Economic Research

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Malaysian Rating Corporation Berhad
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Macroeconomic Outlook Update: "V" for Variation

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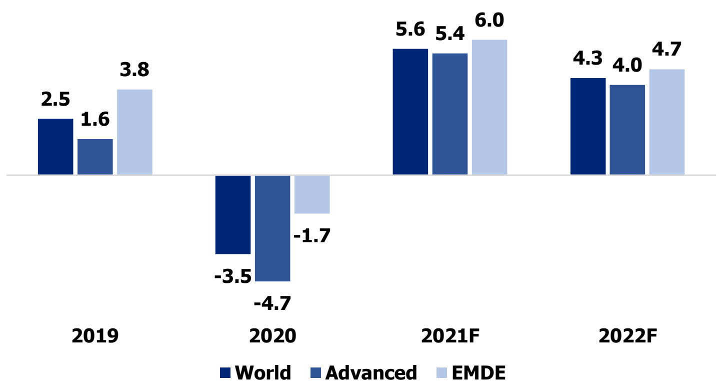
Chart 1: Global real GDP growth (% y-o-y)



Sources: World Bank, MARC Research

- The COVID-19 pandemic has driven the global economy to the trough of the economic cycle. MARC's 2021 Outlook report highlighted that the global economy would witness a V-shaped recovery in 2021, primarily driven by four main factors. One, the global economy will unlikely record another drop in output, or a double-dip recession, as countries begin to reopen their economies and manage resurgences of COVID-19 in a more structured/ targeted manner. Two, the low base effect will take place from both quarter-on-quarter and year-on-year perspectives. Three, a speedier resumption of economic activities correlates with the rate of vaccine deployment. And four, the rise of aggregate demand will pose risks to the stabilisation policy taken in 2020.

- Although a more robust 2021 economic growth is to be led by developing economies, as with any other fiscal year, almost all high-income countries would record a stronger rebound while low-income economies would be worse off than earlier estimates. The recent development strengthens the notion of unevenness in the global recovery. In 2020, the World Bank's baseline forecast estimated that the world economy would see a full-year contraction of 3.5%. Similar patterns were also recorded in advanced economies and emerging and developing economies (EMDE) at -4.7% and -1.7%. In contrast, the World Bank expects that the global economy will rebound at 5.6%, a difference of 1.5% from its January estimates, in 2021. The major drivers of the global economic growth will come from the United States (US) and China, where they would contribute about one-quarter of global growth in 2021. GDP growth in 2022, however, is forecast to moderate at 4.3% globally, 4.0% for advanced economies, and 4.7% for EMDEs.

- The International Monetary Fund (IMF) expects the global economy to record a contraction of 3.3% in 2020, which is 1.1% smaller due to the early easing of lockdowns. Still, it will rebound to 6% GDP growth in 2021 before moderating to 4.4% in the following year. The Organisation for Economic Cooperation and Development (OECD) forecasts a similar recovery trend with 5.4% growth in 2021 due to an upward revision from its earlier take (4.2%) six months ago.

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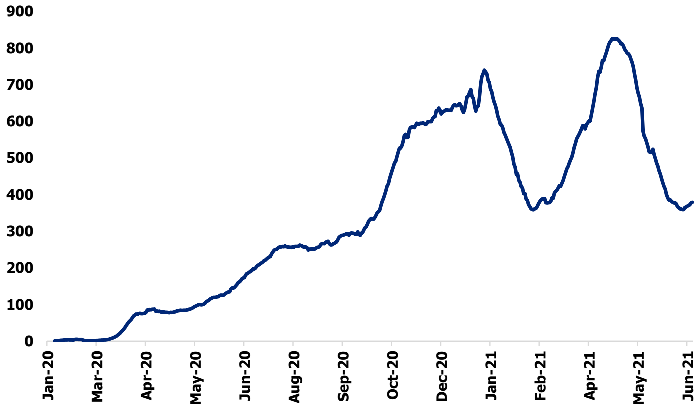
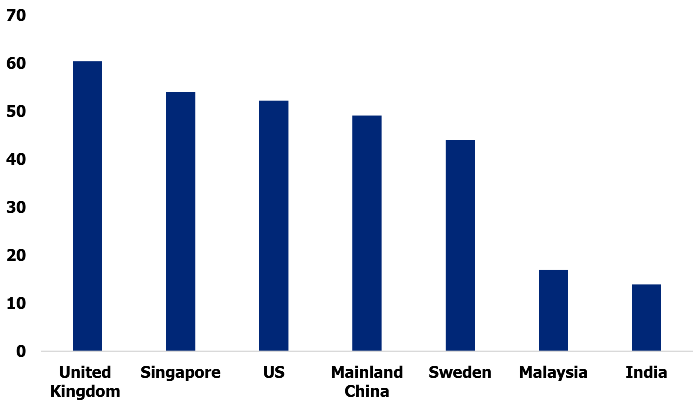
Chart 2: Global COVID-19 cases , 7-day moving average (person, thousand)



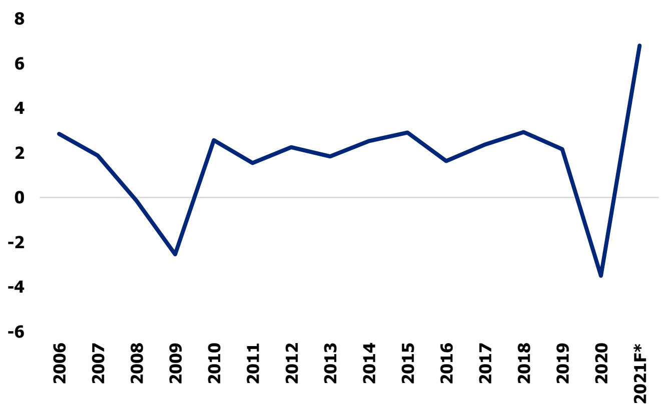
Sources: John Hopkins University, MARC Research

Chart 3: Vaccination rates by selected countries (% people covered by vaccines)



Sources: Bloomberg, MARC Research

Chart 4: US' real GDP growth (% y-o-y)



Sources: World Bank, MARC Research

- As more populations are gradually being vaccinated, this has prompted governments to reopen their economies. However, the supply of vaccines appears to favour wealthier countries. The recent trend creates a divergence and an uneven economic recovery between developed and developing economies. Additionally, uncertainties and challenges arise as new variants and mutations appear.

- Among EMDEs excluding China, the World Bank is projecting GDP growth of 4.4% in 2021, or a percentage point higher than its January 2021 projection, supported by the surges of external demand and higher commodity prices. Among the challenges EMDE countries face is the gradual withdrawal of government support that slows down the recovery phase. The pandemic will leave long-run scarring, for instance, skills corrosion due to being out of the workforce and education, especially in EMDE regions. The vaccination rollouts have been lagging in certain countries, which will badly affect businesses and individuals over time.

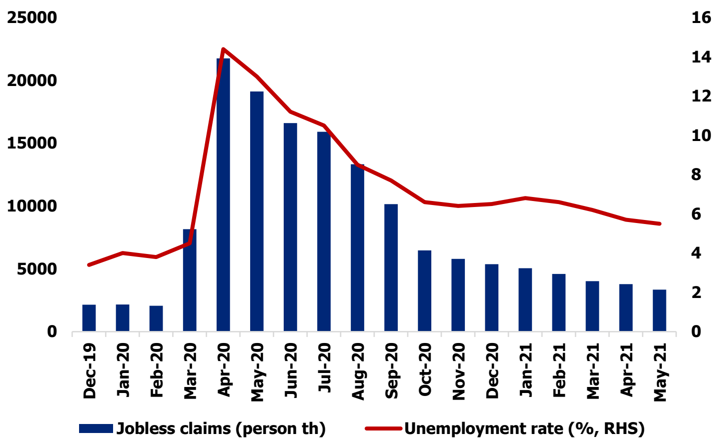
- As economies start reopening, the economic growth proportion will shift from investment to consumption. Some countries have also commenced mutual travel bubbles to boost the services sector, especially tourism and air travel which were significantly impacted in 2020 due to global mobility restrictions. However, due to the emergence of new COVID-19 variants, the travel industry may not return to its pre-pandemic levels in the immediate term.

- Therefore, we believe that the V-shaped narrative is intact but more highly uneven than anticipated. The pandemic will pull down the per capita incomes of developing and least developed countries away from that of developed countries, resulting in a sizeable income gap between rich and emerging nations. This scenario is primarily driven by the speed of resumption of economic activities and the size of fiscal response against lockdowns.

The US: Biden, a man with plans

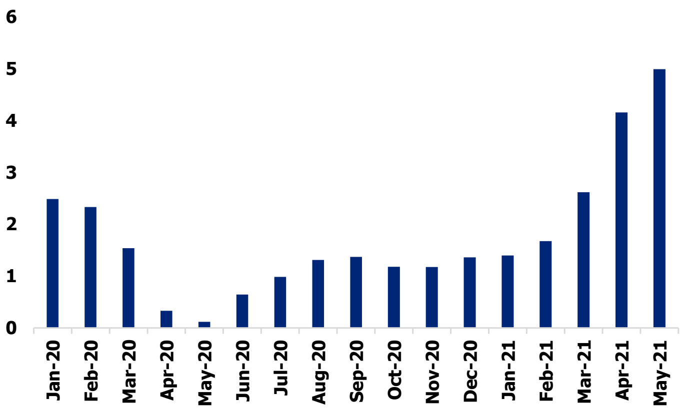
- The Biden Administration has done well to get the economy back on track. In 2021, the IMF is projecting US GDP growth of 6.4%, a massive upward review of 3.3% from its October 2020 projection. The OECD appears to take a more optimistic viewpoint to end the fiscal year with 6.9% GDP growth, aligning with the World Bank's projection of 6.8%. However, the US GDP growth in 2022 is expected to taper off to 3.5% and 3.6% respectively, but the World Bank is projecting a much higher output growth of 4.2%. It is worth noting that the latter's projection is the latest among the three multilateral institutions.

Chart 5: US' jobless claims and unemployment rate



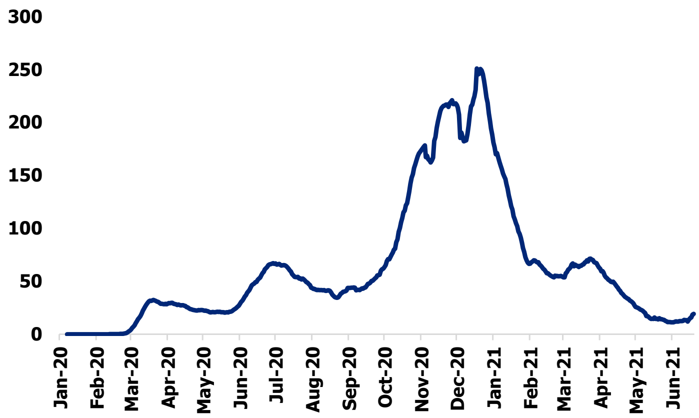
Sources: US Department of Labor, Bureau of Labor Statistics, MARC Research

Chart 6: US' Consumer Price Index (CPI) (% y-o-y)



Sources: CEIC, MARC Research

Chart 7: US' COVID-19 cases , 7-day moving average (person, thousand)



Sources: CEIC, MARC Research

- Much of the US recovery narrative is due to massive fiscal responses and a rapid vaccine deployment since 2H2020. In addition to the USD2.3 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act (2020), the USD868 billion Coronavirus Response and Consolidated Appropriations Act (2021) and the USD1.8 trillion American Rescue Plan (ARP) Act (2021) provided the necessary fiscal support to bolster private consumption. The US debt -to-GDP has spiked from 108% in March 2020 to 134% a year later, while its fiscal balance in 2020 recorded more than USD3.3 trillion amid stabilisation policies.

- These scenarios allowed the labour market to readjust swiftly, as seen in the massive drop in the unemployment rate from 11.1% in June 2020 to 5.9%, a year later. Jobless claims continue to fall from 18,748 persons per thousand to 2,308 in May 2021. Besides, news reports claim that employers struggle to find retrenched workers as the economy resumes, suggesting a tremendous rebound following the COVID-19 pandemic.

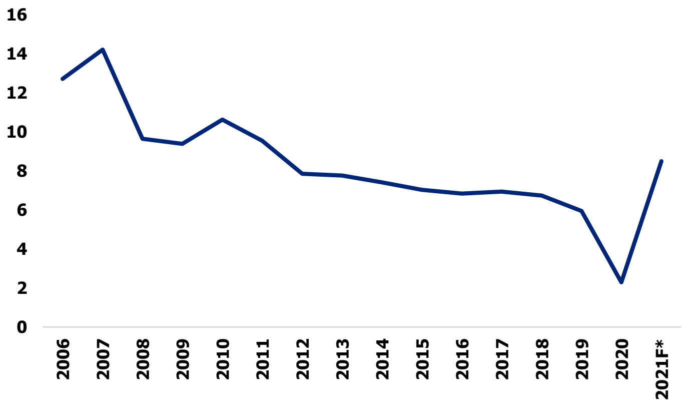
- US President Biden's Rescue Plan consists of three key policy plans. The American Jobs Plan (AJP) aims to boost job creation and domestic spending through infrastructure investments. The Made in America Tax Plan will solidify AJP to incentivise the corporate sector to invest domestically. The American Families Plan (AFP), however, is not part of the overall pandemic response but rather aims to promote a greater labour force participation and address caregiving responsibilities.

- In the near term, the key risk to growth is inflation. The steady rise in y-o-y CPI from 1.4% in January 2021 to 5% in May 2021, albeit transitory, is a concern if commodity prices remain elevated amid improvements in the overall global demand. This scenario raises concerns about interest rates normalisation, the earlier-than-expected tapering, and the overarching Tax Plan if both fiscal and monetary means are used to tame rising prices.

- Since almost 50% of Americans have received their second dose, together with the historic levels of government spending, the recovery path appears solid. Consequently, the number of COVID-19 cases reported has been declining, which eased mobility restrictions. The gradual reopening of the economy allows the people to heal from the economic scars quickly, thus, boosting their household income. With the pent-up demand in overall goods, the demand in tourism and air travels overshoot when many Americans are starting to go for vacations.

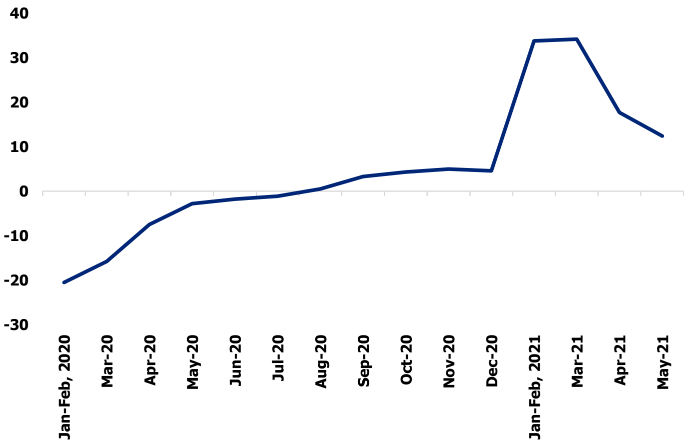
- Despite the dire fiscal metrics, we believe that the US recovery narrative is robust and will continue to perform well in the coming months. It is unclear as to how the US leadership will spill over to the global recovery at large. From the political perspective, we take it that the Democrats will march towards the 2022 US mid-term elections campaign on a solid footing and proceed with the ARP as intended.

Chart 8: China's real GDP growth over the years (% y-o-y)



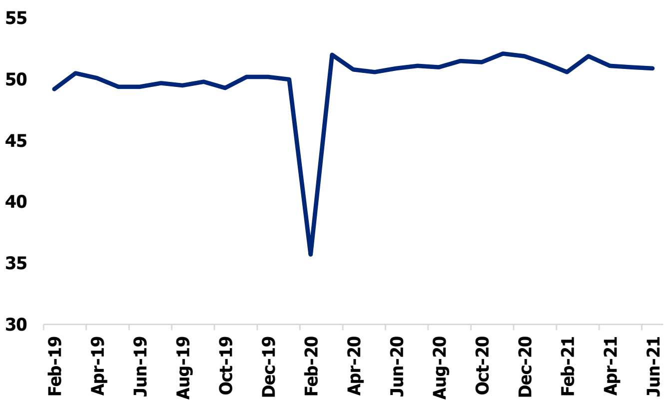
**Forecast by World Bank*
Sources: World Bank, MARC Research

Chart 9: China's retail sales of consumer goods (% y-o-y)



Sources: National Bureau of Statistics, MARC Research

Chart 10: China's Manufacturing PMI (%)



Sources: National Bureau of Statistics, MARC Research

China: Does "dual circulation" means people-first and slower growth?

- As widely expected, China was the only major economy that escaped a contraction in 2020, with y-o-y real GDP growth of 2.3%. In 2021, the IMF is projecting the Chinese economy to grow at 8.4%, or 0.2% higher than its January estimates. The World Bank and the OECD are forecasting similarly strong growth of 8.5%, which is also marginally higher than earlier projections by 0.6%. China recorded a strong rebound in its y-o-y 1Q2021 GDP growth of 18.3% following a deep contraction a year earlier. In the coming year, growth is expected to taper off, according to the IMF (5.6%), the World Bank (5.4%), and the OECD (5.8%).

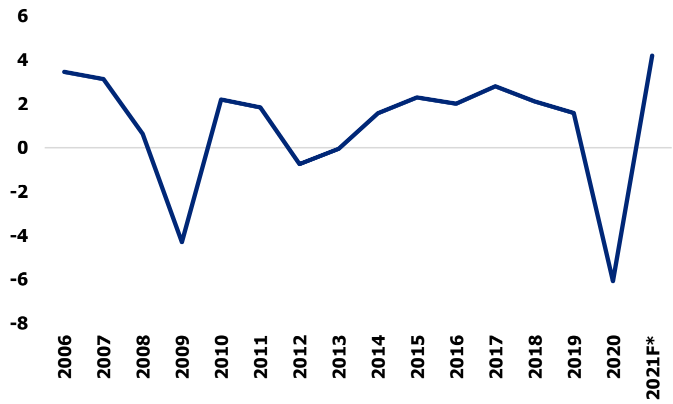
- Notwithstanding the robust outlook of the Chinese economy in the remaining period of the year, its 1Q2021 q-o-q(sa) growth came in much lower at merely 0.6%. Its quarterly performance also came in much lower than in the previous quarter of 3.2%. One possible explanation for this is the surge in its q-o-q(sa) imports from 7.3% in 4Q2020 to 32.7% in 1Q2021, leading to a narrow trade surplus of USD186.2 billion. Nevertheless, it was China's biggest trade surplus ever recorded in history.

- The main contributor to growth is the increase in private consumption, buttressing its "dual circulation" strategy. The retail sales of consumer goods in China, the major indicator of consumer demand, indicates an impressive growth. In May 2021, it recorded 12.4% year-on-year (y-o-y) growth. This denotes that consumer confidence continues to expand due to the government's harsh but highly effective pandemic control measures. The improvement in external demand boosts Chinese export growth to the European Union (EU), India, and ASEAN member states.

- The manufacturing sector has been showing expansion with the strengthening of the manufacturing base. The Manufacturing Purchasing Managers' Index of China has been steady at above 50 after experiencing a slump of 35.7 in February 2020. In addition, investment in fixed assets is on a laudable level of growth of 25.6% in the first quarter of 2021.

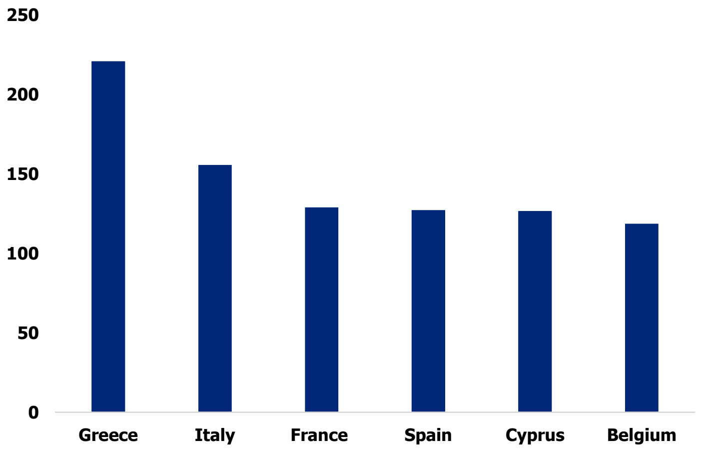
- During winter 2021, China's daily new confirmed COVID-19 cases spiked to low triple digits, but this was short-lived and numbers remained extremely low up to the time of writing. There has been zero COVID-19-related deaths throughout most of the year so far. As of June 15, 2021, 15.5% of the population have been fully vaccinated, whereas 43.2% have received the first dose of the COVID-19 vaccine. Due to its population size, China's daily vaccination doses administered per 100 people is currently the world's highest at 1.53 as of end-June 2021. Suffice to say, as far as COVID-19 containment measures are concerned, we firmly believe that the Chinese government's proactive response will stand the economy in good stead in the event another variant emerges or a resurgence were to take place in the remaining months of the year.

Chart 11: European Union's (EU's) real GDP growth (% y-o-y)



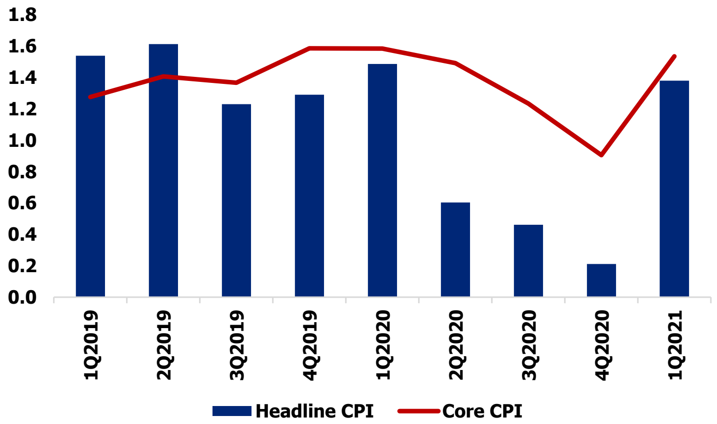
**Forecast by World Bank*
Sources: CEIC, MARC Research

Chart 12: 2020 Debt-to-GDP in selected EU countries (%)



Sources: CEIC, MARC Research

Chart 13: EU's headline and core CPI (% y-o-y)



Source: CEIC, MARC Research

The European Union: All good, for now

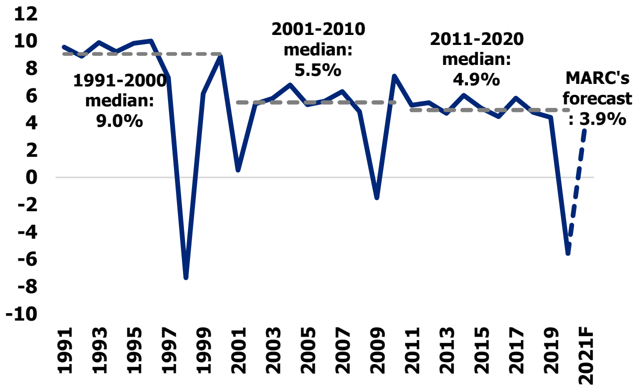
- The European Union (EU) recorded the deepest contraction in history of 6%, whereas the euro zone suffered a 6.6% contraction in 2020. Compared to its January projections, the IMF expects the euro area to rebound with a marginal increase of 0.2% to 4.4% GDP growth in 2021. Both the World Bank and the OECD have also revised their projections upwards to 4.2% and 4.3%, respectively. The three multilateral institutions expect the euro area to grow between 3.8% to 4.4% in 2022. Meanwhile, the EU's 1Q2021 q-o-q(sa) stood at -0.14%.

- Much of the region's recovery is debt-led, where it spiked from 77.59% in 2019 to its highest level of 90.07% a year later. Belgium, Cyprus, France, Montenegro and Spain have seen their debt-to-GDP breach the 100% level while Greece surpassed the 200% level and remains the most indebted nation in the region. Italy saw its debt grew more than 20% within the same period to 155.81%. Debt has always been the EU's long-standing problem due to the disconnect in monetary and fiscal priorities, and this is expected to be prolonged in the foreseeable future.

- The recent wave of COVID-19 cases did not result in a similar catastrophe as the first wave did in 2020. The number of daily positive cases per million people dropped significantly in 1Q2021 from 397.37 to 28.78 cases as of end-June 2021. The fatality rate has been trending sideways around 2.5% amid the steadily increasing share of the population already administered with one dose or having been fully vaccinated since the beginning of the year. We take it that the emergence of the COVID-19 Delta variant may prompt governments to put their economies under lockdown but this is unlikely to affect the region as it did in 2020.

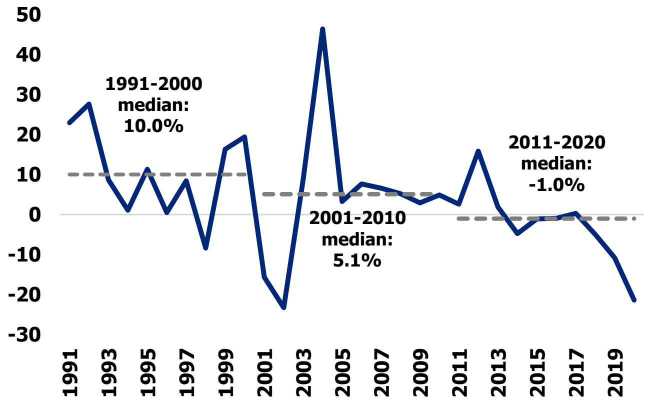
- We believe that it is challenging to ascertain the true impact of Brexit on the EU (and the euro area) economy, which has been masked in recent quarters by the pandemic. Inflation increased from 0.21% in 4Q2020 to 1.38% in 1Q2021 amid the low base effects and higher commodity prices. We note the spike in the debt metrics, which is justifiable in light of the efforts in fighting the pandemic, but this will likely impact the region's long-term growth prospects. Furthermore, it does not help that high debt countries view the low-interest rates environment as a means of relieving fiscal pressure instead of reducing debt.

Chart 14: Malaysia's real GDP growth (% y-o-y)



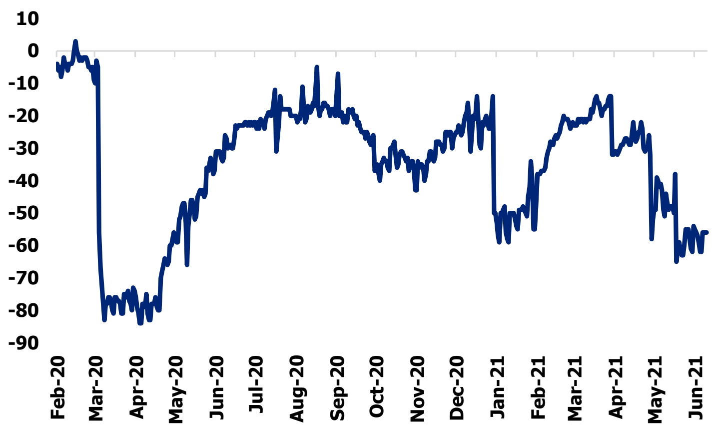
Sources: Department of Statistics Malaysia (DOSM), MARC Research

Chart 15: Malaysia's private investment (% y-o-y)



Sources: DOSM, MARC Research

Chart 16: Malaysia's Google mobility retail and recreational



Sources: Google LLC, MARC Research

Malaysia: rebound faces strong lockdown headwinds

- MARC's January 2021 GDP growth forecast for Malaysia came in at 6.4%. Since then, back-to-back mobility restrictions have prompted us to shave off our earlier forecast to 3.9% y-o-y for 2021, which is even lower than the previous review of 5.1%. This implies that the economy will perform 2% below the pre-pandemic level this year. We expect the economy to recover to pre-pandemic GDP levels only in late 2022, or even later if mobility restrictions were to continue as is.

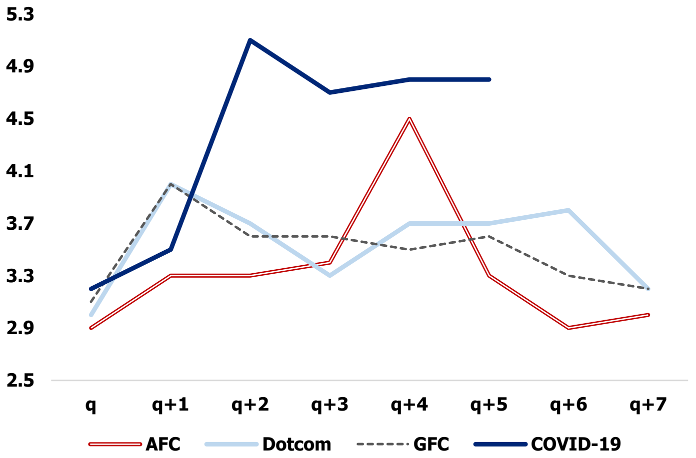
- The increase in testing capacity pushed the number of positive COVID-19 cases higher, prompting a nationwide Full Movement Control Order (FMCO) starting June 1, 2021. The longer-than-planned nationwide lockdown is set to weaken prospects for recovery further, with more significant economic scarring arising from increased insolvencies and higher retrenchments. These, coupled with looming political uncertainties, will see business and consumer sentiment deteriorate even further, undermining discretionary spending and investment.

- We foresee a q-o-q double-dip contraction following the latest MCO. Nevertheless, a repeat of 2Q2020, where the first nationwide lockdown or Movement Control Order (MCO) 1.0 plunged the economy into deep contraction (-17.2%), is unlikely. We believe that the economic slump in 3Q2021 to be less severe than in 2Q2020 due to the following considerations: i) more sectors are allowed to operate compared with MCO 1.0; ii) businesses bank on past experiences in adapting to the lockdown; and iii) exports are more supportive, given sturdy commodity prices and our major trading partners already being on the recovery path.

- Moving forward, Malaysia's growth outlook is solely dependent on how stringent mobility restrictions are. According to the recently announced National Recovery Plan (NRP), the government aims to reduce the number of daily positive COVID-19 cases to below 500 and achieve a 60% inoculation rate before allowing a full reopening of the economy in November or December 2021. However, we believe that the target is ambitious given the vaccine supply constraints and the lack of explanation of how the number of positive cases could be reduced in the future. At the time of writing, only 11.3% of the population is fully inoculated, which is still far behind the target.

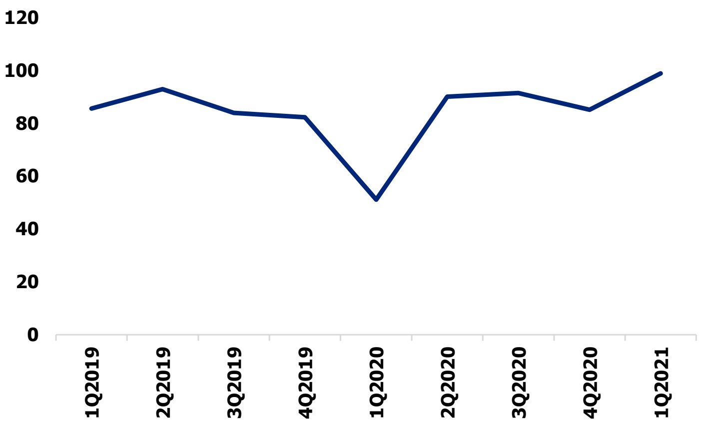
- Private consumption, the main driver of economic growth, will be hard hit in the near term due to the strict lockdown measures such as the closure of non-essential services. The latest Google Mobility data show footfalls to retail and recreation have dropped by more than 50% during FMCO compared with pre-pandemic levels, which is only slightly smaller than the declines seen during MCO 1.0.

Chart 17: Malaysia's unemployment rate (% y-o-y)



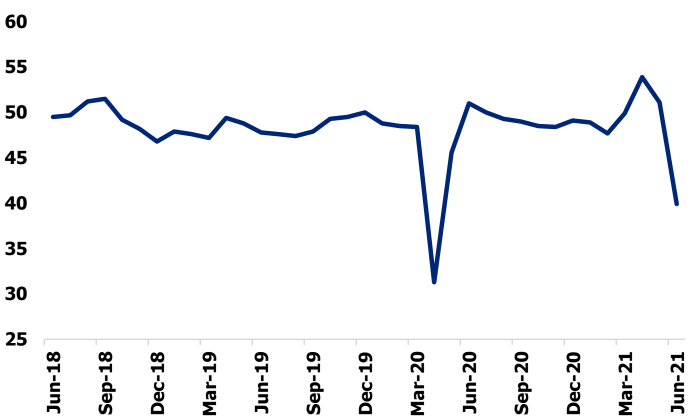
Note: q denotes quarter
Sources: DOSM, MARC Research

Chart 18: Consumer sentiment index (cut off point=100)



Sources: Malaysian Institute of Economic Research (MIER), MARC Research

Chart 19: Malaysia's Manufacturing PMI



Sources: Bloomberg, IHS Markit, MARC Research

- The ominous labour market has deeply impacted consumer confidence. Notably, the unemployment rate could see an uptick in the coming months and remain elevated for the rest of the year. As such, we predict the unemployment rate to rise to 4.7% in 2021 (2020: 4.5%). Nevertheless, the government's extensive support measures, such as cash aids, loan moratorium, wage subsidies, and income loss assistance, could help cushion the pandemic's impact on consumer spending.

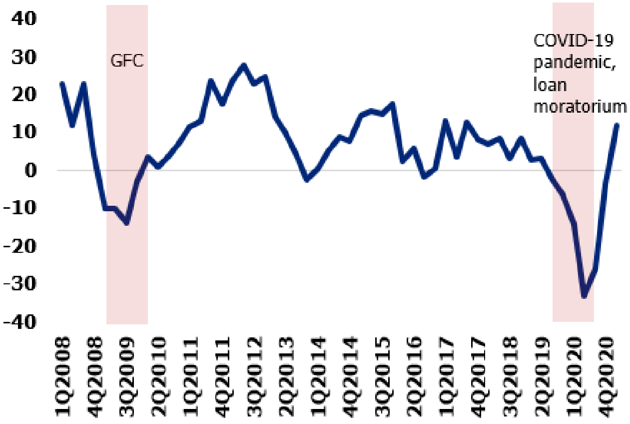
- While we expect a quick rebound in private consumption once mobility restrictions are lifted due to pent-up demand, the recovery will likely be uneven given the economic scarring. Disparities between higher and lower-income cohorts have been widening. Spending by low-income households, which experienced higher job and income losses, will likely remain below pre-pandemic levels for a more extended period, especially when stimulus support expires.

- Despite a convincing 1Q2021 GDP performance, businesses have been grappling with persistent supply chain disruptions and falling domestic demand since MCO 1.0. The challenging business operating environment would push firms to delay or even cancel their investment decisions. It does not help that some quality foreign direct investments (FDI) bypassed Malaysia and instead made a beeline towards our regional neighbours. Ongoing political uncertainties, in addition to the pandemic, have shaken FDI confidence. These are critical lost opportunities that Malaysia can ill-afford given their potential as, among other things, new sources of growth, as well as drive a high-productivity recovery. The newly approved National Investment Aspirations (NIA) framework could be one good initiative, but we believe it lacks the bite to attract quality investments.

- The manufacturing sector, which has been a significant contributor to the economic recovery, would be affected by the 60% capacity restriction imposed among the strict lockdown measures. IHS Markit manufacturing PMI has fallen to 39.9 in June 2021 after a record high of 53.9 in April 2021 and maintaining value at above 45 in the first five months of 2021. In parallel to the potential reduction in manufacturing output, export growth will likely reduce in the coming months.

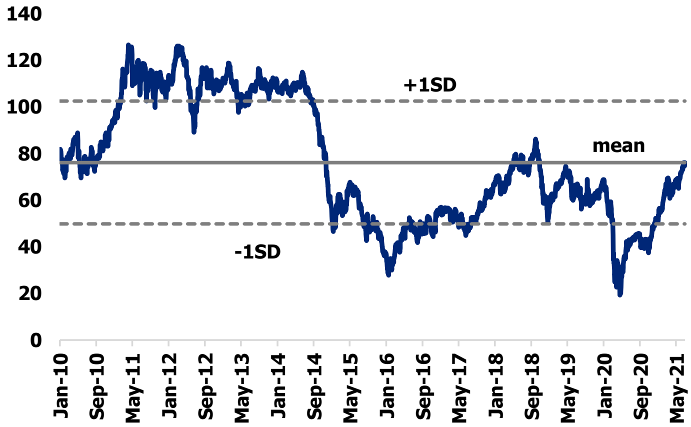
- Small and medium-sized enterprises (SMEs) are likely more vulnerable to a prolonged lockdown given their limited financial capabilities. The government has taken note of this and introduced a range of measures including targeted repayment assistance, wage subsidies, tax deferrals, and additional grants to mitigate cash flow shortages and looming insolvencies. Digitalisation and automation offer a way out of the crisis, but progress has been slow due to SMEs' limited access to funding. More importantly, SMEs run primarily on a low-cost model, so the take-up rate is not of great interest.

Chart 20: SME Loan repayment (% y-o-y)



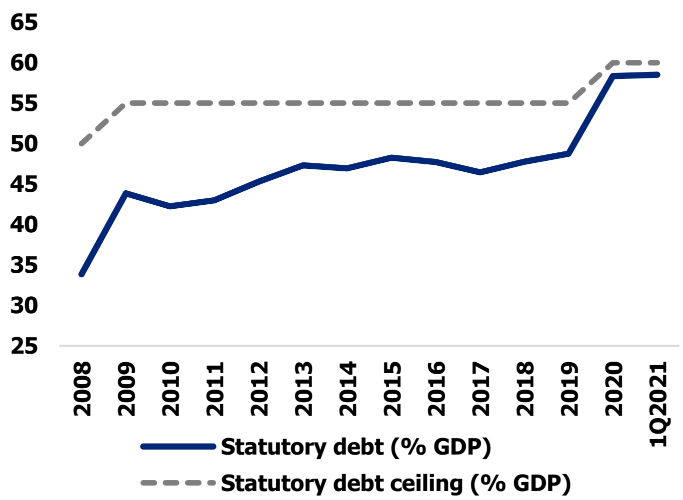
Sources: Bank Negara Malaysia (BNM), MARC Research

Chart 21: Brent crude oil price (USD per barrel)



Sources: Bloomberg, MARC Research

Chart 22: Malaysia's statutory debt (% GDP)



Sources: Ministry of Finance (MOF), MARC Research

- Given the changing economic landscape due to the pandemic, we believe that it is sensible for the government to revise its Shared Prosperity Vision 2030 (SPV2030) targets to safeguard its competitiveness and relevance in the global economy. However, due to the delayed announcement of the 12th Malaysia Plan, it is unclear how the SPV2030 will be mainstreamed into existing policies to push for economic growth and development in the long term.

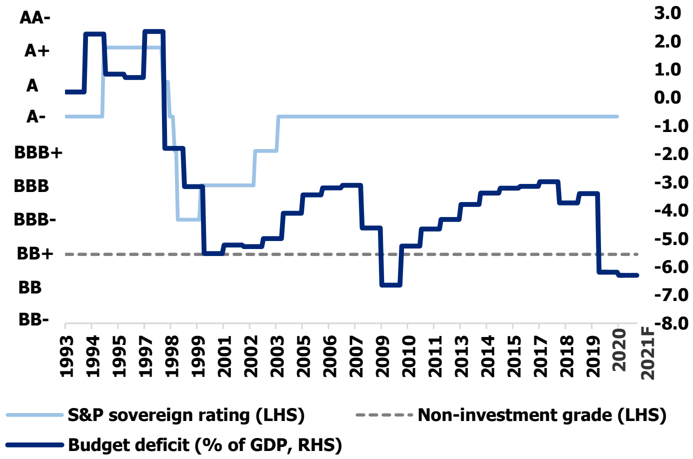
- Given the significant revenue shortfalls and rising expenditures to finance various stimulus packages, the fiscal deficit will likely breach the current target set by the government of 6.0% of GDP in 2021. Instead, we anticipate the fiscal deficit to come in at 6.3% of GDP. Including the PEMULIH package, the total stimulus packages amount to RM530.0 billion (37.4% of GDP) thus far, of which RM87.6 billion (6.2% of GDP) constitute direct fiscal injection. We believe that more fiscal support could still be forthcoming, albeit in smaller sizes amid the increasingly constrained fiscal space, until the recovery path is clear.

- Notwithstanding this, the rally in global crude oil prices by more than 40% since the beginning of this year could help ease some of the fiscal pressure. We expect the Brent crude prices to record an average of around USD65 per barrel in 2021 (2020 average: USD43 per barrel). Studies have estimated that a USD1 increase in Brent crude oil price will increase Malaysia's fiscal revenue by around RM365 million.

- The narrowing policy space and limited fiscal resources could push the government to temporarily raise the self-imposed statutory debt ceiling again, this time to 65%. Even if the government could avert this, the raising of the statutory debt ceiling to 60% of GDP will likely remain in place even after end-2022.

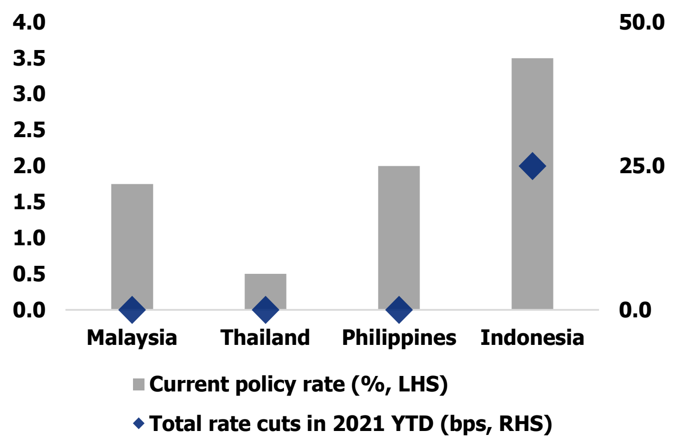
- Given the deteriorating economic and fiscal metrics, we see a higher risk of a rating downgrade by another international credit rating agency; S&P's A-rating on Malaysia has a negative outlook. Having said that, a sovereign rating downgrade may not necessarily be translated into lower overall economic sentiment/confidence per se throughout a historically low interest rate environment. It will mean that Malaysia is no longer the second highest-rated ASEAN member state after Singapore.

Chart 23: Credit rating and budget deficit



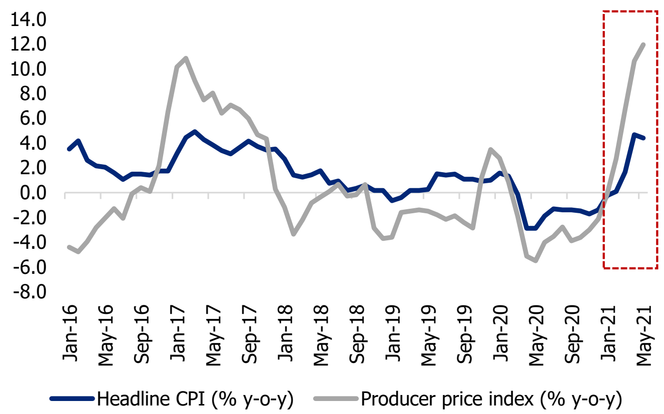
Source: MARC Research

Chart 24: Policy rates in selected ASEAN countries



Source: Bloomberg, MARC Research

Chart 25: Malaysia's headline CPI and producer price index



Sources: DOSM, MARC Research

- As the current monetary stance remains adequately accommodative, we opine that Bank Negara Malaysia (BNM) will continue to retain the overnight policy rate (OPR) at a historical low of 1.75%. Lowering the current OPR will result in banks being more cautious in lending money, more so given the recent announcement of an automatic repayment moratorium. If this happens, it will impact the working capital of businesses, especially SMEs.

- In any case, monetary policy is a blunt policy tool. Rigorous fiscal policy is more plausible than monetary policy during a low interest rate environment. Expansionary fiscal policy remains the primary vehicle to boost and accelerate economic growth. Wider vaccinated populations will allow for greater mobility and the opening of economic activity. The resumption of economic activities is the only silver bullet that will improve the country's economic performance in the remaining months of the year.

- Headline consumer prices (CPI) have been in the positive area since March 2021. We forecast that inflation in 2021 will come in at 3% after experiencing a deflation of 1.1% last year. The upward movement in oil prices pushes the prices compared to 2020 where oil was cheaper. Hence, this also affects logistics cost and adds pressure to prices of essential goods. The total lockdown will result in supply-side inflation as production is lower than the available capacity, exacerbating recovery prospects along the way.

- Discounting the volatile price movement in food and energy, we expect the core inflation to remain muted due to lacklustre demand. Considering that lockdowns have driven up the unemployment rate and forced businesses to operate below capacity, the demand side will continue to be bland and dull.

- The outlook on the ringgit has weakened following the implementation of FMCO. The current position of the ringgit is still low compared to the appreciating trends of the ringgit in April 2020. The uncertainties surrounding the pandemic remain the major hurdle to ensuring the recovery of Malaysia's economy. Additionally, looming political tensions weaken the ringgit further as steps taken to retain political stability remain highly contested. The strong US recovery is another determining factor of a weaker ringgit against the USD. However, we believe that the ringgit's decline will be limited due to sturdy crude oil prices.

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