Executive Summary

Economic and Financial Developments in 2020

In 2020, the global economy experienced its deepest recession since the Great Depression. This was a culmination of economic disruptions resulting from the containment measures implemented in response to the Coronavirus Disease 2019 (COVID-19), and heightened risk aversion. Consequently, labour market conditions weakened amid a decline in firms' production activities, which weighed on countries' domestic demand, external trade and global growth, particularly in the second quarter of 2020. This triggered unprecedented global policy responses, including large fiscal stimuli, accommodative monetary policies and quantitative easing measures. The quick and significant policy responses averted a deeper downturn in global economic activities. In the second half of the year, as containment measures were gradually lifted, global growth showed signs of recovery, albeit at an uneven and gradual pace. While heightened risk aversion triggered a massive flight to safety at the onset of the COVID-19 outbreak in March 2020, global financial markets have since recovered in a synchronised manner across asset classes amid significant liquidity injections and low-for-long monetary policy commitments by major central banks. For the year as a whole, the global economy and trade contracted by 3.5% and 9.6%, respectively.

Amid a highly challenging global and domestic operating environment, the Malaysian economy contracted by 5.6% in 2020, the lowest since 1998 (-7.4%). This was due to broad-based weaknesses in exports, production and domestic demand, arising from adverse external spillovers and the introduction of stringent domestic containment measures to combat COVID-19. The weaker domestic economic activities led to a deterioration in labour market conditions and income losses, thereby impacting consumer spending. Private investment activity was affected by adverse business confidence and the slower implementation of projects. Public expenditure was also affected mainly by the initial implementation of the Movement Control Order. The impact was the largest in the second quarter of 2020, with GDP contracting by 17.1%. Growth gradually improved in the second half of the year, partly supported by the improvement in external demand and reopening of the domestic economy amid a more targeted approach to containment measures. Lingering uncertainties surrounding the development of the pandemic, however, continued to weigh on Malaysia's growth recovery. Headline inflation was negative at -1.2% (2019: 0.7%), primarily due to the decline of global oil prices. Underlying inflation remained subdued at 1.1% (2019: 1.5%) amid spare capacity in the economy and weaker labour market conditions. Domestic financial market developments were broadly in tandem with global financial market movements. The flexibility in the ringgit exchange rate has been crucial to absorb and mitigate adverse spillovers from external shocks to the domestic economy.

Overall, Malaysia has adopted a comprehensive and complementary policy response to the crisis. This played a significant role in cushioning the economic impact of the COVID-19 pandemic on the domestic economy and supporting a growth recovery. A series of stimulus packages worth RM305 billion (20% of Malaysia's GDP) was unveiled to support the economy throughout the crisis. Significant and immediate fiscal support, such as cash transfers, tax incentives and wage subsidies, coupled with financial measures, including a six-month automatic loan moratorium for households and small- and medium-sized enterprises (SMEs) as well as the establishment of various financing facilities for SMEs, provided immediate relief to households and businesses. These policy measures eased cash flow constraints and helped reduce job losses. The Monetary Policy Committee (MPC) reduced the OPR by a cumulative 125 basis points to a historical low of 1.75% in 2020 to provide support to the economy. In addition, the reduction of the Statutory Reserve Requirement (SRR) ratio from 3.00% to 2.00% in March 2020, alongside a temporary flexibility to recognise holdings of Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (MGII) by banking institutions as part of the SRR compliance, have eased liquidity conditions. With various policy support measures, overall financing activities were broadly sustained. Supply-side policies, such as active labour market measures to promote workforce upskilling and reskilling, and initiatives to accelerate digitalisation, were implemented to sustain growth momentum and assist vulnerable segments of the economy.

Outlook and Policy in 2021

In 2021, the global economy is expected to continue its gradual and uneven recovery path from the second half of 2020. Global growth prospects will continue to be shaped by developments surrounding the COVID-19 pandemic, particularly the rollout of vaccines, ongoing structural shifts in the economy, and the extent of scarring in labour markets. Notwithstanding the expected global recovery, continued policy support will be vital to sustain the overall growth momentum amid elevated uncertainty. Global monetary policy is also expected to remain supportive of growth. The commitment towards a 'low-for-longer' interest rate environment in major advanced economies and implementation of accommodative monetary policies in major EMEs will support demand. Despite the surge in long-term government bond yields in the US which began in January 2021 and the increased global financial market volatility, major central banks have continued to maintain the stance that monetary policy will remain accommodative amid considerable economic slack, transitory inflationary pressures, and high uncertainties on the strength of growth recoveries. On balance, risks to global growth remains tilted to the downside, as pandemic-related downside risks could dampen the prospects of a global recovery. These include the re-imposition of strict and widespread containment measures due to COVID-19 resurgences, slower-than-expected rollout of vaccines or major mutations in the COVID-19 virus that could render the existing vaccines less effective. More severe economic scarring, arising from extensive permanent job losses and business closures, could also weaken long-term global growth. Nevertheless, there is some upside potential to the outlook. Global growth could outperform expectations with a faster rollout and wider outreach of vaccines, especially in EMEs.

The Malaysian economy is projected to rebound to between 6.0% and 7.5% in 2021. Growth will be underpinned by the recovery in global demand and the gradual improvement in domestic economic activity. The growth trajectory will be mainly influenced by the COVID-19 developments, particularly the extent and duration of containment measures and the rollout of vaccines.

Labour market conditions are expected to improve gradually as broad economic activity picks up, along with the ongoing policy support in place to facilitate labour mobility and minimise long-term dislocations or scarring in the labour market. The improvement in labour market conditions is expected to play a key role in the recovery of private consumption.

In addition, policy measures remain in place to support the growth momentum while still assisting the vulnerable segments. These include the extension of measures introduced in 2020, the 2021 Budget, as well as the *PERMAI* and *PEMERKASA* assistance packages. Notable measures to ease financial constraints for affected individuals include the *Bantuan Prihatin Nasional, Bantuan Prihatin Rakyat* and *Bantuan Kehilangan Pendapatan* cash transfers, the Employee Provident Fund *i-Sinar* and *i-Lestari* cash withdrawals, and the Targeted Loan Repayment Assistance. Various tax relief and incentives will also lift overall consumer spending. For businesses, special grants, wage subsidies and the Targeted Relief and Recovery Facility are extended to firms in the services sector, which is the hardest-hit sector. The continued accommodativeness of monetary policy and supportive financing conditions will further maintain a conducive environment for a recovery in domestic demand as the adverse impact from the COVID-19 crisis gradually subsides.

In this highly uncertain environment, the risks to Malaysia's growth projection are tilted to the downside. Key downside risks include the escalation in COVID-19 cases leading to further rounds of containment measures, albeit targeted, and the slower-than-expected rollout or ineffectiveness of vaccines which could result in stronger precautionary behaviour. Heightened global and domestic economic uncertainty could lead to greater financial market volatility, triggering a tightening of domestic financial conditions. Despite this, upside risks to the growth outlook may emanate from a higher-than-expected global growth, faster-than-expected rollout of vaccines, stronger-than-expected impact from policy support, and the realisation of pent-up demand following the lifting of containment measures.

In 2021, headline inflation is projected to average higher, between 2.5% – 4.0%, due mainly to cost-push factors such as the expected increase in global oil and commodity prices, as well as the lapse in the effect from the tiered electricity tariff rebate introduced in April 2020. In terms of trajectory, headline inflation is anticipated to temporarily spike in the second quarter of the year, following the lower base from the low domestic retail fuel prices during the corresponding period in 2020, before moderating by the second half of the year as this base effect dissipates. Underlying inflation, as measured by core inflation, is expected to remain subdued, averaging between 0.5% and 1.5% amid the continued spare capacity in the economy. As a whole, underlying inflation is likely to remain muted, barring unforeseen cost factors, until a more entrenched recovery in demand conditions translates to higher prices. The overall inflation outlook, however, is dependent on global oil and commodity price developments.

Malaysia's highly open domestic financial markets is exposed to risks of heightened volatility due to global factors. This includes the recent rise in long-term Government bond yields in advanced economies, which has also led to higher bond yields in EMEs including Malaysia in the recent months. The Bank's monetary policy and operations will, however, continue to promote orderly market conditions and ensure sufficient domestic liquidity to support the financial intermediation. In addition, the flexibility of the ringgit exchange rate would continue to act as a shock absorber by facilitating necessary adjustments in the economy to ensure sustained resilience against external shocks. Importantly, domestic monetary and financial conditions are expected to remain conducive given the accommodative monetary policy and other ongoing policy support, providing a firm foundation for economic recovery.

Monetary policy in 2021 will remain accommodative to promote the sustainability of the economic recovery. Given the uneven pace of recovery and the downside risks to the outlook, a sufficiently accommodative monetary policy stance will be maintained to support an entrenched economic recovery while ensuring that price pressures remain manageable. The MPC will be mindful to avoid a premature withdrawal of policy support. The MPC will continue to closely monitor the emergence of signs of a more entrenched and sustainable economic recovery in the period ahead, while remaining vigilant against a build-up of financial imbalances. Some signposts underlying such recovery would include, among others, sustained periods of steady improvement of economic performance amid a narrowing of the output gap and an environment of price stability; sustainable growth of private consumption and investment driven by fundamentals without over-reliance on policy support; a stronger labour market underpinned by rising incomes; as well as healthy access to financing for viable borrowers.

The right mix of monetary, financial and fiscal policies is needed to ensure overall effectiveness in securing a sustainable economic recovery. This includes the use of more targeted and sector-specific measures. The Bank will continue to utilise all its policy levers, as deemed necessary, to foster enabling conditions for the purpose of ensuring continued financial intermediation. Coherent structural policies will also be crucial to enable Malaysia to emerge stronger from the pandemic with an innovation-led growth, resilient workforce, as well as enhanced social protection framework for those in need. This is facilitated by the introduction of a diverse source of funds to spur high-tech private investments, and complemented by upskilling and reskilling programmes to ensure that the labour force is equipped with the necessary skills to take on the high-skilled, high-productivity jobs. Finally, initiatives to strengthen social protection in Malaysia, such as the widening of social insurance coverage, are vital as a safeguard against socioeconomic vulnerabilities going forward. These efforts would accelerate digitalisation and enhance productivity in the economy, improve standards of living, and further strengthen growth recovery in a sustainable manner.