



MALAYSIAN ECONOMIC OUTLOOK

2nd Quarter 2022

Executive Summary



Strong Growth This Year, but Recession Fears for 2023

It is estimated that it will take about two and half years for Malaysia to recover and surpass the pre-Covid-19 output level that prevailed in 2019. Real GDP growth in the second quarter of 2022 needs to perform much better than growth in the first quarter of 2022 (1Q 2022: 5.0%; 4Q 2021: 3.6%), and it must register at least 6.0% year-on-year growth.

The anticipated stronger growth is likely achievable on the basis of all the positive signs and prevailing macro indicators. Meanwhile, global growth forecasts have been consistently revised downwards by well-established multilateral financial institutions and international rating agencies, pointing to slower growth this year and possibly a recession in the next 12 months.

The World Bank in its latest Global Economic Prospects (GEP, June 2022) has warned of the numerous risks that could derail the global economic recovery process, which currently seems precarious.

Global growth is expected to slow to 2.9% in 2022 and to edge only to 3.0% in 2023, pointing to a sharper-than-expected reduction in global growth, as had been announced earlier by the IMF World Economic Outlook (IMF WEO, April 2022; 2022 and 2023: 3.6%). High commodity prices and monetary policy tightening are expected to persist, while global downside risks remain on the horizon. These include intensifying geopolitical tensions, rising financial instability and worsening food insecurity.

The Malaysian economic recovery process is expected to gain momentum with continuing support by consumer spending, registering a strong growth of 5.8% in 2022 (2021: 3.1%; 2020: -5.6%). **Real GDP growth** is forecast to slow down slightly to a more sustainable growth rate of between 5.0% to 6% in 2023, more or less defying global recession fears on the external front.

The mid-point baseline forecast is 5.5% for the year as a whole in 2023, representing the upper side potential output growth of the Malaysian economy, whereby the existing pool of the labour force and available capital stock are fully employed and utilized at normal intensity. This forecast rests on the optimistic side, which is also in line with medium term growth projection, assumed under Medium Term Fiscal Framework (MTFF) as elaborated in the MOF's Fiscal Outlook 2022.

Medium term growth forecasts reflect both the expected success in short-term macroeconomic stabilisation measures as well as medium term structural adjustment programs. These include pro-active and measured approaches in demand management policies, enhanced measures to attain financial stability and to reduce vulnerabilities in the economy and, more importantly supply-side disinflation programs.

The latter include import substitution initiatives, encouraging more food production activities in the agriculture sector by facilitating greater movement of labour and higher capital investment. Non-tradable and domestic-oriented activities need to be further encouraged, while export restrictions, price caps and market interventions need to be gradually phased out, allowing the market mechanism to operate in an efficient manner.

While economic growth is clearly gaining momentum and private sector dynamism is clearly back on track, we have to find ways and means to further support these favourable developments, avoiding to a large extent restrictive measures that inhibit the growth process, especially in the medium and longer term. There are still short-term weaknesses in the macroeconomic fundamentals that are expected to persist in the second half of this year and also next year. These include continuing net outflows of portfolio and “other investments” by domestic residents; rising cost of living; and elevated public sector and household debts.

While there is a less optimistic scenario in the second half of this year, the economic recovery process is still expected to continue, albeit at a moderate scale, as reflected by continuing strong growth in the industrial production index (IPI), steady expansion in exports of goods and services (amid rising imports), and continued inflows of foreign direct investment (FDI), among other factors. Nonetheless, lagging and coincident indicators need to be closely monitored, especially with the rising number of non-performing loans (NPLs) and elevated credit risk levels. There is also the problem of slowing vacancies and job placement rates alongside rising private sector nominal wages and continued property market overhang. Finally, one must consider the continuing weaknesses in financial market condition.

National inflation, which is essentially “suppressed inflation”, supported largely through massive subsidies, has been creeping up in recent months and inflation expectations are not fully well-anchored in the longer term.

The real fixed deposit rates for 3-month and 12-month remain in negative territory, discouraging further savings by households and limiting to a large extent domestic mobilization of resources for investment purposes. The second hike in the OPR by BNM on 6 June 2022 by 25 basis points (0.25%) is expected to help in normalising the situation, moving from the lowest 1.75% to the current 2.25%, which is still lower compared to 3.0% during the pre-pandemic era in 2019. Further hikes are expected in the coming Monetary Policy Committee (MPC) meetings, whereby the OPR level will potentially reach between 2.75% to 3.0% by the end-2022.

Nevertheless, there is certainly a need to carefully look at the externalities or implications of these progressive hikes, taking into account the overall “political-economy” scenario, encompassing not only macroeconomic considerations, but also socio-economic implications, and more importantly welfare gains or losses to society

as a whole. An important issue to take note of are negative externalities on vulnerable households and marginalised groups, following higher borrowing costs and the extra burden of servicing existing loans. Other considerations include rising individual bankruptcies and forced evictions, among others.

Moving from a high inflation environment to low inflation and finally to price stability requires a lot of sacrifices and also tough balancing acts between ongoing high public sector debt and a low suppressed inflation with massive subsidies. Fiscal space and public debt sustainability with moderate inflation remain the utmost priority. The benefits of low inflation through carefully measured hikes in policy interest rates far outweigh the costs, whether they be monetary or non-monetary costs alike. The latter include poverty and hunger, as a result of higher bankruptcies, forced evictions and loss of jobs, among others. Further hikes need to be done in a measured, determined and sustained manner, providing a good signalling mechanism and forward guidance to all economic agents and stakeholders.

Meanwhile on the domestic front, **fiscal prudence and discipline** should continue to be the hallmarks of good public finance, as we exit confidently and safely from Covid-19 pandemic era to an endemic environment with relatively less financial stress. We certainly need to ensure that the fiscal consolidation process of the Federal Government finance gets back on track, and debt sustainability and fiscal risk are managed in a prudent and sustainable manner.

Of greater significance, short term stabilization measures through hawkish monetary policy tightening needs to be avoided, taking into account the suffering and hardships faced by economic agents, encompassing all consumers, firms and businesses that have only recently emerged from the catastrophic health and economic impacts, associated with Covid-19 pandemic in the last two years. Knee-jerk reactions with monetary policy reaction functions using a simple inflation targeting framework may not always be the best of policy measures.

We need to avoid tough cost-cutting austerity measures that bring back previous miseries and hardships to vulnerable population groups. Meanwhile, it will be useful to curb unjustified salary increases, review the extension of cash handouts and electronic transfer payments, and curtail rent-seeking activities given the current difficult environment. Corrective fiscal consolidation measures need to be implemented in a quick manner, helping to improve fiscal and debt sustainability in the medium and longer term. These include the possible reintroduction of the Goods and Services Tax (GST), but with better implementation details. In considering our tax system, be it a well-considered consumption tax or some modification of the existing sales and services taxes, it is necessary to conduct an exhaustive costs and benefits analysis before any system is implemented. It is also necessary to study the reprioritization of spending programs and austerity measures without a too drastic deterioration in the welfare of the *rakyat*, although it may be necessary to rationalize

subsidies to avoid rampant abuses and leakages. Moreover, spending on subsidies and social assistance is reportedly expected to reach a gargantuan level at about RM80 billion this year, compared to only RM17.3 billion originally allocated under the Budget 2022.

External competitiveness through a weaker MYR also did not help in an environment of weak external demand, as shown by the negative contribution of net exports of goods and services in 2021 as well as in the first quarter of 2022. The **MYR exchange rate** needs to be aligned closely with real macroeconomic fundamentals, and foreign exchange intervention is necessary only to align the external value of MYR with these real fundamentals. Occasionally it will be required to stem volatile short-term speculative flows, in either direction.

The strong US dollar in the current environment is associated with its privilege as a major international reserve currency and more importantly, US dollar-denominated assets are considered a “safe asset”, especially with liquid and efficient financial markets with lower transaction costs. Moreover, the US economy remains relatively strong, as shown by the engineered reduction in demand-pull inflation, while the unemployment rate is declining fast with continuing labour market tightness. There are prospects for continuing higher interest rates in the US, especially with headline inflation touched 9.1% in June 2022, the highest since 1981.

While there is a lot of volatility in daily and short-term MYR movements, long-term support certainly requires good and solid macro fundamentals, political stability and enhanced investor confidence, among other factors. A stable MYR rests on an optimal mix of macroeconomic policies and confidence in policy commitment as well as credibility and a reputation in managing the macro economy, including past crises. It will certainly take a while longer for the MYR to revert back to a fair value of RM4.00 per US dollar, especially with the shifting up of **breakpoints** from RM3.50 to RM4.50 and possibly to RM5.50 per US dollar as repeatedly mentioned by a former finance minister, although the last scenario is to be avoided. Moreover, the FX risk is increasing over time with no bound set, unlike bonds and equities with underlying properties.

We also need to quickly adjust to the post Covid-19 pandemic era by vigorously implementing **structural adjustment and reform programs**, and re-aligning our economic growth strategies and initiatives on the path to achieve a high-income and *rakyat*-oriented developed nation status by the year 2030 or earlier than that - perhaps in 2025.

Targeted relief for vulnerable households has been suggested, especially through **spending reprioritization**. Improving education and increasing labour force participation rates are among some of the medium- and long-term structural adjustment policy measures.

Prudent macroeconomic management should be the key priority, especially in attaining fiscal and debt sustainability, and encouraging a greater role for the **private sector to be the engine of economic growth** and focussing more on the green economy and digital transformation as well as the adoption of new technologies. We need to benefit from strong economic expansion this year, maximizing the welfare of the *rakyat* as a whole through sustainable and inclusive growth in our quest to further improve the living standards, happiness and wellbeing of all Malaysians.