AMRO Country Report
ACR/21-01

AMRO Annual Consultation Report

Malaysia - 2020

ASEAN+3 Macroeconomic Research Office (AMRO)

May 2021

Acknowledgments

1. This Annual Consultation Report on Malaysia has been prepared in accordance with the functions of AMRO to monitor, assess and report its members' macroeconomic status and financial soundness, to identify relevant risks and vulnerabilities, and to assist them in the timely formulation of policy to mitigate such risks (Article 3 (a) and (b) of the AMRO Agreement).
2. This Report is drafted on the basis of the Annual Consultation of AMRO on Malaysia from November 16 to December 4, 2020 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr Sumio Ishikawa, Group Head and Lead Economist. Members include Ms Diana del Rosario, Economist; Mr Ming Han (Justin) Lim, Economist; Dr Nguyen Thi Kim Cuc, Senior Economist and Deputy Group Head; Mr Prashant Pande, Financial Market Specialist; Dr Andriansyah, Fiscal Specialist; Ms Yang Chunyu, Researcher; and Mr Takashi Yonemura, Associate Researcher. AMRO Director Mr Toshinori Doi and Chief Economist Dr Hoe Ee Khor also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on Malaysia for 2020 was peer reviewed by Dr Lee Jae Young, Group Head and Lead Economist, and Ms Catharine Kho Tjing Yiing, Economist; and approved by Dr Hoe Ee Khor, AMRO Chief Economist.
3. The analysis in this Report is based on information available up to 19 March 2021.
4. By making any designation of or reference to a particular territory or geographical area, or by using the term "member" or "country" in this Report, AMRO does not intend to make any judgments as to the legal or other status of any territory or area.
5. On behalf of AMRO, the Mission team wishes to thank the Malaysian authorities for their comments on this Report, as well as their excellent meeting arrangements and hospitality during our visit.

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Executive Summary

The Malaysian economy continues to deal with the disruptions due to the COVID-19 pandemic. A strong recovery momentum emerged in Q3 after the lockdowns were lifted, although it was interrupted by a renewed spike in COVID-19 cases. The recovery was also uneven, leaving the construction and services sector depressed while manufacturing posted an export-led expansion. Against this backdrop, supportive economic policies remain critical to protect people's welfare and strengthen the recovery. At the same time, preserving monetary policy space and advancing a medium-term plan to rebuild fiscal buffers would contribute toward economic stability and resilience post-pandemic.

1. A strong recovery momentum took hold in Q3 2020, although it has since been weakened by the resurgence of COVID-19 infections. The Malaysian economy bounced back after a steep recession in Q2, as the nationwide lockdown was lifted and production caught up with backlogs and pent-up demand. However, the resurgence of COVID-19 infections starting in September prompted partial lockdowns in some parts of the country, which consequently weakened the growth momentum in Q4. Malaysia may face another downturn in Q1 2021, albeit less severe than the one in Q2 2020, as stricter but targeted movement curbs were imposed in most parts of the country at the start of the year.

2. Malaysia is in a strong position to ride a vaccine-led global economic recovery once the domestic COVID-19 situation is under control. Increasing coverage of ongoing vaccination programs globally bodes well for a broader pick-up in global demand and Malaysia's external sector. A strong rebound in Malaysia's domestic demand could likewise ensue, especially once the current wave of local infections is under control. Against this backdrop, GDP growth is expected to rise from -5.6 percent in 2020 to 5.6 percent in 2021 and 6.2 percent in 2022, underpinned by supportive economic policies, ample domestic savings, a diversified economy, and resilient banking system. Notwithstanding the strong rebound, the damage to the balance sheets of businesses and the labor market suggests that the economy may not return to its pre-pandemic growth path in the short term.

3. The swift deployment of a comprehensive economic package has crucially supported the recovery. The COVID-19 stimulus response, comprising both on- and off-budget spending, was successively expanded as the economic impact of the pandemic mounted. By March 2021, it had grown to MYR340 billion or about 22 percent of GDP. Guided by fiscal prudence, on-budget spending—primarily through cash transfer and wage subsidy schemes—was about a fifth of the total package. Meanwhile, off-budget measures leveraged on the (1) healthy banking system to implement loan deferral schemes and deploy BNM's concessional lending facilities to small and medium enterprises (SMEs), and (2) substantial and well-managed retirement savings that enabled account withdrawals and lower contributions. Credit guarantee schemes were also made available to SMEs and larger businesses. The continuation of both on- and off-budget measures through 2021 is appropriate to ensure that the economic recovery remains on track.

4. The weak inflationary environment provided BNM ample room to ease monetary policy to stabilize financial markets and support the economy during the COVID-19 crisis. The policy rate was lowered by a total of 125 basis points in the first seven months of 2020 to a record low of 1.75 percent, where it has remained since. Additional liquidity was also injected into the financial system through adjustments in the banks' statutory reserve requirements and increased monetary operations. The subsequent improvement in risk sentiment was manifested in a decline in bond

yields and a rebound in the equity market after the sharp sell-off in March 2020. Foreign capital inflows to the bond market resumed and allowed for a rebuilding of BNM's reserves buffer. Meanwhile, supported by the easing of domestic financing conditions and economic support measures, bank lending and corporate bond issuances expanded by over 4 percent in 2020 through January 2021.

5. The banking system is in a strong position to manage increased credit risks and facilitate continued credit expansion. Banks' liquidity coverage ratio stayed over 140 percent throughout 2020 even as the 100 percent minimum requirement was relaxed temporarily during the period. Meanwhile, stress-testing exercises by AMRO and BNM indicate that the banks have ample room to absorb loan impairments given their strong capital buffers.

6. However, Malaysia's economic outlook remains subject to the uncertain developments of the pandemic. A prolonged resurgence of COVID-19 infections and delays in the pace of vaccinations, in Malaysia and the major economies, cast a cloud over the growth outlook. In a tail risk scenario, a protracted decline in economic activity would imperil the soundness of the financial system, and lead to renewed market distress. Expanding the fiscal stimulus would be appropriate in this situation, although another adjustment to the debt limit could heighten concerns over debt sustainability. On the upside, a faster containment of the current wave of infections in and outside Malaysia could lead to an earlier and sharper economic rebound relative to our baseline scenario.

7. While continued fiscal policy support is warranted, the build-up in government debt also underscores the need to restore fiscal buffers when the economic recovery is on a firm footing. In AMRO's view, reforms to broaden the tax base would be necessary to lower the fiscal deficit and guide the government debt back to the pre-pandemic statutory limit of 55 percent of GDP over the medium term. Revenue measures, including the re-instatement of the goods and services tax, should be planned and implemented in such a way to avoid a cliff effect to growth.

8. Monetary policy should be on an easing bias as uncertainty continues to cloud the growth outlook. Despite the recent weakening in the recovery momentum, the current low policy rate remains accommodative and should be given more time to be transmitted fully to the real economy. But with risks to the outlook tilted to the downside and given available policy space, it would be appropriate to maintain an easing bias to ensure that monetary conditions remain supportive in the event of a sharper weakening in economic activity. That said, the low interest rate environment calls for vigilance against a potential build-up of financial imbalances.

9. Enhancing BNM's reserve buffer while maintaining a flexible exchange rate would help to preserve market confidence. Malaysia's high degree of financial openness entails the accumulation of international reserves during periods of strong capital inflows to provide ample coverage against external liabilities. At the same time, the exchange rate should remain flexible as the first line of defense against external shocks.

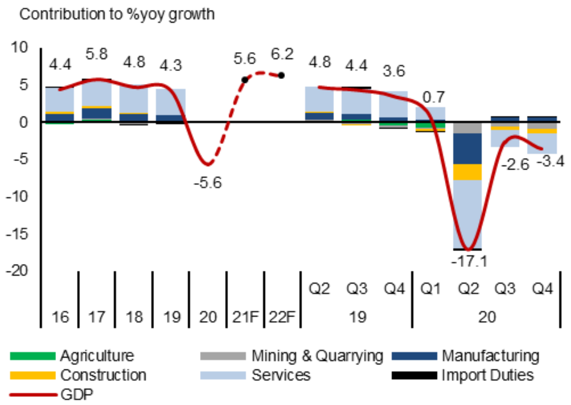
10. Over the medium term, sustaining policy reforms to safeguard people's welfare and raise productivity are critical to achieve a dynamic and inclusive economy in the post-pandemic new normal. Moreover, incorporating a broad-based environmentally sustainable agenda into the development plan would enhance economic resilience as Malaysia advances from an upper middle-income to a high-income nation.

A. Recent Developments and Outlook

A.1 Real Sector Developments and Outlook

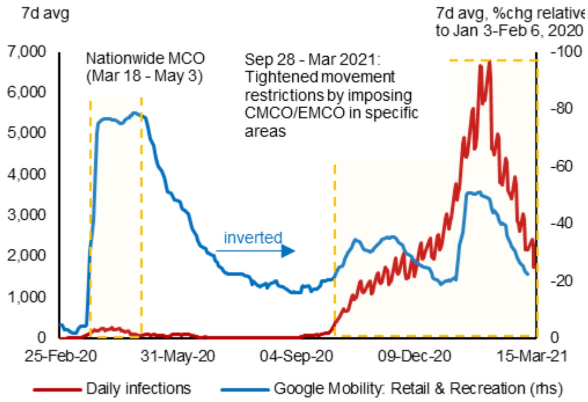
1. **A strong recovery momentum took hold in Q3 2020, although it has since been weakened by another wave of COVID-19 infections.** The Malaysian economy bounced back after a steep recession in Q2, as the nationwide lockdown was lifted and production caught up with backlogs and pent-up demand (Figure 1). However, the resurgence of COVID-19 infections starting in September prompted partial lockdowns in some parts of the country, which consequently dampened the growth momentum in Q4. Malaysia may face another downturn in Q1 2021, as most of the country underwent lockdowns at the start of the year. That said, the downturn would be less severe than the one in Q2 2020, given the more targeted coverage of the latest movement restrictions and as more businesses in the affected areas were allowed to remain open. For one, mobility indicators for retail and recreation activities were considerably less affected than in Q2 2020 despite the stronger surge in COVID-19 cases (Figure 2).

Figure 1. Real GDP Growth—Supply-Side Contribution



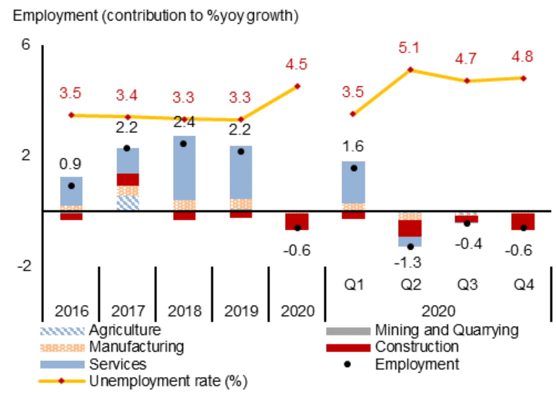
Source: Department of Statistics Malaysia (DOSM).
Note: Estimates and projections are by AMRO.

Figure 2. Daily COVID-19 Cases and Mobility Indicators



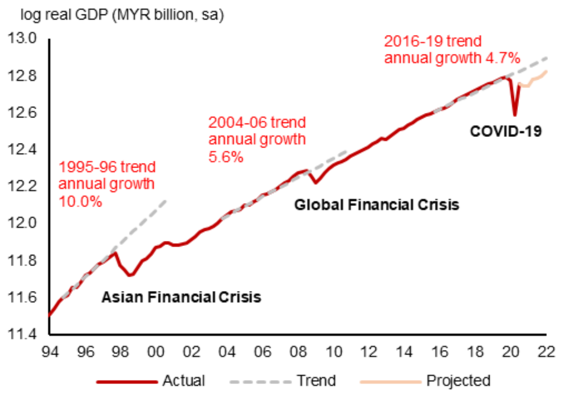
Source: Google and Johns Hopkins University.
Note: MCO stands for Movement Control Order, Malaysia's equivalent of a lockdown. CMCO and EMCO refer to conditional (partial lockdown) and enhanced MCO, respectively. EMCO is synonymous to MCO but refers to specific areas only.

Figure 3. Employment Growth and Unemployment Rate



Source: DOSM.
Note: *Refers of October-November average.

Figure 4. Real GDP against Trend



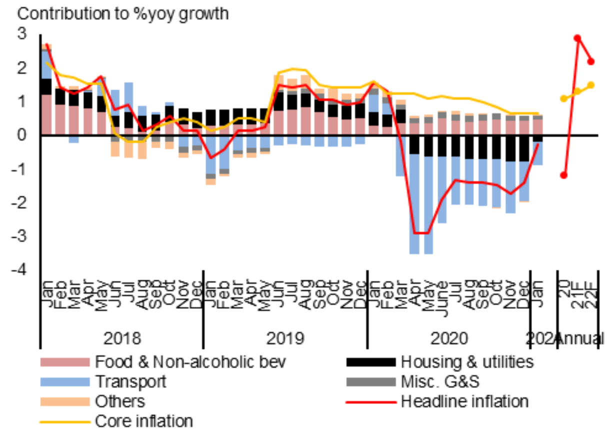
Source: DOSM, AMRO staff calculations and projections.

2. **The pandemic has left an uneven impact on the Malaysian economy so far.** The manufacturing sector, for instance, recorded an export-led expansion in the second half of 2020 as global economic activity improved, while construction and service-oriented activities remained largely depressed (Figure 1). However, despite the rebound in manufacturing output, wages remained lower than before the pandemic. In fact, labor market conditions have weakened overall, with the unemployment rate rising to an average of 4.7 percent in March-December 2020 from the long-run average of 3.3 percent (Figure 3). In this regard, supportive and well-calibrated policies would remain crucial to broaden the recovery.

3. **Looking ahead, Malaysia is in a strong position to ride a vaccine-led global economic recovery once the domestic COVID-19 situation is brought under control.** In the near term, the ongoing roll-out of COVID-19 vaccinations in the advanced economies and the gradual improvement in mobility that may follow, bode well for a broader pick-up in Malaysia's merchandise exports. Domestic demand could likewise bounce back in Q2 2021 as the current wave of local infections is brought under control, similar to the case in Q3 2020 after the nationwide lockdown was lifted. Meanwhile, international travel and tourism activities are only expected to start gaining traction in 2022 as COVID-19 vaccines become more widely available. Against this backdrop, GDP growth is expected to rebound from -5.6 percent in 2020 to 5.6 percent in 2021 and 6.2 percent in 2022. The speedy recovery would be underpinned by Malaysia's ample domestic savings, diversified economy, and resilient banking system, and supported by calibrated stimulus policy. However, the damage caused by the pandemic to the balance sheets of households and businesses, and the labor market suggests a significant downward shift in Malaysia's growth path relative to the pre-pandemic trend (Figure 4).

4. **Inflation is expected to remain benign as it normalizes in 2021.** Headline inflation dropped to -1.2 percent in 2020 as the collapse in global crude oil prices spilled into domestic fuel prices (Figure 5). Inflation was also pulled down by policy measures—electricity bill discounts and sales tax exemption on passenger cars, as part of the economic stimulus package. Meanwhile, core inflation stayed in positive territory, albeit moderating over the course of 2020 owing to weak domestic demand. In 2021 and 2022, a recovery in crude oil prices, the expiry of stimulus measures, and improvement in domestic demand are expected to guide headline and core inflation higher, with headline inflation likely to climb past its long-run average of 2.0 percent.

Figure 5. Headline and Core Inflation



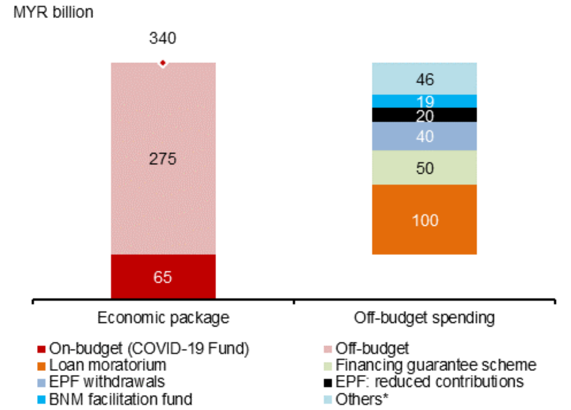
Source: DOSM, AMRO.
Note: AMRO staff projections.

A.2 Fiscal Sector Developments

5. **Economic stimulus measures were promptly and progressively deployed as the health and economic crises unfolded.** The COVID-19 stimulus response, which comprises on- and off-budget spending, grew from the initial MYR20 billion in February 2020 to MYR340

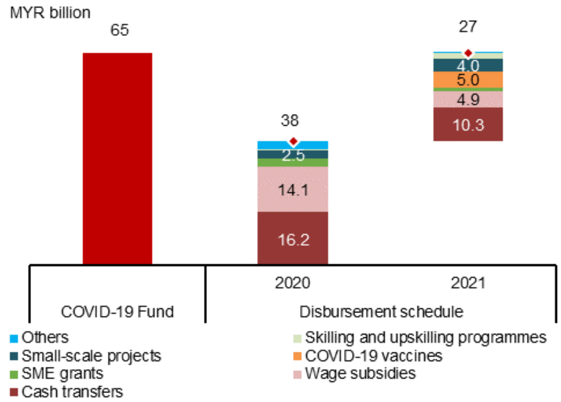
billion by March 2021 as the economic cost of the containment measures mounted. Reflecting the delicate balance to support the economy and contain the fiscal deficit, the on-budget stimulus—classified under the COVID-19 Fund—was limited to MYR65 billion, about a fifth of the total package (Figure 6). While the COVID-19 Fund is set by law to run through 2022, the current allocation is targeted by the Ministry of Finance (MOF) to be disbursed in 2020 and 2021 (Figure 7). Regular progress reports of the MOF indicate that the cash transfer and wage subsidy schemes—comprising 80 percent of the 2020 COVID-19 Fund allocation—had disbursement rates of over 60 percent and 70 percent, respectively.[1] The two measures remain key components of the 2021 COVID-19 Fund allocation, together with additional expense for the procurement of COVID-19 vaccines.

Figure 6. Aggregate Total of the 2020-21 Economic Packages



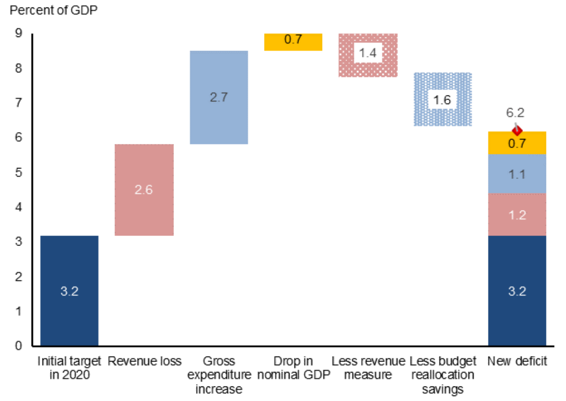
Source: MOF, AMRO staff estimates.
Note: EPF stands for Employees Provident Fund. *Others include the MYR15 billion package announced in January 2021 and MYR20 billion package announced in March 2021.

Figure 7. Composition of the COVID-19 Fund



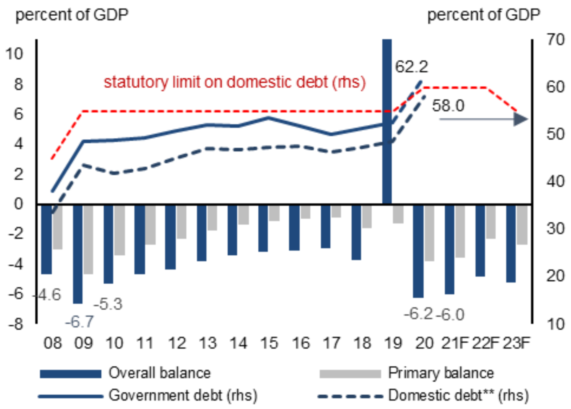
Source: MOF, AMRO staff estimates.
Note: The COVID-19 Fund is a temporary fund that spans three years until end-2022. It comprises projects under the economic stimulus and recovery packages.

Figure 8. Breakdown of the Fiscal Deficit in 2020



Source: DOSM, MOF, AMRO staff estimates.
Note: Computations are based on difference between the revised and original 2020 Budgets, but using actual 2020 fiscal deficit ratio.

Figure 9. Fiscal Balance and Federal Government Debt Ratios



Source: AMRO, BNM, DOSM.
Note: Projections by AMRO. **Domestic debt refers to Malaysian Government Securities (MGS), Malaysian Government Investment Issues (MGII), and Malaysian Islamic Treasury Bills (MITB).

[1] The World Bank (2020) noted that Malaysia was able to leverage existing programs and implementation infrastructure, including a universal national ID system, wide mobile phone coverage, and high financial inclusion, in carrying out a quick and wide-ranging social protection response.

6. **Off-budget measures have supplemented the fiscal stimulus in providing critical liquidity and income support to households and businesses.** An automatic loan moratorium was extended to individuals and small and medium enterprises (SMEs)—those without arrears for over 90 days—for six months until September 2020. Viable corporates also had options to defer or restructure their loan repayments. Concessional lending facilities and credit guarantee schemes were likewise made available to SMEs and larger businesses. Meanwhile, withdrawals from pension savings were allowed, in addition to a reduction in employees' pension contributions and deferment or restructuring of SME employers' contributions. The said measures comprise the bulk of the MYR340 billion economic package (Figure 6), equivalent to about 22 percent of the 2020-21 average GDP. The measures were extended through 2021 with some modifications, such as the shift to a targeted loan repayment assistance, slight increase in the employees' statutory pension contribution rate[2], and the creation of additional credit facilities to assist SMEs.

7. **Despite fiscal prudence, the large stimulus package has raised the fiscal deficit and government debt ratios considerably in 2020 and through the medium term.** The pandemic is set to reverse the downward trend of the fiscal deficit in the past several years, with an AMRO-projected average deficit of 5.7 percent of GDP in 2020-22 against 3.3 percent in the preceding five years. In 2020, funding needs increased substantially to cover for the large stimulus package and revenue shortfall from the economic contraction, while special dividends from government-linked corporations and a reallocation of the original 2020 Budget were sizable cushions (Figure 8). To accommodate the medium-term increase in the fiscal deficits, the statutory debt limit has been raised to 60 percent of GDP until 2022 (Figure 9). This temporary adjustment affords space for additional fiscal support in the interim, before the limit reverts to the pre-pandemic level of 55 percent starting in 2023 (see Selected Issue 1: Medium-term Debt Sustainability and Fiscal Reform Considerations).[3]

A.3 Monetary Conditions and Financial Market Developments

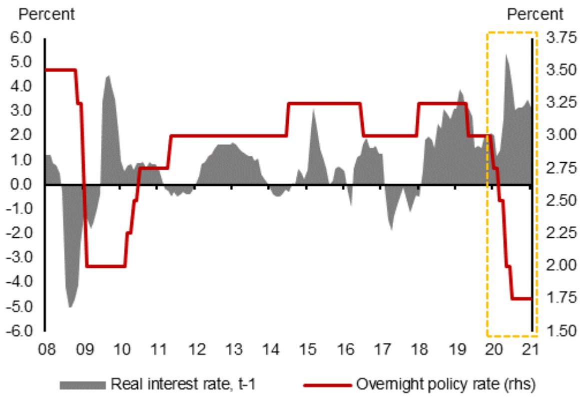
8. **The aggressive loosening of monetary conditions complemented the economic stimulus and helped stabilized financial markets.** A cumulative reduction of 125 basis points in the first seven months of 2020 brought the overnight policy rate to a record low of 1.75 percent. The successive policy rate cuts, facilitated by the decline in headline inflation and easing of global financing conditions, helped to stabilize domestic financial markets after the US dollar funding stress in March (Figure 10). Bond yields declined across the curve and the equity market rebounded after the sell-off in March. However, the sharper easing of bond yields at the front end of the curve led to a widening of the differential between the 10-year and 3-year yields to a near 5-year high at the end of 2020 (Figure 11). Large bond issuances coupled with lower net contributions to the retirement funds which are major institutional investors in the bond market, put upward pressure on yields for the longer tenors. However, banks—with ample liquidity from the adjustments in the statutory reserve requirement (SRR) and declines in the loan-to-deposit ratio—absorbed nearly three-quarters of the bond issuance in 2020, thereby raising their aggregate holdings to 30 percent of total (Figure 12). Over the medium term, domestic bond issuances would

[2] Employees' minimum statutory contribution rate to the Employees Provident Fund (EPF) was lowered to 7 percent from 11 percent in April to December 2020, and has been raised to 9 percent throughout 2021.
[3] The statutory debt limit only refers to certain domestic components of the total federal government debt. These are the Malaysian Government Securities (MGS), Malaysian Government Investment Issues (MGII), and Malaysian Islamic Treasury Bills (MITB).

be sufficiently absorbed by the sizable balance sheets of domestic savings institutions (see Selected Issue 2: Assessing Demand and Supply for Malaysian Government Bonds in 2021).

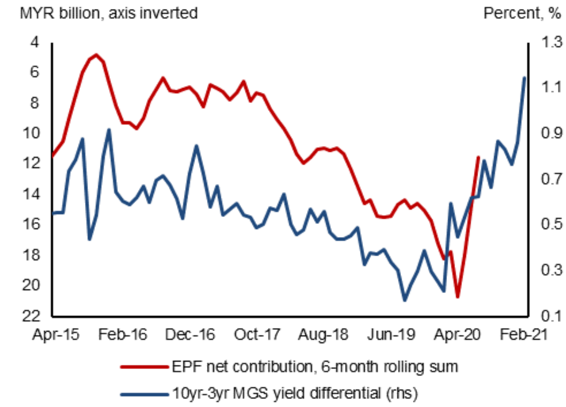
9. **The resumption of foreign capital inflows after the massive sell-off in March 2020 supported the ringgit and allowed BNM to build up its reserves buffer.** While residents recorded steady outflows throughout 2020, foreign portfolio investment outflows intensified in Q1 but eased thereafter as global risk aversion subsided (Figure 13). In particular, foreign capital returned to the bond market in May 2020 through January 2021 and mitigated the continued foreign sell-off in the equity market (Figure 14). This resumption of foreign investor inflows supported the ringgit (MYR), which strengthened by 7 percent against the U.S. dollar between April and December 2020. It also facilitated a steady rebuilding of BNM's gross international reserves, which have been shored up by gains from foreign investments (Figure 15). Moreover, the net short forward position was pared down, resulting to an improvement in net international reserves, even as other foreign currency (FCY) liabilities such as U.S. dollar deposits with BNM increased in tandem with market demand. With this improvement, the net reserves would be sufficient to cover more than 100 percent of the short-term external debt, bolstering the adequacy of BNM's reserve position.

Figure 10. Overnight Policy Rate and Real Interest Rate



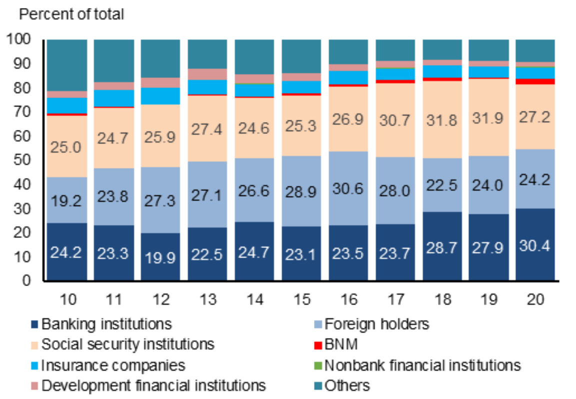
Source: BNM, DOSM.
Note: Real interest rate is overnight policy rate less headline inflation.

Figure 11. Employees Provident Fund—Net Contributions and Bond Yield Differential



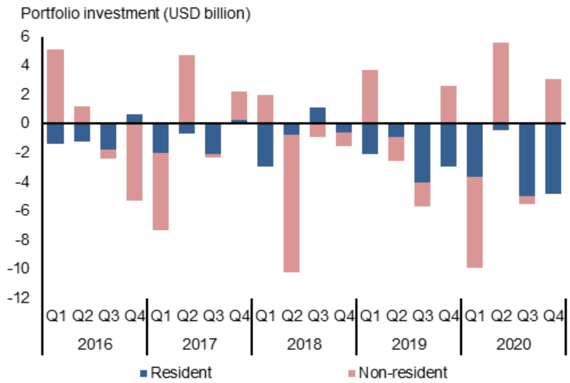
Source: BNM.

Figure 12. Federal Government Debt—Holders of Local Currency Bond Issues



Source: BNM.

Figure 13. Portfolio Investment Flows

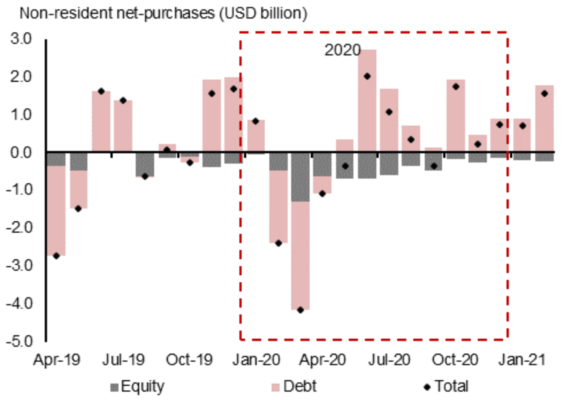


Source: BNM, DOSM.

Authorities' Views

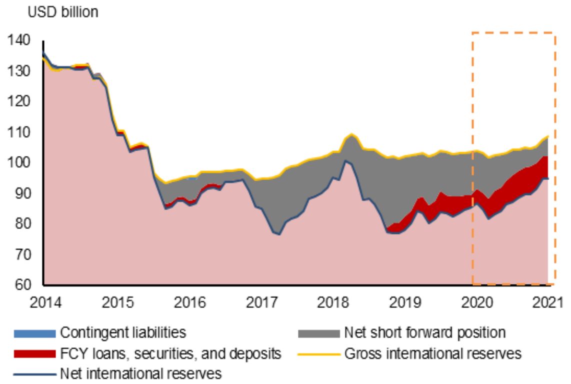
10. **BNM clarified that the build-up of FCY deposits is a response of the banks to the increase in domestic U.S. dollar liquidity.** Banks tend to increase FCY buffers pre-emptively, through offshore interbank borrowing, in anticipation of or during market stress, such as in Q1 2020. In 2020, banks deposited the excess U.S. dollar liquidity in the system with BNM at market-determined interest rates, while FX swap transactions with the central bank were reduced. Banks can place dollar deposits with BNM to mitigate operational and credit risk, while increased placements may also indicate ample dollar liquidity in the system. Rates on these U.S. dollar deposits can be in line with those of BNM interbank bills (BNIB).

Figure 14. Non-resident Net Purchases in Domestic Debt and Equity Markets



Source: BNM, Bursa Malaysia.

Figure 15. Gross and Net International Reserves



Source: BNM.
Note: Net international reserves refer to gross reserves net of pre-determined short-term outflows related to contingent liabilities, BNM's forward position, and FCY loans, securities and deposits.

A.4 External Sector and the Balance of Payments

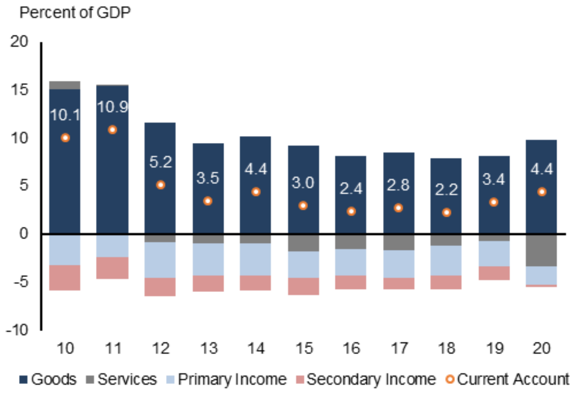
11. **The improvement in risk sentiment has reinforced Malaysia's strong external position, which is supported by a sustained surplus in the current account and continued FDI flows.** The current account surplus widened in 2020 as the goods trade surplus expanded and more than offset the larger deficit in services trade—owing to the collapse in travel and tourism—and primary income (Figure 16). Foreign direct investments (FDI) were understandably muted in 2020, but FDI commitments—particularly in the manufacturing sector—had risen substantially in 2018 through 2020 (Figure 17). These buoyant investment commitments alongside proactive efforts by the government to attract foreign investments bode well for stronger FDI flows going forward.[4] The pick-up in manufacturing FDI commitments was coming mostly from China and the U.S., which may have resulted from investment diversions as the U.S.-China trade tensions started to escalate in March 2018.

12. **Merchandise exports bounced back in the latter half of 2020 driven by pandemic-related demand primarily from the U.S. and China.** After movement restrictions were eased starting in May, exports quickly turned around and expanded by an average of 5

[4] As part of the economic recovery plan, the government in June 2020 created the Project Acceleration and Coordination Unit (PACU) under the Malaysian Investment Development Authority (MIDA) to facilitate the speedy implementation of investment projects in Malaysia. It has also announced special tax rates spanning 10 to 15 years for manufacturing and selected services companies bringing in new investments to Malaysia until end-2022.

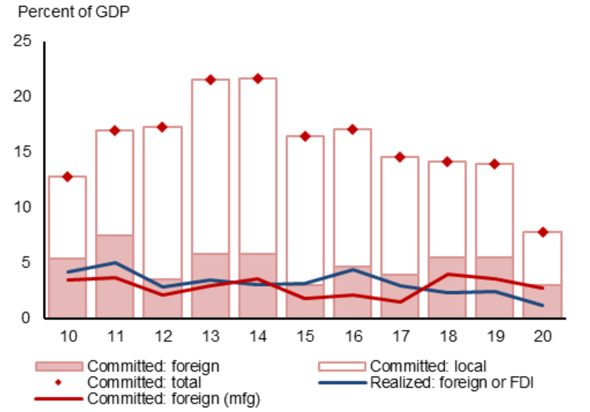
percent year-on-year from June to December 2020. The recovery was initially led by exports to China, but gradually broadened to the U.S. and Europe (Figure 18). The exports rebound was driven by demand for electrical and electronic products, rubber gloves, furniture, and base metals (Figure 19). China's investment-led recovery from the pandemic led to increased demand for steel from Malaysia, while exports of electronic devices—particularly, solid-state storage devices (SSDs) and integrated circuits—to China may have been boosted by the U.S. sanction on exports of semiconductors to Huawei (Figure 20). Medical devices and rubber gloves also shored up exports to China. Meanwhile, the surge in remote work arrangements drove exports of various electrical and electronic products as well as furniture to the U.S. (Figure 21). Strong demand for personal protective equipment in medical facilities likewise buoyed shipments of rubber gloves (see Box A. Outperformers in the Pandemic—The Case of Malaysian Glove Makers). These positive trade developments with Malaysia's key export markets illustrate how Malaysia's diversified and mature manufacturing base is able to benefit from the uneven impact of the pandemic on global trade.

Figure 16. Current Account Balance



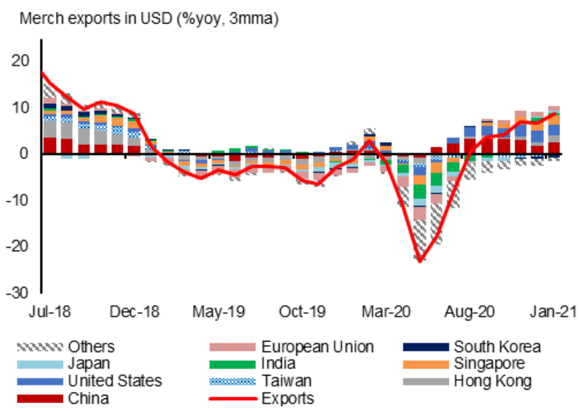
Source: BNM, DOSM.

Figure 17. Foreign Direct Investment—Committed and Realized



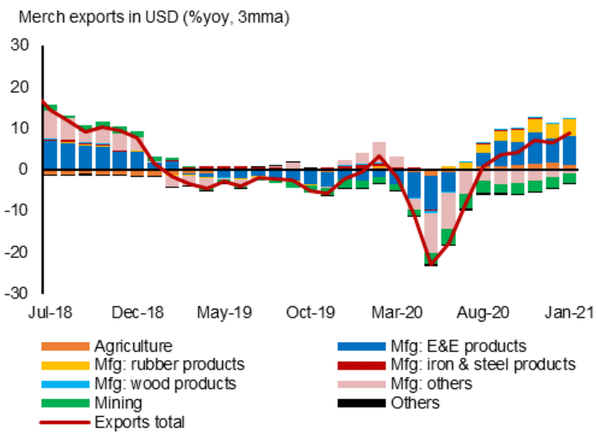
Source: BNM, DOSM, MIDA.
Note: *2020 data cover up to Q3, except for realized FDI which covers the full 2020 period.

Figure 18. Merchandise Exports by Destination



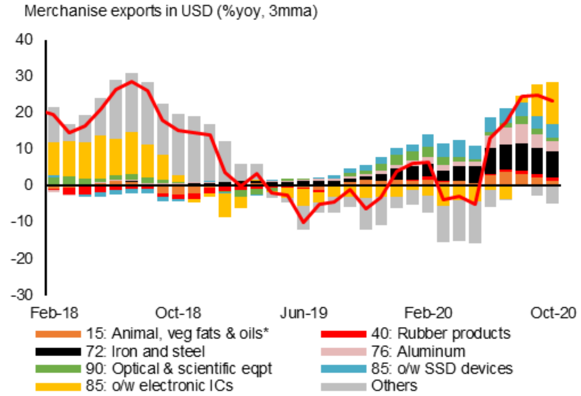
Source: BNM, DOSM.

Figure 19. Merchandise Exports by Sector



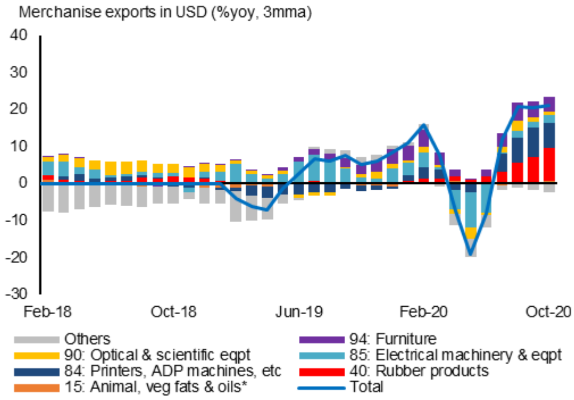
Source: BNM, DOSM.
Note; E&E refers to electrical and electronic products.

Figure 20. Merchandise Exports—Malaysia to China



Source: DOSM via The Global Trade Atlas database.
Note: *Primarily refers to palm oil products; SSDs refers to solid-state storage devices; ICs refers to integrated circuits.

Figure 21. Merchandise Exports—Malaysia to the U.S.



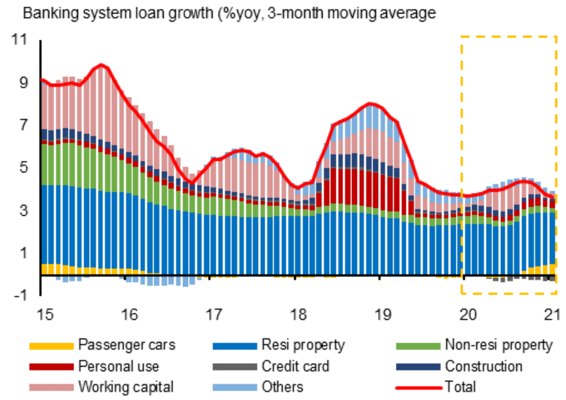
Source: DOSM via The Global Trade Atlas database.
Note: *Primarily refers to palm oil products; ADP stands for automated data processing.

A.5 Financial System Developments

13. **The banking system has been able to support the economy with continued lending to the private sector.** Lending continued to expand throughout 2020, albeit at a relatively muted pace compared to prior years (Figure 22). Credit growth was supported by the sizable reduction in the policy rate, which saw strong transmission to wholesale and retail lending rates (Figure 23), as well as the initiatives to support SMEs and stimulate domestic demand. The BNM's lending facilities, which are channeled through the banks for on-lending to SMEs at concessional rates, likely drove the pick-up in working capital loans. At the same time, incentives to encourage the purchase of residential property and passenger cars may have encouraged lending amid much lower borrowing costs. That said, banks remained cautious in extending credit, with approval rates that were generally stable or lower than in 2019. Personal use loans were an exception, as their approval rates increased in 2020.

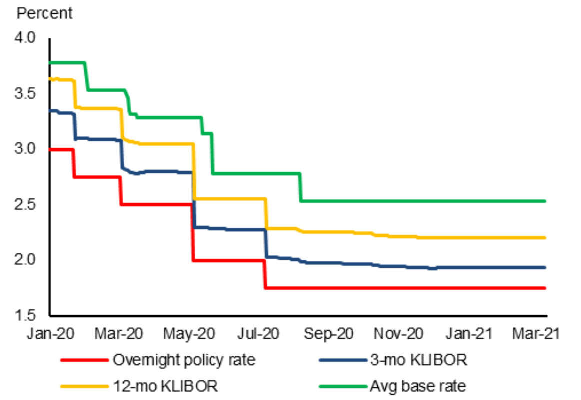
14. **Banking liquidity remained ample throughout 2020.** Ringgit liquidity in the banking system was shored up by the 100-basis-point reduction in the SRR and the recognition of financial institutions' holdings of government securities in meeting SRR compliance. Liquidity also got an added boost from BNM's increased open market operations, such as through outright purchases of government securities and reverse repo operations, and the decline in the loan-to-deposit (LDR) ratios for the most part of 2020 (Figure 24). On the decline in LDR ratio, stimulus measures to provide liquidity support to households and businesses, and the increase in risk aversion as the economic impact of the pandemic broadened, led to the faster expansion of deposits relative to loans. As a result, total ringgit liquidity placed with BNM only fell by MYR13.8 billion from end-February to MYR147.0 billion as of end-2020. The banking system's liquidity coverage ratio (LCR) also stayed over 140 percent throughout 2020 even as the 100 percent minimum threshold was relaxed temporarily during the period (Table 1). The market stress in March prompted banks to increase FCY buffers, although banks' offshore borrowings—accounting for over 50 percent of the country's total short-term external debt—were limited to 10 percent of total onshore financing as of September 2020. Net repayments of the interbank borrowings in the third and fourth quarters led to a decline in the short-term external debt (Figure 25).

Figure 22. Bank Credit by Purpose



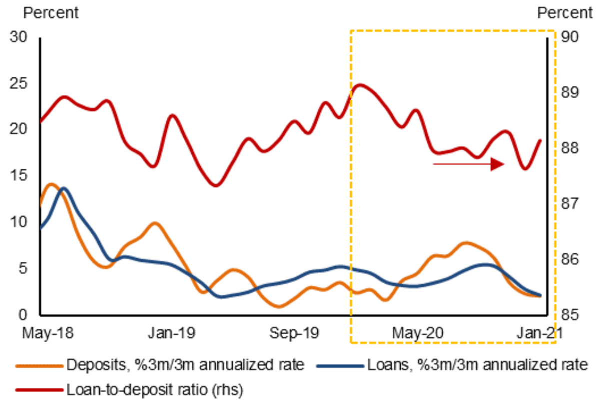
Source: BNM.

Figure 23. Policy Rate against Wholesale and Retail Lending Rates



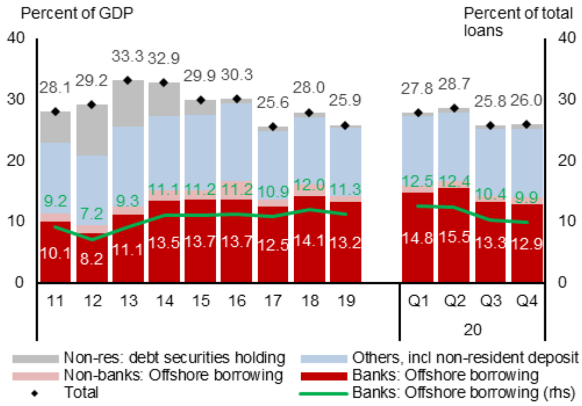
Source: Bloomberg Finance LP and BNM.

Figure 24. Banking System Deposit and Loan Growth and Loan-to-Deposit Ratio



Source: BNM.

Figure 25. Short-term External Debt by Components



Source: BNM, DOSM.

Table 1. Selected Financial Soundness Indicators

Percent, %	2018				2019				2020			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Common Equity Tier 1 Capital to Risk-Weighted Asset	13.2	13.4	13.2	13.9	13.8	14.0	13.8	14.6	14.0	14.6	14.7	14.8
Total Capital to to Risk-Weighted Assets	17.6	17.6	17.3	18.1	18.0	18.0	17.8	18.6	18.0	18.3	18.5	18.5
Impaired Loans to Total Gross Loans	1.6	1.6	1.5	1.5	1.5	1.6	1.6	1.5	1.6	1.4	1.4	1.6
Net Impaired Loans to Net Total Loans	0.9	0.9	0.9	0.9	0.9	1.0	1.0	1.0	1.0	0.9	0.8	1.0
Total Provisions to Total Financing	1.4	1.5	1.4	1.4	1.4	1.3	1.3	1.2	1.3	1.4	1.5	1.7
Loan-to-Deposit Ratio	88.7	89.7	89.9	89.2	89.0	89.2	89.5	89.9	90.6	89.0	89.2	89.5
Loan-to-Fund Ratio	82.3	84.1	84.3	83.1	82.8	82.6	82.9	83.2	83.2	82.0	81.9	82.5
Loan-to-Fund and Equity Ratio	71.8	73.4	73.6	72.6	72.1	72.2	72.5	72.8	72.4	71.5	71.5	72.0
Non-interest Expense to Gross Income	42.2	41.2	41.9	42.0	42.6	41.5	41.9	42.3	41.9	42.9	42.6	-
Return on Assets, annualized	1.4	1.5	1.4	1.4	1.3	1.5	1.5	1.5	1.2	1.2	1.1	-
Return on Equity, annualized	12.4	13.3	12.8	12.7	11.5	13.0	12.9	13.0	10.4	10.0	9.8	-
Interest Margin to Gross Income	58.7	58.7	60.6	61.0	59.2	56.7	57.5	57.8	57.9	54.7	57.0	-
Liquidity Coverage Ratio	139.8	139.3	139.5	143.2	143.0	153.0	143.5	149.1	141.4	149.2	151.5	148.2
Liquid Assets to Short-Term Liabilities	149.1	146.1	144.9	151.0	151.5	163.6	152.8	158.8	145.0	151.2	155.8	-

Source: BNM, IMF.

15. **The banking system is in a strong position to manage increased credit risks given strong capital buffers.** Loan impairments were mitigated by the six-month automatic loan moratorium and other repayment assistance schemes, and thus remained low at the end of 2020 despite the economic recession. The extent of asset quality deterioration may only manifest itself starting in the latter half of 2021 as the ongoing targeted repayment assistance is set to expire. According to BNM's simulations, banks' capital buffers would remain above regulatory thresholds should impairments rise to 4.1 percent of total loans by end-2021.[5] The findings

[5] See BNM Financial Stability Review for First Half 2020.

are in line with our stress-test exercises (see Selected Issue 3: Loan Repayment Reliefs and the Credit Fallout from the COVID-19 Crisis). The increase in loan impairments is expected to be driven largely by businesses in the services industries and lower-income households facing uncertain income prospects. The pandemic has increased the likelihood of a correction in property prices, although financial stability risks are mitigated by the low exposure of banks to vulnerable segments of the property market at about 6 percent of total loans.[6] Responding to the likelihood of increased credit risks, banks have pre-emptively set aside an additional MYR8.9 billion (net of write-offs and recoveries) of impairment provisions as of end-2020, equivalent to 1.7 percent of total financing compared to 1.2 percent at end-2019 (Table 1).

B. Risks, Vulnerabilities and Challenges

B.1 Near-term Risks to the Macro Outlook

16. **The ongoing economic recovery is subject to uncertainty over the duration of the pandemic.** A prolonged resurgence of COVID-19 infections and delays in the pace of vaccinations, in Malaysia and the major economies, would cast a cloud over the economic outlook. Extended movement restrictions would constrain domestic demand and disrupt international trade, which is also susceptible to prolonged tensions between the U.S. and China. In the event, the recovery could be derailed and turned into another economic downturn which would cause further impairment of households and businesses' balance sheets and strain the financial system. Expanding the fiscal stimulus would be appropriate, although another adjustment to the debt limit could heighten sovereign rating concerns. On the upside, a faster containment of the current wave of infections in Malaysia and externally could lead to an earlier and sharper economic rebound relative to our baseline scenario.

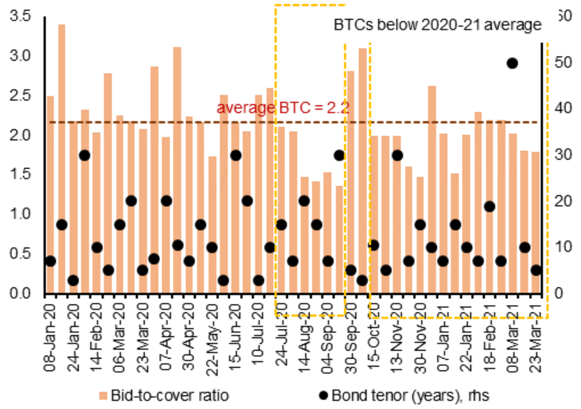
17. **While risk sentiment has turned positive following the U.S. Presidential election and reports of effective COVID-19 vaccines, a sudden reversal could easily trigger foreign capital outflows and dampen demand for government bonds.** The government's large financing needs coupled with the slower growth in EPF contributions have already put some pressure on longer tenor bonds, as reflected in below-average bid-to-cover ratios (Figure 26). While the recent improvement in risk sentiment could ease some of the pressure, a sudden spike in risk aversion—perhaps owing to an unrelenting surge of COVID-19 infections globally amid hurdles in mass vaccination drives—could weaken forthcoming bond auctions. Weak auction results do not pose a problem in itself, given Malaysia's ample buffers to support bond issuances. However, they add to investor concerns and may put upward pressure on financing costs. The EPF, other savings institutions, banks, and BNM can increase their purchases of government securities, providing a backstop against a sharp rise in yields. A potential spike in foreign exchange (FX) volatility from heightened risk aversion can also be smoothened through judicious interventions by BNM given its adequate level of reserves.

[6] Vulnerable segments of the property market refer to hotels, office space and shopping complexes, and property developers with unsold housing units. Risks to financial stability arising from the residential property segment are deemed manageable, as bulk of the loans refer to owner-occupied homes that would have a relatively lower risk of default. At the same time, macroprudential measures introduced since 2010 and the slower growth in house prices since 2013 have dampened speculative activity.

Authorities' Views

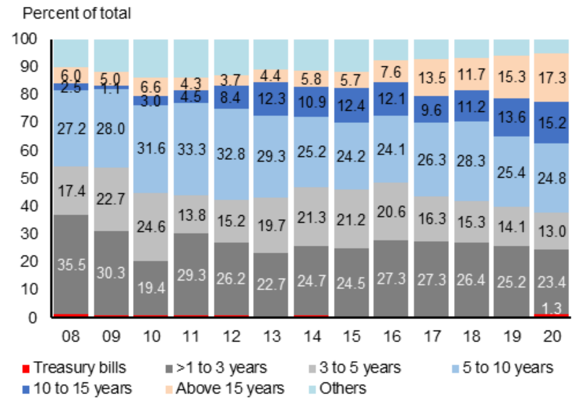
18. **MOF shared that the maturity structure of new bond issuances can be adjusted accordingly to match market preference and investor risk appetite.** Last year, for example, saw an increase in issuances of treasury bills (Figure 27) in light of the uncertainty over the duration of the COVID-19 crisis. That said, the proportion of short-term borrowings is small at about 1 percent of total domestic issues. The government's borrowing profile is, in fact, well-distributed across maturities. Meanwhile, BNM has ample room to increase outright purchases of government securities if need be, to support the bond market.

Figure 26. Federal Government Debt Issuances in 2020-21—Bid-to-Cover Ratios



Source: BNM, AMRO staff calculations.

Figure 27. Federal Government Debt—Domestic Issues by Maturity



Source: BNM.

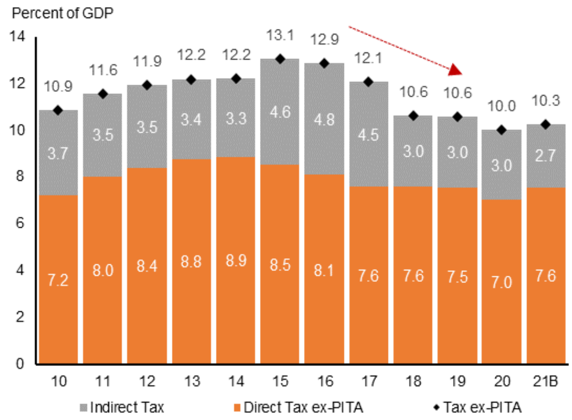
B.2 Longer-term Challenges and Vulnerabilities

19. **The narrowed tax base and large share of non-discretionary expenditure limit the flexibility to manoeuvre and react to adverse shocks, and likewise pose a challenge to medium-term fiscal consolidation.** Both direct and indirect tax revenue were already on a secular decline relative to GDP prior to the pandemic (Figure 28). The direct tax revenue, excluding petroleum income, had not grown in line with the broader expansion of the manufacturing and service sectors. Indirect tax collections also fell following the reinstatement of the sales and services tax (SST)—a single stage tax with a narrower scope—in September 2018, in place of the multi-stage goods and services tax (GST) that was introduced in April 2015. At the same time, emoluments and retirement charges account for an average of 40 percent of total operating expenditure (Figure 29). Clearly, a higher tax revenue base is needed to increase the fiscal space to counter adverse shocks and facilitate the restoration of fiscal buffers thereafter.

20. **Malaysia faces the challenge of raising productivity across sectors to advance from an upper middle-income to a high-income nation.** The country has progressively developed from its heavy dependence on commodities in the 1960s-70s to its rapid industrialization in the 1980s-90s. However, productivity and competitiveness of the manufacturing sector appear to have slipped since the early 2000s, with BNM noting the twin decline in the shares of employment and manufacturing output. Between 2000 and 2011, Malaysia recorded a decrease in employment shares in the higher value-added segments of manufacturing—knowledge creation (research and development, design, and branding) and support services (distribution and logistics)—whereas Korea and Taiwan Province of China, for example, have created more employment in those industries. The slower progress of the

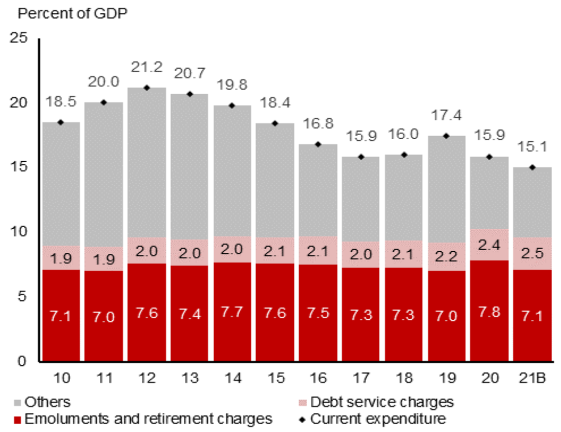
manufacturing sector has been attributed, among other factors, to the lack of industry-government coordination and technology upgrading.[7] This may have, in turn, kept employment compensation lower in Malaysia, which at 35.7 percent of GDP in 2018 is lower than Singapore (39.7 percent) and Korea (45.7 percent), as cited in the Shared Prosperity Vision 2030. There is thus a need to raise productivity across the manufacturing sector. But equally important, the service sector—being the largest contributor to the economy—should be able to support manufacturing in creating high-skilled, high-paying jobs that are commensurate with the level of productivity.

Figure 28. Tax Revenue



Source: DOSM, MOF.
Note: 21B refers to the projections under the 2021 Budget.

Figure 29. Current Expenditure



Source: DOSM, MOF.
Note: 21B refers to the projections under the 2021 Budget.

C. Policy Discussions and Recommendations

C.1 Crucial Role of Fiscal Policy in Facilitating the Economic Recovery

21. **A supportive and proactive fiscal policy remains critical to counter the severe economic loss wreaked by the pandemic.** Fiscal policy has appropriately taken an active role in supporting the economy during the crisis. AMRO commends the prompt deployment of another economic package shortly after tightened movement curbs were imposed in January-February 2021. Initiatives such as targeted cash transfers, tax reliefs, and job retention and hiring incentives schemes as well as enhanced healthcare services are appropriate to continue through 2021 to protect the welfare of vulnerable groups. Likewise, the extension of the targeted repayment assistance, withdrawal of retirement savings and reduced contributions, credit guarantees, and BNM's soft loans to SMEs, have helped to ease cash flow constraints and support a sustained economic recovery going forward. As such, the targeted loan repayment assistance and credit support to SMEs may remain in place and recalibrated as needed, but due regard must also be given to the restoration of employees' retirement savings post-pandemic.

22. **At the same time, policy responses should be geared toward securing greater economic opportunities for Malaysians post-pandemic.** In this regard, proactive and concerted efforts to encourage domestic and foreign investments are welcome. The authorities are on the right track to ramp up investment in transport and digital infrastructure, roll out time-bound investment incentives in high-value manufacturing and service activities,

[7] Tengku Mohamed Asyraf et al., *Is Malaysia Experiencing Premature Deindustrialisation?* BNM Quarterly Bulletin First Quarter 2019, 19-25.

and extend credit guarantees including to foreign-owned companies with a mostly Malaysian workforce. Such initiatives are likewise appropriately complemented with grants to upgrade labor skills and speed up digitalization across industries and SMEs. With comprehensive measures in place, fiscal resources would have to be deployed efficiently and effectively. In this regard, we commend the regular progress reports by the Ministry of Finance on the economic support measures, which can be used to gauge the effectiveness of existing initiatives or whether a recalibration is necessary to enhance their economic impact.

C.2 Reforms to Restore Fiscal Buffers over the Medium Term

23. **The enlarged debt burden underscores the importance of committing to a medium-term plan to restore fiscal buffers.** The government has announced a lower fiscal deficit of 4.5 percent of GDP in 2021-2023 under the Medium Term Fiscal Framework (MTFF). To this end, we welcome plans to enhance the fiscal revenue by exploring new sources, widening the revenue base, improving tax administration, and generally aligning revenue efforts toward achieving the MTFF. The government also intends to consolidate the tax incentive packages, based on impact and cost-benefit analyses, and improve overall spending efficiency, where in our view, the shift to a targeted subsidy scheme should be one area for reform. Encouragingly, these efforts build on the proposals of the Tax Reform Committee that was created under the previous administration. Moreover, it is pushing ahead with the planned legislation of the Fiscal Responsibility Act in 2021 to institutionalize the sound management of public finances, including the reporting of tax expenditure. Efforts are likewise ongoing to facilitate a more active management of debt and liabilities, such as by strengthening the function of the Debt Management Office.

24. **When the economic recovery is on a firm footing, tax reforms may be implemented to guide the federal government debt back to the pre-pandemic statutory limit over the medium term.** Our debt sustainability simulations indicate that meeting the lower statutory limit of 55 percent of GDP by end-2023—as currently planned by the government—would be challenging under baseline assumptions.[8] That said, in our estimates, re-introducing the 6 percent GST would raise the additional revenue needed to narrow the deficit and substantially lower the government debt toward the desired limit. Thus, there is a need to design and implement revenue-raising tax reforms that would not jeopardize the economic recovery. The reforms may be implemented once the economic recovery firms up and the uncertainty over the outlook dissipates, to avoid cliff effects. For instance, the GST can be re-introduced gradually at a lower initial rate, while the following measures can also be considered:

- The scope of the SST can be broadened before the GST is reintroduced. The government can build on efforts from the introduction of the digital service tax in January 2020, and the move under the 2021 Budget to impose a tax on cigarettes in duty free zones as part of the strategy to curb illicit trading of cigarettes.

- Additional revenues can also be generated from: (1) raising the personal income tax rate for the high-income groups; (2) raising excise tax rates on selected products, for example, up to 70 percent of the unit consumer price of tobacco in line with the WHO's Tobacco Free Initiative; and (3) introducing a capital gains tax, aside from

[8] The statutory debt limit of 60 percent of GDP in 2020-22 and 55 percent from 2023 onwards only applies to the domestic component of the government debt. See footnote 2.

property. These measures would supplement the other revenue-enhancing measures in the 2021 Budget, such as curbing the smuggling of high-duty goods, imposing a 10 percent excise duty on electronic and non-electronic cigarette devices, and expanding the tourism tax to cover online bookings.

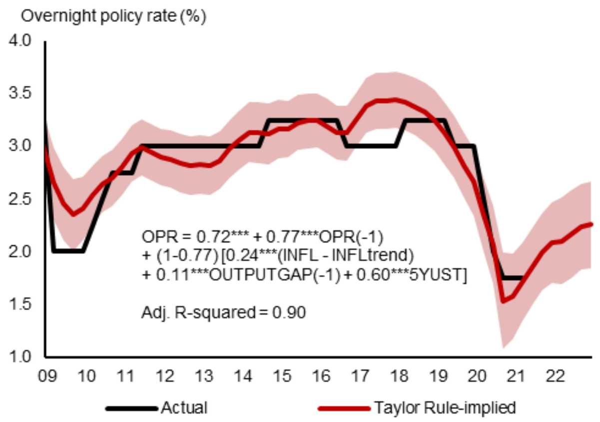
- Over the medium or long term, the introduction of a carbon tax can be explored, to facilitate the transition to a green economy while augmenting fiscal revenues.

The proposed reforms can be reinforced by ongoing efforts to improve tax administration, including the adoption of the tax identification number, enhancement of tax audits and enforcement, and promotion of tax education programs.

C.3 Maintaining Accommodative Monetary Conditions to Support the Recovery

25. **Monetary policy should be on an easing bias given the uncertainty over the growth outlook.** The policy rate has been appropriately kept on hold since September 2020 as the economy rebounded sharply with the lifting of the nationwide lockdown. Despite the recent weakening in the recovery momentum, the record low policy rate remains accommodative and thus, should be given more time for the effects to be transmitted fully to the real economy. Our expectations of an economic recovery starting in Q2 2021 also warrant modest policy rate increases by a total of 50 basis points starting in the latter half of 2021 through 2022, as suggested by the augmented Taylor Rule model (Figure 30). However, given the high degree of uncertainty around the economic outlook and the available space for monetary policy, it would be appropriate to maintain an easing bias to ensure that monetary conditions remain supportive in the event of a weakening in economic activity.

Figure 30. Actual and Augmented Taylor Rule-implied Overnight Policy Rates



Source: BNM, AMRO staff calculations.
Note: The range refers to +/-1 standard error. The projection assumes no change in the Federal Funds Rate through end-2022. INFLtrend refers to the deviation of headline inflation from its linear trend.

26. **BNM should stand ready to inject additional liquidity to maintain market stability.** The lingering uncertainty surrounding the global pandemic risks triggering a spike in risk aversion and market volatility. In this regard, BNM should stand ready to maintain conducive financing conditions by injecting liquidity through reverse repo operations and FX swap transactions as well as purchases of government securities. Lowering the SRR ratio would have minimal liquidity impact with less than MYR3 billion left of banks' statutory reserves as of end-October. In this regard, we welcome the move to extend the ongoing flexibility rendered to banks in complying with the SRR from May 2021 to end-2022, in order to provide continued support to the bond market.

C.4 Safeguarding Financial Sector Stability

27. **Financial supervision should continue to be intensified in light of heightened credit risks.** With the extended targeted repayment assistance scheme keeping loan impairments

low, banks have stepped up customer engagements and made greater use of alternative data sources, such as data analytics, to obtain better and more timely visibility on the quality of their loan book. Likewise, BNM has intensified its coordination with the banking institutions, industry associations, and other regulatory agencies. BNM staff are also closely monitoring and engaging banks on lending trends, such as new loans' debt service ratio (DSR), loan-to-value ratio (LTV) and growth in personal financing. These efforts are crucial to ensure that banks are not engaged in excessive risk-taking in light of the low interest rate environment, but rather remain supportive of financing to viable businesses and households. In addition, BNM has run various stress-testing exercises, including under significantly adverse scenarios, to assess potential vulnerability since the onset of the crisis. Stress-testing exercises were also conducted by domestic banking groups on their major overseas operations, and the results show that most foreign subsidiaries have sufficient capital to withstand severe COVID-19 related shocks, limiting the need for capital support from domestic parent banks. Existing efforts should be continuously reviewed and enhanced, especially as the crisis continues to evolve and its broad economic impact remains uncertain.

C.5 Strengthening Buffers Against External Shocks

28. **It would be prudent for BNM to continue to build up its international reserves while maintaining a flexible exchange rate system to strengthen buffers against external shocks**. The BNM's reserves are adequate by standard international metrics, but low relative to emerging market peers, owing largely to Malaysia's more open and developed financial sector (see Box B. BNM's International Reserves as a Fraction of Malaysia's External Assets). In this regard, it would be appropriate for BNM to continue accumulating reserves during periods of strong capital inflows to increase its coverage against the external liabilities. It would also be prudent to limit the aggregate amount of potential net short-term drains on BNM's reserves (FX swaps and US dollar deposits) to preserve market confidence. At the same time, flexibility in the exchange rate should continue to act as the primary buffer against external shocks.

29. **FX policy adjustments in late 2016 have contributed to lower capital flow volatility during the recent stress episode.** Tightened enforcement against offshore ringgit trading, particularly in non-deliverable forwards (NDF), in November 2016 followed by initiatives to develop the onshore FX hedging market in the following months have led to capital flows which are more stable and less speculative in nature (see Box C. Taking Stock of Malaysia's Onshore Financial Markets).[9] They may have averted larger capital outflows and a sharper disruption to Malaysia's financial markets in March 2020. We recognize that the FX policy adjustments were made based on the unique situation facing Malaysia and has become an integral part of the policy mix. In this regard, containing speculative trading may be warranted under the current environment to moderate capital flow and FX volatility. At the same time, we support BNM's continuing efforts to improve the trading flexibility of market participants, as they would contribute to the deepening of the onshore financial markets.[10] We have been encouraged by the following developments, in addition to those acknowledged by FTSE Russell in its September 2020 review:

[9] Subsequent initiatives to develop the onshore FX hedging market in December 2016 entailed the requirement to convert three-quarters of export proceeds to ringgit and the limitation on outward FCY investments of residents with domestic borrowings. These measures have since been refined further.
[10] FTSE Russell, a major bond index provider, has placed Malaysia under review since April 2019 on concerns about the accessibility of its local bond and FX markets to foreign investors.

- **Two pilot initiatives offering greater flexibility to market participants.** The first, which began in September 2020, allows registered index-tracking non-resident investors to trade FX forwards without an underlying investment, albeit on a limited basis. The second, commencing in November 2020, allows non-resident banks to enter into ringgit-denominated interest rate swaps (IRS) without underlying commitment directly with pilot onshore banks or via their appointed overseas offices (AOOs). Sustaining efforts to enhance trading flexibility should help to draw foreign investors and improve liquidity in the onshore debt and FX markets. To this end, the second initiative was formalized recently to allow non-resident banks to trade ringgit-denominated IRS without underlying commitment with **any** onshore bank or its AOOs starting on March 15, 2021.

- **Refining the export conversion requirement in order to improve business efficiency.** Starting April 30, 2020, export proceeds below MYR200,000 per transaction have been exempted from the conversion requirement into MYR. This adjustment exempts at least 80 percent of all export transactions and reduces cost of doing business by SME exporters in managing their foreign currency cash flows.

- **Providing greater flexibility for corporates in managing FX risks**. The following four measures also took effect on April 30, 2020. First, residents are able to hedge their FCY loan obligations up to the underlying tenure of their loans, from only up to 12 months previously. Second, residents and non-residents, with the exception of portfolio investors not registered under the dynamic hedging framework, are allowed to freely unwind their hedging positions. Third, residents are free to obtain financial guarantee from non-residents without limit to support entities operating in Malaysia. Fourth, residents are likewise free to issue financial guarantees to non-residents without limit (but with some exceptions) to enhance Malaysian firms' ability to support their global operations.[11]

BNM should continue the engagements with market participants, including corporate treasurers and investors, and the collaboration with MIDA to ensure that the onshore markets are sufficiently deep and liquid to meet investors' needs. BNM intends to build on its current efforts by organizing biannual investor engagement sessions in 2021 to allow for a two-way communication platform between the authorities and market participants. Further enhancements to the FX policy should also continue to be aligned with the goals of deepening onshore financial markets and preserving market stability.

C.6 Achieving a Resilient and Robust Economy Post-pandemic

30. **Concerted efforts to enhance the investment ecosystem would contribute toward greater export diversification and productivity gains.** The authorities' proactive efforts to improve the ease of doing business and accelerate investments are timely given considerations among some major economies and multinational companies (MNCs) to diversify their supply chains in order to enhance resilience.[12] The forthcoming implementation of the Regional Comprehensive Economic Partnership (RCEP) could also increase the incentive to reconfigure the regional supply chains and production hubs as tariffs are lowered

[11] For more information on the FX policy refinements in April 2020, kindly refer to the link provided by BNM here: https://bnmold.bnm.gov.my/files/doc/fea/intro/FEP%20Refinement_Summary%20Note.pdf
[12] See footnote 3 and paragraph 23 for the recent initiatives.

sharply among the 15 members, including ASEAN+3.[13] Initiatives to enhance the already favorable ecosystem should increase Malaysia's attractiveness to strategic foreign investments, such as in high-technology production, research and development, and principal hub. The initiatives have the potential to broaden the export base and boost productivity, in turn supporting Malaysia's goal of advancing to a more inclusive, high-income nation.

31. **Aligning the economic recovery plan to an environmentally sustainable agenda would strengthen Malaysia's ability to adapt to emerging global trends and develop a more resilient economy.** In this regard, the country is taking steps in the transition towards a green economy, with the planned issuance of its first sovereign "sustainability bond" in 2021. This initiative is facilitated by BNM's ongoing work to develop a common taxonomy that would make financial institutions accountable for their climate risk commitments.[14] Building on these initiatives would position Malaysia to benefit from the global trend towards sustainability investment. More importantly, committing to a broad-based environmentally sustainable agenda would enhance the resilience of the economy in the post-pandemic new normal.

Authorities' Views

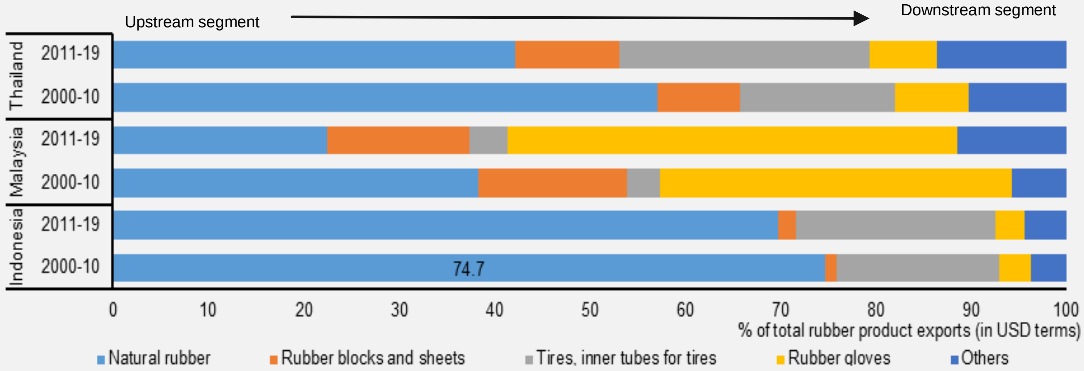
32. **The authorities broadly agreed with AMRO's economic outlook and policy considerations.** BNM and MOF both acknowledged the necessity for revenue measures, including the re-introduction of the GST, in restoring fiscal space. MOF also acknowledged that income tax collections had not grown in line with the economy, while there is likewise a need to provide better tax packages for business. To this end, MOF expressed its consideration to incorporate the tax measures proposed by AMRO in the medium-term revenue strategy. For example, MOF is currently conducting a holistic study of consumption tax models, including a cost-and-benefit analysis of the current SST and the previous GST system. At the same time, the government is currently in the process of revisiting the current tax incentive framework to ensure that the framework is in line with generating quality and high-value investment, and narrowing the economic disparities across the country. Moreover, the government is in the early stage of exploring the feasibility of implementing a carbon tax, as an initiative to bring the country in line with the Paris Agreement to reduce greenhouse gas emissions by 45 percent relative to 2005 levels by 2030. Meanwhile, BNM shared that it has been working actively with ASEAN central banks on the role of the region's monetary authorities in managing climate and environmental-related risks.

[13] Under existing free trade agreements (FTA), intermediate goods imported by an FTA-member country from a non-member country may not be eligible for lower tariffs accorded by the specific FTA. Alternatively, RCEP member-countries could build on existing regional supply chain linkages, and take advantage of the uniform reduction in tariff and non-tariff barriers.
[14] For instance, CIMB—a major domestic banking institution—announced in December 2020 to phase out coal financing from its portfolio starting in 2021 through 2040.

Box A. Outperformers in the Pandemic—The Case of Malaysian Glove Makers[15]

Malaysia's rubber glove industry tells a successful story of moving up the value chain of resource-based manufacturing. A typical rubber-related value chain consists of three segments, i.e. upstream, midstream, and downstream, with moving downstream earning higher value-added.[16] The history of Malaysia's rubber upstream and midstream segments dates back to the colonial period. The downstream segment in the rubber industry, meanwhile, started to develop during the 20-year New Economic Policy (NEP) that was adopted in 1971, to move downstream into production of new materials for heavy industries, including tires and other automobile parts, construction goods and gloves. That said, it only took off with the emergence of both foreign and local rubber glover makers, stimulated by the demand in latex glove usage following the HIV/AIDS epidemic outbreak in the late 1980s. Most notably, home-grown firms, in close collaboration with public R&D institutions, led cutting-edge innovations, including the development of allergy-free latex medical gloves (Kawano, 2019). They also pioneered the introduction of automation to production lines, which helped boost productivity to a significant extent.[17]

Figure A1. Rubber Exports by Major Product Categories: Selected ASEAN



Source: GTA, AMRO staff calculations. Data are period averages.

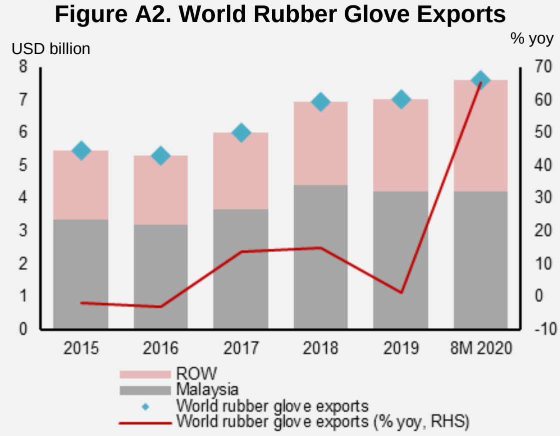
Against these backdrops, Malaysia's local glove makers survived the Asian Financial Crisis, and thrived to become the largest supplier to the world market today. Exports of rubber gloves have increased steadily in Malaysia over the years, accounting for almost 50 percent of its total exports of rubber products between 2011 and 2019, compared to 7 percent in Thailand and 3 percent in Indonesia (Figure A1). Malaysia has also become the largest glove exporter with about 60 percent of the global market share, leading its runner-ups, i.e. Thailand (17 percent) and China (10 percent), by a wide margin.

Malaysian glove makers have benefited tremendously from a surge in demand during the COVID-19 pandemic. The pandemic has triggered a sharp increase in the world demand for rubber gloves, notably medical gloves but also non-medical ones. The total value of global rubber glove exports stood at USD7.6 billion in the first eight months of 2020, exceeding the whole amount of 2019 and increasing 65 percent from the same period of the previous year (Figure A2). Accounting for about two thirds of the global share, Malaysia recorded USD4.2 billion worth of rubber glove exports in the same period. This marks a 66 percent increase from a year earlier, which has been attributed to higher demand across all markets, especially the U.S., Europe, China, and Japan (Figures A3 and A4).[18] A booming export performance has contributed to record-high profits for Malaysia's glove

[15] Prepared by Nguyen Thi Kim Cuc.
[16] The upstream segment involves raw rubber cultivation and harvest; the midstream segment involves the processing of raw rubber into intermediate products, namely technically specified rubber (TSR), generally called block or standard rubber, ribbed smoked sheet (RSS), and latex concentrate. The downstream segment involves the manufacturing of various rubber-based products for transportation vehicles (tires, belts), industry usage (plates, bearings), general uses (threads, shoes), and hygiene and medical application (rubber gloves, condoms) (Kawano, 2019).
[17] According to the Malaysia Rubber Glove Manufacturers' Association, the productivity rose from roughly 3,000 gloves per hour in the late 1980s to 45,000 gloves per hour currently (International Labour Organization, 2016).
[18] In volume terms, Malaysia's rubber glove exports in the first nine months of 2020 increased almost 27 percent from a year earlier.

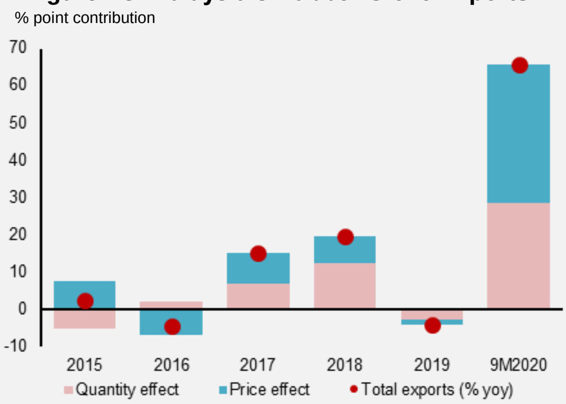
makers and an unprecedented rally in their share prices that outperforms the overall stock market (Figure A5).

Figure A2. World Rubber Glove Exports



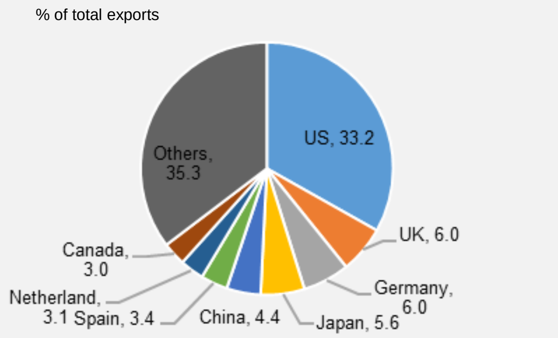
Source: Global Trade Atlas (GTA), AMRO staff calculations

Figure A3. Malaysia's Rubber Glove Exports



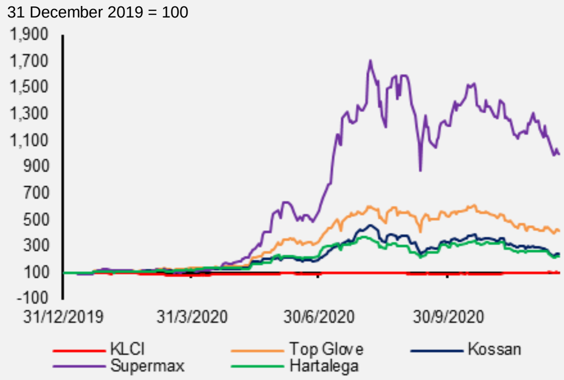
Source: GTA, AMRO staff calculations

Figure A4. Malaysia's Rubber Glove Exports by Major Markets



Source: GTA, AMRO staff calculations.
Note: Data are based on Malaysia's 9M 2020 exports.

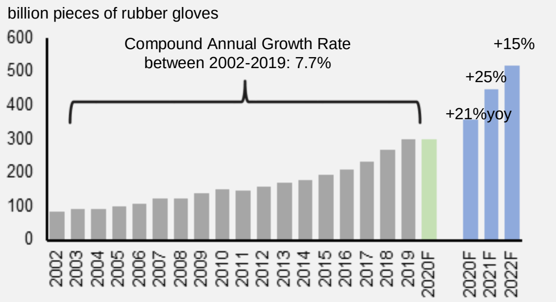
Figure A5. Share Prices of Malaysia's Four Largest Rubber Glove Makers versus KLCI



Source: Thomson Reuters Datastream, AMRO staff calculations.
Note: Daily data up to 18 December 2020.

At the same time, the pandemic underscores a number of challenges inherent to the industry. Despite increased automation, the industry remains labor-intensive and local firms have relied on foreign workers to a significant extent. International border shutdowns triggered by the pandemic have therefore made it difficult for firms to hire more (foreign) workers. Furthermore, the living condition in glove worker dormitories have made the headlines following the recent COVID-19 outbreak. The outbreak has led to the suspension of operations in affected factories, highlighting the risk of output disruptions. Last, but not least, the pandemic has increased the volatility in glove material prices. This could be critical for Malaysian firms due to their increased reliance on the import of material inputs against the backdrop of a shrinking upstream segment.

Figure A6. Global demand for rubber gloves



Source: Economic Intelligence Centre (Siam Commercial Bank), JP Morgan, Malaysian Rubber Glove Manufacturers' Association, AMRO staff calculations.
Note: The forecast bar in light green was made pre-pandemic, while those in blue are updated with pandemic-triggered demand.

Notwithstanding the challenges, the outlook for Malaysia's glove makers remains bright. The booming demand for rubber gloves is likely to continue in the short-term, driven by the ongoing pandemic and future vaccination programs (Figure A6). With high production capacity and recent investment ramp-ups, Malaysian glove manufacturers have been well positioned to meet an increase in global demand. Out of 360 billion glove pieces needed globally in 2020, Malaysia is expected to produce about 240 billion, up from 182 billion in 2019 (Campbell and Raghu, 2020). Moving beyond the pandemic, rising needs for high-quality medical services in not only advanced economies but also developing countries, would sustain the glove demand in the long run.

References:

Campbell, Matthew and Anuradha Raghu. 2020. "The Pandemic is a Bonanza for Malaysia's Medical Glove Industry", Bloomberg Businessweek, April 21. https://www.bloomberg.com/news/articles/2020-04-21/the-pandemic-is-a-bonanza-for-malaysia-s-medical-glove-industry.

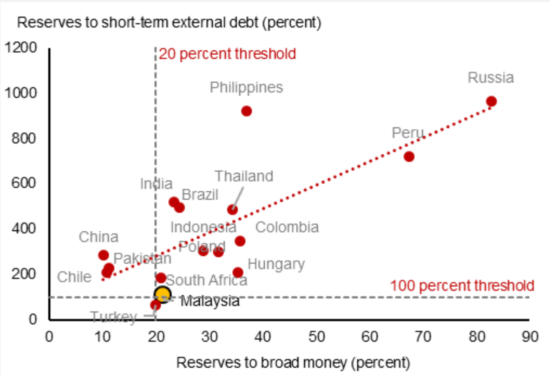
International Labour Organization. 2016. "Analysis of the Economic Development Role of Sectoral Business Associations in the Rubber, Electronics and Electrical, and Automotive Sectors in Malaysia, Thailand, and Vietnam." Working Paper No. 16, Geneva.

Kawano, Motoko. 2019. "Changing Resource-Based Manufacturing Industry: The Case of the Rubber Industry in Malaysia and Thailand." In *Emerging States at Crossroads,* edited by Keiichi Tsunekawa and Yasuyuki Todo, 145-62. Emerging-Economy State and International Policy Studies. Springer, Singapore.

Box B. BNM's International Reserves as a Fraction of Malaysia's External Assets[19]

At current levels, BNM's international reserves are adequate according to standard metrics, although at the low end relative to emerging market (EM) peers. This is particularly the case when central bank reserves are compared against short-term external debt, where the adequacy threshold is 100 percent—and against broad money supply, where the threshold is 20 percent (Figure B1).[20] On a positive note, Malaysia's ranking is slightly better relative to peers for other metrics, such as months of imports and separately, current account liabilities—a reflection of Malaysia's larger external trade sector. Moreover, Malaysia is among the only few EM economies with a positive net external asset position over the last ten years (Figure B2). This implies that besides BNM's reserves, the country has also accumulated significant amount of other forms of external assets, such as equities and direct investments abroad, some of which can be deployed to meet external liabilities that are coming due.

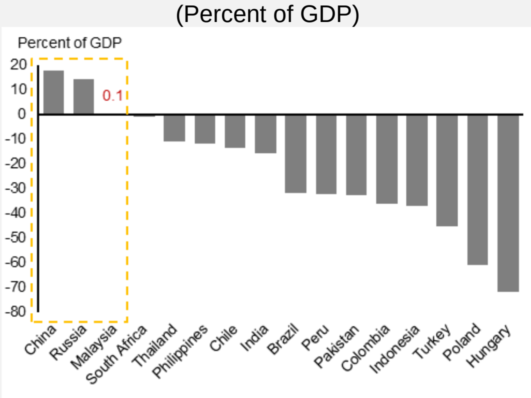
Figure B1. Selected Reserves Adequacy Metrics across Emerging Market Economies



Source: IMF, AMRO's ARTEMIS database. Note: Reserves-to-short-term external debt ratios refer to August 2020 data, except for Peru (February 2020). Reserves-to-broad money ratios refer to October 2020 data, except for Brazil (June 2018) and Peru (February 2020).

Figure B2. Net International Investment Position across Emerging Market Economies

(Percent of GDP)



Source: IMF.
Note: Period refers to the average for 2010-19. The 10-year average is taken as the IIP position can fluctuate across years due to exchange rate movements, among other factors.

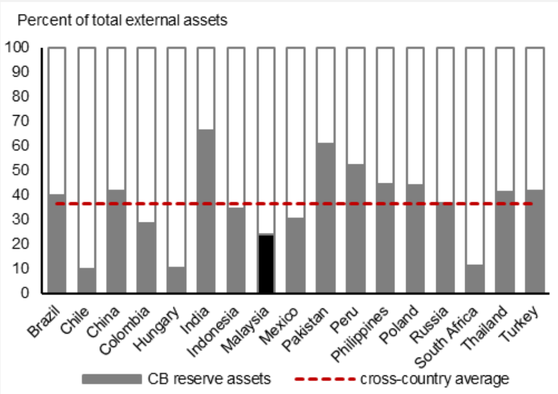
Indeed, the country's substantial external assets bolster the adequacy of BNM's international reserves. Malaysia has a well-developed financial sector and many of its banks and corporates are multinational companies. As a result, substantial external assets (and liabilities) are held by the corporates and financial institutions such as banks, pension funds and investment companies. As shown in Figure B3, only a quarter of the country's external assets are held by the central bank, and this proportion is at the low end relative to EM peers. As for the rest, over three-quarters of Malaysia's external assets are held by private institutions, which can be used to service their respective external liabilities without having to draw on BNM's FX reserves. In total, external assets amounted to 136 percent of GDP as of end-2020, and assets net of liabilities amounted to over 5 percent of GDP (Figure B4). That said, Malaysia's net external assets had fluctuated between surplus and deficit positions in the last 10 years, partly as a result of exchange rate movements and investment decisions of residents and non-residents.

For example, three Malaysian companies, which account for a major proportion of direct investment assets (DIA), have liquid FCY assets to cover for their respective short-term FCY liabilities. Direct investment assets (DIA) account for nearly a third of Malaysia's USD455 billion of

[19] Prepared by Diana del Rosario.
[20] The Guidotti-Greenspan rule proposes a 100 percent cover for repayments related to a country's short-term external debt, and ideally including the value of long-term external debt that is due within one year (residual maturity). Meanwhile, the reserves-to-broad money ratio measures the potential demand for foreign assets from domestic sources, and is considered relevant for countries with financially developed markets and an open capital account (Arslan and Cantú, 2019).

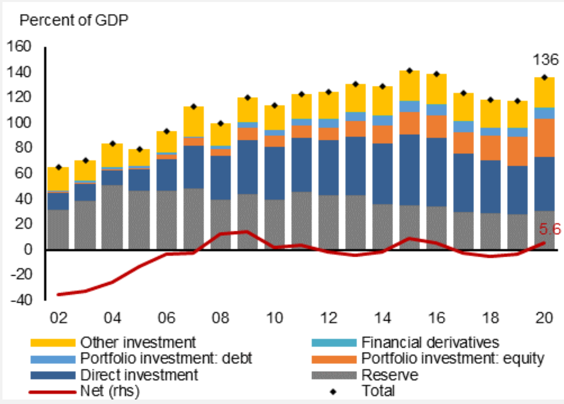
external assets as of September 2020. Of the total DIA, nearly 13 percent is accounted for by the mining sector (Figure B5), largely by the state-owned oil and gas corporation, PETRONAS.[21] PETRONAS has debt amounting to USD21.7 billion as of September 2020, and of which USD2.7 billion has a maturity of less than one year and is considered short-term (Figure B6). However, PETRONAS' FCY cash holdings, amounting to USD13.3 billion as of September 2020, is more than sufficient to repay its short-term debt, even if all of the short-term debt is assumed to be in FCY. Similarly, Maybank and CIMB—Malaysia's largest banking groups by asset—have expanded overseas, particularly in Asia, and would be a reasonable representation of the DIA in the financial services industry. The banking groups' cash holdings can cover for their short-term FCY borrowings, should the need arise, without potentially creating a claim on BNM's FX reserves (Figure B6).

Figure B3. Central Bank Reserve Assets across Emerging Market Economies



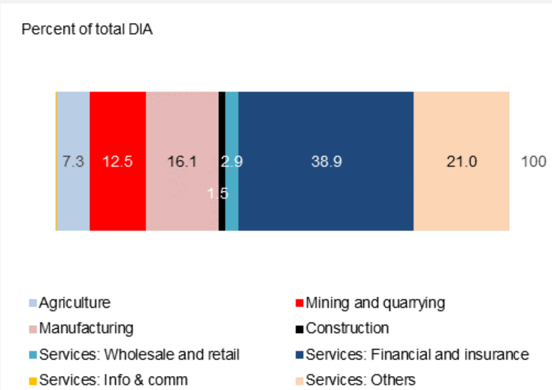
Source: IMF accessed via Haver Analytics. Note: Data for 2019. CB refers to central bank.

Figure B4. External Assets by Component—Malaysia



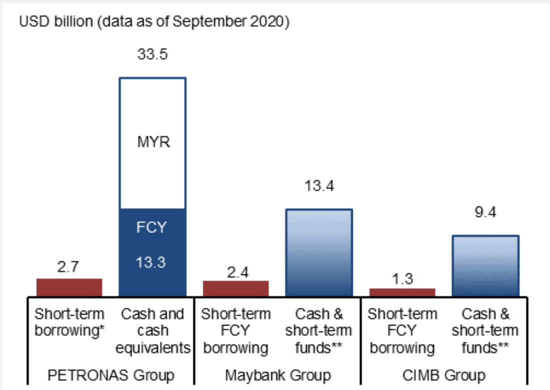
Source: BNM, DOSM.

Figure B5. Direct Investment Assets by Economic Sectors, Q3 2020



Source: BNM.

Figure B6. Short-term FCY Borrowing and Cash Position of Selected Malaysian Firms

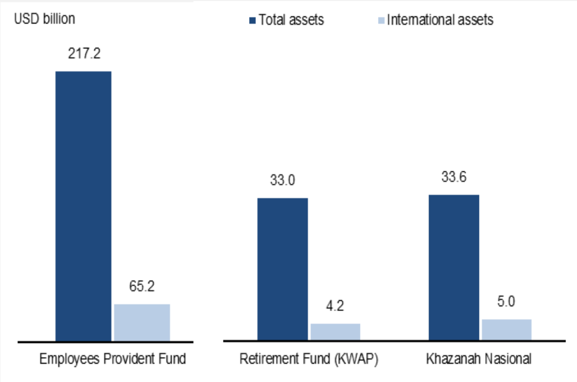


Source: Corporates' financial results announcements for Q3 2020. Notes: *PETRONAS does not report currency breakdown for short-term borrowing. **Maybank and CIMB do not report currency breakdown for cash and short-term funds. Short-term FCY borrowing for Maybank and CIMB includes subordinated obligations. MYR figures converted to USD using end-September 2020 official FX rate.

[21] While foreign asset data are unavailable, PETRONAS' international capital investments between 2016 and Q3 2020 amounted to USD22 billion, compared to the mining sector's DIA of USD18.1 billion as of Q3 2020. The smaller amount of assets in the mining sector may be due to overseas asset liquidations by PETRONAS or other companies during the same period or earlier.

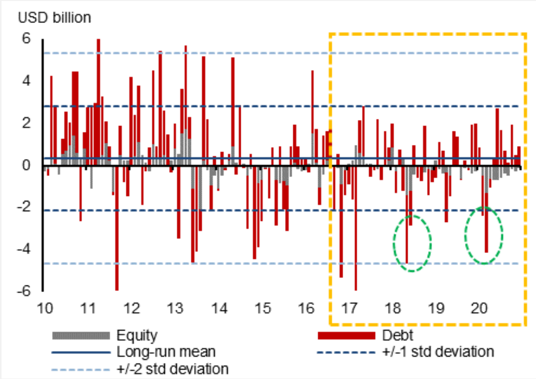
Portfolio investment assets present another line of support for BNM's reserves. Government-linked investment corporations (GLICs), such as the two biggest retirement funds EPF and KWAP, and sovereign wealth fund Khazanah Nasional, have foreign assets amounting to at least USD74 billion which are largely in portfolio equity investments (Figure B7). These assets can be repatriated back to the country during emergency such as a financial crisis, to service external liabilities.

Figure B7. Total and International Assets of Selected GLICs



Source: Company reports and press releases. Notes: Assets of EPF are as of June 2020; end-2018 for KWAP; and end-2019 for Khazanah Nasional. MYR figures have been converted to USD using same period official FX rates. Amount of international assets for Khazanah are obtained from a media report.

Figure B8. Non-resident Net Purchases in Local Equity and Debt Markets



Source: BNM, Bursa Malaysia.

However, despite BNM's adequate reserves and the country's sizable external assets, the reserves position can be improved further. Doing so would ensure that buffers remain ample in the event of external shocks, where there may be a need for BNM to draw on reserves to moderate MYR volatility and preserve overall market confidence. This is especially relevant for Malaysia, where higher reserves volatility during periods of market stress—a broad proxy for FX intervention—has been associated with lower FX volatility (Aziz, 2013). In this regard, a comfortable reserves position would be at a level that would keep both gross and net reserves on par with the level of short-term external debt or 20 percent of broad money, whichever is higher, despite large capital outflows. Looking at historical experience, extreme outflows amounting to two standard deviations above the 2010-19 average outflows—equivalent to USD5.3 billion per month—occurred for two consecutive months, at least, during the post-NDF period starting in November 2016 (Figure B8). Hence, to be more prudent, BNM could augment its reserves position by another USD10 billion to provide ample cover for 2 consecutive months of adverse scenario capital outflows, while remaining above the reserve adequacy threshold.

References:

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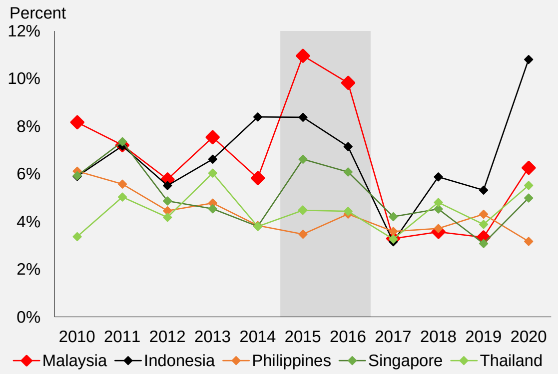
Aziz, Norzila Abdul. 2013. "Foreign Exchange Intervention in Malaysia." BIS Papers No 73, Bank for International Settlements, Basel. https://www.bis.org/publ/bppdf/bispap73p.pdf.

Box C. Taking Stock of Malaysia's Onshore Financial Markets[22]

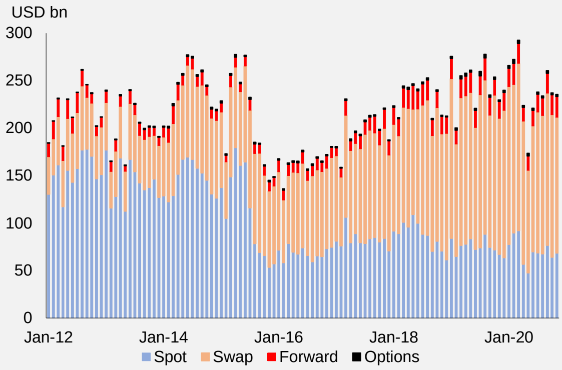
A key catalyst for development of Malaysia's onshore FX markets was the NDF clampdown in November 2016. Volatility of ASEAN currencies picked up in 2015-16 but MYR volatility stood out (Figure C1). Empirical studies by Schmittmann and Chua (2020) provide empirical evidence that prior to November 2016, NDF influenced the onshore spot and was probably the source of increased volatility in spot market. However since the NDF clampdown, which was complemented by measures to develop the onshore FX hedging markets, MYR volatility had reduced significantly and the direction of spillover was also reversed with the onshore spot rate having an influence on NDF markets. The volatility remained low until the pandemic-driven market turbulence in 2020, but the rise was a lot more muted than in 2015-16.

Figure C1. Daily realized volatility (Annualized)



Source: Bloomberg Finance LP., AMRO staff calculations

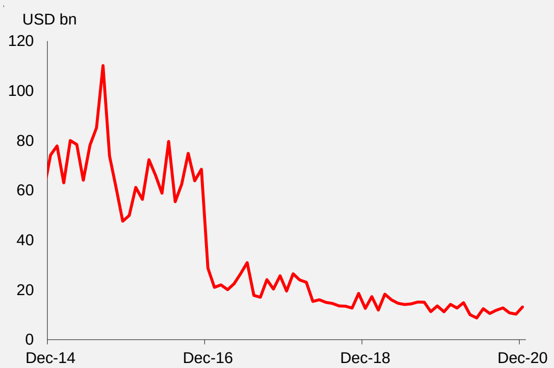
Figure C2. Onshore FX Transactions



Source: BNM, AMRO staff calculations

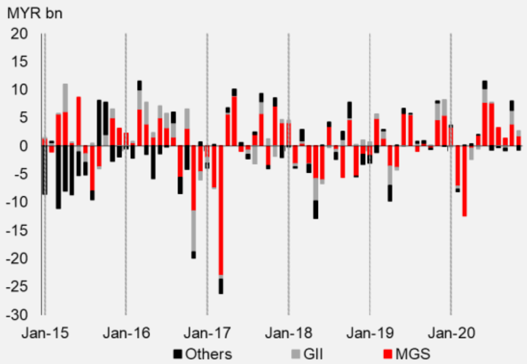
Transactions in the onshore FX swap markets have grown since late 2016 while the turnover in the NDF market declined sharply. The turnover in the onshore FX swap markets have grown steadily (Figure C2), after a part of the offshore trading of MYR forwards migrated onshore with the introduction of the dynamic hedging program in December 2016. Steady growth in FX transactions was facilitated by successive measures to balance FX supply and demand domestically, including the export proceed conversion requirement, the expansion of the Appointed Overseas Office (AOO) program, and improved hedging opportunities for foreign investors, among others. FX transactions dropped sharply in March 2020 following the U.S. dollar funding stress, but recovered quickly in the succeeding months. Meanwhile, volumes in the offshore non-deliverable ringgit (NDF) forwards fell in late 2016 and have steadily declined (Figure C3), indicating its diminished price discovery role for the MYR compared to the onshore market.

Figure C3. NDF Volume Traded



Source: Bloomberg Finance LP., AMRO staff calculations.

Figure C4. Foreign Debt Flows



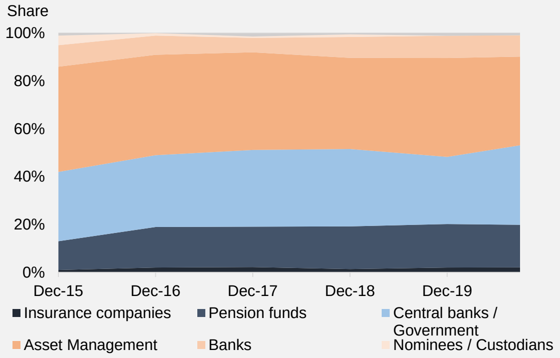
Source: Havers Analytics, AMRO staff calculations.

Foreign interest in domestic bond markets was dented after the NDF clampdown, but has been on a recovery path since then. There were sizable outflows from Malaysia bond markets in the months following the clampdown. Gradually, foreign investors became more comfortable with

[22] Prepared by Justin Lim Ming Han and Prashant Pande.

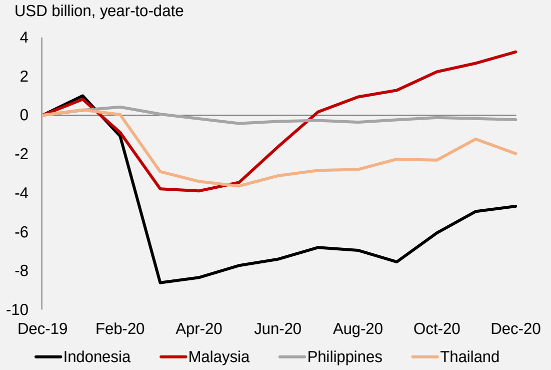
investing again in Malaysian bond markets (Figure C4) as authorities took efforts to provide reliable FX hedging instruments and, over the past couple of years, also worked on improving bond market liquidity. Some of the key measures include enhancing accessibility to dynamic hedging through AOO program, improving auction calendar, and consolidating the number of different bonds trading in the market, among others. Since the clampdown, the proportion of foreign holdings of government bond with a long-term horizon (central banks, pension funds, insurance companies) has increased from 44.6 percent to 53.1 percent (Figure C5). A higher presence of long-term investors lends greater stability to foreign flows in domestic bond markets.

Figure C5. Non-Resident Holdings of Malaysia Government Bonds



Source: BNM, AMRO staff calculations.

Figure C6. Accumulated Foreign Flows in Regional Bond Markets



Source: National authorities, AMRO staff calculations.

Continued refinements to the FX policy, including efforts to improve accessibility to the debt and FX markets, are increasingly being taken constructively by market participants. We gather that bond market liquidity and the ability to hedge interest rate and exchange rate risk flexibly are important considerations among foreign investors. Toward this end, the authorities have launched pilot initiatives to allow some non-resident banks to trade in ringgit-denominated interest rate swaps (IRS) or hedge more flexibly if certain eligibility criteria are met (see paragraph 28). Moreover, prior efforts to improve liquidity and accessibility of both bond and FX markets were acknowledged by FTSE Russell, indicating that these measures have played an important role in avoiding a downgrade of Market Accessibility Level by FTSE Russell for Malaysia bonds in September 2020, which was placed on negative watch list in April 2019. Also, improved confidence of foreign investors toward Malaysian bond markets was evident last year when the flows into the Malaysian bond market recovered quickly and registered net inflows in 2020, while other regional peers (Indonesia, Thailand and Philippines) saw outflows (Figure C6). Total registered assets and the share of these assets that is actually hedged under the dynamic hedging program grew from MYR30.4 billion (12.8 percent of portfolio investments[23]) in Q4 2018 to MYR45.6 billion (15.9 percent of portfolio investments) in Q4 2020 (Financial Markets Association Malaysia, 2020), indicating improving reception of the program among foreign investors. As such, sustained efforts by the authorities to enhance the experience of market participants in the local markets should be continued to reinforce the development of the onshore financial markets.

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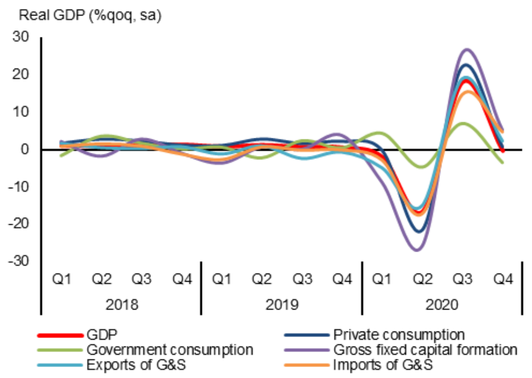
[23] The portfolio investments considered here include both foreign investments in Malaysia and investments of domestic investors abroad. We use this as Dynamic Hedging is available to both domestic and foreign investors. The denominator, however, excludes investments in deposits and deposit-like securities.

Appendices

Appendix 1. Selected Figures for Major Economic Indicators

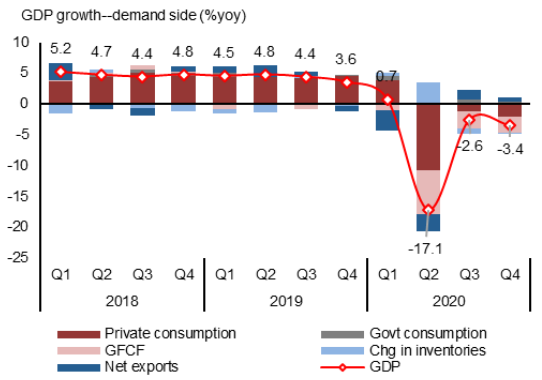
Figure 1.1. Real Sector

The economy rebounded sharply in Q3 but tightened movement curbs weakened the momentum in Q4.



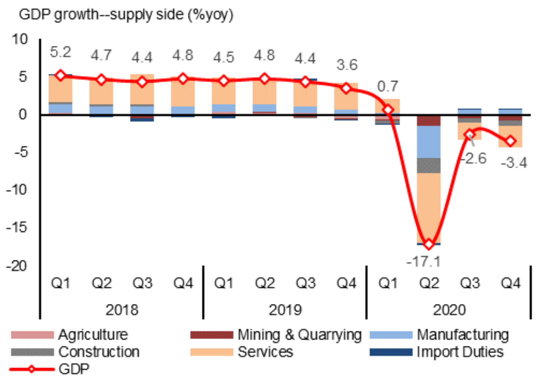
Source: Department of Statistics Malaysia (DOSM).

The exports rebound in Q3 and Q4 2020 bucked the continued downturn in domestic demand.



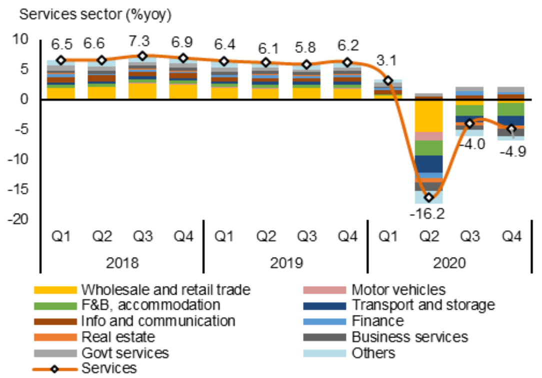
Source: DOSM.

The manufacturing sector recovered in H2 while other sectors continued to contract.



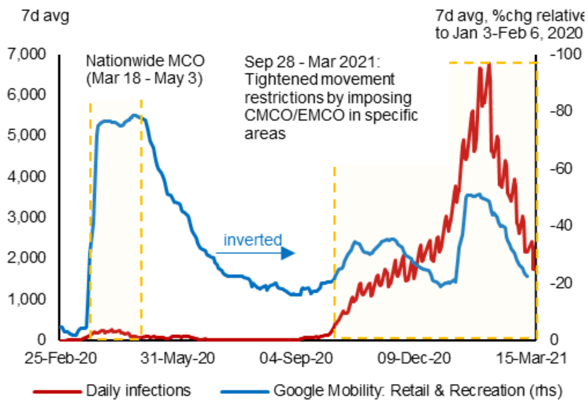
Source: DOSM.

Information and communication avoided the severe impact of the movement curbs on the service sector.



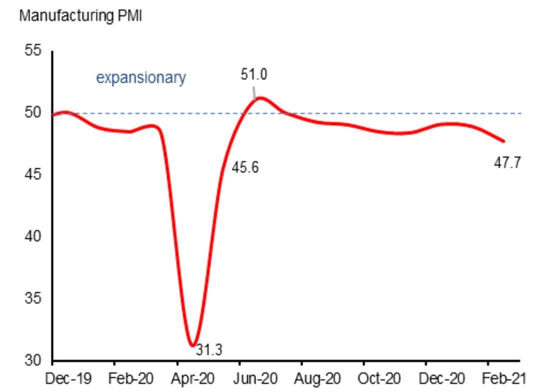
Source: DOSM.

The resurgence of Covid-19 infections in Q4 through early 2021 held back retail and recreation activities.



Source: Google and Johns Hopkins University.

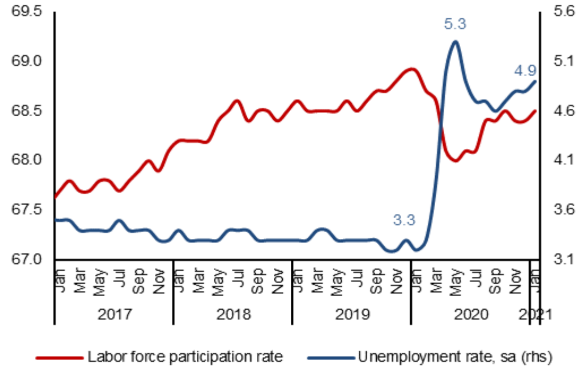
Manufacturing activity also weakened in early 2021 as COVID-19 continued to disrupt global demand.



Source: IHS Markit.

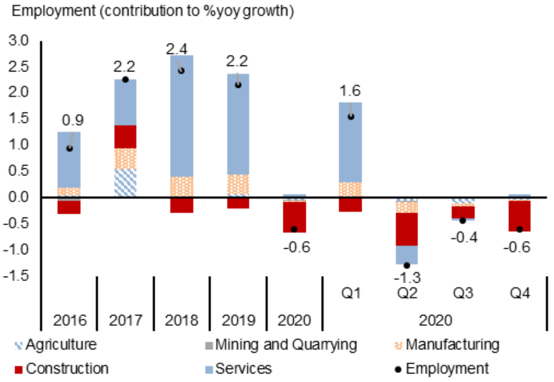
Figure 1.2. Labor and Inflation

Labor market conditions improved slightly in H2 2020, but remained weaker than pre-pandemic levels.



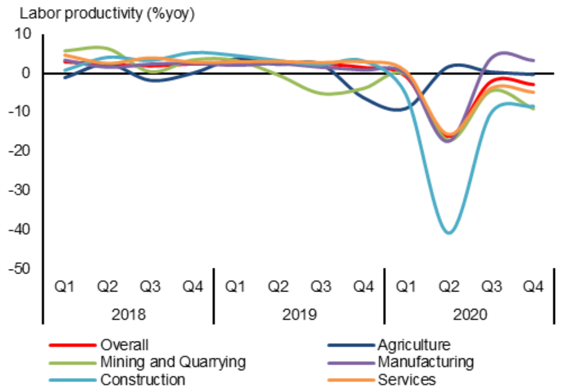
Source: DOSM.

The decline in employment was broad-based, affecting all sectors especially construction.



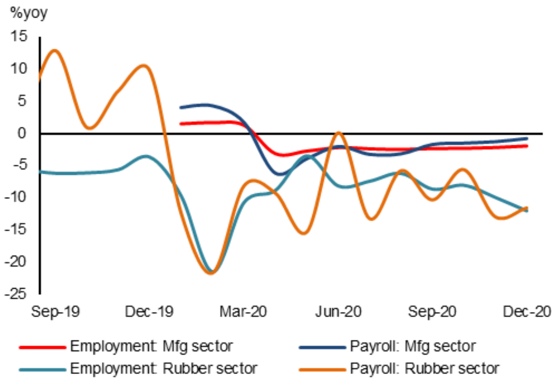
Source: DOSM.

Except for manufacturing in H2, labor productivity across sectors was hit by the movement curbs.



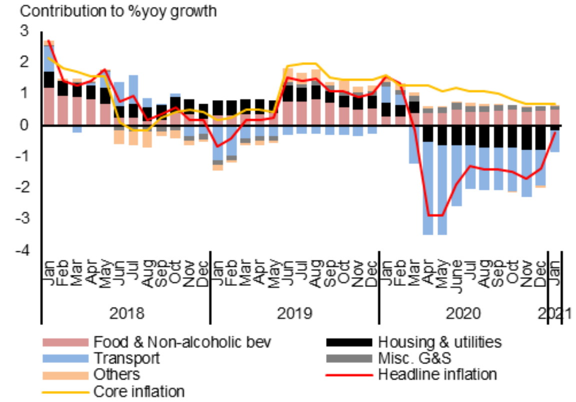
Source: DOSM.

Payrolls and employment fell in the manufacturing and rubber sectors.



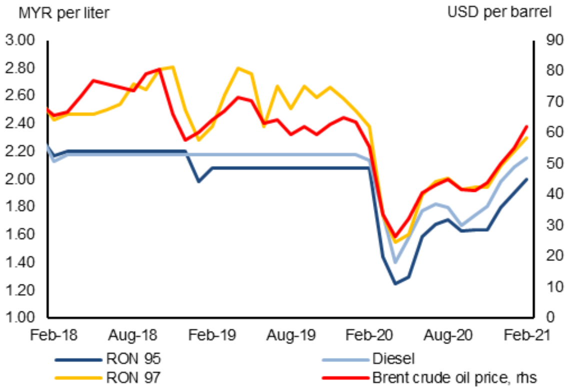
Source: DOSM.

Meanwhile, headline inflation turned negative owing to the sharp decline in the transport index.



Source: DOSM.

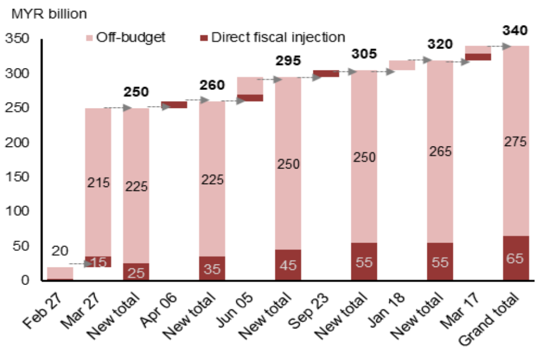
Domestic retail fuel prices gyrated with global crude oil prices in 2020 through early 2021.



Source: Bloomberg Finance LP and Ministry of Domestic Trade, Cooperatives and Consumerism.

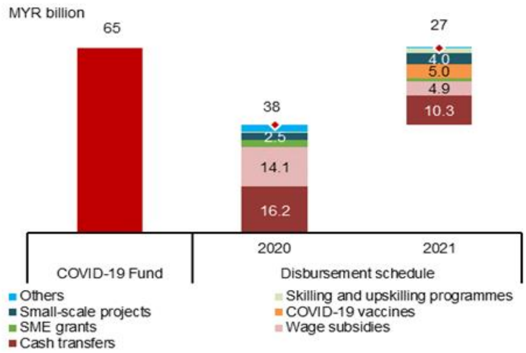
Figure 1.3. Fiscal Sector

The economic stimulus package was successively expanded to currently amount to MYR340 billion or 22 percent of GDP.



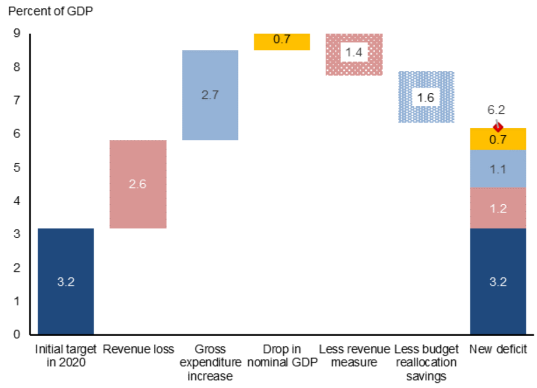
Source: MOF; AMRO staff compilations.
Note: *Off-budget* items refer largely to the debt repayment moratorium by the banking system, credit facilities by the BNM, and credit guarantees by Danajamin—a government financial institution.

The direct fiscal injection under the COVID-19 Fund is limited to MYR65 billion and disbursements are currently spread out in 2020 and 2021.



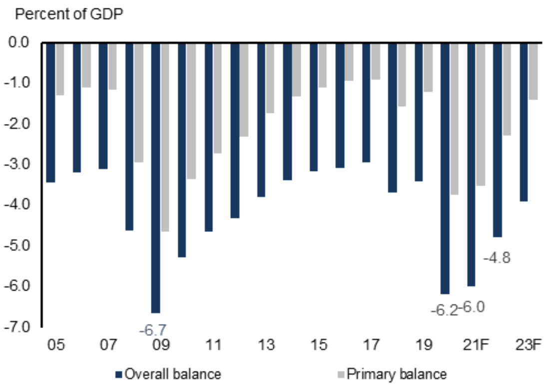
Source: MOF.
Note: The COVID-19 Fund is a temporary fund that spans three years until end-2022. The Fund comprises initiatives under the economic stimulus and recovery packages.

The fiscal deficit rose to 6.2 percent of GDP in 2020 from the initial target of 3.2 percent.



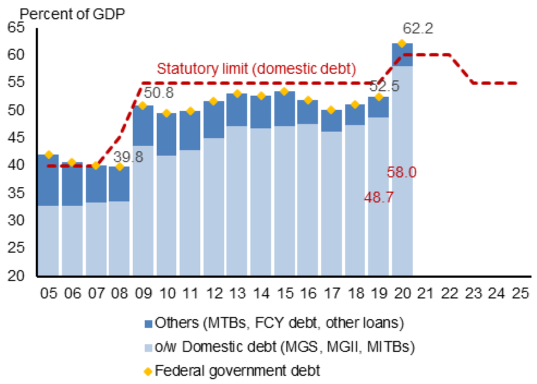
Source: DOSM, MOF, AMRO staff estimates.
Note: Computations are based on difference between the revised and original 2020 Budgets, but using actual 2020 fiscal deficit ratio.

Fiscal consolidation is expected to proceed gradually over the medium term.



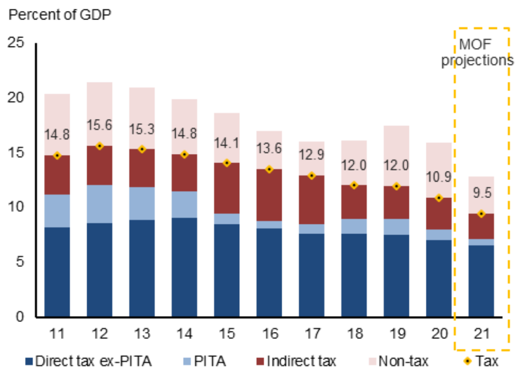
Source: AMRO, DOSM, MOF.
Note: Projections by AMRO.

The increase in the government debt has prompted a temporary revision to the statutory debt limit.



Source: DOSM, MOF.

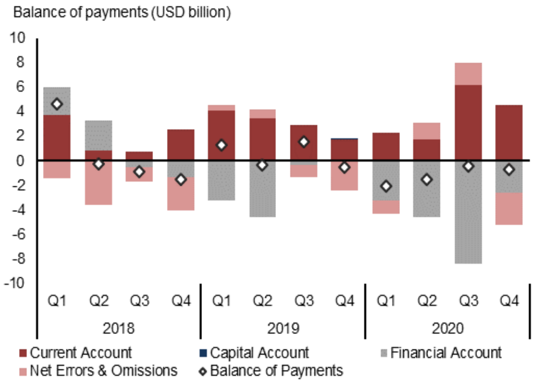
The tax base needs to be broadened to facilitate fiscal consolidation.



Source: DOSM, MOF.
Note: PITA refers to the petroleum income tax account.

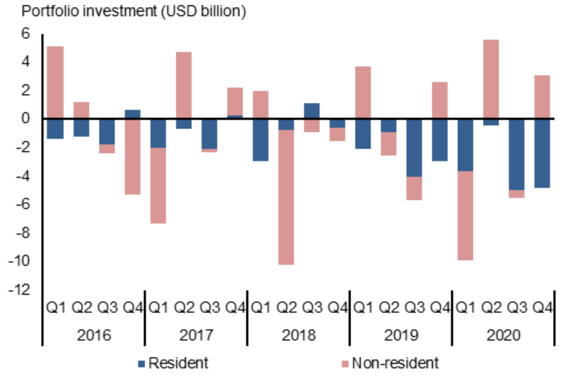
Figure 1.4. External Sector

A wider current account surplus in H2 2020 partly offset outflows in the financial account.



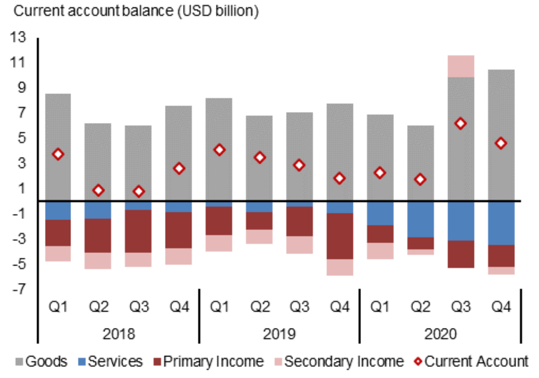
Source: BNM.

Resident portfolio investment outflows intensified in 2020, while non-resident flows recovered after Q1.



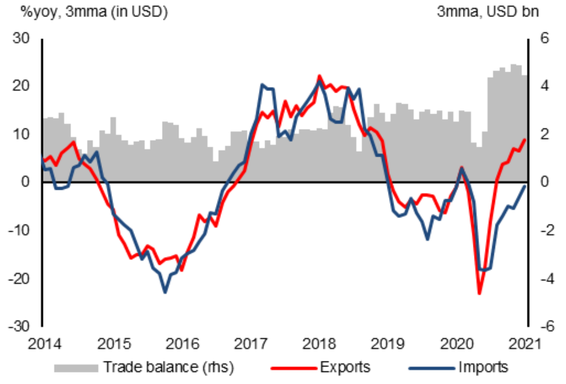
Source: BNM.

The current account surplus swelled on goods trade, offsetting larger deficits in services trade.



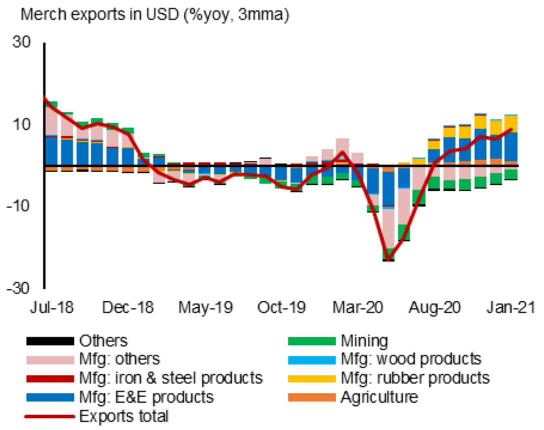
Source: BNM, DOSM.

The trade surplus widened on a faster exports recovery relative to imports.



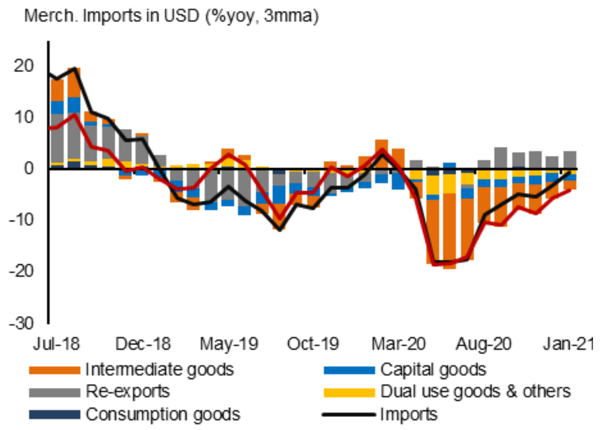
Source: DOSM.

Exports rebounded in H2 2020, led by electrical and electronic products and rubber gloves.



Source: DOSM.

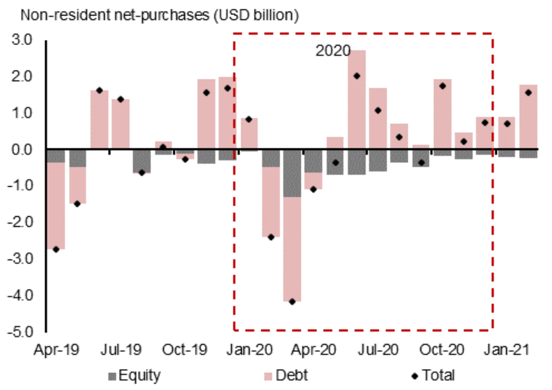
Meanwhile, imports continued to contract, but at a slower pace on improving domestic conditions.



Source: DOSM.

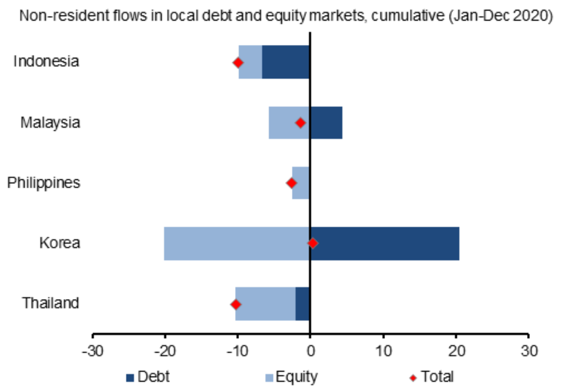
Figure 1.5. Financial Markets

Non-resident sell-offs in local markets intensified in March, but eased thereafter led by bond inflows.



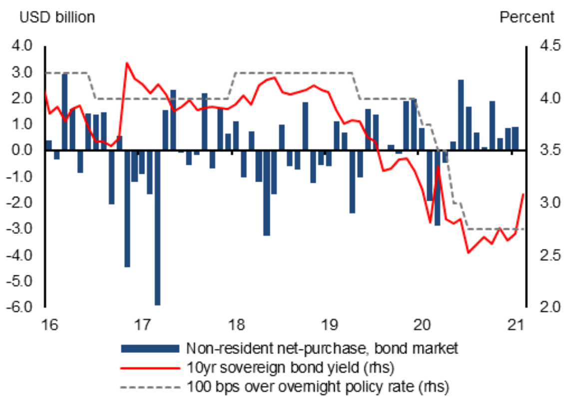
Source: BNM; Bursa Malaysia.

Foreign sell-offs in Malaysia were muted relative to other emerging Asian markets.



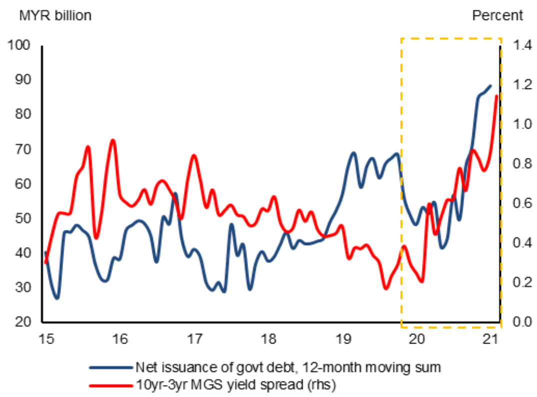
Source: National sources.
Note: Data for Philippines and Vietnam are only available for the equity market.

Non-resident purchases and policy rate cuts led to the decline in bond yields until February 2021.



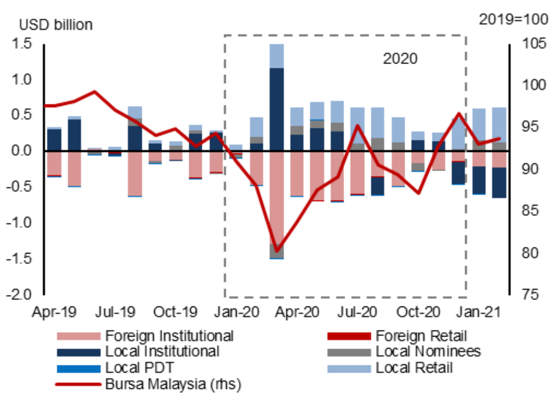
Source: Bloomberg Finance LP and BNM.

However, the yield curve steepened sharply as bond supply rose and in 2021, US treasury yields rose.



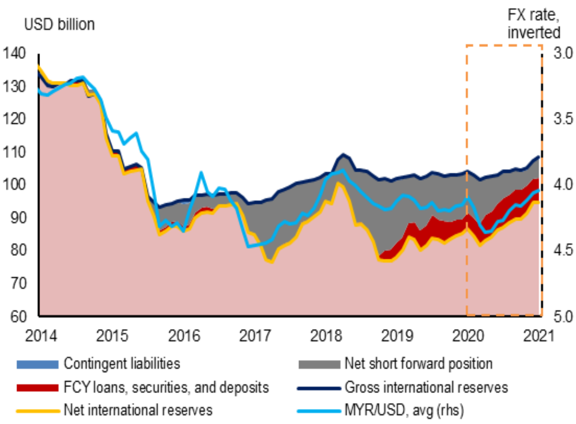
Source: Bursa Malaysia.
Note: MGS stands for Malaysia Government Securities.

Retail investors largely absorbed the equity non-resident sell-off in 2020 and early 2021.



Source: Bursa Malaysia.
Note: PDT = proprietary day trading.

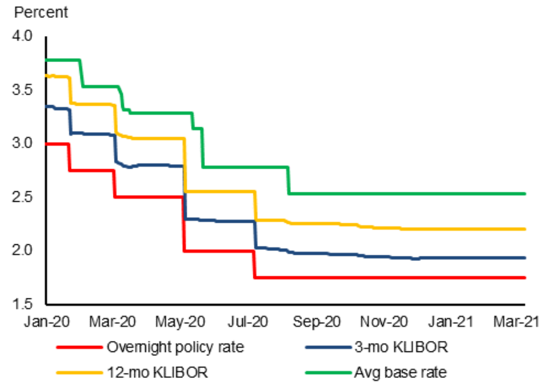
Improved risk sentiment after March buoyed the MYR/USD rate and the build-up of BNM's reserves.



Source: BNM; DOSM.

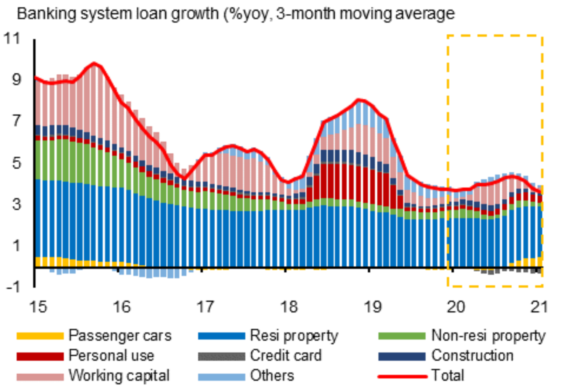
Figure 1.6. Financial System

Policy rate cuts in 2020 were quickly transmitted into lower wholesale and retail lending rates.



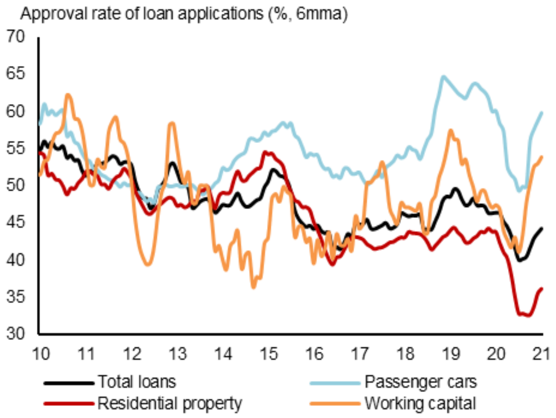
Source: Bloomberg Finance LP and BNM.

Low rates and policies to prop up domestic demand sustained the credit growth in 2020 to early 2021.



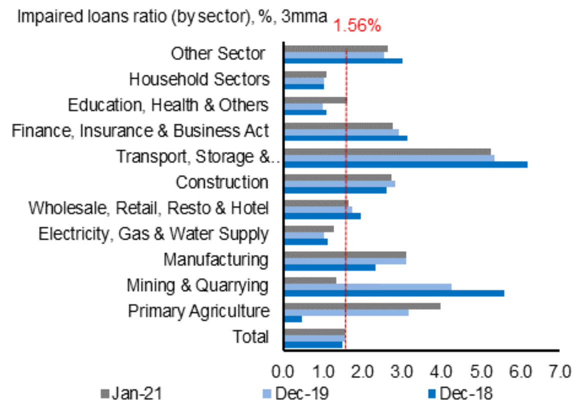
Source: BNM.

Despite sustained credit growth, banks' loan approval rates were relatively contained in 2020.



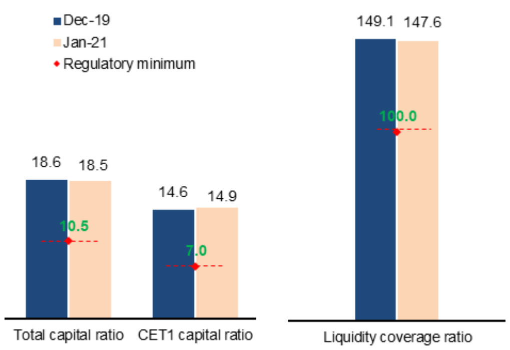
Source: BNM. Note: Loans for the purchase of passenger cards, residential property, and for working capital comprise two-thirds of total banking system loans.

The extensive loan repayment assistance schemes kept loan impairments low and fairly stable.



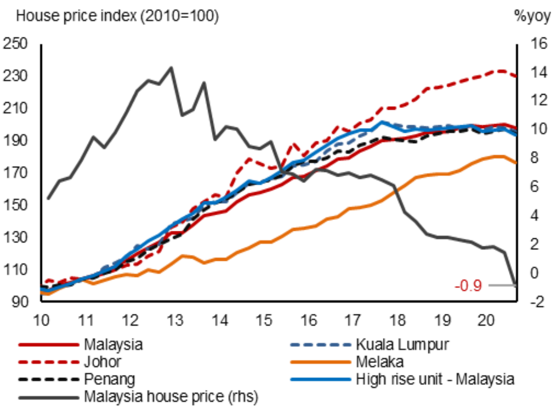
Source: BNM.

With ample capital and liquidity buffers, banks are in a strong position to withstand higher credit risks.



Source: BNM. Note: *Including capital conservation buffer of 2.5 percent for the capital adequacy thresholds.

Meanwhile, house prices dipped in Q3 2020 as weak demand added to the supply overhang.



Source: National Property Information Centre (NAPIC).

Appendix 2. Selected Economic Indicators for Malaysia

	2017	2018	2019	2020	Projections	
					2021	2022
Real sector and prices	(in percent change, unless specified)					
Real GDP	5.8	4.8	4.3	-5.6	5.6	6.2
Private consumption	6.9	8.0	7.6	-4.3	8.0	6.1
Government consumption	5.7	3.2	2.0	4.1	-0.3	0.5
Gross capital formation	6.3	-1.7	-3.9	-12.2	9.0	5.0
Gross fixed capital formation	6.1	1.4	-2.1	-14.5	8.8	4.9
Exports of goods and services	8.7	1.9	-1.3	-8.8	8.8	11.3
Imports of goods and services	10.2	1.5	-2.5	-8.3	11.6	10.0
Labor market	(percent, annual average)					
Unemployment rate	3.4	3.3	3.3	4.5	4.2	3.6
Prices	(in percent change, unless specified)					
Consumer price inflation (period average)	3.7	1.0	0.7	-1.2	2.9	2.2
Core inflation (period average)	2.3	0.8	1.1	1.1	1.3	1.5
GDP deflator	3.8	0.7	0.1	-0.8	2.2	2.7
External sector	(in billions of U.S. dollars, unless specified)					
Current account balance	8.9	8.0	12.3	14.8	11.6	11.6
(in percent of GDP)	2.8	2.2	3.4	4.4	3.1	2.8
Trade balance	27.2	28.4	29.8	33.1	35.4	38.0
Exports	186.4	205.7	196.9	185.1	195.2	207.0
Imports	159.1	177.3	167.1	152.0	159.8	169.0
Services balance	-5.3	-4.3	-2.6	-11.4	-16.2	-17.7
Receipts	37.1	40.2	41.0	21.8	23.0	26.7
Payments	42.4	44.6	43.6	33.2	39.2	44.4
Primary income, net	-9.0	-11.2	-9.7	-6.2	-6.8	-7.4
Secondary income, net	-4.0	-4.9	-5.1	-0.7	-0.8	-1.3
Financial account balance	-1.1	2.8	-8.2	-18.8	-9.6	-5.1
Direct investment, net	3.8	2.5	1.3	0.0	0.5	2.5
Direct investment assets	-5.6	-5.8	-7.7	-4.1	-9.1	-10.1
Direct investment liabilities	9.4	8.3	9.0	4.1	9.6	12.6
Portfolio investment, net	-3.6	-12.2	-7.0	-11.7	-6.5	-8.0
Portfolio investment assets	-4.5	-3.0	-10.1	-13.7	-13.0	-10.1
Portfolio investment liabilities	0.9	-9.3	3.1	2.0	6.5	2.1
Other investment, net	-1.2	12.3	-2.4	-7.5	-3.7	0.2
Overall balance	3.8	1.9	2.0	-4.6	2.0	6.5
Official reserves asset (end-period)	102.4	101.4	103.6	107.6	109.6	116.1
(in months of goods & services imports)	6.1	5.5	5.9	7.0	6.6	6.5
Total external debt (percent of GDP)	64.5	63.8	62.6	67.7	64.0	63.0
Short-term external debt (percent of total)	39.7	43.9	41.4	38.3	40.0	40.0
Short-term external debt (ratio to international reserves)	1.2	1.0	1.1	1.2	1.1	1.1
Fiscal sector (National Government)	(in percent of GDP)					
Government revenue	16.1	16.1	17.5	15.9	15.1	15.3
Government expenditure	19.0	19.8	20.9	22.1	21.1	20.1
Fiscal balance	-2.9	-3.7	-3.4	-6.2	-6.0	-4.8
Primary balance	-0.9	-1.6	-1.2	-3.8	-3.5	-2.3
Government debt	50.0	51.2	52.5	62.2	63.9	63.6
Government guaranteed debt	17.4	18.4	18.2	20.8	20.5	20.0
Monetary sector	(in percent change, end-period unless specified)					
Broad money	4.9	9.1	3.5	4.0	7.1	7.5
Private sector claims	5.8	8.4	4.4	3.5	5.5	6.0
Loans	3.8	7.1	4.2	3.2	5.4	6.0
Securities	23.6	18.5	5.7	6.0	6.1	5.7
Memorandum items:						
Exchange rate (MYR per USD, average)	4.30	4.04	4.14	4.20	-	-
Exchange rate (MYR per USD, eop)	4.06	4.14	4.09	4.01	-	-
Nominal GDP (in billions of ringgit)	1,372.3	1,447.5	1,510.7	1,415.2	1,528.4	1,665.9
Nominal GDP (in billions of U.S. dollar)	319.3	358.3	364.7	336.7	379.0	417.4
GDP per capita (in U.S. dollar)	9,965.1	11,077.5	11,213.1	10,309.0	11,561.4	12,694.8
Brent crude oil price (U.S. dollar per barrel)	54.8	71.5	64.2	43.2	-	-

Source: National authorities, AMRO staff estimates and projections.

Appendix 3. Balance of Payments

	2014	2015	2016	2017	2018	2019	2020
	(in billions of ringgit, unless specified)						
Current account balance (I)	48.6	35.2	29.9	38.3	32.3	50.9	62.1
Trade balance	113.3	109.2	102.0	117.1	114.6	123.3	139.1
Exports, f.o.b.	678.9	681.3	686.9	801.4	830.1	815.5	778.2
Imports, f.o.b.	565.5	572.1	584.8	684.3	715.5	692.1	639.1
Services balance	-10.7	-20.6	-18.9	-22.9	-17.5	-10.9	-48.0
Receipts	137.6	136.1	147.6	159.4	162.4	169.8	91.7
Payments	148.3	156.7	166.5	182.2	179.9	180.7	139.7
Primary income, net	-36.6	-32.1	-34.6	-38.7	-45.1	-40.3	-26.2
Secondary income, net	-17.4	-21.3	-18.6	-17.3	-19.7	-21.3	-2.8
Capital account (II)	0.3	-1.1	0.1	0.0	-0.1	0.3	-0.4
Financial account (III) (+ indicates net inflows)	-80.0	-55.4	-0.2	-4.7	11.4	-33.8	-79.1
Direct investment, net	-18.0	-1.8	13.8	16.2	10.1	5.6	-0.2
Overseas direct investment	-52.6	-39.7	-42.2	-24.2	-23.4	-31.9	-17.3
Foreign direct investment	34.6	37.9	56.0	40.4	33.5	37.5	17.1
Portfolio investment, net	-39.4	-26.1	-14.2	-15.4	-49.4	-29.0	-49.1
Portfolio investment assets	-28.1	-9.1	-15.0	-19.4	-12.0	-41.7	-57.6
Portfolio investment liabilities	-11.2	-17.0	0.8	4.1	-37.4	12.6	8.5
Financial derivatives, net	-1.0	-0.7	-0.8	-0.2	1.0	-0.5	1.6
Other investment, net	-21.7	-26.8	1.0	-5.3	49.7	-9.9	-31.4
Net errors and omission (IV)	-13.0	-32.2	-23.9	-17.1	-35.9	-9.0	-2.0
Overall balance (= I + II +III + IV)	-44.1	-53.6	5.9	16.4	7.8	8.4	-19.4
Change in Reserve Assets	44.1	53.6	-5.9	-16.4	-7.8	-8.4	19.4
Memorandum items:							
Current account balance (in percent of GDP)	4.4	3.0	2.4	2.8	2.2	3.4	4.1
Official reserve assets (in billions of U.S. dollar)	115.9	95.3	94.5	102.4	101.4	103.6	105.0
In months of goods & services imports	6.4	6.1	6.3	6.1	5.5	5.9	6.7
Changes in official reserve assets (in billions of U.S. dollar)	-19.0	-20.6	-0.8	7.9	-1.0	2.2	1.4
Exchange rate (MYR per USD, average)	3.27	3.91	4.15	4.30	4.04	4.14	4.20
Nominal GDP (in billions of U.S. dollar)	338.1	301.4	301.3	319.1	358.3	364.7	336.7

Source: BNM, DOSM, AMRO staff calculations

Appendix 4. Federal Government Budget

	2015	2016	2017	2018	2019	2020	2021B
Federal government	(in billions of ringgit, unless specified)						
Revenue (I)	219.1	212.4	220.4	232.9	264.4	225.1	236.9
Tax revenue	165.4	169.3	177.7	174.1	180.6	154.4	174.4
Direct	111.8	109.6	116.0	130.0	134.7	112.5	131.9
Direct: Income	101.6	99.6	105.2	119.2	123.2	101.8	120.0
Companies	63.7	63.6	64.5	66.5	63.8	50.1	64.6
Petroleum	11.6	8.4	11.8	20.1	20.8	12.8	13.0
Individuals	26.3	27.6	28.9	32.6	38.7	39.0	42.4
Direct: Others	10.2	10.0	10.9	10.9	11.5	10.7	11.8
Stamp duty	6.0	5.7	5.7	5.9	6.2	5.5	6.5
Others	4.2	4.3	5.2	4.9	5.3	5.2	5.3
Indirect	53.7	59.7	61.6	44.0	45.8	41.9	42.5
Export duties	1.0	1.0	1.4	1.7	1.1	0.7	0.9
Import duties	2.7	2.9	2.8	2.9	2.7	2.3	2.1
Excise duties	11.9	11.7	10.1	10.8	10.5	9.9	8.8
Goods and services Tax (GST)	27.0	41.2	44.3	20.2	-	-	-
Sales tax	5.2	0.1	0.0	4.0	15.4	14.8	15.2
Service xax	3.0	0.1	0.0	1.5	12.3	12.0	12.7
Others	2.7	2.7	3.0	2.9	3.8	2.2	2.9
Non-tax revenue	51.5	40.0	39.5	51.1	79.8	62.0	54.5
Petroleum royalty	5.1	3.7	4.4	5.2	5.8	4.2	4.3
Investment interest and returns	32.8	21.4	21.6	31.9	60.1	46.1	36.8
PETRONAS' dividend	27.0	16.0	13.0	26.0	54.0	24.0	18.0
Non-revenue receipts	2.2	3.1	3.2	7.7	4.0	8.6	8.0
Expenditure (II = III + V - VI + VII)	256.3	250.8	260.7	286.3	315.9	312.7	321.7
Current expenditure (III)	217.0	210.2	217.7	231.0	263.3	224.6	236.5
Emoluments	70.1	73.1	77.0	80.0	80.5	83.0	84.5
Retirement charges	18.9	21.0	22.8	25.2	25.9	27.5	27.6
Debt service charges (IV)	24.3	26.5	27.9	30.5	32.9	34.5	39.0
Domestic	23.7	25.7	27.2	29.9	32.2	33.8	38.1
External	0.6	0.7	0.7	0.7	0.7	0.7	0.9
Supplies and services	36.4	30.1	34.7	35.3	31.5	29.3	32.8
Subsidies	27.3	24.7	22.4	27.5	23.9	19.8	18.9
Asset acquisition	1.7	0.7	0.5	0.4	0.8	0.6	0.5
Others	38.4	34.1	32.4	32.0	67.8	29.8	33.3
Development expenditure (V)	40.8	42.0	44.9	56.1	54.2	51.4	69.0
Defence and security	4.8	4.8	5.3	4.9	5.6	5.8	7.8
Economic services	23.3	25.1	24.2	36.1	31.3	28.7	38.9
Social services	11.2	10.4	12.4	12.9	14.5	13.8	18.4
General administration	1.6	1.6	2.9	2.2	2.8	3.0	4.0
Loan recovery (VI)	1.5	1.3	1.9	0.8	1.6	1.3	0.8
COVID-19 Fund (VII)						38.0	17.0
Current balance (I - III)	2.1	2.2	2.7	1.9	1.1	0.5	0.4
In percent of GDP	*0.2*	*0.2*	*0.2*	*0.1*	*0.1*	*0.0*	*0.0*
Overall balance (I - II)	-37.2	-38.4	-40.3	-53.4	-51.5	-87.6	-84.8
In percent of GDP	*-3.2*	*-3.1*	*-2.9*	*-3.7*	*-3.4*	*-6.2*	*-5.4*
Primary balance (I - II + IV)	-12.9	-11.9	-12.5	-22.8	-18.6	-53.2	-45.8
In percent of GDP	*-1.1*	*-1.0*	*-0.9*	*-1.6*	*-1.2*	*-3.8*	*-2.9*
Memorandum item:							
Oil and gas-related revenue (in percent of total revenue)	21.5	14.6	15.7	23.4	31.7	22.0*	16.0

Source: DOSM, MOF, AMRO staff calculations.
Notes: B = Budget estimate. 2021 budget estimates presented in the table are of the government's. *Refers to estimate by MOF based on revised 2020 fiscal estimates.

Appendix 5. Data Adequacy for Surveillance Purposes: a Preliminary Assessment

Key Indicators for Surveillance	Data Availability[(i)]	Reporting Frequency/ Timeliness[(ii)]	Data Quality[(iii)]	Consistency[(iv)]	Others, if any[(v)]
National Accounts	• Available	• Quarterly GDP data is available six weeks after the reference period	-	-	-
Balance of Payments (BOP) and External Position	• Available	• Quarterly BOP data is available six weeks after the reference period	-	-	• Net errors and omissions can be sizable and make data analysis and interpretation difficult
State Budget and Government/ External Debt	• Available • Data for the consolidated public sector only includes data for 29 of the main non-financial public enterprises	• Quarterly federal government budget data is available two months after the reference period • Top-line budget data for the consolidated public sector is available on a yearly basis in October, 10 months after the reference period • Government debt and external debt are available on a quarterly basis, two to three months after the reference period		-	• Government guarantees that require fiscal support have been identified, but their corresponding annual budget expense is not explicitly identified
Money Supply and Credit Growth	• Available	• Money supply and credit growth data is available on a monthly basis, one month after the reference period	-	-	-
Financial Sector soundness indicators	• Available • Lack of data availability on household disposable income	• Banking sector soundness indicators are available on a monthly basis, two months after the reference period • Official household debt-to-GDP data is released on a yearly basis, with a time lag of three months	-	-	-
State-owned enterprises (SOE) statistics	• Available if publicly listed on the stock exchange, otherwise limited	-	-	-	-
Others, if relevant	-	-	-	-	-

Source: AMRO staff compilation. This preliminary assessment will form the "Supplementary Data Adequacy Assessment" in the EPRD Matrix.

Notes:
(i) Data availability refers to whether the official data are available for public access by any means.
(ii) Reporting frequency refers to the periodicity of the available published data. Timeliness refers to how up-to-date the published data are relative to the publication date.
(iii) Data quality refers to the accuracy and reliability of the available data given the data methodology.
(iv) Consistency refers to both internal consistency within the data series and horizontal consistency with other data series.
(v) Other criteria might also apply. Examples include, but are not limited to, potential areas of improvement for data adequacy.

Annexes: Selected Issues

1. Medium-term Debt Sustainability and Fiscal Reform Considerations[24]

The negative impact of the COVID-19 pandemic on economic growth and the sizable fiscal response have raised concerns about medium-term debt sustainability in Malaysia. This selected issue aims to assess medium-term fiscal paths under alternative risk scenarios and analyze possible fiscal consolidation measures to strengthen the fiscal position.

Background

1. **Malaysia's government debt rose sharply after the Global Financial Crisis (GFC) and hovered at around 50 percent of GDP until prior to the pandemic.** The debt level surged from about 40 percent of GDP in 2008 to nearly 51 percent in 2009. It stayed at around that level until end-2019, although it was on the higher side relative to EM peers in the region.[25] In addition, contingent liabilities have grown since the GFC on the back of increased off-budget spending. That said, the government consolidated the fiscal deficit in the past decade and successfully contained government debt within self-imposed and statutory limits (Table A1.1).[26] The former applied to total government debt, while the latter applied to domestic debt only. Both were set at 55 percent of GDP before the onset of the pandemic. Government debt stood at 52.5 percent of GDP and domestic debt at 48.7 percent of GDP at the end of 2019.

Table A1.1. Federal Government Debt Limits

Rules	Statutory	Administrative
Domestic debt ceiling (MGS, MGII, MITB)	**Not exceeding 60% of GDP until end-2022,** before returning to 55% onwards (previously at 55% of GDP)	***Self-imposed limit is temporarily suspended*** (previously at 55% of GDP)
MTB ceiling	**Not exceeding MYR10 billion**	
Offshore borrowing ceiling	**Not exceeding MYR35 billion**	

Source: Ministry of Finance (MOF).

2. **Despite the fiscal consolidation, the fiscal system faces two major challenges—**a **narrowing tax base and large committed expenditure.** Fiscal revenue, which is largely dependent on oil and gas, declined from 18.6 percent of GDP in 2015 to 15.9 percent in 2020. Tax revenue narrowed owing to the decline in corporate income tax and the replacement of the goods and services tax (GST) with the sales and services tax (SST) in 2018. On the expenditure front, debt service charges, emoluments and retirement charges, which account for more than half of current expenditure, limit the space for other spending (see Figures 28 and 29 in the Recent Developments and Outlook section).

3. **The fiscal stimulus package and the GDP contraction in the wake of the COVID-19 pandemic have raised the government debt ratio to a historically high level.** The overall government debt-to-GDP ratio as well as the domestic debt-to-GDP ratio increased to 62.2 percent and 58.0 percent in 2020, respectively. In response, the administrative self-imposed limit has been temporarily suspended and the statutory debt limit raised to 60 percent of GDP

[24] Prepared by Andriansyah and Takashi Yonemura.
[25] The debt-to-GDP ratio at the end of 2019: Indonesia 30.7%, Malaysia 52.6%, Philippines 41.5%, Thailand 41.2%.
[26] The statutory debt limit only refers to certain domestic components of the total federal government debt. These are Malaysian Government Securities (MGS), Malaysian Government Investment Issues (MGII), and Malaysian Islamic Treasury Bills (MITB).

until the end of 2022 before returning to 55 percent of GDP after that. At the same time, additional dividends from government-linked corporations helped to limit the impact of the stimulus and recession on the fiscal deficit and the government debt.

Debt Sustainability Analysis (DSA)

4. **We derive medium-term projections on Malaysia's government debt using a traditional debt sustainability framework.** Debt dynamic is a function of the previous period's debt stock, interest rate on debt, exchange rate, inflation, real GDP growth rate, and the primary balance. The sizable fiscal package in response to the pandemic and the revenue shortfall due to the economic recession raised the fiscal deficit from 3.4 percent in 2019 to 6.2 percent of GDP in 2020. Assuming the pandemic is contained, GDP growth is expected to rebound to 5.6 percent in 2021 and 6.2 percent in 2022, before reverting to its long-run average of 4.8 percent from 2023 onwards. Revenue will rebound as the economy recovers, while pandemic-related expenditure is gradually unwound. As a result, the fiscal deficit will decline at a gradual pace, to 6.0 percent of GDP in 2021 and to 3.4 percent in 2025 (Table A1.2).

5. **Under the baseline scenario, the federal government debt ratio is estimated to remain above 60 percent over the medium term** (Figure A1.1). The increase in 2020 was driven by the widening of the primary deficit, the drop in real GDP, and the increase in the real interest rate owing to a sharp decline in inflation (Figure A1.2). The government debt ratio is projected to stay within 63-64 percent in 2021-22 as the fiscal and primary deficit would only decline gradually despite a growth rebound during this period. The government debt ratio is expected to start declining moderately in 2022 toward 61.6 percent in 2025, in line with the further improvement of the primary deficit. Domestic debt, meanwhile, is also projected to decline from 59.1 percent in 2021 to 57.0 percent in 2025, although it would be above the lower statutory limit—at 55 percent of GDP—from 2023 onwards.

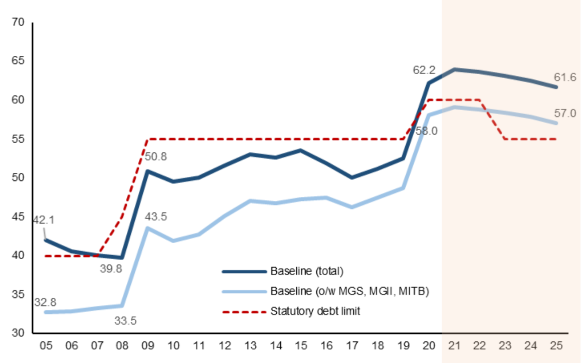
Table A1.2. Macro Assumptions

Baseline Scenario			AMRO projection				
	2019	2020	2021	2022	2023	2024	2025
Real GDP growth (%)	4.3	-5.6	5.6	6.2	4.8	4.8	4.8
Inflation (GDP deflator)	0.1	-0.8	1.9	2.1	2.1	2.1	2.1
Revenue (% of GDP)	17.5	15.9	15.1	15.3	15.4	15.3	15.6
Expenditure (% of GDP)	20.9	22.1	21.1	20.1	19.3	19.0	19.0
Fiscal balance (% of GDP)	-3.4	-6.2	-6.0	-4.8	-3.9	-3.7	-3.4
Primary balance (% of GDP)	-1.2	-3.8	-3.5	-2.3	-1.4	-1.2	-0.9
Exchange rate –average (MYR/USD)	4.1	4.2	4.0	4.0	4.0	4.0	4.0
Lower Growth Scenario			**AMRO projection**				
	2019	2020	2021	2022	2023	2024	2025
Real GDP growth (%)	4.3	-5.6	3.6	3.2	4.0	4.0	4.0
Inflation (GDP deflator)	0.1	-0.8	1.9	2.1	2.1	2.1	2.1
Revenue (% of GDP)	17.5	15.9	15.1	15.3	15.4	15.3	15.6
Expenditure (% of GDP)	20.9	22.1	21.1	20.1	19.3	19.0	19.0
Fiscal balance (% of GDP)	-3.4	-6.2	-6.0	-4.8	-3.9	-3.7	-3.4
Primary balance (% of GDP)	-1.2	-3.8	-3.5	-2.3	-1.4	-1.2	-0.9
Exchange rate –average (MYR/USD)	4.1	4.2	4.0	4.0	4.0	4.0	4.0

Higher Growth Scenario			AMRO projection				
	2019	2020	2021	2022	2023	2024	2025
Real GDP growth (%)	4.3	-5.6	7.0	8.0	5.5	5.5	5.5
Inflation (GDP deflator)	0.1	-0.8	1.9	2.1	2.1	2.1	2.1
Revenue (% of GDP)	17.5	15.9	15.1	15.3	15.4	15.3	15.6
Expenditure (% of GDP)	20.9	22.1	21.1	20.1	19.3	19.0	19.0
Fiscal balance (% of GDP)	-3.4	-6.2	-6.0	-4.8	-3.9	-3.7	-3.4
Primary balance (% of GDP)	-1.2	-3.8	-3.5	-2.3	-1.4	-1.2	-0.9
Exchange rate –average (MYR/USD)	4.1	4.2	4.0	4.0	4.0	4.0	4.0
GST Reintroduction Scenario			**AMRO projection**				
	2019	2020	2021	2022	2023	2024	2025
Real GDP growth (%)	4.3	-5.6	5.6	6.2	4.8	4.8	4.8
Inflation (GDP deflator)	0.1	-0.8	1.9	2.1	2.1	2.1	2.1
Revenue (% of GDP)	17.5	15.9	15.1	16.1	16.9	16.8	17.1
Expenditure (% of GDP)	20.9	22.1	21.1	20.1	19.3	19.0	19.0
Fiscal balance (% of GDP)	-3.4	-6.2	-6.0	-4.0	-2.4	-2.2	-1.9
Primary balance (% of GDP)	-1.2	-3.8	-3.5	-1.5	0.1	0.3	0.6
Exchange rate –average (MYR/USD)	4.1	4.2	4.0	4.0	4.0	4.0	4.0

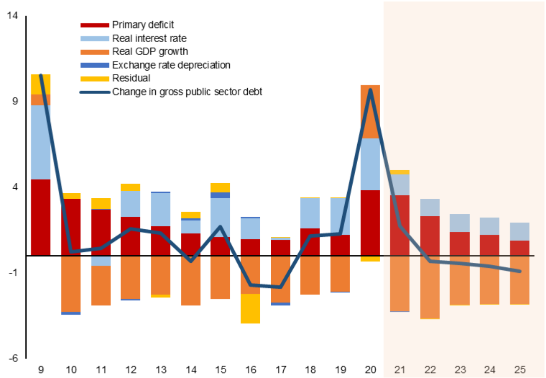
Source: DOSM, MOF, AMRO staff projections (for 2020-2025).

Figure A1.1. Debt to GDP ratio—Baseline
(Percent of GDP)



Source: DOSM, MOF, AMRO staff calculations.

Figure A1.2. Debt Creating Flow—Baseline
(Percentage points)

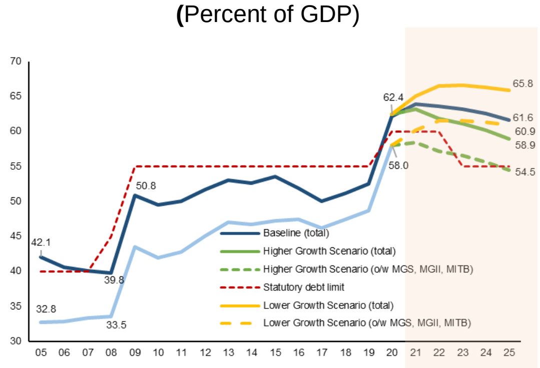


Source: DOSM, MOF, AMRO staff calculations.

6. **Alternative scenarios suggest that higher GDP growth and a re-introduction of the GST could lower the government debt ratio substantially.** We examine how government debt could evolve over the medium term under the following alternative scenarios:

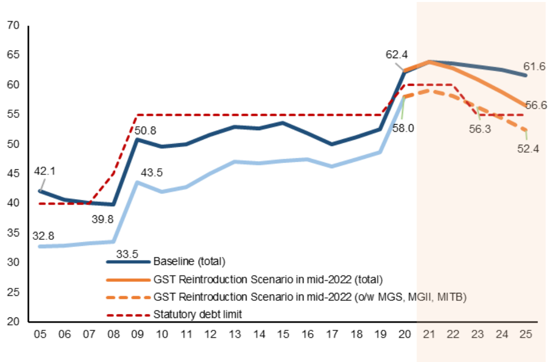
- *Higher and lower GDP growth*. A higher medium-term growth scenario of 7 percent in 2021, 8 percent in 2022, and 5.5 percent in 2023-25 is projected to lead to a faster decline in the government debt ratio from 62.2 percent of GDP in 2020 to 58.9 percent in 2025. The domestic debt ratio will decline from 58.0 percent in 2020 to 54.5 percent in 2025, though it will remain slightly above the limit in 2023. Meanwhile, under the lower growth scenario of 3.6 percent in 2021, 3.2 percent in 2022 and 4 percent in 2023-25—assuming a considerable degree of economic scarring from a prolonged pandemic—the government debt ratio would rise to about 65 percent of GDP over the medium term. The domestic debt ratio would also remain elevated at around 60.0 percent through 2025 (Figure A1.3).

Figure A1.3. Debt to GDP ratio: Higher and Lower Growth Scenarios
(Percent of GDP)



Source: DOSM, MOF, AMRO staff calculations.

Figure A1.4. Debt to GDP Ratio—GST Re-introduction Scenario
(Percent of GDP)



Source: DOSM, MOF, AMRO staff calculations.

- *GST re-introduction*. The reinstatement of the GST at a rate of 6 percent in mid-2022 is estimated to contribute an additional 1.5 percent of GDP in revenue relative to the SST, representing a significant boost to the fiscal coffers.[27] If the GST were to be re-introduced in mid-2022, the government debt ratio would fall sharply from 63.9 percent of GDP in 2021

[27] The estimate is based on the two full years of implementation of the GST in 2016 and 2017, when compared to the average revenue from the SST prior to 2015.

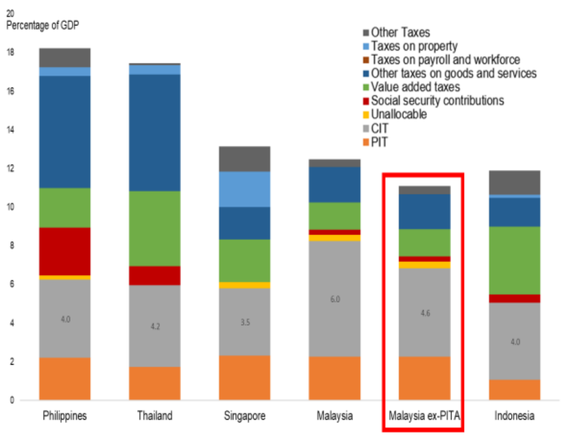
to 56.6 percent by 2025 as the primary deficit would consolidate at a faster pace. Moreover, the domestic debt ratio would be only slightly above the statutory limit in 2023. (Figure A1.4).

Fiscal Consolidation Measures

7. **The debt sustainability exercise highlights the need to strengthen fiscal consolidation efforts, but only when the economic recovery is entrenched, to avoid a cliff effect.** In terms of medium-term debt targets, the GST has been shown to be a key driver to a faster pace of fiscal consolidation. The reinstatement of the GST could also be supplemented with other revenue and spending measures to provide space for investments in strategic sectors and initiatives to boost productivity. Overall, there is a need to reverse the trend decline in the tax revenue-to-GDP ratio. That said, new taxes should only be introduced when the economic recovery is already on a firm footing and uncertainty around the trajectory of the pandemic has dissipated.

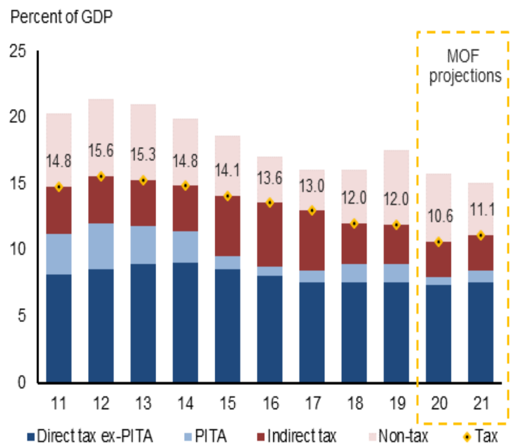
8. **A cross-country comparison shows that tax collection in Malaysia could be boosted through indirect taxes.** The share of indirect taxes, including value-added taxes as well as other taxes on goods and services, accounted for 3.2 percent of total tax revenues in 2018 in Malaysia, lower than in other EMs in the region (Figure A1.5). Therefore, there is some scope to increase tax collections through indirect taxes, such as the GST/SST, carbon tax, and tobacco excise tax (see Box A1.1). On the other hand, although the share of direct taxes excluding petroleum income tax—corporate and individual income taxes—is large in Malaysia, corporate income tax collection has declined as a share of GDP in the past decade, which means the tax buoyancy of corporate income tax has been less than one, or as a result of the cut in the tax rate from 25 percent to 24 percent in 2015 (Figure A1.6). In this regard, a review of corporate tax incentives is underway by the authorities.

Figure A1.5. Tax Revenue Structure, 2018–ASEAN-5 Economies



Source: OECD.
Note: PIT and CIT refer to taxes on income, profits and capital gains of individual and corporate, respectively.

Figure A1.6. Malaysia Tax Revenue Structure, 2011-2018



Source: DOSM, MOF.
Note: PITA refers to the petroleum income tax account.

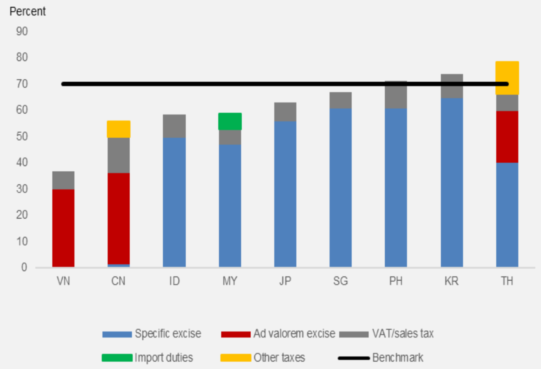
Box A1. Tax Measures for Policy Consideration

Broadening SST coverage. Without a GST in place, broadening the SST to approximate the coverage of the GST could be a compensating revenue measure in the near term. While SST coverage was broadened once in 2019 to cover amusement parks, cleaning services, and imported digital services, it can be broadened further. Currently, the SST covers 38 percent of goods in the CPI basket and the number of goods exempted via SST is 10 times more than those exempted through GST. Broadening the SST coverage to 50 percent of goods in the CPI basket—close to the level of GST coverage at 52-60 percent—could increase tax collection by 0.9 percent of GDP (OECD 2019a). Alternatively, the authorities might need to review the scope for reducing the number of goods exempted from the standard SST rate to reduce the administrative burden on businesses and, hence, broaden the tax base.

Increasing tobacco excise taxes. The introduction of the sugar tax in July 2019, and the move to tax cigarettes and tobacco products in duty-free islands and free zones starting in January 2021, could be followed by an increase in tobacco excise taxes. Additionally, it is important to use excise taxes to influence consumer behavior to achieve health outcomes as well as to raise revenue. The National Institutes of Health (2020) estimates that approximately 21.3 percent of the Malaysian population, aged 15 years and over, smokes. The World Health Organization (2011) has recommended that one of the best practices in tobacco taxation is for the final price paid by a consumer to have an excise tax share of at least 70 percent. The total tax component of the most widely sold brand's price in Malaysia in 2018 stood at about 59 percent, while the share of excise itself was 47 percent, lower than in other countries (Figure A1.7). An additional MYR0.1 excise levy per cigarette, together with tightened enforcement to reduce the share of the illicit market by 50 percent, could result in additional indirect tax collection of 0.05-0.19 percent of GDP.

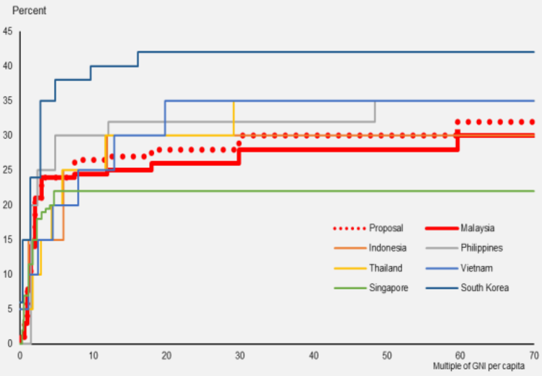
Raising PIT rates*.* PIT rates for higher income groups in Malaysia are relatively lower than those in other Asian economies (Figure A1.8), which means the PIT rates for high income groups earning a tax base income of more than MYR250,000 per annum could be increased potentially by 2 percentage points. This increase could potentially generate additional revenue of about 0.1-0.2 percent of GDP within a year of implementation (Table A1.3, next page). In the efforts to reduce income inequality, authorities could also consider reducing the number of items eligible for tax relief for the high-income group such as insurance premiums and lifestyle relief, while increasing the amount of relief for other individuals and households, to simplify tax administration in terms of record-keeping and claim audits. The increase in administrative efficiency might also be achieved by reducing the number of brackets and widening the income bands since Malaysia's PIT structure has more brackets than those in other Asian countries.

Figure A1.7. Tobacco Taxes Per Unit Price for the Most Widely Sold Cigarette Brand, 2018



Source: WHO.

Figure A1.8. Personal Income Tax Rates, by Income Level



Sources: AMRO staff calculations.

Introducing the capital gains tax*.* While capital gains are not taxed in Malaysia, a real property gain tax (RPGT) is imposed on gains derived from the sale of real property or on the sale of shares in a real property company, at a rate of 10-30%, depending on the length of ownership/holding period. The RPGT could be adjusted by removing exemptions for intercompany transactions, or broadened to include other assets such as planes, yachts, and intangible financial assets. However, a capital gain tax on the sale of financial assets must be introduced carefully as it may discourage investments in the capital markets. Based on the examples of peer countries that impose capital gains tax such as the Philippines, we estimate that implementing a capital gains tax could contribute an additional revenue of between 0.03 and 0.3 percent of GDP.

Table A1.3. Actual and Proposed Adjustments to the Personal Income Tax Rate

Chargeable Income (MYR)	Multiple of GNI per capita	2013-2014	2015	2016-2017	2018-2019	2020	Proposal
1-5,000	0-0.2	0%	0%	0%	0%	0%	0%
5,001-20,000	0.2-0.6	2%	1%	1%	1%	1%	1%
20,001-35,000	0.6-1.0	6%	5%	5%	3%	3%	3%
35,001-50,000	1.0-1.5	11%	10%	10%	8%	8%	8%
50,001-70,000	1.5-2.1	19%	16%	16%	14%	14%	14%
70,001-100,000	2.1-3.0	24%	21%	21%	21%	21%	21%
100,001-250,000	3.0-7.5	26%	24%	24%	24%	24%	24%
250,001-400,000	7.5-11.2	26%	24.5%	24.5%	24.5%	24.5%	26.5%
400,001-600,000	11.2-17.9	26%	25%	25%	25%	25%	27%
600,001-1,000,000	17.9-29.8	26%	25%	26%	26%	26%	28%
1,000,001-2,000,000	29.8-59.6	26%	25%	28%	28%	28%	30%
Above 2,000,000	59.6-	26%	25%	28%	28%	30%	32%
Personal Income Tax per GDP		2.20%	2.24%	2.15%	2.29%	-	+ ~0.1-0.2%

Source: MOF, AMRO staff calculations.

Introducing a carbon tax. Malaysia has committed to the Paris Agreement to reduce its greenhouse gas emissions by 45 percent by 2030, from its emissions intensity per unit of GDP in 2005. Environmental taxes—in the form of a carbon tax—offer the promise of simultaneously boosting revenue and helping achieve environmental objectives by discouraging harmful behavior. The implementation of the carbon tax in Singapore could be a good example for Malaysia. According to Singapore's Carbon Pricing Act, any industrial facilities emitting 25,000 tCO2e or more annually will have to pay a carbon tax set at a rate of SGD5/tCO2e (USD3.7) from 2019 to 2023. The OECD (2019a) projected that a carbon-pricing scheme commencing at a rate of about MYR35/tCO2e would generate annual average revenue equivalent to 1 percent of GDP. However, if the rate gradually rises to MYR150/tCO2e by 2028, Joshi (2019) estimated the annual average revenue would be equivalent to 1.5 percent of GDP. By assuming the imposed rate is more in line with Singapore's, we estimate that the revenue impact of introducing a carbon tax could be in the range of 0.5-0.75 percent of GDP per annum.

9. **Tax administration must be strengthened further.** Tax administration in Malaysia has been relatively satisfactory in terms of the on-time filing rate, PIT audit coverage, collectible arrears, and role of large taxpayer offices (Table A1.4, next page). However, taxpayer coverage and the administrative arrangement for tax disputes can be improved. Tax administration can be further strengthened by reducing informality, conducting tax education programs, promoting cooperative compliance programs[28] through large taxpayer offices, and improving human resources and electronic systems. The implementation of the Common Reporting Standards for the Automatic Exchange of Information is also expected to improve efforts to deter and detect tax evasion through the use of offshore bank accounts.

10. **Given growing fiscal burden arising from emoluments and pension charges, there is an urgent need to increase spending efficiency and effectiveness, and rightsizing the civil service.** The authorities could continue to rationalize spending to make more room for discretionary spending in operating expenditure and to increase the share of development expenditure. Additionally, the effectiveness of fiscal incentives also needs to be assessed. A

[28] Cooperative compliance, previously referred to enhanced relationship, is the relationship between the tax administration and large business taxpayers that is "based on co-operation but with the purposes of assuring compliance" and characterized as "transparency in exchange for certainty" (OECD, 2013).

necessary initial step may be the periodic publication of the tax expenditure report, as a part of the IMF Fiscal Transparency Code, which requires a government to disclose and manage revenue loss from tax expenditure. AMRO supports the planned legislation of the Fiscal Responsibility Act in 2021 to institutionalize the sound management of public finances by publishing a statement of tax expenditure. Also, Malaysia's civil service is larger in size than its peers and there may be scope to rightsize the civil service over the medium term.

Table A1.4. Tax Administration Performance Indicators

	Malaysia	OECD	Non- OECD
Registered personal income taxpayers (% population)	23.1	58.3	26.5
On-time filing (%)			
Corporate income tax	97.3	82.2	73.3
Personal income tax	97.6	88.3	80.8
PIT audit coverage (per 100 active PIT taxpayers)	24.2	4.7	3.5
Collectible arrears (% total year-end arrears)	95.4	55.5	52.0
Cases resolved in favor of the tax administration (%)	50.0	71.7	66.9
Percentage of revenue collected through large taxpayer offices	49.8	41.6	49.2
Change in the "cost of collection" ratio 2016-2017	13.2	-2.5	-3.0

Source: OECD.
Note: The number of countries varies. Based on 2017 data

11. **Overall, the tax measures under consideration have the potential to contribute up to an additional 3.25 percent of GDP (Table A1.5)**. Given the fragility of economic recovery, any revenue measures that are adopted through taxation must avoid excessive contractionary effects on economic growth. This can be done through consumption, environment, and property taxes that are less harmful than corporate and personal income taxes. On the expenditure side, reducing the scope and scale of tax expenditures is also important to boost revenues while maintaining the country's competitiveness.

Table A1.5. Estimated Impact of Proposed Revenue Measures

Measure	Estimated Revenue Impact (percent of GDP)
1. Faster broadening of SST	≤ 0.9
2. Re-introduction of the GST	≤ 0.6
3. Introducing a carbon tax (rate in line with Singapore's)	0.5 – 0.75
4. Review of excise taxes and customs measures	0.05 – 0.2
5. Broadening of the capital gains tax	0.03 – 0.3
6. Adjusting the rate paid by the highest PIT bracket	0.05 – 0.2
TOTAL	**≤ 2.95**
7. Enhancing tax administration	NA

Source: AMRO staff estimates.
Note: "2. Re-introduction of the GST" excludes the impact of broadening the coverage of goods. If the GST is re-introduced with broader coverage, the estimated revenue impact will be 1.5 percent of GDP, the sum of "1. Faster broadening of SST" and "2. Re-introduction of the GST".

Concluding Thoughts

12. **The sizable debt burden imposed by the COVID-19 crisis requires the gradual re-building of the fiscal space over the medium term as the economic recovery is firmed up.** The DSA exercise shows that the federal government debt will remain elevated under a medium-term baseline scenario where growth returns to the pre-pandemic average and fiscal consolidation proceeds moderately. This leads to a narrower fiscal space to respond to adverse shocks post-pandemic. Indeed, the COVID-19 pandemic has once again highlighted—as with other crises—the importance of maintaining ample policy buffers during peacetime. On a positive note, the narrow tax base provides a number of potential reform options that can be considered in rebuilding policy space, alongside measures to ensure spending efficiency.

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2. Assessing Demand and Supply for Malaysian Government Bonds in 2021[29]

Despite the increased issuance, Malaysian government bond markets were well supported in 2020 owing to attractive valuations and ample liquidity from the banking system. In 2021, the net supply of government bonds will be similar to that seen last year but the demand may not be as robust. The demand from the banking system may decline while that from the EPF may not yet turn around. However, demand from other investors, both foreign and local, will likely pick up as valuations remain attractive. We also believe that the authorities have enough policy levers to pull if there is a need to support bond markets. In this note, we closely examine the domestic financing of the fiscal deficit, through the issuance of Treasury bills, conventional bonds and sukuks or government investment issues[30].

1. **The pandemic has had a sizable impact on Malaysia's budget deficit.** The economic recession and the fiscal stimulus that it has entailed resulted in a near doubling of the budget deficit to 6.0 percent of GDP in 2020 from the initial target of 3.2 percent (see Figure 8 in the Recent Developments and Outlook section). The deficit is expected at 6 percent in 2021, and would remain considerably higher than pre-pandemic levels with the continuing need to support the economy during the COVID-19 crisis.

2. **The bond issuance was significantly higher in 2020 and most of it was absorbed by banks.** The net issuance of bonds in 2020 rose to MYR89.1 billion from MYR46.3 billion in 2019.[31] Most of it was absorbed by banks (51 percent of the total net issuance in 2020, excludes securities placed with BNM for liquidity operations, Table A2.1). The two main factors which contribute to higher demand from banks are 1) increased liquidity in the banking system, and 2) lowered demand for credit as shown in the loan-to-deposit ratio (Figure 24 in the Recent Developments and Outlook section). During 2020, the fall in bank's SRR with BNM would have eased liquidity conditions. On the other hand, loan growth was anaemic while deposit growth was in line with the pre-pandemic 2019 level (Figure A2.1). Both these factors provided ample opportunity for banks to increase their holdings of bonds. Foreign and other investors[32] increased their holdings of bonds in 2020 by MYR22.4 billion and MYR15.5 billion, respectively. The demand from foreign investors looks impressive when compared to other regional peers, where foreign investors reduced their net holdings of domestic bonds (Figure C6 in Box C. Taking Stock of Malaysia's Onshore Financial Markets).

3. **The robust demand of bonds in 2020 was underpinned by BNM policy measures.** Firstly, BNM increased its holdings of bonds by MYR9.2 billion in 2020, which accounted for 10.3 percent of the net bond supply. These purchases were concentrated in April 2020 and were aimed at ensuring smooth functioning of the markets and sufficient liquidity in the bond market. Secondly, BNM provided liquidity to the banking system through two channels 1) the changes in SRR which released MYR42.3 billion of liquidity in the banking system (Figure A2.2) and 2) open market operations which provided an estimated MYR5.3 billion of liquidity through reverse repo operations. A significant part of these liquidity injections would have found their way to augmenting the demand of bonds. This seems to be the most impactful policy measure by the BNM in order to support bond demand. Thirdly, the policy easing (rate

[29] Prepared by Prashant Pande.
[30] Collectively referred to as "bonds" in the rest of this box.
[31] Net issuance of debt in a particular period is defined as gross issuance less maturities and buybacks. In other words, this is the change in the outstanding amount of debt over the period.
[32] Includes statutory bodies, nominees and trustee companies and cooperatives, certain institutional investors and unclassified items.

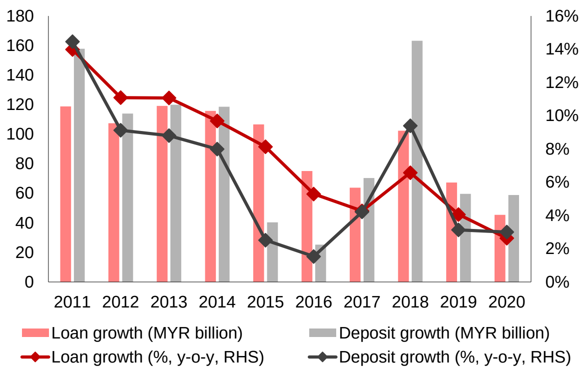
cuts of 125 basis points in 2020) coupled with low inflation made valuations attractive (Pande, 2020) and was one of the factors which kept investors interested in the bond markets.

Table A2.1. Year to date purchases of bonds by investor type

	Net issuance	Banks	EPF	Foreign holders	BNM*	KWAP	Developmental financial institutions	Non-bank financial institutions	Insurance	Others
	(MYR bn)	Net increase in holding of government debt (MYR billion)								
2015	39.3	0.7	16.6	25.2	0.0	-1.5	-0.8	0.1	0.2	-1.1
2016	37.7	6.9	11.4	15.8	2.9	2.9	-2.2	-0.2	1.7	-1.6
2017	40.8	10.3	39.2	-5.6	2.6	-3.5	-1.1	0.3	-1.5	0.0
2018	54.0	48.9	22.8	-24.0	1.6	1.6	0.7	0.1	4.1	-1.9
2019	46.3	6.9	14.5	21.5	-6.1	0.5	-1.1	0.1	-0.2	10.1
2020	89.1	45.2	-12.2	22.4	14.4	0.2	-2.0	0.1	5.4	15.5
		% of net issuance								
2015 to 2019		34%	48%	15%	0%	0%	-2%	0%	2%	3%
2020		51%	-14%	25%	16%	0%	-2%	0%	6%	17%
		Holdings of government debt (as % of outstanding)								
2020		31%	25%	25%	2%	3%	2%	0%	5%	7%

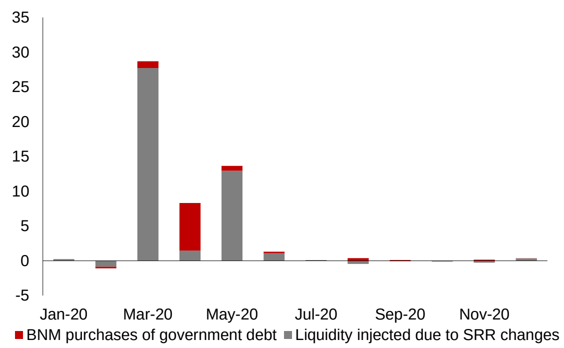
Source: BNM, AMRO staff calculations.
Note: BNM's holdings include the securities held as a result of monetary operations.

Figure A2.1. Bank Deposits and Loans
(Percent year-over-year, in MYR billion)



Source: BNM, AMRO staff calculations.

Figure A2.2. BNM's Purchases of Government Securities and Liquidity Released from SRR Adjustments (MYR billion)



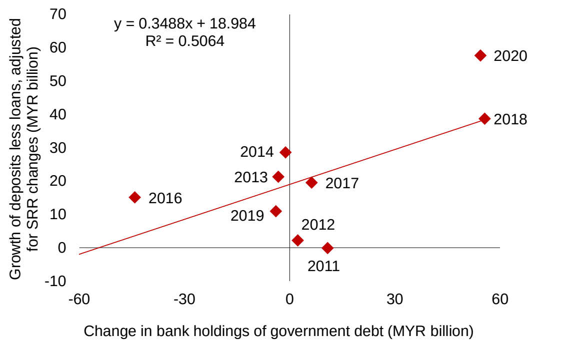
Source: BNM, AMRO staff calculations.

4. **Among major investors, only EPF decreased its holding of bonds during 2020 as net contributions were reduced and withdrawals were allowed under the economic package.** The withdrawals of retirement savings were first allowed in April 2020 and since then the cap on withdrawals has been progressively increased. In addition, a reduction in contributions were allowed for employees and employers. This has led to EPF reducing its holding of bonds by MYR12.2 billion, likely to meet the withdrawals (Table A2.1). That said, EPF still remains one of the largest holders of bonds (25 percent of outstanding bonds), only behind the banking system (31 percent).

5. **Looking ahead, demand from the banking system will likely be more constrained in 2021 as compared to 2020.** The factors which prompted banks to increase their holdings of bonds in 2020—liquidity injections through SRR cuts and subdued loan growth—may fade in 2021. The economy is expected to see a strong recovery which will stimulate loan growth and may lead to a rise in loan-to deposit ratio, which will tighten liquidity in the banking system. On the other hand, the SRR balance with BNM is only MYR2.8 billion as of December 2020, down from MYR45.7 billion in February 2020 (Figure A2.4), which means that BNM's capacity to

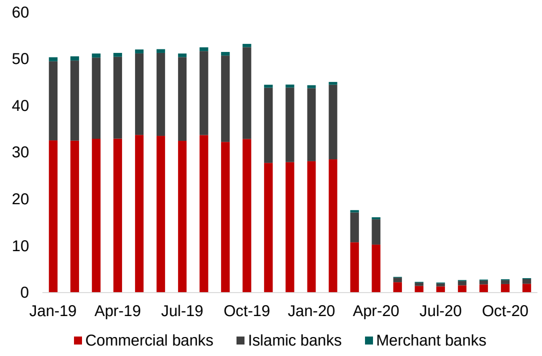
induce durable liquidity in the banking system through additional SRR adjustments is very limited.

Figure A2.3. Deposit (Adjusted for loans, SRR) Growth and Increase in Bank Holdings of Bonds



Source: BNM, AMRO staff calculations.

Figure A2.4. SRR Deposits of Commercial, Islamic and Merchant Banks with BNM
(MYR billion)



Source: BNM, AMRO staff calculations.

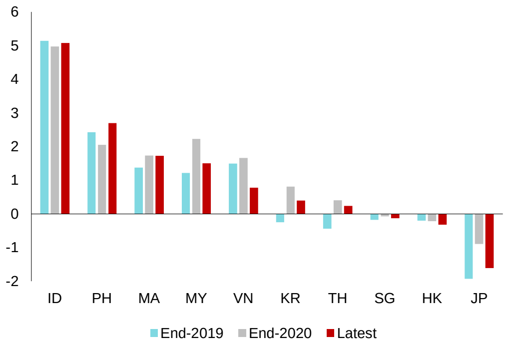
6. **With EPF withdrawals continuing in 2021, its demand for bonds may not see an immediate turnaround.** The 2021 budget reduced EPF contribution rate for employees from 11 percent to 9 percent, and also allowed targeted withdrawal from EPF accounts for those in need of relief. As per budget estimates, the total impact on these measures will be MYR70 billion against a yearly inflow of MYR80 billion (Kanyakumari, 2020). The net increase in EPF's funds will therefore be depressed, limiting a pick-up in EPF's demand for local assets, including bonds. The main drag on EPF assets is the increased allowance for cash withdrawals for individuals. These withdrawals could, however, (at least partially) add to the deposits with the banking system and a part of this may be deployed in government bonds, thus compensating for the fall in EPF demand for bonds to some extent. In effect, the demand (at least partially) shifts from EPF to the banking system. This shift can, however, steepen the bond yield curve as EPF typically invests in longer tenor bonds while banks may park their surplus liquidity in shorter tenor securities.

7. **Although the structural factors are not supportive of bank and EPF demand, they may still have some flexibility to absorb bonds.** As noted above, the drag in EPF demand may not have a severe impact on overall bond demand. Apart from that, bonds account for only 9.3 percent of banking system assets (much lower than regional peers, with Indonesia at 20.6 percent and Philippines at 26.0 percent) and 25.7 percent of all EPF investments (Indonesia's pension fund at 24.5 percent). There seems to be some flexibility for absorption of bonds by the banking system and, to a lesser extent, by EPF, especially if liquidity conditions warrant and there is a repricing of bonds which improves its valuations as compared to other assets.

8. **Demand from foreign and other investors may remain buoyed due to attractive valuations, however, risks remain.** Malaysia government debt was one of the few EM debt markets to receive net inflows in 2020. Attractive valuations (high spread against U.S. Treasury yields, Figure A2.5) amid favourable backdrop for EM currencies were one of the key factors which kept foreign investors interested. The real rates are still high and spreads against US Treasury yields are still higher than those seen before the pandemic. If global financial markets remain buoyed and the volatility remains low, the foreign demand for

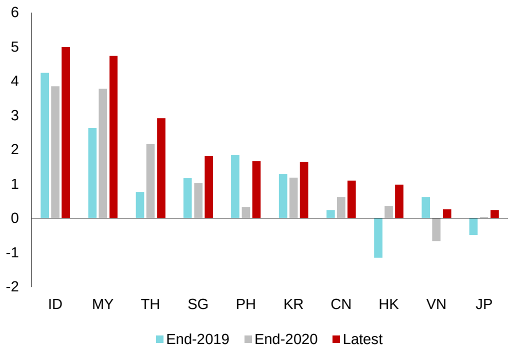
Malaysian debt may remain supported. Domestic investors may also find bonds attractive in a higher real rates backdrop (Figure A2.6). It is worth noting that investor demand for Malaysian debt is contingent on the global risk sentiment and any significant deterioration driven by the pandemic or other factors, could lead to significant outflows.

Figure A2.5. Bond Yield Spreads over U.S. Treasury Yield (Percent spread between 10-year sovereign yield and 10-year US Treasury yield)



Sources: Havers Analytics, AMRO staff calculations.
Note: Higher spread over US yields indicates attractive valuations.

Figure A2.6. Real Rates in Regional Bond Markets (Percent spread of 10-year sovereign yield over 12-month average inflation)



Sources: Havers Analytics, AMRO staff calculations.
Note: Higher real yield indicate attractive valuations.

9. **Policy support can act as an important backstop for demand of bonds.** Though the SRR is at its lowest level and policy rates have also already reached record lows, it does not mean that the authorities are short of ammunitions to support bond demand. In a scenario where bond demand falters, as a first step, the BNM can provide additional liquidity to the banking system through open market operations. In an extreme scenario, BNM can itself step into the markets to absorb excess bond supply. As per the Central Banking Act 1958 (Revised 1994, 2006), the BNM can purchase 1) 10 percent of MGS issued in primary market (~MYR7.5 billion, in our estimates, assuming 50 percent of gross issuance are MGS) and 2) 10 percent of the outstanding MGS amount in secondary markets (MYR40 billion, in our estimates). The likelihood of these measures being initiated, let alone being fully utilized, is very low in our view, but the room available with BNM to purchase bonds will be important to stabilize the bond market.

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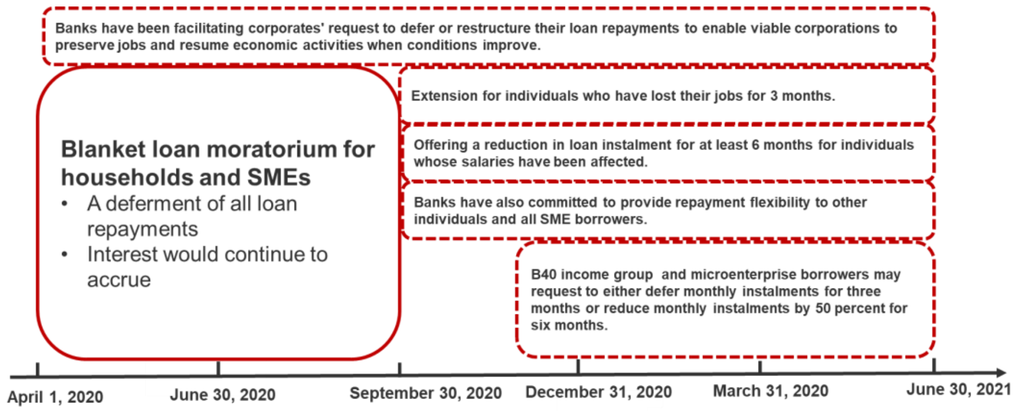
3. Loan Repayment Reliefs and the Credit Fallout from the COVID-19 Crisis[33]

The automatic loan moratorium and subsequent Targeted Repayment Assistance (TRA) initiated by BNM played an important role in supporting liquidity-constrained households and businesses during the pandemic. The loan relief measures have also kept the loan impairment ratio low, but there will be a high degree of uncertainty over the extent of loan impairment after the expiry of the TRA, in June 2021 at the least. Against this backdrop, we examine various scenarios of loan impairment post-TRA and find that major banks in Malaysia will be able to maintain capital buffers above regulatory thresholds under all scenarios.

1. **A six-month automatic loan moratorium was introduced as a key support measure to households and businesses affected by the pandemic.** Within the economic stimulus and recovery package deployed over the course of 2020, the six-month automatic loan moratorium was the biggest component, comprising a third of the total.[34] Under the moratorium, households and SMEs were automatically allowed to defer their principal and interest payments to banks from April to September 2020. The moratorium was applicable to MYR-denominated loans that had not been in arrears for more than 90 days at the time the scheme commenced on 1 April 2020. Notably, interest on the deferred principal payment would continue to accrue during the moratorium period.[35] Meanwhile, corporates may also request from their banks to defer or restructure their loan repayments.

2. **The initial take-up of the automatic loan moratorium by households and SMEs was high.** At the start, more than 95 percent of individuals and SME borrowers opted to avail of the repayment deferral. As at end December 2020, loan repayment for individuals and SMEs were at 93 percent and 116 percent of respective pre-COVID-19[36] levels, based on the value of loan repayments.

Figure A3.1. The Timeline for the Loan Moratorium and the Targeted Repayment Assistance



Sources: BNM, AMRO.
Note: 1) The dotted text box indicates that the timeline is soft. 2) Targeted repayment assistance remains available for all borrowers affected by COVID-19 throughout 2020 until at least June 2021.

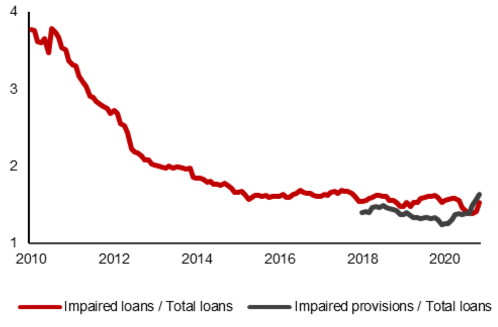
3. **The automatic loan moratorium was transitioned into a TRA in October 2020.** The TRA comprises (1) a three-month extension of the loan moratorium for individuals who lost

[33] This selected issue is prepared by Yang Chunyu, with contributions from Diana del Rosario and Justin Lim.
[34] Please refer to Figure 6 in the Recent Developments and Outlook section.
[35] As the automatic loan moratorium excluded credit card loans, credit card holders may opt to convert outstanding credit card balances into a term loan of no more than 3 years at an effective interest rate of not more than 13 percent per annum.
[36] Pre-COVID-19 refers to the monthly average repayments in the first quarter of 2020.

their jobs; or (2) reduction of the loan installment for at least six months for individuals whose salaries were affected by COVID-19 (Figure A3.1). At the same time, banks have continued to extend repayment flexibilities to other individuals and SME borrowers affected by the pandemic. The TRA was enhanced in November 2020 and expanded to all eligible individuals in the bottom 40 percent (B40) income group and microenterprise borrowers. These borrowers may request to either defer monthly instalments for three more months or reduce monthly instalments by 50 percent for six months until at least June 2021. Meanwhile, the repayment assistance would remain available for borrowers whose incomes have been affected by the pandemic. Borrowers who have opted not to avail of the repayment assistance would still be able to apply for the TRA throughout 2020 and until at least June 2021, if their financial circumstances were to change. According to BNM, as at 5 February 2021, a total of 1.5 million applications for the TRA were received, with a 95 percent approval rate—and of which, 54 percent received a moratorium extension and 46 percent received an instalment reduction. As the economy recovers, there is room for the approach to repayment assistance to adjust accordingly.

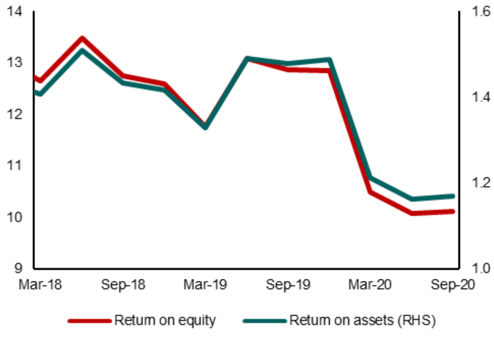
4. **Regulatory measures to assist with loan repayments have kept loan impairments low, but also created challenges in assessing banks' asset quality.** As loans under automatic loan moratoriums and the TRA continue to keep their prior loan classifications,[37] the severe economic recession has yet to be manifested in a meaningful increase in the loan impairments ratio (Figure A3.2). Loan impairments were broadly stable and remained low at 1.6 percent of total loans at the end of 2020. The automatic loan moratorium—and its gradual transition to the TRA—may provide borrowers time to rebuild their finances to a certain extent. This will potentially prevent a surge in impairments after their expiry. However, for the time being, the extended forbearance has created challenges in gauging banks' asset quality accurately.

Figure A3.2. Impaired Loan and Impairment Provisions of the Banking System in Malaysia (Percentage Points)



Sources: BNM, AMRO staff calculations.

Figure A3.3. Returns of the Banking System (Percentage Points)



Source: IMF.

5. **Notwithstanding the continued financial support from the TRA, credit risk remains pronounced in hard-hit sectors, and among SMEs and vulnerable households.** The outlook for hard-hit sectors—such as the tourism-related, wholesale and retail sectors—that

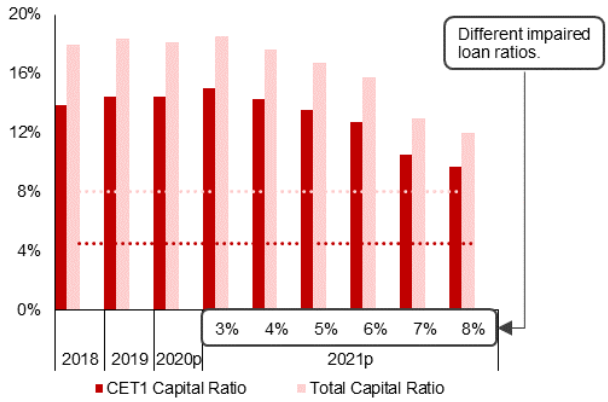
[37] Applications for loan moratorium and TRA schemes will not appear on a borrower's credit records, and do not necessarily prompt a change in loan status. Separately, under Malaysian Financial Reporting Standards 9 (MFRS 9), performing loans are classified as Stage 1; under-performing loans (30 days past due or exhibit significant increase in credit risk) are classified as Stage 2; and non-performing loans (90 days past due) as Stage 3. Loans of Stage 2 and Stage 3 will require provisions to account for 'lifetime expected credit losses' (lifetime of the loan), while loans classified as Stage 1 are required to make provisions under the assumption of projected losses over a 12-month period.

make up approximately 25 percent of bank loans[38], is still expected to remain challenging given the ongoing pandemic situation and stricter lockdown measures. Moreover, microenterprises and SMEs will likely experience greater financial distress if the pandemic extends beyond the TRA. In the household sector, credit risk is greater among the more leveraged and lower-income household groups earning less than MYR5,000 per month. This subset is, therefore, more susceptible to an economic downturn.

6. **A weak and uncertain credit outlook has prompted banks to pre-emptively set aside additional provisions, which in turn weighed on banks' profits.** Notwithstanding the stable impairments ratio, the banking sector increasingly set aside impairment provisions in 2020 as a pre-emptive measure against increased credit risks (Figure A3.2). In addition, banks had to book a one-off modification loss[39] in Q2 2020, which stemmed from a waiver of additional interest charges for hire-purchase loans and fixed rate loans/financing during the loan moratorium. The pre-emptive provisions pushed up loan loss provisions to MYR29.9 billion as of end-November 2020, as against MYR22 billion as of end 2019. This dampened bank profitability in the first three quarters of 2020 (Figure A3.3), in addition to the successive policy rate cuts and subdued credit growth during the period. In 2021, bank profitability could remain subdued if provisions continue increasing and loan growth remains moderate. However, minimal one-off modification loss and the likelihood of no further policy rate cuts would ease the pressure on banks' profits.

7. **We conducted a stress test for eight major Malaysian banks, and the results show that the capital buffer will be reduced but will remain above regulatory thresholds.** The eight domestic banks in the exercise account for 76 percent of banking system assets as at December 2020, and are crucial to financial stability. Our stress test ran different impaired loan ratios after the termination of the TRA. The range for the impaired loan ratios is within 3-8 percent. We took the cue from the GFC, when loan impairments ranged between 4.4 percent and 8.5 percent. Meanwhile, BNM's stress test exercise estimated loan impairments to rise to 4.1 percent by end 2021.[40] As Figure A3.4 shows, banks will have ample capital buffer with such estimates of the impairment ratio. Even in an extreme case, where loan impairments double from BNM's projection to 8 percent, the CET1 capital ratio and total capital ratio (TCR) would remain above their respective regulatory minimum.

Figure A3.4. Stress Test Results for Local Banks

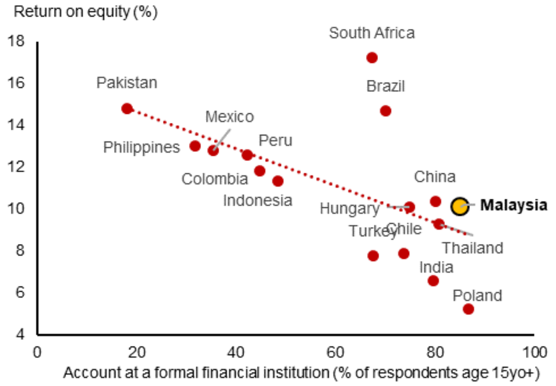


Sources: BankFocus, AMRO staff projections.
Note: The light pink and red dotted lines are the Basel III minimum requirements for TCR and CET1, respectively.

[38] See Bank Negara Malaysia's Financial Stability Review for First Half 2020.
[39] Or what is known as a Day 1 modification loss. On 6 May 2020, Finance Minister Tengku Datuk Seri Zafrul Abdul Aziz announced that no additional interest charges will be imposed on borrowers with hire-purchase loans/financing during the six-month moratorium period. Banks not being able to collect additional interest on it will lead to a one-off modification loss, reflecting the opportunity cost over time from not having received cash flows during the loan deferment period.
[40] Bank Negara Malaysia (2020). Bank Negara Malaysia Financial Stability Review for First Half 2020.

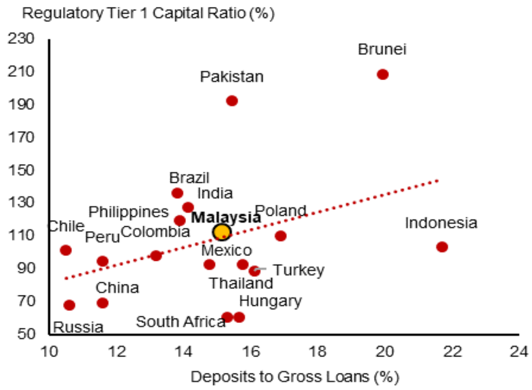
8. **Malaysian banks have room to deal with the credit fallout from the COVID-19 crisis as they have strong capital buffers.** Malaysian banks have a feature of relatively low profitability, compared to their emerging market peers (Figure A3.5). This may be due to low interest rates and fierce competition among banks owing to Malaysia's higher level of banking penetration. But they have had relatively strong capital buffers (Figure A3.6). Liquidity buffers were likewise ample, with the liquidity coverage ratio remaining well above the 100 percent minimum throughout 2020. Therefore, Malaysian banks are expected to absorb any deterioration in credit quality—due to the pandemic—to a large extent.

Figure A3.5. Bank Profitability and Financial Access – Emerging Market Economies



Source: AMRO Artemis Database, World Bank Global Financial Development Database.
Note: Data for the y-axis (return on equity) refer to September 2020, and the x-axis (financial access) to end-2017, the latest data prior to the COVID-19 pandemic.

Figure A3.6. Capital Adequacy and Liquidity Indicators – Emerging Market Economies



Source: AMRO Artemis Database.

9. **The impact of the crisis is likely to differ across banks, especially when contagion is taken into consideration.** The impact of the crisis on banks will depend on their loan structures. Banks that have a lower exposure to corporates in the services sector and vulnerable households would be less affected and could report relatively lower impaired ratios by end 2021. At the same time, in an interconnected financial system, credit distress in one bank could spill over to other banks owing to interbank relationships and market sentiment, among others. In another study, Sun (2020) found that contagion will increase the total expected credit loss of Malaysia's domestic systemically important banks by 13 percent. The analysis assumes a 20-basis-point increase in the probability of default of such banks, which typically refers to a downgrade from investment to speculative rating.

10. **Notwithstanding Malaysia's strong banking system, uncertainty over the loan quality in the future remains a key source of concern.** Loan quality will depend on the strength of economic recovery and how effectively COVID-19 is contained. Economic policies going into 2021 should remain supportive of the economic recovery, particularly in terms of providing enough financing facilities to affected households and businesses, such as the Targeted Relief and Recovery Facility, High Tech Facility and the Micro Enterprises Facility. At the same time, supervisory authorities should monitor credit risk in a granular manner by conducting more frequent stress testing exercises. Authorities must also continue to encourage banks to communicate regularly with borrowers to keep them updated of their financial health.

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