, even as the risks of financial imbalances currently remain contained.

The current level of the OPR will continue to support the Malaysian economy. The MPC will monitor closely the evolving economic outlook, including the impact of the OPR adjustment in January 2018. The Bank's monetary operations will continue to ensure that domestic liquidity in the financial system will remain sufficient to support the orderly functioning of the domestic financial markets.

⁴ The expected moderation in export growth is in part due to the high base in 2017 and dissipating support from commodity prices.

⁵ Refers to the 5-year average (2012-2016: 2.5%) and 10-year average (2007-2016: 3.3%).

⁶ The Malaysian Institute of Economic Research (MIER) Consumer Sentiments Index as at 4Q 2017, Nielsen Consumer Confidence Index as at 3Q 2017 and Mastercard Index of Consumer Confidence as at 2H 2017, were all below the optimism thresholds.

FISCAL POLICY

Lower fiscal deficit target of 2.8% of GDP in 2018

Fiscal policy in 2018 will continue to focus on strengthening the Government's fiscal position, while ensuring sustainable and more inclusive economic growth. In consonance with a robust growth environment, the Federal Government's fiscal deficit is expected to narrow further to 2.8% of GDP in 2018 (2017: -3.0%; from a peak of 6.7% of GDP in 2009), supported by higher growth in revenue. This marks the ninth consecutive year of fiscal consolidation, which is a reflection of the Government's commitment towards fiscal reform.

Fiscal reforms over the past few years have ensured that the Government maintained its fiscal position on a consolidation path. This was achieved through initiatives to optimise both expenditures and enhance revenues. The moderation in growth of key operating expenditure items reflects the Government's efforts to rein in spending. The share of operating expenditure as a percentage of GDP declined to 16.1% in 2017 compared to 17.1% in 2016 due to subsidy rationalisation and a reduction in non-critical spending on grants and transfers. For 2018, the share of operating expenditure is expected to amount to 16.2% of GDP. The Government also continued to diversify its sources of revenue through the introduction of new measures which include a spectrum auction⁷, vehicle entry permits and a tourism tax. Measures to enhance tax compliance were further reinforced by the Collection Intelligence Arrangement (CIA) through integrated information sharing across the Inland Revenue Board, Royal Malaysian Customs Department and the Companies Commission of Malaysia.

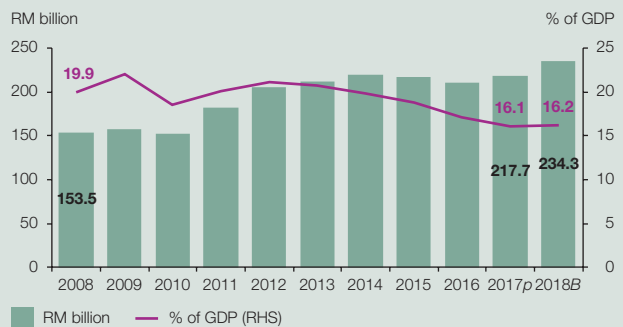
As outlined in the 2018 Budget, fiscal resources in 2018 will prioritise infrastructure projects with large multiplier effects, capacity building programmes and initiatives to raise productivity. These include public infrastructure projects such as highways, railways and urban public transportation⁸. In fortifying the fourth industrial revolution

⁷ A spectrum auction is a process where the government auctions the right to companies to use specific radio frequencies or radio waves, for various purposes including telecommunications, aeronautics, and industrial use. A well-designed auction could efficiently allocate resources to the parties that value them the most, while generating government revenue in the process.

⁸ Public infrastructure projects include the Pan Borneo Highway, East-Coast Rail Link (ECRL), High Speed Rail (HSR) and Mass Rapid Transit Line 2 (MRT2).

Chart 4.1: Federal Government Operating Expenditure

Federal Government operating expenditure as a percentage of GDP has gradually declined since 2012



^p Preliminary
^B Budget

Source: Ministry of Finance, Malaysia

Chart 4.2: Federal Government Revenue

Share of oil-related revenue has declined following revenue diversification measures



^p Preliminary

^B Budget

Source: Ministry of Finance, Malaysia

(Industrial Revolution 4.0) and the digital economy, the Government will continue to promote measures to incentivise innovation and automation⁹, which are necessary to increase Malaysia's competitiveness. Emphasis has also been placed on human capital development through the enhancement of various active labour market programmes¹⁰ consistent with the

⁹ These include matching grants under the Domestic Investment Strategic Fund to enhance smart manufacturing facilities and the Green Technology Financing scheme to promote investment in the green technology industry.

¹⁰ Examples include the implementation of the Technical Vocational Education Training (TVET) Masterplan, establishment of Science, Technology, Engineering, and Mathematics (STEM) centres, and apprenticeship programmes and open interviews under 1Malaysia Training Scheme (SL1M).

aspirations of *Transformasi Nasional 2050*¹¹, such that resources are concentrated on developing future-relevant skills.

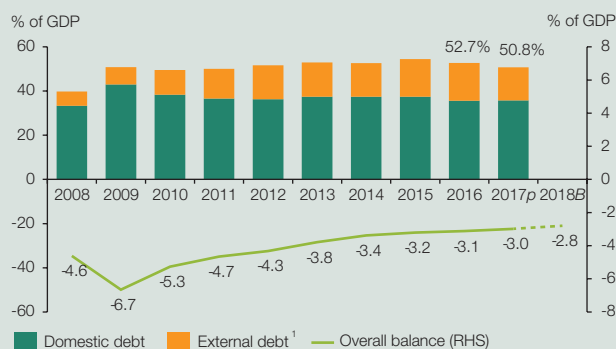
In ensuring inclusive economic growth, the Budget also lends support towards the lower- and middle-income segments through welfare enhancement programmes and fiscal transfers¹². These programmes will provide support to private consumption spending given the higher marginal propensity to consume of these segments. To sustain the capacity of the underserved groups to cope with the higher cost of living, socio-economic assistance is also dispersed through various programmes, including affordable housing¹³ and educational support¹⁴.

The Government has indicated its commitment to the fiscal consolidation plan of achieving a near-balanced budget over the medium term. Towards this end, the adoption of the Medium Term Fiscal Framework since 2015 could enhance communication and increase transparency on the direction of fiscal policy. However, further enhancement of the Medium Term Fiscal Framework is critical. This is to ensure that spending on various programmes and projects, particularly those

extending beyond the annual planning horizon will remain within the budgeted expenditure. This will provide fiscal flexibility and support the Fiscal Policy Committee in ensuring the sustainability of public finance and the effectiveness of the Government's fiscal policy.

Chart 4.3: Federal Government Fiscal Balance and Debt

This year marks the ninth consecutive year of fiscal consolidation



¹ External debt comprises foreign currency debt (offshore borrowing) and non-resident holdings of RM-denominated debt (MGS, Gil, T-bills and *Sukuk Perumahan Kerajaan*)

p Preliminary
 B Budget
 Source: Ministry of Finance, Malaysia

Table 4.3: Federal Government Finance

	RM billion		Annual change (%)	
	2017p	2018B	2017p	2018B
Oil price (USD/barrel)	50	52		
Revenue	220.4	239.9	3.8	8.8
Total expenditure	262.6	280.3	4.1	6.7
<i>Operating expenditure</i>	217.7	234.3	3.6	7.6
<i>Gross development expenditure</i>	44.9	46.0	6.9	2.5
Loan recoveries	1.9	0.6		
Overall balance	-40.3	-39.8		
% of GDP	-3.0	-2.8		
<i>Sources of financing:</i>				
Net domestic borrowing	40.8	-		
Net external borrowing	-0.3	-		
Realisable assets ¹ and adjustments	-0.1	-		

¹ A negative (-) sign indicates a build-up in assets
 p Preliminary
 B Budget
 Note: Numbers may not add up due to rounding
 Source: Ministry of Finance, Malaysia

¹¹ *Transformasi Nasional 2050* (TN50) is an initiative to plan for the future of Malaysia for the year 2020 to 2050.

¹² Welfare enhancement programmes and fiscal transfers include *Bantuan Rakyat 1Malaysia* (BR1M) and a 2 percentage point reduction in income tax for the chargeable income tax band between RM20,000 and RM70,000.

¹³ Affordable housing schemes include the People's Housing Programme (PPR), *Rumah Mesra Rakyat*, PR1MA and PPA1M.

¹⁴ The Government announced matching grants of RM500 for contributors between 7 and 12 years old under *Skim Simpanan Pendidikan Nasional 1Malaysia* (SSPN1M).