Economic Research

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MALAYSIA: Macro Update

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10 July 2020

GDP growth forecast by the International Monetary Fund (June 2020)

	2019	2020	2021
Global economy	2.9	-4.9	5.4
Advanced Economies	1.7	-8.0	4.8
United States	2.3	-8.0	4.5
Euro	1.3	-10.2	6.0
Japan	0.7	-5.8	2.4
Emerging Market and Developing Economies	3.7	-3.0	5.9
China	6.1	1.0	8.2
India	4.2	-4.5	6.0
ASEAN-5	4.9	-2.0	6.2

Source: International Monetary Fund (IMF)

"The COVID-19 pandemic has had a more negative impact on activity in the first half of 2020 than anticipated, and the recovery is projected to be more gradual than previously forecast; …..the adverse impact on low-income households is particularly acute, imperiling the significant progress made in reducing extreme poverty in the world since the 1990s."

The IMF WEO, June 2020

GDP growth forecast for Malaysia for 2020/2021

	2020	2021	Last updated
Bank Negara Malaysia	+0.5% ~ -2.0%	N.A.	3 April 2020
MARC Bhd	-1.5% ~ -3.0%	6.2% - 6.7%	2 June 2020
Asian Development Bank	-4.0%	6.5%	17 June 2020
International Monetary Fund	-3.8%	6.3%	21 June 2020
World Bank	-3.1%	6.9%	24 June 2020

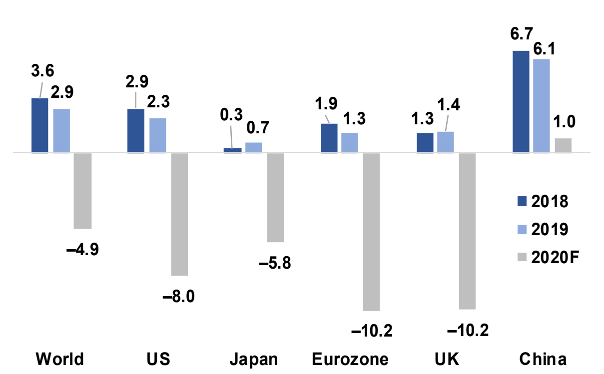
Sources: IMF, World Bank, ADB, BNM, MARC Research

"Our expectation of a pickup in GDP growth in 2021 does not suggest that Malaysia's potential output, which reflects the productive capacity of the economy, will emerge from the crisis unscathed. Of concern is the small and medium-sized enterprises (SME) sector which has been badly hit and will add pressure to the banking sector as bad loans start to increase. Such increases could, in turn, restrict lending by banking institutions not only to this segment of borrowers, but to other industries."

MARC Bhd

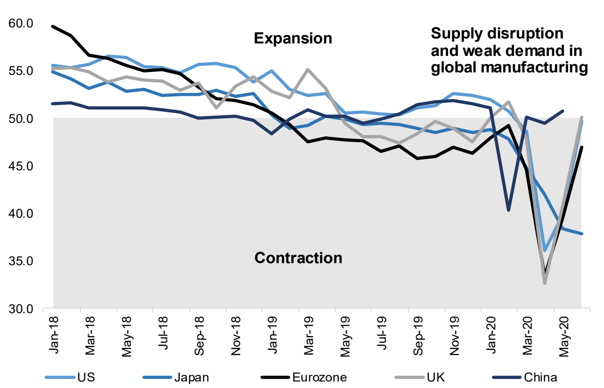
Global economy will recover in 2021; economic activities to remain sluggish as uncertainties over the long-term impact of the pandemic persist

Chart 1: Real GDP growth (% y-o-y) of major economies



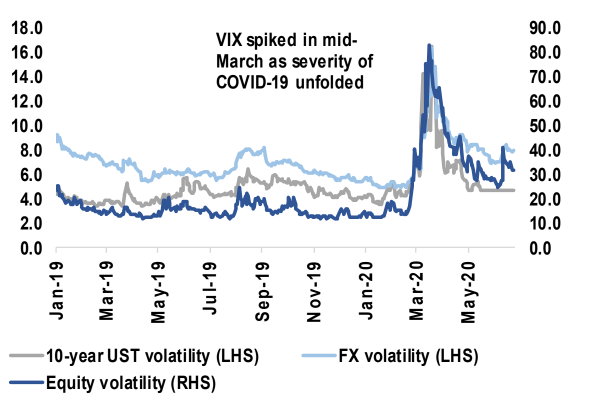
Source: IMF

Chart 2: Manufacturing PMIs of major economies



Source: Bloomberg

Chart 3: Financial market volatility indices – VIX



Source: Bloomberg

The global economy has bottomed out, economic activities will remain sluggish for the rest of the year

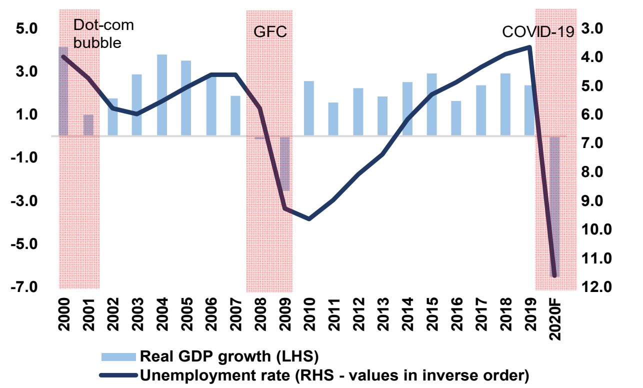
- Green shoots appeared in major economies (the US, Europe and China) after restrictions on movement were lifted. Manufacturing activities have rebounded in most major economies. Manufacturing Purchasing Managers' Indices (PMIs) in China and the US improved in June (China: +0.5 pts; US: +10 pts) as lockdown measures were eased.
- However, activities will likely remain sluggish as businesses and households take time to adjust to the new normal of living with the novel coronavirus (COVID-19).
- The World Bank's baseline forecast expects the global economy to contract by 5.2%, with the assumption that the related negative spillover effects will recede in 2H2020. The recession in emerging market and developing economies (EMDE) is projected to be shallower at -2.5% compared to -7.0% in advanced economies. However, a rebound in the global GDP is anticipated in 2021 (+4.2%).
- The IMF revised downwards its global growth projection for 2020 to -4.9% (previous: -3.0%), but foresees a rebound to 5.4% in 2021. Advanced economies and EMDE are expected to contract by 8.0% and 3.0% (2021: +4.8%; +5.9%).

Medium-term prospects hinge on whether the pandemic has left permanent scars that could affect future growth capacity

- Going forward, the prospects of the world economy hinge on whether the pandemic leaves lasting scars that could change the long-term growth trajectory of the global economy. These include investment decisions, the structure of global trade and supply chain linkages as well as the productivity of human capital.
- Varied policy response by different countries will add uncertainties about the future direction of the global economy. Rising protectionism and the blame game on the outbreak's origins could cloud the prospects going forward. Rising financial market volatility could also disrupt global growth recovery.

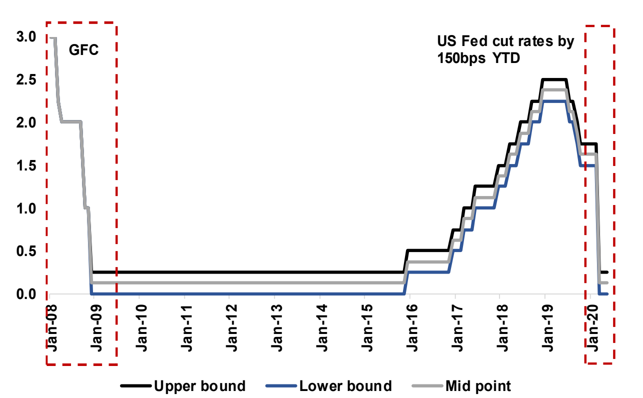
The US economy has officially entered a recession; China's economy is slowly healing

Chart 4: US real GDP growth (%y-o-y) and unemployment rate (%)



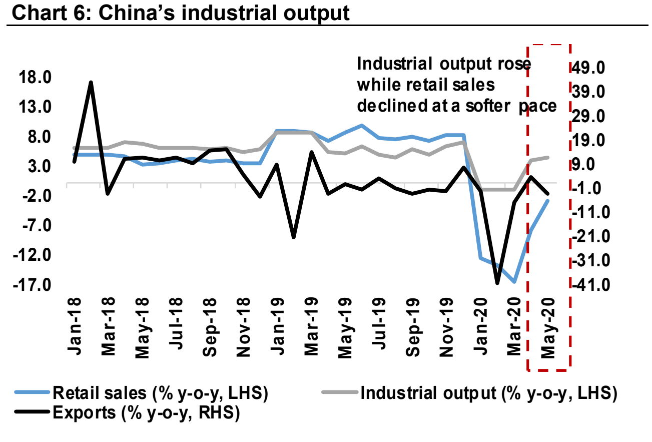
Sources: US Bureau of Economic Analysis (BEA), CEIC

Chart 5: US FFR (%)



Source: The Fed

Chart 6: China's industrial output



Sources: CEIC, MARC Economic Research

The US economy officially entered a recession in February 2020, triggered by the COVID-19 crisis

- The US Federal Reserve (the Fed) expects the economy to contract by 6.5% in 2020, the worst downturn since the Global Financial Crisis (GFC) (IMF: -8.0%). While restoration of pre-pandemic levels could still be a long way off, the US economy has shown signs of a rebound as the nation moves toward a phased reopening. The IMF is projecting a 4.5% growth in 2021.
- The unemployment rate has started to ease from a record high of 14.7% in April (June: 11.1%; May: 13.3%). Moreover, unprecedented fiscal support – at least USD2 trillion – and massive monetary stimulus – over USD3 trillion – will help shore up spending by individuals and firms. However, recent social unrest and tensions with China would threaten the US' nascent economic recovery.
- The Fed's pledge to keep the target range for Fed Funds Rate (FFR) at an ultra-low level of 0-0.25% for a considerable period will continue to support asset prices. The concern, however, is whether the financial market is due for another correction that could disrupt the recovery process if a second-wave infection of the COVID-19 emerges.

China's economy is gradually recovering from the COVID-19-induced contraction, reflected in the strong rebound in industrial output

- Real GDP will rebound in 2Q2020 from its trough in 1Q (-6.8%). The IMF has forecast an overall growth of 1.0% in 2020 (2021: +8.2%). Nevertheless, the economic outlook remains clouded by uncertainties as fears of a second wave of the COVID-19 infection are weighing on private consumption, while trade tensions with the US are exerting a downward pressure on China's external sector.
- Against this backdrop, the government has scrapped its annual GDP growth target announcement at the National People's Congress. To bolster the economy, the government has pledged a rescue package worth CNY4 trillion, which includes tax exemptions, waived contributions to social welfare funds, lower bank interest rates and others.

MALAYSIA

Growth to rebound to 6.2%-6.7% in 2021; but concerns over deficits and debt will linger

- ***GDP will contract by 1.5% to 3.0% in 2020; but will rebound to 6.2%-6.7% in 2021***
- ***Budget deficits to climb to 6.0%-6.5% of GDP in 2020; government debt will surpass the self-imposed limit of 55% of GDP (our forecast: 56%-60% of GDP)***
- ***Rising deficits and debt will weigh on Malaysia's sovereign credit rating; but will be mitigated if credible medium-term revenue-enhancing measures are introduced***
- ***MYR will benefit from the weaker USD, a rebound in crude oil prices and increasing inflows into the financial market***
- ***A slim possibility of further reductions in the OPR in 2020 after the latest cut to 1.75%***

In a nutshell

- GDP growth is expected to decelerate further in 2Q2020 after posting a sharp slowdown in 1Q2020 (+0.7%). We expect the overall growth for 2020 to be between -1.5% to -3.0% due to the worldwide impact of the COVID-19 pandemic. An economic recovery is expected in 2021 with GDP growth of between 6.2% and 6.7% (Bloomberg May survey: 5.0%).
- We foresee budget deficits to climb to 6.0%-6.5% of GDP in 2020 (Ministry of Finance (MoF): 5.8%-6.0% of GDP). The increase is due to the declining revenue as well as rising expenditures to finance various stimulus packages introduced to support the economy. Our budget deficit forecast also assumes some revenue enhancement measures of 1.0%-1.5% of GDP (via government-linked companies (GLCs), BNM etc.).
- With higher budget deficits, the federal government domestic debt level will surpass the 55% self-imposed threshold in 2020 (our forecast: 56%-60% of GDP). The plus point, however, is that only 3% of the government debt is in foreign-denominated currency.
- Increasing budget deficits and government debt will weigh on Malaysia's sovereign credit rating. Two out of three major international credit rating agencies (CRAs) have adjusted Malaysia's sovereign credit rating outlook to "negative" from "stable". Going forward, however, a quick and sustainable recovery in global crude oil prices and credible medium-term revenue-enhancing measures by the government will mitigate some of the pressure.
- We foresee a slim possibility of further reductions in the Overnight Policy Rate (OPR) in 2020 after BNM lowered it to a historical low of 1.75% on 7th July. The resumption of global economic activities in 2H2020, although not at full capacity, will change the general pessimistic view towards the end of the year. Notwithstanding this, a major risk will be the emergence of a second wave of the pandemic.
- The MYR will benefit from the weakening USD as global economic prospects improve and crude oil prices rebound. The increasing inflows of portfolio capital into the local bond market will add to the strength of the MYR (June: +RM11.6 billion; May: +RM1.5 billion).

SURVEYS BY THE DEPARTMENT OF STATISTICS MALAYSIA (DOSM)

Respondents: 41,386 individuals
Date of survey: April 10-24, 2020

Key findings

COVID-19 influenced lifestyle	96.3%
Willing to adapt to the new norm	92.9%
Joined online learning sessions for 1-5 hours daily during MCO	67.5%
Internet access for online learning is "average"	54.5%
PRIHATIN is effective in reducing financial burden	70.1%

Respondents: 4,094 companies/businesses
Date of survey: April 10-May 1, 2020

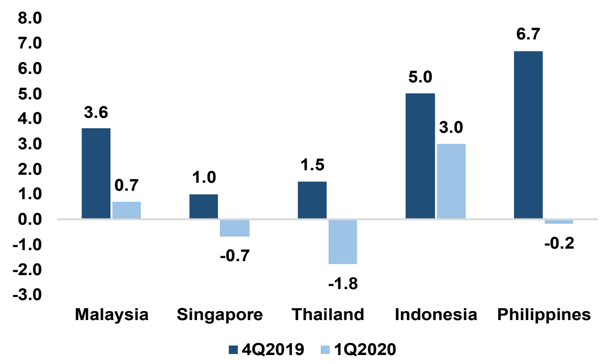
Key findings

Able to survive 1-2 months only if they provide full-time/half paid leave to employees during MCO	53.4%
No sales/revenue during the MCO	67.8%
Earned revenue through online sales/services	12.3%
Would take more than 6 months to recover as normal if COVID-19 outbreak is restrained	42.5%
Would not recover and is expected to close	1.9%

Private consumption will moderate as consumer sentiment remains fragile

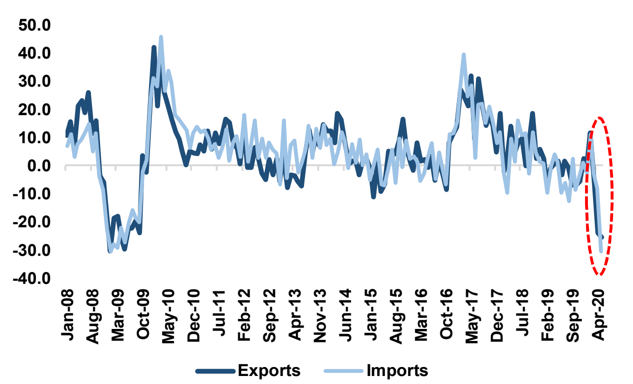
- Consumer spending, which contributed significantly to headline growth in 1Q2020 is set to moderate in the remaining three quarters despite the buildup in pent-up demand following the Movement Control Order (MCO) in March and April. We expect private consumption growth to weaken to 3.0% in 2020.
- Consumer sentiment has been affected by the rising unemployment rate which surged to a 30-year high of 5.0% in April (March: 3.9%). A recent survey by the Department of Statistics Malaysia (DOSM) indicates that the COVID-19 outbreak has significantly influenced consumers' perception with 92.9% of respondents now willing to adapt to the new norm after the MCO. The DOSM is anticipating the jobless rate to climb to 5.5% in 2020 due to deteriorating business conditions.
- The Malaysian Institute of Economic Research's (MIER) employment index has also slumped by 40.6% y-o-y in 1Q2020, the sharpest drop since December 2008 during the GFC. The consumer sentiment index also declined sharply by 40.3% in 1Q2020, the most since June 1998.
- Businesses have been deeply affected, i.e. wholesale and retail trade value contracted by nearly 37.0% y-o-y in April (March: -5.7%). Sales value of retail trade alone contracted by 32.4% (March: -6.7%) while motor vehicle sales plunged by 93.2%. While statistics for the month of April represent a blip due to the MCO, the whole year's performance is not expected to be encouraging.
- In the manufacturing sector, sales declined sharply by 33.0% in April (March: -3.0%), dragged by transport equipment and other manufactures products (-69.5%), non-metallic mineral products, basic metal and fabricated metal products (-67.5%), as well as electrical and electronics (E&E) products (-39.6%). The number of employees declined by 3.2% while their salaries and wages dropped by 6.2%.
- Reflecting the deterioration in business conditions, the MIER's business condition index contracted for the sixth consecutive quarter in 1Q2020 (-12.0%; 4Q2019: -7.4%), the longest streak since 2014-2015.
- Going forward, the road to recovery could remain bumpy. According to DOSM's survey, about 42.5% of businesses indicate that they would take more than 6 months to recover (28.7% between 4-6 months). Accordingly, the two main forms of assistance needed by businesses are finance/subsidies from the government (83.1%) and corporate tax deductions (67.0%).

Chart 7: Real GDP growth of ASEAN-5 countries (%y-o-y)



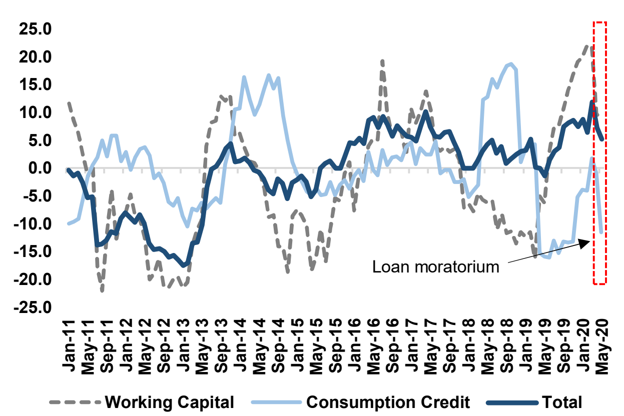
Sources: Respective government agencies

Chart 8: Malaysia's trade performance (% y-o-y)



Sources: DOSM, CEIC, MARC Economic Research

Chart 9: Non-performing/impaired loans growth for Malaysia's banking system by selected purposes (% y-o-y)



Source: BNM, CEIC, MARC Economic Research

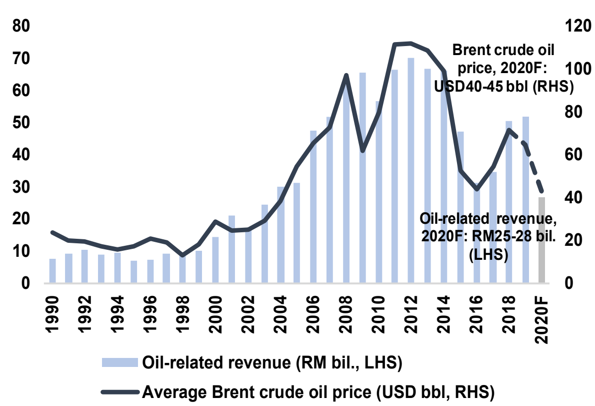
A rebound in growth in 2021 on the back of a low base and improvements in domestic and global economies

- GDP growth moderated sharply to 0.7% y-o-y in 1Q2020 and is expected to decelerate further in 2Q2020, due to the full impact of the MCO. We expect the overall GDP to contract between 1.5% and 3.0% in 2020 (IMF: -3.8%).
- For 2021, we maintain our GDP growth forecast of between 6.2% and 6.7% on account of the low base in 2020 as well as some recovery in private consumption and improvements in the external sector (IMF: +6.3%). Investment growth will be below trend as global uncertainties persist post the COVID-19 pandemic.
- On the external front, global merchandise trade volume growth will pick up by between 21% and 24% in 2021, according to the World Trade Organisation (WTO) (2020: between -13% and -32%). We expect global trade recovery to push up Brent crude oil prices to an average of USD50-USD55 per barrel (bbl) in 2021 (2020F: USD40-45 bbl).
- This will provide a boost to Malaysia's real GDP growth and the government's coffers in 2021. Studies have indicated that a USD1 increase in the price of Brent crude oil price will increase Malaysia's (i) real GDP growth by about RM650 million; and (ii) fiscal revenue by RM365 million.
- That said, there still remains the possibility of a second-wave pandemic that could lead to another global lockdown. Our expectation of a pickup in GDP growth in 2021 does not suggest that Malaysia's potential output, which reflects the productive capacity of the economy, will emerge from the crisis unscathed.
- Of concern is the SME sector which has been badly hit and will add pressure to the banking sector as bad loans start to increase. Such increases could, in turn, restrict lending by banking institutions not only to this segment of borrowers, but to other industries.

Chart 10: Malaysia's fiscal balance (% GDP)

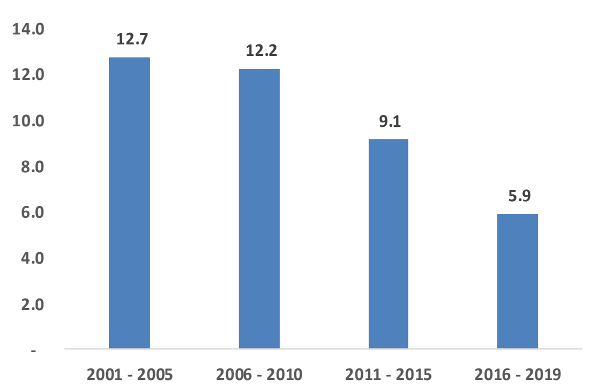
Sources: DOSM, MoF, MARC Economic Research

Chart 11: Oil-related revenue and Brent crude oil price



Sources: MoF, Bloomberg, MARC Economic Research

Chart 12: Growth of government debt (CAGR %)

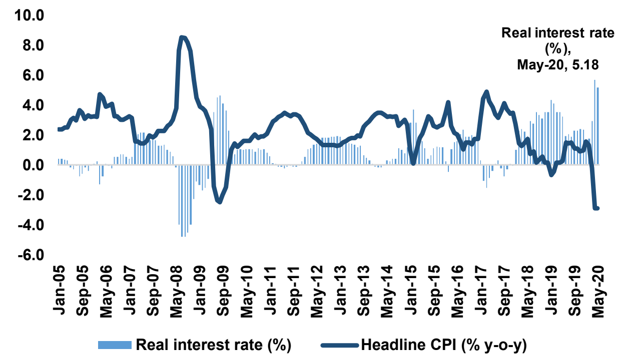


Sources: MoF, CEIC, MARC Economic Research

Increasing fiscal deficit and debt will weigh on sovereign rating; but credible medium-term revenue-enhancing measures will mitigate pressure

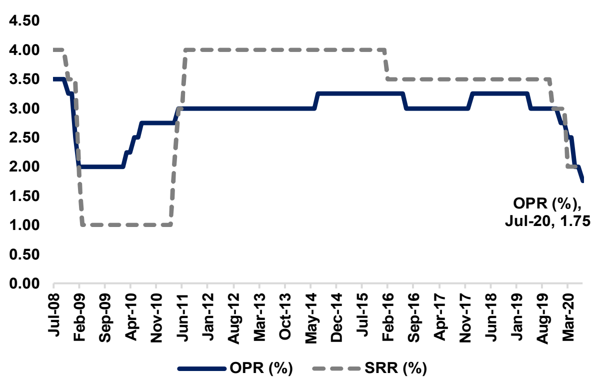
- Given the drop in revenue and rising expenditures to finance various stimulus packages, we expect Malaysia's budget deficit to climb to 6.0%-6.5% of GDP in 2020 (MoF: 5.8%-6.0% of GDP). Including PENJANA, the total stimulus package amounts to RM295 billion (roughly 20% of nominal GDP). Total government direct injection is estimated to be RM45 billion.
- The sharp drop in global crude oil prices by almost 35% since the beginning of 2020 has added pressure to the government's coffers. Our crude estimate suggests that at an average Brent crude oil price of USD30 bbl projected by the government, oil-related revenue will shrink to roughly RM25-28 billion in 2020 (2019: RM53.8 billion).
- Notwithstanding this, revenue enhancement of circa 1.0%-1.5% of GDP (from e.g. GLCs, BNM etc.) will cushion the drop in the revenue. On balance, we expect the budget gap for 2020 to come in between RM85-RM90 billion.
- The rise in fiscal deficits will raise the Malaysian government's domestic debt level to above the self-imposed 55% of GDP (our forecast: 56%-60% of GDP). This will weigh on Malaysia's sovereign credit rating by international CRAs. Two out of three major international CRAs have adjusted Malaysia's sovereign credit rating outlook to "negative" from "stable". Going forward, however, a quick and sustainable recovery in global crude oil prices and credible medium-term revenue-enhancing measures by the government will mitigate some of the pressure on the rating.
- We concur with the view that extraordinary times call for extraordinary measures and larger budget deficits are justified to ensure businesses and consumers are well supported. However, from the investors' point of view, a critical question is whether the deficits and debt can be pared down within the targeted time frame (i.e. 3-4 years).

Chart 13: Malaysia's real interest rate (3-month KLIBOR-CPI gap)



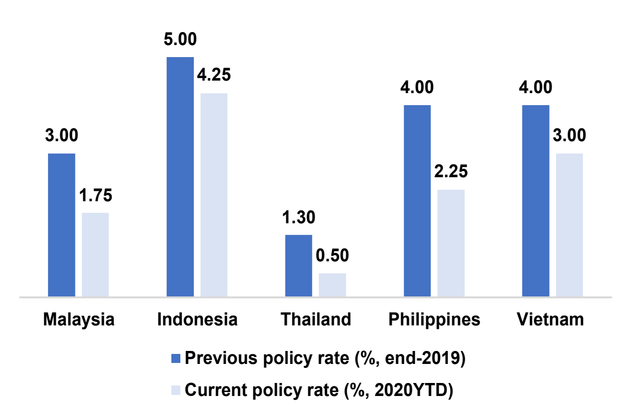
Sources: DOSM, Bloomberg, MARC Economic Research

Chart 14: OPR and Statutory Reserve Requirement (SRR)



Source: BNM

Chart 15: Key policy rates of selected countries

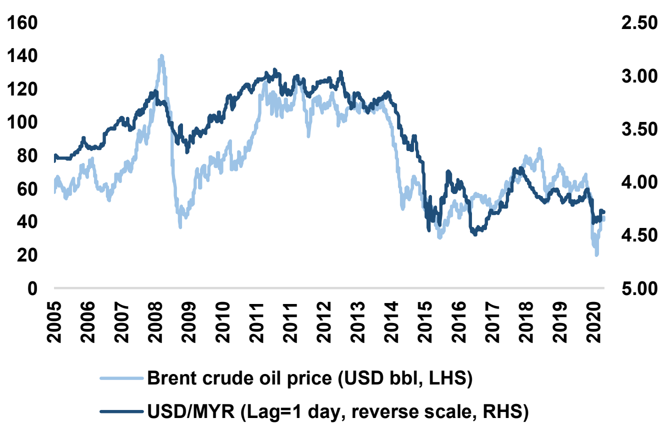


Sources: Respective central banks

A slim possibility of further reductions in the OPR in 2020 after the latest cut to a historical low of 1.75%

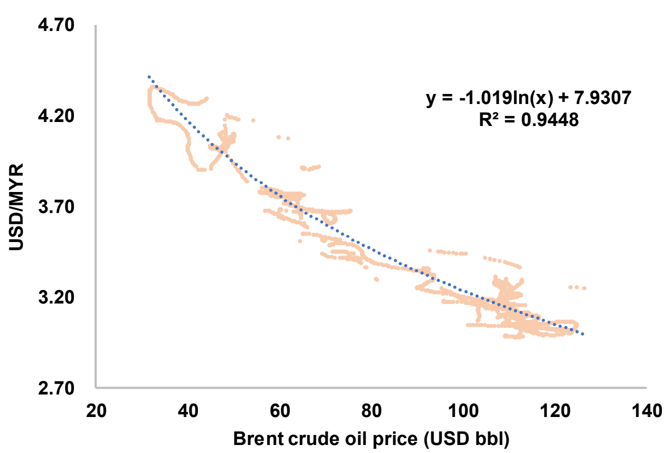
- With consumer price inflation already in negative territory, real interest rates remain higher than the historical norm (average gap: 166 bps between 2015 and 2019; May 2020: 518 bps).
- Notwithstanding this, we foresee a slim possibility of further OPR cuts in 2020 after BNM reduced it to a historical low of 1.75% on 7th July. Going forward, fiscal policy will take a more prominent role in uplifting growth. The combined PRIHATIN and PENJANA stimulus packages are expected to boost growth by 3.0%-3.5%.
- Although remaining weak by historical norms, the global economy is expected to start healing from the pandemic towards the end of 2020. With global banks likely to keep interest rates at the current low levels for a considerable period while their governments continue to pump prime their economies, capacity slack will be reduced. A rebound in global economic growth (IMF forecast: +5.4% in 2021) will benefit an open economy like Malaysia.
- Further reductions in the OPR will also add pressure on the banking sector's performance. This could result in banks becoming extra cautious in their lending activity going forward. This is especially true after banking institutions' bottom lines are expected to be hit by the impact of loan moratorium measures imposed for six months and the 125 bps cut in the OPR year-to-date (YTD).
- Further reductions in interest rates will also not augur well for the MYR which, on a YTD basis, has depreciated by 4.3% against the USD. With below-trend global crude oil prices continuing to weigh on the MYR, additional downward pressure is not needed at this juncture.
- Most of all, studies often suggest that there are limitations to monetary policy's ability to support growth. This signals the likelihood of not adjusting the rates too aggressively unless the economic situation really warrants it. Hence, we are of the view that it is unlikely for BNM to further adjust the OPR downward in 2020.

Chart 16: MYR and Brent crude oil price



Source: Bloomberg

Chart 17: MYR and Brent oil price regression



Source: Bloomberg, MARC Economic Research

MYR to benefit from USD weakness in the short-term

- The MYR has appreciated by roughly 4% from its low of RM4.45 in March as the USD weakened on the back of better economic prospects in 2H2020. The US dollar index (DXY) has declined by 5.8% from its recent high in March as investors rebalanced their portfolios away from US-denominated assets. This was in view of the sharp decline in US Treasury yields and brighter recovery prospects amid the relaxation of lockdown measures in many countries.

- The initial downward pressure on the MYR was largely associated with the collapse of global crude oil prices that would slash government revenue and raise fiscal deficits in 2020. Malaysia's oil-related revenue accounts for an average of 20% of total receipts in the past five years. Based on the assumption that Brent oil prices will average circa USD30 bbl in 2020 (according to MoF's forecast), we estimate oil-related revenue to be between RM25-RM28 billion, approximately half of 2019's level.

- The recovery of global crude oil prices in the recent month, however, has improved capital flows into Malaysian shores. In June, total net foreign inflows into Malaysia's bond market climbed to RM11.6 billion (May: +RM1.5 billion). This has benefitted the MYR.

- The historical relationship between Brent crude oil prices and the MYR suggests that at an average of USD40-USD45 bbl (our forecast), the MYR will be in the range of RM4.10 to RM 4.20 per USD.

- The medium-term prospects of the MYR however, partly hinge on macro parameters that affect the sovereign rating outlook. The market will pay close attention to further actions by international CRAs on Malaysia's sovereign rating. From their perspective, any measures to further broaden the government's revenue base will be credit positive and this will improve the prospects of the MYR. On the other hand, continuous dependency on oil-related revenue will hamper the MYR's prospects.

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