MALAYSIAN ECONOMIC OUTLOOK

Executive Summary 4th Quarter 2021

Moving from Recovery to Sustainable Growth

Over the last quarter of 2021 (4Q 2021), there were favourable signs and strong sentiments that the Malaysian economy would perform much better in the second half of 2021. It appeared as if Malaysia was fully recovering from the health and economic crises experienced in the last two years. Unfortunately, the new Covid-19 variant of concern (VOC), Omicron, is wreaking havoc in the US, UK, and Europe, and has the potential to reach our shores. We need to be mindful that this new wave of the Omicron variant is fast moving towards being the worst phase of the Covid-19 pandemic, at least as seen in the US. However, on account of its milder symptoms there is lower risk of straining hospital capacity and the overall healthcare system. Advances in healthcare technologies, especially new anti-viral treatments and also greater usage of therapeutic drugs will contain the effects of this variant.

Adding to this continually evolving epidemiological setback were the extreme weather events on the domestic front, linked directly to the effects of climate change, culminating in floods, mudslides and landslides that occurred in late December 2021 and early January this year. These two events (incidence of Covid and the floods) were catastrophic and devastating, resulting in misery and hardships to the affected households, especially the poor and vulnerable groups. They also resulted in an increase in poverty and inequality.

While the worst part of the Covid-19 pandemic is not yet over and the expected second wave of floods has already arrived, risks to the Malaysian economy in the near and short term remain tilted to the downside. On the real side of the economy, there are still aggregate demand and supply imbalances, resulting in market disequilibrium or frictions in the goods and labour markets. The economy is still affected by supply chain disruptions and bottlenecks. This is coupled with pent-up demand that has exceeded the available supply of goods and services. These factors have resulted in higher prices, especially for transport, housing, and other durable goods, such as furniture, furnishings as well as for basic food items. On the external front, there are other risk factors, such as a slower-than-expected growth in China, geopolitical tensions in the Indo-Pacific region and at the Ukrainian borders, and a radicalization of politics and religions.

The performance of the Malaysian economy was weaker than expected in the third quarter of 2021(3Q 2021), especially after the recorded sharp upturn in the preceding second quarter, pointing to essentially underperformance of real GDP growth rate on quarterly year-on-year (y-o-y) basis. The unexpected sharp contraction in the third quarter of 2021 was initially triggered by the re-imposition of inter-state travel restrictions, stay-at-home orders, and other Covid-19 suppression measures by the Government in July 2021, which were eased considerably in the latter months.

The Malaysian economy recovered relatively quickly following the pandemic and the floods, registering an average of 3.0% in the first three quarters of 2021 (i.e., first three quarters of 2020 = -6.4%, 2020 = -5.6%). Taking into account an optimistic projection of an upturn in the fourth quarter of 2021 (4Q 2021= 5.8%), real GDP growth rate is estimated to record closer to 4.0% at 3.7% for all of 2021.

The outlook for the Malaysian economy remains uncertain and could be underperforming, especially in the first quarter of 2022. The subsequent years are likely to move strongly to a more sustainable growth trajectory of about 5.8% this year (2022) and 5.5% to 6.0% in 2023.

The key drivers for a relatively quick economic recovery included the well-executed Program Imunisasi COVID-19 Kebangsaan (PICK), adequate fiscal relief and support measures. The implementation of major regulatory changes in both financial and monetary policies also contributed significantly. The phased and measured reopening of the economy under the NRP and the continued civic mindedness of Malaysians, by observing standard operating protocols (SOPs), helped contribute to the recovery.

Even with a somewhat optimistic 3.7% real GDP growth rate estimated for all of 2021, the growth of the economy would still be below its potential output growth of approximately 5.5% per year. This points to a long-term secular stagnation. With consumer price inflation on the rise again, some quarters think that "stagflation" could appear. Our view is that this is unlikely to happen since it can easily be avoided in the Malaysian context with the use of well-designed policies.

The fiscal position needs careful consideration. More specifically, the on-budget overall balance of the Federal Government financial position, which has been in deficit since the Asian Financial Crisis in 1998, cannot be ignored. The accumulated Federal Government debt (including external debt) has already exceeded 64% of nominal GDP as at the end-September 2021 (end-Sept 2021= RM969.3 billion). Federal fiscal space could be further constrained, taking into account off-budget commitments, such as the realized contingent liabilities associated with Government guarantees under Public Private Partnership (PPP) and Private Finance Initiatives (PFI) of the long-established Government's Privatization Policy and investment in strategic industries.

The regional outlook is positive but not vibrant. The Asian Development Bank (ADB) in its latest Asian Development Outlook (ADO) Supplement, in December 2021 indicates that Covid-19 pandemic is far from over, downgrading growth forecasts for Developing Asia to 7.0% in 2021 and 5.3% in 2022. China, the world's second largest economy, is expected to grow more slowly, registering 8.0% in 2021 and 5.3% in 2022, while India is projected to grow close to 9.7% for fiscal year 2021 and 7.5% for 2022. Growth forecasts for India remain impressive, representing a truly bright spot in Developing Asia. Regional inflation is expected to be manageable for Developing Asia with forecasts of only 2.1% for 2021 and marginally higher at 2.7% in 2022.

There are divergent trends in key economic indicators. While prices of major commodity exports such as crude oil and palm oil prices are surging higher, the MYR exchange rate, as measured by nominal effective exchange rate (NEER), remains weak. Clearly, we are experiencing commodity-currency shocks. There are also weaknesses in the basic macroeconomic fundamentals. These include the rising cost of living, elevated public sector and household debts. These are expected to persist at least for the rest of this year. The possibility of a further

downgrading of ratings for Malaysia's sovereign debt - Fitch Ratings presently is at BBB+ - cannot be ruled out. Coupon payments and expected maturity of issued bonds in the later part of this year would certainly test the fiscal stress of Malaysia's sovereign risk.

Notwithstanding these areas of concern, there are clear indicators of continued economic recovery. These are reflected in the continuing strong growth of the net export of goods and services and the higher net foreign direct investment (FDI). There has been a pickup in the industrial production index (IPI), most notably in the manufacturing component. There has also been an uptrend in loans approved and disbursed by the banking system, and BNM continues to enjoy higher net international reserves. Foreign investors are displaying more confidence as reflected in the smaller outflows of portfolio investment.

Lagging indicators, however, need to be closely monitored, especially with the rising number of non-performing loans (NPLs). The labour market is sluggish with slowing vacancies and job placement rates. The property market is sub-optimal as evidenced by the rising property market overhang. Additionally, real fixed deposit rates for 3-month and 12-month remain in negative territory, discouraging savings by households. The performance of the local equity market is lagging behind neighbouring bourses, especially Indonesia and Thailand.

While the Government is giving greater emphasis to the revival of the economy under the National Recovery Plan 2.0 (NRP 2.0), prudent management of public finance requires that the primary balance turn positive or be in surplus, moving forward. This goal seems to be difficult to achieve under the 2022 Budget with primary debt at 3.3% of GDP. There has to be greater control of public debt. Attempting to maintain a Federal Government overall and primary deficit for a long period of time is certainly not suggestive of good public financial management. Long term institutional investors are generally looking for "safe assets" to invest and the demand for Malaysian Government Securities (MGS), especially by non-resident investors requires that higher premium be given for taking extra risks. This could result in the costs of borrowing to finance continuing deficit move upwards.

The Twelfth Malaysia Plan (12th MP, 2021-2025) was tabled by the Government in Parliament on 26 September 2021. 12MP will have beneficial effects in driving the economy towards recovery and even towards attaining the goal of high-income and developed nation status. The effective implementation and stronger coordination of public sector development projects will also play an important part in this process. Other factors that will help include high quality domestic-driven private investment and continued FDI inflows into the country. If these are achieved, developed nation status could be realized well before 2030, possibly even in 2025.

As part of the process towards achieving developed country status we have to preserve macroeconomic stability and maintain economic resilience. However, macroeconomic stability should be guarded from being derailed by rising inflation and a higher cost of living. This should be complemented by good management of the macro economy through fiscal and monetary policies. We need to review our social policies and pay more attention to social safety nets. The twin disasters (Covid and the floods) have shown the need for this.

Macroeconomic stabilization measures in managing short term economic and business fluctuations, and structural adjustments and reform programs for long-term growth and macroeconomic stability require strong support

by all stakeholders. There must be clear forward guidance, good signalling mechanisms and credible policies for market participants. Extensive consultations with relevant stakeholders will ultimately help to avoid uncertainty and negative perceptions of stakeholders. In summary, we need to ensure continued happiness and a good life for the *rakyat* by encouraging greater kindness and showing strong compassion to others. The flames and spirit of "Keluarga Malaysia" need to be nurtured and preserved for the good well-being and greater welfare of all Malaysians.

While the economy is expected to register a strong growth of 5.8% this year (2021= 3.7%), the Malaysian economy, as measured by total output of goods and services in constant prices, is expected to be just slightly above the pre-pandemic level in 2019, indicating that we have recovered from the sharp contraction in 2020. Most pertinently, it took two years for us to recover and attain sustainable growth. Moreover, real GDP growth was slower-than-expected last year, despite massive fiscal expansionary measures of close to RM530 billion. This was supported with accommodative monetary policy and financial regulatory changes, and labour market adjustments. Fiscal policy needs to remain supportive of growth, while at the same time ensuring that the fiscal consolidation process is back on track and debt sustainability and fiscal risk are managed in a prudent manner. Meanwhile, monetary policy should gradually move back to its traditional role of anchoring inflation expectations and ensuring high quality growth and price stability.

We also need to quickly adjust to the "new environment" post Covid-19 by vigorously implementing structural adjustment and reform programs. and aligning again our economic growth strategies and initiatives right on the path to achieve a high-income and *rakyat*-oriented developed nation status by the year 2030, or even earlier than that. 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. We should adopt a "Recovery++" approach by focussing more on the green economy and digital transformation, as well as through the adoption of new technologies.

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