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Malaysia: How bad can it get?

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Not so Mini Budget

The second stimulus package unveiled by the Deputy Prime Minister, Datuk Seri Najib, is a bold effort by the government to boost domestic growth in the wake of rapidly deteriorating global economic conditions. The larger-than-expected package of RM60 billion which is equivalent to 9% of Malaysia's GDP and nine times the size of the first package, is expected to soften the impact from sharply declining world trade activities since the last quarter of 2008 that has continued to weigh heavily on Malaysia's macroeconomic performance.

MARC opines that the second stimulus package is more comprehensive in that it does not only focus on expanding development expenditure but also cuts across a wider scope of the economy by creating employment opportunities and establishing working capital guarantee schemes to small-and-medium enterprises (SMEs).

Due to a larger than expected stimulus package, our estimated budget deficit has increased to between 7% and 8% of GDP from 6% of GDP, in line with the government's projection. At the same time, we also foresee an increase in government debt to 46% of GDP in 2009 from an estimated 41% of GDP in 2008. Funding however, will not be an issue as the government can tap domestic bond market which is now the second biggest in Asia Pacific excluding Japan.

Efforts to relieve the burden on *rakyat* through a 63,000 employment creation in the government sector, additional training and re-training programs via joint collaboration between government and private sector as well as higher food subsidy to avert price increases of necessities will provide a critical buffer against a steep drop in consumer spending, which has been a major force behind Malaysia's strong economic expansion, contributing an annual average of 3.7-percentage points to growth since the new millennium.

Measures to boost business sentiments such as double taxation for employers who hire retrenched workers will also help ease the pressure in the labour market which in January this year recorded a threefold increase in retrenchment to 4,325, from January 2008.

Notwithstanding the positive effects of the stimulus package, the extent of external negative forces that continue to ripple through the domestic economy would lead to economic activity decelerating at a pace sharply faster than anticipated. Combined with the fact that cash outlays for direct fiscal injection and tax incentives under the mini-budget was smaller than expected, we expect the Malaysian economy to experience a contraction of 1.5% in 2009 in our base case scenario.

Are we following the steps of Willie E Coyote?

The sharper-than-expected deceleration in Malaysia's GDP growth in 4Q2008 to 0.1% year-on-year (y-o-y) from 4.7% y-o-y in the earlier quarter has taken many by surprise. What was more shocking was the 3.6% quarter-on-quarter contraction, the sharpest in the past 18 years, primarily triggered by a rapid deterioration in external sector, evidenced by a dramatic 40.1% drop in net real exports. In addition, negative external forces have reverberated into the domestic economy, reflected by drastic turnaround in investment activity which contracted by 10.2% from a 3.1% expansion in the preceding quarter. At the same time, growth in private consumption, a major pillar for the economy, moderated to 5.3% in the 4Q2008 from 8.1% in the preceding quarter, signaling that consumers were tightening their purse strings in view of the deterioration in labour market. As a result, many are beginning to wonder whether our economy is in the same predicament as Willie E Coyote, the popular cartoon character who in pursuit of his nemesis, suddenly runs off a cliff, peddling his feet in the air before plunging down with a startled look on his face.

Based on eight important indicators we tracked in analyzing the dynamics of the current economic downturn – industrial production, exports, vehicle sales, Kuala Lumpur Composite Index, sales tax, wholesale and retail, private consumption and number of retrenchments – only two components had outperformed their levels in 2001, suggesting that the current down cycle is likely to become more serious than in 2001 when the economy grew by a minuscule 0.5%. On a brighter side however, five of indicators showed that the present cycle is less severe than the 1998 downturn, suggesting that the economy may not fall into a deep contraction as experienced a decade ago during the Asian Financial Crisis.

Table 1: GDP growth by expenditure

% chg	2007	2008*	2009F
GDP	6.3%	4.6%	-1.5%
Domestic Demand	9.8%	6.9%	2.7%
Consumption Expenditure	9.9%	9.1%	4.2%
Private Consumption	10.8%	8.4%	2.8%
Public Consumption	6.6%	11.6%	9.7%
GFCF	9.6%	1.1%	-2.0%
Private Investment	9.8%	0.9%	-14.0%
Public Investment	9.3%	1.3%	10.5%
Exports	4.2%	1.5%	-10.6%
Imports	5.4%	2.2%	-10.0%

Source: MARC Economic Research

** Private & Public Invesment are estimated figures*

Analyzing the current dynamics

By examining previous downturns, it is possible to predict the severity of the current economic cycle. In doing this, Malaysia's industrial production peaks are used as reference points (indexing it to 100). The movements of several variables, as indicated below, are traced out in each economic cycle.

- Industrial production
- Exports
- Vehicle sales
- Stock market
- Sales tax
- Wholesale and retail trade
- Private consumption
- Number of workers retrenched

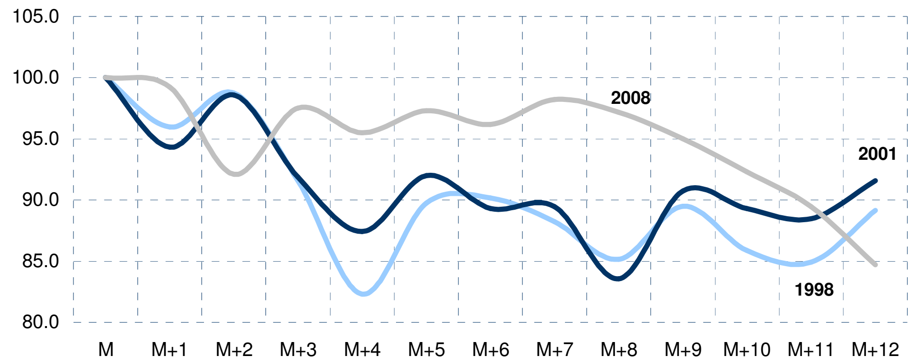
Comparison is made to two recent periods of downturn: 1998 when the economy experienced a full-blown recession; and in 2001 when the economy fell into a technical recession, defined as two consecutive quarters of negative growth (using 1987 base).

Industrial production – slower contraction initially but gained speed in recent months

Industrial production dropped more rapidly in 1998 and 2001 in the first four months following their peaks. By the fourth month, industrial production plunged by 18% in 1998 and 13% in 2001 down cycles. In contrast, in the current economic slowdown, industrial production fell by only 4.5% in the first four months. The speed of the decline in industrial production in 1998 and 2001, probably led to the plunge in consumer and business sentiments in both periods.

However, in the current downturn the situation changed dramatically only after the twelfth month. Industrial production fell sharply in December 2008, making this cycle the most severe compared with the previous two downturns. As such, statistics on industrial production will be critical in the next few months in evaluating the impact on the economy particularly on labour market and private consumption.

Chart 1 **Industrial production index**



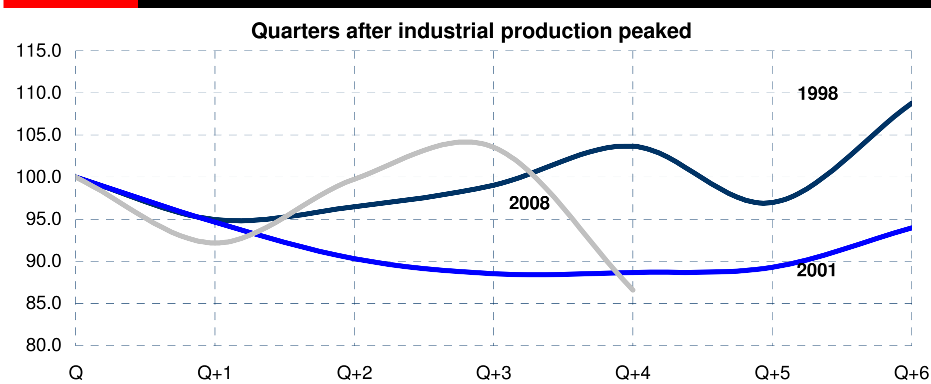
Source: CEIC & MARC Economic Research
Re-base to 100 in October 1997, October 2000 and December 2007

Exports deteriorated more than previous two cycles

Exports are the culprit of the current downturn of Malaysian economy. Plunging demand was initially caused by weaknesses in G3 economies – US, Euro and Japan – but now has spread to Asian economies. In the current cycle, major turnaround in exports was noticeable in the fourth quarter following the peak of industrial production when exports dropped by 13% from its base. During the downturn in 2001, exports contracted by as much as 11% in the fourth quarter following the peak of the industrial production cycle before rebounding. In 1998, exports fared better, falling by only 5% before rebounding.

The severity of export performance during this cycle is not surprising as demand dissipated from all over the world. Not only G3 countries (US, Euro and Japan) are scaling purchases, Asian economies, which are not as deeply affected by the global turmoil are cutting back on their imports from Malaysia. And the outlook in the medium term is not so encouraging. Demand for global chip sales are expected to drop by 5.6%, according to Semiconductor Industry Association (SIA). International Data Corp (IDC), another market research firm on IT and consumer electronic predicts an even worse outcome, forecasting semiconductor sales to plunge by 22% this year. With compounding effect of slumping commodity prices of oil and crude palm oil, Malaysian export sector may contract more severely than in 2001 or 1998.

Chart 2 **Real export**



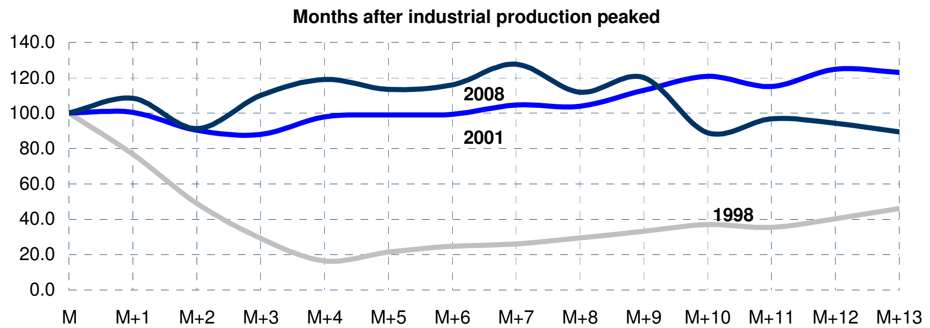
Source: CEIC & MARC Economic Research
Re-base to 100 in October 1997, October 2000 and December 2007

Vehicle sales are now below 2001's level

Statistics on vehicle sales suggest that the current downturn is not as severe as in 1998 when vehicle sales fell by a whooping 83% by the fourth month after the peak of the economic cycle in October 1997. Only 6,872 vehicles were sold in February 1998, compared with a high of 41,591 in October 1997. High interest rates, massive job losses and reduction in incomes were the primary reasons for the sharp decline in vehicle sales in 1998.

During the 2001 technical recession, sales fell by only 12% by the third month following the cycle peak but rebounded in subsequent months. On contrary, in the current cycle, after an initial dip in the second month, vehicle sales continued to rise until the seventh month following the peak of industrial production. However, by the tenth and eleventh month, sales deteriorated more severely than in 2001. By the thirteenth month of the current downturn, sales were 10% lower than its base level in December 2007.

Chart 3 **Vehicle sales**



Source: CEIC & MARC Economic Research

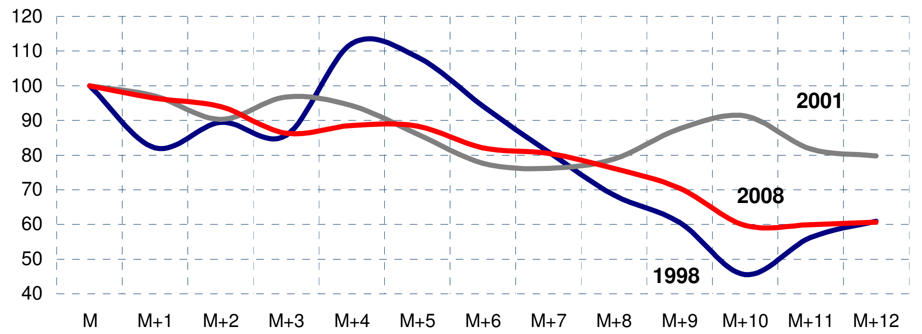
Re-base to 100 in October 1997, October 2000 and December 2007

Stock market – worse than 2001 and 1998

The recent sharp decline in the Kuala Lumpur Composite Index (KLCI) since hitting its monthly high of 1,445.03 in January 2008 has raised concerns on the impact on private consumption. The recent decline in the KLCI to 890.67 points at the end of February 2009, represents a 38% correction from its peak. During the 2001 downturn, the KLCI fell from its monthly closing high of 982 points in February 2000 to as low as 572 in May 2001, a 42% decline in 15 months. As a result, growth in private consumption slowed dramatically to 2.1% in the 3Q2001 from 15.3% in the 1Q2000.

Looking at percentage declines from the peaks of the cycles (again we use the peak of industrial production as the base), one can see that the KLCI dropped more drastically during the current downturn (-40%) compared with the 2001 cycle (-24%) in the first 10 months. However, by the thirteenth month following the peaks of the cycles in 1998 and 2001, stock market started to rebound. On contrary, during the current down cycle, the KLCI remained near its low, falling by 38% (1998: -12%; 2001: -8%).

Chart 4 **KLCI**

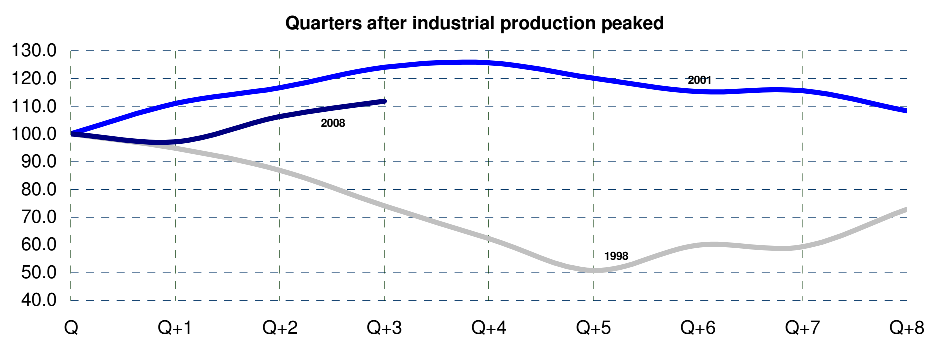


Source: CEIC & MARC Economic Research
Re-base to 100 in October 1997, October 2000 and December 2007

Sales tax signals a slower economy in the near term

The trend in sales tax provides a more positive picture of the economy, indicating that we are currently not facing a severe condition as in 1998 recession. In terms of percentage, sales tax, calculated using 4-quarter moving average, has actually increased by 11.8% in the 3Q2008, three quarters after industrial production peaked. This is almost similar to the situation in 2001 when sales tax initially trended up in the subsequent quarters following the cycle peak. After the fifth quarter however, sales tax started to decline. This is in stark contrast with the situation in 1998 where sales tax fell by as much as 49% by March 1999, five quarters after the cycle peaked in 1997.

Chart 5 **Sales tax - 4Qtr moving average**

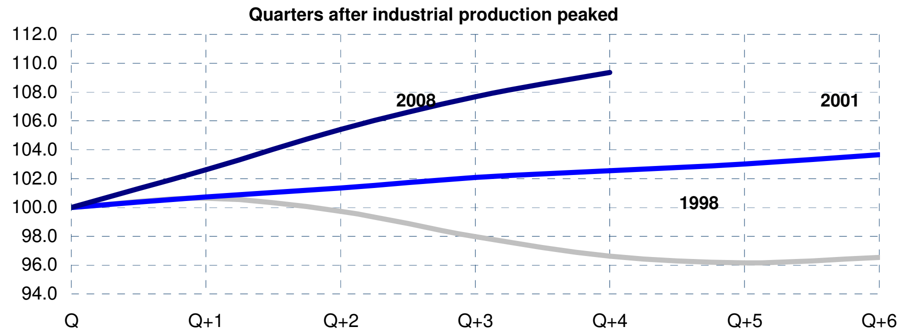


Source: CEIC & MARC Economic Research
Re-base to 100 in October 1997, October 2000 and December 2007

Wholesale and retail trade looks more encouraging

The statistics on wholesale and retail trade in the current downturn also reflect a positive outlook. During the 1998 downturn, wholesale and retail trade fell by as much as 4% by the fifth quarter following its peak before starting to rebound. In terms of value, calculated using 4-quarter moving average (using 1987 real prices), wholesale and retail trade dropped from RM7.37 billion in the 4Q1997 to RM7.10 billion in 1Q1999. During the 2001 downturn, private consumption was more resilient as evident in the persistent rise in the value of wholesale and retail trade in the quarters following the peak of the industrial production. What is surprising is the fact that consumer spending is even more resilient now judging by the increase in the value of wholesale and retail trade which rose by 9.4% in the 4Q2008, compared with 4Q2007.

Chart 6 **Wholsale and retail trade**



Source: CEIC & MARC Economic Research

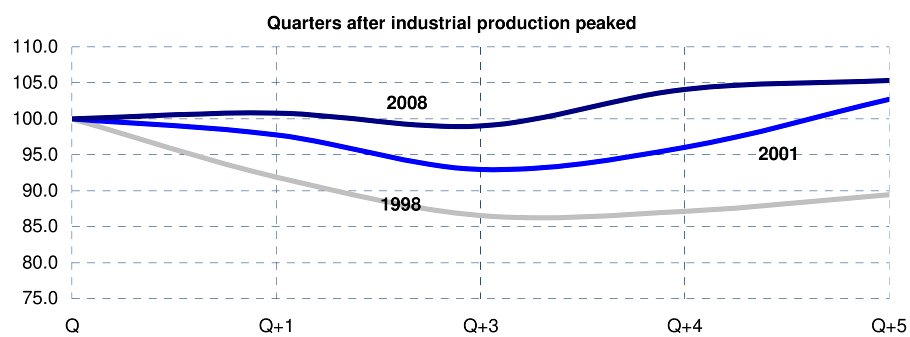
Re-base to 100 in October 1997, October 2000 and December 2007

Overall private consumption – are consumers in denial?

Thus far, private consumption in Malaysia remains remarkably resilient. This is rather astonishing, considering that the current global economic turmoil is impacting major economies on a scale not seen since the Great Depression of the 1930s. In Malaysia, during the 1998 recession, real private consumption declined by 13% from RM37.7 billion at the peak of the cycle to RM32.8 billion within three quarters. It took nine quarters before it rebounded and surpassed the previous peak.

In 2001, private consumption was more resilient. It slipped by 7% from its peak after two quarters into the downturn before rebounding. In terms of value, private consumption declined from RM41.3 billion in the 4Q2000 to RM38.4 billion, two quarters later. In 2008, private consumption was even stronger. After the industrial production peaked in December 2007, private consumption fell by only 1% in the 2Q2008 and rebounded in the following quarter. In the 4Q2008, growth in private consumption finally started to flatten, but remained above the levels of 2001 and 1998.

Chart 7 **Real private consumption**



Source: CEIC & MARC Economic Research

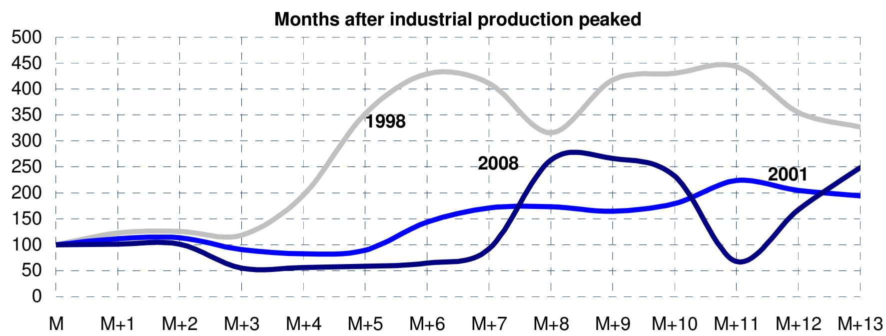
Re-base to 100 in October 1997, October 2000 and December 2007

Labour market condition may explain

What's holding up private consumption in the past few quarters? We are of the opinion that it is none other than the labour market condition, which has not weakened as drastic as it did in 1998, although the situation is slowly changing as more export-oriented industries are closing down amid waning global demand, During the 1998 downturn, the monthly average number of people retrenched from jobs (calculated using 3-month moving average) shot up from 1,972 in October 1997 to 8,224 within a short-time frame of nine months. This represented a 417% increase within three quarters. The situation was less severe in 2001 in which the monthly average number of people who lost their jobs rose by 165% within nine months. In the current downturn, the number of people retrenched initially climbed at a very slow pace until the seventh month into the cycle after which it escalated by 266% in the ninth month following the cycle peak.

The important thing to note is the fact that the relatively stable labour market has prevented private consumption from collapsing during this downturn. In addition, retrenchment has not spread beyond the manufacturing sector. In 2008, 77% of those retrenched was from the manufacturing sector, a stark contrast with the situation in 1998 where only 59% was from that sector.

Chart 8 **No of retrenchment - 3 month moving average**



Source: CEIC & MARC Economic Research

Re-base to 100 in October 1997, October 2000 and December 2007

Table 2: Comparing current cycle to previous recession/technical recession

	Worse than 2001?	Worse than 1998?
Industrial production	YES	YES
Real Exports	YES	YES
Vehicle sales	YES	NO
Stock market (KLCI)	YES	YES
Wholesale and retail	NO	NO
Sales tax	YES	NO
Real Private consumption	NO	NO
Retrenchment	YES	NO
Overall	6/8 YES	3/8 YES

Source: MARC Economic Research

Policy Implication

One obvious conclusion that can be made is that labour market condition is critical in supporting the economy. A shaky labour market, characterized by massive job losses will deteriorate consumer confidence, will ultimately result in reduced consumption. Judging from past experiences, a broad-based increase in the number of retrenchments will undermine consumers' appetite for consumption. One positive characteristic of the ongoing slowdown in the Malaysian economy is that the majority of job losses have been confined to the manufacturing sector without spreading to the other segments such as banking and real estate. It is therefore necessary for the government to take extra efforts to prevent labour market conditions from deteriorating. Measures to incentivize employers not to retrench workers may help prevent a massive increase in unemployment. Employers should also be encouraged to cut employees' working hours rather than retrench them.

Although not proposed in the second stimulus package, we are still of the view that other measures such as direct distribution of cash or shopping vouchers to selected group of people should be given consideration. Australia and Taiwan for instance have implemented such measures to boost disposable income and to support private consumption. In terms of monetary policy, Bank Negara (BNM) has frontloaded its monetary easing by slashing interest rates by more than expected quantum in January and February. In the near term, the central bank will likely hold the key rate steady to allow for the effects to filter through the economy. However, we are of the opinion that the BNM has sufficient headroom for flexibility to respond to sudden changes in macro development in the second half of the year.