MALAYSIA

RISING FISCAL RISK

Although the political situation has stabilised somewhat following the appointment of a new prime minister, the economic environment has deteriorated. The spread of the Covid-19 pandemic in April forced the government to reintroduce lockdown measures that led to an economic contraction in Q2 2021. The situation is unlikely to improve before Q4, once health restrictions are lifted thanks to an accelerated vaccination campaign. In an attempt to boost growth, the government launched a series of economic support plans, even though fiscal revenue fell short of the full-year target in the first seven months of the year. Consequently, according to the Ministry of Finances, the fiscal deficit is expected to swell to between 6.5% and 7% of GDP, and it is likely to hold well above the pre-pandemic level over the next two years. The government announced that it would ask parliament to raise the debt ceiling in October. Even though the central government can easily access financing on the domestic market, it must face up to a structural decline in fiscal revenues and higher interest charges.

REAL GDP CONTRACTS IN Q2 2021

After reporting a contraction of 5.6% in 2020, Malaysian economic growth is likely to be much milder than initially expected this year. The recovery was cut short by a resurgence of the pandemic within a population with a low vaccination coverage ratio.

Malaysia was hard hit by the most recent wave of the Covid-19 pandemic, which began in April and peaked in June. The government reintroduced health restrictions in May, including the shutdown of non-essential businesses and restrictions on inter-regional travel. These measures were stepped up in June with the shutdown of companies in certain sectors and the reduction of workforce capacity to a maximum of 60% in the sectors still allowed to operate despite the pandemic. This triggered a sharp decline in domestic demand and an increase in the unemployment rate (+0.3pp to 4.8% in June). As a result, seasonally-adjusted economic activity contracted 2% in Q2 2021, compared to the previous quarter. Household consumption and corporate investment declined 10.7% and 7.5% q/q, respectively, while exports were still buoyant.

Economic growth in Q3 was impacted by the health restrictions that were still in place in the majority of States in July and August, including Kuala Lumpur and Johor, which together account for 26% of GDP. Industrial output contracted 6% in July compared to the previous month. Retail sales rebounded slightly compared to the month of June, but were still lower than the Q2 figure. The wholesale sector continued to decline. According to the PMI survey, industrial activity contracted again in August for the third consecutive month, even though PMI rebounded slightly to 43.4 (well below the 50 threshold that separates expansion from contraction).

Yet with the acceleration in the vaccination campaign (nearly 63% of the population had been vaccinated at the end of September 2021, compared to less than 1% in early April), health restrictions have been eased, raising hopes for a significant rebound in household consumption in Q4 2021. In full-year 2021, growth is expected to reach 4.1% according to the consensus forecast of economists.

THE DEBT CEILING IS RAISED FOR THE SECOND TIME SINCE THE OUTBREAK OF THE HEALTH CRISIS

Public finances have deteriorated sharply. In full-year 2020, the fiscal deficit swelled to 6.2% of GDP, compared to an average of only 3.3% over the period 2015-2019. Despite swinging back into growth in 2021, public finances could deteriorate further this year. In June, the Ministry of Finance raised its deficit target from an initial 5.4% of GDP to 6.5-7% to take into account the slowdown in growth due to the second wave of the pandemic and fiscal support measures.

In the first eight months of 2021, fiscal revenue had reached only 58% of the full-year target, even though the government had set a particularly low target this year (15.1% of GDP, compared to an average of 17% in 2015-2019).

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	4.4	-5.6	4.1	5.6
Inflation (CPI, year average, %)	0.9	-1.2	2.3	0.4
General Gov. balance / GDP (%)	-3.4	-6.2	-6.1	-3.8
General Gov. debt / GDP (%)	52.4	62.1	66.3	67.9
Current account balance / GDP (%)	3.5	4.2	3.1	3.0
External debt / GDP (%)	62.6	67.6	73.2	74.0
Forex reserves (USD bn)	100	100	104	106
Forex reserves, in months of imports	5.7	6.2	5.7	5.6

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

ACTIVITY INDICATORS

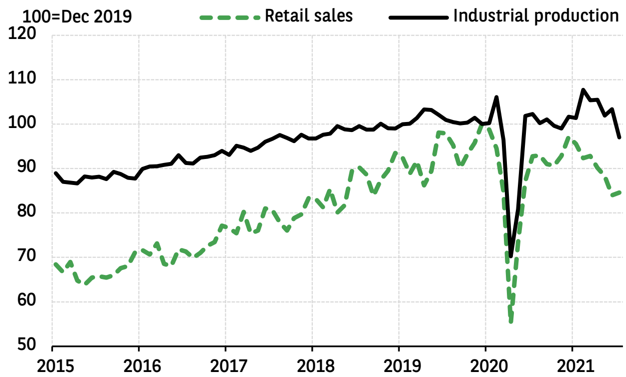

CHART 1

SOURCE: CEIC

This decline can be attributed to the absence of an exceptional dividend pay-out by Petronas, which accounted for 4.4% of revenue in 2020 (0.7% of GDP). The government is seeking to reduce its dependence on oil revenue, which has risen sharply since the elimination of the goods and services tax in 2018.

Although the government initially planned to increase fiscal spending by 1.1 percentage points (pp) compared to 2020, the full-year target of 20.5% of GDP had already been surpassed in the first eight months of the year. The government's initial budget called for pandemic-related expenses of more than 1% of GDP. But with the pandemic's spread and the introduction of lockdown measures, this figure had to be adjusted upwards. Between March and June 2021, the government announced the adoption of four supplemental fiscal programmes for a total value of MYR 225 bn (16% of GDP), although the direct impact on the budget should be limited to only 2% of GDP.

In the first eight months of the year, the deficit was almost entirely financed via the domestic market. The government did not have the least difficulty in issuing bonds, even though interest rates have risen since the beginning of the year (10-year bond yields rose 50 basis points in the first eight months of the year).

Under this environment, the debt-to-GDP ratio continued to deteriorate in H1 2021. The federal government's debt (excluding state-backed guarantees and 1MDB's debt) swelled to 64.3% of GDP in Q2 2021 (62% of GDP according to the definition used by parliament to calculate the debt ceiling), which is 12 pp higher than at year-end 2019. After including all contingent liabilities, we estimate the total public debt at 91.3% of GDP.

Since the debt ratio is higher than the legal threshold of 60% of GDP (using parliament's definition), the government will ask parliament to raise the debt ceiling by 5 pp to 65% of GDP in October, for the second time since the outbreak of the Covid-19 crisis. On the same occasion, the government will present its 2022 budget. It plans to continue pursuing an expansionist fiscal policy to offset the impact of the Covid-19 pandemic. Once again, the consolidation of public finances will have to wait. So far, the government has had no trouble covering its financing needs. Given the abundance of funding on the local domestic market, the government does not need to issue bonds on the international markets. At the end of June 2021, residents held nearly 76% of government debt, which was denominated almost exclusively in the local currency. In contrast, the increase in the interest charge since 2018 is a source of concern, because it reduces the government's manoeuvring room to support the economy. In the first six months of the year, the interest charge accounted for 17% of revenues (compared to only 11% five years earlier).

TOWARDS A LESS STABLE POLITICAL SITUATION?

The political situation has been unstable since the 2018 elections: the ruling coalition is comprised of several small parties and can only claim a very slim majority in parliament. The resignation of Prime Minister Mahathir Mohamad in February 2020 only increased the instability. Appointed by the king to replace Mahathir Mohamad, Muhyiddin Yassin was eventually forced to resign in August 2021, after 18 months of political tension in the midst of a health crisis, because he had lost the support of part of the United Malay National Organisation (UMNO).

On 20 August, Ismail Sabri Yaakob was named Prime Minister, which should restore some stability, at least in the short term. Although this appointment marks the return of the UMNO (directed by Anwar Ibrahim), the ruling political party between 1957 and 2018, the new prime minister will still have only a very small parliamentary majority (114 seats out of 220). To continue to adopt economic support measures, the prime minister just signed a protocol agreement with the main opposition party, the Pakatan Harapan (HP), which has 88 seats. The agreement covers the fiscal support package but also judicial independence and parliamentary reform. Such an agreement should help ensure some stability, at least over the next several months. The next elections are scheduled for 2023, but we cannot rule out the possibility that early elections will be called in the meantime.

PUBLIC FINANCES

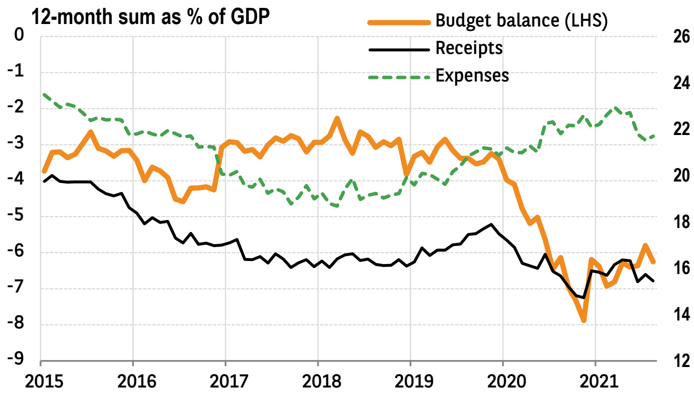

CHART 2

SOURCE: MOF, CEIC

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