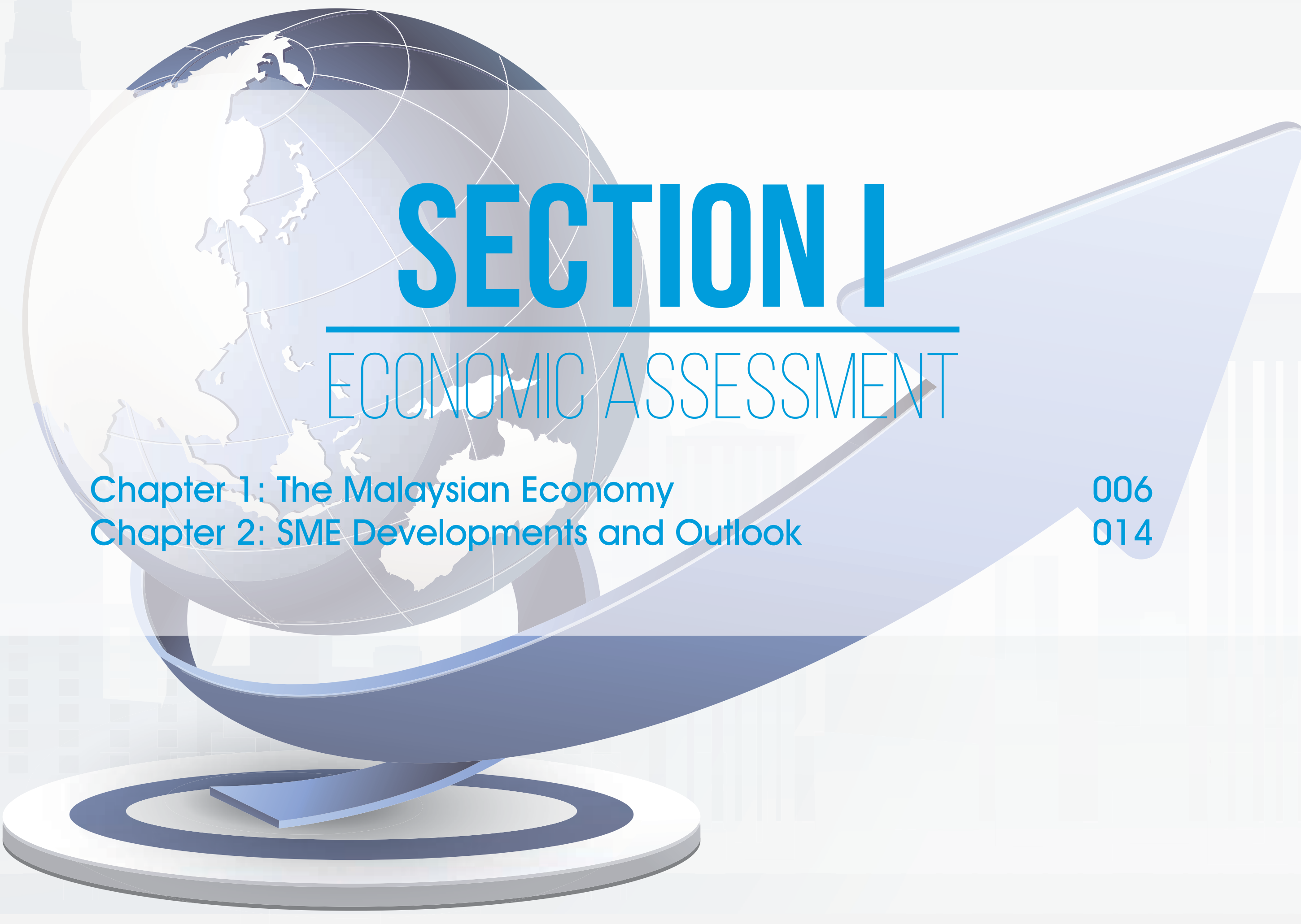

SECTION I

ECONOMIC ASSESSMENT

The Malaysian Economy

Amidst continuing uncertainties in the world economy, the global growth rate for 2016 was the lowest since the Global Financial Crisis. However, against a backdrop of external and domestic headwinds, the Malaysian economy registered a commendable real Gross Domestic Product (GDP) growth of 4.2% in 2016 (2015: 5.0%). The moderate growth was supported by domestic demand mainly by private sector spending. Following the strong growth in the first half of 2017 at 5.7%, Malaysia's GDP growth is expected to expand by more than 4.8% in 2017, higher than the earlier official growth projection of between 4.3 - 4.8%. This growth will also be supported by a more entrenched global recovery and positive spillovers to the domestic economy.

Domestic demand will continue to be the key driver of growth, sustained primarily by private sector spending. The Government's commitment to fiscal consolidation, continued implementation of key infrastructure projects, sound macroeconomic fundamentals and expectations of recovery in export growth in-line with the improvement in global growth will be key elements to enable the country to move towards a sustainable growth path.

PERFORMANCE IN 2016

Despite the challenging economic environment, the Malaysian economy continued to record a commendable growth of 4.2% in 2016 (2015: 5.0%), largely supported by continued expansion in domestic demand.

Private consumption was the main driver that anchored economic performance in 2016. Wage and employment growth as well as Government measures have supported the domestic market while the increase in minimum wage in July 2016 and civil servants salary in the second half of the year affected a higher salary growth. The Government had also introduced measures to support household spending in the form of a reduction in employees' Employees Provident Fund (EPF) contributions (from 11% to 8% in the period of March 2016 to December 2017), higher Bantuan Rakyat 1Malaysia (BR1M) payouts and special tax relief of RM2,000 to individual taxpayers.

Private investment moderated further to 4.3% in 2016 (2015: 6.3%) as firms adjusted to the challenging market environment where profitability and business sentiments remained weak.

Public consumption growth moderated to 0.9% (2015: 4.4%) due to lower spending on supplies and services following the Government's adoption of expenditure rationalisation in early 2016 as low crude oil prices led to lower petroleum-related revenue.

Public investment continued to support economic growth mainly from developing transportation infrastructure, enhancing industrial development, improving public utilities and accelerating the development of the agriculture and rural sector.

Table 1.1: Real GDP by Expenditure (at 2010 prices)

	2015	2016[p]	1H 2017[p]	2017[e]
	Annual change (%)			
Domestic Demand[1]	5.1	4.3	6.7	4.4
Private Sector Expenditure				
Consumption	6.0	6.0	6.9	6.0
Investment	6.3	4.3	10.0	4.1
Public Sector Expenditure				
Consumption	4.4	0.9	5.3	-0.2
Investment	-1.1	-0.5	-0.9	1.5
Net exports of goods and services	-3.7	1.5	-6.7	5.3
Exports	0.3	1.1	9.7	2.2
Imports	0.8	1.1	11.8	1.8
Real GDP	**5.0**	**4.2**	**5.7**	**4.3 ~ 4.8**

[1]Excluding stocks, p: preliminary, e: estimate based on BNM Annual Report 2016

Source: Department of Statistics, Malaysia

On the **supply side**, all major economic sectors, except the agriculture sector, recorded an expansion in 2016. The services sector grew by 5.6% in 2016 (2015: 5.1%) owing to sustained demand in the consumer-related sectors while other sectors expanded more moderately. The agriculture sector contracted due to a decline in crude palm oil (CPO) production as yields were affected by the El Niño weather phenomenon.

While labour market conditions generally remained stable, the unemployment rate however edged higher to 3.5% in 2016 (2015: 3.1%) due to slower job creation as employers adopted a cautious stance and refrained themselves from expanding their workforce too quickly amid more moderate economic growth.

Table 1.2: Real GDP by Key Economic Activity (at 2010 prices)

	2015	2016 ^{p}	1H 2017 ^{p}	2017 ^{e}
	Annual change (%)			
Agriculture	1.3	-5.1	7.1	4.0
Mining & Quarrying	5.3	2.2	0.9	2.7
Manufacturing	4.9	4.4	5.8	4.3
Construction	8.2	7.4	7.4	8.0
Services	5.1	5.6	6.1	4.9
Real GDP	**5.0**	**4.2**	**5.7**	**4.3 ~ 4.8**

p: preliminary, e: estimate based on BNM Annual Report 2016

Source: Department of Statistics, Malaysia

Headline inflation was maintained at 2.1% in 2016 (2015: 2.1%). The inflation rate was led by a series of adjustments in administered prices such as reduction in electricity rebates and cooking oil as well as higher fresh food prices due to El Niño weather phenomenon. Headline inflation was also more volatile throughout the year due to external global factors.

Table 1.3: Inflation and Unemployment Rate

	2015	2016 ^{p}	2017 ^{e}
	Annual change (%)		
Inflation			
Consumer Price Index (2010 = 100)	2.1	2.1	3.0 ~ 4.0
Producer Price Index (2010 = 100)	-7.4	-1.1	-
Unemployment	3.1	3.5	3.6 ~ 3.8

p: preliminary, e: estimate based on BNM Annual Report 2016

Source: Department of Statistics, Malaysia

Table 1.4: Balance of Payments

	2015	2016 p	2017 e
	RM billion		
Current Account	34.7	25.2	17.4
% of GNI	3.1	2.1	1.0 ~ 2.0
Goods	109.6	101.2	98.4
Export of Goods	685.4	686.0	723.4
Gross Export (% annual change)	1.6	1.1	5.5
Import of Goods	575.8	584.8	625.1
Gross Import (% annual change)	0.4	1.9	6.4
Services	-21.0	-22.6	-24.0
Primary Income	-32.0	-34.7	-36.3
Secondary Income	-21.9	-18.7	-20.7
Financial Account	**-50.9**	**-4.2**	**-**
Direct Investment	4.8	17.9	-
Assets	-37.2	-34.3	-
Liabilities	41.9	52.2	-
Portfolio Investment	-28.2	-19.7	-
Assets	-9.1	-15.0	-
Liabilities	-19.1	-4.7	-
Financial Derivatives	-0.7	-0.8	-
Other Investment	-26.8	-1.7	-
Net Errors and Omissions	**21.1**	**-6.3**	**-**
Overall Balance (surplus + / deficit -)	3.8	14.8	-
Net International Reserves BNM	409.1	423.9	-
Net International Reserves of BNM (USD billion)	95.3	94.5	-
Reserves as Months of Retained Imports	8.4	8.7	-

p: preliminary, e: estimate based on BNM Annual Report 2016

Source: Department of Statistics, Malaysia

Malaysia's **external sector** remained resilient in 2016 despite a recent sharp decline in commodity prices. Malaysia's trade balance remained strong in surplus although it has narrowed. The narrowing of the current account surplus reflected the lower trade surplus and persistent structural deficits in the services and income accounts. This highlights the importance of advancing structural reform measures in order to promote trade and investment diversification as well as competitiveness.

OUTLOOK FOR 2017

In 2017, global economic activities are expected to expand at a faster pace. This will be supported by an expansion in domestic demand in the advanced and emerging market economies as well as expectations of a recovery in trade activities in the emerging regions.

According to the **International Monetary Fund (IMF) latest World Economic Outlook (WEO) Update, July 2017,** the projected pick up in **global growth** remains on track with the cyclical recovery continues. The IMF upgraded its forecasts for Japan and Europe's main economies such as Germany, France, Italy and Spain as well as in large emerging and developing economies such a Brazil, China and Mexico, reflecting a stronger than expected outturn in the first quarter of 2017. High-frequency indicators for the second quarter of 2017 also provide signs of continued strengthening of global activity. Specifically, the global trade in 2017 is projected higher than 2015 and 2016 rates. World growth is expected to rise from 3.2% in 2016 to 3.5% in 2017 and 3.6% in 2018, maintaining its forecast from April 2017 WEO.

Table 1.5: IMF World Economic Outlook (WEO) Update, July 2017

	2016[p]	2017[e]	2018[f]
World Output	**3.2**	**3.5**	**3.6**
Advanced Economies	**1.7**	**2.0**	**1.9**
United States of America	1.6	2.1	2.1
Euro Area	1.8	1.9	1.7
Japan	1.0	1.3	0.6
United Kingdom	1.8	1.7	1.5
Emerging and Developing Economies	**4.3**	**4.6**	**4.8**
Emerging and Developing Asia *	6.4	6.5	6.5
China	6.7	6.7	6.4
India	7.1	7.2	7.7
ASEAN-5 **	4.9	5.1	5.2
Emerging and Developing Europe	3.0	3.5	3.2
Latin America and the Caribbean	-1.0	1.0	1.9
Middle East, North Africa, Afghanistan and Pakistan	5.0	2.6	3.3
World Trade Volume (goods and services)	**2.3**	**4.0**	**3.9**

p: preliminary, e: estimate, f: forecast

** China, India, Indonesia, Malaysia, Philippines, Thailand & Vietnam*
*** Indonesia, Malaysia, Philippines, Thailand & Vietnam*

Source: IMF World Economic Outlook Update, July 2017

While **risks** around the global growth forecast appear broadly balanced in the near term, they remain tilted to the **downside** over the medium term. On the upside risk, the pickup in activity in the euro area, with buoyant market sentiment and reduced political risks, could be stronger and more durable than currently projected. On the downside, prolonged policy uncertainty or other shocks could trigger a correction in market valuations, especially for equities and an increase in volatility. In turn, this could dampen spending and confidence more generally, especially in countries with high financial vulnerabilities. Lower commodity prices would further intensify macroeconomic strains and complicate adjustment needs in many commodity exporters. Other downside risks threatening the strength and durability of the recovery include non-economic factors, such as rising geopolitical tensions, domestic political discord and shocks arising from weak governance and corruption.

Meanwhile, on the outlook for the **Malaysian economy** in 2017, **domestic demand** will continue to be the principal driver of growth, which will be sustained primarily by private sector activities. **Private consumption** is projected to grow by 6.0% in 2017, sustained by a stable labour market, continued wage growth and increase in disposable income due to various Government measures including increasing the amount for BR1M cash transfers, reduction in employees' contribution to EPF from 11% to 8% until December 2017 and special assistance to all civil servants (RM500) and retirees (RM250). The anticipated higher commodity prices are also expected to support incomes, particularly for rural households. Tourism activities are expected to continue to increase with more tourist arrivals and spending from China and India, due to the eVisa programme as well as intensified promotions targeting specific sectors, such as medical, health and sports tourism.

Private investment is projected to grow at a moderate pace of 4.1% in 2017 as business sentiment remains cautious with some degree of uncertainty in the economy. Given this situation, activities will still be supported by higher capital expenditure in export-oriented industries and implementation of on-going and new projects, mainly in the manufacturing and services sectors. Continued capacity expansion in domestic-oriented industries such as the telecommunications and real estate sub-sectors has continued to support the services sector. In line with the gradual improvement in global growth, investment in the manufacturing sector is expected to be driven particularly by export-oriented industries such as the electrical & electronics and resource-based sub-sectors.

With the Government's continuing commitment to fiscal consolidation, **public consumption** growth is projected to record a marginal contraction of 0.2% in 2017. The more prudent spending on supplies and services is expected to weigh on overall growth notwithstanding the continued expansion in emoluments. Meanwhile, **public investment** is expected to grow by 1.5%, being driven by higher capital expenditure by both the Government and public corporations. This also reflects the on-going implementation of main infrastructure projects that cut across many sectors, including the utilities and transportation sub-sectors, as well as the downstream oil and gas sector.

On the **supply side**, all major economic sectors are expected to register positive growth in 2017 with the key contributors to growth emanating from the services and manufacturing sectors while the construction sector will also grow at a faster pace. Meanwhile, growth in the agriculture sector is projected to improve as yields recover from the El Niño weather phenomenon. The mining sector is projected to pick up on higher natural gas output following the opening of the new Malikai oil field.

Despite continued uncertainties in the global environment, Malaysia is expected to remain resilient on the **external sector.** Following the gradual improvement in global trade, commodity prices and domestic demand, the net exports as well as import of goods and services are expected to strengthen and provide some support to real GDP growth in 2017. Nevertheless, import growth is projected to continue to outpace export growth, resulting in a lower trade surplus. The **services account** is projected to record a larger deficit in line with higher trade and improvement in investment activity. Overall, the **current account** is expected to register a surplus of between 1.0 - 2.0% of Gross National Income (GNI) in 2017.

Headline inflation is projected to average higher in the range of 3.0 - 4.0% in 2017, due mainly to the prospects of higher global commodity and energy prices as well as the impact of the depreciation in the ringgit exchange rate. These cost-driven factors are not expected to cause substantial spill-overs to broader price trends given the stable domestic demand conditions.

Overall, the Malaysian economy is projected to expand at a steady pace with continued strength in global growth. Malaysia's GDP growth is expected to expand by **more than 4.8% in 2017**, higher than the **earlier official growth projection** of between **4.3 - 4.8%** given the strong growth in the first half of 2017 at 5.7%. Growth prospects will continue to be driven by domestic demand with some lift from exports, steady wage and employment growth, on-going implementation of infrastructure projects and continued external demand from major trading partners. Similarly, in the latest update of World Economic Outlook in July 2017, IMF has also revised upward Malaysia's GDP growth projection for 2017 to 4.8% from 4.5% due to stronger-than-expected economic performance as well as commendable monetary and fiscal policies.

Table 1.6: Malaysia Real GDP Growth Forecast, (%)

	2015	2016 [p]	2017 [e]	2018 [f]
	Annual change, %			
BNM [1] (official forecast)	5.0	4.2	> 4.8	N/A
IMF [2]	5.0	4.2	4.8	4.8
Analysts Consensus [3]	5.0	4.2	5.4	4.9

p: preliminary, e: estimate, f: forecast

Source:
[1]Bank Negara Malaysia (BNM) Second Quarter GDP Press Release, 18 August 2017
[2]IMF World Economic Outlook Update, July 2017
[3]Asia Pacific Consensus Forecasts, September 2017

> "Malaysia's GDP growth is expected to expand by more than 4.8% in 2017, higher than the earlier official growth projection of between 4.3 - 4.8% given the strong growth in the first half of 2017 at 5.7%"

Meanwhile, **monetary policy** in 2017 will continue to ensure that its stance is consistent with sustaining a steady growth path amid price stability. The economy will be challenged by higher inflation, volatile capital flows and lingering uncertainties in the global economic and financial environment even with growth expected to improve due to better performance of the external factors. Monetary policy will also continue to consider the risk of destabilising financial imbalances although these have largely been contained. Given the expectation of periods of volatility in capital flows, Bank Negara Malaysia's monetary operations will continue to ensure that domestic liquidity in the financial system will remain sufficient to support the orderly functioning of the domestic financial markets. The focus of the Monetary Policy Committee would therefore be on ensuring that the stance in monetary policy remains consistent with achievement of steady growth and stable inflation, supported by healthy financial intermediation in the economy.

Fiscal policy in 2017 will focus on further strengthening of the Government's fiscal position while ensuring continued support for domestic growth and promoting economic inclusiveness. Continued fiscal consolidation amidst the challenging domestic and external economic environment is a reflection of the Government's commitment to fiscal reforms while recognising the need to ensure a pro-growth environment in the economy. The Federal Government's fiscal deficit is expected to narrow further to 3.0% of GDP in 2017 (2016: -3.1%), supported by sustained growth in revenue and a marginal expansion in operating expenditure. Following fiscal reforms, the Government has managed to rein in the growth in operating expenditure. The share of operating expenditure as a percentage of GDP has declined to 17.1% in 2016 compared to 18.8% in 2015. This is expected to decline further to 16.2% following efforts to reduce non-critical spending on grants and transfers to statutory bodies and the further rationalisation of subsidies.

In the **2017 Budget**, fiscal resources have been strategically prioritised towards high impact infrastructure projects and programmes for capacity building. These include public infrastructure such as highways and railways that expand connectivity between urban and rural areas. Development of human capital will be strengthened through enhancement of up-skilling programmes and industrial training. The improvement of the quality of talent to meet the needs of industry is critical to accelerate Malaysia's progress towards becoming a high-income nation.