MALAYSIAN ECONOMIC OUTLOOK

1st Quarter 2022

Executive Summary

MALAYSIAN INSTITUTE OF ECONOMIC RESEARCH

Recovery Gains Momentum amid Successive Setbacks

The Malaysian economic outlook is influenced by various factors, ranging from economic and financial shocks to public health safety concerns; extreme weather events; domestic political uncertainty; and geopolitical risks. There is currently a war-related crisis on the geopolitical front brought about by Russia's invasion of Ukraine. The conflict adds fuel to the already higher inflation environment and pushes the global economy towards the so-called "stagflation", especially with stagnant or slower economic growth. Tough economic and financial sanctions on the Russian economy will also see negative impacts and externalities on global asset prices, financial conditions and possibly capital outflows from emerging market and developing countries. Additionally, there is a fallout in terms of sovereign debt default in the tourism-dependent economy of Sri Lanka. Meanwhile, the **International Monetary Fund (IMF)**, in its latest World Economic Outlook (WEO, April 2022), released on 19 April 2022, has revised downward the annual growth estimate for the **world economy** to 3.6% for 2022-2023 (2021: 6.1%; 2020: -3.1%), pointing to stagnating growth forecasts for both years. The threat from the Omicron variant is mentioned to be fading, passing the acute phase of the Covid-19 pandemic. Nonetheless, downside risk from the emergence of new Covid-19 variants or recombinants remains on the horizon, especially with rising new infections in major Chinese cities, especially Shanghai and Shenzhen and China's zero Covid-19 tolerance policy.

The Malaysian economy registered slower-than-anticipated growth last year, expanding moderately by only 3.1% (2020: -5.6%; 2019: 4.4%), on the back of continued Covid-19 pandemic health and economic impacts and extreme floods that occurred in December 2021. With actual real GDP growth in 2021 at the lower end of the Officials' earlier forecasts of between 3% to 4%, the Malaysian economy, measured by the total output of goods and services at constant prices, remained below the average pre-pandemic level in 2019. Meanwhile, the Government has facilitated massive RM530 billion emergency direct financial support and relief measures during the past two years, coupled with accommodative monetary policy and financial regulatory changes and administrative arrangements. The slower economic recovery reflects a certain degree of lack of effectiveness in the Government spending multiplier, especially in an environment where both households and firms generally adopt a cautious approach. We have to realise the severity of the Covid-19 pandemic-driven health and economic impacts, which have never been seen in Malaysia, pushing the Malaysian economy down to the depth of the recession in the second quarter of 2020 and cumulatively 35,437 deaths, as of 19 April 2022. Other non-economic factors could also play their parts, especially with fragile political stability and much politicking on the political front, as reflected by frequent Government changes at both Federal and state levels and also lack of transparency as well as clarity in public sector programs and projects.

Several crucial issues have to be examined and fine-tuned in moving forward. Firstly, we have to look at the on-budget overall balance of the **Federal Government financial position**, which has been in deficit since the Asian Financial Crisis (AFC) in 1998, while accumulated Federal Government debt (including external debt) has already exceeded 63.5% of nominal GDP as at the end-December 2021 (end-Dec 2021= RM979.8 billion; end-Dec 2020= RM879.6 billion, 62.1% of GDP). Secondly, there are pressing issues, especially with the rising cost of living, associated with higher prices of food and necessities and the planned implementation of the national minimum wage of RM1,500 per month, effective on 1 May 2022.

While Covid-19 pandemic lockdowns and border closures in the past two years have primarily contributed to an elevated deficit in the services account of the **balance of payments** (BOP), entrenched structural issues need to be carefully examined. Strategic measures are undertaken to reverse the ballooning of these deficits over so many years. The services sector is currently the largest sector on the sectoral value-added or activity side of the economy, comprising 57% of real GDP in 2021. Meanwhile, the manufacturing industry, which used to be the pride of the Malaysian economy in the 1980s and 1990s, has weakened considerably, comprising a little over 24.3% of the Malaysian economy in 2021 (2020: 22.9%). This legacy issue termed "premature deindustrialisation, " needs to be carefully examined, strengthening its back and moving away optimally from the tourism and hospitality sectors. The manufacturing sector has recovered quickly with strong growth in 2021 (2021: 9.5%; 2020: -2.6%; 2019: 3.8%) and taking centre stage, contributing 2.2 percentage points to 3.1% growth last year. The manufacturing sector is providing an adequate supply of domestically produced goods and substituting imports of goods, especially intermediate and consumption goods, which are on decelerating growth in recent months. Apart from focusing on tourism-related services sectors, the export-oriented strategy and import substitution policy of the long-neglected manufacturing sector needs to be re-examined to strengthen back the vibrancy of the manufacturing sector with high value-added and high-tech activities providing high income to Malaysian workers and reduce vulnerability to external shocks. The manufacturing sector proved to be more resilient and agile in facing tough economic setbacks that come successively one after the other.

The Malaysian economic landscape is moving towards a consumption-based economy, as total consumption as a per cent of gross national income (GNI) is steadily moving up from 70% in 2017 to 73% in 2021 (2020: 75% of GNI), also exacerbated by rising public consumption in the last two years. Meanwhile, the share of gross fixed capital formation (GFCF) or Investment registered a sharp reduction from 35% of GNI in 2017 to just 23% last year (2020: 20% of GNI), pointing to the need to quickly address the issue of domestic investment malaise, which has been going on for many years. Malaysia needs to produce more, earn more and consume less, as gross national savings (GNS) as a percentage of GNI is steadily declining. Private consumption and savings behaviour, especially during difficult times and changing economic circumstances, need further study so that domestic savings can be effectively mobilised for productive purposes in the country. Cash handouts and transfer payments by the Government, while undoubtedly necessary and helpful during difficult times, need to be conditional, differentiated, and targeted. Most pertinently, public investment in large infrastructure projects, entrusted essentially to GLCs and classified as "off-budget", reportedly lacks cost-benefit analysis, stakeholders' analysis, and cost-effectiveness analysis.

Geopolitical uncertainty is moving up the ladder to be the top downside risk, especially in the immediate and near term. Geopolitical tensions between superpowers are emerging fast in the Indo-Pacific region, propelled by the conflict in Ukraine. While the emergence of a new Covid-19 variant remains a health safety threat on the horizon, representing a downside risk to the economy, the economic recovery process is also being curbed by a higher cost of living and declining purchasing power of incomes. As such, good management of the macroeconomy is becoming an urgent priority, especially in preserving macroeconomic stability and maintaining the macroeconomic resilience of the country. These macroeconomic objectives can only be realised through a suitable mixture of well-balanced fiscal and monetary policies and other relevant macroeconomic policies, including macroprudential arrangements, exchange rate management and labour market income policy. The latter has been more or less neglected in the past decades, as we successfully moved up the ladder of economic development under normal circumstances. Of greater significance right now are foreign relations and diplomacy, shaped by new geopolitical order and geopolitical tensions. We need to reaffirm our foreign policy and diplomacy, especially with ongoing Russia's aggression on Ukraine and the rise of a new aggressive superpower in the Indo-Pacific region.

While we are still in the early phase of the endemic environment and the possibility of the emergence of a new Covid-19 variant or its recombinant remains on the horizon, we certainly need to continue staying vigilant and follow all the Covid-19 health safety protocols. We, more importantly, continue to believe strongly in collective action by banding together as responsible citizens. In our case, we must continue taking the lingering effects of the Covid-19 pandemic seriously, as we entered safely into an endemic environment, living consciously with the continually evolving Covid-19 virus and its mutations. Breakthrough infections, long Covid-19 and physiological symptoms are the medical things that need to be carefully monitored and examined in greater detail and cannot be ignored. Moreover, there are increasingly many reported cases of new infections involving schools and colleges, indicating that our students and future generations are at-risk, more so younger children at home. Public health safety concerns, protecting lives are as important as promoting growth and employment and protecting livelihoods and living standards.

On the economic front, the Malaysian economy is moving from economic recovery last year to an expansion phase and strong growth this year and slowing down moderately towards a more sustainable growth trajectory in the medium and longer-term. This necessitates efforts to deepen further economic and social development and ultimately enhance the national well-being and welfare of the rakyat. In this respect, new advances in technologies will need to be adopted by utilising more high-quality capital-embodied technology and intensifying educational and training opportunities, producing a greater number of the skilled-and-educated workforce, thereby deepening and widening the talent pool in the country. The key priority of economic policy actions must be in the medium and long-term structural adjustment and reform programs, supported by appropriate short-term stabilisation measures and suitable macro-prudential arrangements.

Looking at macroeconomic policies, there is a limit to continuing accommodative monetary policy for too long, as monetary tightening measures are expected to occur shortly in major developed economies that will quickly see strong reverberations in the global financial markets. Moreover, inflation expectations need to be anchored in the longer term. At the same time, monetary policy also needs to respond to exchange market pressures, movements in asset prices, risk premiums and spreads in market interest rates. While fine-tuning and good balancing acts seem relevant in the short term, a hike in the policy rate from the lowest level in the last two years (end-Dec 2021: 1.75%; end-Dec 2020: 1.75%; end-Dec 2019: 3.0%) is a valid option and necessary, especially in the second half of this year. Considering that, fiscal policy should take centre stage and responsibility for addressing inflation and strong domestic demand following an expansion in domestic economic activity. There is a well-known fiscal theory of inflation, whereby there is a limit to expansionary fiscal policy, especially with continuing unconstrained discretionary fiscal relief and support measures, akin to “helicopter rain of money” and certainly much faster with ATM, resulting in too much money chasing few goods and accusation of money printing or monetisation of debt. Moreover, there are still lingering supply-demand imbalances, rising labour market tightness, higher costs of inputs, mark-ups in prices, and profiteering activities.

More importantly, discretionary "stabilisation measures" should be implemented mainly as tools for short-term macroeconomic management, smoothing business cycles and economic fluctuations, and not be seen as part of any electoral strategy (*political business cycle*). Multi-party competition, agenda manipulation, and shifting party coalition in a weak Coalition Government usually result in many biases in the reported official measurement of macroeconomic statistics, depending on who controls the information and, worst still, drama and backstabbing. MoU with the opposition, which is expected to expire on 31 July 20022, seemed relevant in maintaining political stability and good management of the macroeconomy. Nonetheless, with the proposed Fiscal Responsibility Act Framework, the present Government has a rock-solid commitment to the fiscal consolidation process to ensure the credibility and reputation of financial institutions in managing Public Finance. Tax incentives and financial support for domestic-driven private investment, which is currently on the move again, are urgently needed to boost business confidence further and help to enhance the long-term potential output growth of the economy. Strong expansion in gross fixed capital formation remains the key driver for the long term growth of the Malaysian economy, especially in the post-pandemic years, helping to boost growth in total factor productivity and improve wages for workers. The **role of the private sector** as the key driver of the economy needs to be further strengthened, providing them with necessary support and improvement in terms of financial and credit conditions and minimising, to a large extent, unfair competition from GLCs.

While global growth is expected to be affected by shocks from the ongoing war in Ukraine, especially in Europe and significant industrial countries as well as in emerging market and developing economies, some countries are fortunate enough to benefit from continuing strong external demand for specific manufactured products and rising energy and commodity prices, of which Malaysia included. The financial exposures from the Russian sanctions and sovereign debt default by Sri Lanka are rather limited, at least for now. The Malaysian economic recovery process is expected to gain momentum this year, registering a strong growth of 5.8% in 2022 (2021: 3.1%; 2020: -5.6%) and moving steadily to the more sustainable development of between 5% to 6% in 2023. The mid-point baseline forecast is 5.5% for 2023, representing the potential output growth of the Malaysian economy. The existing labour force pool and the available capital stock are fully employed and utilised at normal intensity, barring further economic shocks. This estimate is also in line with the medium-term growth projection assumed under the Medium Term Fiscal Framework (MTEF) of the Federal Government.

Fiscal prudence and discipline should be the hallmarks of sound public finance in Malaysia as we transition safely from the Covid-19 pandemic era to the endemic environment. Meanwhile, monetary policy needs to move progressively back to its traditional roles in anchoring inflation expectations in the longer term and ensuring the country's high-quality growth and price stability. We also need to quickly adjust to the "new environment" post Covid-19 pandemic era by implementing vigorously structural adjustment and reform programs and aligning our economic growth strategies and initiatives again right on the path to achieving a high-income and *rakyat*-oriented developed nation status by the year 2030 or earlier than that in 2025. Prudent macroeconomic management should be the key priority, especially in attaining fiscal and debt sustainability and encouraging a more significant role for the **private sector to be the engine of economic growth** and focusing more on the green economy and digital transformation and adoption of new technologies. Climate change initiatives, minimising the land and ecosystem degradation, seem relevant to avoiding natural disaster risks. We need to gain more benefits from the ongoing economic recovery process and substantial expansion this year, maximising the rakyat's welfare through strong economic growth and more excellent employment opportunities, amid successive setbacks in our quest to improve the living standards and happiness of Keluarga Malaysia. *Keluarga Malaysia* is everything to us in this challenging environment.