BNM Economic & Monetary Review 2022

Growth to slow in 2023 amid external challenges, policy to remain accommodative

Summary

- Bank Negara Malaysia (BNM) forecasts Malaysia's GDP to grow moderately between 4.0% to 5.0% in 2023 (2022: 8.7%). In comparison, the Ministry of Finance (MoF) forecasted 4.5%, while our in-house estimate of 4.7% is near the upper end of the BNM's forecast range.
- BNM expects the moderate growth expansion to be supported by firm domestic demand attributable to improvement in employment and income levels, ongoing government infrastructure projects, and higher tourism activity. Nonetheless, the economy continues to face challenges, mainly from external headwinds.
- BNM projects the CA balance surplus to expand further to 2.5%-3.5% (KIBB: 2.6%; 2022: 2.6% of GDP) due to the continued recovery in tourist arrivals and China's prospective demand recovery. While we agree with BNM's assessment, we remain cautious about the potential impact of a possible global recession and weakening global demand.
- BNM reaffirmed its commitment to supporting growth while keeping inflation risks under control. It believes that strong domestic demand will counteract any potential negative impact from external factors, but domestic inflation remains a concern. On balance, although we expect there is room for another 25 basis points (bps) rate hike, we reckon BNM has reached the end of its tightening cycle and the overnight policy rate (OPR) would stay at 2.75% for the rest of the year.
- In the near term, Fed's monetary policy guidance and China's post-reopening recovery is expected to influence the ringgit's direction. Despite rising uncertainties, BNM expect that the economy would be bolstered by a stronger domestic demand recovery. Combined with political stability, it would support our view that the ringgit would strengthen. Hence, we maintain our end-2023 USDMYR forecast at 4.11.
- BNM highlighted the importance of implementing both short and long-term reforms to tackle Malaysia's insufficient retirement savings and gaps in the current retirement saving system. The proposals include ringfencing retirement funds, improving data and digitalisation, and enhancing old-age assistance and labour participation..

- **BNM is projecting Malaysia's GDP growth to moderate between 4.0% to 5.0% in 2023 (2022: 8.7%), backed by firm domestic demand amidst external headwinds**
  - The latest projection range is within most forecasts by official institutions such as the Ministry of Finance (4.5%), IMF (4.4%) and World Bank (4.0%), as well as Bloomberg's median consensus estimate (4.0%). This also in line with our in-house view, as we project a 4.7% growth.
  - BNM anticipates a moderate growth expansion in 2023 as the economy faces challenges primarily from external headwinds. Nonetheless, BNM expects economic growth will be contributed mainly by solid domestic demand backed by improvement in labour markets, implementation of multi-year government investment projects and higher tourism activity.
  - According to BNM, there are risks to domestic growth, but they are fairly balanced. The main downside risk comes from external factors such as weaker global growth due to tighter global monetary policy or worsening sentiments in financial markets. Additionally, the escalation of geopolitical tensions could weigh on trade performance. Higher-than-expected inflation could also affect household's purchasing power and could lead to higher costs for businesses. However, BNM

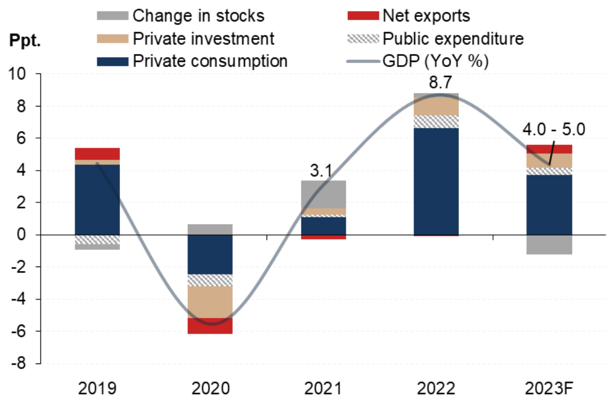
Table 1: Real GDP Growth

YoY %	2022	KIBB 2023F	MoF 2023F	BNM 2023F
By Sector				
Agriculture	0.1	0.6	1.1	0.7
Mining	3.4	1.9	1.2	2.0
Manufacturing	8.1	4.1	3.9	4.0
Construction	5.0	5.1	6.1	6.3
Services	10.9	5.6	5.3	5.0
Real GDP	**8.7**	**4.7**	**4.5**	**4.0 – 5.0**
By Expenditure				
Consumption	9.9	4.7	5.2	5.3
Public	3.9	1.5	1.0	1.3
Private	11.3	5.4	6.1	6.1
Investment	6.8	5.7	6.0	6.0
Public	5.3	6.5	7.0	7.0
Private	7.2	5.4	5.8	5.8
Public Spending	4.3	2.7	2.5	2.7
Private Spending	10.4	5.4	6.1	6.1
Aggregate Demand	9.2	4.9	5.4	5.4
Exports	12.8	3.9	3.1	2.7
Imports	14.2	3.5	2.3	2.1
Net exports	-1.8	8.7	13.0	9.7
Real GDP	**8.7**	**4.7**	**4.5**	**4.0 – 5.0**

Source: BNM, Dept. of Statistics, Kenanga Research believes that there are positive factors that could boost the domestic growth outlook, namely better job opportunities, strong tourism activity, and the implementation of large government projects.

- **Slower growth trajectory but mainly supported by firm domestic demand**
  - Domestic demand (5.4%; 2022: 9.2%): remained an anchor of the domestic growth trajectory
    - Private spending (6.1%; 2022: 10.4%): BNM expects private consumption (6.1%; 2022: 11.3%) to grow moderately, below its long-term average 2011-2019 of 7.1%. While households are expected to adjust spending due to an increase in the cost of living, BNM expects the consumption spending to remain supported by improvement in labour market conditions as the central bank projects the 2023 unemployment rate to improve to 3.5% (2022: 3.8%), matching house forecast. In addition, according to BNM, government policy measures such as an increase in the minimum wage, coverage of employees entitled for overtime pay, tax revision on individual income tax rates, and cash transfer programmes are expected to further support household income. Similarly, private investment is anticipated to chart a sustained expansion (5.8%; 2022: 7.2%), albeit slower. Growth will be supported by the realisation of new and ongoing investment in key infrastructure projects. One of which is the Malaysia Digital Economy Blueprint (MyDIGITAL), mainly to enable greater automation in industries and the digitalisation of the economy. This will be further supported by the implementation of the record investment approvals worth RM265.0b received in 2022 and various initiatives under the New Investment Policy. We agree with BNM's view that there will be notable improvements in investment as there is now political stability and a clear policy direction from the government.

Graph 1: GDP by Expenditure



Source: Dept. of Statistics, Kenanga Research

    - Public spending (2.7%; 2022: 4.3%): Matching our house forecast, as BNM expects public consumption to expand moderately (1.3%; 2022: 3.9%) due to contraction in supplies and services spending brought by the lapse in COVID-19 related expenditure. But this will be partially supported by higher emoluments spending due to a Special Additional Annual Salary Increment of RM100 for civil servants and the absorption of contract officers to permanent positions in the health and education services. According to BNM, public investment is expected to grow more strongly, with a projected growth rate of 7.0% (2022: 5.3%). This is due to increased capital spending by the government and public corporations as well as progress in large-scale infrastructure projects like ECRL, LRT3 and Pan Borneo Highway. Additionally, the government will invest in transportation, education, public utilities, and healthcare projects, while major public corporations will invest in transitioning to net zero carbon emission by 2050 to further boost growth.
  - Net exports (9.7%; 2022: -1.8%): sharp moderation in import growth expected to continue to raise net export growth
    - Exports (2.7%; 2022: 12.8%): BNM expects export growth to moderate in tandem with a slower global growth outlook, particularly in advanced economies. This is largely caused by reduced demand for consumer electronics and a decline in exports of commodities as well as slower growth in the non-E&E manufacturing sectors. However, BNM predicts that growth will be boosted by the increased production of a major oil refinery in Johor. There is also the possibility of faster growth if China recovers more quickly. Despite this, BNM expects that gross exports will slow down sharply by 1.5% (2022: 25.0%), which is lower than the house estimate of 5.8%.
    - Imports (2.1%; 2022: 14.2%): sharp moderation in import growth is expected as growth in domestic demand and manufactured export eased. A slower external demand is also expected to bring about a smaller growth in intermediate goods imports. Meanwhile, continued sustained growth in domestic demand would likely support higher imports of consumption and capital goods. Overall, BNM projects gross imports to slow sharply by 1.1% (2022: 31.3%), following higher growth in the previous year.
- **Modest expansion is projected across all sectors, supported by consumer and tourism-related subsectors.**
  - Services (5.0%; 2022: 10.9%): BNM expects growth to moderate by more than half compared to last year's growth. Growth will be driven mainly by consumer and tourism-related activities on the back of further resumption in international tourism activity. In addition, business-related services as well as information and communication

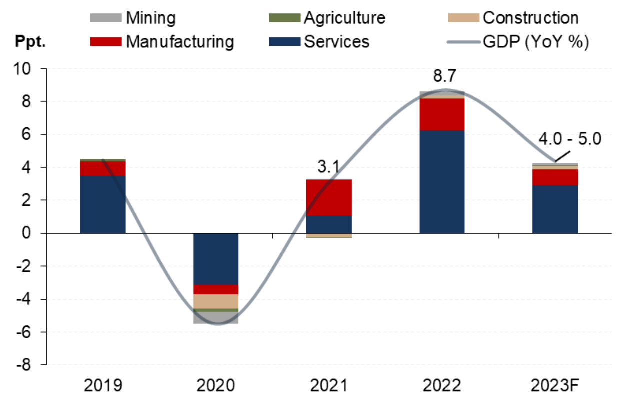
subsectors will continue to expand amid an increase in construction activity and sustained demand for data services. Nonetheless, BNM's growth projection is lower than MoF (5.3%) and house (5.6%) forecasts.

- Manufacturing (4.0%; 2022: 8.1%): BNM projects moderate growth with key sectors such E&E cluster to grow below its long-term average of 6.2% amid the expected slowdown of global semiconductor sales. This is also expected in the consumer-related clusters due to the normalisation of household spending activities. Meanwhile, the construction-related cluster is expected to be supported by investment in structures. Nonetheless, the growth moderation is expected to be supported by expansion in the primary-related cluster driven by higher capacity utilisation at a major oil refinery in Johor. Overall, BNM's growth projection for the manufacturing sector aligns with our forecast (4.1%).

- Agriculture (0.7%; 2022: 0.1%): Growth is expected to expand this year, in line with house projection (0.6%), mainly backed by higher palm oil production amid improvement in the labour supply and improved soil moisture due to heavier rainfall in the early part of the year. Furthermore, growth in livestock and other agriculture subsectors is expected to expand, backed by a gradual recovery in raw material supplies, particularly fertiliser and animal feed.

- Mining and Quarrying (2.0%; 2022: 3.4%): BNM expects a moderate growth expansion but slightly higher than the house (1.9%) and MoF (1.2%) forecasts. Growth will be supported by higher production in new and existing oil and gas facilities but is likely to be capped by the impact of maintenance-related closures in several facilities and maturing oil and gas fields.

Graph 2: GDP by Industry



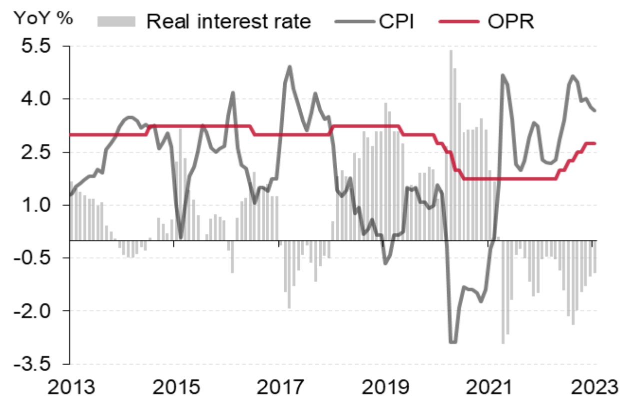
Source: Dept. of Statistics, Kenanga Research

- Construction (6.3%; 2022: 5.0%): BNM expect growth to expand at a faster rate, underpinned by improvement in activities within the civil engineering and residential subsectors. This is likely due to the faster progress of existing large transportation and utility projects as well as an increase in new housing launches. Nonetheless, we remain cautious about growth for this sector largely due to the impact of cumulative rate hikes by BNM, which could result in slower demand for residential subsectors.

- **BNM to retain a supportive stance towards economic growth whilst maintaining a balance with inflation management**

  - BNM stressed that its monetary policy stance will continue to prioritise managing inflation risks whilst still supporting sustainable economic growth amidst global economic headwinds. It also reiterated that the Monetary Policy Committee (MPC) will continue to consider the cumulative impact of past OPR adjustments in future decisions in view of the lag effects of monetary policy on the economy. BNM highlighted that stronger domestic demand could still offset external downside risks to growth, with further upside potentially arising from a stronger-than-expected labour market, tourism activity, and the implementation of large projects from the retabled Budget 2023. That said, a more intense domestic inflationary pressures remain a key risk to the overall inflation outlook, despite a moderation in global cost factors.

Graph 3: BNM OPR and Inflationary Trend



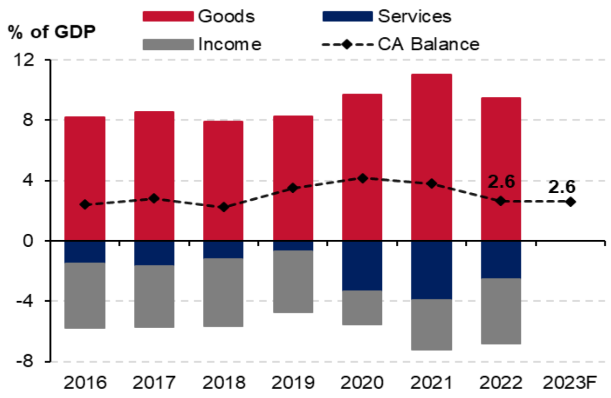
Source: Dept. of Statistics, Bloomberg, Kenanga Research

  - We still believe that BNM has reached the end of its tightening cycle and will keep the OPR unchanged at 2.75% for the rest of the year. This is predicated on a further downtrend in headline and core inflation to below 3.0% and an expected global economic slowdown amid tighter financial conditions, which could weigh on domestic growth over the next year. We believe that BNM's dedication to maintaining both stable prices and sustainable economic growth is coherent with this view. However, we reckon there is still room for the central bank to adjust the policy rate, probably with another 25 bps rate hike to 3.00%, should an unexpected shock to global commodity prices or global financial markets, as well as changes to local subsidy policy, lead to a resurgence in domestic inflationary pressures. Ceteris paribus, we do not expect BNM to cut rates in 2023 or 2024.

- **Current account (CA) balance is projected to remain in surplus amid an expected increase in tourism activity and solid demand from China**

  - BNM expected that the current account of the balance of payments will continue to record a surplus in 2023 (2.5-3.5% of GDP; 2022: 2.6%). This will be driven by a continued surplus in the goods account and a lower deficit in the services account. The goods account may remain in surplus (RM173.1b; 2022: 169.3b) due to a slowdown in import growth (2.1%; 2022: 14.2%), offsetting a moderation in export growth (2.7%; 2022: 12.8%). The services account is predicted to have a smaller deficit of -RM33.6b (2022: -RM45.4b), reflecting a further recovery in the travel account due to the continued recovery in tourist arrivals. However, the overall services account will still be in deficit due to Malaysia's continued reliance on foreign services, especially in the transportation segment. The primary income account will remain in deficit (-RM64.0b; 2022: -RM63.6b) due to income payment accrued to foreign investors in Malaysia, while the secondary income account is expected to have a larger deficit (-RM18.3b; 2022: -RM13.1b) driven by higher outward remittances by foreign workers.

Graph 4: Current Account Trend (% of GDP)



Source: Dept. of Statistics, Kenanga Research

  - Although we anticipate a slowdown in external activities due to weaker global demand amid the rising risk of a recession, our in-house view aligns with BNM's projection that the current account balance will remain above 2.5% in 2023. In comparison, we forecast the CA balance to expand by 2.6% of GDP in 2023, mainly due to an expected increase in tourism activity and solid demand recovery from China. Despite multiple potential risks to the global economy, we believe these factors will positively impact Malaysia's current account balance.

- **While the slowdown in global economic activity, the easing of supply bottlenecks and the decrease in commodity prices may alleviate inflationary pressure, uncertainties still persist**

  - BNM anticipates a more moderate global cost environment in 2023, as a result of lower prices for key commodities, further normalisation in supply chain disruptions, and weakening external demand, which are expected to contribute to lower inflation (2.8%-3.8%; 2022: 3.3%). However, headline inflation is still expected to be elevated due to continued strength in domestic demand, improvement in labour market, gradual subsidy rationalisation efforts and uncertainty surrounding global commodity prices and extreme weather conditions. Prices could continue to increase as costs rise, which may lead to more persistent inflation. However, it is unlikely that there will be a wage-price spiral. There is a chance that inflation could decrease due to lower global commodity prices and a reduction in pent-up demand.

  - House CPI forecast for 2023 is lower at 2.5%. We base this on two key assumptions, (1) weaker global economic growth outlook, made worse by the ongoing banking crisis in the US and Europe, leading to reduced external demand and (2) no significant changes in domestic policies regarding subsidies and price controls (except for eggs and chickens). However, we agree with BNM's assessment that the inflation outlook is highly uncertain due to various risk factors. One such risk is the potential increase in tourism activity, which may spur demand and push up prices of goods and services. Heightened geopolitical uncertainty and stronger-than-expected demand from China are other possible risks that could lead to higher commodity prices and add to inflationary pressures. Nevertheless, for now, the probability is higher for consumer prices to remain below 3.0% in 2023.

- **Ringgit's trajectory to be influenced by Fed's monetary policy direction and domestic economic fundamentals**

  - Although Malaysia is facing external challenges such as the rapid increase in US interest rates, greater volatility in the global market, and concerns of contagion due to banking system problems in the US and Switzerland, these factors may weaken the ringgit and negatively impact investor sentiment. However, Malaysia's strong economic fundamentals and financial system are expected to provide support for the local currency. Moreover, the ringgit could potentially experience an uplift due to the sustained growth of Malaysia's domestic economy, and also due to positive spillover effects from China's reopening. The ringgit's flexibility to allow for adjustments in the external sector could help to cushion the impact of negative global shocks on the Malaysian economy. Additionally, to prevent the ringgit's volatility from causing disruptions to the economy, BNM may continue to conduct two-way foreign exchange rate interventions to ensure a balanced exchange rate and promote access to hedging instruments.

- We are also bullish on the ringgit in view of the weaker USD position due to the Fed's expected pivot to dovish from hawkish, along with Malaysia's improving political landscape and economic outlook, which may attract foreign capital inflows and support the local currency. The strengthening of the yuan amid China's potential robust post-reopening recovery may also help to bolster the ringgit due to its strong positive correlation. Once the Fed begins to ease its monetary policy, potentially by 50 basis points in 4Q23, it could lead to an increase of net capital flows into high-yielding emerging markets, benefitting the ringgit. However, we recognise that external risks such as the escalating tensions between the US and China and the Russia-Ukraine war, could have adverse effects on the ringgit and influence its direction. Nonetheless, at this juncture, we still maintain our end-2023 USDMYR forecast at 4.11.

- **Policy reforms are needed to address Malaysia's insufficient retirement savings and gaps in the retirement savings framework**
  - In its box article on "Rebuilding Retirement Savings and Financial Safety Nets in Malaysia", BNM emphasised the need for reforms to ensure that Malaysians are adequately protected during their retirement without straining government finances or significantly increasing contribution rates. The central bank highlighted Malaysia's low retirement savings, with only 23.0% of EPF members on track to achieve the minimum savings target of RM240.0k upon reaching the retirement age of 55. Meanwhile, income levels remained relatively low, household indebtedness high, and the informal sector significantly limiting access to social protection; a survey by the Malaysian Financial Planning Council found that only 22.0% of Malaysians have a financial plan for retirement and that 56.0% have no retirement savings at all. Special withdrawals during the COVID-19 pandemic have caused many individuals to deplete their EPF savings, which will have long-term consequences on their standards of living. Insufficient retirement savings is a global problem that is expected to worsen in the future, with the World Economic Forum predicting a shortfall of USD400.0t in global pension savings by 2050.
  - BNM recommends several policy reforms to improve retirement savings. In the short-term, voluntary contributions to EPF should be encouraged and programmes to improve financial literacy and retirement savings awareness should be deployed. In the long-term, reforms could include ringfencing retirement funds, by reinvesting a portion of savings that would have been withdrawn upon the withdrawal age, to extend accumulation periods and reduce longevity risk, following the successful cases of ringfencing in Singapore and Chile. To enhance old-age social safety nets, increased cash assistance should be provided to the vulnerable elderly, which could also benefit younger generations by reducing reliance on children for subsistence. Likewise, suitable job opportunities for older workers should be created to tap into old age productivity, given that elderly workforce participation has been stagnant for two decades; policies could offer hiring incentives to encourage employers to hire the elderly. Finally, BNM suggests that all 18-year olds be automatically registered into EPF and SOCSO databases to build a unified social protection database to reduce information gaps and better target policies for vulnerable groups and those in the informal sector.
  - We strongly agree with BNM that reforms are necessary to address the significant risks to retirement in Malaysia. To add, we reckon that greater tax exemptions could be given to retirement contributions to encourage higher voluntary contributions. Besides ringfencing retirement funds and improving old-age social safety nets, the retirement age, currently 60, could be raised given the potential for Malaysia's average life expectancy to continue improving going forward. This would align with BNM's recommendation that job opportunities for older workers be created and increased via policy measures, to ensure adequate employment for individuals of all ages. Lastly, raising individual and employer contribution rates may eventually be necessary, but it is crucial to be mindful of disposable income levels and to implement this alongside sufficient wage growth and stable unemployment rates.

Table 2: Forecast and Assumptions

	2015	2016	2017	2018	2019	2020	2021	2022	KIBB 2023F	BNM 2023F
Real GDP (%YoY)	5.0	4.2	5.9	4.7	4.4	-5.6	3.1	8.7	**4.7**	**4.0 – 5.0**
Consumer Price Index (avg.)	2.1	2.1	3.7	1.0	0.7	-1.2	2.5	3.3	**2.5**	**2.8 – 3.8**
Current Account Balance (% of GDP)	3.0	2.4	2.8	2.1	3.4	4.4	3.8	2.6	**2.6**	**2.5 – 3.5**
Fiscal Balance (% of GDP)	-3.2	-3.1	-3.0	-3.4	-3.4	-6.2	-6.5	-5.5	**-5.0**	**N/A**
Unemployment Rate (%)	3.2	3.3	3.4	3.4	3.3	4.5	4.6	3.8	**3.5**	**3.5**
Manufacturing Output (%YoY)	4.8	4.3	6.0	5.0	3.8	-2.7	9.5	8.1	**4.1**	**4.0**
Exports of Goods (%YoY)	1.6	1.2	18.8	7.3	-0.8	-1.1	26.1	25.0	**5.8**	**1.5**
Overnight Policy Rate (end-period)	3.25	3.00	3.00	3.25	3.00	1.75	1.75	2.75	**2.75**	**N/A**
USDMYR (end-period)	4.29	4.49	4.05	4.13	4.09	4.02	4.17	4.40	**4.11**	**N/A**

Source: MoF, BNM, Bloomberg, Kenanga Research, F = Forecast

For further information, please contact:

Wan Suhaimie Wan Mohd Saidie
Head of Economic Research
wansuhaimi@kenanga.com.my

Muhammad Saifuddin Sapuan
Economist
saifuddin.sapuan@kenanga.com.my

Afiq Asyraf Syazwan Abd. Rahim
Economist
afiqasyraf@kenanga.com.my

Zalman Basree
Economist
zalman@kenanga.com.my

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KENANGA INVESTMENT BANK BERHAD (15678-H)
Level 17, Kenanga Tower, 237, Jalan Tun Razak, 50400 Kuala Lumpur, Malaysia
Telephone: (603) 2172 0880   Website: www.kenanga.com.my   E-mail: research@kenanga.com.my