

2014 Review of the Economic Performance

Global growth in 2014 was a modest 3.4 percent, with uneven growth across and within regions. There was a pickup in growth in advanced economies relative to the previous year. Meanwhile, emerging market and developing economies exhibited a slowdown in 2014.

In 2014, the global financial markets were characterised by two distinct trends. For the first eight months of 2014, the global financial markets were enjoying a relatively low volatile period. But the global financial markets were plagued with higher volatility in the subsequent period of the year mainly due to uncertainty surrounding the monetary policy normalisation in the US, a resurgence of concerns over global growth prospects, and increased uncertainty over the implications of the sharp decline in commodity prices on commodity-producing countries.

The US economy in 2014 continued to show broader signs of improvement despite being held down by the weather-related blip in the first quarter when GDP contracted. Positive outlook was further bolstered by the increase in business investment and employment.

Economic activity in the euro area remained subdued although the initial hopes were particularly high that the region would finally turn the tide and returned to solid and accelerating growth. The economy failed to gain momentum in the first half of 2014 and came largely to a standstill in the second mainly due to investment which grew less-than-expected although private consumption and exports developed.

Japanese economy saw higher consumer spending prior to the consumption tax hike in April. Thereafter, consumer spending declined. The weak demand conditions weighed on business activity. The economy entered into a technical recession in the third quarter despite better export performance.

Emerging market and developing economies exhibited a slowdown in 2014. Despite the slowdown, these economies still accounted for three-fourths of 2014 global growth. In Asia, while most economies benefitted from higher external demand, growth remained divergent across the region. Domestic demand moderated in a number of economies amid country-specific developments.

China's structural reforms led to a larger-than-expected slowdown in economic activity. Nevertheless, the periodic introduction of targeted policy measures to support the productive and rural sectors did help stabilise China's 2014 growth. India performed better than that of commodity centric nations like Brazil, Russia, and South Africa. Declining inflation and current account imbalance from the proficient monetary policies, together with some serious efforts to consolidate fiscal balance were the main factors. Growth in the selected ASEAN countries like Indonesia, Philippines, Singapore and Thailand decelerated due to policy stabilisation, bad weather and political issues.

In the case of Malaysia, strong private consumption and exports powered GDP growth to a 4-year high of 6.0% in 2014, despite slowdowns in both fixed investment and government spending. Private consumption grew by a robust 7.1%, near the pace in the previous

year, to contribute more than half of GDP growth from the demand side. The rise was driven by job creation, low unemployment, and higher wages. Cash transfers from the government continued to supplement incomes and support consumption. Government efforts to rein in the budget deficit saw expansion in government consumption ease to 4.4%.

Fixed investment growth slowed for a second straight year to 4.7%. Although private fixed investment decelerated, it still grew by 11.0%, with a focus on manufacturing and services. The government's fiscal tightening and the completion of some projects led to a 4.9% contraction in public fixed investment. While a decline in inventories dragged down GDP growth, a rebound in net exports after seven years of negative contribution to GDP growth.

Services sector grew by 6.3% to generate most of the economic growth in 2014. Communications, wholesale and retail trade, and real estate and business services registered robust growth, reflecting buoyant household spending and business expansion. Tourism spurred the pace of growth in accommodation and restaurants.

Manufacturing rose 6.2% in 2014, the strongest performance in 4 years supported by export-oriented manufacturing activities, particularly electronics and electrical products, and in consumer products, including food and drinks. Construction maintained double-digit expansion of 11.6% for a third year on vigorous housing activity in the Klang Valley, Penang, and Johor and on civil engineering projects that included the Klang Valley mass rapid

transport system, Janamanjung power station, and the expansion of the North–South Expressway.

Though much smaller than services or manufacturing, mining made its most significant contribution to GDP growth in 7 years as crude oil production recovered by 4.3% in 2014 from contraction in 2013, and as natural gas production posted a small gain. Better food production lifted growth in agriculture to 2.6%, despite a sharp fall in natural rubber production and floods on the east side of the peninsula that hit palm oil production late in 2014. The price of palm oil weakened as plunging global oil prices undercut demand for biofuel.

Inflation picked up in 2014 to average 3.1%, the highest in 3 years. Upwards inflationary pressure was driven mainly by domestic cost factors particularly from the government decisions to reduce subsidies namely fuel and raise electricity tariffs. Fuel subsidies, which largely benefitted higher-income groups, were cut in 2013 and removed in 2014. Also, inflationary pressure stemmed from the buoyant consumer demand.

In 2014, external sector remained resilient amid continued uncertainty in the global economic and financial environment. The trade and current account surpluses widened. Exports grew 6.4% following a robust performance from manufactured goods, particularly electronics and electrical products, and higher exports of commodities, partly from rising oil production and shipments. Merchandise imports lagged exports. Imports of consumer products and intermediate goods needed by manufacturers grew, but imports of capital goods fell, reflecting slower fixed investment.

Overall, the current account recorded a larger surplus equivalent to 4.8% of gross national income in 2014.

Malaysia's external debt was \$213.0 billion at the end of 2014, equal to 69.6% of GDP, a marginal increase over 12 months. Slightly over half of the external debt has medium- to long-term maturity, and about half comprises non-resident holdings of ringgit-denominated debt securities and deposits.

Bank Negara Malaysia raised its policy interest rate by 25 basis point to 3.25% in July 2014 to dampen inflationary pressure expected from the planned introduction of a 6.0% goods and services tax in April 2015. It was also concerned about speculation in property and high household debt. Growth in lending to households moderated to 9.9% in December 2014 from 11.5% a year earlier, while lending to businesses picked up to 9.4% from 7.9%.

Ringgit performance in 2014 followed two noticeable patterns. Between February and August 2014, the ringgit was broadly on a strengthening trend due to sustained portfolio inflows. From September onwards, the ringgit, along with most regional currencies, faced depreciation pressures as investors unwound their holdings of financial assets in the region amidst nervousness about a possible change in US monetary policy and signs of weakness in the global growth momentum. Also the sharp drop in global oil prices weighed on the performance of the ringgit. For the year as a whole, the ringgit depreciated by 6.1% to RM3.4950 against the US dollar.

Malaysian Government Securities (MGS) yields were affected by domestic and external factors during the year. Market expectations and the eventual policy rate increase by BNM led to upward adjustments at the shorter-end of the MGS yield curve. Sustained interest from non-resident and local investors contributed to the downward shift at the longer-end of the MGS yield curve. This downward trend, however, was reversed in December as resident investors consolidated their investment positions towards the end of the year.

Government's effort to lower the budget deficit saw the fiscal gap narrow to 3.5% of GDP in 2014, mainly on higher revenue. Strong economic growth added with rising oil and gas production generated 3.4% higher revenue. The government raised operating expenditure by 3.9% but continued to trim net development expenditure, by 5.5% in 2014.

Economic Prospects in 2015

Global growth is expected to remain moderate, likely to expand by 3.5% with uneven prospects across the main countries and regions. Outlook for advanced economies is expected to improve from 2014, generally benefiting from lower oil prices. The US economy should grow around 2.6% in 2015, with domestic demand supported by lower oil prices, more moderate fiscal adjustment, and continued support from an accommodative monetary policy stance, despite the projected gradual rise in interest rates and some drag on net exports from stronger dollar. Euro area is showing signs of picking up, likely to expand by 1.0% supported by lower oil prices, low interest rates, quantitative easing and a weaker euro.

After a disappointing 2014, growth in Japan is also projected to pick up 0.8% from a weaker yen and lower oil prices.

Emerging market and developing economies is projected to be lower in 2015 in view of weaker prospects for some large emerging market economies and oil-exporting countries. Yet, these regions will still account for more than 70% of global growth in 2015. Brazil's growth is likely to contract by 1.1% affected by a drought, tightening of macroeconomic policies and weak private sector sentiment. Russia should likely experience a contraction of 3.7% impacted by the sharply lower oil prices and increased geopolitical tensions.

China's growth is expected to decelerate moderately to 7% as the government continues to focus on high-quality growth added with its ongoing gradual structural reform. Growth will benefit from lower commodity prices, which will bolster domestic consumption and invigorate global demand for PRC exports. India's growth prospects look promising at this stage despite significant challenges remain, expected to grow 7.4% in FY2014. The economy is anticipated to overtake China to become the third fastest growing economy in the region.

In ASEAN, Indonesia's growth of 5.1% projected in 2015 depends on the government's reform speed and policies to accelerate infrastructure development, improve the investment climate, reduce logistic costs, and enhance budget implementation. Philippines is expected to register strong growth of 6.7% in 2015 based on buoyant private consumption, a solid outlook for investment and exports, and recovery in government expenditure.

Singapore's projected 2.4% growth in 2015 will be influenced by the global economic recovery, domestic services sector with finance, insurance, and business services will be the main drivers of growth again in 2015 while growth in labour-intensive sectors like construction, retail, and food services could be constrained by the persistently tight labour market. Thailand's 2.8% growth in 2015 will come from a relatively calm political environment, the restoration of government investment, better prospects for exports to the major industrial economies, and lower fuel costs for businesses and consumers.

For other emerging market commodity exporters, lower oil and other commodity prices will take a toll on the terms of trade and real incomes. Oil exporters will have to absorb a large terms-of-trade shock and face greater fiscal and external vulnerabilities. Those with fiscal space can allow public spending to adjust gradually to lower oil revenues. With some exchange rate flexibility, a depreciation would facilitate the adjustment.

As for oil importers, lower oil prices will reduce inflationary pressure and external vulnerabilities. Meanwhile, economies with oil subsidies, the lower oil prices will provide some fiscal space to strengthen their fiscal positions. Adding on, space for macroeconomic policy to support growth remains limited in many emerging market and developing economies.

Malaysia's economic growth prospect in 2015 is expected to slow down to 4.7% owing to softer demand and the slump in prices for oil and other commodities. The slowdown will be tempered by expected benefits to manufacturing,

which now comprises one quarter of the economy, and to services such as tourism. The benefits will flow from lower fuel costs, ringgit depreciation, and improving economic outlook in the major industrial economies, particularly the US.

Private consumption is expected to moderate in 2015. Lower earnings from oil and other commodities will weigh on spending. So will the new 6% goods and services tax. Lending to households should decelerate further with the economy's household debt at 87.9% of GDP. A cooling housing market and recent weakness in share prices could dent confidence, as indicated by consumer and business sentiment weakening late in 2014. Nevertheless, healthy labour market, lower fuel prices with fuel subsidies abolished and government cash transfers will provide positive booster to private consumption.

Fixed investment will face headwinds from the slump in commodities, ringgit depreciation, fiscal tightening, and possibly higher borrowing costs. The government's Economic Transformation Programme to upgrade industry and infrastructure continues to generate investment projects, though the flow from this pipeline to oil and other commodity projects may diminish this year.

All the economic sectors are expected to expand, albeit at a more moderate pace in 2015. The services and manufacturing sectors would remain as key growth drivers, benefiting from the resilience of domestic demand. Growth in the mining sector is projected to be sustained amid rising output from a new oil field. Weighed down by lower commodity prices, the agriculture sector is expected to record lower but still positive growth.

Export is expected to moderate in 2015 to 1.5% due mainly to lower commodity exports which constitute 23% of total exports, dragged by softer prices of crude oil, liquefied natural gas (LNG) and crude palm oil (CPO). However, manufactured products stand to benefit from the improvement economic environment in several of the advanced economies and the sustained growth in Asia. The expected improvement in manufactured exports will come from the E&E sector with moderate growth from non-E&E exports mainly from the resource-based products, particularly chemicals, petroleum and rubber products.

The current account of the balance of payments is projected to remain in a surplus position of about 3.0% of gross national income (GNI). Even though gross exports are expected to record slower growth amid lower commodity prices, the improvement in economic activity in several advanced economies and sustained growth of regional economies will lend support to manufactured exports. Stronger travel account in conjunction with 'Malaysia - Year of Festivals 2015' tourism promotion is expected to provide a lift to the services account.

Headline inflation is projected to be lower at 2.5% in 2015 due mainly to lower energy and food prices. In particular, the decline in global oil prices would lead to lower domestic fuel prices through the managed float fuel pricing mechanism. The subdued external price pressures would also mitigate increases in the cost of imports stemming from the recent ringgit depreciation, thereby moderating imported inflation. These would partly offset some of the impact from the implementation of the GST on 1 April 2015.

After raising its policy interest rate once in 2014 to 3.25%, Bank Negara has paused in light of surprisingly low inflation and heightened risks to growth. The monetary policy is expected to focus on ensuring steady growth of the domestic economy amid contained risks to inflation.

In January 2015, the government revised its budget and reset the fiscal deficit target for 2015 at 3.2% of GDP, a modest tightening from 2014's actual deficit of 3.5%. Meeting this target could be a challenge as almost one-third of government revenue derives from oil and gas.

Revenue will also suffer from slowing economic growth, weak prices of commodities other than hydrocarbons, and income tax cuts for individuals and businesses. Further, reconstruction after floods late in 2014 adds budget strain. On the positive side, subsidy reform will produce substantial fiscal savings, and the goods and service tax will broaden sources of revenue.