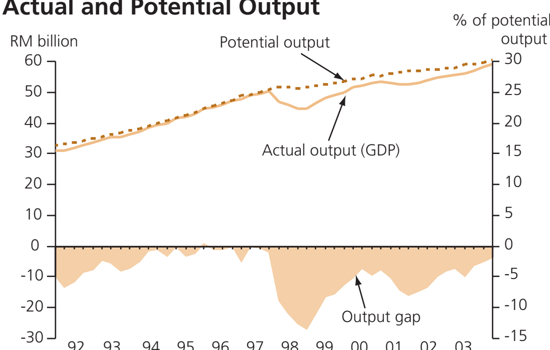
Potential Output of the Malaysian Economy

Potential output is output derived from the full use of available capital and potential employment, which is the level of employment that is consistent with the "natural" or "long run" rate of unemployment. Therefore, the potential output is defined as the maximum capacity of output that the economy can achieve without experiencing either inflationary pressures or external imbalances. The output gap is the difference between actual and potential output and is measured as a percentage of potential output. When actual output is lower than its potential, the output gap is negative and, theoretically, output can sustain an increase without exerting undue inflationary pressures on the economy.

Table 1
Actual GDP and Potential Output

Period	Actual GDP	Potential output	Investment	Labour	Output Gap
	Annual change (%)				(% of potential output)
1992-1997	9.2	8.2	14.1	3.9	-1.9
1998	-7.4	3.7	-43.0	-2.1	-11.4
1999	6.1	2.4	-6.5	3.7	-8.3
2000	8.5	4.0	25.7	4.3	-4.3
2001	0.3	3.2	-2.8	3.3	-6.9
2002	4.1	1.7	0.3	3.1	-4.8
2003	5.2	3.4	2.7	3.3	-3.1

Graph 1
Actual and Potential Output



During the high growth years of the early 1990s, actual output closely followed its potential, as shown in Table 1 and Graph 1. Amidst the pronounced contraction in output experienced after the Asian financial crisis, the output gap had widened significantly in 1998 but as the economy recovered, the gap narrowed. In 2002, the output gap was 4.8% compared to 6.9% in 2001. Subsequently, in 2003, the stronger pickup in economic activity compared to the growth in potential output led to a further narrowing of the output gap. Bank Negara Malaysia's latest estimates of potential output indicated that actual GDP increased at a faster pace (5.2%) compared to potential GDP (3.4%). Nevertheless, the faster growth of GDP did not exert inflationary pressures as actual GDP would have to increase by more than 8% before the output gap could be bridged in 2003.

The potential growth rate doubled in 2003, due mainly to stronger growth in capital investment (2.7%; 2002: 0.3%) as business sentiment improved amidst higher capital utilisation rates in selected sectors of the economy.

The estimated short-run elasticity of capital is significantly higher than the short-run elasticity of labour, implying that changes in capital have a greater impact on output and that returns to capital have continued to improve. This has encouraged firms to accelerate their investment activities, including the upgrading of technological capabilities that, in turn, could have had an immediate impact on output.

In line with previous findings, the long-run elasticity of capital, which is estimated to be 0.50, is higher than its short-run counterpart. This higher return to capital implies more efficient capital utilisation, as calculated by the ratio of output to capital, which has had a faster rate of increase compared to the ratio of output to labour. Previous supportive infrastructure investments, which have long gestation periods, have begun to show positive returns, while stronger investment activities were visible in the services sector, mainly in technology and logistics infrastructure. With the greater focus and emphasis placed on a knowledge-driven economy, expectations are for potential output to expand further.