Despite robust private consumption in the first half of 2011, a weaker external environment left growth lower than expected. Therefore, although investment and public spending are projected to quicken in the second half, the forecast for full-year GDP growth is trimmed from that projected in *Asian Development Outlook 2011* in April this year. The GDP performance is seen improving in 2012 relative to 2011. Inflation this year will be higher than foreseen in April, but will likely ease next year.

### Updated assessment

A weaker external environment contributed to lower than expected economic growth in the first half of 2011. It slowed from 4.9% year on year in January–March to 4.0% in April–June (Figure 3.6.1), for a first-half outcome of 4.4%.

Private consumption made the biggest contribution from the demand side. It rose by 6.6% in the first 6 months from the prior-year period, reflecting firm labor market conditions and generally positive consumer sentiment, as well as favorable prices for most agricultural commodities (which support farm incomes). Government consumption rose at a similar pace to private consumption in the first 6 months.

Fixed investment growth decelerated to 4.7%, mainly owing to a decline in public investment. Private investment was sustained by expansion in some areas of manufacturing and by an increase in exploration and development of oil and natural gas.

By sector, services (accounting for about three-fifths of GDP) expanded by 6.4% in the first half and contributed nearly all the overall rise (Figure 3.6.2). This sector gained from robust growth in wholesale and retail trading, reflecting the strength in private consumption, coupled with growth in financial services (owing to higher loans and deposits) and business services (on higher levels of stock-market trading and computer services).

Industrial output inched up by a mere 1.7%. Growth in the manufacturing subsector (about 28% of GDP) slowed to 3.8%, undermined by the weakness in external demand, including that for electrical and electronic products, and disruptions to electronics and automobile production from the March earthquake in Japan.

Delays in infrastructure projects contributed to weak growth of 2.1% in construction. Crude oil production fell by about 21%, in part reflecting temporary shutdowns for maintenance, so that overall mining production contracted by 6.6%, even though natural gas output continued to expand. Reduced oil output also dented production of refined petroleum products.

After shrinking in January–March, agriculture rebounded in April–June, mainly owing to the impact of better weather on crude palm oil

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This chapter was written by Jin Cyhn and Gary Krishnan of the Southeast Asia Department, ADB, Manila.
and natural rubber. Agricultural production increased by 3.4% in the first half.

Employment rose by 2.9% in the 12 months to June 2011 and the unemployment rate declined from 3.6% to 3.2% over the period.

Consumer prices trended up, too, propelled mainly by higher costs for food and transport. Inflation quickened from 2.2% in December 2010 year on year to 3.5% in June 2011, then eased marginally in July (Figure 3.6.3). For the first 7 months the consumer price index rose by 3.1%, with prices of food and beverages up by 4.6%. Increases in administered prices of fuel pushed up costs of transport. Electricity tariffs were raised in June.

The producer price index increased by 10.2% in the second quarter, accelerating from 7.4% in the first, on account of sharp price rises in domestic production materials.

Merchandise exports in nominal United States (US) dollars rose by 16.6% to $111.5 billion in the first half of 2011 (Figure 3.6.4). High global prices and solid demand for energy and commodities underpinned this growth. However, shipments of electrical and electronic products (about 34% of total exports) fell by 6.5%. Exports to the US fell by 7.7% in the first 6 months and shipments to the European Union rose a slight 3.9%. By contrast, exports to developing markets rose strongly—to India, for example, by nearly 34%.

On the same basis, merchandise imports rose faster than exports, by 18.9%, to $87.0 billion. (In real terms, imports of goods and services rose at twice the pace of exports.) Buoyant imports of consumption goods reflected robust private consumption and higher food prices.

These moves lifted the goods trade surplus by 9.3% year on year to $24.5 billion. After accounting for widening deficits in services and transfers, as well as a narrower income deficit, the current account surplus rose by nearly 23% to $16.2 billion in the first half.

Net portfolio investment inflows more than doubled to $18.8 billion in the first 6 months from the prior-year period (Figure 3.6.5), channeled mainly into domestic debt securities. This surge, coupled with lower net outflows of other investment, took the financial account into a large surplus from a prior-year deficit. Net foreign direct investment inflows almost doubled to about $7 billion, while net foreign direct investment outflows by residents also increased sharply, to about $6 billion.

The overall balance of payments in the first half recorded a large surplus of $25.7 billion, and international reserves totaled $135.4 billion at end-July, sufficient to finance 9.6 months of retained imports.

Federal government revenue showed a quicker ascent than spending in the first 6 months of 2011. Receipts, boosted by higher average prices for domestic oil production, rose by 26.4%; and operating expenditure rose by 14.9% (including the cost of subsidies). Development expenditure fell by 24.0%. Consequently, the budget deficit compressed to the equivalent of 1.1% of GDP from 4.7% a year earlier. Federal government debt rose slightly as a ratio to GDP, to 52.7%.

Growth in broad money supply (M3) accelerated through June to 12.4% year on year (Figure 3.6.6), reflecting higher credit to the private sector and surging portfolio inflows, before the pace of growth eased in July.

With liquidity building in the banking system, Bank Negara Malaysia, the central bank, raised the reserve requirement for commercial banks...
in three steps from 1.0% to 4.0% during April–July 2011 to drain excess liquidity. It also took macro-prudential measures to curb risky personal lending and credit for speculation in housing.

The central bank raised its policy interest rate in May by 25 basis points to 3.0% (Figure 3.6.7), continuing to unwind monetary stimulus injected in 2009 when the economy was in recession. Although the policy rate is still below inflation, the monetary authorities in July kept it at 3.0%, in view of global uncertainties that raised risks to Malaysia’s growth.

The ringgit appreciated by 3.5% against the US dollar in the first 8 months of the year (Figure 3.6.8), supported by capital inflows and the strong external accounts. Yields on 10-year government bonds declined from 4.1% in January 2011 to 3.6% at end-August.

Prospects

Malaysia is well integrated into the global economy (trade in goods and services is above 100% of GDP). Thus downward revisions in this Update’s baseline assumptions for growth in major industrial economies and in world trade have dimmed Malaysia’s outlook over the next couple of years.

The outlook assumes that the government will accelerate public sector projects in the forecast period. Its overarching economic goal is to restructure the economy and so break free of the middle-income trap and reach high-income country status by 2020. The aim is to more than double gross national income per capita by 2020, to $15,000.

To this end, the government has started to carry out its Economic Transformation Programme to improve the investment climate and develop higher-value-added industries. This program is supported by investment from the government’s Tenth Malaysia Plan 2011–2015.

Investment projects starting this year include an $11.5 billion mass rapid transit rail system for Kuala Lumpur and redevelopment of a military airbase at Sungai Besi near the capital that has residential, commercial, and retail projects. Construction of these and other major government-backed projects is expected to pick up in 2012, stimulating investment from the private side as well.

Private investment is also expected to be stimulated by high capacity utilization rates in some manufacturing industries and by global demand for Malaysia’s oil and natural gas as well as its agricultural commodities.

In June 2011, the federal government approved a $4.3 billion supplementary budget for extra spending this year. Its fiscal deficit is now projected to widen in 2011 from last year’s 5.6% of GDP. The Ministry of Finance said in its second quarter update of the economy that it expects public expenditure to accelerate in the second half of this year. The budget for 2012, scheduled to be outlined in October 2011, may also be expansionary.

The impact on supply chains of the earthquake in Japan is fading. Further, reconstruction in Japan will spur demand for raw materials from Malaysia (and other countries). The forward-looking Business Conditions Index, compiled from a survey of manufacturers, rose in the second quarter of this year, implying increasing domestic investments in the second half.
Private consumption will be sustained during the forecast period by expected favorable labor market and credit conditions, as well as good prices for agricultural commodities. The Consumer Sentiments Index remained positive in the second quarter, but showed a slight decline reflecting concerns about inflation and global uncertainties.

The government’s leading index of economic activity grew by an average of 1.9% in the first 6 months of 2011 and the pace of increase quickened in June from May (Figure 3.6.9), suggesting moderate growth in the near term.

On the balance of these factors, GDP growth is expected to quicken in July–December from the first 6 months, though the full-year growth forecast is trimmed to 4.8%, owing to the weaker than anticipated first-half outcome and the downward revision in growth in industrial countries. The pace is seen picking up to 5.1% in 2012 (Figure 3.6.10), provided that growth in these economies and in world trade meets expectations.

The forecast for inflation this year is raised from Asian Development Outlook 2011 to 3.4%. In 2012, inflation is seen subsiding to average about 3.0% (Figure 3.6.11), as global food and oil prices level off. Inflation could be influenced by mooted proposals coming into effect to phase out price controls and subsidies and to introduce a broad-based goods and services tax.

Although the authorities are expected to be cautious about raising the policy interest rate further in view of the global uncertainties and potentially volatile capital inflows, they may tighten monetary policy if they see signs of persistent inflation. The central bank stated in July that it would consider “further normalization of monetary conditions” if the momentum of economic growth is sustained. The ringgit is expected to remain firm against the US dollar owing to the strong capital inflows and external position.

In light of the moderate growth in exports and sustained private consumption and investment, which will draw in imports, the current account surplus is still projected at about 10% of GDP this year and next.

The main downside risk to the forecasts comes from weakness in the recovery of major industrial economies, which has become more apparent since April. Domestically, delays in the government’s Economic Transformation Programme and associated efforts to ramp up investment would dent growth prospects.