BNM ANNUAL REPORT 2020 – ACCOMMODATIVE MONETARY POLICY INTACT

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ECONOMIC RESEARCH

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ECONOMIC GROWTH WILL HINGE ON MALAYSIA'S VACCINATION CAMPAIGN

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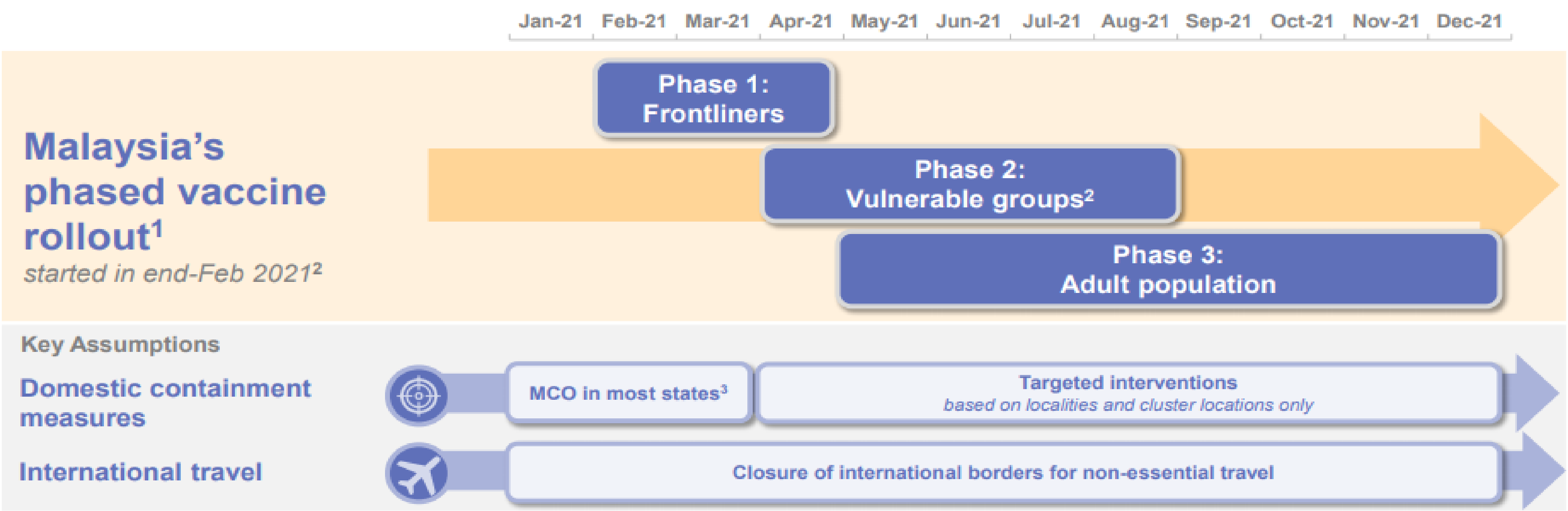
- ✓ The BNM's annual report for 2020 was published today and we attended the analyst briefing to hear from the horse's mouth. The central bank is of the view that the global technology up cycle would benefit the country's external sector. At the same time, major infrastructure would be the key catalyst for domestic investment that would propel the aggregate demand. Having said that, the BNM acknowledged that the state of the economy is highly fluid. This was reflected in **the forecast range of between 6.0% and 7.5% (Previously 6.5% - 7.5%) for the 2021 GDP growth (2020: -5.6%) (Consensus: 5.1%, Bank Islam: 4.0%).**
- ✓ The growth trajectory will hinge on the pace of the vaccination progress in the country. As of 30 March 2021, 661,661 individuals have been vaccinated while over 7.2 million people have registered for the vaccination program in the country. The vaccination rate in the country is expected to increase as more vaccines enter the market in the coming months.
- ✓ As such, the Malaysia's central bank is committed to ensure the monetary policy would remain accommodative in order to facilitate a sustainable economic recovery.



[1] At least 80% coverage of adult population by December 2021
[2] Refers to senior citizens and high risk groups, and also remaining healthcare and essential workers not vaccinated in Phase 1
[3] Refers to MCO 2.0 which was imposed in all states except Sarawak by 22 January, which has ended in all states as of 4 March

 Sources: Economic And Monetary Review 2020

MALAYSIA'S GDP IS EXPECTED TO REBOUND BETWEEN 6.0% AND 7.5% IN 2021 FROM 5.6% CONTRACTION IN 2020

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Y-o-Y%	Share 2020	2016	2017	2018	2019	2020	2021F
GDP	**100.0%**	**4.4%**	**5.8%**	**4.8%**	**4.3%**	**-5.6%**	**6.0% - 7.5%**
By Expenditure:							
Domestic Demand (excluding stocks)	93.9%	4.3%	6.5%	5.5%	4.3%	-5.7%	7.4%
Private Sector	**75.2%**	**5.5%**	**7.4%**	**7.1%**	**6.2%**	**-6.0%**	**7.4%**
-Consumption	59.5%	5.9%	6.9%	8.0%	7.6%	-4.3%	8.0%
-Investment	15.7%	4.5%	9.0%	4.3%	1.6%	-11.9%	5.4%
Public Sector	**18.7%**	**0.2%**	**3.5%**	**0.0%**	**-2.8%**	**-4.6%**	**7.4%**
-Consumption	13.4%	1.1%	5.7%	3.2%	2.0%	4.1%	4.4%
-Investment	5.2%	-1.0%	0.3%	-5.0%	-10.8%	-21.4%	15.2%
Net Exports of Goods and Services	**6.5%**	**0.4%**	**-3.9%**	**6.2%**	**9.7%**	**-12.3%**	**4.8%**
-Exports	61.6%	1.3%	8.7%	1.9%	-1.3%	-8.8%	13.1%
-Imports	55.1%	1.4%	10.2%	1.5%	-2.5%	-8.3%	14.1%
By Industry:							
Services	57.7%	5.7%	6.3%	6.8%	6.1%	-5.5%	6.6%
Manufacturing	23.0%	4.4%	6.0%	5.0%	3.8%	-2.6%	8.8%
Mining and Quarrying	6.8%	2.2%	0.4%	-2.2%	-2.0%	-10.0%	3.1%
Agriculture	7.4%	-3.7%	5.9%	0.1%	2.0%	-2.2%	4.2%
Construction	4.0%	7.5%	6.7%	4.2%	0.1%	-19.4%	13.4%

Sources: BNM Economic And Monetary Review 2020, CEIC

DOMESTIC DEMAND CONTINUED TO BE THE ANCHOR OF GROWTH

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01 Private Consumption

- Private consumption is expected to recover by 8.0% in 2021 (2020: -4.3%), driven by gradual improvement in overall income and employment growth.
- Vaccination programme is anticipated to support consumer sentiment.
- Targeted policy measures are available to support spending.
- Acceleration in online shopping would help to sustain private consumption.

02 Public Consumption

- Public consumption is projected to increase by 4.4% in 2021, extending the 4.1% growth in 2020.
- This is due to higher Federal Government spending particularly for Covid-19 related expenditure, including vaccine procurement and logistics spending.

03 Gross Fixed Capital Formation (GFCF)

- GFCF is forecasted to rebound by 7.8% in 2021 (2020: -14.5%), supported by the rise in capital spending from private and public sectors.
- Private investment will be driven by the progress of ongoing large projects especially in civil engineering sub sector.
- Public investment would be underpinned by large-scale infrastructure projects such as ECRL, MRT2 and Pan Borneo Highway.

04 Exports

- Export is anticipated to record a positive growth of 13.1% in 2021 (2020: -8.8%).
- External spillovers from the broader recovery in global demand would sustain domestic production, investment and export activities.
- Export-oriented industries are expected to benefit from improving domestic demand in key trade partner economies such as the US and China, as well as the global technology upcycle.
- Firm global demand for Electrical & Electronics (E&E) products.

Source: BNM Economic And Monetary Review 2020

ALL ECONOMIC SECTORS ARE EXPECTED TO REBOUND IN 2021

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Services

- Services sector is expected to register a positive growth of 6.6% in 2021 (2020: -5.5%), leading by information and communication, as well as finance and insurance sub-sectors.

Manufacturing

- Robust growth of 8.8% is anticipated in 2021(2020: -2.6%) for manufacturing sector following structural shifts towards digitalization. As such, this help to spur demand for telecommunications, cloud computing, medical devices and E&E products.

Mining and Quarrying

- Mining and quarrying sector is projected to recover by 3.1% in 2021 (2020: -10.0%) as the operationalisation of new gas fields together with the ramp-up of the Petronas Floating Liquefied Natural Gas 2 (PFLNG2) facility in East Malaysia will lead to higher production of natural gas in 2H2021.

Agriculture

- Agriculture sector is forecasted to expand by 4.2% in 2021 (2020: -2.2%), supported by a recovery in oil palm production, as well as an increase in tapping activities due to higher natural rubber prices.

Construction

- Construction sector is estimated to rebound by 13.4% in 2021 from a 19.4% contraction previously. Resumption of activities across subsectors such as civil-engineering, residential, as well as special trade are expected to drive the growth.

Source: BNM Economic And Monetary Review 2020

INFLATION TO RISE IN 2021 FROM A LOW BASE

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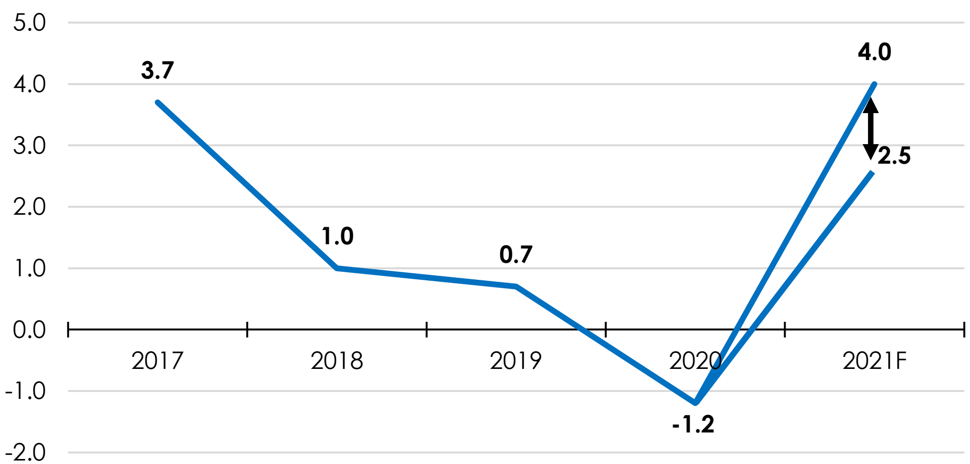
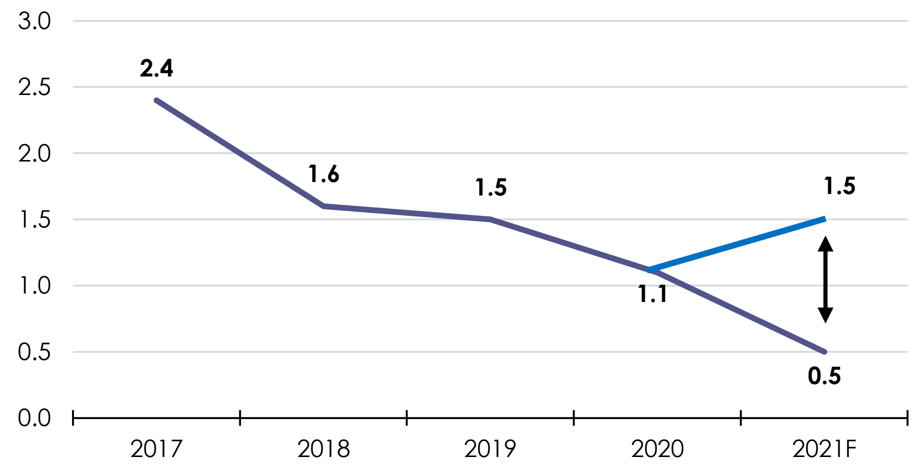
Malaysia's Headline Inflation, Annual Change (%)



Malaysia's Core Inflation, Annual Change (%)



Source: BNM Economic And Monetary Review 2020

- ✓ The inflation rate is expected to grow in the range of 2.5% to 4.0% in 2021 (2020: -1.2%), underpinned by higher global oil prices and the lapse in effect from the tiered electricity tariff rebate introduced in April 2020.
- ✓ On a quarterly basis, the headline inflation rate is expected to see a temporary surge in 2Q2021 amid a low base effect mainly caused by lower retail fuel prices in 2Q2020. Recall that the 2Q2020 average RON95 domestic retail fuel price stood at RM1.37/litre, while the year-to-date average price is RM1.96/litre. However, inflationary pressures will be limited as the government announced a ceiling price of RM2.05 for RON95 under the PEMERKASA stimulus package.
- ✓ Notwithstanding this, inflation will moderate from 2Q2021 onwards as the low base effect from 2Q2020 fades.
- ✓ In contrast, the core inflation is forecasted by BNM to average between 0.5% and 1.5% in 2021(2020: 1.1%) due to the spare capacity in the economy.

MONETARY POLICY WILL REMAIN ACCOMMODATIVE

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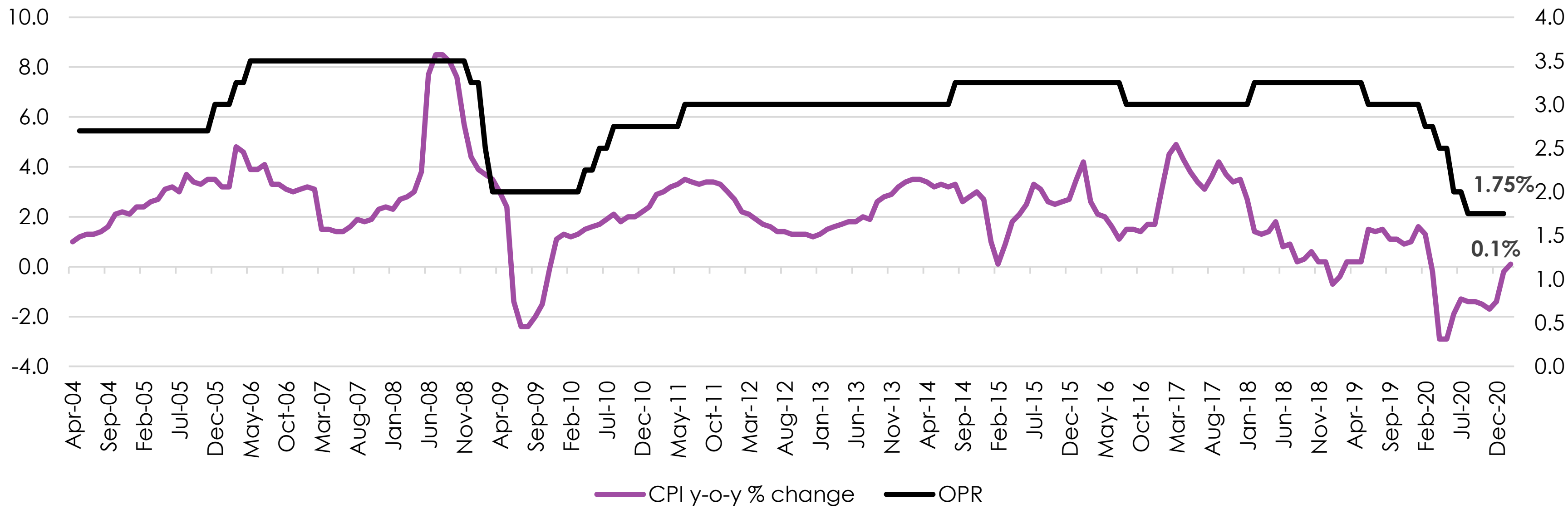
- ✓ With the inflation rate forecasted to be higher in a range of 2.5% to 4.0% in 2021 (2020: -1.2%), expectations for BNM to raise the OPR is inevitable. So, the question now revolves on the appropriate time for BNM to begin raising the OPR to anchor the inflation expectation.
- ✓ While many data points are pointing towards a recovery as seen in exports in the manufacturing sector which expanded by 20.9% year-on-year (y-o-y) in February 2021 (January 2021: 11.7%), spare capacity remains in other key sectors namely services related industries such as tourism.
- ✓ Henceforth, BNM will need to be mindful to avoid a premature withdrawal of policy support which will exert downward pressure on the growth trajectory.
- ✓ More importantly, the current OPR of 1.75% remains adequate to accommodate the economy while managing price pressures.

CPI, y-o-y vs. OPR,%



Source: CEIC, DOSM

UNEMPLOYMENT EXPECTED TO REMAIN HIGH IN 2021

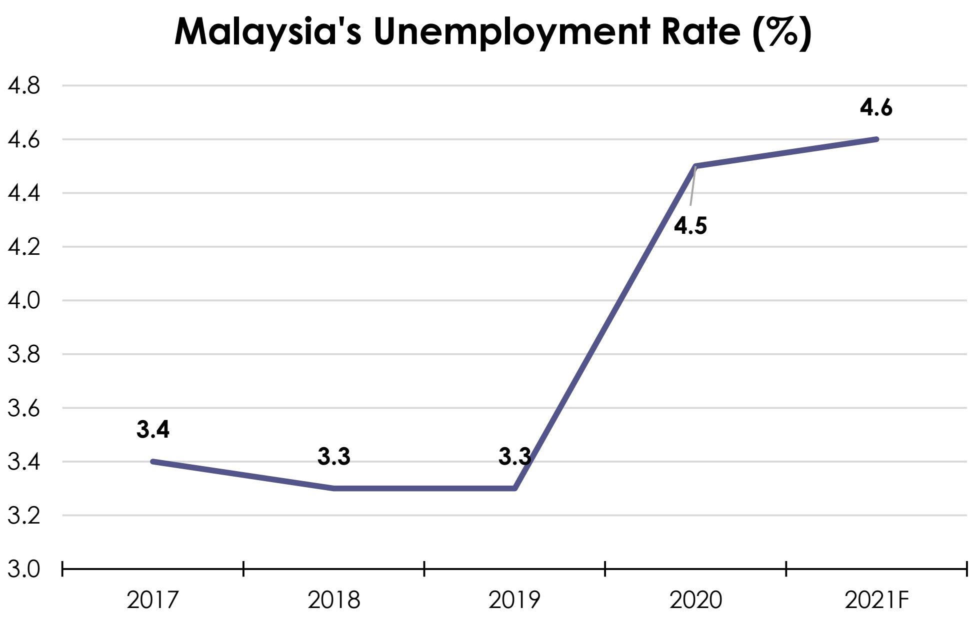
- ✓ Although the economic activity is expected to recover once the pandemic is contained, the recovery in employment is likely to be uneven across groups.
- ✓ For instance, the three structural issues in Malaysia's labour market due to the pandemic shown below may continue to exert pressure towards unemployment in youths. Therefore, a closer policy focus is needed to limit long term scarring effects on the youth.
- ✓ Aside from that, structural shifts in the labour market induced by the pandemic, such as accelerated adoption of digitalisation would make groups such as gig workers vulnerable due to their limited access to capital. This would likely increase long-term unemployment in the near-to-medium term.
- ✓ Therefore, BNM is cautious on the outlook of the labour market and is forecasting the unemployment rate to inch higher to 4.6% in 2021 (2020: 4.5%).

Structural Issues in Malaysia's Labour Market

Prevalence of low-cost production model and high dependence on low-skilled foreign workers.

Low creation of high-skilled jobs, which has lagged behind the supply of graduates.

Significant mismatches between skills required by industry and those that workers possess.



Source: BNM Economic And Monetary Review 2020

FINANCIAL SECTOR REMAINS RESILIENT

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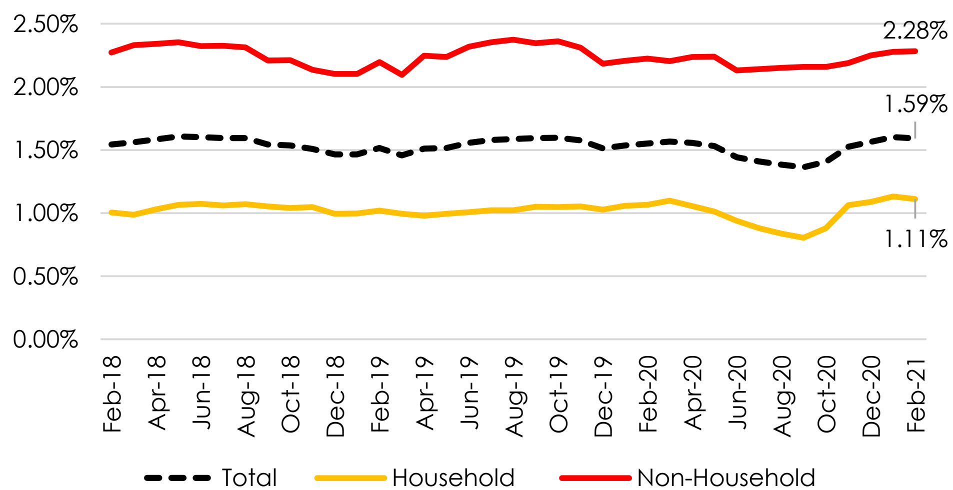
GIFR (%)



Source: CEIC, BNM Financial Stability Review 2H2020

Adverse Scenario (AS)

AS1

- ✓ A sharp economic downturn in 1Q2021 of similar magnitude to the contraction in 2Q2020.
- ✓ Initial recovery driven by pent-up demand and gradually normalising across all sectors by 2022.
- ✓ GDP returning to pre-pandemic levels by 3Q2021.

AS2

- ✓ A much steeper economic contraction in 1Q2021, surpassing deepest slump experienced in the crisis thus far.
- ✓ Sluggish recovery with GDP registering negative growth in 2021 and remaining below pre-pandemic levels even by the end of 2022.

- ✓ The impairment was revised lower to 2.9% for AS1 and 3.3% for AS2 by end of this year from a 4.1% projection during the previous exercise in view of significantly better turnout for repayment.
- ✓ On the flip side, the banking system's Gross Impaired Financing Ratio (GIFR) has gradually increased from 1.41% in October last year to 1.59% in February this year after the 6-month blanket ended in September 2020. Judging from this, Malaysia's banking sector remains resilient as the GIFR was lower compared to BNM's stress test.
- ✓ Nevertheless, BNM foresees that the overall impairment could rise to 4.0% under AS1 and 5.4% under AS2 by the end of 2022 mainly driven by household segment.

AMPLE ASSISTANCE FOR SMES

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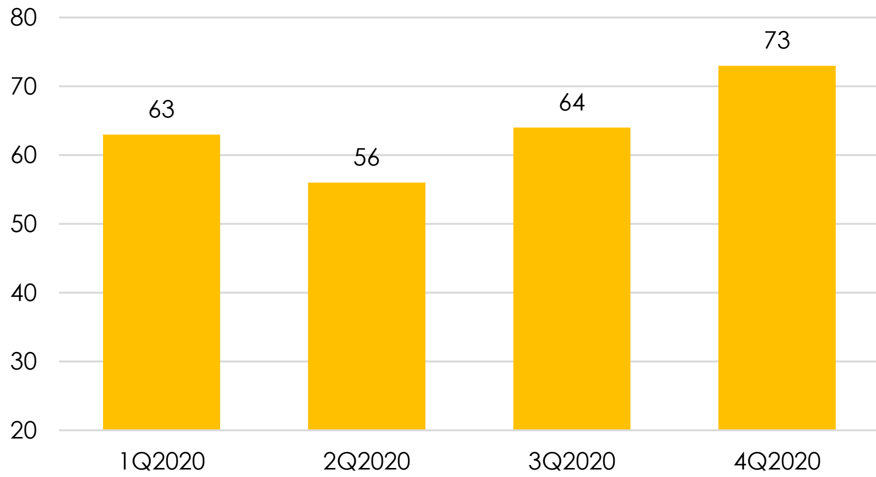
Financing disbursed to SMEs, RM billion



Source: BNM Financial Stability Review 2H2020

BNM's fund for SMEs –selected facilities in 2020

	Special Relief Facility (SRF)	Agrofood Facility (AF)	SME Automation & Digitalisation Facility (ADF)	PENJANA Tourism Financing (PTF)	Targeted Relief & Recovery Facility (TRRF)	High Tech Facility-National Investment Aspirations (HTF-NIA)
PURPOSE	EASE CASH-FLOW CONSTRAINTS	INCREASE FOOD PRODUCTION AND EXPORTS	INCENTIVISE AUTOMATION AND DIGITALISATION	AID THE TOURISM SECTOR	SUPPORT RELIEF AND RECOVERY OF SERVICE SECTOR	SUPPORT HIGH-TECH AND INNOVATIVE SECTORS
DATE ANNOUNCED	27 FEB 2020	27 FEB 2020	27 FEB 2020	30 JUL 2020	06 NOV 2020	15 DEC 2020
TOTAL ALLOCATION	RM 10.0 BILLION	RM 1.5 BILLION	RM 1.0 BILLION	RM 0.6 BILLION	RM 4.0 BILLION	RM 0.8 BILLION
AVAILABLE BALANCE	FULLY UTILISED	RM 0.2 BILLION	RM 0.8 BILLION	RM 0.5 BILLION	RM 2.7 BILLION	RM 0.8 BILLION
APPROVAL RATE	78%	91%	83%	64%	88%	100%

- ✓ Continued access to finance for SMEs is a key focus area following the substantial impact from the Covid-19 crisis.
- ✓ SMEs relatively have low cash buffers and narrow profit margins which are more susceptible to cash flow and financing constraints during Covid-19 pandemic.
- ✓ Therefore, the loan disbursement for SME has increased significantly to RM64.0 billion in 3Q2020 and RM73.0 billion in 4Q2020 in order to support recovery of hard-hit economic sectors.
- ✓ In addition, various programs were offered to help sustain the business activities and to safeguard jobs, as well as to enhance innovative capacity of SMEs.
- ✓ Looking forward, a survey done by banks indicated that credit conditions could tighten a little more for corporate borrowers, while conditions are expected to ease for SMEs in the first half of 2021 compared to conditions in 2020.

OUR VIEW

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- ✓ The potential output growth which takes into account the input factor of labour, capital and technology is likely to be in the region of 3.0% to 4.0% in 2021 (2020: 3.3%). The number suggests that there is still some room for productive capacity to expand which is very much in line with the increasing demand currently experienced by the key industries (rubber gloves, semiconductor, oil & gas etc). However, other industries particularly tourism may continue to be a drag on potential output growth as travel restrictions remain prevalent.
- ✓ Taking this into consideration, the BNM is of the view that the output gap which is the difference between the actual output level and the rate of decline in the potential output level is likely to be lower in 2021. This is due to the expected rebound in actual output growth to 6.0% to 7.5% in 2021 which exceeds the 3.0% to 4.0% range for the potential output growth in 2021.
- ✓ Against a backdrop of a higher inflation rate in 2021 combined with spare capacity in key sectors, **we foresee that BNM would maintain the Overnight Policy Rate (OPR) at 1.75%. The earliest point at which BNM may raise the OPR could be in 2022 when the economic growth approaches towards normalisation.**

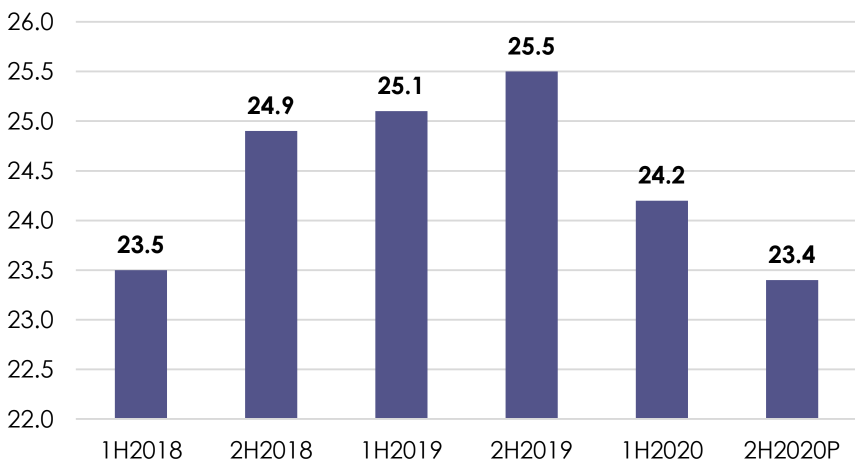
Malaysia's Potential Growth

Year	Annual Growth in Potential Output (%)
2019	4.8
2020	3.3
2021F	3.0 - 4.0

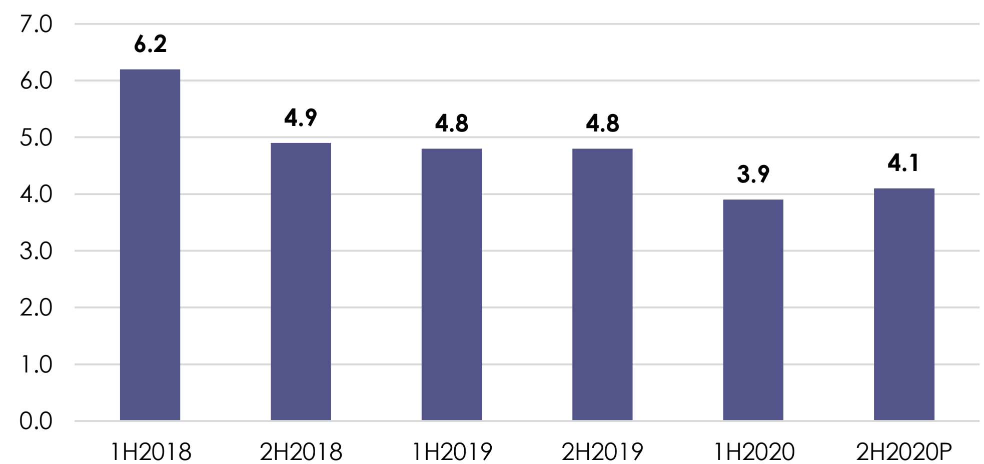
Source: BNM Economic And Monetary Review 2020

- ✓ BNM is of the view that financial stability risks are manageable as higher provisions by banks will cushion any rise in credit risk in 2021 and thereafter.
- ✓ Overall, preliminary lending targets for 2021 across banks suggest that the banking system will be more than able to support credit demand in tandem with the projected economic recovery.
- ✓ In light of the expected rebound in GDP this year, corporate earnings should follow suit to grow as shown by the debt-to-equity ratio which was lower at 23.4x in 2H2020 (1H2020: 24.2x) Furthermore, the interest coverage ratio of the business sector also improved to reach 4.1x in 2H2020 (1H2020: 3.9x).
- ✓ However, there is an exception for businesses in the non-residential property segment which continues to be affected by travel restriction. Moreover, many businesses have began downsizing their office space in light of the flexible working arrangements. Therefore, the non-residential property segment should be monitored closely by banks in terms of their key financial metrics.

Debt-to-equity ratio of the business sector, times



Interest coverage ratio of the business sector, times



Source: BNM Financial Stability Review 2H2020
P=preliminary

	As at end					
	1H 2018	2H 2018	1H 2019	2H 2019	1H 2020	2H 2020p
	% (or otherwise stated)					
Banking System						
Total Capital Ratio	17.6	18.1	18.0	18.6	18.3	18.5
Tier 1 Capital Ratio	14.2	14.6	14.7	15.1	15.1	15.3
Common Equity Tier 1 Capital Ratio	13.4	13.9	14.0	14.6	14.6	14.8
Return on Assets	1.5	1.4	1.5	1.5	1.2	1.1
Return on Equity	13.3	12.7	13.0	13.0	10.0	9.2
Liquidity Coverage Ratio	139.3	143.2	153.0	149.1	149.2	148.2
Net Impaired Loans Ratio	0.9	0.9	1.0	1.0	0.9	1.0
Capital Charge on Interest Rate Risk in the Trading Book to Capital Base	1.1	1.1	1.1	1.2	1.2	1.1
FX Net Open Position to Capital Base	5.0	5.5	4.9	4.4	4.9	5.3
Equity Holdings to Capital Base	0.6	0.9	0.7	1.6	1.3	1.5
Insurance and Takaful Sector						
Capital Adequacy Ratio	238.7	243.9	230.0	226.9	227.1	219.7
Life Insurance and Family Takaful						
Excess Income over Outgo (RM billion)	2.9	6.6	16.5	7.7	4.7	16.8
New Business Premium / Contribution (RM billion)	8.2	7.6	9.7	9.0	9.0	9.9
Capital Adequacy Ratio	237.9	234.8	213.2	206.2	210.6	203.5
General Insurance and General Takaful						
Underwriting Profit (RM billion)	0.7	0.8	0.5	0.6	0.9	0.8
Operating Profit (RM billion)	1.3	1.6	1.4	1.5	1.7	1.7
Gross Direct Premium / Contribution (RM billion)	10.2	9.9	10.6	10.2	10.3	10.5
Claims Ratio	57.9	58.2	59.3	59.1	55.9	54.6
Capital Adequacy Ratio	262.5	278.3	273.2	279.8	287.1	282.6
Household (HH) Sector						
HH Debt (RM billion)	1,156.8	1,186.7	1,217.7	1,251.8	1,265.9	1,320.6
HH Financial Assets (RM billion)	2,462.5	2,543.5	2,627.6	2,708.8	2,751.9	2,905.7
HH Debt-to-GDP Ratio	82.1	82.0	82.3	82.9	87.5	93.3
HH Financial Assets-to-Total HH Debt Ratio	212.9	214.3	215.8	216.4	217.4	220.0
HH Liquid Financial Assets-to-Total HH Debt Ratio	145.4	143.4	145.6	143.2	143.8	145.5
Impaired Loans Ratio of HH Sector[1]	1.3	1.2	1.2	1.2	1.0	1.1
Business Sector[2]						
Return on Assets	2.2	1.6	1.5	1.5	0.8	1.0
Return on Equity	3.9	3.0	2.8	3.0	1.6	1.9
Debt-to-Equity Ratio	23.5	24.9	25.1	25.5	24.2	23.4
Interest Coverage Ratio (times)	6.1	4.9	4.8	4.8	3.9	4.1
Operating Margin	6.4	5.6	5.7	5.7	5.0	4.7
Impaired Loans Ratio of Business Sector	2.6	2.4	2.6	2.5	2.5	2.6
Development Financial Institutions[3]						
Lending to Targeted Sectors (% change)	-1.9	-0.3	0.4	-0.3	3.9	7.7
Deposits Mobilised (% change)	1.3	0.4	1.8	2.5	2.0	6.6
Impaired Loans Ratio	6.0	5.8	6.7	6.4	5.9	5.1
Return on Assets	1.2	1.5	1.5	1.5	1.1	1.1

[1] Refers to both banks and non-bank financial institutions
[2] The financial performance metrics of publicly listed corporates are as at the third quarter of 2020
[3] Refers to development financial institutions under the Development Financial Institutions Act 2002
p Preliminary
Note: Figures may not necessarily add up due to rounding

Source: Bank Negara Malaysia, Bursa Malaysia, Department of Statistics, Malaysia, Employees Provident Fund, Securities Commission Malaysia, S&P Capital IQ and Bank Negara Malaysia estimates

Sources: BNM Financial Stability Review 2H2020

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