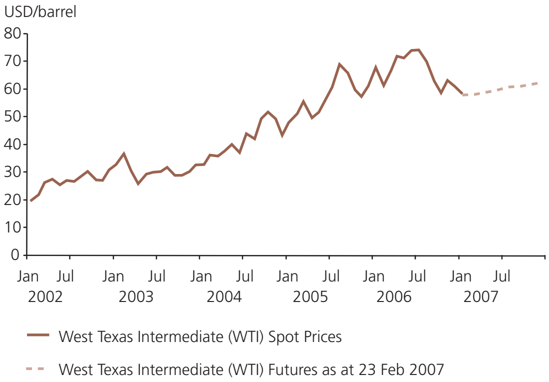
Chart 4.6
West Texas Intermediate (WTI) Spot and Future Prices



in productivity, which are expected to create downward pressure on inflation. Imported inflation would also be more subdued given that global inflation is expected to be broadly lower in 2007 compared to 2006. In particular, a sharper moderation in the inflation rates of Malaysia's trade partners could reinforce the decline in domestic consumer prices. Overall, at the point of writing, the risks to the inflation outlook relative to the central projection are judged to be reasonably well balanced.

MONETARY POLICY IN 2007

In line with the objectives of monetary policy, Bank Negara Malaysia will continue to promote price stability and sustainable economic growth in 2007. Decisions on monetary policy will remain conditional upon the evolution of the Bank's assessment of domestic and global macroeconomic conditions and the prospects for inflation and economic growth.

Despite the expected softening in global growth during the first half of 2007, growth of the global economy and world trade in 2007 as a whole are likely to be sustained at above 4% and 6% respectively. Domestic growth drivers are expected to remain strong, underpinned by the momentum in private investment, as well as resilient private consumption. Public demand will also remain supportive of economic growth. Employment prospects are expected to remain positive and supportive of income growth and consumer sentiment.

The outlook for inflation is relatively benign and is not expected to pose a significant policy challenge. Inflation is expected to be significantly lower than in 2006. The Malaysian economy is expected to operate close to its potential output (Box Article), with the

Potential Output of the Malaysian Economy

Potential output is the trend level of output that is consistent with the aggregate productive capacity of an economy. It traces the sustainable growth path of the economy based on its available productive inputs. Conceptually, the growth in potential output is primarily determined by the expansion and non-inflationary utilisation of physical capital and the labour force, as well as the rate of technological progress and improvement in overall economic efficiency and productivity. Therefore, the sustainability of long-term growth of an economy depends crucially on investment in physical capital and its efficient utilisation, increases in the size and productivity of the labour force, and the improvement in the general economic environment.

The latest estimates for Malaysia show that potential output grew at 6.3% in 2006, with the output gap[1] estimated at an average of positive 0.4% of potential output. With the continuous improvement in productivity and expansion of both capital stock and labour force during the year, the output gap narrowed and closed towards the second half of 2006, resulting in the Malaysian economy growing close to its potential level at the end of the year.

[1] The output gap is the difference between the levels of actual and potential output and the gap is measured as a percentage of potential output. A positive output gap indicates that actual output is above potential output, while a negative output gap indicates the reverse.

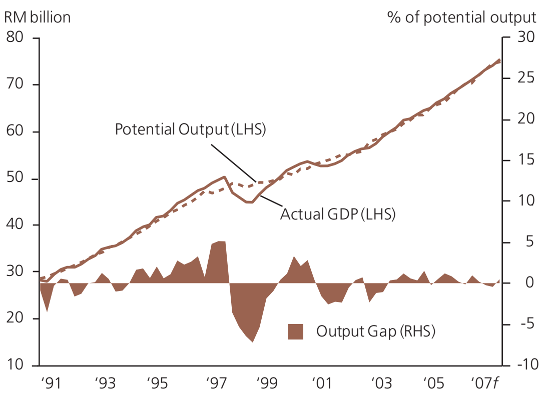
On the whole, the performance of the Malaysian economy since the year 2000 has been characterised by three clear developments. Firstly, the growth path of the Malaysian economy has been relatively balanced. Despite numerous external shocks to the region and the growing global imbalances, the economy did not experience any large deflationary or inflationary cycles, as indicated by the modest deviations between actual and potential output during the period. This provides a reflection of Malaysia's growing economic resilience. Secondly, this period also witnessed Malaysia's transition away from a factor-driven to more a productivity-driven economy. Compared to a decade before, productivity growth now accounts for a greater proportion of overall potential output expansion. This indicates that productivity levels have steadily improved.

Table 1
Actual GDP and Potential Output

Period	Actual GDP	Potential Output	Investment	Labour	Output Gap
	(Annual change in %)				(% of potential output)
1992-1999	6.7	6.7	4.5	3.1	0.1
2000	8.9	4.6	25.7	4.3	2.2
2001	0.3	3.9	-2.8	1.6	-1.3
2002	4.4	3.4	0.3	3.5	-0.4
2003	5.5	6.3	2.7	3.6	-1.1
2004	7.2	5.4	3.1	4.0	0.6
2005	5.2	4.9	4.7	4.1	0.8
2006e	5.9	6.3	7.9	2.2	0.4

e Estimate

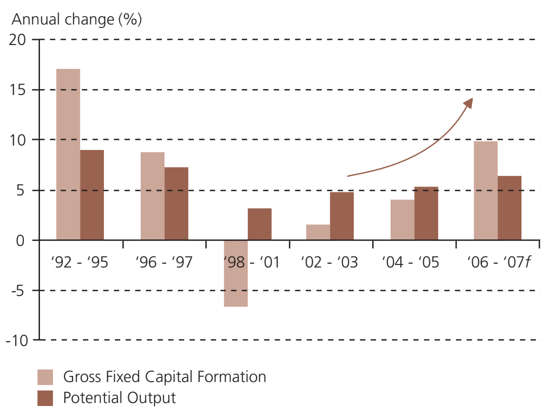
Chart 1
Actual and Potential GDP: Balanced Growth



f Forecast

Finally, the Malaysian economy also saw a recovery in investment activity from the second half of 2003 onwards, particularly in the private sector. This favourable development has contributed to the further growth of potential output in recent years (see Chart 2), thus expanding the productive

Chart 2
Investment Recovery Contributed to Continued Potential Output Expansion



f Forecast

capacity of the economy, which in turn will promote higher levels of economic activity over the near term.

Going forward, potential output of the economy is expected to grow above 6% in 2007 with the output gap remaining negligible during the year. The potential output growth would be driven by the continuous expansion of both the capital stock and labour force. This balanced expansion is expected to prevail going into the future, supported by further recovery of investment activity and the improvement in economic resilience and productivity.

output gap remaining negligible during the year. With continued investment by the private and public sector, the productive capacity of the economy would be further expanded. This implies that while demand will continue to grow, it is not expected to cause undue pressures on prices. Apart from these domestic factors, the global environment is also expected to remain relatively favourable given the lower oil and commodity prices. Importantly, inflation expectations are expected to remain well anchored.

Nevertheless, there are risks and uncertainties going forward that could have a material impact on the policy environment. The direction and volatility of oil prices in the global markets could become a source of concern. Although the current forecast is for the world economy to grow at a slightly slower pace, it is also possible that economic growth will turn out to be better than currently estimated, in which case demand pressures could emerge. Alternatively, there remain some downside risks emanating from the correction in the US housing market which could affect consumption in the US, with possible repercussions on world trade and growth of the world economy.

Capital flows could potentially pose a challenge to the management of monetary policy for most of the regional economies in 2007. As with any small open economy with liberal exchange control policies, capital flows need to be closely monitored. Such flows could result in excessive volatility in the financial markets and the economy. There would thus be continued intensive surveillance. The country is better positioned to absorb the volatility and the strategy of a gradual and sequential liberalisation of its capital account remains on course.

The conduct of monetary policy in 2007 will continue to balance between the need to ensure that interest rates remain at a level that would enable the central bank to respond to any risks of rising inflation, while remaining conducive to sustaining growth in domestic demand. At current interest rate levels, monetary policy remains accommodative. Bank Negara Malaysia will continue to assess developments in the domestic and international economies and will adjust its monetary policy stance as circumstances require.

Liberalisation of the Foreign Exchange Administration Policies

Malaysia has always undertaken a structured approach in reviewing the foreign exchange administration policies based on the readiness of the economy. Over the years, the foreign exchange administration policies have been progressively liberalised, aimed at enhancing Malaysia’s competitiveness through reducing cost of doing business, increasing efficiency of the regulatory delivery system, providing a greater degree of risk management to businesses while safeguarding economic and financial stability.