

# Outlook and Policy in 2022



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## 2022: A FIRMER RECOVERY WHILE UNCERTAINTIES AROUND

Continued recovery in the global economy as most countries gradually transition towards normalcy, albeit at varying degrees

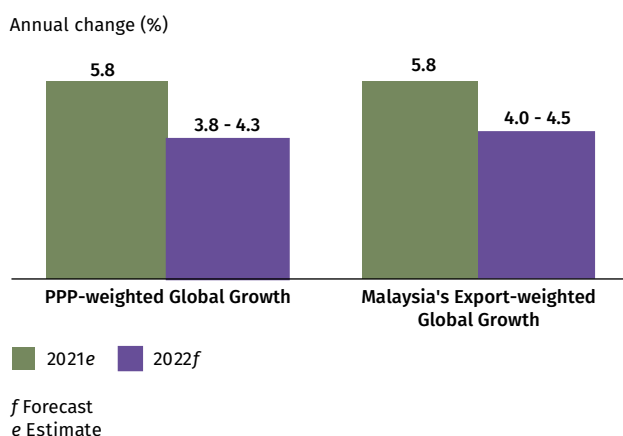
The global economy is expected to continue its recovery path in 2022, with PPP-weighted global growth and Malaysia's export-weighted global growth<sup>1</sup> projected to expand between 3.8% and 4.3%, and between 4.0% and 4.5%, respectively (Chart 2.1).<sup>2</sup> The improvement in labour market conditions amid the progressive reopening of economies over the past year is expected to facilitate the recovery in private sector activity. Labour markets are expected to further improve in 2022, with the unemployment rate in some major economies returning to pre-pandemic levels. With improving growth prospects and higher inflation, policy support is expected to be gradually withdrawn. Leading indicators (Chart 2.2) depict a continued recovery momentum in the first few months of the year, despite a temporary slowdown of economic activity posed by resurgences of COVID-19 cases due to the Omicron variant. Nevertheless, the ongoing military conflict in Ukraine is expected to weigh on global growth.

The growth outlook remains conditional on the path of the COVID-19 pandemic. New variants could emerge and cause a resurgence that may necessitate

<sup>1</sup> Aggregate growth of Malaysia's key trade partners, as weighted by their shares in Malaysia's exports. This measure of global growth is more reflective of Malaysia's exports and growth prospects.

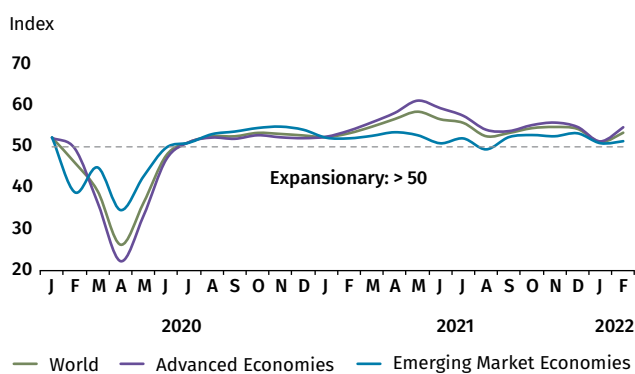
<sup>2</sup> Global growth in 2022 is expected to be more moderate compared to 2021, as economic activity normalises. The high growth in 2021 partly reflects the exceptionally low base effect from the growth contraction in 2020.

Chart 2.1: Global Real GDP Growth



Source: Bank Negara Malaysia

Chart 2.2: Composite Purchasing Managers Index (PMI)



Source: IHS Markit

a reintroduction of containment measures. In addition, resurgences of COVID-19 could also lead to labour absenteeism that would affect economic activity, due to isolation requirements and sickness. Nonetheless, the impact of such resurgences on growth is expected to be smaller compared to previous phases in 2020 and 2021, due to several factors. First, there has been continued good progress in vaccinations, as well as the introduction of new treatments. This will allow authorities to better manage the public health implications of

resurgences without resorting to tight containment measures as in previous years. Nevertheless, some countries continue to maintain a relatively stricter COVID-19 containment policy. As vaccinations progress from relatively lower rates of primary and booster vaccinations in EMEs, remaining containment measures could also be lifted.<sup>3</sup> Second, as we move into the third year of the pandemic, more targeted approaches to containment will be favoured in balancing between considerations for public health and livelihoods. Going forward, countries will likely narrow the focus of containment measures to activities with higher risk of transmission, such as high-touch services activities, rather than the *manufacturing* sector.<sup>4</sup> Some countries are also gradually phasing out the use of containment measures altogether, in an attempt to fully adapt to ‘living with the virus’. Third, greater business and consumer adaptability, through wider adoption of e-commerce, digital solutions, and efficiency-enhancing technologies, would lead to more muted impact of targeted containment measures.

Fiscal policy is expected to remain supportive of the recovery, despite some scaling back as governments pare down emergency support amid the ongoing economic recovery (Chart 2.3). In AEs, fiscal support is expected to shift away from direct support for households and firms. Instead, support will focus on long-term initiatives such as the green transition, digitalisation, as well as repairing and upgrading public infrastructure. Notably, the US Infrastructure Investment and Jobs Act<sup>5</sup> is expected to allocate funds to strengthen and develop various infrastructure including transportation, power, and connectivity (broadband development). Under this initiative, funding will also be allocated to infrastructure needed for the green transition. Meanwhile, the European Union’s Multiannual Fiscal Framework and NextGenerationEU package<sup>6</sup>, together with national budget allocations by Member States, will continue to support investments for both the green and digital transitions. Given the shift in

<sup>3</sup> During the recent Omicron wave, given the lower vaccination rates in EMEs (except China), containment measures were tighter compared to AEs. For example, in India, several state governments implemented weekend curfews and night curfews during the peak of the Omicron wave.

<sup>4</sup> Given the continued focus of containment measures towards high-touch services, some unevenness in the pace of recovery between sectors is expected to continue.

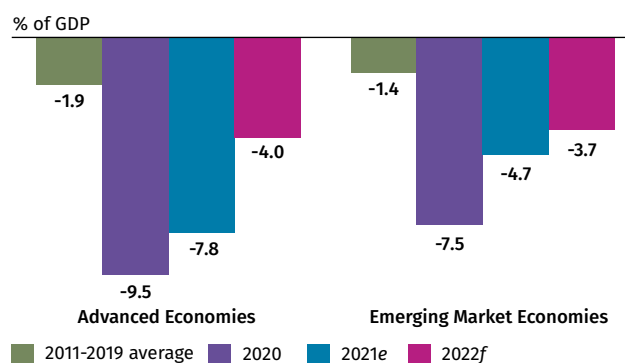
<sup>5</sup> The Act authorises about USD 550 billion in new spending, to be spread over 5 years.

<sup>6</sup> The package totals up to EUR 806.9 billion, of which EUR 338 billion and EUR 385.8 billion are in the form of grants and loans, respectively, for national governments. The remaining funds are allocated for additional spending of various EU programmes.

the composition, fiscal policy would provide more support for investment activity, while consumption support should moderate.

In EMEs, fiscal support is expected to remain expansionary. The scale of fiscal support, however, is expected to be smaller as some countries embark on fiscal consolidation. This reflects the more limited fiscal space and higher borrowing costs. Spending priorities for EMEs in 2022 differ according to domestic needs. India, for example, would be increasing public capital expenditure to boost infrastructure investment, amid a slight fiscal consolidation. In contrast, the Brazilian government is planning to introduce a new cash transfer programme to improve their social safety net. Meanwhile, China is expected to provide continued fiscal support to offset risks to growth from its COVID-19 containment policy and regulatory reforms. Measures include increased quota allocations for local government special bonds, which would support investment activity.

Chart 2.3: Primary Fiscal Balance



e Estimate  
f Forecast

Source: International Monetary Fund (IMF)

The military conflict in Ukraine, however, is expected to weigh on global growth in 2022. The impact will be most severe for the economies of Ukraine and Russia, due to disruptions brought upon by the military incursion and impositions of sanctions, respectively. Spillovers would stem mainly from disruptions in commodity supply, given the large role of Russia and Ukraine as commodity producers in the global economy. The conflict thus far has already led to a rise in commodity prices<sup>7</sup> and global inflation, which would result in increased cost pressures on firms and lower real incomes affecting household spending. While governments are expected to partially offset the impact through

<sup>7</sup> Brent oil prices have risen from USD 91 at the end of January to average around USD 112 between 1st March and 24th March.

fiscal support, limited fiscal space may constrain the extent of the support. In addition, the impact of the conflict on growth prospects would vary among net commodity exporters and importers. For commodity exporters, an improvement in their terms of trade that leads to higher incomes and currency appreciation, would partially mitigate the impact of higher commodity prices on inflation, and subsequently, growth. The magnitude and timeline of the impact from the conflict remains uncertain as developments in the conflict continue to unfold. Actions of key countries, which includes the major economies, in response to the conflict will also have an important bearing on the outlook for global growth and inflation.

## Elevated inflation due to higher energy prices and continued supply chain disruptions in an environment of sustained demand recovery

As the global economy recovers, inflation is projected to rise and remain elevated in 2022. This is driven by the sustained demand pressures in an environment of higher energy and commodity prices and ongoing disruptions in the global supply chain. Since late February, the ongoing conflict between Ukraine and Russia, which are major exporters of various commodities, have further exacerbated price pressures (see footnote 7), and introduced significant uncertainty to the global inflation outlook. Additionally, there is a risk that the easing of supply chain disruptions could be delayed, due to concentrated production of key inputs in Russia and Ukraine. Country-specific factors would influence the extent and sources of inflationary pressures. This would include the pace of recovery, magnitude of policy support, and regulations on energy prices.<sup>8</sup> In addition, idiosyncratic factors like labour market dynamics also play a role. For example, in a number of economies, notably the US, labour shortages are expected to contribute to strong wage pressures and demand-pull inflation, amid a strong recovery in demand. Nevertheless, inflation amongst regional economies in Asia will likely remain relatively lower. This is due to existing price controls and subsidies

on energy in some regional economies.<sup>9</sup> Additionally, the concentration of global manufacturing supply chains in regional economies will help to mitigate the impact of supply chain disruptions on prices, for example, through smaller increases in shipping costs.

Amid continued strength in inflationary pressures globally, a further normalisation of monetary policy is anticipated in 2022. Most central banks in AEs have signalled intentions to reduce monetary support. Having completely tapered its purchases of US Treasury and agency mortgage-backed securities, the Federal Reserve has begun to increase its policy rates. Meanwhile, the European Central Bank affirmed its intentions to scale back its asset purchase programme during the year. In EMEs, most central banks are also expected to begin normalising their monetary policies following continued inflationary pressures in some EMEs and emerging pressures in others, amid an improving growth outlook. In some European and Latin America EMEs, strong domestic demand recovery and wage pressures are expected to lead to further rate hikes. Meanwhile, regional EMEs in Asia are expected to begin normalisation of their policy rates in 2022 amid higher price pressures, following stronger recoveries during the year. In contrast, the People's Bank of China is expected to provide further monetary accommodation to support the slowing growth momentum, in an environment of low inflation<sup>10</sup>.

Nonetheless, the pace and magnitude of monetary policy normalisation remain uncertain, as they depend largely on the persistence of inflationary pressures and the strength of recovery in the economy and labour market. These uncertainties could lead to heightened financial market volatility and tightening of financial conditions. This is especially the case if there is significant misalignment between major central banks' policy paths and financial markets' expectations. As the global economy shifts away from unprecedented levels of monetary accommodation, capital flow reversals from EMEs could follow, especially from those that have seen a build-up of inflows in the past year. In addition, escalation in geopolitical tensions may exacerbate the risk of capital outflows from EMEs, as increased investor risk aversion

<sup>8</sup> For further information, please refer to the box article titled "An Anatomy of Inflation: Effects from the Prolonged Pandemic".

<sup>9</sup> For example, in its December 2021 Monetary Policy Report, the Bank of Thailand noted that the strength of Thailand's energy inflation would be partially offset by the Oil Fund which subsidises the diesel and cooking gas prices. Indonesian authorities have committed to keeping domestic energy prices low despite expected volatility in global commodity prices amid the recovery.

<sup>10</sup> Aside from relatively weak domestic demand, inflation in China has remained low due mainly to a fall in pork prices as swine stocks recovered from a culling in 2020 due to an outbreak of African Swine Fever.

would lead to higher demand for safe haven assets.<sup>11</sup> These large and sudden capital flow reversals could, in turn, cause abrupt tightening of financial conditions, particularly for economies with large external financing needs, and risk derailing the global recovery momentum.

### Balance of risks to global growth remains tilted to the downside, amid heightened geopolitical tensions and continued uncertainties surrounding COVID-19

The primary risk to growth arises from a potential reimposition of broad-based and strict containment measures in the event of a COVID-19 resurgence due to severe and vaccine-resistant Variants of Concern (VOCs). Strict containment measures could affect operations in production and logistics facilities, causing a re-escalation of supply chain disruptions. This, in turn, would also lead to higher and more persistent inflation, which could erode real incomes and lead to weaker spending. There is also the possibility of even higher commodity prices due to extreme weather conditions and disruptions in the production of commodities adding to inflationary pressures. Meanwhile, slower-than-expected recovery in China would pose a downside risk to global growth and trade prospects. Additionally, the unfolding developments surrounding the military conflict in Ukraine has emerged as a key risk, especially if the conflict continues to escalate further and is prolonged, or if trade and financial sanctions are intensified.

An environment of more persistent inflation or de-anchoring of inflationary expectations could lead to an increased pace of monetary policy tightening, which would lead to slower demand and tighter global financial conditions. Moreover, in an environment of tighter global financial conditions, there is an increased risk of sharp capital outflows that could lead to disorderly exchange rate adjustments and unwinding of prevailing financial sector imbalances<sup>12</sup> especially among vulnerable EMEs.

<sup>11</sup> This was observed during the recent military conflict in Ukraine. Greater uncertainties and investor risk aversion led to heightened volatility in the global financial markets, and higher demand for safe haven assets, such as the US dollar and Treasuries.

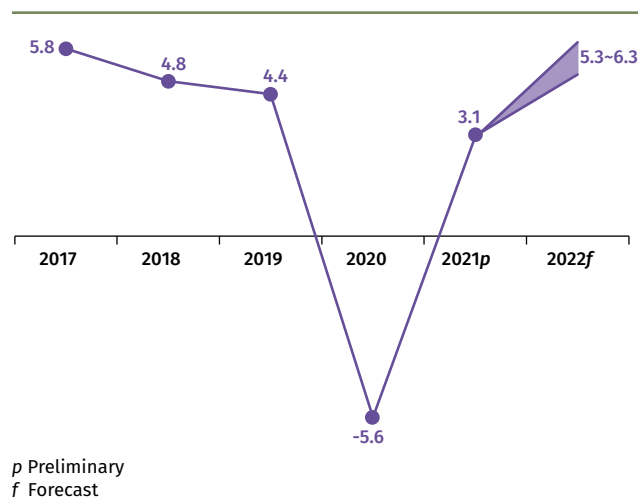
<sup>12</sup> Amongst EMEs, types of financial sector imbalances differ across countries. Some countries have high levels of sovereign debt that could become unsustainable amid tighter-than-expected global financial conditions, while other countries may have large external financing needs, or vulnerabilities in the banking sector.

Nevertheless, there are upside risks to global growth, arising from a faster and wider rollout of COVID-19 primary and booster vaccines as well as new treatment options for COVID-19 infections. This could reduce the severity of supply chain disruptions and the need for containment measures, supporting growth prospects while reducing inflationary pressures. There is also the possibility of additional fiscal policy support, especially in AEs.

### The Malaysian economy is expected to improve further, with growth projected to be between 5.3% and 6.3% in 2022

For the Malaysian economy, the recovery is expected to gain momentum in 2022 (Chart 2.4). This is underpinned by several factors including continued expansion in external demand, full upliftment of containment measures, reopening of international borders, and further improvement in labour market conditions. In addition, the implementation of investment projects and targeted policy measures will provide further support to economic activity and aggregate demand. Taken together, these factors pave the way towards a more broad-based and sustainable recovery for Malaysia.

Chart 2.4: Malaysia's GDP Growth



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

Developments surrounding COVID-19 remain key in influencing Malaysia's growth trajectory in 2022, particularly in the shift towards a more calibrated and proportionate approach to managing the

domestic epidemic<sup>13</sup> situation. After enduring the COVID-19 pandemic for two years, the Government, businesses, and healthcare system are now more adept at managing the spread of the virus. Under the National COVID-19 Immunisation Programme, Malaysia has achieved high vaccination rates and swiftly rolled out booster doses, which has helped to lower hospitalisations and severity of infections. As of 24 March 2022, 97.5% of Malaysia's adult population had been fully vaccinated, while 66.2% had received booster shots. Vaccines are also being rolled out to adolescents aged 12 to 17 (91.5% fully vaccinated), and children aged 5 to 11 (36.1% received first dose). The promising recent discoveries of antiviral drugs and treatments for severe COVID-19 cases would also contribute to lowering hospitalisations and deaths due to infections going forward. Therefore, where capacity of the national healthcare system remains sufficient, the Government has reaffirmed its position to avoid impositions of nationwide lockdowns and strict containment measures. Significant resurgences of COVID-19 cases could, however, impact economic activity through other channels. High absenteeism rates, for example, resulting from workers having to take medical leave and undergo quarantines may impact productivity, while cautious sentiments may suppress mobility and consumer spending. Nevertheless, measures taken to contain future outbreaks<sup>14</sup> would balance national health considerations while minimising adverse impacts on livelihoods and the economy.

The external sector will continue to be supported by global demand, with gross exports projected to grow by 10.9% (2021: 26.0%). Strong demand from major trade partners for electrical and electronic (E&E) products, amid the continued technology up-cycle and 5G infrastructure rollouts globally, will provide support to manufacturing, investment, and exports. Being an open economy, Malaysia will, however, be affected by the impact of the military conflict in Ukraine on global growth, mainly through the trade channel. Nevertheless, the corresponding increase in global commodity prices are expected to provide support to commodity exports and some lift to nominal incomes. Meanwhile, gross imports is projected to expand by 8.1% (2021: 23.3%), reflecting

in part the demand for manufactured exports. Improvement in domestic investment activity and consumer spending will lead to higher imports of consumption and capital goods.

Domestic-specific factors, such as higher production from new manufacturing and mining facilities, expansion in existing facilities, and continued progress of large infrastructure projects,<sup>15</sup> are expected to drive the recovery in overall economic activity. The reopening of international borders and resumption in international travel activity would lend further support to the rebound in consumer-facing and tourism-related sectors. Meanwhile, production frictions from supply chain disruptions and labour shortages<sup>16</sup> are expected to gradually ease as the year progresses, constituting a smaller drag on growth going forward.

In the labour market, conditions are expected to improve gradually as economic activity picks up, with the unemployment rate expected to decline further to around 4% of the labour force. Early indicators suggest continued improvements in labour market conditions and affirm expectations of a further recovery in wages and income. Targeted measures also remain in place to boost labour demand, facilitate re-skilling and up-skilling, and reduce labour market frictions as re-entrants and new entrants to the labour force seek re-employment.<sup>17</sup> These initiatives would further benefit workers who have been displaced by the COVID-19 shock, and mitigate long-term scarring effects. A sustained recovery in employment and income is expected to drive an improvement in household spending.

A stronger recovery in private sector expenditure is expected to be the main driver of growth amid the full lifting of containment measures. Private consumption is expected to record a growth of 9.0% (2021: 1.9%), as household spending will be primarily supported by recovery in income and employment. Consumer confidence is also expected to improve as vaccinations progress and containment measures are fully eased, leading to some materialisation of pent-up demand. Nevertheless, this is contingent upon the

<sup>15</sup> Key infrastructure projects supporting growth in 2022 include East Coast Rail Link (ECRL), Pan Borneo Highways and LRT3.

<sup>16</sup> The labour shortages in Malaysia, which were exacerbated by the closure of international borders, tend to occur in mid- and low-skilled occupations, which are usually taken up by foreign workers.

<sup>17</sup> Job retention policies that seek to maintain existing employment relationships were newly introduced by the Government in 2020, in the form of the Wage Subsidy Programme (WSP). Additionally, the Government also implemented worker reallocation policies to boost job creation and redirect employment, through the introduction of hiring incentives under PenjanaKerjaya and JaminKerja initiatives.

<sup>13</sup> 'Epidemic' refers to an increase, often sudden, in the number of cases of a disease above what is normally expected in that population in that area. 'Pandemic' refers to an epidemic that has spread over several countries or continents, usually affecting a large number of people.

<sup>14</sup> Going forward, potential reimpositions of restrictions are expected to be targeted at reducing social activities, while most economic activity will still be allowed to operate without restrictions.

developments in the domestic epidemic situation. Meanwhile, the expected recovery in private investment (5.3%, 2021: 2.6%) reflects the resumption of existing projects and commencement of new capital spending by businesses. Overall investment intentions remain healthy, given the increase in approved investments in 2021,<sup>18</sup> particularly in export-oriented manufacturing industries such as E&E, metal, rubber, and chemicals. Investment activity will also be supported by greater adoption of automation and digitalisation solutions, and continued capacity expansions, particularly in the *manufacturing* sector.

Importantly, policy support for households and businesses remains in place to facilitate the recovery momentum, albeit more targeted in nature, to assist vulnerable segments that were significantly affected by COVID-19. Support from the 2022 Budget measures from various cash transfers, targeted wage subsidies, and targeted loan repayment assistance will continue to provide further impetus to the economic recovery. Allocations for the Bantuan Keluarga Malaysia, EPF-related measures and tax reliefs will also provide some support to household spending. For businesses, vulnerable sectors such as tourism-related industries and agriculture would benefit from the Wage Subsidy Programme and numerous targeted grants. These measures will continue to ease cashflow burdens and safeguard

employment conditions, thereby enabling a more entrenched recovery in domestic demand.

Given the rapidly-evolving macroeconomic environment, risks to the domestic growth projection remain tilted to the downside. Downside risks stem mainly from the developments surrounding COVID-19, such as the emergence of severe and vaccine-resistant VOCs which could lead to potential reimpositions of broad-based containment measures. Other domestic factors that could affect the recovery path include slower-than-expected rollout of public infrastructure projects, more persistent labour shortages and supply chain disruptions, as well as higher-than-expected inflation which would reduce disposable income and adversely affect consumer sentiments. On the external front, worsening supply chain disruptions and heightened volatility leading to disorderly financial conditions could significantly affect Malaysia's growth and trade outlook. Additionally, prolonged and further escalation of the geopolitical tensions, particularly the military conflict in Ukraine, represents a key risk to the Malaysian economy as well, emanating from its impact to global growth and trade, prices, and financial market volatility. Conversely, factors which pose upside risks to the growth outlook emanate from higher-than-expected global growth and stronger-than-expected improvement in tourism-related sectors amid the reopening of borders.

### Domestic demand continues to be the main anchor of growth

On the demand side, growth in 2022 is expected to improve, underpinned by the continued recovery in private sector expenditure. Without ruling out the possibility of future COVID-19 resurgences, the operating environment is expected to be less restrictive, with a more targeted approach to manage outbreaks compared to 2021 given the high vaccination rate among the population. This would be less disruptive to economic activity, and in turn would support a more entrenched recovery in the labour market and smoother progress of investment projects. The continued expansion in the global economy will benefit Malaysia's exports, with spillover to investments in export-oriented industries. An accommodative monetary policy, as well as targeted fiscal and financial measures for households and businesses would continue to provide additional support to growth.

Private consumption is expected to expand by 9.0% in 2022 (2021: 1.9%). This is anchored in the continued improvement in labour market conditions. In addition, the absence of strict containment measures would provide a lift to household spending. The rise in online spending since the onset of the pandemic in 2020 is expected to continue and will further spur private consumption. The materialisation of some

<sup>18</sup> Approved investments amounted to RM306.5bn in 2021 (2020: RM167.4bn; 2019: RM211.4bn). (Source: Malaysian Investment Development Authority)

pent-up demand for selected discretionary items<sup>19</sup> which were previously restricted due to the imposition of containment measures is also expected to provide some support to overall spending. These include discretionary spending on restaurants, hotels and recreational activities. The strength of the pent-up demand, however, is subject to the path of the epidemic situation in Malaysia. Continued targeted policy measures, particularly for vulnerable households, such as Bantuan Keluarga Malaysia and targeted loan repayment assistance remain available to help support overall spending.

Gross fixed capital formation (GFCF) is projected to rebound to 6.3% (2021: -0.9%) following an increase in capital spending by both the private and public sectors. The higher growth is primarily driven by the improvement in structures investments and continued high capital spending in machinery and equipment (M&E) to meet the increasing demand as the economy gradually recovers.

Table 1

**Real GDP by Expenditure (2015=100)**

	2021p	2021p	2022f	2021p	2022f
	% of GDP	Annual change (%)		Contribution to real GDP growth (percentage point)	
<b>Domestic Demand<sup>1</sup></b>	<b>92.7</b>	<b>1.9</b>	<b>7.2</b>	<b>1.8</b>	<b>6.7</b>
Private sector expenditure	74.3	2.0	8.2	1.5	6.1
Consumption	58.8	1.9	9.0	1.1	5.3
Investment	15.6	2.6	5.3	0.4	0.8
Public sector expenditure	18.3	1.6	3.2	0.3	0.6
Consumption	13.8	6.6	1.2	0.9	0.2
Investment	4.5	-11.4	9.6	-0.6	0.4
Gross Fixed Capital Formation	20.1	-0.9	6.3	-0.2	1.3
<b>Change in stocks</b>	<b>1.3</b>			<b>1.7</b>	<b>-1.0</b>
<b>Net Exports of Goods and Services</b>	<b>6.0</b>	<b>-5.8</b>	<b>2.6</b>	<b>-0.4</b>	<b>0.2</b>
Exports	69.2	15.9	4.8	9.8	3.4
Imports	63.2	18.5	5.1	10.2	3.2
<b>Real Gross Domestic Product (GDP)</b>	<b>100.0</b>	<b>3.1</b>	<b>5.3 ~ 6.3</b>	<b>3.1</b>	<b>5.3 ~ 6.3</b>

<sup>1</sup> 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 is expected to improve by 5.3% (2021: 2.6%). This is supported by the continued expansion in global demand and the realisation of new and ongoing investments. Of significance, investment intentions remained high as reflected in the increase in approved investments in 2021, particularly in the *manufacturing* sector. Investments would also be accelerated by ongoing efforts by the Government to attract new quality investments and facilitate implementation of projects such as the Project Acceleration and Coordination Unit (PACU) and One Stop Centre (OSC) for Business Travellers.<sup>20</sup> The implementation of key infrastructure projects, such as the Malaysia Digital Economy Blueprint (MyDIGITAL), coupled with the incentives announced in 2022<sup>21</sup> Budget would provide additional support to private investment activity.

Public investment is projected to expand by 9.6% (2021: -11.4%), driven by continued capital spending by both the General Government and public corporations. Investment by public corporations across all sectors is

<sup>19</sup> For more details on pent-up demand, please refer to White Box titled "Methodologies in Assessing Pent-up Demand" on page 62.

<sup>20</sup> PACU provides end-to-end facilitation services for investors throughout the investment journey while OSC aims to ease the entry of eligible business travellers.

<sup>21</sup> Key 2022 Budget measures on investment include tax incentives under the Digital Ecosystem Acceleration Scheme, tax incentives to support the development of the Electric Vehicle (EV) industry, and SME Digitalisation Grant Scheme to increase digital adoption among SMEs.

projected to improve, in line with the resumption of economic activity. The increase in fixed assets spending by the Government would be largely channelled towards public projects in transportation, education, healthcare and public utilities. Among the major infrastructure projects include the Light Rail Transit Line 3 (LRT3), East Coast Rail Link (ECRL), and Pan Borneo Highway.

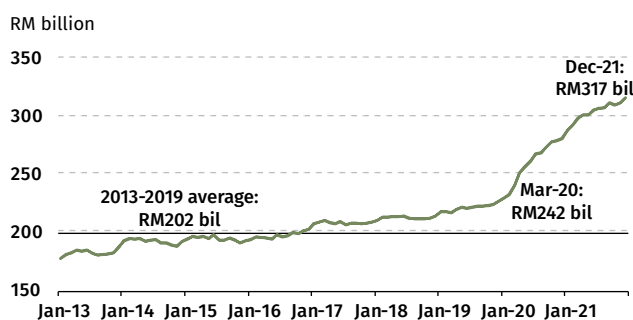
Public consumption is expected to expand by 1.2% (2021: 6.6%). The moderation is due to a slower growth in emoluments and contraction in supplies and services expenditure. Growth in public consumption, however, will remain supported by COVID-related spending which include purchases of medical supplies and procurement of vaccines and booster doses, as well as allocation for small repairs and maintenance works.

## Methodologies in Assessing Pent-up Demand

Since early 2020, there was an overall increase in balances in demand and savings deposit accounts of individuals (Chart 1). Between March 2020 and December 2021, demand and savings deposits accelerated, growing at a monthly average of 18.3%. This was about five times higher than the monthly average growth in 2019 (4.1%). This increase is mainly driven by middle- and high-income households.<sup>22</sup>

The significant build-up of large savings partly reflects precautionary behaviour as well as households not being able to spend on selected goods and services (such as restaurants, hotels, recreational activities, as well as household furnishings and equipment) due to mobility restrictions from the lockdowns. This in turn contributed to a build-up in excess savings<sup>23</sup> (Bank of England, 2021; Batty et al., 2021).

**Chart 1: Savings and Demand Deposits of Individuals in Malaysia**



Source: Bank Negara Malaysia

The build-up in excess savings is expected to be transitory as the savings accrued during lockdowns are above and beyond the average amount prior to the pandemic period (2013-2019). As the economy recovers and international borders reopen, the need for precautionary savings would lessen and together with the lifting of mobility restrictions, households are expected to draw down on the accumulated excess savings to spend on travel and selected discretionary items. In this regard, the estimation of excess savings can provide some indication on the potential strength of pent-up demand, which in turn is expected to support household spending during the year.

<sup>22</sup> Obtained from Bank Negara Malaysia's Credit and Funding Conditions Survey conducted in August 2021. The survey is qualitative, and the data is based on aggregated responses from 16 banks with a market share of 94% of total banking sector liabilities. The question posed to banks in the survey is "Since the onset of the crisis, a significant increase in demand and savings deposit balances of individuals' bank accounts has been observed. From a distributional perspective, how does the increase in deposit balances, from end-2019 to date, differ across income groups?"

<sup>23</sup> Excess savings is generally estimated as the cumulative amount by which household savings during the pandemic exceed the pre-pandemic level or the level that is likely to have prevailed without the pandemic.

There are two methodologies<sup>24</sup> that BNM uses in estimating excess savings among households in Malaysia. These methodologies differ in terms of the coverage of the savings instruments based on their liquidity. Based on these methodologies, the stock of excess savings in Malaysia is estimated to be between RM60 to RM80 billion as at end-2021, which is equivalent to about 7% to 10% of consumer spending in 2021<sup>25</sup>.

The first methodology takes into account the most liquid forms of household savings in Malaysia, namely savings and demand deposits. Excess savings is calculated as the deviation of the actual amount of outstanding savings from the linear trends calculated from the pre-COVID-19 period of 2013 to 2019. This reference period saw a relatively stable level of savings, averaging at about RM200 billion every month. The estimated excess savings is approximately RM82 billion as at end-December 2021.

The second methodology considers a wider range of instruments from which households with excess savings can potentially draw down and spend. Excess savings is calculated as the sum of flows into individual savings and demand deposits, fixed deposits, investments in domestic equity market and unit trust funds, above and beyond the 2013 – 2019 average. Using this method, Malaysia's excess savings is estimated to be about RM57 billion between March 2020 and December 2021.

As economic activity normalises in 2022, spending based on pent-up demand through the release of some of the excess savings will provide additional support to household consumption. It is assumed that households will only spend about 25% of the excess savings accumulated.<sup>26</sup> In addition, the pent-up demand is expected to be temporary and will gradually dissipate with the full reopening of the economy. Going forward, the recovery in labour market conditions would provide the main support to household spending, with early signs of recovery already being observed in 4Q 2021.

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<sup>25</sup> The translation from excess savings to consumer spending could be smaller if households choose not to draw down on the savings, but to accumulate them to build wealth.

<sup>26</sup> This is a conservative estimate given the rapidly evolving macroeconomic environment, particularly on the developments surrounding COVID-19.

## Expansion in all economic sectors

All economic sectors are projected to expand in 2022. The improving growth trajectory will be driven by the recovery in domestic-oriented sectors as almost all economic and social sectors return to normalcy amid Malaysia's high vaccination rate and rapid rollout of booster shots. The re-opening of international borders will facilitate the recovery of tourism-related industries and alleviate pockets of foreign labour shortages in the domestic economy. Meanwhile, export-oriented sectors will continue to benefit from strong external demand and expansion in domestic production capacity.

Table 1

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

	2021p	2021p	2022f	2021p	2022f
	% of GDP	Annual change (%)		Contribution to growth (ppt) <sup>1</sup>	
Services	57.0	1.9	6.9	1.1	3.9
Manufacturing	24.3	9.5	5.2	2.2	1.3
Mining and quarrying	6.7	0.7	2.5	0.0	0.2
Agriculture	7.2	-0.2	1.5	0.0	0.1
Construction	3.7	-5.2	6.1	-0.2	0.2
Real Gross Domestic Product (GDP)	<b>100<sup>1</sup></b>	<b>3.1</b>	<b>5.3 ~ 6.3</b>	<b>3.1</b>	<b>5.3 ~ 6.3</b>

<sup>1</sup> 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 projected to register a higher growth in 2022, led by the consumer and tourism-related subsectors. The improvement is expected to be supported by lifting of nationwide containment measures and re-opening of international borders for tourism. This would facilitate greater mobility and provide further support for the momentum in consumer spending observed in 4Q 2021, to continue into 2022. However, activities in certain subsectors such as food, beverage and accommodation are likely to remain below pre-pandemic levels, given the expectation of a gradual recovery in tourist arrivals. Business-related services will continue to remain supportive of growth. This will mostly be in the logistics and professional services, in line with the continued expansion of manufacturing and construction activity. The information and communication subsectors are also expected to provide further lift to the *services* sector. This will be driven by demand for data services mainly for e-commerce and e-payment activities.

While growth in the *manufacturing* sector is projected to increase at a more moderate pace, it will still be above the long-term average. Malaysia's E&E cluster, which is highly integrated in global value chains, will benefit from continued demand for E&E products globally. Additionally, E&E growth will be further reinforced by ongoing expansions in domestic production capacity. In the Bank's regional economic surveillance, E&E firms indicated strong order books for the year. The primary-related cluster is also projected to expand. Demand for refined petroleum products is expected increase in line with higher mobility and economic activity, while continued health and hygiene awareness will support demand for rubber and chemical products. Meanwhile, production in the construction-related manufacturing clusters is also expected to grow following the resumption of construction projects and improvement in the residential property market. In addition, growth in the consumer-related manufacturing cluster is projected to improve, in tandem with the recovery in consumption activity. Amid strong external and domestic demand, the increase in production in certain *manufacturing* subsectors such as E&E and chemical products could be affected by pockets of labour shortages and global supply disruptions. Nevertheless, higher adoption of automation and productivity improvements since the onset of COVID-19 pandemic will help to partly offset these factors.

The recovery in the *agriculture* sector will be driven primarily by higher oil palm production. This is premised on expectations for a gradual improvement in labour supply. Heavier rainfall in the early part of the year is also expected to improve soil moisture and increase oil palm yields in the latter part of the year. In addition, the recovery in domestic demand is expected to support the continued strong expansion in livestock and other agriculture subsectors.

The *mining* sector is projected to register higher growth. This reflects the continued increase in crude oil and natural gas production due to the operationalisation of new facilities such as the Pegaga gas project in Block SK320 located in offshore East Malaysia, which commenced operations in March 2022. Growth will also be supported by higher production in existing oil and gas facilities including the PFLNG2 facility and following the completion of several maintenance works. The end of OPEC+ oil output cut agreement by the second half of the year is also expected to result in higher production.

Growth in the *construction* sector is expected to rebound in 2022 following the reopening of the economy. Ongoing construction activity in large infrastructure projects and implementation of small-scale projects under the 2022 Budget measures will support growth in the civil engineering and special trade subsectors. Meanwhile, the residential subsector will benefit from new housing projects and launches, in tandem with the expected recovery in demand as income and employment prospects improve. Growth in the non-residential subsector is expected to be lifted by both existing and new commercial and industrial projects.

## 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 and capital) and productivity.

In 2021, potential output continued to expand at a moderate pace of 2.3% (2020: 1.6%, 2011-2019 average: 4.9%). The expansion was attributable to a marginal improvement in labour force participation (2021p: 68.6%; 2020: 68.4%), and in total factor productivity (TFP). This more than offset slower capital accumulation amidst a continued decline in investment activity (2021: -0.9% 2020: -14.5%).

The faster growth in actual output in 2021 (3.1%; 2020: -5.6%) led to a narrowing of negative output gap to -6.0% (2020: -6.8%). However, the negative output gap remained sizable<sup>27</sup>. This reflects the economic slack arising from the underutilisation of factors of production given the moderate recovery in actual output. The negative output gap has contributed to moderate demand-driven price pressures, as indicated by low core inflation of 0.7% in 2021 (2020: 1.1%). The increase in headline inflation to 2.5% (2020: -1.2%) was mostly accounted for by base effects<sup>28</sup> and cost factors such as elevated commodity prices.

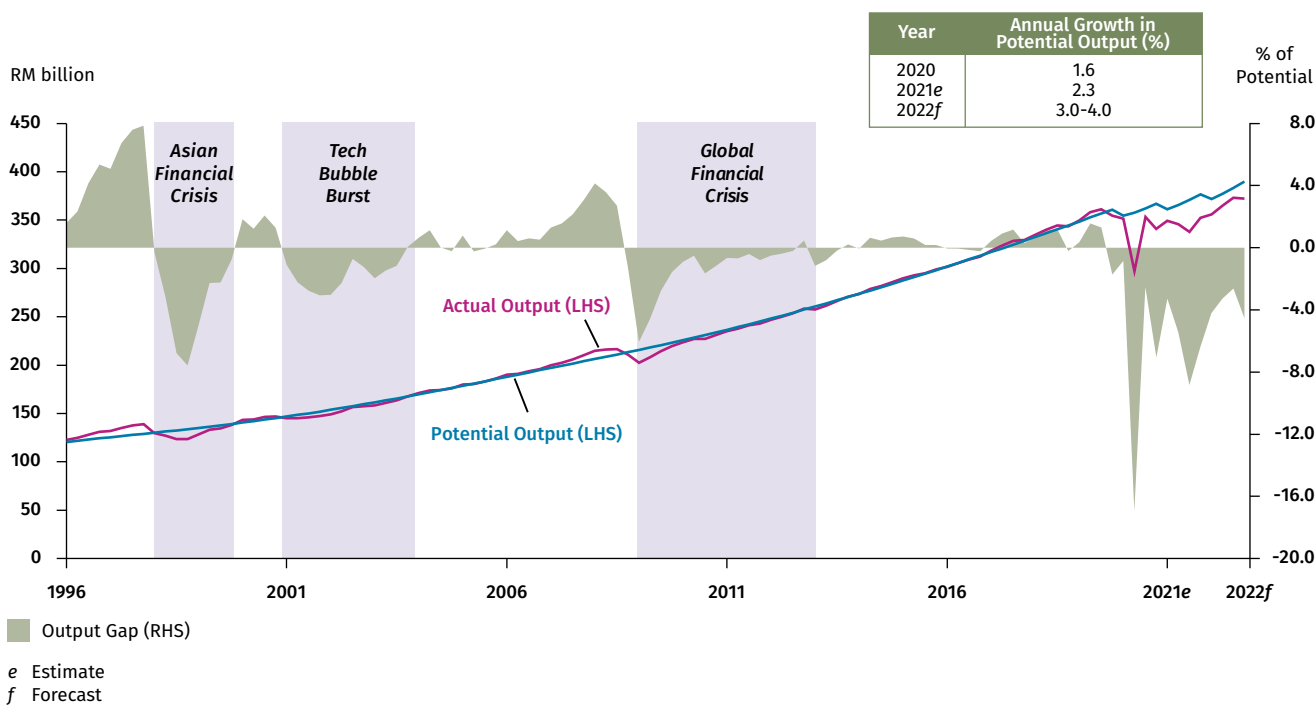
Going forward, the negative output gap is expected to narrow further in 2022, as actual output growth of 5.3%-6.3% is projected to outpace potential output growth of 3.0%-4.0%. Potential output growth will be supported mainly by a recovery in capital expenditure and labour force expansion<sup>29</sup>. Over the medium term, potential output growth is projected to revert to the pre-crisis rate of 4.0-5.0%, as economic activity continues to recover. This will also be supported by the continued progress in automation, digitalisation, and implementation of digital infrastructure projects, which can enhance productivity and technology levels.

<sup>27</sup> The output gap is formally defined as  $\frac{\text{Actual output level} - \text{Potential output level}}{\text{Potential output level}} \times 100\%$

<sup>28</sup> In the second quarter of 2021, fuel inflation surged higher due to base effects following the exceptionally low global oil prices in 2020 (2Q 2021 average domestic fuel (RON95) price: RM2.05/litre; 2Q 2020: RM1.37/litre). For more details, please refer to Chapter 1 Inflation Developments.

<sup>29</sup> Workers are expected to re-enter the labour market following the full lifting of containment measures and normalisation of economic activity.

Chart 1: Actual and Potential Output



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

## Continued export growth in 2022

Malaysia’s exports are expected to grow by 10.9% in 2022 (2021: 26.0%). This is driven by continued external demand, especially from Malaysia’s key trade partners. As one of the world’s largest exporters of electrical and electronics (E&E)<sup>30</sup>, Malaysia will continue to benefit from the strong global demand for E&E products amid the drive for digitalisation and automation. Improvement in commodity production and higher prices of crude oil, LNG and CPO will provide further impetus to Malaysia’s exports.

Manufactured exports are projected to expand by 5.3% in 2022 (2021: 25.6%), supported by a broad-based expansion across all segments. In particular, Malaysia is expected to continue benefitting from strong semiconductor demand in line with the global sales forecast.<sup>31</sup> This is corroborated by insights from the Bank’s regional economic surveillance which suggest healthy order books for E&E firms for 2022.

Commodities exports are projected to remain robust (45.8%; 2021: 29.0%), driven by both higher commodity prices and production in 2022. Exports of agriculture products will be supported mainly by the CPO exports amid the higher prices and expected gradual easing of labour shortage. Meanwhile, minerals export growth is expected to be underpinned by higher prices and production amid the commencement of new gas fields and the end of OPEC+ output cuts in the latter part of 2022.

<sup>30</sup> Malaysia is the twelfth largest E&E exporter based on IHS Markit for 2021 trade data.

<sup>31</sup> In March 2022, World Semiconductor Trade Statistics (WSTS) projected a growth of 10.4% for global semiconductor sales in 2022 (2011-2019 average: 4.1%).

## Import growth supported by continued expansion of manufactured exports and improvement in domestic demand

Gross imports are projected to expand by 8.1% in 2022 (2021: 23.3%), driven by higher intermediate imports in line with continued growth in manufactured exports. Capital imports are expected to register a continued expansion driven by the recovery in investment activity. Consumption imports will be supported by the improvement in consumer spending amid better income and employment conditions.

**Table 1**

### External Trade

	2015-2019 average	2021 <sup>p</sup>	2022 <sup>f</sup>
	Annual change (%)		
<b>Gross exports</b>	<b>5.6</b>	<b>26.0</b>	<b>10.9</b>
<i>of which:</i>			
Manufactured	7.6	25.6	5.3
Agriculture	-0.6	36.8	49.6
Minerals	-3.1	19.5	40.5
<b>Gross imports</b>	<b>4.7</b>	<b>23.3</b>	<b>8.1</b>
<i>of which:</i>			
Capital goods	1.2	14.5	5.3
Intermediate goods	3.1	26.9	8.3
Consumption goods	8.4	13.2	14.0
<b>Trade balance (RM billion)</b>	<b>109.5</b>	<b>252.6</b>	<b>307.5</b>

<sup>p</sup> Preliminary

<sup>f</sup> Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

## Current account to remain in surplus

The current account of the balance of payments is expected to register a higher surplus in 2022 at 4.2 – 4.7% of GDP (2021: 3.5% of GDP). This will be driven by the goods surplus amid continued strength in external demand and higher commodity prices.

The services account is projected to remain in deficit, weighed mainly by transportation services amid continued strength in trade activity. The travel deficit is expected to narrow slightly, supported by the higher travel receipts amid the reopening of international borders to inbound tourists. Nevertheless, the pace of international travel recovery is expected to be gradual and remain below (around 20% of) pre-pandemic levels, given the risk aversion and international travel restrictions that still remain in some places.

The primary income account is projected to record a wider deficit, attributable mainly to the higher income payments accrued to foreign investors in Malaysia amid the improvement in the domestic growth outlook. The secondary income account is expected to register a larger deficit driven by the higher foreign worker outward remittances.

Table 2

**Current Account of the Balance of Payments<sup>1</sup>**

Item (Net)	2021p	2022f
	RM billion	
Goods	170.2	227.9
Services	-61.1	-62.3
Primary income	-46.2	-69.2
Secondary income	-9.5	-20.7
<b>Current account balance</b>	<b>53.5</b>	<b>75.8</b>
% of GDP	3.5	4.2 ~ 4.7

<sup>1</sup> 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

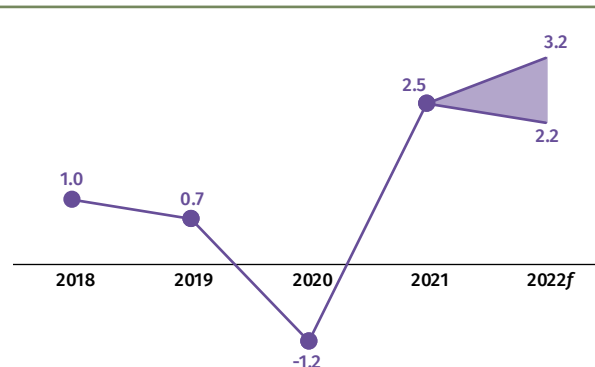
Note: Figures may not necessarily add up due to rounding.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

**Headline inflation to average between 2.2% and 3.2% in 2022 amid higher underlying inflation**

In 2022, headline inflation is forecasted to remain manageable, averaging between 2.2% and 3.2% (2021: 2.5%) (Chart 2.5). Fuel inflation, which underpinned the higher headline inflation in 2021,<sup>32</sup> is projected to moderate in 2022. This is despite expectations of higher global oil prices, given the assumption that the price ceiling on domestic retail fuel prices would remain in place throughout the year. High input costs from rising non-energy commodity prices, however, are expected to exert some pressures on selected fresh food prices, particularly in the first half of the year. Nevertheless, this will continue to be partly mitigated by the price controls on selected food items. Of note, for the second half of 2022, the base effect from electricity prices is projected to contribute to a temporary spike in headline inflation, particularly in the third quarter of 2022.<sup>33</sup>

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



*f* Forecast

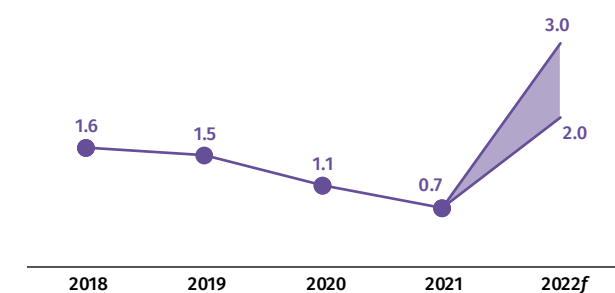
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

<sup>32</sup> In 2021, fuel inflation surged higher due to base effects following the exceptionally low global oil prices in 2020 (2021 average domestic retail fuel (RON95) price: RM2.03/litre; 2020: RM1.67/litre).

<sup>33</sup> Electricity price inflation is expected to experience a temporary spike in the third quarter of 2022 on a year-on-year basis, reflecting the lower electricity prices in the third quarter of 2021 due to the three-month electricity bill discounts implemented from July to September 2021.

Meanwhile, underlying inflation, as measured by core inflation, is expected to average higher between 2.0% and 3.0% in 2022 (2021: 0.7%) (Chart 2.6), driven by the improvement in demand conditions amid lingering cost pressures.<sup>34</sup> For most items in the core Consumer Price Index (CPI) basket, the price pressures in 2022 largely reflect a normalisation after a period of subdued demand and reduced profit margins during the pandemic. However, prices for some CPI segments, such as *food away from home* and some high-touch services<sup>35</sup>, are projected to exceed their pre-pandemic trend due to the confluence of stronger demand and the high cost environment. Nevertheless, the extent of upward adjustments to core inflation will remain partly contained by the continued slack in the economy and labour market.

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

The overall inflation outlook, however, remains susceptible to upside risks, particularly from cost-push factors. These include a more persistent uptrend in input costs due to higher global commodity prices and prolonged disruptions to global supply chains, which could be exacerbated by geopolitical tensions and lockdowns in China. Higher input costs could also induce a larger

pass-through of costs to consumer prices, should businesses expect them to be more permanent in nature. Moreover, there is the risk that excessively high global energy prices could lead to adjustments to domestic retail fuel prices that have remained unchanged since March 2021.<sup>36</sup> On the downside, risks mainly reflect factors which could precipitate a weaker recovery in economic conditions, leading to more benign price pressures. These include larger slack in the domestic economy due to weaker-than-expected demand conditions and labour market recovery, as well as external risks which could derail Malaysia's growth and trade outlook, such as the emergence of severe and vaccine-resistant VOCs.

### Domestic monetary and financial conditions to remain conducive to financial intermediation activities

Domestic monetary and financial conditions are expected to remain supportive of financial intermediation activities, and further catalyse the economic recovery in 2022 amid accommodative monetary policy. Financing activity in the economy will also continue to be underpinned by the sound banking system and well-functioning capital markets.

The lending capacity of Malaysian banks remains intact, given their healthy capital and liquidity buffers. As the economy recovers, banks' willingness to lend is likely to increase amid lower risk aversion and improvement in borrowers' debt servicing ability. Coupled with higher demand for financing by households and businesses to fund consumption and investment activities, credit flows to the private sector are expected to pick up during the year. This is in line with banks targeting a higher outstanding loan growth in 2022.<sup>37</sup> Government and BNM measures, including the targeted repayment assistance and financial management programmes,<sup>38</sup> as well as special funds for SMEs, would also provide support

<sup>36</sup> Refers to domestic retail fuel prices for RON95 and diesel, which have been fixed at the ceiling price of RM2.05/litre and RM2.15/litre, respectively, since March 2021.

<sup>37</sup> Banks' loan growth target in 2022 is 5.4% to 6.4% (2021 actual outstanding loan growth: 4.5%). This is based on the weighted responses of 20 banks, representing 96% of total outstanding banking system loans. Source: 4Q 2021 Credit and Funding Conditions Survey to banks.

<sup>38</sup> Under the Financial Management and Resilience Programme (URUS), borrowers will receive a personalised financial plan that sets out the monthly debt repayment amount scheduled for a period of up to 24 months. It includes an interest waiver for three months; or deferred payments/reduced instalments. There would also be financial advisory support and education throughout the programme.

<sup>34</sup> Cost pressures from elevated global commodity prices and supply-related disruptions are expected to be passed on to consumers to a greater degree as demand conditions improve, as firms recoup compressed margins from the persistently higher costs since 2021.

<sup>35</sup> Including restaurants and hotels, and recreational services. Please refer to the box article on 'An Anatomy of Inflation: Effects from the Prolonged Pandemic' for more details.

for financial intermediation, particularly for vulnerable segments in the economy.

As a highly open economy with substantial linkages to global financial markets, Malaysia is not insulated from the heightened uncertainty and risks emanating from external developments. These include monetary policy normalisation globally and escalating geopolitical tensions. In particular, tighter monetary policies in advanced economies are expected to raise the costs of foreign currency financing globally, increase risks of capital outflows, and result in bouts of volatility in the financial markets. With the large shifts in global liquidity, swings in international investor risk appetites could lead to portfolio rebalancing, which in turn, would affect domestic asset prices, balance sheet valuations, and liquidity in the domestic financial system. In addition, adjustments in global bond yields could spill over to domestic bond yields, leading to higher financing costs.

Nonetheless, as evident in past episodes of capital outflows and heightened volatility, spillovers to domestic financial conditions are expected to be broadly contained. Continuous efforts to strengthen external buffers and economic fundamentals over the years have improved the resilience of the Malaysian economy and financial system against external shocks. Factors supporting this resilience include the continued current account surplus, a healthy external position, and an adequate level of international reserves. Moreover, the presence of domestic institutional investors, as well as deep and liquid financial markets, will facilitate an orderly intermediation of portfolio flows, thus dampening the impact of external financial shocks. The impact from exchange rate fluctuations on domestic financing conditions is mitigated by low reliance on foreign currency financing and availability of hedging facilities for corporates and investors to manage foreign currency exposures. This resilience is vital in ensuring that episodes of capital outflows do not lead to excessive tightening of domestic monetary and financial conditions. Importantly, the flexibility of the exchange rate would also remain as a key shock absorber to facilitate necessary macroeconomic adjustments from external shocks.

Meanwhile, the Bank's monetary policy operations will continue to provide an accommodative monetary environment by ensuring sufficient

domestic liquidity in the financial system to support financial intermediation and orderly functioning of the financial markets. This includes the flexibility provided to banking institutions to comply with the SRR<sup>39</sup> which remains in place until end of the year.

### **Monetary policy will continue to facilitate a sustainable economic recovery while preserving price stability**

Monetary policy in 2022 will continue to support a sustainable economic recovery while preserving price stability. The MPC considers the current stance of monetary policy to be appropriate and accommodative, given the prevailing outlook on growth and inflation for 2022. Going forward, the MPC will focus on ensuring that the degree of monetary accommodativeness is consistent with the expected improvement in economic conditions amid moderate upward price pressures and well-anchored inflation expectations.

Against a background of rapidly evolving conditions and heightened uncertainties, especially in the global environment, the MPC will continue to monitor the outlook for growth and inflation, and the possibility of materialisation of risks. On growth, the downside risks include developments surrounding COVID-19, a weaker-than-expected global growth, ongoing geopolitical conflicts, and a worsening of supply chain disruptions. Considerations for continued monetary policy support would need to be balanced against maintaining low interest rates for a prolonged period, which could lead to an emergence of financial imbalances through excessive risk-taking behaviour and unhealthy build-up in leverage.

The MPC is also mindful of the potential upside risks to inflation, which continue to be subject to global commodity price developments amid risks from ongoing geopolitical conflicts and prolonged supply-related disruptions. While monetary policy may not be the best tool to react to these "first-round" effects, the MPC will assess whether such price pressures could become more persistent and pervasive, and whether they would be reinforced by stronger domestic demand.

<sup>39</sup> Banking institutions are provided the flexibility to utilise MGS and MGII to meet the SRR compliance. This flexibility has been extended to 31 December 2022 from 31 May 2021 previously.

To this end, future monetary policy decisions will continue to be data-driven and guided by the evolving balance of risks surrounding the outlook for domestic inflation and growth. Any potential adjustments to the degree of monetary accommodativeness would be made in a measured and gradual manner. Given the lingering uncertainties and downside risks to growth, monetary policy will remain accommodative, while preserving price and financial stability.

Fiscal policy has played a pivotal role in providing the necessary countercyclical support and remains crucial in providing long-term support to economic development. The measures outlined in the 2022 Budget remain supportive of the economic recovery, and also serve to limit the long-term economic scarring effects from the pandemic. Going forward, the Government is embarking on fiscal reform initiatives to rebuild fiscal buffers and ensure fiscal sustainability. Examples of initiatives include the Fiscal Responsibility Act and the Medium-Term Revenue Strategy.

The recovery period presents a key opportunity to institute structural reforms to ensure a sustainable and inclusive growth going forward. While measures to limit the extent of scarring from the pandemic remain in place, the recovery provides a timely opportunity to prioritise certain structural reforms. The shift towards higher quality investments is essential and must be done in tandem with the development of a future-ready workforce, as well

as an accelerated adoption of automation and digitalisation. The continued push to adopt the Environmental, Social and Governance (ESG) agenda is also critical, particularly to ensure Malaysia remains globally competitive, whilst building a more sustainable and resilient future.

To this end, Malaysia has made important progress in enhancing measures to promote high quality investments, as well as advancing sustainability and digitalisation initiatives. In particular, the adoption of National Investment Aspirations (NIA)<sup>40</sup> into national strategies and the ongoing policy reforms under the New Investment Policy would accelerate the realisation of quality investments in the future. The Twelfth Malaysia Plan (12MP) has laid out further strategies to enhance the education and training ecosystem, intensify digitalisation and accelerate transition to the circular economy. Similarly, the Financial Sector Blueprint 2022-2026 has identified five priorities that would anchor the Bank's efforts to promote a financial system that would support long-term growth, planetary health and shared prosperity. Nevertheless, effective and coordinated execution of all these measures is crucial to ensure the desired outcomes are achieved.

Going into 2022, the overall focus of policies should shift towards long-term objectives of enhancing economic dynamism and increase potential, while balancing the need for short-term relief arising from evolving COVID-19 developments.

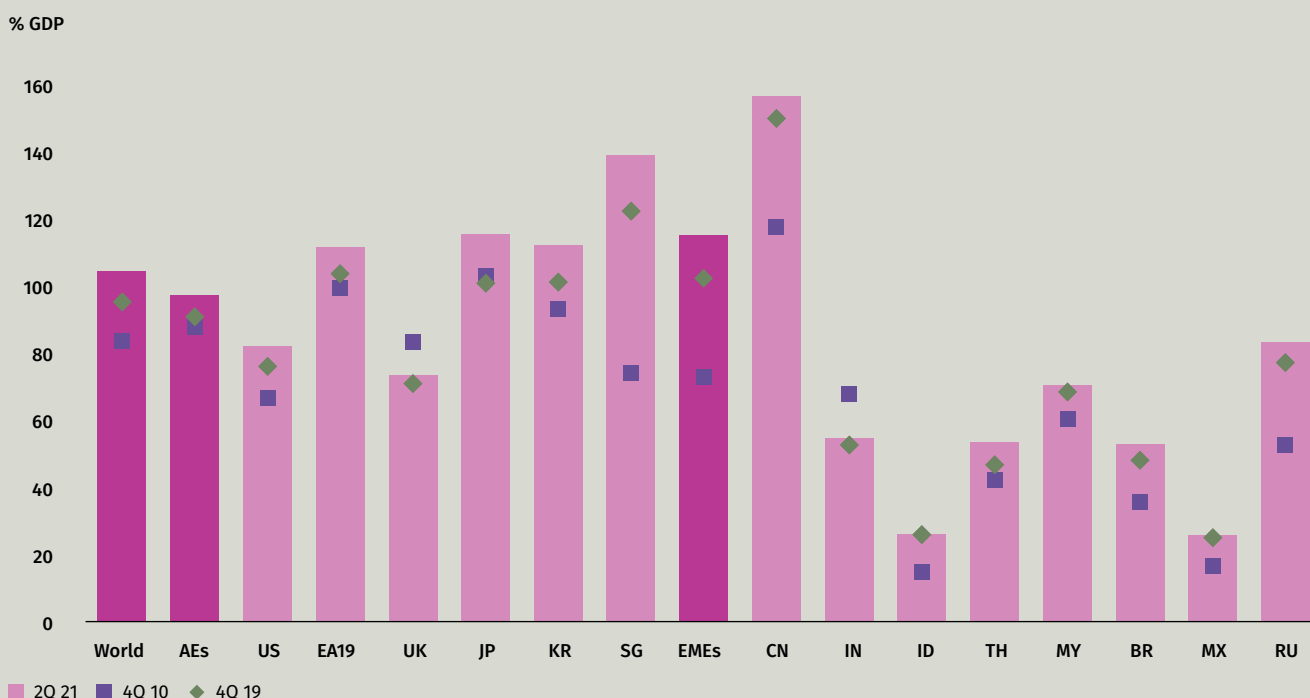
<sup>40</sup> NIA outlines the key criteria for quality investments, which will be used as basis for comprehensive reforms of Malaysia's investment policies. In particular, it focuses on attracting investments that will increase economic complexity, create high-skilled jobs, expand and integrate domestic linkages, develop new and existing clusters, and improve inclusivity. For more information, please refer to the box article titled 'Securing Future Growth through Quality Investments' in the BNM Economic and Monetary Review 2019 and MITI's website (<https://www.miti.gov.my/NIA/>).

## Recovery Prospects in the Global Economy: Lessons from a Corporate Balance Sheet Perspective

### Introduction

Since the COVID-19 pandemic, lockdowns have been one of the policy responses to manage healthcare risks globally. This was especially the case during the early phases of the pandemic. The resultant supply shock, together with the weak demand conditions, meant firms have had to operate amidst highly uncertain conditions and were often unable to generate revenue. For firms that were adversely affected, debt financing helped to tide over periods when revenue and cash flow were affected (Chart 1). Aggressive monetary accommodation and the large fiscal support provided additional support to firms. However, as the pandemic moves past an acute phase, policymakers need to strike a balance between assisting firms that would be viable under less extreme circumstances, while not stifling corporate dynamism vital to future economic growth by protecting non-viable ones, or zombies (Banerjee and Hofmann, 2020). The presence of zombies has been linked with the economic stagnation in Japan during the 1990s and euro area post-Global Financial Crisis (GFC) (Acharya et. al., 2021a; Banerjee and Hofmann, 2020; Hoshi and Kashyap, 2015). This article will cover three main issues, drawing from existing literature. Firstly, it delves into the implications of high corporate debt. Secondly, it looks at Japan and the euro area’s crisis experiences to glean some potential lessons in avoiding a slow and prolonged economic recovery. Thirdly, it concludes with important policy imperatives to secure a sustainable recovery path from the pandemic.

Chart 1: Corporate Debt in Selected Economies



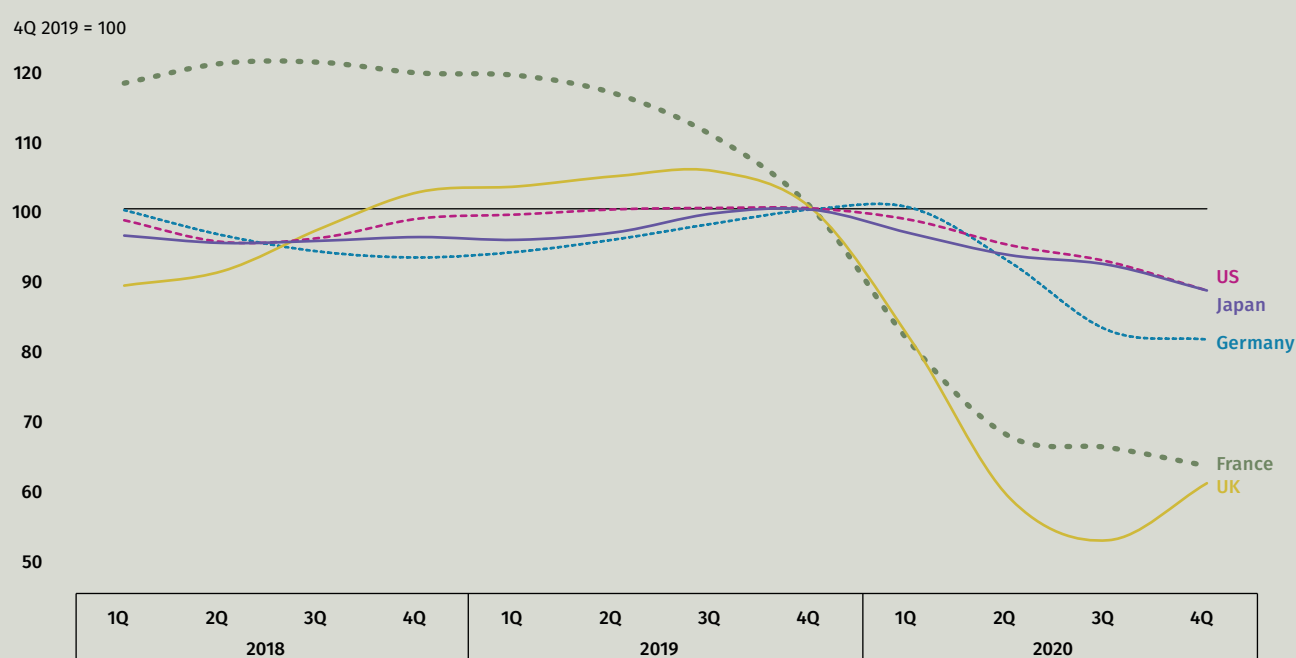
Note: Debt refers to loans and debt securities of non-financial corporates.

Source: Bank for International Settlements (BIS) Credit Database

## Why is High Corporate Debt a Concern?<sup>1</sup>

Corporate debt globally was already at an elevated level at the onset of the pandemic (Roulet, 2020). Hence, the large supply and demand shocks over the past two years increased concerns that corporate bankruptcy would surge, especially if economic recovery was not forthcoming. However, such large-scale bankruptcies have yet to materialise (Chart 2). This risk was mitigated by significant economic and financial support from governments and central banks, which ensured favourable financing conditions and a recovery in demand conditions (OECD, 2021b). Nevertheless, the high level of corporate debt remains a concern during the current phase of economic recovery.

Chart 2: Corporate Bankruptcies in Selected Economies



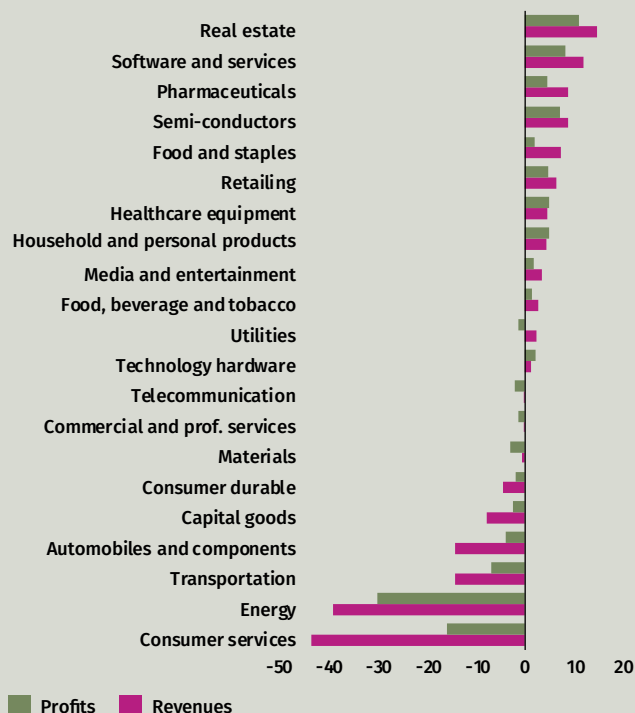
Source: OECD Timely Indicators of Entrepreneurship

Firstly, highly indebted firms tend to reduce investments after economic crises (Kalemli-Özcan et. al., 2019; Barbiero et. al., 2020). This is because they focus on paring down debt instead of investing in new capacity and innovation. However, this has not materialised during the pandemic. Instead, the rise in debt was matched by an increase in short-term and fixed investments (OECD, 2021b). The US is a case in point; investments in equipment and intellectual property recovered strongly in 2021, while structures<sup>2</sup> investments remained weak. This likely owes to higher demand for specific goods and services during the pandemic (Charts 3 and 4), such as communication and digital services and equipment. The recovery in investment was also facilitated by looser monetary policy. In contrast, investments in adversely affected sectors, such as energy, primary-related products (materials) and transportation (industrials), declined. This reflects the pandemic's disproportionate adverse impact in high-touch and travel-dependent services industries. Firm shutdowns and the general decline in movement also reduced demand for energy and fuel, which affected utilities and energy industries.

<sup>1</sup> High corporate debt is also influenced by corporate tax regimes. Interest expenses are deductible from taxable profits. Hence, higher corporate tax rates could incentivise firms, including healthy ones, to accumulate more debt (Graham, 2006; Feld et. al., 2013). However, risks from high corporate taxes are beyond the scope of this article.

<sup>2</sup> Structures refer to physical capital that are constructed at the location where they will be used and typically have long economic lives such as offices and warehouses (Bureau of Economic Analysis, 2018).

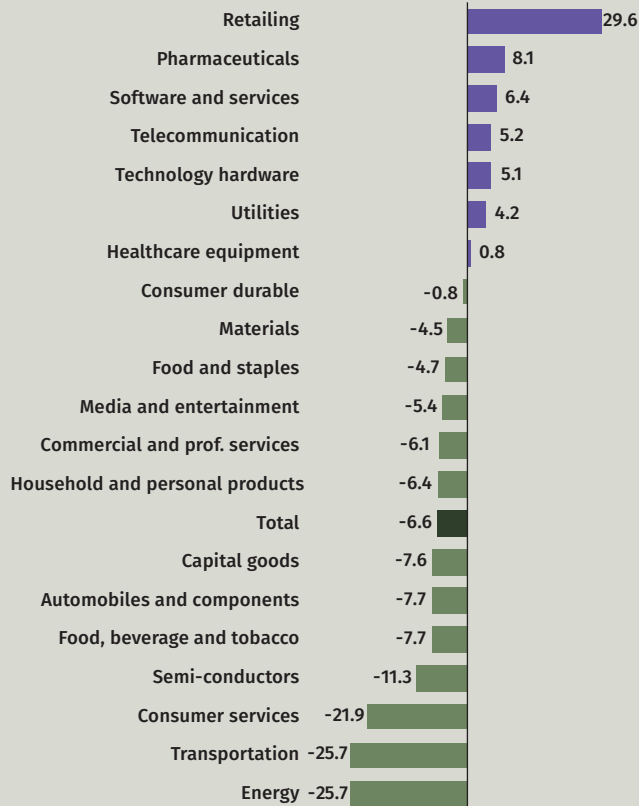
Chart 3: Changes in Revenues and Profits between FY2019 and FY2020 by Industry (%)



Notes: This chart was published in the OECD Economic Outlook (Volume 2021 Issue 1). Profits are measured using earnings before interest, taxes, depreciation, and amortisation (EBITDA). Results are reported for the median firm for each indicator and weighted by the firm's asset size in 2019. The analysis is based on firm-level data provided by S&P Capital IQ. The sample covers 55,000 public and private non-financial companies operating in OECD countries and major (non-OECD) emerging market economies (EMEs), and for which FY 2020 accounts are available. The firms covered are relatively large and collectively represent USD25 trillion of corporate debt. The median firm in the sample had USD30 million in revenues in 2019 and USD35 million in assets. 10% of firms are in EMEs.

Source: S&P Capital IQ and OECD calculations, as cited in OECD (2021a)

Chart 4: Change in Capital Expenditures by Industry (%)



Notes: This chart was published in the OECD Economic Outlook (Volume 2021 Issue 1). Bars show the change in aggregate capital expenditures for each industry. The sample of firms is the same as in Chart 3. According to the OECD (2021a), the investment increase in the retail industry is almost entirely due to the "internet and direct marketing retail" sector, and Amazon in particular.

Source: S&P Capital IQ and OECD calculations, as cited in OECD (2021a)

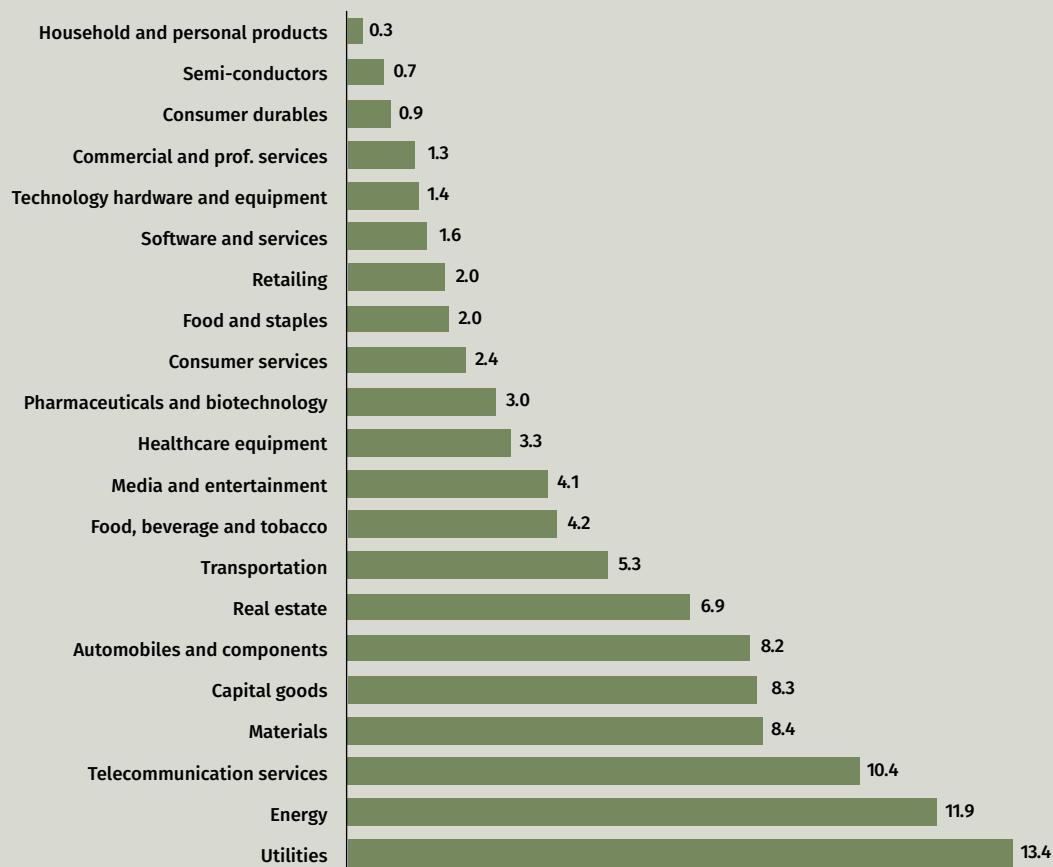
The second source of concern associated with high corporate debt is the declining credit quality of debt. Roulet (2020) found that the share of low credit-quality debt has been increasing between 2004 and 2019, particularly in the US and emerging market economies (EMEs), excluding China.<sup>3</sup> The OECD (2021a) estimated that roughly 30%<sup>4</sup> of non-financial corporate bonds globally was rated 'speculative'<sup>5</sup> and hence, deemed 'risky'. The profile of 'risky' debt among corporate borrowers varies by sector, affecting mainly the energy and utilities sectors (Chart 5). It is important to note that these findings cover mainly large public listed firms. Financial information remains limited for small and medium enterprises (SMEs), who have been disproportionately affected by the pandemic (Chetty et. al., 2020) and account for a large share of debt in high-touch services industries. With interest rates expected to rise, solvency risk remains a concern. This is particularly so if the recovery in the most adversely affected sectors is slow and protracted. This could trigger rating downgrades (for medium and large firms) and defaults amid rising funding costs.

<sup>3</sup> Roulet (2020) used data for 4,670 firms in advanced economies (AEs) and 3,691 firms in emerging market economies (EMEs). The findings highlighted large declines in credit quality of US firms since 2015. The level of debt of risky firms was similar to 2007, before the onset of the GFC. Other EMEs, particularly Latin America, Eastern Europe, the Middle East, and Africa, had the highest levels of risky debt on record. The declining trend in corporate debt quality was more moderate in Advanced Europe, Japan, and China.

<sup>4</sup> The data covered 2,800 public and private non-financial corporates operating in OECD countries and major (non-OECD) EMEs with an active S&P issuer rating.

<sup>5</sup> 'Speculative' indicates high level of credit risk or a default has already occurred.

Chart 5: 'Risky' Debt by Sub-sectors (% share)



Notes: This chart was published in the OECD Economic Outlook (Volume 2021 Issue 1). OECD calculated 'risky' debt as the total debt in firms rated speculative<sup>6</sup> or BBB<sup>7</sup> for 2019. The data covered a subset of a sample of 2,800 public and private non-financial corporates operating in OECD countries and major (non-OECD) EMEs with an active S&P issuer rating. The sample mainly covers large public listed firms incorporated in AEs, but also includes private firms (30%) and/or firms in EMEs (13%).

Source: S&P Capital IQ and OECD calculations, as cited in OECD (2021a)

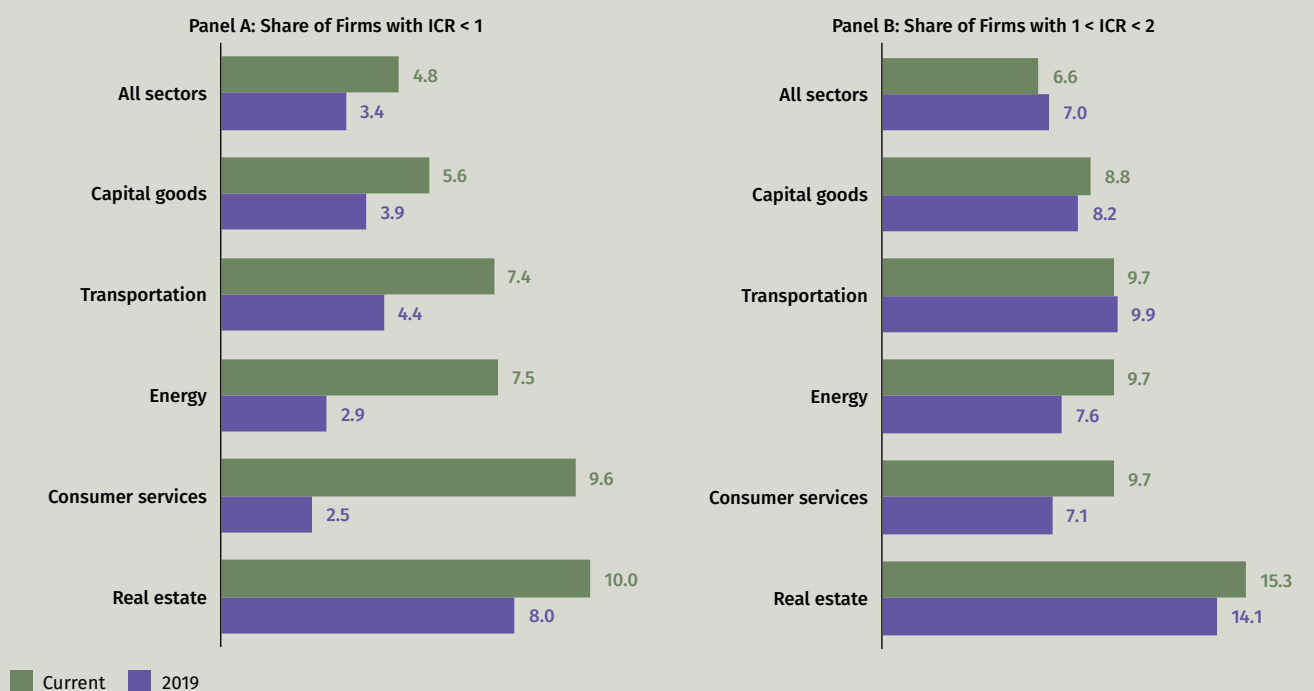
Thirdly, high corporate debt coupled with lower productivity could be symptomatic of rising zombification (Caballero et al., 2008). Zombies can be defined as firms with insufficient revenue to cover loan interest costs (Chart 6) and are dependent on cheap credit to survive<sup>8</sup> (Acharya et al., 2020). Unhealthy banks are more likely to be funding zombies, as their weak balance sheets constrain their ability to absorb losses from zombies' defaults, if they do occur (Andrews and Petroulakis, 2017). This in turn incentivises banks to delay the recognition of losses by rolling over debt. Based on a sample of 14 advanced economies, the share of zombie firms has increased from slightly above 4% in the mid-1980s to 15% in 2017 (Banerjee and Hoffman, 2020). The same study estimated that a quarter of zombies tended to exit the industries, while 60% graduated from zombie status over time (mid-1980s to 2017). However, recovered zombies normally underperform compared to non-zombies and are more likely to fall back into zombie status. This is because weaker profitability among zombies makes them less able to weather economic downturns, compared to non-zombies. More recent research indicates that the number of zombie firms remained contained in France (Cros et al., 2021) and the US (Favara et al., 2021) for 2020. This is likely due to the large magnitude of fiscal support during this period. Nonetheless, the generous financial support, in the form of low interest rates and repayment assistances, has led to concerns on rising zombification, as the pandemic prolongs (Acharya et al., 2020).

<sup>6</sup> 'Speculative' indicates high level of credit risk or a default has already occurred.

<sup>7</sup> Despite OECD's definition, it is acknowledged that BBB firms may not be commonly classified as 'risky', since it is technically still within the 'Investment' grade. 'Investment' grade indicates low to moderate credit risk.

<sup>8</sup> Most studies linked zombies with funding by banks. However, zombies can also be funded via equity issuances (Banerjee and Hoffman, 2020). Denis and McKeon (2020) found that US firms with negative net cash flows often used equity financing, via private placements due to the lower fixed issuance costs, to cover current and subsequent cash flow shortages. Lu et al. (2020) argued that Chinese zombie firms were often supported by the equity market and informal financing, mainly via trade credits.

Chart 6: Share of Larger Firms based on Interest Coverage Ratio (ICR)



Notes: This chart was published in the OECD Economic Outlook (Volume 2021 Issue 2). The OECD analysed 28,000 firms in the S&P database where ICR, the ratio between earnings before interest, taxes, depreciation, and amortisation (EBITDA) and total interest expenses for 2020 or 2021, are available (current ICR). The sample covered medium and large public and private non-financial companies operating in OECD countries and major non-OECD EMEs. ICR below 1 suggests profits are insufficient to pay interest expenses.

Source: S&P Capital IQ and OECD calculations, as cited in OECD (2021b)

The presence of zombies could have negative implications to growth and inflation, directly and indirectly (by affecting non-zombie firms). Firstly, zombies tend to be smaller, less productive and invest less (Banerjee and Hofmann, 2020). A 1 percentage point (ppt) rise in the share of zombies corresponds to a 0.1 ppt drop in productivity<sup>9</sup> growth for the economy.<sup>10</sup> Secondly, the presence of zombies creates excess production capacity, exerting downward pressure on prices (Acharya et. al., 2020). The subsidised credit allows zombies to continue producing despite being less viable. As a result, supply cannot adjust to a drop in demand during crisis, artificially suppressing inflation. For instance, inflation in Europe is estimated to be 0.4 ppt higher between 2012 and 2016, if funding to zombies had not risen. Thirdly, zombies crowd out growth among non-zombie firms by distorting competition in the economy (Caballero et. al., 2008; Banerjee and Hofmann, 2020). Besides depressing prices for their products, zombies also inflate wages by retaining unproductive workers. This has a spillover impact on non-zombies, as the artificially low prices could compress margins of healthy firms, subsequently hampering investments and new entries of non-zombies. A 1 ppt increase in the share of zombies corresponds to a 0.5 ppt drop in investments by non-zombies.<sup>11</sup> The crowding out effect also occurs through misallocation of resources (e.g., credit and government assistance) to zombies. The presence of zombies impedes the flow of resources to more productive firms, affecting the growth and survival of non-zombies. In short, zombies have a long-term impact on the economy as they are not only less productive, but they hinder growth of healthy firms.

<sup>9</sup> Proxied by Total Factor Productivity (TFP)

<sup>10</sup> Calculated based on firm-level data from 14 countries - Australia, Belgium, Canada, Switzerland, Germany, Denmark, Spain, France, UK, Italy, Japan, Netherlands, Sweden, and the US (Banerjee and Hoffman, 2020).

<sup>11</sup> Calculated based on firm-level data from 14 countries - Australia, Belgium, Canada, Switzerland, Germany, Denmark, Spain, France, UK, Italy, Japan, Netherlands, Sweden, and the US (Banerjee and Hoffman, 2020).

## Lessons from Past Crises

In this section, we draw lessons from past crises in avoiding slow and protracted recoveries. We look at episodes in Japan and the euro area – the Japanese asset bubble burst (1989 to 1992) and banking crisis (1997), and the 2008 GFC and sovereign debt crisis in the euro area (2010 to 2012). These crises are different compared to the pandemic, but the concern on rising zombification provides common ground. Zombie lending, compounded by the slow recapitalisation of banks, was found to be a key reason behind the economic stagnation in Japan and euro area (Hoshi and Kashyap, 2015). Insufficient policy responses and lack of structural reforms also contributed to the prolonged stagnation. This indirectly leads to the creation of more zombies, which tend to emerge during periods of downturns (Banerjee and Hoffman, 2020). A potential explanation is the two-fold impact of downturns – lower revenue hurts firms’ ability to service debt, while the increased reliance on debt<sup>12</sup> may come at the expense of future productivity<sup>13</sup>.

### (i) Delayed and Insufficient Policy Responses

During the GFC, monetary policy was eased in Japan, US, and euro area. However, differences in the speed and magnitude of the easing could explain the varying impacts on growth and inflation across the three countries (Hoshi and Kashyap, 2015). In particular, the US acted relatively quicker. The Federal Open Market Committee (FOMC) reduced policy rates to zero and deployed unconventional monetary policy tools, namely quantitative easing and forward guidance. As a result, it saw a relatively fast recovery and averted deflation. In contrast, euro area and Japan experienced a delayed recovery and deflation or low inflation. Concerns over the commodity price-wage spiral at the onset of the GFC in the euro area (Kang, Ligthart, and Mody, 2016; Hetzel, 2016) and the already low interest rate in Japan (Shirakawa, 2008) were among factors that could have explained differences in the speed and effects of policy responses compared to the US.<sup>14</sup> The experience in these economies underscores a broader policy dilemma. Low interest rates mitigate short-term impact of crises and thereby contain the rise of zombies, which tend to emerge during downturns. However, keeping rates too low for too long prolongs the life of zombies. This could hurt long-term productivity, stagnating economic growth.

Fiscal support in Japan following the early 1990s asset price declines was also insufficient to cushion the initial downturn (Hoshi and Kashyap, 2015; Posen, 1988). According to Posen (1998), only one-third of the originally announced fiscal measures were implemented. Only in 1995 did the government introduce a larger fiscal package, which led to an outperformance in growth (Hoshi and Kashyap, 2015). However, the withdrawal of these measures just before the Asian Financial Crisis led Japan back into recession by late 1997. Moreover, Japan was facing diminishing return for its public investments by the early 1990s, limiting the impact of its fiscal spending (Doi and Ihuri, 2009).<sup>15</sup> Meanwhile, lack of fiscal support in euro area during the GFC stemmed from limited fiscal space (Hoshi and Kashyap, 2015; Lachman, 2012). In addition, the lack of a fiscal union prevented more uniform support across different Member States. This in turn adversely affected banks’ ability to raise capital via private funding, which is discussed further below. This was in contrast to the US, which introduced of the Troubled Asset Relief Programme (TARP) to stabilise its financial system.<sup>16</sup>

<sup>12</sup> Firms borrowing to sustain operations during downturns.

<sup>13</sup> As explained in the previous section, highly indebted firms tend to reduce investments after economic crises (Kalemli-Özcan et. al., 2019; Barbiero et. al., 2020). To repair their balance sheets, firms focus on paring down debt instead of re-investing in new capacity and innovation initiatives.

<sup>14</sup> Prior to the GFC, Japan was in a position where the low interest rate was ineffective in stimulating economic activity (i.e. liquidity trap) (Akram, 2016). In this environment, other policy tools, such as fiscal, had to be relied on to restore demand (Akram, 2016). There were also concerns that further rate cuts approaching zero would create market distortions, by sustaining low quality borrowers, including zombies (Hoshi, 2013; Acharya et. al., 2021a).

<sup>15</sup> Doi and Ihuri (2009, Chapter 3) found the marginal productivity of public investments declined by the early 1990s, particularly for transportation, agriculture-related, and flood control and forest conservation industries.

<sup>16</sup> TARP was a USD700 billion fund created during the 2008 GFC. It enabled the purchase of the equity or capital of corporates or financial institutions, and consisted of five programmes to stabilise banks, support the automotive industry, restart flow of credit to small businesses and consumers, prevent avoidable foreclosures, and invest in the American International Group (AIG). (US Treasury, accessed online via <https://home.treasury.gov/data/troubled-assets-relief-program/about-tarp> on 3 February 2022)

(ii) Lack of Structural Reforms

Weak growth in the aftermath of the crises was also due to the lack of structural reforms to increase long-term productivity and potential GDP (Hoshi and Kashyap, 2015). These included the lack of reforms in Japan to address rigidities in the labour market<sup>17</sup> that hindered the efficient reallocation of labour to more productive sectors in the long run. This labour market rigidity also prolongs the life of zombies, instead of facilitating an organic exit and entry of new firms after a crisis. In the euro area, the high tax burden and relatively high unemployment benefits also resulted in an inflexible labour market (IMF, 2013a; IMF, 2013b; IMF, 2013c; IMF 2014). In addition, weak firm-level competition contributed to higher input costs while government fiscal consolidation, which was still in progress, left less space for fiscal support during crises (Lachman, 2012). The slowdown in sectoral reallocation of labour and adoption of new technologies led to weak productivity and economic growth (Kollman et. al., 2016). It is worth noting that in contrast to France, Spain, and Italy, Germany was more successful in implementing labour market reforms (Deutsche Welle, 2003). Germany reduced hiring cost by lowering the premium for its national healthcare system and limited the duration of unemployment benefits. Job placement services were also enhanced through a decentralised approach and an increase in the ratio of counsellors to jobseekers.

(iii) Delayed Recovery of Banks' Balance Sheets

Efforts to recapitalise Japanese and European banks were not forthcoming, leading to slower recognition of bad loans and balance sheet recovery among its banks (Collignon, 2012; Hoshi and Kashyap, 2015). In Japan, this was driven by fears of a public outcry against the government bailing out banks using public funds. In the euro area, there was also reluctance among stronger countries to bail out banks in weaker member countries. One of the adverse implications of undercapitalisation in the banking sector is credit misallocation (Peek and Rosengren, 2005). Specifically, it incentivises banks to roll over borrowings to potentially non-viable firms rather than classifying loans as non-performing (i.e. evergreening<sup>18</sup> of loans).<sup>19</sup> This allows banks to avoid recognising losses which would further deteriorate their balance sheets. This sustains zombie firms instead of allowing creative destruction to occur naturally and reduces the flow of credit to more productive firms. Kalemlı-Özcan et. al. (2019) found that highly indebted firms explained the depressed post-crisis corporate investments in Europe. The effect was strongest for firms with large short-term borrowings, reflecting greater rollover risk, with links to weak banks. The effect was also more apparent in peripheral euro area member countries, such as Greece, Ireland, Italy, Spain, and Portugal, with high exposure to domestic sovereign debt.

## Policy Imperatives

As the global economy navigates through the recovery amidst the pandemic, several policy implications can be drawn from lessons offered by past crises.

(i) Timely, Direct and Proportionate Support

Policy support needs to be timely, direct, and proportionate to the size of economic shocks. During the pandemic, most countries met these conditions as they took swift and aggressive actions to support households and firms, especially during the initial lockdown (OECD, 2022). Now that we are past the acute phase of crisis, and with demand conditions improving along with elevated inflation, we are faced with different challenges. Importantly, this includes charting a path of normalising the policy stance. If kept

<sup>17</sup> Japan's lifetime employment system, called the Subsidy for Employment Adjustment, was created in 1975 to avoid redundancies by implementing furloughs, transferring workers to related companies, and internal retraining (Hoshi and Kashyap, 2015). Subsidising firms to maintain employment helps to minimise job losses during crises but may hinder labour reallocation to more productive sectors or firms.

<sup>18</sup> There have been recent guidelines to monitor banks' handling of bad debt. However, there is still scope for abuse and evergreening practices to occur. For instance, banks in Europe can resolve bad loans by renegotiating payment terms, if they feel repayment is still possible (European Banking Authority, 2015). However, there have been cases of abuse in which banks renegotiate with the sole intent of avoiding write-downs (reduction of asset value), rather than reclassifying loans as bad loans (Fredriksson and Frykström, 2019). This leads to continued extension of credit to zombies.

<sup>19</sup> Caballero et. al. (2008) showed that evergreening of loans, proxied by the share of bank customers receiving subsidised credit, rose substantially in Japan from around 5% of firms in the early 1990s to about 30% in the late 1990s. Acharya et. al. (2019 and 2021b) found that undercapitalised banks in Europe increased credit supply to zombie firms while reducing lending to non-zombie firms, relative to better-capitalised banks after the GFC and during the sovereign debt crisis. For instance, credit growth to zombies from undercapitalised banks increased by 2 ppt in Portugal, following an unexpected rise in capital requirement (Blattner et. al., 2019).

for too long, policy accommodation, including low interest rates and generous regulatory forbearance, could lead to rising zombification and affect long-term productivity (Acharya et. al., 2021a). Policymakers will need to carefully weigh the trade-offs between the short- and long-term gains for a more sustainable recovery. As economic recovery gains traction, further government support could be made conditional on firms' viability (Banerjee and Hofmann, 2020). This could be supported by a focus on firms' pre-pandemic profitability and post-pandemic prospects.

(ii) Structural Reform is Key to Enhance Resilience

Beyond short-term measures, structural reforms are key to address long-term weakness and raise the economy's ability to weather downturns. These reforms could include investing in digitalisation in a post-pandemic era. Measures should also be taken to facilitate the efficient movement of labour to expanding firms or sectors. While job retention schemes have supported more than 50 million jobs globally during the pandemic, the recovery phase should now focus on protecting viable jobs, without hindering reallocation (OECD, 2020). For instance, Malaysia's latest five-year economic plan emphasizes the need to create high quality jobs and enhance job matching services, coupled with upskilling and reskilling efforts (Economic Planning Unit, 2021). These measures do not just target the ones retrenched during the pandemic, but those potentially displaced due to automation.

In terms of addressing zombies, policymakers should strengthen insolvency laws to enable easier exit of non-viable firms and smoother restructuring of viable firms (Andrews et. al., 2017). Reducing frictions in the corporate bankruptcy process, such as reducing processing time and personal costs to entrepreneurs, may speed up resource reallocation. For still-viable firms, facilitating a smooth restructuring helps them adapt quickly in a new environment. This includes enabling continued access to credit or a more diversified source of funding and reducing red tape. For instance, Norway passed a temporary act (the 'Restructuring Act') during the pandemic to assist still-viable firms to negotiate payments with their creditors, through a more flexible legal framework (Arntzen de Besche, 2020). This allowed firms to begin negotiations earlier, with simpler processes.<sup>20</sup> For Malaysia, out-of-court debt resolution platforms such as the Corporate Debt Restructuring Committee (CDRC) and Small Debt Resolution Scheme (SDRS) enable viable firms to restructure without resorting to lengthy, costly, and complex legal proceedings (Bank Negara Malaysia, 2021a). These platforms were further enhanced to allow more firms to benefit.<sup>21</sup> Viable firms struggling to service debt obligations can also utilise court-sanctioned rescue mechanisms, under the Companies Act 2016 (CA 2016).<sup>22</sup>

(iii) Maintaining Well-Capitalised Banks is Vital for Macroeconomic and Financial Stability

In times of weakness within the financial sector, accommodative monetary policy needs to be accompanied by a targeted bank recapitalisation programme (Acharya et. al., 2020). This helps to restore banks' balance sheet, which is crucial since zombie firms are normally funded by less healthy banks (Andrews and Petroulakis, 2017).<sup>23</sup> Due to post-GFC reforms, capital positions of banks have strengthened (Bank for International Settlements, 2021; Financial Stability Board, 2021) alongside strengthened resolution and recovery plans for banks in times of stress. This provided crucial countercyclical buffers, which banks could draw down on during downturns. As a result, banks remained largely resilient, averting the need for large-scale recapitalisation during the pandemic. This allowed banks to cushion, rather than amplify the economic shock at the height of the pandemic. For instance, banks in Malaysia were able to extend debt repayment assistance to affected households and businesses, while sustaining lending activities (Bank Negara Malaysia, 2021b).

<sup>20</sup> For example, the court can choose not to appoint a creditor committee if the debtor's business is small or if the case can be handled by the leader of the restructuring committee alone (Arntzen de Besche, 2020). This reduces the number of layers involved in the restructuring process and thus, saves time.

<sup>21</sup> In 2017, the CDRC admission criteria was broadened by lowering the minimum debt threshold from RM30 million in 2010 to RM10 million. In September 2020, the SDRS was absorbed into the Credit Counselling and Debt Management Agency (Agensi Kaunseling dan Pengurusan Kredit, AKPK) to utilise AKPK's established online channel and create a one-stop platform on holistic debt restructuring to reach more micro, small and medium enterprises (MSMEs) (Bank Negara Malaysia, 2021a).

<sup>22</sup> The CA 2016 introduced two new rescue mechanisms, namely the Corporate Voluntary Arrangement (CVA) and Judicial Management (JM), in addition to the widely used Scheme of Arrangement (SOA) (Bank Negara Malaysia, 2021a).

<sup>23</sup> Hence, reducing private costs to banks associated with letting zombie firms default and swiftly resolving non-performing loans (NPLs) could disincentivise evergreening by banks (Andrews and Petroulakis, 2017).

## Conclusion

Since its trough in 2020, global growth has rebounded swiftly in 2021, aided by large-scale economic and financial support. However, the path ahead is far from certain. There remain risks which could derail recovery prospects from this pandemic. This article highlights the risks stemming from high corporate debt, as many firms had to increase leverage to sustain their operations during the pandemic. If left unaddressed, high debt held by non-viable firms (zombies) could affect long-term productivity. Policy lessons drawn from selected crises episodes indicate that the key is to achieve a delicate balance between short and long-term needs. As we move past the acute phase of the pandemic, longer-term reforms to address economic vulnerabilities and ensuring the health of the banking system are vital.

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