

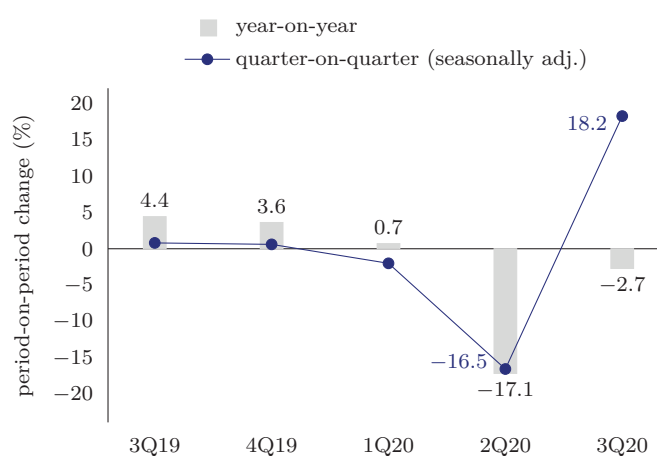
Developments in the Malaysian Economy

HIGHLIGHTS

- The Malaysian economy recorded a smaller contraction of 2.7%.
- Headline inflation was negative while core inflation moderated slightly.
- Higher current account surplus of RM26.1 billion or 7.1% of GDP.

Growth recovery in 3Q 2020

Chart 4: GDP Growth



Source: Department of Statistics Malaysia

In line with the reopening of the economy from earlier COVID-19 containment measures and improving external demand conditions, the Malaysian economy recorded a smaller contraction of 2.7% in the third quarter. This recovery is seen across most economic sectors, particularly the manufacturing sector, which turned

positive on account of strong electrical and electronics (E&E) production activity. On the expenditure side, domestic demand contracted at a slower pace, while net exports rebounded. On a quarter-on-quarter seasonally-adjusted basis, the economy turned around to register an expansion of 18.2% (2Q 2020: -16.5%).

Growth improved across most economic sectors, driven mainly by the manufacturing sector

Chart 5: Growth by Economic Sectors

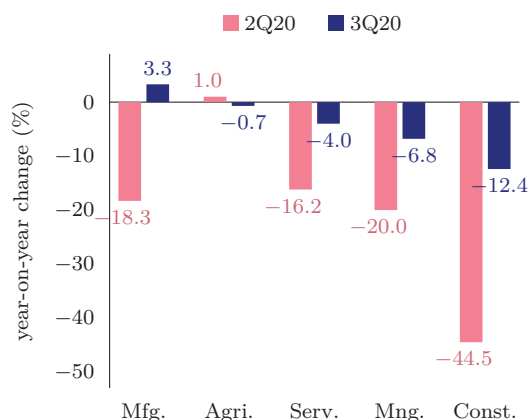
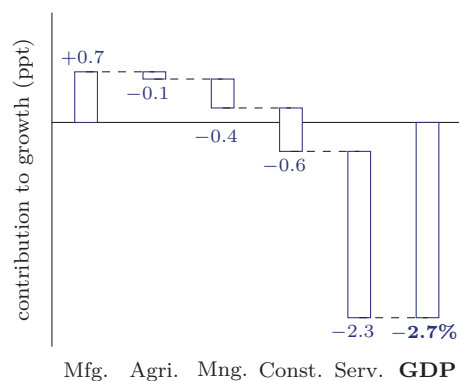


Chart 6: Contributions of Economic Sectors to Real GDP Growth



Source: Department of Statistics Malaysia

Improvements in growth were recorded across most economic sectors, as the country transitioned from the Conditional Movement Control Order (CMCO) into the Recovery Movement Control Order (RMCO).

Activity in the services sector recovered substantially, with growth recording a smaller contraction of 4.0% (2Q 2020: -16.2%). The wholesale and retail trade sub-sector showed a marked improvement, with accelerated sales in the motor vehicles segment following the Sales and Services Tax (SST) exemptions, as well as better performance of the retail trade segment, supported by higher demand for necessities. The recovery, however, was weighed down by subdued spending on non-essential retail goods, such as durable goods and recreational activities. In addition, tourism activity remained weak due to continued closure of international borders, affecting key sub-sectors such as food and beverage and accommodation, as well as transport and storage. Nevertheless, relaxation on movement restrictions enabled resumption of domestic travel activity, and facilitated an incipient restoration of activity in these sub-sectors. Meanwhile, the finance and insurance sub-sector registered positive growth, supported by higher capital market activity, particularly from domestic retail participants, as well as higher net interest and fee income. In addition, growth in the information and communication sub-sector continued

to improve amid higher demand for data communication services, particularly driven by the rise of remote working arrangements.

Growth in the manufacturing sector rebounded to 3.3% (2Q 2020: -18.3%), supported by a broad-based improvement across all the major manufacturing clusters. In the E&E cluster, growth rebounded strongly as production increased to fulfil order backlogs from the previous quarter as well as to cater for front-loading activities amid concerns of rising trade tensions. Growth in the consumer-related cluster also turned positive as Government measures, such as the exemption of export duties and car sales tax, supported the production of refined palm oil and passenger motor vehicles respectively. Meanwhile, the turnaround in the primary-related cluster was driven mainly by strong demand for rubber and pharmaceutical products. Although manufacturing activity in the construction-related cluster continued to record negative growth, the contraction eased as construction activities resumed after the Movement Control Order (MCO) period.

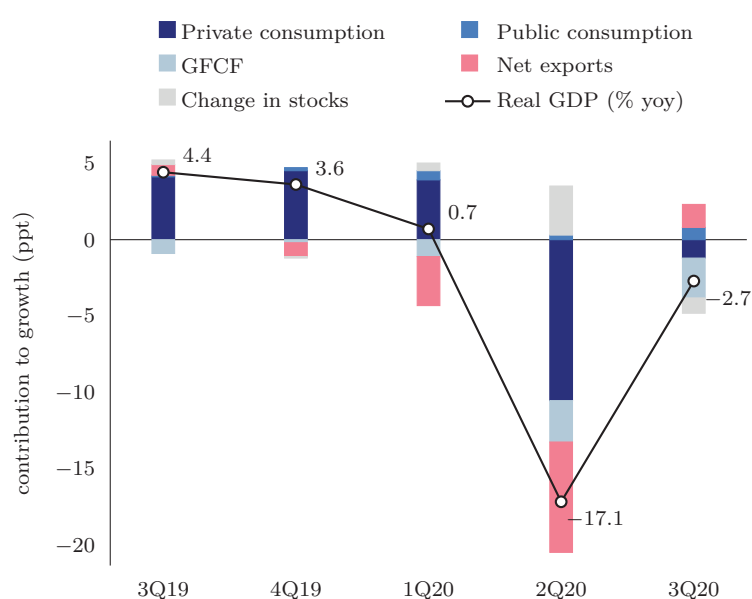
Contraction in the mining sector eased considerably (-6.8%; 2Q 2020: -20.0%) as oil and natural gas production improved amid gradual recovery in external demand. The improvement is also supported by a smaller decline in the other mining segment as production resumed after the MCO period.

Activity in the construction sector improved, contracting by a smaller rate of 12.4% (2Q 2020: -44.5%). Activity resumed across all sub-sectors supported by on-going large transportation projects in the civil engineering sub-sector and affordable housing projects in the residential sub-sector.

The agriculture sector recorded a contraction of 0.7% (2Q 2020: 1.0%), mainly due to the slower growth in the oil palm sub-sector amid labour shortages, which affected harvesting activities during the quarter. This more than offset the recovery in the aquaculture, livestock and other agriculture sub-sectors as demand gradually recovered.

Recovery in domestic and external demand

Chart 7: Contributions of Expenditure Components to Real GDP Growth



Source: Department of Statistics Malaysia

Domestic demand recorded a smaller decline of 3.3% in the third quarter of 2020 (2Q 2020: -18.7%), driven by improvements in both consumption and investment activity. Household spending was mainly supported by gradual recovery in income conditions, while investment activity benefitted from the ease of containment measures. Net exports rebounded to record a positive growth of 21.9% (2Q 2020: -38.6%), driven by a larger improvement in exports vis-à-vis imports.

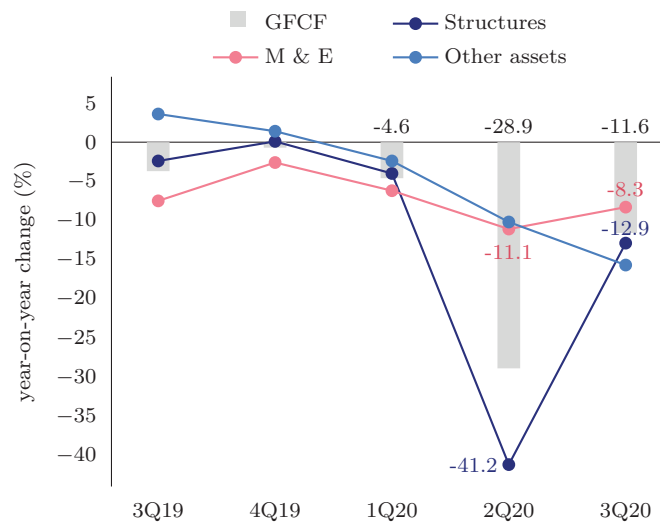
Private consumption recovered significantly from the trough in the second quarter to record a smaller contraction of 2.1% (2Q 2020: -18.5%). Household spending improved with further loosening of

movement restrictions, while broad income conditions gradually recovered amid resumption of economic activities. The improvement in spending was reflected in the uptrend across most retail and financing data during the quarter. Private consumption activity was also supported by stimulus measures such as the EPF i-Lestari withdrawals, wage subsidies and sales tax reduction for cars.

Public consumption registered a higher growth of 6.9% (2Q 2020: 2.3%), benefitting from increased Government spending on supplies and services and faster expansion in emoluments.

Smaller decline in investment activity

Chart 8: GFCF Growth by Type of Asset



Source: Department of Statistics Malaysia

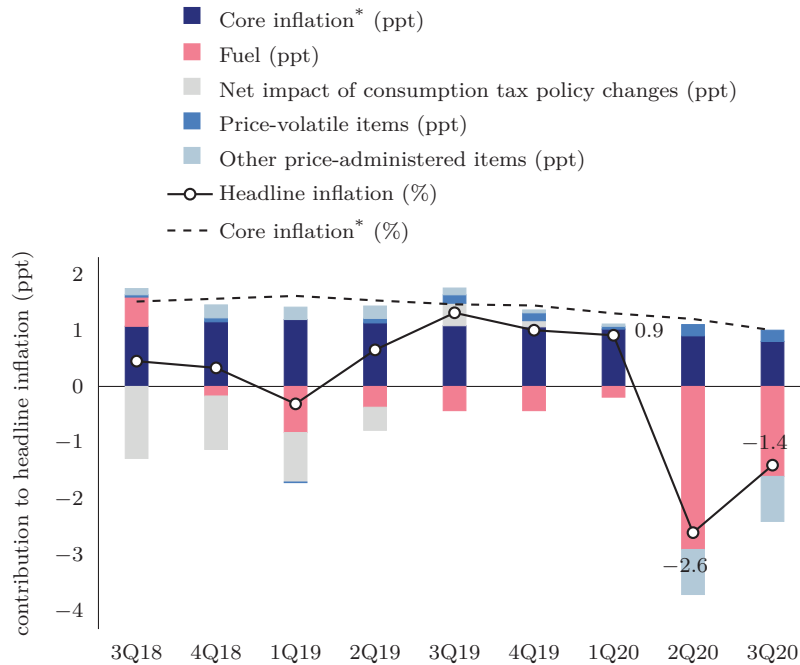
Gross fixed capital formation (GFCF) registered a smaller contraction of 11.6% (2Q 2020: -28.9%), supported by improvements in both public and private sector investment. By type of asset, investment in structures registered a much smaller contraction of 12.9% (2Q 2020: -41.2%), while investment in machinery & equipment (M&E) remained relatively weak (-8.3%; 2Q 2020: -11.1%). In particular, structures investment benefitted from the resumption of construction activity following the gradual lifting of movement restrictions.

Private investment declined by 9.3%, an improvement from the trough in the second quarter of 2020 (-26.4%), mainly supported by the resumption of construction activity as the economy gradually reopens. Furthermore, growth was also underpinned by capital spending in the E&E and healthcare-related sectors, supported by rising demand amid the new normal.

Similarly, public investment registered a smaller decline of 18.6% (2Q 2020: -38.7%). This mainly reflects the improvement in capital spending by general government.

Headline inflation was less negative amid the increase in fuel prices

Chart 9: Contribution to Headline Inflation by Components



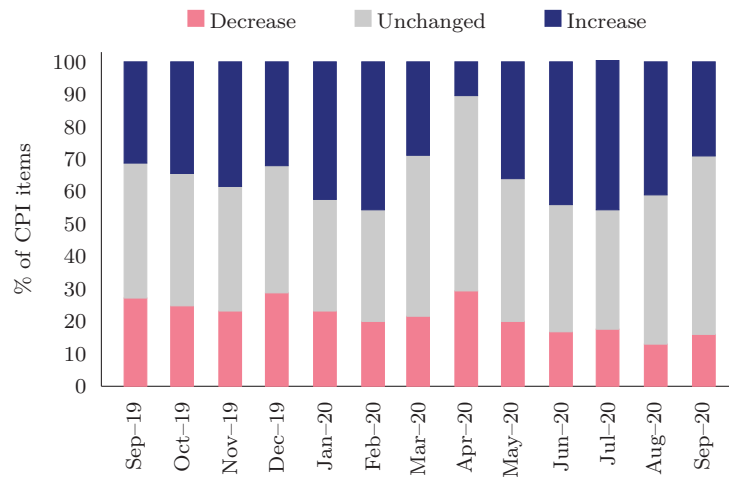
*Core inflation is computed by excluding price-volatile and price-administered items. It also excludes the estimated direct impact of consumption tax policy changes

Source: Department of Statistics Malaysia and Bank Negara Malaysia estimates

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), recorded a smaller negative at -1.4% during the quarter (2Q 2020: -2.6%). This mainly reflected the higher domestic retail fuel prices (average RON95 petrol price per litre in

3Q 2020: RM 1.68; 2Q 2020: RM 1.37) in line with the recovery in global oil prices. Notwithstanding this, headline inflation remained negative as retail fuel prices continued to be significantly below their levels in the corresponding quarter last year.

Chart 10: Month-on-Month Price Changes of CPI Items*



*Based on the month-on-month inflation for 125 CPI items at the 4-digit level

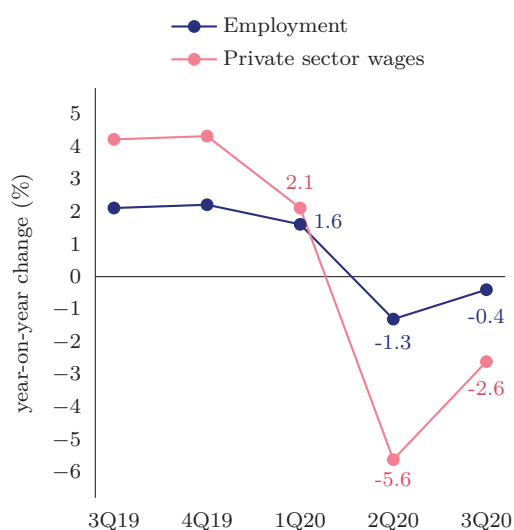
Source: Department of Statistics Malaysia and Bank Negara Malaysia estimates

Broad-based downward pressures on prices were contained during the quarter, as reflected by the limited share of CPI items recording price declines (3Q 2020 Average: 15%; 2010-2019 Average: 21%; April and May 2020 Average: 24%).

Core inflation moderated slightly to 1.0% (2Q 2020: 1.2%) due mainly to lower rental and accommodation inflation. The decline, however, was partially offset by the higher inflation for some other categories such as food away from home and personal grooming services.

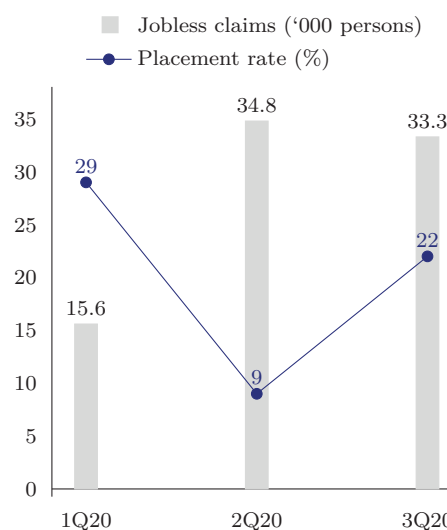
Gradual recovery in labour market conditions

Chart 11: Employment and Wage Growth



Note: Private sector wage growth refers to wage growth of workers in the manufacturing and services sectors.

Chart 12: Jobless Claims and Placement Rate



Note: Jobless claims refers to the number of people who apply for Employment Insurance System (EIS) benefits following loss of employment. The placement rate refers to the number of people placed in new jobs under the EIS for every 100 persons retrenched.

Source: Department of Statistics Malaysia, Employment Insurance System, and Social Security Organisation

Labour market conditions gradually improved, in line with the recovery in economic activity during the quarter. Employment growth registered a smaller contraction of 0.4% (2Q 2020: -1.3%), supported by positive re-hiring activity as demand conditions normalised. Lower job losses were recorded during the quarter (33,309 persons; 2Q 2020: 34,806), as the placement rate of employees into new jobs increased to 22 persons per 100 people retrenched (2Q 2020: 9)¹. As a result, the unemployment rate declined to 4.7% (2Q 2020: 5.1% of the labour force).

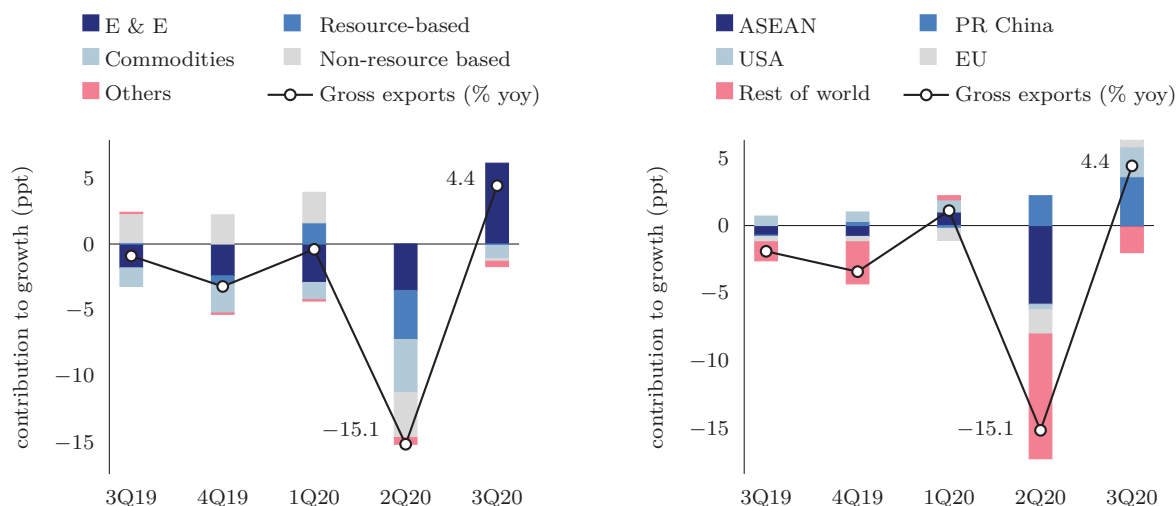
While still remaining negative, private sector wage growth recorded a smaller decline (-2.6%; 2Q 2020:

-5.6%). Wages for the private services sector registered a smaller contraction of 2.5% (2Q 2020: -6.4%). This improvement was driven by tourism-related services subsectors, such as wholesale and retail trade; food and beverage and accommodation; transport and storage; as well as health; education; and arts and entertainment. In the manufacturing sector, wages recorded a lower contraction of 2.7% (2Q 2020: -4.0%), attributable to the E&E, primary-related, and construction-related clusters. Despite an improvement in manufacturing sector growth and positive manufacturing IPI performance during the quarter, employers remained cautious in raising wages due to continued economic uncertainties.

¹ Job losses are proxied by the number of people who apply for the EIS benefits following loss of employment, while the placement rate refers to the number of people placed in new jobs under the EIS programme for every 100 persons retrenched. Thus, the placement rate is indicative of the pace of hiring, relative to retrenchment activity.

Improvement in trade activity amid higher external demand and domestic manufacturing activity

Chart 13: Gross Exports by Product and Market



Source: Department of Statistics Malaysia

During the quarter, gross exports turned around to register a positive growth of 4.4% (2Q 2020: -15.1%), due primarily to the recovery in manufactured exports. Gross imports registered a smaller contraction of 6.3% (2Q 2020: -15.1%) due to a smaller decline in intermediate imports and a turnaround in consumption imports. The trade balance² increased to RM60.4 billion (2Q 2020: RM27.6 billion), the largest quarterly surplus ever recorded.

Malaysia's export performance was supported by higher demand from key trade partners. Manufactured exports turned positive (6.8%; 2Q 2020: -12.6%), driven by higher E&E exports and a smaller decline in non-E&E exports. The rebound in E&E exports (16.0%; 2Q 2020: -9.5%) reflected higher exports to major trade partners, including PR China, the US and Singapore. It also reflected robust demand for work from home equipment, servers and medical devices. To some extent,

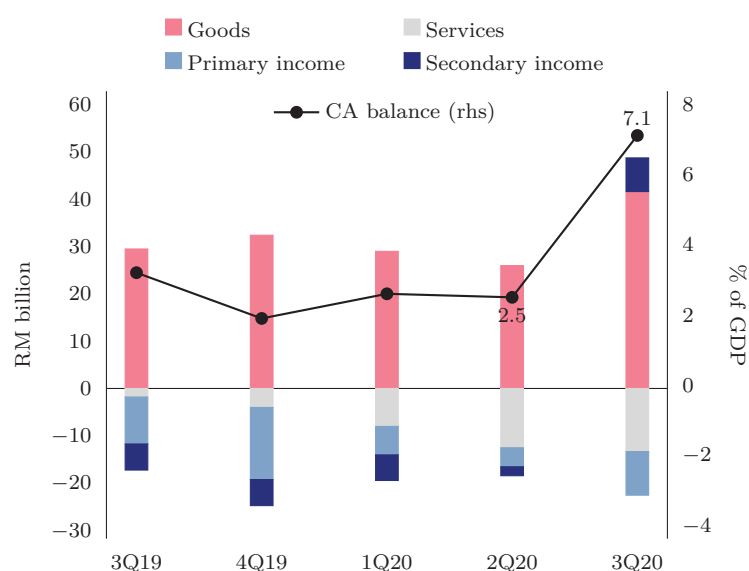
E&E exports was also supported by firms fulfilling backlog orders following the easing of restrictions in June. Non-E&E exports declined at a slower pace (-0.7%; 2Q 2020: -15.1%) mainly attributable to higher exports of rubber products, optical & scientific equipment and iron & steel products. Commodities exports registered a smaller contraction (-7.2%; 2Q 2020: -26.4%) due to broad-based improvement in export volumes.

Intermediate imports also registered a smaller decline during the quarter (-13.6%; 2Q 2020: -23.4%) due to higher imports of industrial supplies and fuel & lubricants amid the recovery in manufacturing activity. Consumption imports grew by 4.6% (2Q 2020: -9.5%), driven primarily by higher imports of consumer durable goods. Meanwhile, capital imports declined by 12.6% (2Q 2020: 14.9%) due mainly to lower imports of machinery and transport equipment.

² The goods and trade surpluses differ because goods for processing, storage and distribution (with no change in ownership) are excluded from the goods account. This is as per the 6th Edition of the Balance of Payments and International Investment Position Manual by the IMF.

Higher current account surplus

Chart 14: Current Account Balance



Source: Department of Statistics Malaysia

The current account of the balance of payments registered a surplus of RM26.1 billion or 7.1% of GDP during the quarter (2Q 2020: RM7.6 billion or 2.5% of GDP), due to a higher goods surplus and a positive secondary income balance.

The goods surplus increased to RM41.5 billion (2Q 2020: RM25.9 billion), as exports increased at a faster pace compared to imports. In the services account, the deficit widened to RM13.3 billion (2Q 2020: -RM12.5 billion) due mainly to higher payment for transportation services. This was in line with higher trade activity during the quarter. The travel account continued to be in deficit (-RM3.5 billion; 2Q 2020: -RM3.1 billion) as international travel restrictions remained.

The primary income account registered a higher deficit of RM9.2 billion (2Q 2020: -RM4.0 billion). This mainly reflected the lower investment income receipts from Malaysian investments abroad.

The secondary income account posted a surplus of RM7.1 billion (2Q 2020: -RM1.9 billion). The surplus was due to transfers received as part of a settlement related to a wholly-owned subsidiary of the Minister of Finance (Incorporated). This more than offset the higher outward remittances by foreign workers amid the pick-up in economic activity during the quarter.

Financial account registered a net outflow

Chart 15: Direct Investment Flows by Sector (3Q 2020)

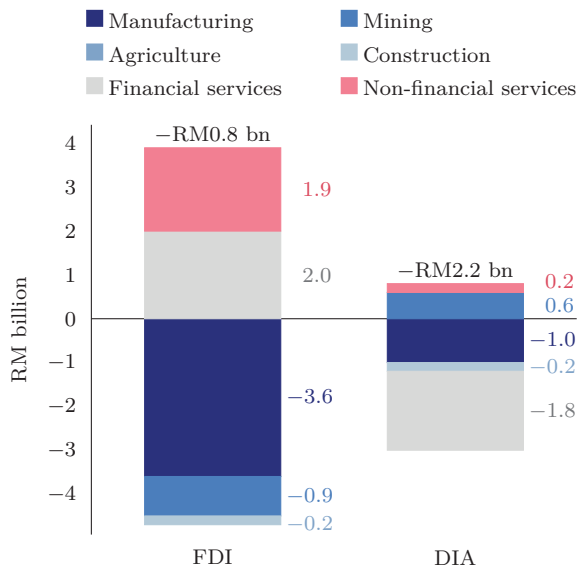
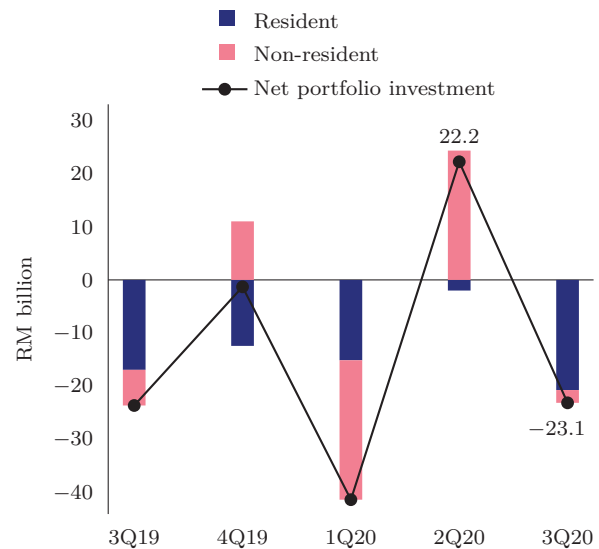


Chart 16: Portfolio Investments



Note: For DIA, positive (negative) values refer to net outflows (inflows). Figures may not sum due to rounding.

Source: Department of Statistics Malaysia and Bank Negara Malaysia

The financial account recorded a net outflow of RM35.2 billion (2Q 2020: -RM19.8 billion), reflecting outflows from all accounts, particularly portfolio investment and other investment accounts.

The direct investment account registered a higher net outflow of RM3.1 billion (2Q 2020: -RM1.2 billion), due mainly to a small net foreign direct investment (FDI) outflow amid lower direct investment abroad (DIA) outflows. Net FDI outflows amounted to RM0.8 billion (2Q 2020: +RM2.2 billion), the first FDI outflows recorded since 4Q 2009, driven by the outflows from debt instruments (3Q 2020: -RM9.4 billion; 2Q 2020: +RM1.1 billion). This reflected intercompany loan extensions and scheduled loan repayments, which are common for multinational corporations' operations, as well as trade credits granted by manufacturing firms, in line with strong exports, especially in the E&E sector. The outflows from debt instruments were however partly offset by higher retained earnings (3Q 2020: +RM4.8 billion; 2Q 2020: -RM2.2 billion), particularly by FDI firms in the manufacturing sector and continued equity capital injections into Malaysia (3Q 2020: RM3.8 billion; 2Q 2020: RM3.4 billion). DIA recorded outflows of RM2.2 billion in the third quarter

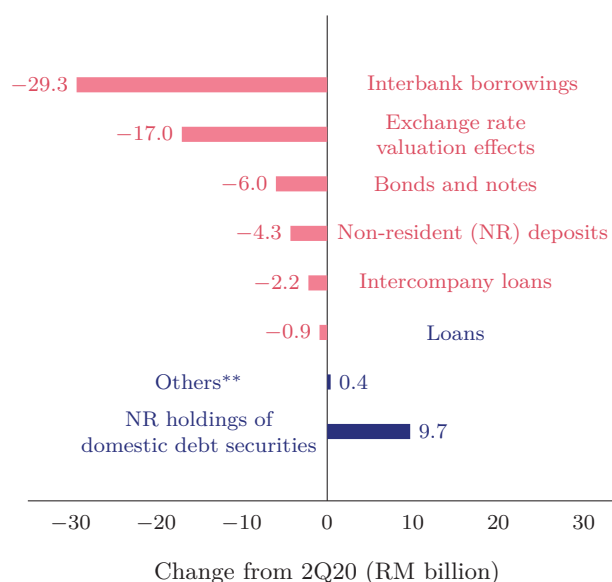
(2Q 2020: -RM3.5 billion). These investments were channelled mainly into the financial services sub-sector and manufacturing sector.

The portfolio investment account registered a significant net outflow of RM23.1 billion (2Q 2020: +RM22.2 billion), following larger residents' portfolio investments abroad of RM20.7 billion (2Q 2020: -RM2.0 billion) and a small non-resident (NR) portfolio investment outflow of RM2.4 billion (2Q 2020: +RM24.3 billion). Residents' portfolio investments abroad were driven by institutional investors' acquisitions of equity and debt securities abroad. NR portfolio investment outflows reflected the continued liquidation of domestic equity securities (-RM6.9 billion; 2Q 2020: -RM8.9 billion), which were partly offset by inflows into debt securities (+RM4.5 billion; 2Q 2020: +RM33.1 billion).

The other investment account registered a smaller net outflow of RM8.5 billion (2Q 2020: -RM41.3 billion). The outflows were due mainly to a net repayment of interbank borrowings. Net errors and omissions amounted to +RM7.7 billion during the quarter, or +1.7% of total trade.

Lower external debt

Chart 17: Changes in External Debt
Net change*: -RM49.6 billion



*Changes in individual debt instruments exclude exchange rate valuation effects.

**Comprises trade credits, IMF allocation of SDRs, and other debt liabilities.

Source: Ministry of Finance Malaysia and Bank Negara Malaysia

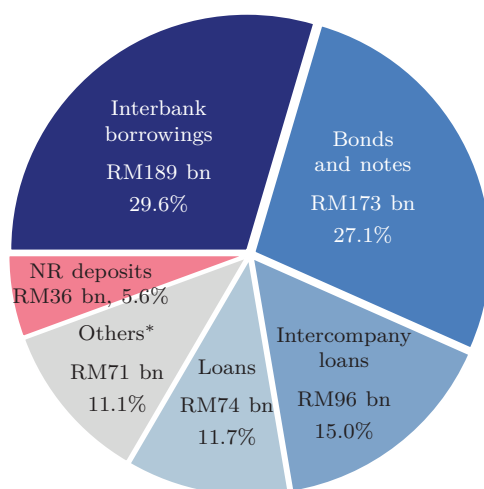
Malaysia's external debt amounted to RM953.3 billion, or 66.5% of GDP as at end-September 2020 (end-June 2020: RM1,003 billion or 69.3% of GDP). The decline was due mainly to a net repayment of interbank borrowings and valuation effects following the stronger ringgit against selected major and regional foreign currencies in the third quarter of 2020. This was partly offset by an increase in NR holdings of MGS.

The country's external debt remained manageable, given its currency and maturity profiles. Ringgit-denominated external debt amounted to RM315.4 billion and accounted for 33.1% of total external debt (end-June 2020: 30.4%). It is largely in the form of NR holdings of domestic debt securities and ringgit deposits in resident banking institutions. These

liabilities were not subject to valuation changes that may arise from fluctuations in the ringgit exchange rate.

Foreign currency (FCY) external debt accounted for the remaining RM638 billion, or 66.9% of total external debt. 50.9% of FCY-denominated external debt were by the corporate sector, and are mainly subject to prudential and hedging requirements. 27.1% of total FCY-denominated external debt were long-term bonds and notes issued offshore, mainly by non-financial corporations and channelled primarily to finance asset acquisitions abroad. Intercompany loans accounted for 15.0% of FCY-denominated external debt, were typically on flexible and concessionary terms, such as no fixed repayment schedule or low interest rate.

Chart 18: Breakdown of FCY-denominated External Debt (RM billion, % share)



* Comprises trade credits, IMF allocation of SDRs, and other debt liabilities.

Source: Ministry of Finance Malaysia, Department of Statistics Malaysia, and Bank Negara Malaysia

Interbank borrowings and FCY deposits in the domestic banking system accounted for 35.2% of FCY-denominated external debt. The lower interbank borrowings observed during the quarter was largely driven by maturing back-to-back intragroup/branch borrowing and lending transactions by banks in the Labuan International Business and Financial Centre. Some domestic banks also benefitted from higher domestic FCY deposits, thus reducing the need for interbank funding from non-residents. Around 80.5% of interbank borrowings were in the form of intragroup borrowings, which are generally more stable, thereby limiting rollover risks faced by banks. Meanwhile, foreign-currency risk, measured in terms of the net open position of FCY-denominated exposures³, remained low at 4.6% of banks' total capital (end-June 2020: 4.9%).

From a maturity perspective, 61.2% of the total external debt was skewed towards medium- to long-term tenure (end-June 2020: 58.7%), suggesting low rollover risk. Short-term external debt accounted for the remaining 38.8% of external debt. Of which, 44.8% were intragroup borrowings among banks and corporations, which were generally stable and on concessionary terms. About another 13% were accounted by trade credits, largely backed by export earnings and are self-liquidating. As at 30 October 2020, international reserves stood at USD104.6 billion, sufficient to finance 8.4 months of retained imports, and is 1.2 times the short-term external debt.

³ Refers to the aggregated sum of the net short or long foreign currency positions for all currencies across banks.

Box
Article

Understanding Deflation *by Sharmila Devadas*

Highlights

- Deflation is the persistent and pervasive decline in prices, distinct from a temporary period of negative inflation.
- The risk of a deflationary environment should be assessed in the context of whether there are signs of persistent and pervasive price declines, falling inflation expectations, and adverse interactions in the economy involving debt, asset prices, credit intermediation and output that feed back into inflation.
- The current episode of negative inflation in Malaysia is driven by the decline in fuel inflation, a development also experienced by some other countries. Price declines are not broad-based while inflation expectations remain well-anchored.

Introduction

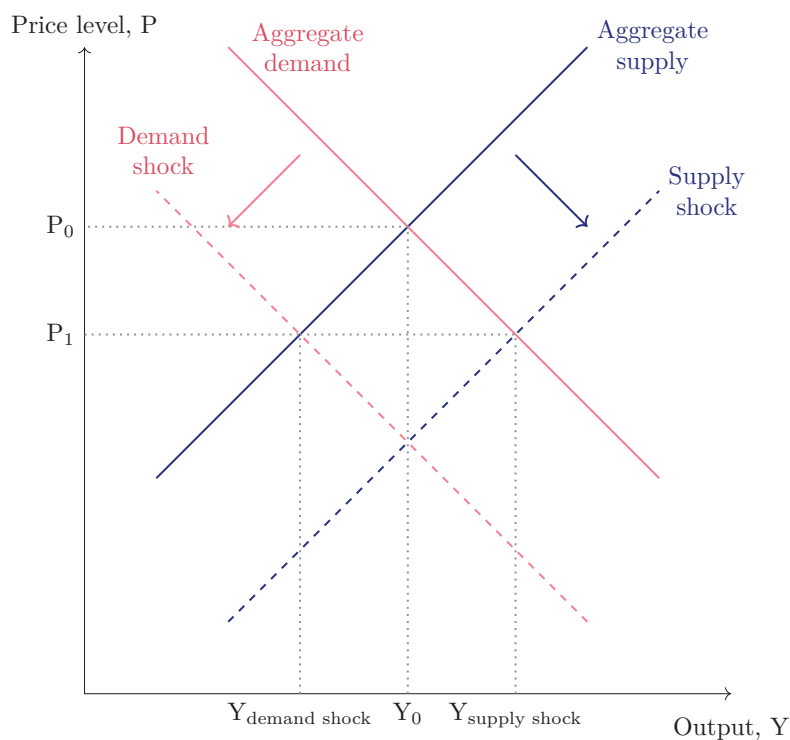
Amid the unprecedented Covid-19 pandemic, there remains considerable uncertainty surrounding the global inflation outlook over the medium term. Its trajectory will depend on the strength of demand, supply disruptions that affect production costs, and the credibility and effectiveness of policies which would influence inflation expectations (International Monetary Fund, 2020). Global oil prices have recovered in recent months but remain lower than last year, and along with the absence of strong demand and weak labour markets, have kept global inflation muted and below pre-pandemic levels. Global inflation is expected to remain positive going forward but subdued in advanced economies, and below average in emerging market and developing economies.¹ The euro area and a number of other countries including Australia, Malaysia, Singapore and Thailand have experienced negative headline inflation in recent months. This article discusses what constitutes deflation and the considerations beyond negative headline inflation that need to be taken into account to assess the risk of a deflationary environment that has adverse consequences. These considerations encompass the nature of underlying inflation dynamics, inflation expectations, and developments in the wider economic environment.

¹ Inflation in advanced economies is projected at 0.8% in 2020, rising to 1.6% in 2021 and stabilising at 1.9% thereafter. Inflation in emerging market and developing economies is projected at 5% in 2020, 4.7% in 2021, and 4% thereafter, below the 2002-2019 historical average of 5.8% (International Monetary Fund, 2020).

Contextualising negative headline inflation: What constitutes a deflationary environment?

Deflation is typically defined as persistent negative headline inflation and is distinctive from moderating inflation, or disinflation, where inflation rates are declining but remain positive. As such, a temporary period of one or two quarters of negative headline inflation does not constitute deflation (International Monetary Fund, 2003). However, a more comprehensive and meaningful perspective would need to take into account the nature of shocks driving the trend in inflation, inflation expectations, and the broader economic context (European Central Bank, 2014). The shocks to inflation may reflect underlying demand or supply factors respectively, with one not having the exact same implications as the other. With demand shocks, declining prices occur in conjunction with falling output; while in the case of supply shocks, declining prices might be accompanied by increases in output (International Monetary Fund, 2003). See Figure 1. The first-round effects of declining prices in the face of supply shocks can be viewed as more benign, especially if reflecting transitory and external factors such as commodity price movements, or structural reforms (for example, in labour and product markets) which could positively affect demand over the near to medium term. Supply shocks can nevertheless also become a concern when sustained price declines lead to lower inflation expectations and second-round effects on other prices and wages – which might occur, for example, when a prolonged oil price decline adversely affects an oil-exporting country or occurs amid a weak economic environment. A temporary fall in the price level driven by oil prices does not qualify as deflation (Decressin and Laxton, 2009).

Figure 1: Aggregate Demand and Supply Shocks



Taking another perspective of demand and supply factors, it is also useful to consider what different types of price declines mean for consumers and businesses. For example, falling prices of imported final and intermediate goods, including commodities, benefit consumers and businesses. However, when final consumer prices are falling due to lower demand for domestic goods and services, it follows that profits of affected businesses are also likely to be declining. Consumers will benefit from falling prices in the first instance, in terms of lower cost of living, but may be affected by subsequent declines in wages and employment. Businesses with nominally fixed long-term debts experience higher real debt values, which may contribute to the curtailment of operations and investment. Similarly, households, experiencing lower income, will also cut back on their spending, with this reduction aggravated by the higher propensity to consume among borrowers (who experience a relatively higher debt service burden given lower income). Crucially, the extent of the effects described above depends on the persistence and pervasiveness of the price declines (with transitory and sector-specific price declines not expected to have as significant aggregate effects). Persistent and pervasive price declines, if they become entrenched in inflation expectations, could lead to the postponement of consumption and investment, as well as possible business closures in anticipation of lower revenues, thus reinforcing negative inflation.

Beyond the persistence and pervasiveness of price declines, as well as evolving inflation expectations, the risk of a deflationary environment that has adverse consequences needs to be assessed in terms of the wider economic environment, where economic activity, debt, asset prices, and credit intermediation interact with each other and inflation, in a feedback cycle (Figure 2). These interactions can be viewed as debt deflation dynamics.² Debt deflation dynamics involve over-indebtedness that leads to defaults and distress selling to liquidate debt – causing asset price declines, and a breakdown in credit intermediation, which feed back into lower spending.³ The fall in net worth due to declining asset prices also impairs credit intermediation by making it costlier to distinguish good borrowers from bad ones resulting in credit rationing or higher charges; and affects banks' health as defaults materialise and banks claim collateral that has lost value.⁴ Deflation caused by lower spending reinforces losses, and could lead to expectations of further deflation. As Borio et al. (2015) note, whether deflation is a symptom or a cause of economic conditions is ultimately an empirical question. As a cause, it is a question of the strength of the nominal rigidities through which deflation operates, that is, via nominal wages, debt burdens, and the zero lower bound for interest rates, and of whether deflation expectations are entrenched.⁵

² Debt deflation was conceptualised by Fisher (1933) as a theory of great depressions (persistent and deep economic recessions) where the dominant factors in serious cycles were over-indebtedness to start with, and deflation following after. Others like Minsky (1982), Bernanke (1983, 1995) and Koo (2009) have since also emphasised the important roles of net worth deterioration and credit contraction in lengthy economic recessions.

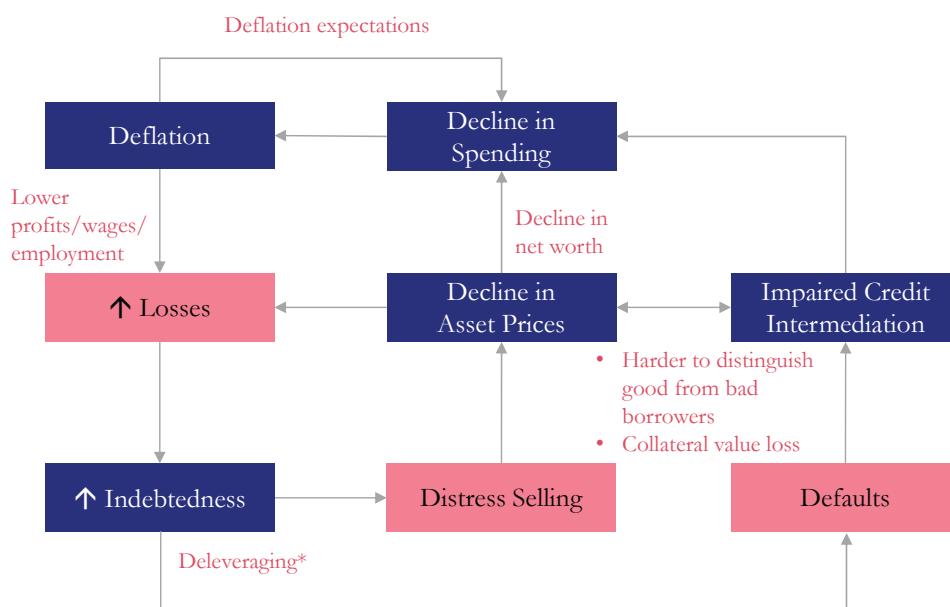
³ Fisher (1933) notes that over-indebtedness starts with the appearance of new investment opportunities. Easy money leads to over-borrowing as it allows for over-speculation. More recent studies on household indebtedness indicate that aside from financial imprudence, over-indebtedness may also arise from unexpected events that modify the conditions under which debt contracts were executed, for example an unexpected reduction in income or unforeseen expenses.

⁴ See Bernanke (1983, 1995).

⁵ See Borio et al. (2015) and Borio and Filardo (2004). In a sample covering 140 years and up to 38 economies, Borio et al. (2015) find that the link between deflation and output growth is weak and derives largely from the Great Depression. The authors find a stronger link between asset price declines and output growth. The most damaging impact on output growth comes from the interaction between property price declines and debt, while little evidence is found for output costs arising from the interaction between deflation and debt.

In the post-World War II period, deflation episodes, that is, involving persistent price declines, are rare – the key case being that of Japan which had a prolonged deflation period from 1998. Japan’s experience displayed the characteristics of debt deflation dynamics, whereby the root of its deflationary environment lay in the unravelling of the boom in housing and equity prices in the early 1990s. While the literature is still divided on the exact interpretation of the chronic stagnation and deflation in Japan, several key factors have been acknowledged: the corporate sector engaged in a long-lasting deleveraging process after previous overinvestments; monetary (in terms of interest rate reductions) and fiscal policy interventions were insufficient; credit intermediation was affected by bad debts, slow bank restructuring and debt evergreening; and inflation expectations were unanchored.⁶ In addition, structural factors may have also played a role, including nominal wage rigidity and demographics.⁷

Figure 2: Debt Deflation Dynamics



*Deleveraging can be carried out through the curtailment of spending, raising of capital or the sale of assets. It can entail a disorderly adjustment process when it is accompanied by margin calls, distress selling of assets and a pullback of credit which hinders those without debt or losses to stabilise markets.

Note: Adapted from von Peter (2005).

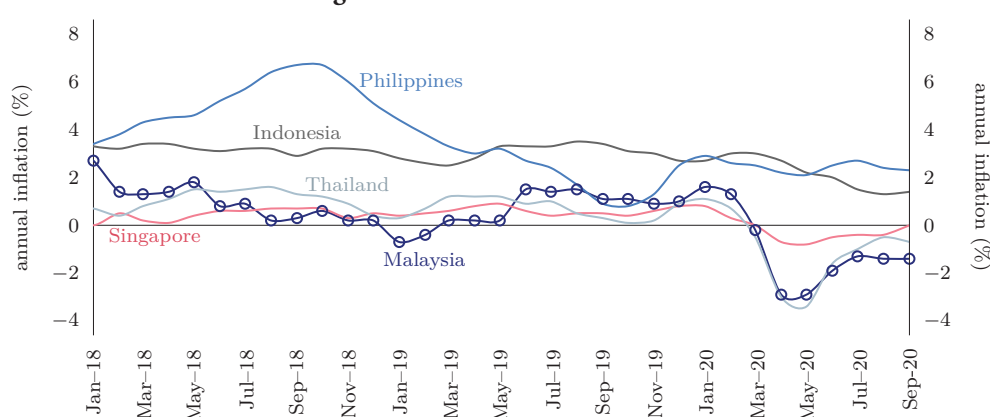
⁶ Debt evergreening refers to the continuous restructuring of lending to insolvent or zombie firms, which leads to the misallocation of resources and affects productivity growth.

⁷ See for instance, Baig (2003), Caballero et al. (2008), Nishizaki et al. (2013) and Piazza (2015) for further discussion on Japan’s experience.

Is the risk of a deflationary environment a concern in Malaysia?

Over the last three decades, Malaysia has experienced three brief periods of negative headline inflation, including the current episode. These declines reflect sector-specific price changes rather than broad-based declines, and are mainly due to global oil prices and policy-driven changes to price-administered goods and services (Table 1). In particular, the negative headline inflation this year has reflected the decline in global oil prices and the tiered electricity tariff rebate, the latter effective since April 2020 as a relief measure. In the region, Singapore and Thailand have also experienced negative headline inflation rates recently, due to the sharp fall in global oil prices (Figure 3).⁸

Figure 3: Inflation in the ASEAN-5



Source: Department of Statistics Malaysia and Bloomberg

Although affected by the moderation in demand pressures, underlying inflation, as measured by core inflation, has remained positive. Core inflation contributed approximately 0.9 percentage points (ppt) to headline inflation on average over March – September 2020, which was offset by the negative contribution from fuel and electricity inflation (-2.1 ppt and -0.8 ppt respectively on average). Compared to 2009, core inflation is more subdued now, reflecting the prevailing capacity in the economy.

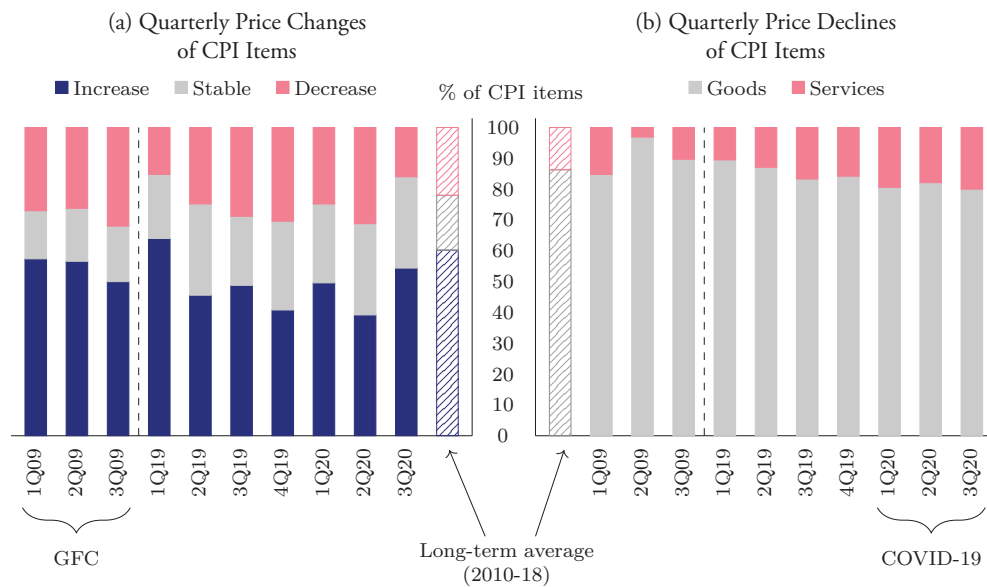
Table 1: Episodes of Negative Headline Inflation

Period of Negative Headline Inflation	Average Headline Inflation (%)	Key Drivers	Average Core Inflation (%)
June – November 2009	-1.7%	<ul style="list-style-type: none"> Cumulative effect from a series of downward adjustments to administered fuel prices since the second half of 2008 in line with the movement in global oil prices. 	1.9%
January – February 2019	-0.5%	<ul style="list-style-type: none"> Lower domestic fuel prices 	1.6%
March – September 2020	-1.7%	<ul style="list-style-type: none"> Lower global oil prices Tiered electricity tariff rebate 	1.2%

⁸ Swings in oil prices have a more pronounced impact on headline inflation in Asia ex-Japan than in the G3 countries due to the greater weight of commodities in the consumer baskets of the former (Monetary Authority of Singapore, 2020).

Price declines have not become more pervasive across the CPI basket of items. In fact, the number of items recording quarterly increases continues to exceed that of recording declines. Price declines are also not unusually high compared to the long-term average or the last previous experience of GDP growth contraction (Figure 4, panel (a)). Of the price declines so far this year, there is a slightly higher share of declines in items related to services on average reflecting to some extent the impact of movement restriction on categories in the CPI basket such as accommodation services and rental (Figure 4, panel (b)).⁹

Figure 4: Pervasiveness of Price Declines

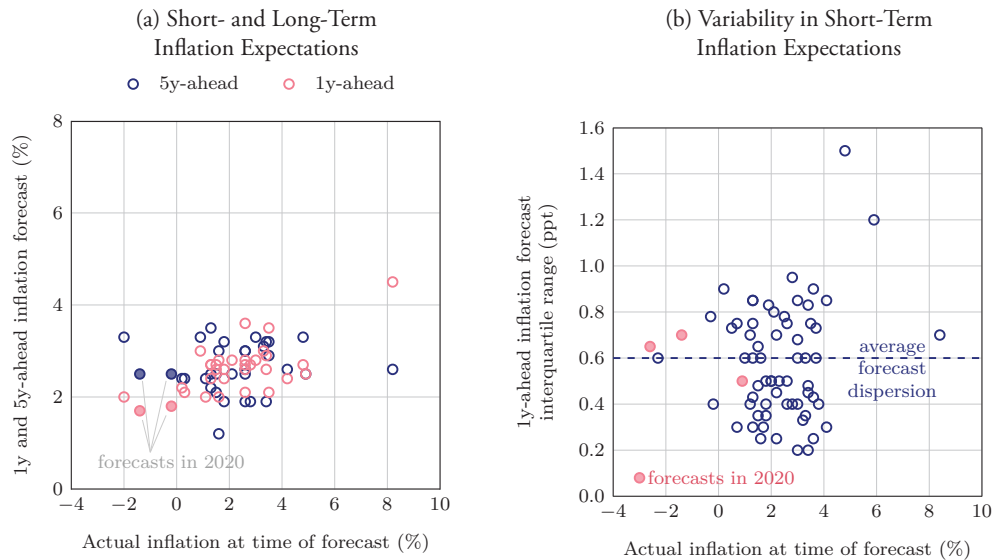


Notes: Based on the change in price from the end of one quarter to another, for 125 CPI items at the 4 digit-level. The long-term averages exclude the quarterly change for June 2015 and June 2018 which capture large effects from consumption tax policy changes.

Source: Department of Statistics Malaysia and Bank Negara Malaysia estimates.

Short to medium-term inflation expectations among professional forecasters have been well-anchored in the past, and remain so this year. This can be observed from the levels projected one-year and five-year ahead, which are positive and close to the long-term average inflation rate, more so for the longer-term forecast (Figure 5, panel (a)). In addition, there is low variability in anticipated future inflation (based on one-year ahead forecasts) – the dispersion among forecasters is similar to the long-term average, suggesting no unusual inflation uncertainty (Figure 5, panel (b)).⁹

⁹ Well-anchored inflation expectations should remain relatively stable at a given level over time with only minor disagreements across forecasters. Deflation is associated with lower inflation expectations and these expectations becoming more backward-looking. In addition, forecast disagreement, as captured by the dispersion across forecasts, has been found to rise with the absolute levels of both, positive and negative inflation. Forecast disagreement indicates greater uncertainty about future inflation which could affect private investment and consumption decisions and lead to an inefficient allocation of resources (Banerjee and Mehrotra, 2018).

Figure 5: Inflation Expectations

Notes: Sample period is 2004 - 2020. Actual Inflation corresponds to headline inflation at the time of the forecast. (a) Forecasts are on a semi-annual basis, for the following year and five years ahead. (b) Forecasts are on a quarterly basis, for the following year.

Source: Department of Statistics Malaysia and Asia Pacific Consensus Forecasts - Surveys of International Economic Forecasts, Consensus Economics Inc.

Key elements that could build into the propagation mechanisms shown in Figure 2 are actively assessed as part of the Bank's day-to-day economic and financial surveillance. Excesses, for example, in relation to speculative activity, are comparatively much less than prior to the Asian Financial Crisis – speculative activity in the housing market has been subdued for some years now. Financial institutions' capital and liquidity buffers remain high. Their strong position when entering the pandemic enabled them to support substantial relief measures and sustain credit intermediation. Though the overall debt servicing capacity of non-financial corporates has weakened, interest coverage ratio remained above two times as at June 2020, reflecting reasonably healthy financial conditions prior to the pandemic. Most households have also remained reasonably resilient, supported by comfortable financial buffers, particularly among the higher income group, and the generally prudent debt servicing levels of households. For vulnerable households, the blanket loan moratorium, introduced in April 2020, and subsequent targeted repayment assistance, provide some relief. While the housing market is more subdued due to the weaker economic conditions, measures have been implemented by the Government to support housing demand; and the targeted assistance packages will help contain any large increase in housing loan defaults.¹⁰ Economic growth is expected to continue to improve but is subject to downside risks related to the resurgence of the pandemic globally and domestically. These risks, if they materialise could feed back into other areas of the economy including inflation. The Bank continues to monitor these risks in its assessment of the economic outlook.

¹⁰ See Bank Negara Malaysia (2020) for further details of the assessment on current and potential risks to financial stability and the resilience of the financial system. Under updated stress tests conducted by the Bank, banking institutions are expected to remain resilient to potential economic and financial shocks that could still arise from the pandemic.

Conclusion

Deflation refers to the persistent decline in headline inflation. However, a holistic assessment of deflationary pressures requires consideration of underlying inflation dynamics, inflation expectations and the wider economic environment. In this regard, the current episode of negative headline inflation does not constitute outright deflation as it primarily reflects negative fuel inflation. Price declines are not unusually pervasive and inflation expectations remain well-anchored. Economic growth, though expected to gradually recover, is subject to downside risks. The Bank will continue to be vigilant of inflation dynamics and its determinants, as well as the potential amplification channels of adverse developments in the economy.

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