MALAYSIA

PRIORITY ON FISCAL SUPPORT

Malaysia is one of the emerging Asian countries hit hardest by the Covid-19 crisis. Although a recovery is underway, it is bound to be hampered by new lockdowns in Q4 2020 and January 2021. Public finances have deteriorated sharply, but the government does not seem inclined to pursue fiscal consolidation. It is giving priority to the economic recovery and support for the most fragile households. The public debt ratio will continue to deteriorate, and in December, the rating agency Fitch downgraded Malaysia's sovereign rating. Yet refinancing risks are moderate: the debt structure is not very risky and the country has a large domestic bond market. Malaysia will continue to report a current account surplus and has a solid banking sector.

DEEP ECONOMIC CONTRACTION IN 2020

Malaysia's economy was hard hit by the coronavirus pandemic. From a health perspective, although Covid-19 did not hit the country nearly as hard as Indonesia and the Philippines, the situation is much worse than in Thailand, South Korea or Vietnam. In March 2020, the government imposed severe shelter-in-place restrictions throughout the country. These restrictions were partially lifted in mid-May, but were tightened again in Q4 2020 and in January 2021 after a surge in the number of new cases. Looking beyond the decline in domestic demand due to the general lockdown of the population, the Malaysian economy – which is highly integrated in world trade – was hard hit by the disruption in global supply chains, the collapse of tourism revenues and the decline in commodity prices. Nonetheless, its external accounts are still solid: at year-end 2020, foreign exchange reserves and the ringgit (MYR) were close to year-end 2019 levels, and the country is expected to report a current account surplus.

In the first three quarters of 2020, real GDP contracted by 6.4% compared to the same period in 2019. Economic activity rebounded strongly between June and September, especially thanks to an upturn in exports, before slowing again in October and November, under the impact of tighter lockdown restrictions. In November, industrial output was 2% below the year-end 2019 level. In full-year 2020, real GDP is expected to decline by 5% compared to 2019.

In 2021, economic growth prospects are looking strong, even though the new lockdown is bound to slow the recovery and the vaccination campaign will not begin before February 2021. Looking beyond a favourable base effect, domestic activity will get a boost from an expansionist fiscal policy that is geared towards helping the most fragile households and increasing public investment. Export activity should remain buoyant as well, bolstered by the rebound in global trade and the electronics market.

To reach its medium-term objective of becoming a high-revenue country by 2023, the government will have to pursue structural reforms to raise productivity growth, which has declined over the past several years. To achieve this, it must increase the level of training and education of workers and improve the business environment to make the economy more propitious for domestic and non-resident private investment, which has been declining since 2018. Yet the government has only a slim majority in parliament, which is not good news for reforms. New elections will also have to be held, as soon as the health situation improves enough for them to be safe.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	4.3	-5.0	7.5	3.9
Inflation (CPI, year average, %)	0.9	-1.2	-0.3	1.0
General Gov. balance / GDP (%)	-3.4	-6.9	-5.6	-4.5
General Gov. debt / GDP (%)	52.5	61.3	63.0	64.7
Current account balance / GDP (%)	3.4	4.0	2.0	2.1
External debt / GDP (%)	62.6	66.5	66.0	65.5
Forex reserves (USD bn)	97	98	98	98
Forex reserves, in months of imports	5.7	6.2	5.7	5.6
Exchange rate USDMYR (year end)	4.1	4.1	4.1	4.1

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INDUSTRIAL OUTPUT

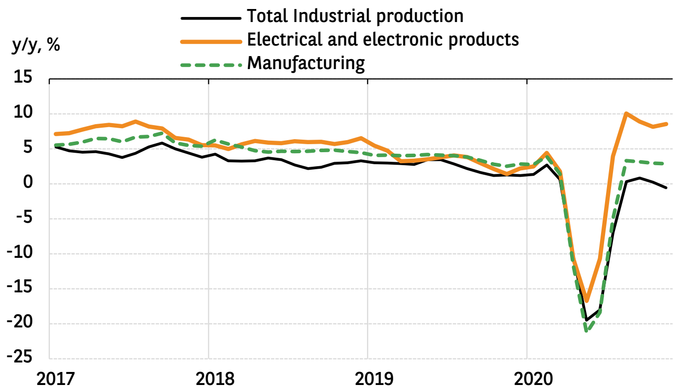

CHART 1 SOURCE: CEIC

EROSION OF PUBLIC FINANCES: WHAT ARE THE RISKS?

Public finances began to deteriorate well before the Covid-19 crisis. In 2018, government revenues (excluding exceptional dividends) began to decline after the newly elected government eliminated the tax on goods and services.

Meanwhile, its dependence on oil revenues increased considerably, and oil revenues accounted for 39% of total revenues in 2019. The new government also followed a much more expansionist fiscal policy. Whereas government expenditures had declined by 5.3 points of GDP in the period 2013-17, they rose by 1.6 points of GDP over the next 2 years to 20.9% of GDP. The increase is mainly due to higher social welfare spending.

In the first 11 months of 2020, government revenues contracted 21.6% in keeping with the downturn in economic activity and the contraction in oil revenues. Spending was reduced by 10.1% thanks to cutbacks in investment spending while sparing social welfare spending. The central bank bore most of the brunt of the support package for households and small businesses. At the end of November 2020, the fiscal deficit had risen by more than 65.6% compared to the same period in 2019. The full-year deficit is expected to swell to nearly 7% of GDP (up from 3.4% of GDP in 2019).

At the same time, the federal government's debt-to-GDP ratio is expected to rise by nearly 9 points to more than 61%. After integrating all of the government-backed guarantees as well as the debt pertaining to 1MDB, total public debt could rise to nearly 88% of GDP at year-end 2020 (up from 77.4% of GDP in 2019).

The government does not seem to be inclined to consolidate the fiscal situation significantly in 2021. It continues to give priority to the economic recovery and to the support oflow-income households. In the 2021 budget that parliament approved in December, the government plans to reduce the fiscal deficit by only 0.6 points to 5.4% of GDP (vs 6% of GDP in the revised 2020 budget). Government spending should remain high (20.5% of GDP) while fiscal revenues, which are still highly dependent on oil, are unlikely to exceed 15.1% of GDP, even though growth is forecast at between 6.5% and 7.5%. The government does not plan to reduce the fiscal deficit to pre-Covid levels even by a horizon of 2022-2023, when it will still amount to about 4.5% of GDP.

These projections do not seem to be very compatible with the target of reducing the federal deficit below the threshold of 55% of GDP by 2023. By then, the federal debt-to-GDP ratio could exceed 65%. Yet refinancing risks are moderate, even though they have been on the rise, as illustrated by Fitch's downgrade of Malaysia's sovereign rating to BBB-.

The interest charge on government debt accounted for only 12.5% of government revenues in 2019, and according to the government, they should rise to only 15.1% in 2021. The cost of financing is still low. In December 2020, 10-year government bond yields were only 2.7% (down from 3.3% in the year-earlier period). Moreover, nearly 97% of government debt is denominated in the domestic currency and is still held primarily by residents (non-residents held 21.8% of debt in Q3 2020). Malaysia has a key advantage over countries like Indonesia: with its highly developed financial markets, the government is able to issue domestic debt easily.

A SUFFICIENTLY SOLID BANKING AND FINANCIAL SECTOR

Malaysia has a solid banking and financial sector. It is in a position to face up to the deterioration in the financial situation of economic agents, the downturn in the real estate market and the increase in credit risk triggered by the Covid-19 crisis.

ECONOMIC RECOVERY DRIVEN BY EXPORTS

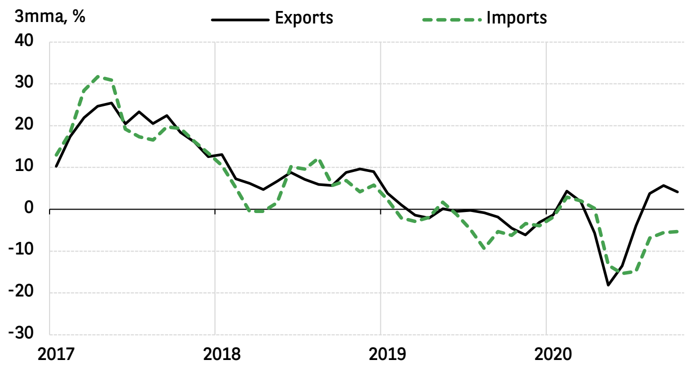

CHART 2 SOURCE: CEIC

Yet companies, already heavily in debt, were hard hit by the Covid-19 crisis after being weakened by the 2019 economic slowdown. In Q2 2020, corporate debt swelled to 108.1% of GDP. Although corporate profits declined, they still covered interest charges by 3.7 times in mid-2020 (down from 4.8 times at year-end 2019).

The household situation has also deteriorated. Household debt rose to 87.5% of GDP in Q2 2020, although it was largely offset by financial assets, the value of which still amounted to 190% of GDP in Q2 2020. Liquid assets still covered household debt by 1.4 times in mid-2020.

As in many other emerging countries, households and corporates benefited from a 6-month moratorium on loan payments between April and September 2020. Moreover, at the end of September, the most fragile households and small businesses could request debt restructuring for a period of 6 months. To prepare for the expected increase in credit risks, banks sharply increased their provisions, which strained profitability. Although ROA and ROE both declined, they still held at 1.2% and 10.1%, respectively, in Q3 2020. According to the central bank, 60% of household loan defaults will occur in H2 2021, and the doubtful loan ratio could rise to 4.1% at year-end 2021, up from 1.4% in Q3 2020. At the end of October, banks had sufficient capital to face up to this situation, with a capital adequacy ratio of 18.4%. Liquidity is also abundant, with a liquidity coverage ratio of 153% at the end of October.

Completed on 11 January 2021

Johanna MELKA
johanna.melka@bnpparibas.com