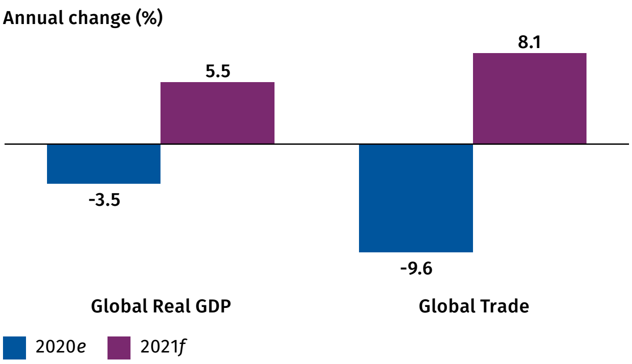
Outlook and Policy in 2021

2021: A GRADUAL, UNEVEN RECOVERY WHILE UNCERTAINTY ABOUNDS

Global growth recovery amid vaccine rollout and continued policy support

In 2021, the global economy is expected to continue its gradual and uneven recovery path (Chart 2.1). Global growth prospects will continue to be shaped by major developments surrounding the COVID-19 pandemic, particularly the rollout of vaccines, the ongoing global structural shifts, and the extent of economic scarring. Thus far, high-frequency production and trade indicators suggest that the global growth recovery remains broadly on track (Charts 2.2 and 2.3), despite the resurgences of COVID-19 cases and the re-imposition of tighter containment measures in some economies. Notwithstanding the expected global recovery, continued policy support will be vital to sustain overall growth momentum amid elevated uncertainty.

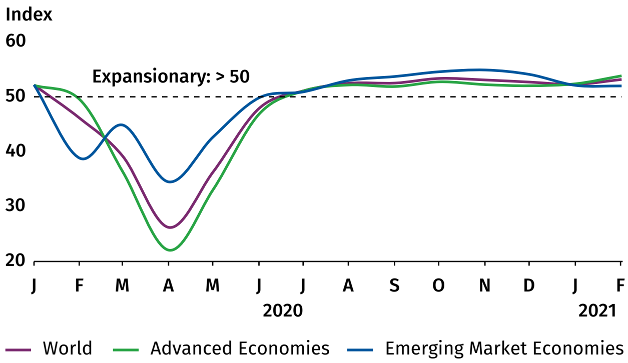
Chart 2.1: Global Real GDP and Trade Growth



e Estimate
f Forecast

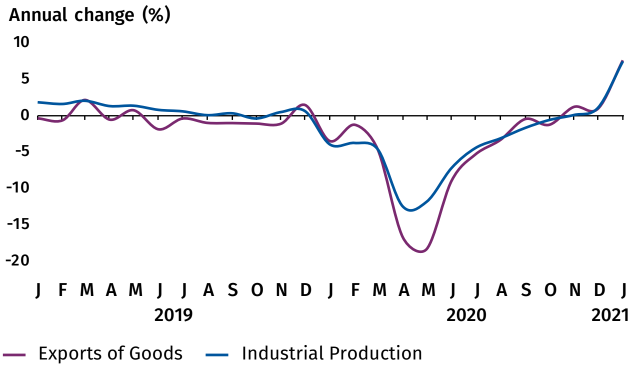
Source: International Monetary Fund (IMF) January 2021 World Economic Outlook

Chart 2.2: Composite Purchasing Managers Index (PMI)



Source: IHS Markit

Chart 2.3: Global Exports of Goods and Industrial Production Growth



Source: CPB Netherlands Bureau for Economic Policy Analysis

The rollout of the COVID-19 vaccines will lend support to global growth in 2021. Nonetheless, the impact will vary across economies due to differences in the timing, speed and scale of the distribution. As the vaccination rollout progresses across countries, containment measures are expected to be gradually eased. This will facilitate the restart of previously constrained activities, lower supply constraints and lift spending. International borders are also expected to reopen in phases, beginning with travel bubble arrangements among economies with manageable COVID-19 situations towards the end of 2021. This would spur a rebound in cross-border tourism activities, but will likely remain below 2019 levels. The vaccine rollout is also expected to lift sentiments as the fear of COVID-19 gradually dissipates. The pace of country-specific growth recoveries will depend on countries' ability to manage vaccine-related logistical and procurement challenges amid some supply constraints and prioritisation of domestic needs in vaccine-producing economies, particularly at the early stages of vaccine production. Countries with first-hand access and strong logistical capabilities to ensure the timely and effective rollout of vaccines, mainly in the advanced economies (AEs) and vaccine-producing emerging market economies (EMEs), such as PR China, India, and Russia, are expected to experience faster growth recoveries.

Beyond vaccines, ongoing global structural shifts are expected to support a gradual improvement in cross-border investment and trade. In the near-term, rising demand for remote working equipment and the digitalisation of businesses could lead to an upswing in the technology cycle. This will benefit manufacturing production, investments, and exports for economies that are part of the electrical and electronics (E&E) global value chain, particularly the regional economies. In AEs, the EU-UK Trade and Cooperation Agreement has removed a key downside risk to EU-UK trade activity from a "no-deal Brexit" scenario. Reflecting the improving demand outlook, global commodity prices are expected to trend higher. Net commodity exporting countries stand to benefit from higher revenues, with potential spillovers to sectors with close linkages to the commodities sector. Higher commodity prices and recovery in demand may also lead to some inflationary pressures across economies, but only to a marginal extent, as some economic slack is expected to remain in 2021.

In line with improving economic activity, labour market conditions are projected to improve, albeit unevenly and partially, owing to the varying degree of scarring across economies. The recovery in unemployment and labour force participation rates, although partial, is likely to be faster in countries with more flexible labour markets, for instance in most advanced and some regional economies[1]. As firms face less hiring frictions, there is a lower risk of individuals entering long-term unemployment after being retrenched. This limits scarring from permanent job and income losses. Continued policy support will also facilitate a gradual normalisation in labour market conditions. Prominent examples include the additional fiscal support in the US and strong automatic stabilisers in the euro area, such as the wage replacement schemes in Germany and France. Despite some policy support in other EMEs, these economies are likely to experience a slower improvement in labour market conditions as less flexible labour markets delay the pace of job creation and is impeded further by higher long-term exits of retrenched workers from the labour force. Overall, the recovery in economic activity is expected to still outpace the recovery in labour market conditions.

Following a sharp decline in 2020, a resumption of private domestic demand is expected, but the pace of recovery across economies will depend on the degree of improvement in labour market conditions and firms' ability to leverage on opportunities in the new normal. Private consumption in major and regional economies will be anchored by a faster recovery in income conditions, in addition to improving sentiments due to the vaccine rollout. Firms in selected sectors, such as the E&E and information and communication technology (ICT)-related industries, are expected to invest in capacity expansions to meet demand, thus lending support to global investments. For example, in the region, the acceleration of 5G infrastructure rollouts[2] will provide impetus to investments. While prevailing household and non-financial corporate debt is elevated across both AEs and EMEs, the expected improvement in income conditions should help sustain spending and debt financing needs.

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1 Inferred from the labour market flexibility index in Miller, Roberts, and Kim (2020). The index has seven components – (i) ratio of minimum wage to the average value added per worker, (ii) hindrance to hiring new workers, (iii) hours rigidity, (iv) difficulty of firing workers, (v) legally mandated notice period, (vi) mandatory severance pay, and (vii) labour force participation. Advanced economies (excluding the euro area), such as the US and Japan and regional economies, such as Singapore, Malaysia, and Thailand, have more flexible labour markets than other major emerging economies.

2 Mobile operators in the Asia Pacific will spend approximately USD331 billion in capital expenditure between 2020 and 2025 on 5G deployments. Nine countries, including Thailand and Singapore have launched commercial mobile 5G services, while twelve countries, including Indonesia and Malaysia, have announced plans to launch 5G (Global System for Mobile Communications Association, 2020).

Aggressive policy actions have prevented more severe adverse growth outcomes in 2020. Continued policy support, which will remain responsive to pandemic developments, is expected to sustain the global growth recovery in 2021. In Japan and the US, new stimulus packages were introduced due to a resurgence of COVID-19 cases. More broadly, however, policy is expected to be recalibrated based on the pace of economic recovery, resulting in smaller fiscal stimuli compared to 2020. This is in line with expectations for a smaller drag from COVID-19 as economies begin to respond to further outbreaks in ways that minimise disruptions in production activity. For example, PR China adopted targeted mobility restrictions and mass, rapid, random (MRR) testing to tackle the resurgence of cases in its North and Northeastern regions in January 2021, thus limiting supply disruptions. Nevertheless, as the full extent of economic scarring from the pandemic remains difficult to gauge, policymakers may opt to sustain current policy support in a more targeted manner, with a gradual recalibration of policy space over the medium-term. For instance, the EU has suspended rules on limiting public debt and fiscal deficits in the Stability and Growth Pact beyond 2021 until economic activity in its Member States have reached pre-crisis levels, to ensure flexibility in refining fiscal policy to support economic recovery.

Global monetary and financial conditions are expected to remain supportive of growth recovery despite continued bouts of financial market volatility

Broadly, global monetary policy is also expected to remain supportive of growth. The commitment towards a 'low-for-longer' interest rate environment in major AEs, such as the US and euro area, may keep global monetary and financial conditions favourable for an extended period. In major EMEs, accommodative conventional and unconventional monetary policies[3] will support demand. These would mitigate the risk of a premature tightening of financial conditions, which could weigh on the recovery in private sector spending.

Notwithstanding this, long-term government bond yields in the US began to surge in January 2021, driven by higher inflation expectations in anticipation of a faster economic recovery. This has led to the steepening of government bond yield curves in other AEs and EMEs. Global financial market volatility has also increased, and could continue intermittently going forward. Against this backdrop, there is a need to ensure orderly adjustments in financial markets and conducive financial conditions that will support a more entrenched economic recovery.

Despite recent developments, major central banks have continued to maintain the stance that monetary policy will remain accommodative amid considerable economic slack, transitory inflationary pressures, and high lingering uncertainties on the strength of growth recoveries. Hence, the generally loose monetary and financial conditions globally should continue to support favourable domestic financial conditions in EMEs. Easy financial conditions amid an exuberance in investors' risk appetite, however, could also contribute to a concurrent build-up in financial and external sector imbalances, potentially increasing countries' susceptibility to external shocks. Policymakers need to be vigilant against these risks as they could affect the sustainability of growth recovery.

Balance of risks to global growth remains tilted to the downside amid continued economic uncertainty

Notwithstanding the expected global recovery, uncertainty remains elevated arising from various sources, notably the effectiveness of the rollout of nationwide vaccination programmes across countries and the duration of policy support. This could weigh on global growth due to precautionary behaviour among firms and households.

The primary source of downside risk remains pandemic-related. This includes the re-imposition of strict and widespread containment measures due to COVID-19 resurgences leading to economic disruptions. Furthermore, the slower-than-expected rollout of vaccines due to logistical challenges or slower delivery by vaccine providers could affect sentiments and lead to more severe

[3] Unconventional monetary policies use tools other than the calibration of the policy interest rate to influence financing conditions, such as forward guidance, asset purchases, and term funding facilities.

containment measures. Finally, major mutations in the COVID-19 virus could render the existing vaccines less effective and renew risks of the reintroduction of strict lockdowns. More severe economic scarring, arising from extensive permanent job losses and business closures, could also weaken long-term global growth.

Downside risks to global growth extend beyond pandemic-related factors. Heightened global financial market volatility could contribute to capital flow reversals from EMEs, leading to sharp exchange rate adjustments and the tightening of domestic financial conditions. Financial conditions could tighten further should prevailing financial sector imbalances[4] unwind, especially in vulnerable EMEs with elevated private sector debt. In addition, if inflation expectations in major economies become unanchored, this could precipitate disorderly adjustments in global financial markets. Other risk factors such as extreme weather conditions may result in sudden disruptions to production and incomes, disproportionately affecting low-income economies amid more limited policy space. Finally, rising protectionist measures and deglobalisation of global supply chains could also adversely affect productivity and hinder global growth recovery.

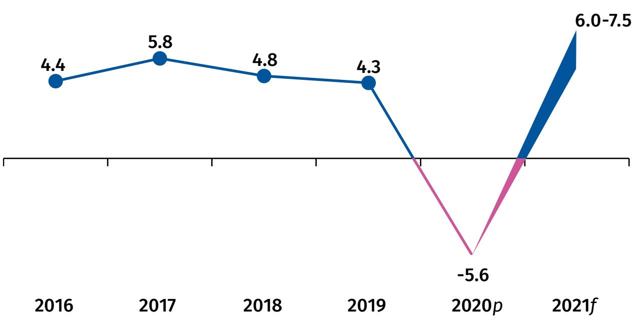
Nevertheless, there is some upside potential to the global growth outlook. Global growth could outperform expectations with a faster rollout and wider outreach of vaccines, especially in EMEs. The global economy could benefit on two counts. Firstly, containment measures may be phased out in more countries at a faster pace, which alleviates the drag on business activities and risk aversion due to pandemic fears. Secondly, positive sentiments could set in earlier and stronger, boosting the recovery in private sector spending. Another source of upside risk is a more prolonged or larger-than-expected fiscal support which would underpin a faster recovery in demand, such as in the US, or cushion any unexpected economic shocks.

The Malaysian economy is projected to rebound to between 6.0% and 7.5% in 2021

Recovery in the domestic economy, which began in the second half of 2020, is expected to continue in 2021. The recovery, nevertheless, is expected to be uneven and will be shaped by several factors, including the course of the COVID-19 pandemic and vaccine rollout, the extent of external spillovers, sector-specific developments, and the degree of improvement in labour market conditions. Amid a highly uncertain operating environment, continued and targeted policy measures will remain central in supporting growth going forward.

COVID-19 developments remain key in influencing Malaysia's growth trajectory in 2021, particularly the extent and duration of containment measures and the rollout of vaccines. Malaysia entered the year with the tightening of containment measures in most states with a resurgence in cases since late last year[5]. The corresponding restrictions and weakness in sentiments amid the uncertain progress of the pandemic will likely weigh further on spending in the early part of 2021. Nevertheless, the overall impact for the year is expected to be smaller than in 2020, owing to a less restrictive and more targeted approach to contain the COVID-19

Chart 2.4: Malaysia's GDP Growth



p Preliminary
f Forecast
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

[4] The January 2021 Global Financial Stability Review (GFSR) noted several financial vulnerabilities that were evident before the pandemic or have emerged since the pandemic, including rising corporate and sovereign debt, non-bank financial institutions sector fragilities, as well as declining banking sector profitability in some economies (International Monetary Fund, 2021).

[5] The Movement Control Order (MCO) 2.0 was initially imposed in five states, namely Selangor, Penang, Johor, Malacca, and Sabah, as well as the federal territories of Kuala Lumpur, Putrajaya and Labuan from 13 to 26 January 2021. This was later imposed in Kelantan and Sibu, Sarawak. As cases remained high, MCO 2.0 was extended further until 4 March 2021 for Selangor, Penang, Johor and Kuala Lumpur, and until 18 February 2021 for all other states and federal territories, except Sarawak.

resurgence. In particular, the flexibility for more economic sectors to operate should lessen supply and demand disruptions. Firms and consumers are also better adapted to physical distancing requirements and other operating procedures to contain the spread of infections.

Concurrently, the rollout of vaccines domestically beginning February 2021 will provide some lift to consumer sentiments and spending. However, as mass vaccination to induce herd immunity is expected to occur in a phased manner, the improvement in sentiments is expected to be gradual. As such, international tourism activities for Malaysia are unlikely to resume in a meaningful way, to limit community transmission and imported cases.

Notwithstanding the COVID-19 situation, a positive development is on the external spillovers from the broader recovery in global demand. This will sustain domestic production, investment, and export activity. Firms in the export-oriented industries and the supporting sectors are poised to benefit from improving domestic demand in key trade partner economies and the global technology upcycle. Of note, the rising demand for remote working equipment and medical-related products augurs well for firms in the manufacturing industry, particularly E&E as Malaysia forms an integral part of the global value chain. Beyond these, the recovery in global commodity prices and demand should lift commodity production and export revenues.

Other domestic sector-specific factors, such as higher production from new and existing manufacturing and mining facilities, and the pick-up of large infrastructure projects, would provide further impetus to overall economic activity. Meanwhile, high-touch services are expected to recover more slowly owing to a more gradual improvement in consumer sentiments and limited foreign tourist spending, thus contributing to an uneven recovery across sectors. To this end, many firms have adjusted their business models, including shifting to online e-commerce platforms to cater to the changing consumer preferences to shop more online. These would enable firms to meet demand in the near-term and importantly, lead to higher productivity gains over the longer term.

As broad economic activity picks up, labour market conditions are expected to improve gradually, with policy measures in place to facilitate labour mobility and minimise long-term dislocation or scarring in the labour market. Following the elevated number of retrenchments and income declines during the height of the COVID-19 crisis in 2020, there have been encouraging signs of re-employment[6] and a recovery in income levels that are expected to persist in 2021. Targeted policy measures remain in place to sustain this recovery by supporting labour demand and reducing labour market frictions as unemployed individuals seek re-employment. This will particularly benefit affected workers in COVID-19-vulnerable industries, such as the retail- and tourism-related industries. Key measures to safeguard the employment of these workers include the targeted wage subsidy programmes, various upskilling and reskilling opportunities, as well as extensions to the Employment Insurance System (EIS) jobless claims allowance for those retrenched.

An improvement in labour market conditions is expected to play a key role in the recovery of private consumption. While pockets of households will remain more vulnerable to the adverse impact from the pandemic, continued policy assistance for these groups is expected to support spending. Equally crucial to the growth recovery is the projected pick-up in investment activity going forward. Improving capital spending by firms, particularly in critical areas such as digitalisation, automation, and transportation, will boost near-term growth and future productive capacity. Reflecting the expansion in domestic consumption and investment activity, as well as external demand, imports is expected to observe a broad-based increase.

In addition, policy measures remain in place to support the growth momentum while still assisting the vulnerable segments that are particularly affected by the COVID-19 developments. 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 *Bantuan Prihatin Nasional*, *Bantuan Prihatin Rakyat* and *Bantuan Kehilangan Pendapatan* cash transfers, the

[6] Higher job placement rates were observed in the second half of last year (31 placements per 100 jobless claims, 1H2020: 15).

Employee Provident Fund (EPF) *i-Sinar* and *i-Lestari* cash withdrawals[7], and the Targeted Repayment Assistance. Furthermore, 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. Complementary to these measures are the continued accommodativeness of monetary policy and supportive financing conditions, which will maintain an environment that is conducive for a recovery in domestic demand as the adverse impact from the COVID-19 crisis gradually subsides.

In a highly uncertain and rapidly evolving 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. Continued susceptibility to domestic commodity production shocks could also weigh on baseline growth. Moreover, 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.

Domestic demand to remain the key driver of economic growth

In 2021, growth is expected to improve, underpinned by the recovery in the global economy and better domestic economic activity. However, given the rise in COVID-19 cases since late last year, growth is expected to be affected in early 2021 due to the impact from domestic containment measures. Notwithstanding this, growth would be supported by higher domestic demand, particularly private sector spending. The improvement in the global economy, meanwhile, is expected to translate into a rebound in external demand, and benefit Malaysia's exports during the year. The performance would also be lifted by the implementation of infrastructure projects, particularly in the transport-related projects. Furthermore, growth will also be supported by the continued accommodative monetary policy and the targeted assistance from fiscal and financing measures.

Private consumption growth is expected to rebound to 8.0% in 2021, supported by the gradual improvement in overall income and employment growth, as well as relatively less stringent mobility restrictions compared to 2020. Consumer sentiment is also expected to improve gradually as the vaccination programme is rolled out, particularly towards the second half of the year. Furthermore, targeted policy measures remain available to support spending, especially for vulnerable households. These include the EPF *i-Sinar* and *i-Lestari* withdrawals, disbursement of the *Bantuan Prihatin Nasional, Bantuan Prihatin Rakyat* and *Bantuan Kehilangan Pendapatan* cash transfers, various tax relief and incentives, as well as the Targeted Repayment Assistance. Going forward, household expenditure will also be characterised by shifting consumption trends. The divergent pace of recovery between spending in essential goods and services, and discretionary items is expected to continue in 2021, as leisure-related spending is likely to remain modest. The acceleration in online shopping since the onset of the pandemic is also likely to persist, partly mitigating a decline in physical spending when targeted movement restrictions remain in place. To this end, firms' ability to shift their business models towards meeting growing demand in the new normal and reinvigorate discretionary spending will partly help to sustain private consumption.

Gross fixed capital formation (GFCF) is projected to rebound to 7.8% (2020: -14.5%), supported by the rise in capital spending by the private and public sectors. The higher capital spending would be driven by the recovery in both structures and machinery and equipment (M&E) investments, amid improvement in global and domestic economic activity.

[7] These facilities allow EPF members to withdraw a share of funds from their savings accounts to alleviate cash flow constraints, particularly for individuals affected during the course of the COVID-19 crisis.

Table 1

Real GDP by Expenditure (2015=100)

	2020p	2020p	2021f	2020p	2021f
	% of GDP	Annual change (%)		Contribution to growth (percentage point)	
Domestic Demand[1]	**93.9**	**-5.7**	**7.4**	**-5.4**	**7.0**
Private sector expenditure	75.2	-6.0	7.4	-4.5	5.6
Consumption	59.5	-4.3	8.0	-2.5	4.8
Investment	15.7	-11.9	5.4	-2.0	0.8
Public sector expenditure	18.7	-4.6	7.4	-0.8	1.4
Consumption	13.4	4.1	4.4	0.5	0.6
Investment	5.2	-21.4	15.2	-1.3	0.8
Gross Fixed Capital Formation	20.9	-14.5	7.8	-3.4	1.6
Change in stocks	**-0.4**			**0.7**	**-0.3**
Net Exports of Goods and Services	**6.5**	**-12.3**	**4.8**	**-0.9**	**0.3**
Exports	61.6	-8.8	13.1	-5.6	8.1
Imports	55.1	-8.3	14.1	-4.7	7.8
Real Gross Domestic Product (GDP)	**100.0**	**-5.6**	**6.0 ~ 7.5**	**-5.6**	**6.0 ~ 7.5**

[1] Excluding stocks
p Preliminary
f Forecast

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Private investment growth is expected to improve to 5.4% (2020: -11.9%) following the gradual recovery in external demand as vaccines begin to roll-out on a wider scale. Growth will also be supported by the progress of ongoing large projects especially in the civil engineering sub sector, and the continued investment intentions, particularly in the manufacturing sector. This is observed from the sustained investment approvals in the manufacturing of E&E, petroleum products, and metal products. Furthermore, the measures announced in 2021 Budget including investment incentives, tax allowances and the implementation of key projects to spur the development of the digital economy such as under the Malaysia Digital Economy Blueprint (MyDigital), will provide further support to private investment activity.

Similarly, **public investment** is projected to register an expansion of 15.2% (2020: -21.4%). This will be driven by improvement in both General Government and public corporations spending, amid further progress of large-scale infrastructure projects, such as ECRL, MRT2, and Pan Borneo Highway. With less restrictive containment measures in the first quarter of 2021 compared to in 2020, and further pick-up in economic activity from the second quarter onwards, progress of most infrastructure projects are expected to be on track, or even ahead of schedule. For example, the ECRL project which was 20% completed as at end-2020, was slightly ahead of schedule, and is targeted to reach 30% completion rate by end-2021[8]. The Government's fixed asset spending will be channelled mainly towards transportation, education, public utilities, housing and healthcare projects. In addition, investment to improve digital infrastructure and connectivity nationwide, as well as the implementation of small-scale projects as announced under the 2021 Budget and *PEMERKASA* package, will provide further lift to growth.

Public consumption growth is expected to continue to expand at 4.4% (2020: 4.1%), in line with continued expansion in Federal Government spending, largely supported by COVID-19 related expenditure, including the vaccine procurement and logistics spending.

[8] Malaysia Rail Link website, 6 January 2021.

Growth expansion in all economic sectors

All economic sectors are projected to record positive growth in 2021. The improving growth trajectory will be supported by stronger external demand, especially in digital products and services as the world continues to adapt to the “new normal”. In addition, the gradual resumption in economic activities as businesses adapt to the COVID-19 Standard Operating Procedures (SOPs), and nationwide vaccinations are also expected to provide broad impetus to growth. Nonetheless, the pace of recovery across industries will vary depending on its exposure to the COVID-19 outbreak and operational restrictions arising from the containment measures. Most industries are only expected to record positive growth beginning second quarter of the year given the imposition of MCO 2.0 in the first quarter.

Table 1

Real GDP by Kind of Economic Activity (2015=100)

	2020*p*	2020*p*	2021*f*	2020*p*	2021*f*
	% of GDP	Annual change (%)		Contribution to growth (ppt)[1]	
Services	57.7	-5.5	6.6	-3.2	3.8
Manufacturing	23.0	-2.6	8.8	-0.6	2.0
Mining and quarrying	6.8	-10.0	3.1	-0.7	0.2
Agriculture	7.4	-2.2	4.2	-0.2	0.3
Construction	4.0	-19.4	13.4	-0.9	0.5
Real Gross Domestic Product (GDP)	**100.0[1]**	**-5.6**	**6.0 ~ 7.5**	**-5.6**	**6.0 ~ 7.5**

[1] Figures may not necessarily add up due to rounding and exclusion of import duties component
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The *services* sector is expected to register a growth recovery in 2021. The information and communication, as well as finance and insurance sub-sectors are poised to lead the recovery as demand for digital solutions, especially in e-commerce and e-payment continues to accelerate. Nonetheless, the re-imposition of the MCO 2.0 in the early part of the year will weigh on activities in the wholesale and retail sub-sector. Additionally, the closure of Malaysia’s international borders will continue to affect tourism-related industries (e.g. food and beverage, accommodation and air travel).

The *manufacturing* sector is expected to record robust growth as the COVID-19 pandemic accelerates the structural shifts towards digitalisation, spurring demand for telecommunications, cloud computing and medical device products. Malaysia’s E&E cluster will stand to benefit as it is well integrated in these global value chains. Growth in the primary-related cluster is also expected to benefit from increased production of refined petroleum and petrochemical from the large petrochemical facilities in Johor. On the domestic-front, production in the construction-related manufacturing clusters are also expected to be supported by the pick-up in construction of large infrastructure projects. Growth in the consumer-related *manufacturing* cluster is also expected to improve, in tandem with the recovery in consumption activity, as most major consumer industries and their supply chain are expected to operate, while observing the SOPs. Additionally, the Government’s extension of tax exemptions for car sales will likely boost support for car production.

Growth in the *agriculture* sector is expected to expand, primarily due to a recovery in oil palm production. Slightly higher-than-average rainfall in the beginning of the year due to the La Nina phenomenon is expected to improve oil palm yields particularly towards the later part of the year. Meanwhile, higher natural rubber prices will support increased tapping activities, while continued growth in household spending will support a strong expansion in livestock production.

Activities in the *mining* sector are projected to recover, despite planned maintenance closures in the first half of the year following the continuation of voluntary supply adjustments by PETRONAS. The offsetting support to growth is expected to materialise in the second half of the year as the operationalisation of new gas fields along with the ramp-up of the PFLNG2 facility in East Malaysia will lead to higher production of natural gas.

Growth in the *construction* sector is also expected to rebound, driven by resumption of activities across all subsectors. In the civil engineering subsector, growth is expected to recover in line with the ramp up of construction activity in large infrastructure projects. Meanwhile, launches of affordable housing projects in the previous years will continue to provide support for activity in the residential subsector. Growth in the special trade subsector is expected to strengthen further with support from solar power projects, *Jalinan Digital Negara* (JENDELA), small-scale projects under the 2021 Budget and *PEMERKASA* measures, as well as end-works from the completion of large projects. However, completion of large commercial projects is expected to weigh on growth in the non-residential subsector.

Potential output and the output gap of the Malaysian economy

Potential output is the highest non-inflationary level of output that can be produced in an economy. It indicates the economy's sustainable growth path, based on its prevailing factors of production (i.e. labour, capital) and level of productivity.

In 2020, potential output growth is estimated to have moderated to 3.3% (2019: 4.8%, 2011-2019 average: 4.9%). Firstly, investment activity registered a contraction in 2020 (-14.5%; 2019: -2.1%), as a result of weak demand conditions, softer business sentiments and heightened uncertainty amid the COVID-19 pandemic. Subdued investment activity is expected to result in weaker total factor productivity (TFP) growth as firms undertake less investments in productive capital (e.g. machinery & equipment and ICT). Secondly, participation in the labour force declined marginally (4Q 2020: 68.5%, 2019: 68.7%), due to weaker job market prospects amid rising unemployment during the year. Additionally, the MCO period and the associated SOPs negatively impacted labour productivity, which are also expected to adversely affect the TFP.

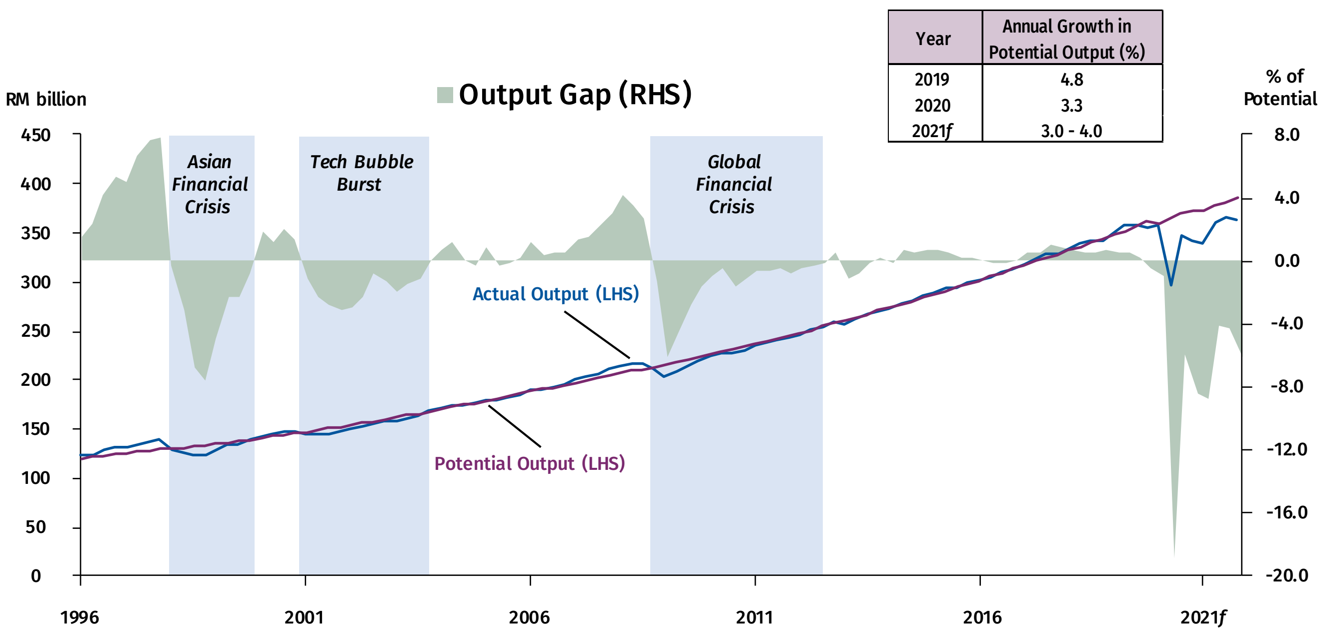
The actual output growth of -5.6% in 2020 was significantly below the potential output growth of 3.3%. This was due to the concurrent supply and demand shocks that led to an underutilisation of the economy's resources. On the supply side, capacity restrictions introduced especially during the MCO period and physical distancing measures resulted in lower production activities. On the demand side, subdued domestic and external demand conditions led to a contraction in private consumption and exports growth during the year.

Consequentially, the output gap turned negative (-8.5%, 2019: 0.2%) as actual output fell below potential output[9]. This reflects slack in the economy from the underutilisation of factors of production. The slack in the economy led to further easing of price pressures as the inflation rate decreased to -1.2% (Core inflation: 1.1%).

Going forward, the negative output gap is projected to narrow in 2021. This is due to the expected rebound of actual output growth to 6.0%-7.5%, which is above the potential output growth that is estimated to remain subdued at 3-4%. A slower recovery in selected industries, such as tourism-related sectors, due to international travel restrictions and the re-imposition of the MCO 2.0, is expected to result in only a gradual improvement in the output gap.

[9] The output gap is formally defined as $\frac{\text{(Actual output level- Potential output level)}}{\text{Potential output level}}$ x 100%.

Chart 1 : Actual and Potential Output



f Forecast

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

Export growth to rebound in 2021

Malaysia's export growth is expected to rebound to 8.2% in 2021 (2020: -1.4%), following two consecutive years of contraction. The expansion will be driven primarily by the improvement in external demand, especially from Malaysia's key export partners, such as the US and PR China. Malaysia's exports will also benefit from firm global demand for E&E products, and higher commodity prices and production.

Manufactured exports is expected to expand by 8.4% in 2021 (2020: 0.8%), supported by broad-based improvement across both the E&E and non-E&E segments. Capacity expansion and commencement of new E&E production facilities will enable firms to benefit from the stronger global demand for semiconductors.

In the non-E&E sector, export growth will be supported by selected segments. These include rubber-related products such as gloves and Personal Protective Equipment (PPE). In addition, exports of construction-related products, namely iron and steel and manufactures of metals will be supported by the recovery in investment activity in PR China. Commodities exports are projected to rebound (3.3%; 2020: -12.5%), driven by both higher commodity prices and production. Mineral exports are expected to recover due to higher prices of crude oil and natural gas. The expected operationalisation of new gas fields in the second half of 2021 will also support natural gas export volumes.

Import growth to recover

Gross imports is projected to rebound to 9.1% in 2021 (2020: -6.3%), driven mainly by a turnaround in intermediate imports in line with higher manufactured exports. Capital import growth is also expected to rebound driven mainly by higher investment in the manufacturing sector as well as the implementation of large scale infrastructure projects. Consumption imports will be driven primarily by demand for imported food and beverages.

Current account to remain in surplus

The current account balance is projected to remain in surplus, albeit lower at 2.5 – 3.5% of GDP in 2021 (2020: 4.4% of GDP). The goods surplus is expected to increase in 2021 as goods exports are expected to outpace the recovery in imports and benefit from higher commodity prices.

Services exports is expected to remain subdued, due mainly to lower travel receipts as international border restrictions are expected to remain in place. Payments for professional and technical services are expected to rise as investment activity recovers. As a result, the services deficit is expected to widen in 2021.

The income account is projected to record a wider deficit, attributable to the higher FDI income payment accrued to foreign investors in Malaysia as manufacturing activity improves. The higher FDI income payment is expected to outpace the increase in income accrued to Malaysian firms investing abroad. The secondary income account is expected to register a larger deficit. This reflects the increase in outward remittances by foreign workers as economic activity improves and the large base effect from the settlement received related to a wholly-owned subsidiary of the Minister of Finance (Incorporated) in third quarter of 2020.

Table 1

External Trade

	2015-2019 average	2020*p*	2021*f*
	Annual change (%)		
Gross exports	**5.6**	**-1.4**	**8.2**
of which:			
Manufactured	7.6	0.8	8.4
Agriculture	-0.6	8.7	-1.2
Mining	-3.1	-29.6	8.9
Gross imports	**4.7**	**-6.3**	**9.1**
of which:			
Capital goods	1.2	-9.8	4.6
Intermediate goods	3.1	-9.5	12.2
Consumption goods	8.4	-0.3	6.9
Trade balance (RM billion)	**109.5**	**184.8**	**192.2**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 2

Current Account of the Balance of Payments[1]

Item (Net)	2020p	2021f
	RM billion	
Goods	139.1	161.7
Services	-48.0	-57.7
Primary income	-26.2	-41.6
Secondary income	-2.8	-18.1
Current account balance	**62.1**	**44.3**
% of GDP	4.4	2.5 - 3.5

[1] In accordance with the Balance of Payments and International Investment Position Manual, Sixth Edition (BPM6) by the International Monetary Fund (IMF)
p Preliminary
f Forecast

Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

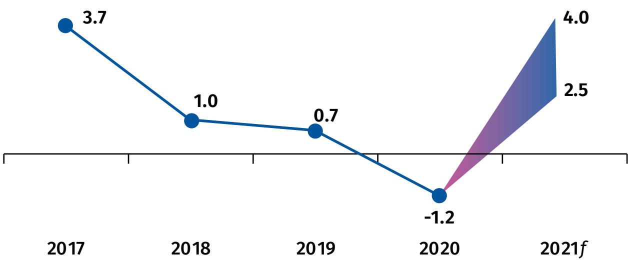
Headline inflation to average higher, between 2.5% and 4.0%, while underlying inflation to remain subdued in 2021

In 2021, headline inflation is projected to average higher, between 2.5% and 4.0%, due mainly to cost-push factors such as the expected increase in global oil prices, as well as the lapse in the effect from the tiered electricity tariff rebate introduced in April 2020 (Chart 2.5). In terms of trajectory, headline inflation is anticipated to temporarily spike in the second quarter of the year, due mainly to the lower base from the low domestic retail fuel prices[10] during the corresponding period in 2020. Nevertheless, headline inflation is expected to moderate by the second half of the year as this base effect dissipates.

Underlying inflation is expected to remain subdued amid the continued spare capacity in the

[10] 2Q2020 average domestic retail fuel price (RON95): RM1.37/litre; Year-to-date (up to 31st March 2021); RM1.96/litre.

Chart 2.5: Malaysia's Headline Inflation, Annual Change (%)



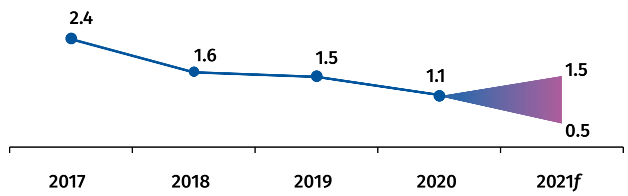
f Forecast

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

economy. Core inflation is forecasted to average between 0.5% and 1.5% in 2021 (Chart 2.6). Despite the improvement in economic conditions, the output gap is still projected to remain negative this year, in part due to continued weakness in selected industries. 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. It is also subject to downside risks, including further rounds of containment measures, albeit targeted, which could weigh on demand. A slower-than-expected rollout of vaccines could also affect the extent of the economic recovery, thereby further tempering inflationary pressures. Nevertheless, upside risks also remain, stemming

Chart 2.6: Malaysia's Core Inflation, Annual Change (%)



f Forecast

Note: 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

from cost factors such as higher fresh food inflation and disruptions to global supply lines.

With the pandemic, structural changes are taking place in regards to shifts in consumer spending habits and competitive dynamics among firms. As we enter the phase of a new normal, the extent to which such changes evolve and remain will pose as a great challenge in assessing inflation dynamics.[11]

Domestic monetary and financial conditions to remain supportive of intermediation activity in 2021

Domestic monetary and financial conditions are expected to remain conducive given the accommodative monetary policy and other ongoing policy support. Following the significant reductions in the Overnight Policy Rate (OPR) in 2020, the accommodative conditions will continue to provide broad-based support to the economy. In particular, the flow of credit to the private sector will be underpinned by the sound banking system and well-functioning capital markets. Banks continue to have adequate lending capacity to support financing needs as the economy recovers, given their healthy capital and liquidity buffers.

Nevertheless, the prevailing uncertain economic conditions and outlook, along with the higher credit risks and rising impairments, could increase banks' risk aversion and intensify some of the frictions in credit flows. Banks may be less willing to lend to segments or activities deemed to be more risky, and credit may not be allocated efficiently and productively across economic segments. To some extent, these frictions may affect the translation of lower interest rates to higher bank lending. Meanwhile, the highly open domestic financial markets remain exposed to risks of heightened volatility and financial spillovers due to global factors. For instance, expectations of higher inflationary pressures and faster economic recovery in the US could lead to further increase in the long-term government bond yields in EMEs, including Malaysia, which has materialised to some extent in the recent months.

[11] See Second Quarter 2020 BNM Quarterly Bulletin box article titled "COVID-19: Impact on Inflation".

The Bank's monetary policy and operations will, however, continue to provide an enabling environment and ensure sufficient domestic liquidity to support the financial intermediation process. Existing liquidity operations and measures, including among others, reverse repos and the flexibilities provided for the Statutory Reserve Requirement (SRR) compliance, will remain in place throughout the year. These measures would also continue to support the smooth functioning of the domestic money and bond markets. In line with this, 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.

Together with the other targeted Government and BNM measures, including the special funds for small- and medium-sized enterprises (SMEs), credit guarantee schemes, Targeted Repayment Assistance programmes and the regulatory flexibilities extended, the series of policy measures are expected to collectively facilitate credit flows to the economy and provide a firm foundation to support economic recovery.

Monetary policy in 2021 will remain accommodative to promote the sustainability of the economic recovery

Monetary policy in 2021 will focus on supporting a sustainable economic recovery amid modest price pressures. Decisions on monetary policy will continue to be data-driven, given the fast-evolving conditions and lingering uncertainties, such as the strength of the economic recovery and the degree to which the re-imposition of containment measures and the rollout of vaccines, both globally and domestically, will affect economic activity.

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

The gravity and scope of the COVID-19 shock necessitates the complementary use of monetary, fiscal and financial sector policies, which includes the use of more targeted and sector-specific measures for the affected segments of the economy to support and secure a sustainable economic recovery. The optimisation among these policies also avoids overburdening any single policy. In this regard, 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 to support economic recovery. These include liquidity operations, appropriate regulatory and supervisory measures, the establishment of financing facilities and other complementary financial sector policies that serve to ensure orderly market conditions, preserve the smooth functioning of the financial intermediation process and encourage financing to the real economy.

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[12]. Firstly, it is important to improve economic dynamism and to capitalise on emerging technologies by attracting quality investments. This is facilitated by the introduction of a diverse source of funds to spur high-tech private investments, such as the High Tech Facility-National Investment

[12] Refer to box articles on "Getting the Great Reset Right: Structural Labour Market Issues in the Post-COVID-19 World", "Innovation Malaysia: Towards Higher Quality Growth in a Post-Pandemic Future" and "A Vision for Social Protection in Malaysia".

Aspirations (HTF-NIA) funds, as well as various SME digitalisation grants and loans. This can be complemented by upskilling and reskilling programmes to redeploy redundant workers into new growth areas and ensure that the labour force is equipped with the necessary skills to take on the high-skilled, high-productivity jobs generated by these investments. 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. Taken together, these efforts would accelerate digitalisation and enhance productivity in the economy, improve standards of living, and further strengthen growth recovery in a sustainable manner.

The collective impact of these policies would provide the needed countercyclical and longer-term support to enhance Malaysia's economic dynamism towards a sustainable economic recovery. To this end, efforts will continue to focus towards ensuring an optimal policy configuration for the economy to stand on a solid base for recovery.