Economic Research

MALAYSIAN RATING CORPORATION BERHAD
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Economic Outlook 2021

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V(accine)-shaped recovery in the offing

Governments' response to the resurgence of COVID-19 will shape the global economy in the immediate term

- At the time of writing, COVID-19 continues to ravage the global economy with over half a million daily cases reported since October 2020; more than 1.8 million lives have succumbed to the virus. This has led to countries, particularly in the northern hemisphere, to impose another round of lockdowns despite a rebound in 3Q2020. Earlier forecasts for 2021 may soon be overtaken by rapidly changing events as economies face a difficult trade-off between managing public health and charting a strong recovery path.

We have seen it all in 2020

- Owing to the fast-tracked development and deployment of vaccines, we are hopeful with the International Monetary Fund's (IMF) projections for a broad-based global recovery from the low base of -4.4% in 2020 to 5.2% in 2021. Emerging market and developing economies (EMDEs) will take the lead in global recovery to record 6.0% growth in 2021 – led by China (8.2%), India (8.8%), and ASEAN-5 (6.2%) – followed by advanced economies with 3.9%. The World Bank and Organisation for Economic Co-operation and Development (OECD) are also projecting a similar V-shaped recovery for the global economy this year.

Table 1: Real GDP projections by international agencies

	IMF		World Bank		OECD		ADB	
	2020	2021	2020	2021	2020	2021	2020	2021
World	-4.4	5.2	-5.2	4.2	-4.2	4.2	-	-
Advanced Economies	-5.8	3.9	-7.0	3.9	-	-	-	-
US	-4.3	3.1	-6.1	4.0	-3.7	3.2	-	-
Euro Area	-8.3	5.2	-9.1	4.5	-7.5	3.6	-	-
EMDEs	-3.3	6.0	-2.5	4.6	-	-	-	-
China	1.9	8.2	2.0	7.9	1.8	8.0	2.1	7.7
India	-10.3	8.8	-9.6	5.4	-9.9	7.9	-8.0	8.0
ASEAN-5	-3.4	6.2	-	-	-	-	-4.4	5.2

Sources: IMF, World Bank, OECD, Asian Development Bank (ADB)

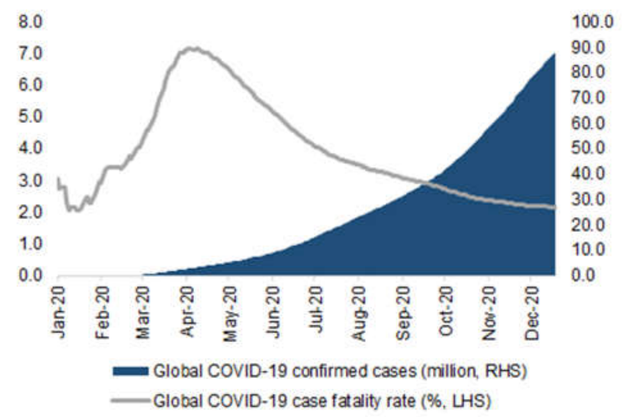
The low base effects

- The projected rebound in 2021 is contingent upon the gradual resumption of economic activities in 2021, banking on strong quarter-on-quarter (q-o-q) performance, and the role of both fiscal and monetary policies to manage economic fallout. We anticipate that, in the event of rising COVID-19 cases, governments would prefer targeted rather than nationwide lockdowns to allow economic activities to thrive, smoothening the path towards recovery. However, this may not necessarily be the case as the virus is constantly mutating into different strains over time. We anticipate that the vaccine euphoria will offer a quick relief to the global economy, but the aftermath of the crisis will linger at least throughout 2021.

We anticipate a speedier resumption of economic activities as risks dissipate

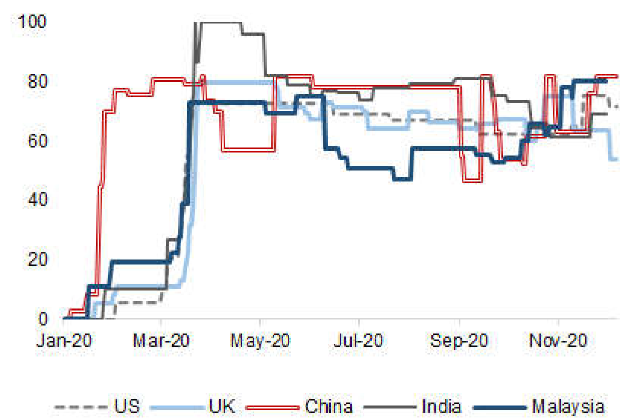
- Downside risks continue as aggregate supply is still operating far below the full capacity as governments continue to 'flatten the curve'. It is important to note that although the number of COVID-19 cases keep surging, so is the recovery rate. This will prompt governments to normalise economic activities sooner as risks dissipate.

Chart 1: Global COVID-19 confirmed cases and case fatality rate



Sources: Bloomberg, MARC Research

Chart 2: COVID-19 government response stringency index



Source: Oxford COVID-19 Government Response Tracker

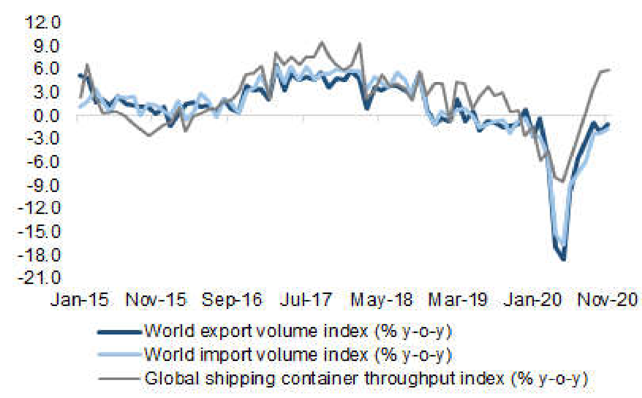
Aggregate demand will eventually pick up and will pose risks to stabilisation policy taken in 2020

- The overall market outlook for 2021 will continue to trend below pre-pandemic levels. We stand by the IMF's projection that inflation will remain low, where this year's outlook for advanced economies is expected to be at 1.6% whereas EMDEs will be at 4.7%, including the ASEAN-5 at 2.3%. Low inflation and a low interest rate environment will persist in 2021 but it may not be long before sovereign debt service becomes problematic amid the unprecedented debt-led stabilisation policy in 2020. A persistent yet elevated unemployment rate will keep economies on alert as well.

More trade, more oil

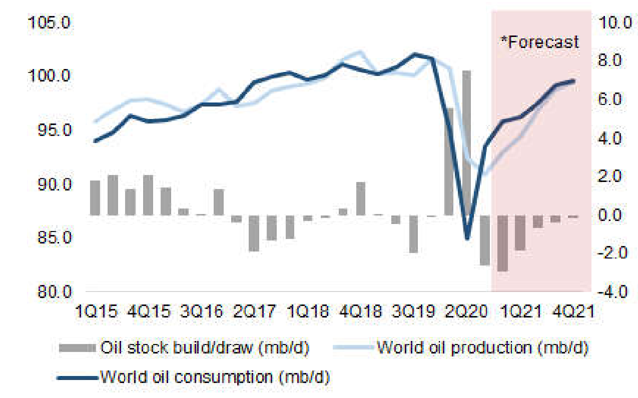
- Despite the present headwinds, the World Trade Organisation (WTO) expects merchandise trade to rise to 7.2% in 2021, a rebound from -9.2% a year earlier. The US Energy Information Administration (EIA) estimates Brent crude to average at USD49 per barrel in 2021 as demand will pick up alongside the resumption of economic activity. The Organisation of the Petroleum Exporting Countries (OPEC) also projects global oil demand to rise in 2021, led by the transportation and industrial sectors apropos a rebound in global oil demand by 5.9 million barrels per day (mb/d) in 2021 from the record contraction of 9.8 mb/d in 2020.

Chart 3: World trade indicators



Sources: CPB, RWI/ISL, MARC Research

Chart 4: World oil production and consumption balance



Source: US EIA

Prospects of major economies

United States of America: A new hope?

The US economy will recover and re-engage with the world

- There is a sense of renewed optimism with the US economy following the victory of Joe Biden in the 2020 US Presidential Election. This is not only due to the President-elect's overdrive fiscal policy mode but also the Democrats' continuous majority in the House of Representatives, albeit lower than in the 2018 midterm elections. The Democratic Party's control over the upper and lower houses will lend more weight to the Biden administration this year as well. We are sanguine that the President-elect will find a way to accelerate the economy's path towards a stronger recovery and US re-engagement with the global economy, particularly China.

Fed's bond-buying programme will spill over into 2021

- As such, we are in consonance with the IMF and OECD for the US economic rebound in 2021 at 3.1% and 3.2%, subject to the effects of further fiscal measures. There is a consensus that historic low-interest rates will continue to support fiscal spending throughout 2021, even if the interest rate were to hover above the 2% target. We expect the Fed's bond-buying spree will continue so that the probability of a post-pandemic financial crisis is kept at bay.

A bumpy ride ahead as the number of COVID-19 cases remains high

- There is still a downside risk to such prospects as the daily rate of COVID-19 cases sees no sign of abating sans rapid vaccine deployment and a patchy recovery in the US labour market. The US unemployment rate and weekly jobless claims continue to remain higher than pre-pandemic levels following the unprecedented spike in unemployment from 3.5% in February 2020 to 14.7% two months later. The core personal consumption expenditures (PCE) growth is still trending below the Fed's target rate of 2%. The Institute of Supply Management's (ISM) Manufacturing Purchasing Managers' Index (PMI) recorded a reading above 50 since June 2020 though it may lose momentum amid higher COVID-19 cases during the winter months. Furthermore, it is unclear whether US President Donald Trump will pull a last-minute challenge to Biden during the lame-duck period, but we believe it will not be detrimental to the overall outlook of the US economy in 2021.

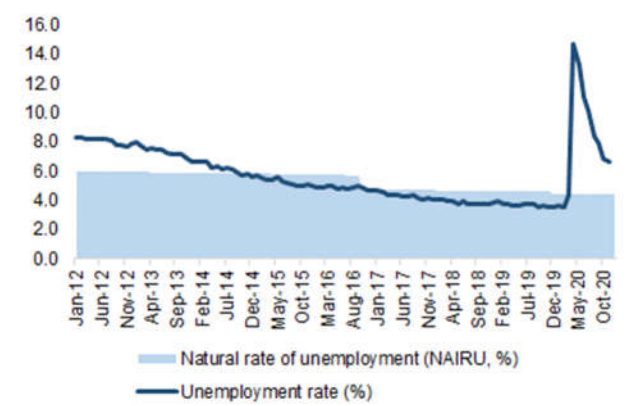
Political risks remain high in the US

- Despite Biden's victory and Democratic control over both the upper and lower houses, almost 77 million voters did not vote for the President-elect. This signals that the incoming Commander-In-Chief will still be facing significant hurdles in pursuing his policy agenda throughout his term. We anticipate that political tensions will remain for as long as Donald Trump remains as a driving force of the Republican party.

Chart 5: US manufacturing PMI

Source: Bloomberg

Chart 6: US unemployment rate



Source: US EIA

China: Better, stronger, faster

China's "dual circulation" economic strategy will set the tone for 2021

- Amid US-China trade tensions and the ongoing pandemic, the Communist Party of China (CPC) concluded a set of guidelines for the 14th five-year (2021-25) growth strategy in late October 2020. Dubbed as the "dual circulation" strategy, the guidelines aim to capitalise growth on the economy's strong urban household consumption which accounts for 78% of total consumption today, and to mitigate external risks. We opine that China's consumption-stimulating policies will shape its mid-term growth model, which will be deliberated further by the National People's Congress in 1Q2021.

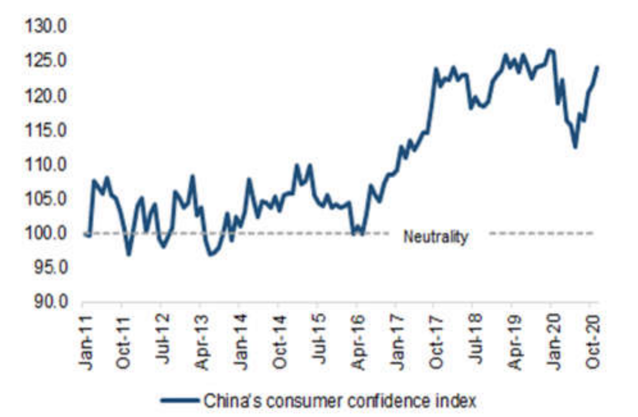
Act fast, recover faster

- China's early and harsh response to COVID-19 has not only enabled the authorities to keep infections under control but also put the economy on a robust recovery path post-lockdown. As it stands, the Chinese economy is already on its way to perform at pre-pandemic levels. Despite a contraction of 6.8% in 3Q2020, China is poised to be the only G20 economy to record positive growth in 2020 and anchor the Asian economy's growth in 2021. The IMF projects that the Chinese economy will record an 8.2% growth in 2021 compared to 1.9% a year earlier, against the backdrop of improved business and consumer confidence. Throughout 2020, China's PMI trended consistently above 50 apart from in February. New export orders have also normalised. Most key economic indicators are already pointing towards pre-pandemic levels and we believe that this trend will continue to offer a strong tailwind to the Chinese economy and its major trading partners, including Malaysia.

COVID-19 resurges, but it will not pose a threat to the Chinese economy in 2021

- Both fiscal and monetary drivers will continue to support China's super-speed growth this year. We do not anticipate further fiscal stimulus as the government plans to keep its fiscal health in check as the 3.6 trillion yuan (USD500 billion) stimulus in 2020 pushed the deficit to 3.6% in 2020 from 2.8% a year earlier. That said, the monetary policy will remain accommodative and support for deferment of loan payments to small and medium-sized enterprises (SMEs) will continue until 1Q2021. Given China's track record in managing the spread of COVID-19 in the early days, we are not anticipating a downside risk to growth even if infections were to rise following new strains in 2021.

Chart 7: China's consumer confidence



Sources: National Bureau of Statistics of China, CEIC

Chart 8: China's manufacturing PMI

Source: Bloomberg

European Union: trouble averted… for now

The rise in the number of COVID-19 cases in the recent weeks changed the outlook for 2021

- The IMF projects the Euro Area to record a contraction of 8.3% in 2020 before a rebound of 5.2% in 2021. The OECD, however, appears to take an optimistic stand of -7.5% growth in 2020 but a pessimistic view of a 3.6% growth in 2021, compared to the IMF. As the latter is a more recent forecast than the former, the OECD's projections consider the strong 3Q2020 output rebound, but the recent mobility restrictions in the wake of a raging COVID-19 spread of late will put a drag on the economy's recovery pace this year.

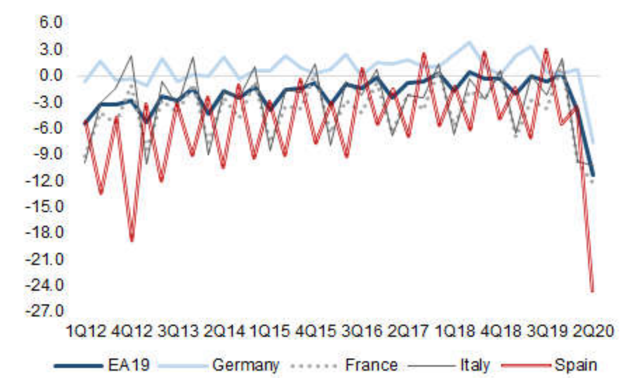
2021 will see realignment of economic engagements among the EU, Britain and the rest of the world

- Now that both the European Union (EU) and Britain have effectively dodged the no-deal bullet, 2021 may present itself as the year of realignment of economic activities in Europe. We do not anticipate an immediate economic fallout in the EU following the conclusion of the Brexit deal on December 30, 2020.

The scarring effects of lockdowns will persist

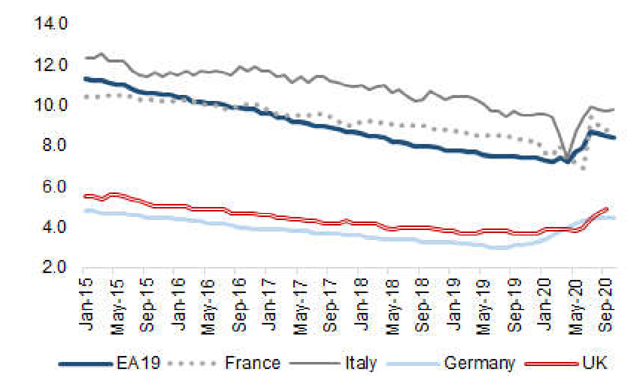
- Despite the projected rebound in 2021, we take note of the EU's main downside risks in 2021. The European Commission forecasts that the unemployment rate will rise to 8.6% in 2021 from 7.7% in 2020, suggesting that unemployment will remain elevated throughout 2021 and will not return to pre-pandemic levels in the near term. The fiscal deficit will also likely follow the same trend, although inflation is expected to rise to 1.3% in 2021 from 0.7% in 2020. We take it that the European Central Bank (ECB) will maintain the interest rate on the main refinancing operations at 0% throughout 2021 for as long as inflation continues to trend below 2%.

Chart 9: General government surplus/deficit in selected European countries (% of GDP)



Sources: Eurostat, CEIC

Chart 10: Unemployment rate in selected European countries (%)



Sources: Eurostat, CEIC

Malaysia

Growth risks to fade with vaccine

Low consumer and business confidence will affect strong 3Q2020 rebound

- According to Malaysia's latest quarterly GDP data, the economy contracted at a slower pace of 2.7% year-on-year (y-o-y) in 3Q2020, compared with 2Q2020's contraction of 17.1%. The 3Q2020 GDP growth data suggest that the worst may be over for 2020. Nevertheless, consumer and business confidence remains low given the effects of the intertwined public health and economic crisis. According to the Malaysian Institute of Economic Research (MIER), consumers remain cautious with its 3Q2020 Consumer Sentiment Index (CSI) remaining well below the 100-point optimism threshold at 91.5 (2Q2020: 90.1). It does not help that both household debt (1H2020: 87.5% of GDP) and unemployment (3Q2020: 4.7%) remain elevated.

Our forecast for 2021

- We foresee that the Malaysian economy will rebound to 6.4% y-o-y in 2021, driven by a strong pick up in private consumption and investment at 7.7% and 6.5%. The increase in domestic demand is expected to drive inflation higher to 2.0% while unemployment will remain elevated at 4.0%, subject to a full recovery in 2021. A more detailed breakdown of our forecast is illustrated in Table 2.

Table 2: Summary of main economic indicators

	2017	2018	2019	2020F	2021F
Real GDP (% y-o-y)	5.8	4.8	4.3	-5.7	6.4
Domestic demand (% y-o-y)	6.5	5.5	4.3	-5.4	6.6
Private consumption (% y-o-y)	6.9	8.0	7.6	-3.8	7.7
Public consumption (% y-o-y)	5.7	3.2	2.0	4.8	3.8
Private investment (% y-o-y)	9.0	4.3	1.6	-12.3	6.5
Public investment (% y-o-y)	0.3	-5.0	-10.8	-20.5	1.4
Real exports (% y-o-y)	8.7	1.9	-1.3	-9.1	4.3
Real imports (% y-o-y)	10.2	1.5	-2.5	-10.0	5.9
Net exports (% y-o-y)	-3.9	6.2	9.7	-2.0	-7.8
Inflation (% y-o-y, annual average)	3.8	1.0	0.7	-1.1	2.0
Unemployment rate (%, annual average)	3.4	3.3	3.3	4.5	4.0

Sources: DOSM, CEIC, MARC Research

The massive rollout of COVID-19 vaccines in 2021 will lift overall consumer confidence

- The government expects 30% of the population to be vaccinated this year. Coupled with successful containment measures, this should lead to fading downside risks and improving consumer sentiment. We expect private consumption growth, given this positive development and low-base effects, to rebound going forward, though it is unlikely to return to a sense of normalcy in 2021. We expect private consumption growth to come in at 7.7%.

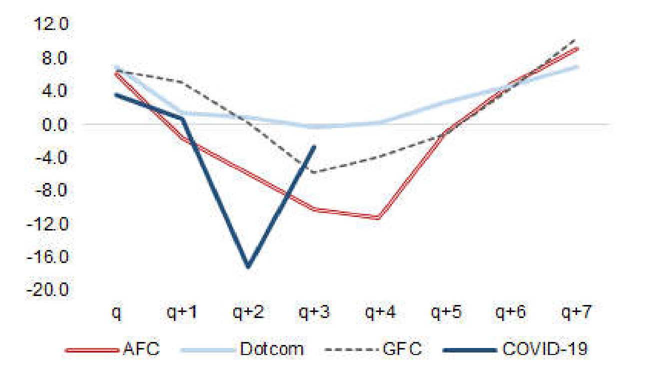
The effects of relaxing Movement Control Order (MCO)

- Meanwhile, MIER's Business Conditions Index (BCI) rose by 25.3 points in 3Q2020 to settle at 86.3 points. Business sentiment thus remains cautious, though most BCI components showed substantial improvements q-o-q, thanks to the resumption of domestic and export demand post-MCO. This is in line with improving monthly industrial production (IPI) growth data. After first diving into negative territory in March 2020 (-4.9% y-o-y), IPI growth trended sideways for four months before resurfacing into positive territory and staying put (September: 1.0%; August: 0.2%; July: 1.2%). We expect this positive development to continue given improving prospects with the vaccine breakthrough and sans a full-scale MCO.

An uneven "V"

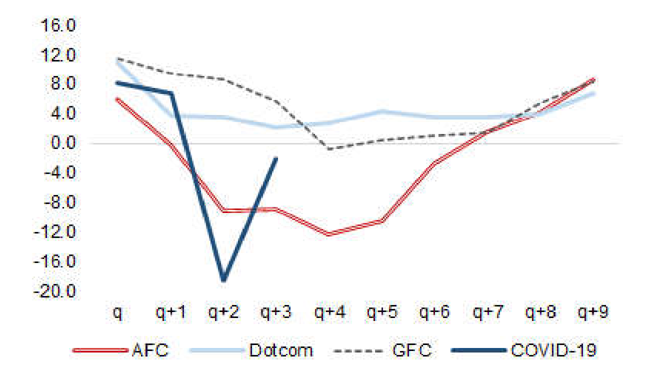
- With the backdrop improving, we expect GDP growth to recover in 2021 and come in at 6.4%. At the sectoral level, however, recovery will very likely remain choppy. For example, the tourism sector, an important growth contributor (2019: 15.9% of GDP), is not expected to see any significant improvement even with a vaccine rollout. It is important to note that the current gap in resources for logistics and personnel, as well as vaccine confidence, needs to be filled before the vaccine can be successfully distributed.

Chart 11: Real GDP growth in different cycles (% y-o-y)



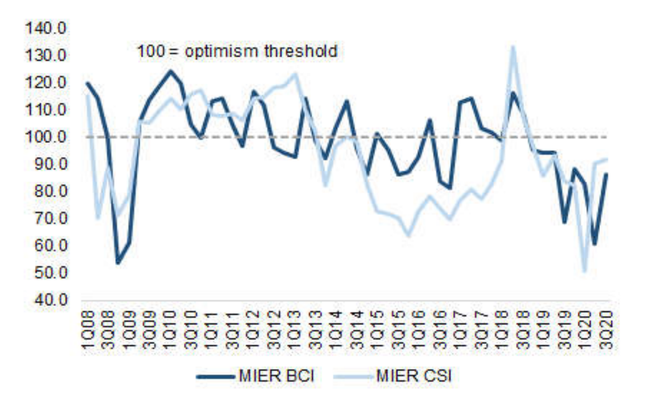
Sources: Department of Statistics Malaysia (DOSM), CEIC, MARC Research

Chart 12: Private consumption growth in different cycles (% y-o-y)



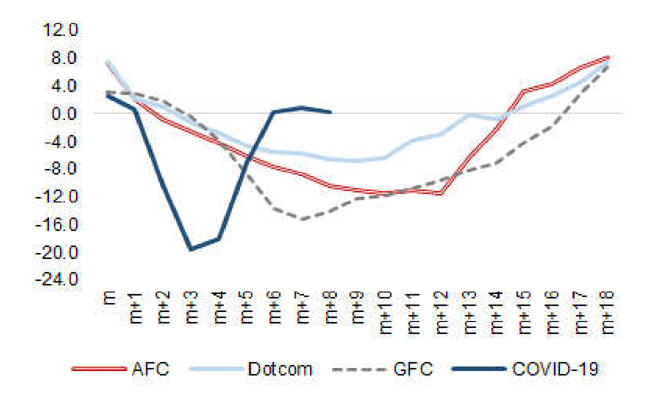
Sources: DOSM, CEIC, MARC Research

Chart 13: Business and consumer sentiment indicators



Sources: MIER, CEIC

Chart 14: IPI in different cycles (% y-o-y, 3mma)



Sources: DOSM, CEIC, MARC Research

Fiscal position has weakened further

The wrecking ball

- The government's stimulus packages, while having helped soften the impact of the pandemic, have set back fiscal consolidation. Since the pandemic outbreak, the government has announced stimulus packages totalling RM305 billion (20.2% of GDP), of which RM55 billion are direct fiscal injections. This stimulus alone is larger than the initial federal government budget estimate in 2020 of RM297 billion.

Debt-led stabilisation policy may continue

- Given the unprecedented scale and scope of the pandemic's impact, it is likely that more fiscal support could be forthcoming, and (again) debt-led, despite the vaccine breakthrough. If this is so, Malaysia's fiscal balance will likely fall further into deficit territory and consequently debt will creep further upwards. In the absence of further fiscal support, we expect the budget deficit to come in at between 5.3% and 5.8% of GDP and government debt at 60% of GDP. Amid these developments, it is important to remember that the share of foreign currency denominated debt remains low at about 3% of total debt.

Malaysia's indirect tax regime will be under the spotlight yet again

- The sharp drop in oil prices has again signalled the urgent need to further reduce oil dependency and broaden the tax base with new sources of tax revenue. Following the reversal of the Goods and Services Tax (GST) to Sales and Service Tax (SST), the sense of urgency of this fiscal theme has been renewed. However, it comes as no surprise that the government, given the current crisis backdrop, has indicated it will introduce new taxes only when the economy has recovered.

Malaysia had managed to bring high fiscal deficit to a manageable level in the past

- In any case, we do not interpret the widening budget deficit and rising debt as the start of a long-term deteriorating fiscal trend. This is akin to, for example, the situation in 2009 when the deficit, with the implementation of a RM60 billion stimulus package, had climbed two percentage points to 6.7% of GDP. We see the government's recent policy moves to prevent economic collapse, despite the negative short-term fiscal implications, as necessary to prevent permanent economic and consequently financial damage.

Fitch's downgrade

The downgrade comes as no surprise

- Negative rating pressure had been building up even before COVID-19 emerged. With the pandemic, GDP growth had collapsed and the deficit ballooned on unprecedented stimulus spending, which consequently pushed up government debt.

The negative outlook will continue throughout 2021

- Prior to the downgrade by Fitch Ratings to BBB+ from A-, Malaysia's debt-to-GDP ratio was already on the high side compared to those of its rating peers. As of end-September 2020, it came in at 61.0%, well above its then statutory debt limit of 55.0%. It did not help that amid the developing pandemic, oil prices had collapsed, and political uncertainty spiked. Given these developments, the risk of a rating downgrade by another international credit rating agency – S&P's A- rating on Malaysia has a negative outlook – is likely. Having said that, a sovereign rating downgrade may not necessarily be translated into lower overall economic sentiment/confidence per se throughout a historically low interest rate environment.

COVID-19 vaccines will assist recovery in the immediate term

- Fitch's downgrade had come at the heels of positive news about COVID-19 vaccine development and the UK's approval of the Pfizer/BioNTech vaccine on December 2, 2020. Its move supports our view that while the economy might rebound – albeit gradually – given its diversified, competitive and resilient nature, the fiscal balance sheet will likely continue to deteriorate over the medium term. Be forewarned also that the expected long-term economic scarring from COVID-19 could push Malaysia into a less competitive position in the post-pandemic world, especially due to lagging investments and many companies being still unprepared for digitalisation and automation.

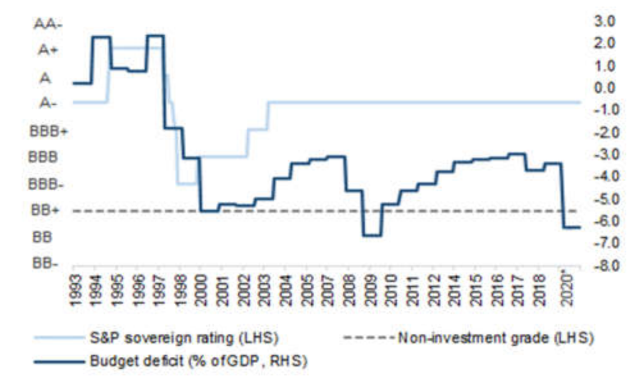
Another round of fiscal stimulus will prompt the government to raise the debt ceiling again

- Malaysia's federal government domestic debt is capped at 55% of GDP under the Loan (Local) Act 1959 and Government Funding Act 1983. To help ease the pandemic's blow on businesses, Parliament had in August passed the

Temporary Measures for Government Financing (Coronavirus Disease 2019) Act 2020 to temporarily increase the statutory debt limit from 55% to 60% of GDP for two years. We think that given the pandemic's expected long-term economic scarring and the unprecedented fiscal measures necessary to mitigate the effects, the statutory debt limit could be raised again, possibly to 65%.

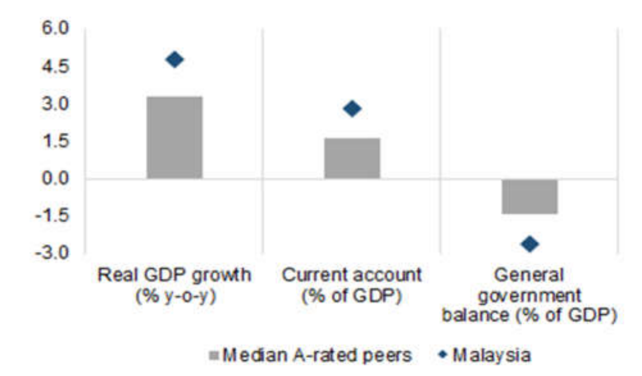
- We take note that most forecasts reflect the 3Q2020 rebound but discount the recent spikes in COVID-19 cases. Hence, in the event of another round of fiscal support, we foresee the Parliament raising the statutory debt ceiling again and extending the temporary measures further. This reflects growing challenges for the government going forward to balance growth and development with fiscal prudence.

Chart 15: Sovereign rating vs budget deficit



**Forecast by MARC Research*
Sources: DOSM, Ministry of Finance Malaysia, S&P Ratings, MARC Research

Chart 16: Selected indicators of Malaysia vs other A-rated peers (5-year median)



Sources: IMF, MARC Research

Labour market

The unemployment rate spiked, reduced but is trending sideways

- The labour market is showing signs of fatigue in moderating to its pre-MCO levels. The unemployment rate continues to remain elevated at 4.7% in October 2020, but lower than the year peak of 5.3% in May 2020. The recovery is expected to extend into 2021, in sync with improving economic conditions and the possible reopening of international borders. We laud the government's extensive support in cushioning the impact of the pandemic on the labour market, but the pace of recovery, undoubtedly, will depend on how the pandemic develops in the coming weeks.

Labour market repair will take time

- Countries around the world have begun the rollout of COVID-19 vaccines. As such, we hope that the government will take heed of the recent events and begin deploying the vaccine as early as in 1Q2020. Given the economic damage, we understand that it will be challenging to recover jobs lost within a fiscal cycle, especially in the hard-hit services sector, namely the tourism, retail, food and beverages sub-sectors. In addition, the unemployment rate may be understated due to the rise of the informal sector in recent years. On balance, we envisage that the unemployment rate will remain elevated, but it will moderate to 4.0% from 4.5% in 2020, assuming a full recovery in 2021.

Inflation

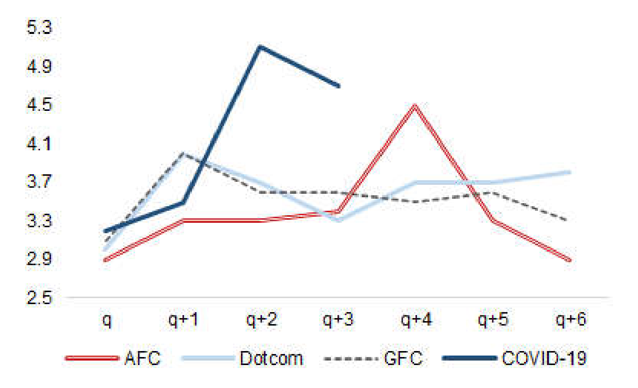
Inflation will rise progressively over the coming months

- Headline consumer prices (CPI) have dropped into deflationary territory since March 2020, declining by an average of 1.7% during March–November 2020. The main driver of deflation, the transport component of the CPI basket, subtracted 1.9 percentage points from headline CPI. However, core CPI – which excludes prices of fuel and fresh foods – remained benign at 1.1% during the same period.

Global oil prices will pick up modestly

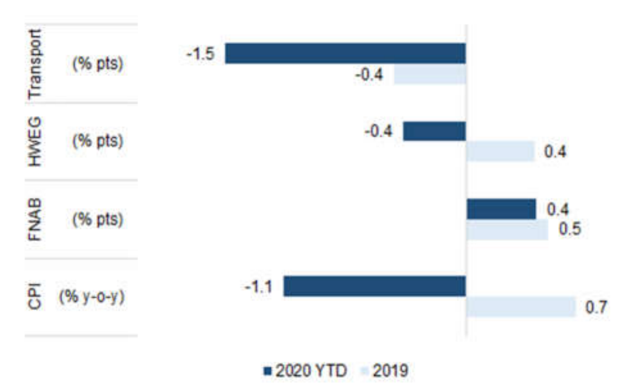
- We envisage CPI growth to return to positive territory by end-1Q2021 mainly due to the low base effect. For full year 2021, we expect headline CPI to rise to 2.0%. We do not anticipate a significant inflationary threat from fuel prices, which are expected to rise modestly; in 2021, average Brent crude will likely stay below USD55 per barrel (2020 average: USD43 per barrel).

Chart 17: Unemployment rate in different cycles (%)



Sources: DOSM, CEIC

Chart 18: Inflation rate and inflation contribution



**FNAB - food and non-alcoholic beverages; HWEG - Housing, water, electricity, gas & other fuels*
Sources: DOSM, CEIC, MARC Research

Monetary policy

OPR of 1.75% will remain as is

- We see low likelihood of overnight policy rate (OPR) adjustments throughout 2021 after the 125-bps rate cut to the historical low of 1.75% in 2020. With both domestic and external demand expected to recover further going forward, we see further rate reductions as off the table. We expect monetary stance, in any case, to remain accommodative for an extended period.

Another rate cut is highly unlikely

- While there is still room to lower the OPR should downside risks materialise, we are cognisant of the limitations of monetary policy to support growth. Further OPR cuts could potentially exacerbate financial vulnerabilities, for example rising property prices and household debt. Banks could also become extra cautious in their lending activities – which will act to limit the effectiveness of OPR cuts – given that lower interest rates will impact bank performance.

Ringgit

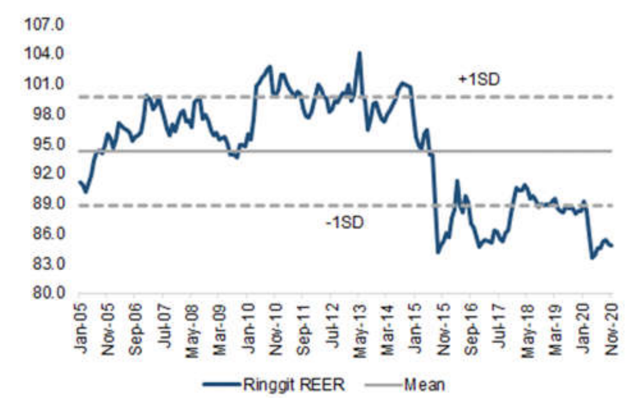
Watch out for US Dollar movements

- The ringgit, riding on positive risk sentiment, has been on an appreciatory trend when it hit 4.47 against the US dollar in March 2020. We expect more upside for the ringgit given that its real effective exchange rate (REER) is currently trading at one standard deviation below its 10-year mean. Several factors will likely be supportive of the ringgit against the US dollar going forward. This includes; (a) prospects of a weaker US dollar on the back of a slow US economic recovery that could translate into wider US twin deficits and relatively low US interest rates; (b) consistent economic recovery in Malaysia; and (c) steady crude oil prices. Ringgit volatility, especially following the recent sovereign rating downgrade by Fitch Ratings, will likely persist on concerns that include a) rising fiscal deficit and debt; and b) rising political uncertainty culminating in an early general election in 2021.

Chart 19: Policy rates in selected ASEAN countries

Sources: Respective central banks, CEIC, MARC Research

Chart 20: Ringgit REER



Sources: Bank of International Settlement (BIS), CEIC, MARC Research

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