Potential Output of the Malaysian Economy

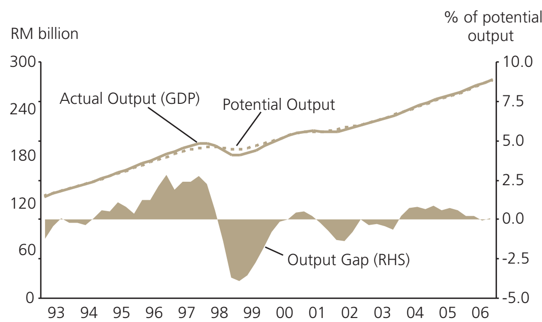
Potential output is the trend level of output that is consistent with the aggregate productive capacity of an economy. It traces the sustainable growth path of the economy. Conceptually, the growth in potential output is primarily determined by the expansion and non-inflationary utilisation of physical capital and the labour force, as well as total factor productivity (TFP) growth. TFP growth captures productivity increase arising from improvements in the utilisation of factor inputs due to technological progress and overall efficiency improvement. Therefore, the sustainability of long-term growth of an economy depends not just on factor accumulation but also crucially on improvements in skills, capital efficiency, the overall economic environment, as well as technological progress.

Table 1
Actual GDP and Potential Output

Period	Actual GDP	Potential Output	Investment	Labour	Output Gap
	(Annual change in %)				(% of potential output)
1994-1998	5.8	7.3	2.7	3.1	0.9
1999	6.1	1.0	-6.5	3.7	-3.1
2000	8.9	6.4	25.7	4.3	-0.1
2001	0.3	3.3	-2.8	1.6	0.0
2002	4.4	2.8	0.3	3.5	-0.8
2003	5.4	4.8	2.7	3.6	-0.4
2004	7.1	5.8	3.1	4.0	0.7
2005e	5.3	5.7	4.7	4.1	0.7

e Estimates

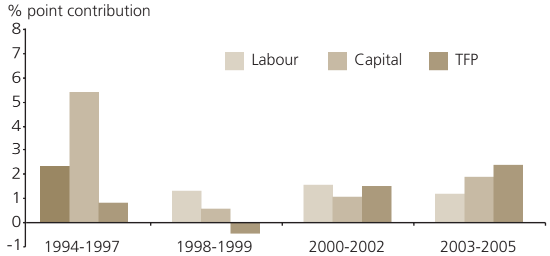
Graph 1
Actual and Potential Output



The latest estimates for Malaysia show that potential output grew at 5.7% in 2005, with the output gap[1] estimated at positive 0.7% of potential output. This indicated that the Malaysian economy was operating slightly above its potential in 2005. Overall, the period corresponding to the 8th Malaysia Plan (2001-2005) was characterised by relatively balanced growth, with the economy expanding close to its potential capacity. Amidst a backdrop of a recovering capital stock, potential output grew at an average annual rate of 4.6% compared with 4.5% for actual output during this period. The output gap, which captures the extent to which the economy is deviating from the non-inflationary trend of output, was on average less than ±1% of potential output. Despite numerous external shocks to the region and the growing global imbalances during this period, the economy did not experience any large deflationary or inflationary cycles, indicating Malaysia's growing economic resilience.

The period of 2001-2005 also witnessed a transition of the Malaysian economy in terms of factor contributions and the general level of economic efficiency. As shown in Graph 2, the growth in potential output was driven mainly by the accumulation of capital in the early 1990s, with moderate contributions from labour and TFP growth. However, beginning 1997, the contribution from capital accumulation began to decline and from 2001, TFP growth started to improve. This shift suggests that Malaysia has been moving from a factor-driven to a productivity-driven economy.

Graph 2
Factor Contributions and TFP Growth



Going forward, potential output of the economy is expected to grow at a pace of 6% in 2006 with the positive output gap closing towards the end of the year due to the continuous improvement in productivity and expansion of both capital stock and labour force. This trend of a balanced expansion of the Malaysian economy is expected to be sustained into the future, given the continued upward trend in productivity and increased resilience.

[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.