社会经济研究中心

SOCIO-ECONOMIC RESEARCH CENTRE

Quarterly Economy Tracker (Jul-Sep 2017)

Malaysia: Gaining ground, preparing for future

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Agenda

Global economy is gaining momentum

A broadening base for domestic growth

2018 Budget – Preparing for the future

Conclusion

Key messages

Global economy on upswing, but risks remain

- Global growth outlook remains favourable
- Confidence rising, sustained recovery in manufacturing and trade
- Policy reforms to raise the growth potential; declining productivity growth

Malaysia faces challenges in a position of strength

- The Malaysian economy is gaining ground
- Policy actions needed to boost growth, competitiveness and productivity
- Address as well as contain vulnerabilities to build economic resilience

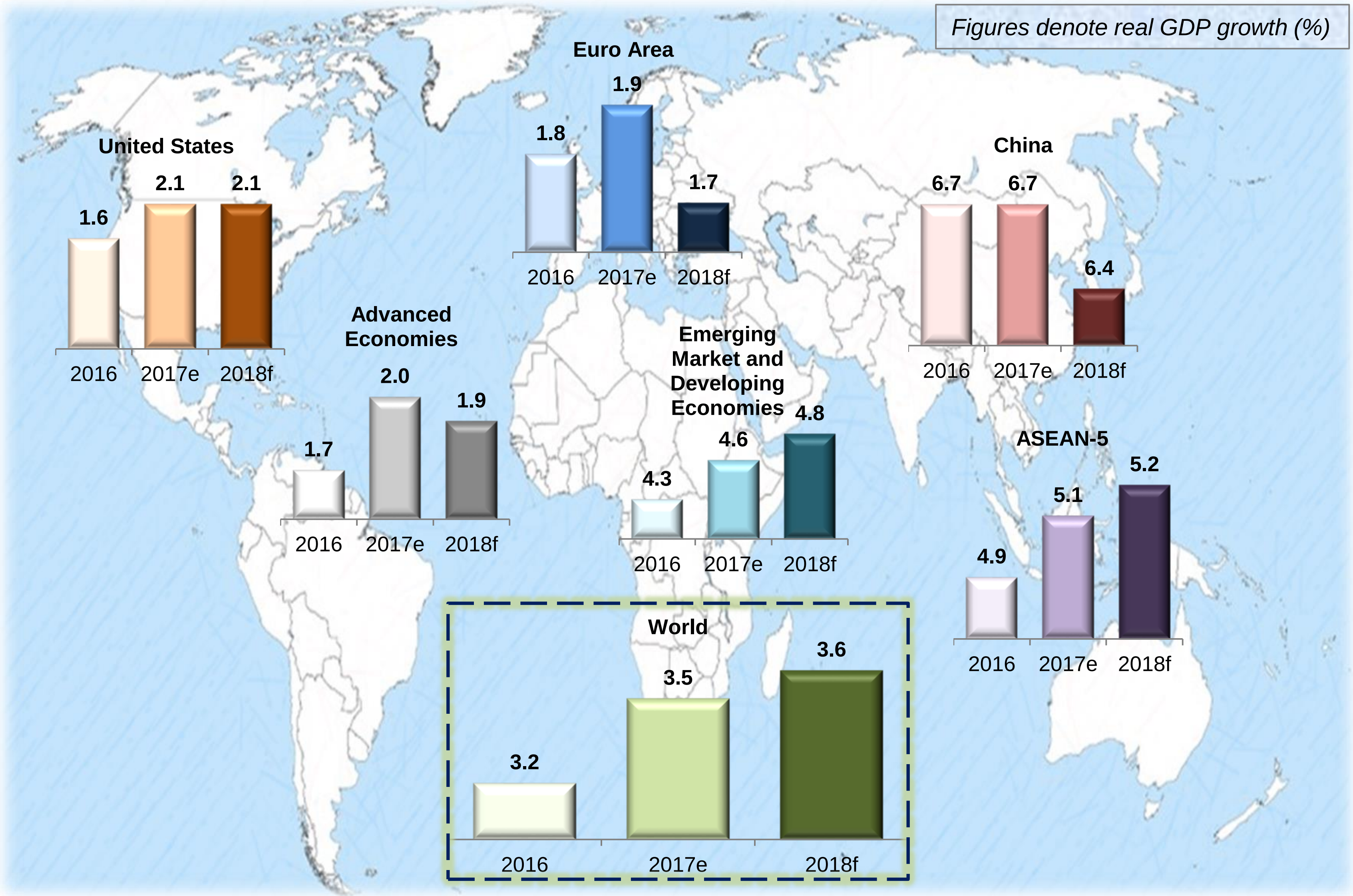
2018 Budget: Preparing for the future

- Fiscal consolidation continues; optimization of expenditure
- Re-engineer strategies and re-shaping competitiveness
- Focus on domestic demand, connected economy, and e-commerce

Section 1:

The Big Picture in review…

Global economy is in a synchronised recovery

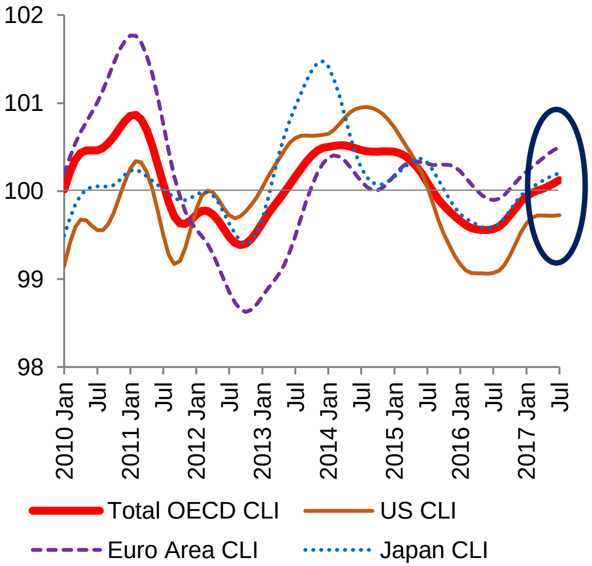


Source: IMF (WEO July 2017)

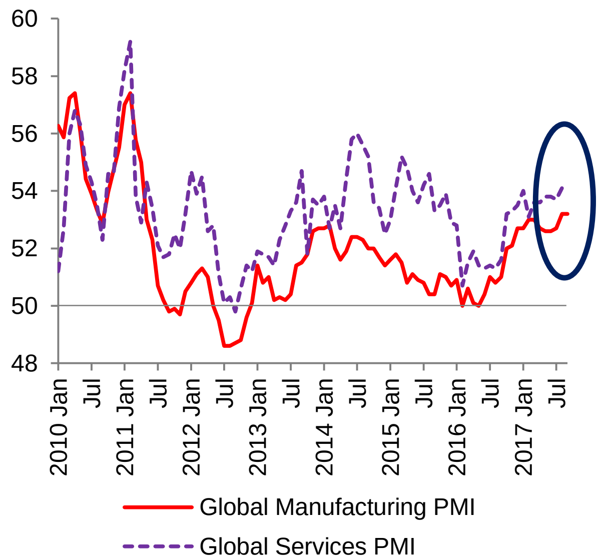
Global indicators point to steady global growth ahead

- Macro optimism comes from potential cut taxes, boost fiscal spending and loosen regulations.
- Markets are more focused on the prospects of the Trump's reflationary policies and less on the risk of policy shifts or other undesirable geo-politics outcomes.
- OECD Composite leading indicators and PMIs suggest upside risks to global growth.

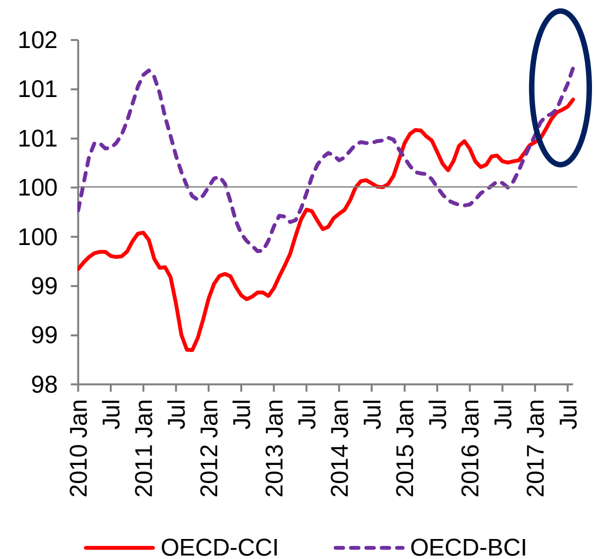
OECD composite leading indicators still steadying



Global PMI for manufacturing and services on uptrend



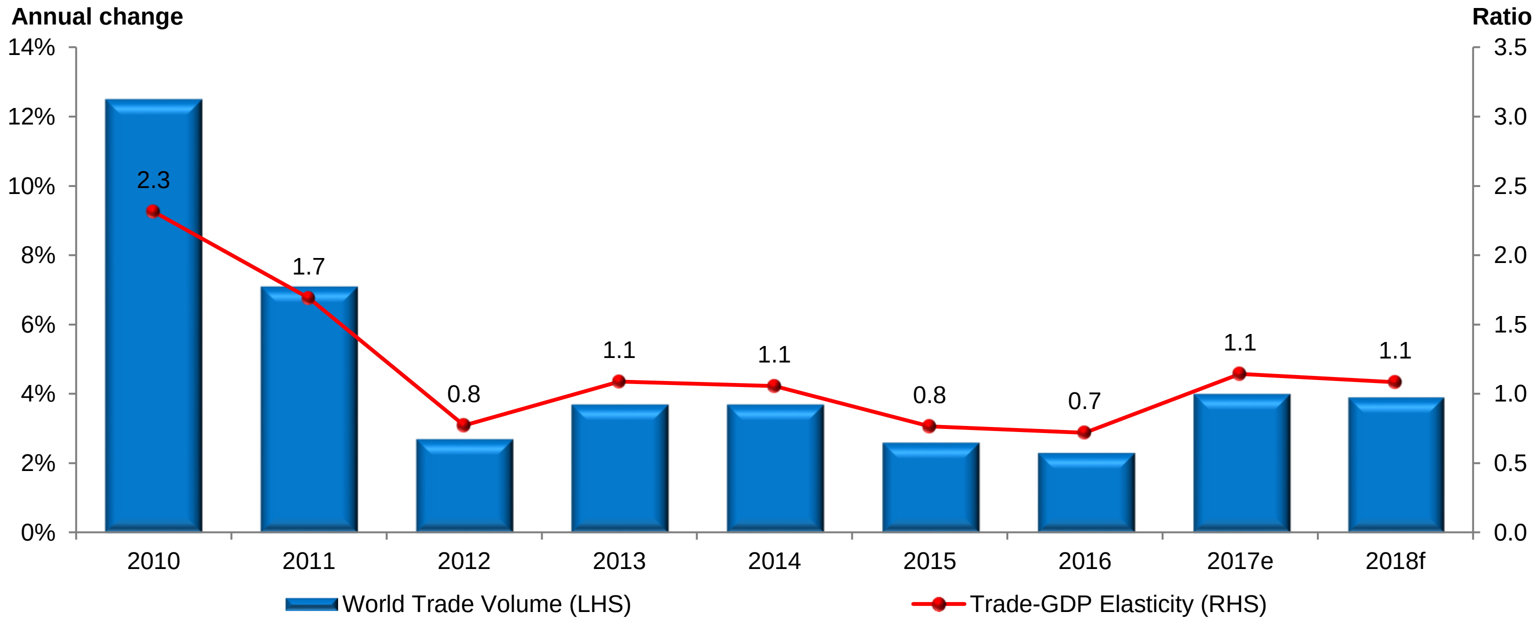
Business and consumer confidence trending higher



Source: OECD; Markit

Global trade rebounding but risks remain

- WTO revised upwards this year's global trade growth to 3.6% vs. IMF's 4.0% (1.3% in 2016) from 2.4% previously. For 2018, global trade growth is estimated at 3.2% vs. IMF's 3.9%.
- Rebounding trade growth is supported by accelerating economic growth and rising import demand in China and the United States, which spurred trade within Asia.
- Trade to GDP ratio, which had slumped to about 1.1x since the GFC from 2.0x, should rise to above 1.1x in 2017-18.

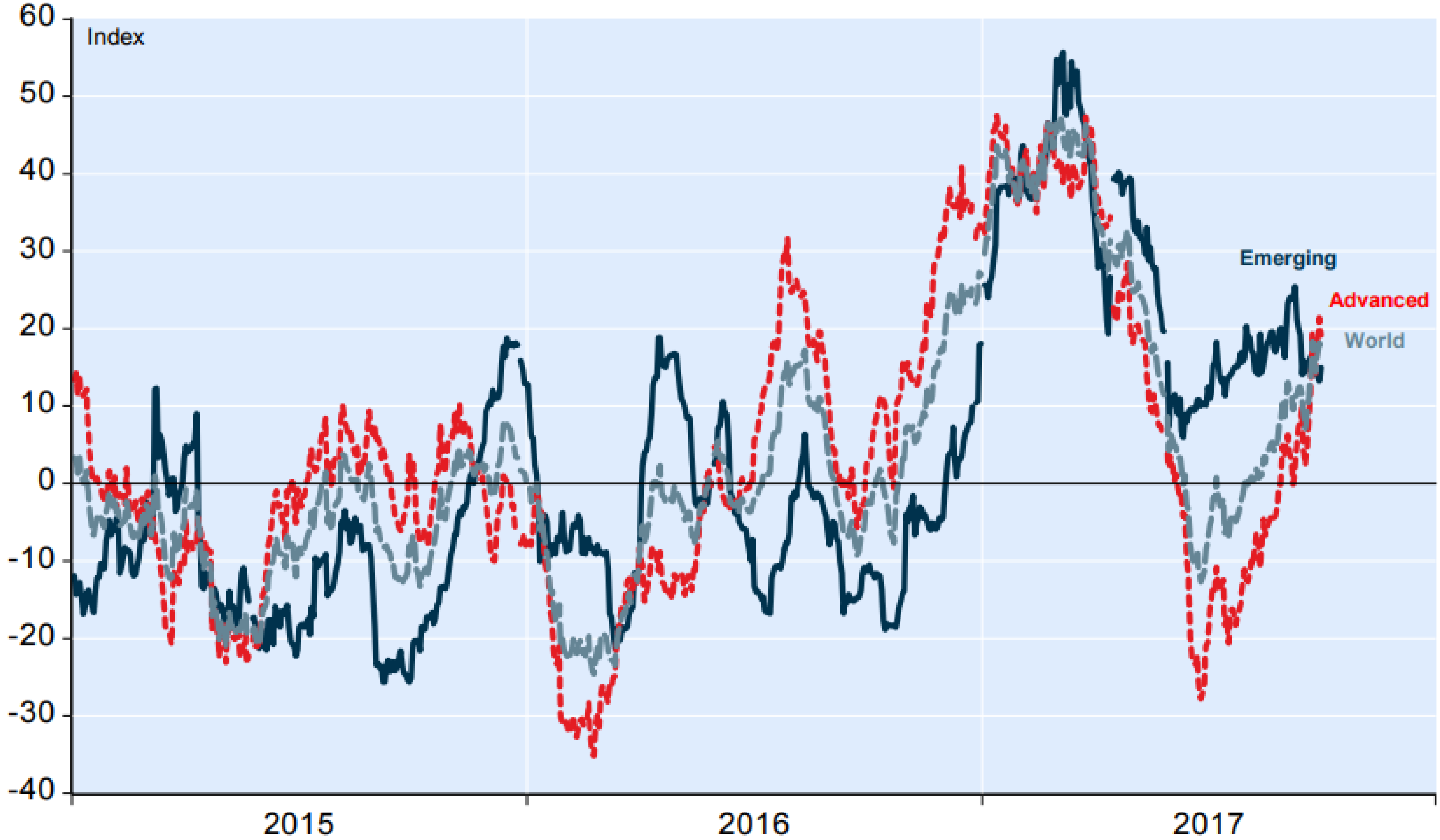


Source: IMF (World Economic Outlook); SERC's computation

Economic surprise index shows widespread improvement

World: Positive economic surprises

Citi economic surprise index for World, Advanced and Emerging markets



NBF Economics and Strategy (data via Bloomberg)

The Fed embarks on the "Great Unwind"

- Potentially, this policy change would impact on the US dollar, US bond yields, and capital flows as well as periods of volatility. But, it is expected that this "Great unwinding" transition will not be as eventful as some fear.
- **First**, the scale of reduction in the Fed's balance sheet in the next few years will be nowhere near as large as the increase during the expansion phase.
- **Second**, some of the effects of balance sheet normalisation may already be factored in the market. The FOMC is very unlikely to shock the market by announcing a more hawkish path than this expectation implies, the impact of the event itself may be rather muted.
- **Third**, the effect of balance sheet tightening may be offset by the Fed adopting an easier path for short term interest rates than it otherwise would have chosen.
- The key point is that the Fed's future stance of monetary policy will be determined by the combination of balance sheet normalisation and the path for the Fed funds rate.

The Fed is determined to avoid a repeat of the 2013 "taper tantrum"

What to expect from the Fed's shrinking balance sheet?

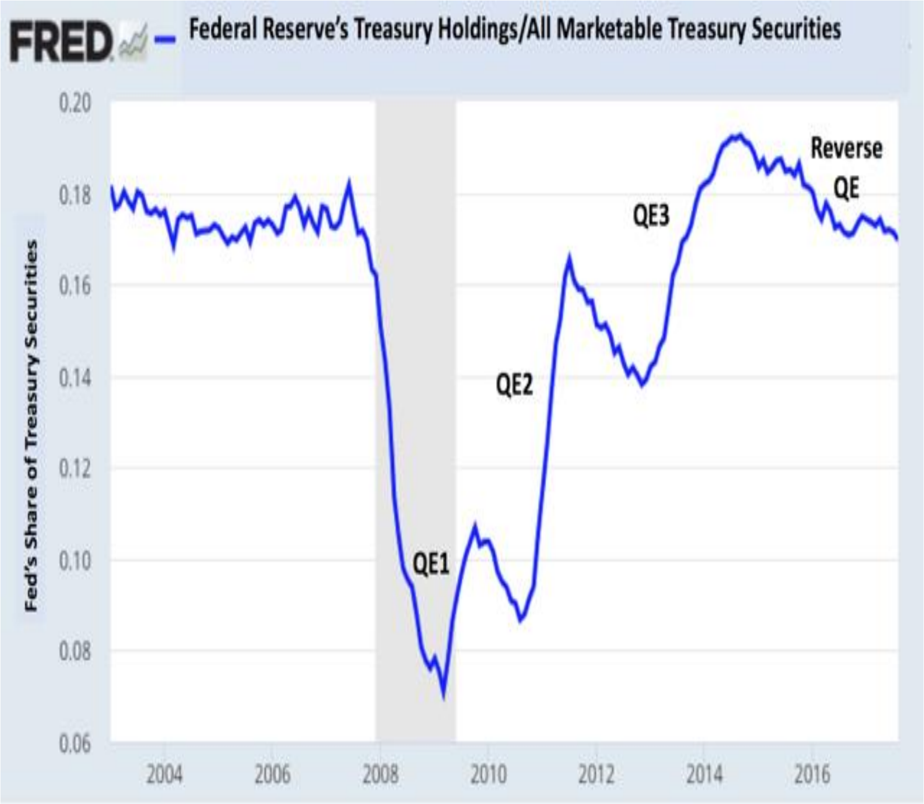
- Less than US$900 billion before the GFC to about US$4.5 trillion today—including about US$2.5 trillion in Treasuries and US$1.8 trillion in mortgage-related securities.
- The Fed will allow US$10 billion to roll off initially, increasing quarterly in US$10 billion increments until the total hits US$50 billion starting in October 2017.
- Potentially, this policy change would impact on the **US dollar**, **US bond yields, and capital flows**.

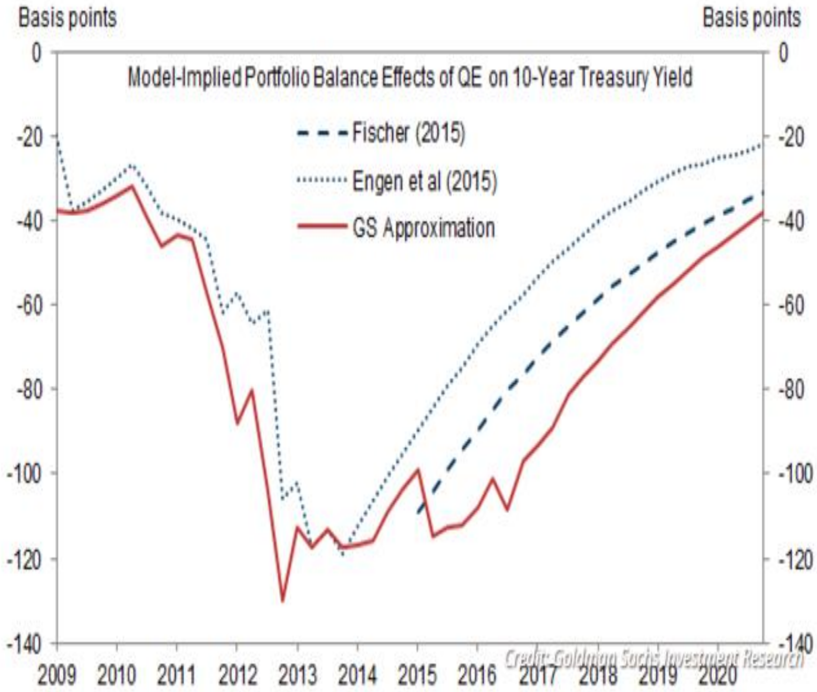
Scale	Market	Interest rate
• US$6bn per month for Treasuries at 3-mth intervals over 12 mths until it reaches US$30bn per month • Mortgage-backed securities, tapering US$4bn per month initially at 3-mth intervals over 12mths until it reaches US$20bn per month	• Some effects of the reduction may be already factored in the market • Unlikely to shock the market by announcing a hawkish path	• Future monetary policy stance will be decided by the normalization of interest rates and unwinding of balance sheet • Balance sheet shrinking will be offset by the adoption of easier short-term interest rate path

To avoid a repeat of the 2013 "Taper tantrum"

The Great Unwinding: What happens to Treasury Yields?

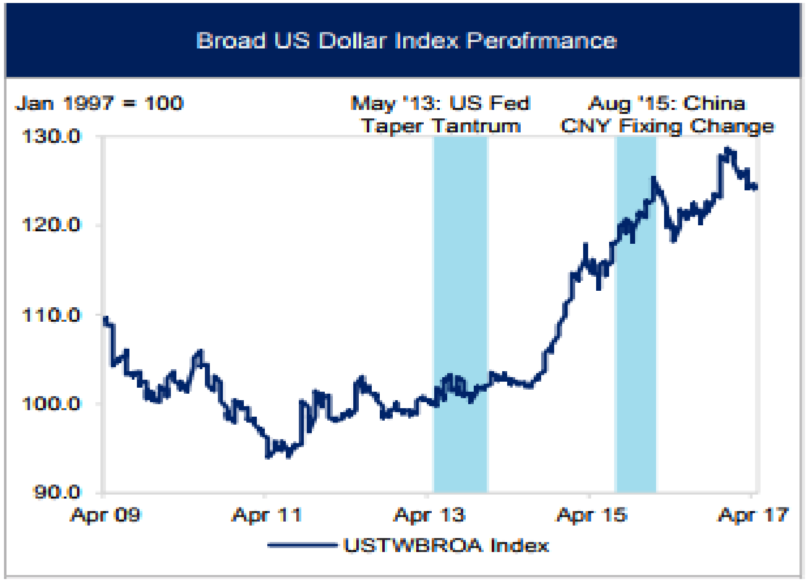
- Fed's QE program effect: Reduced 10-year term premium (bond yield) by 120 basis points in 2013; and reduced the dollar effective exchange rate by 4.5-5.0%.
- It is estimated that the gradual runoff of the Fed's US$4.5 trillion portfolio could drive the 10-year Treasury yield up 15-20 basis points every year.
- End-2017E: 10-year Treasury notes at 2.40%; End-2018F: 10-year Treasury notes at 2.60-80%

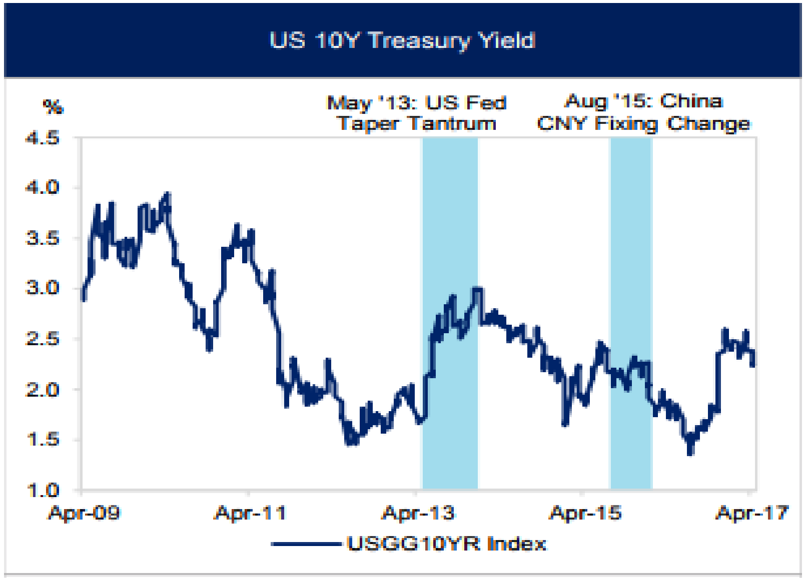


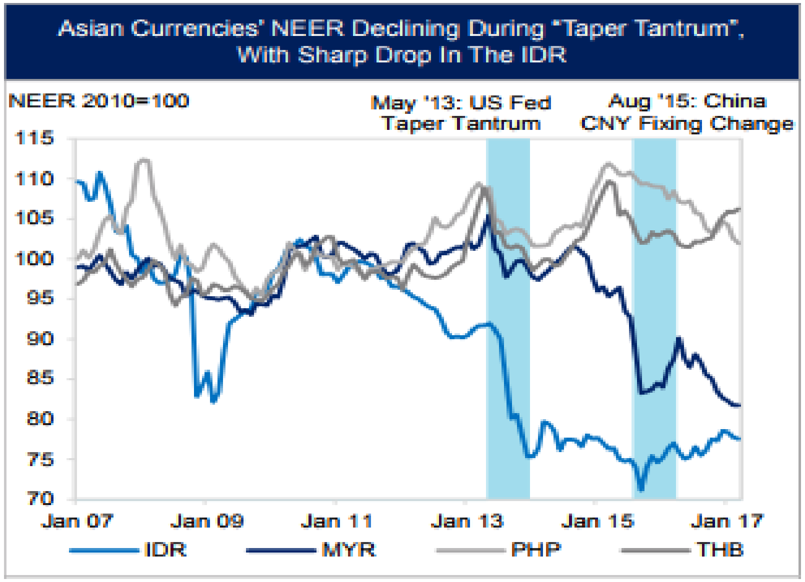


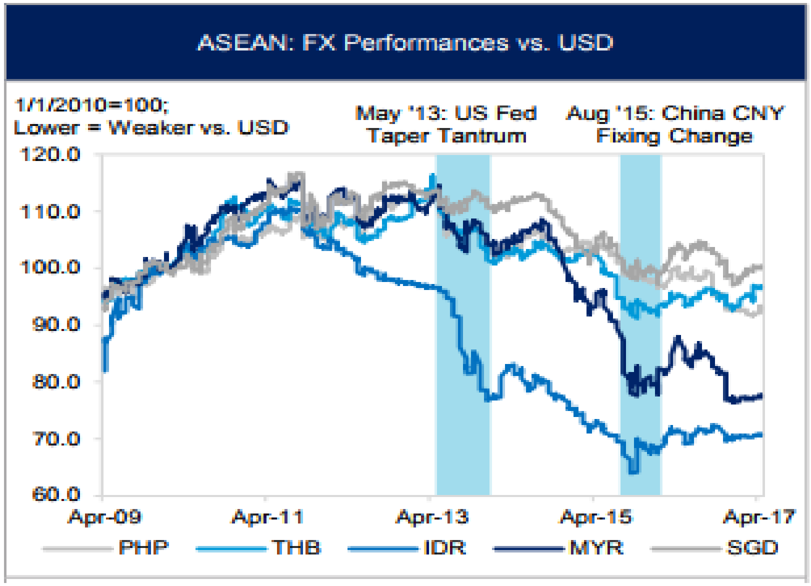
By Goldman Sachs' estimates the balance sheet reduction should hurt stocks and bonds. The red line shows the steady decline of the term premium as the central bank cuts its holdings of government paper.

ASEAN currencies to cope with mild corrections



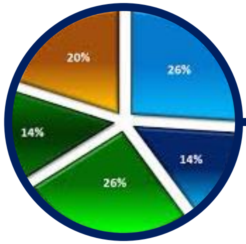






Source: UOB

Malaysia is in a position of strength to withstand negative shocks



Diversified economic and trade structure

Structural transition towards high-value added sectors with varied export products and markets

Well-developed and resilient financial system

Strong capital and liquidity buffers with continued access to financing

Adequate reserves and manageable external debt

Ample international reserves and increased foreign asset holdings act as buffer against external shocks

Policy space and flexibility

Flexible exchange rate and monetary policy space

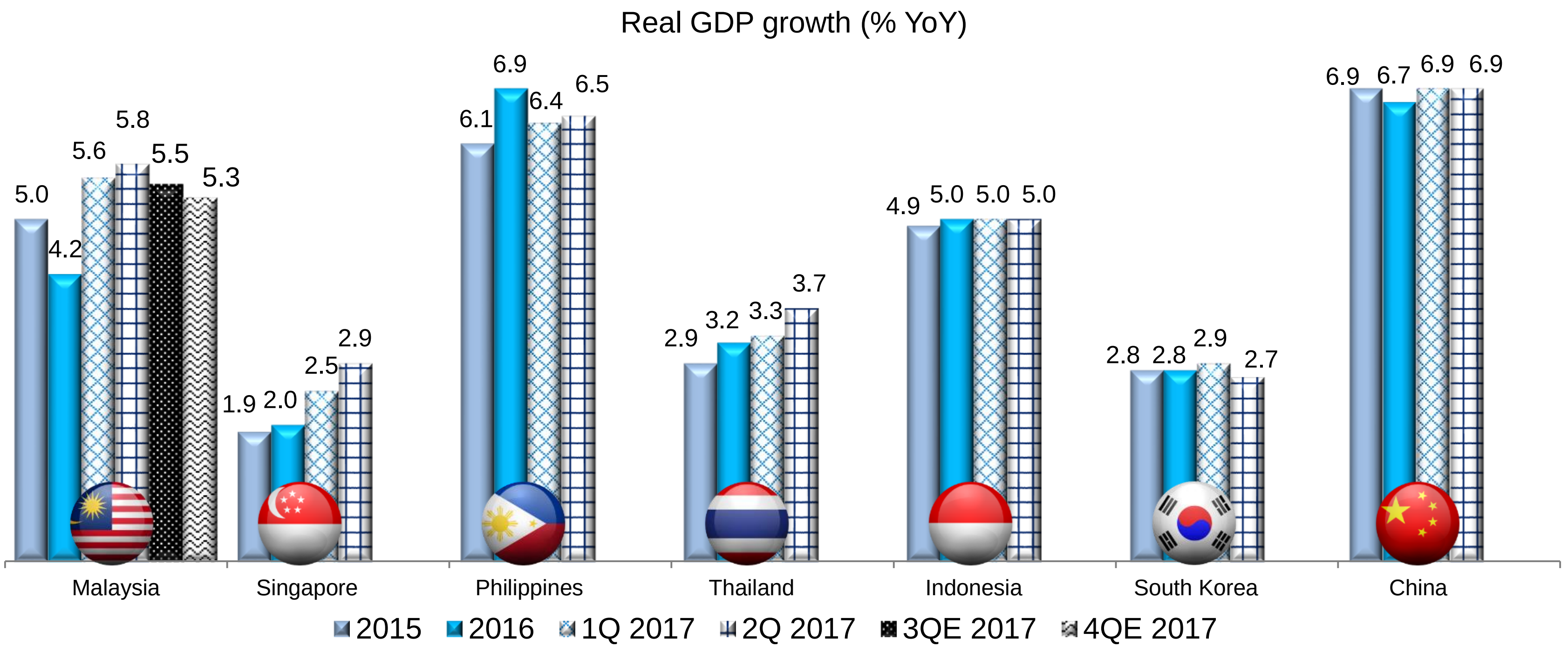
Section 2:

Malaysia: Turning around, looking for growth

The Malaysian economy is gaining ground

- The economy is looking up as the headwinds of past two years dissipate.
- The economy held up strongly (5.7% yoy in 1H17 vs. 4.1% in 1H16), the highest in more than two years. 2017's economic growth will hit 5.5% and estimated 5.1% in 2018.
- Resilient domestic demand, improving prospects for exports and corrective policy steps.

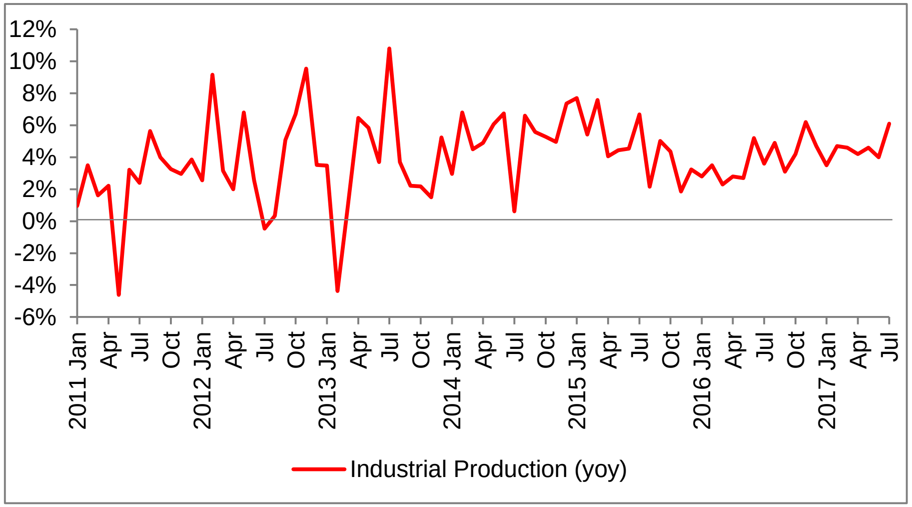
Malaysia was among the fastest-growing economies



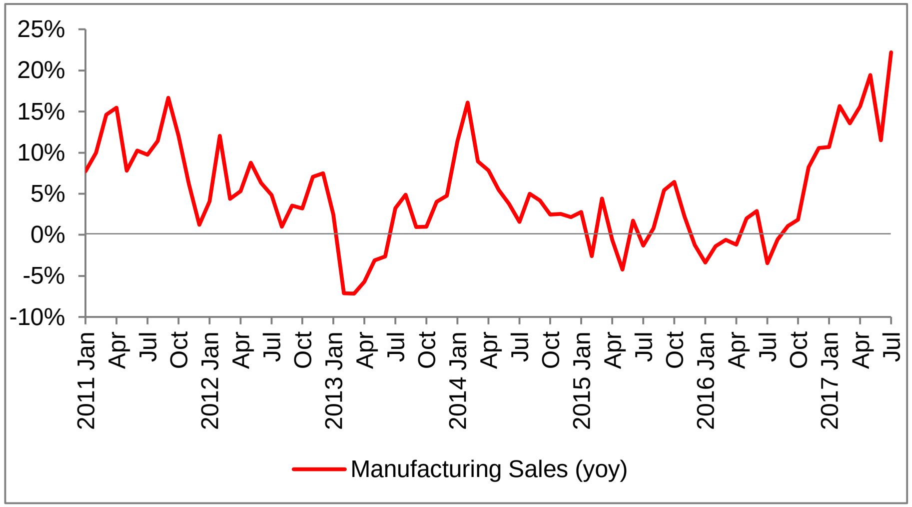
Source: Various officials

Snapshot of real economic and sentiment indicators

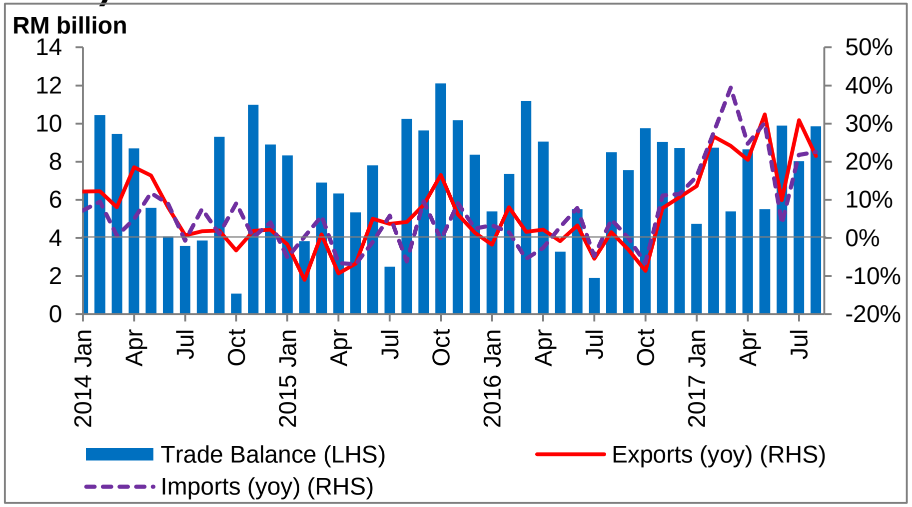
Industrial production grew steadily



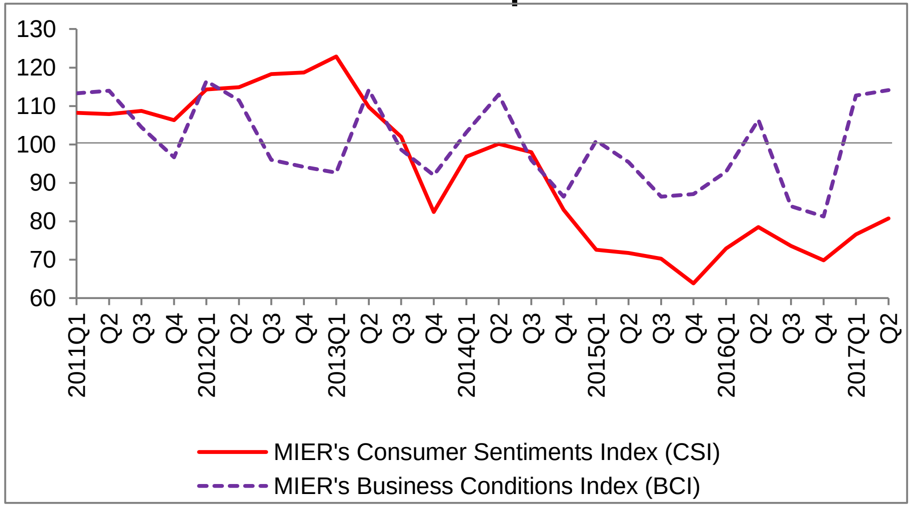
Manufacturing sales recorded highest growth since March 2010



Exports still growing at a robust pace (22.2% in 8M17)



Business condition improves while consumer sentiment still below the 100pt threshold

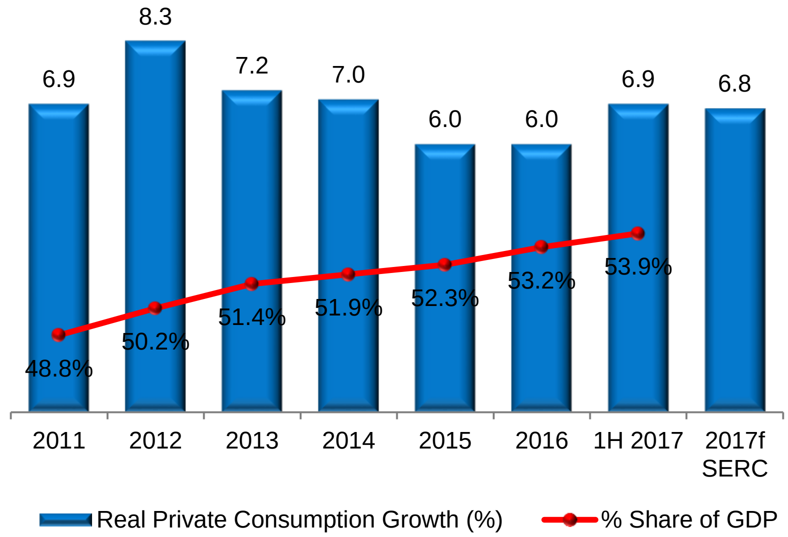


Source: DOS, Malaysia; MIER

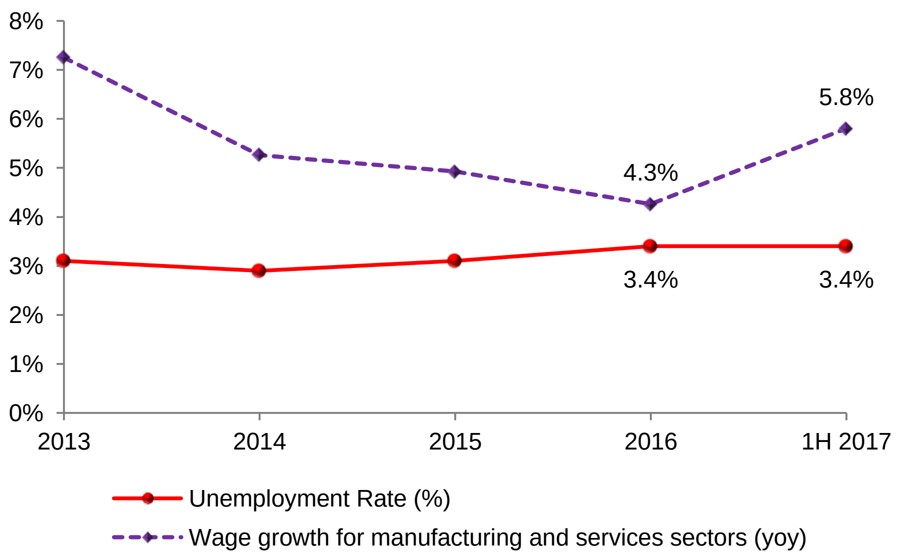
Private consumption still powering the economy

- Resilient consumer spending (6.9% yoy in 1H17; 2017E: 6.8%).
- Factors underpinning consumer spending: employment, wage growth, commodity income and income-support measures.
- Private consumption will remain the dominant driver of growth (2016-2020F: 6.4% pa vs. 7.1% pa in 2011-15).

Real private consumption growth trend (% YoY)



Stable labour market conditions

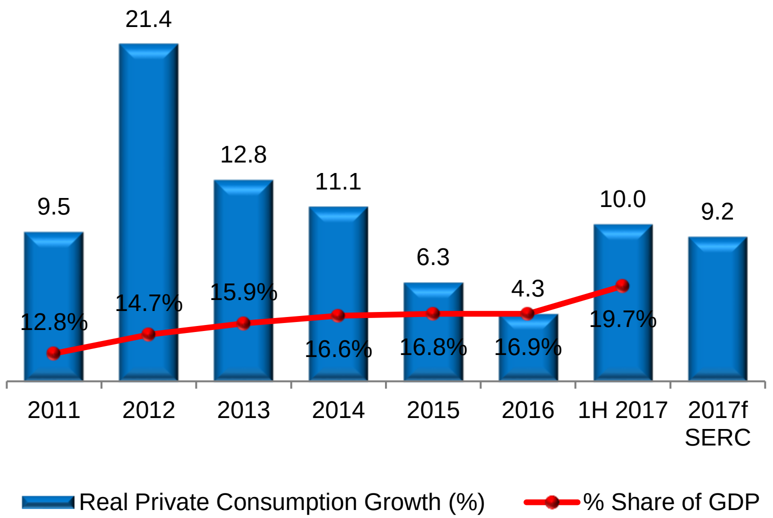


Source: DOS, Malaysia; SERC

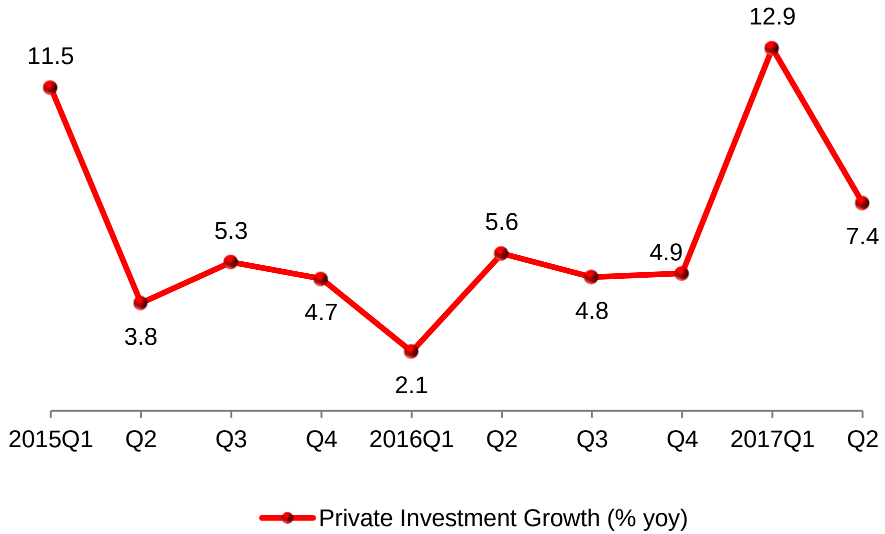
Private investment makes a strong comeback

- Private investment staged a strong expansion of 10.0% yoy in 1H2017 after trapped in lower growth trajectory since 2Q 2015.
- High capital spending in the services and manufacturing sectors.
- Uncertainty ahead of GE14 may temper private investment (2017E:9.2%, 2016-2020F: 8.2% pa vs. 12.2% pa in 2011-15).

Real private investment growth trend (% YoY)



Quarterly real private investment growth (% YoY)

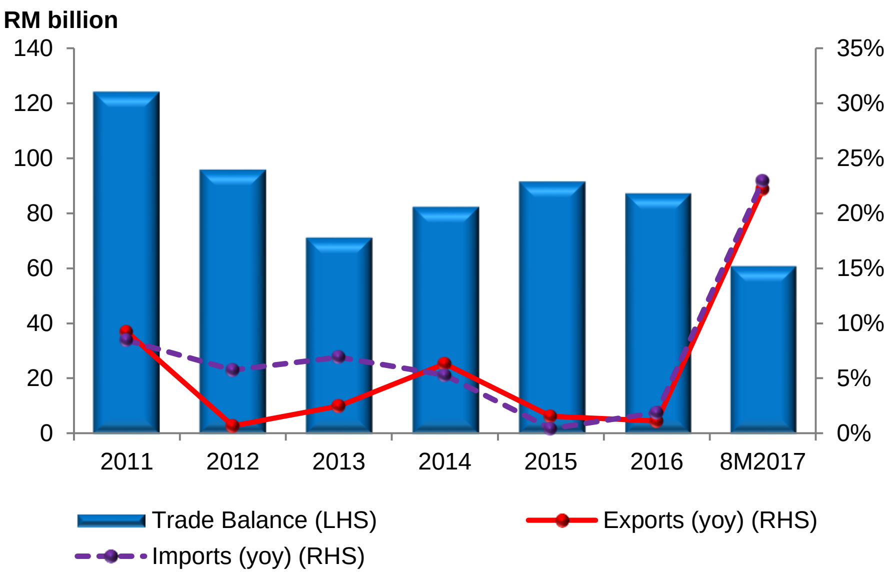


Source: DOS, Malaysia; SERC

Exports swing from a drag to a driver of growth

- Exports have staged a strong recovery since Nov 2016 (estimated 17.5% in 2017 vs. 1.2% in 2016). Exports are projected to rise by 7.5-9.5% pa in 2018-2020.
- Three fundamental drivers: improved global demand, tech demand and higher commodity prices. Base and weak exchange rate effects have inevitably played some part.
- Risks to trade could come from trade protectionism and disruptive policies in advanced economies.

Exports bounced back strongly



Source: DOS, Malaysia

Higher exports across the board

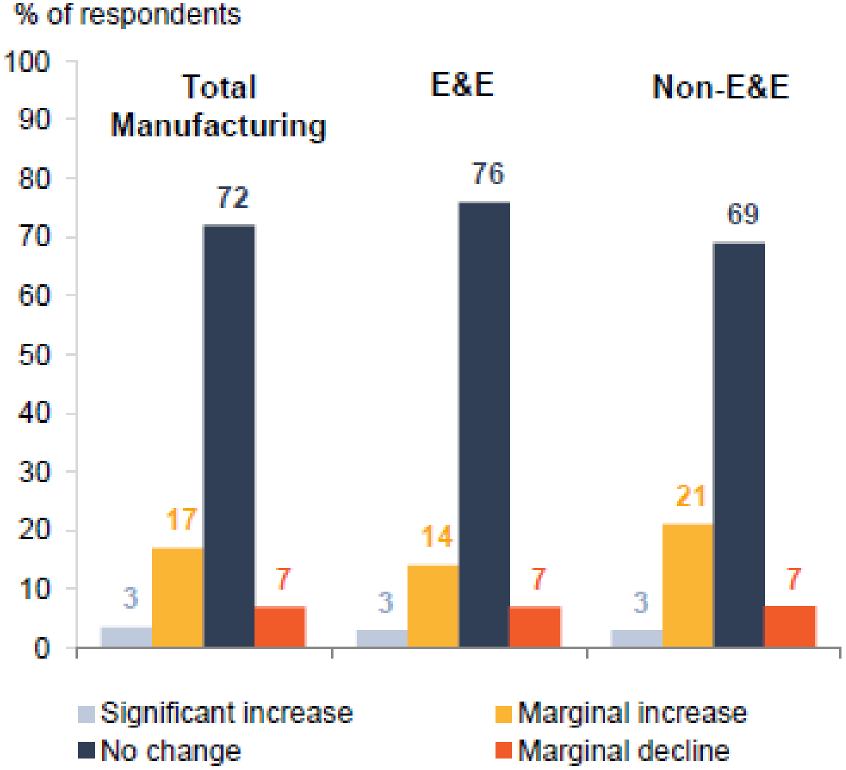
Major export products	2016	8M2017
Electrical & electronics (36.6%)	3.5%	21.4%
Chemical, with products (7.5%)	7.0%	18.3%
Petroleum products (6.9%)	-0.1%	43.6%
Palm oil (5.3%)	3.3%	18.8%
Machinery equipments (4.8%)	4.2%	6.9%
Manufacturers of metal (4.2%)	-4.3%	8.6%
Liquefied natural gas (4.1%)	-28.2%	34.6%
Optical & scientific equip. (3.7%)	10.2%	12.2%
Crude oil (2.8%)	-14.6%	33.2%
Overall gross exports	**1.2%**	**22.2%**

Parenthesis indicates share of overall gross exports in 2016

Malaysian ringgit not sole contributor of higher exports

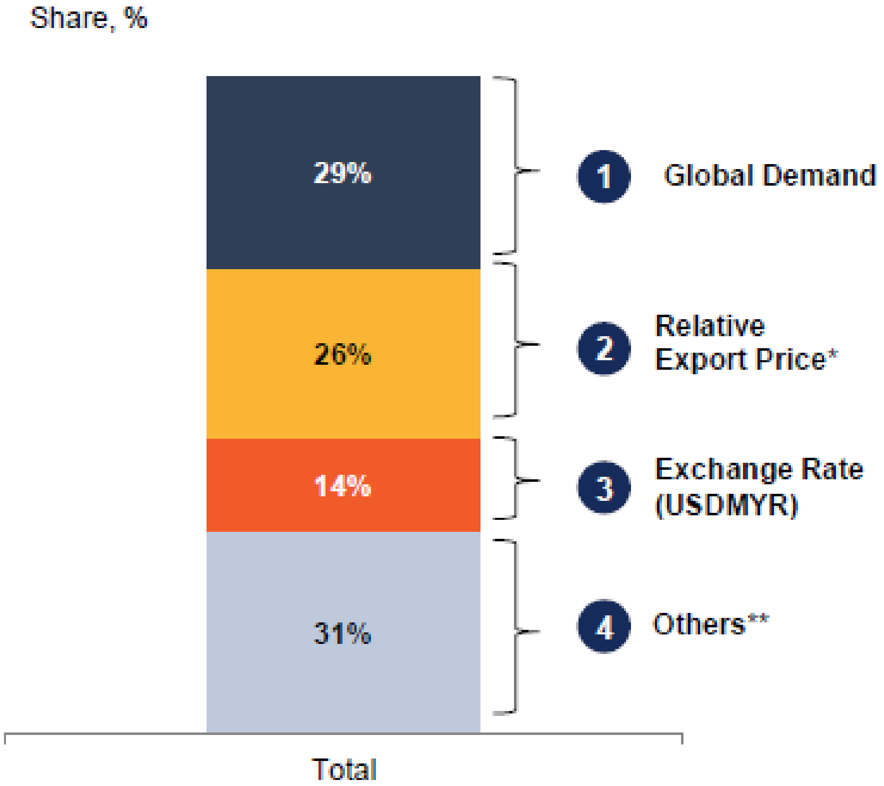
Majority of companies surveyed reported marginal or no benefit from ringgit depreciation

Firm Survey: Impact of Exchange Rate Depreciation on Export Order Volumes



Improving global conditions to underpin export volume growth going forward

Empirical Findings: Contribution to Export Volume Growth, 2005-2016



* Ratio of domestic export prices to global export prices

** Other temporary factors affecting exports that are not included in the model (i.e. the shortage of trade credit in 2008-2009 and the introduction of storage facilities that enabled higher re-exports of petroleum)

Source: Industrial engagements; RES Annual Report Survey (March 2017) – 63 manufacturing exporters, Bank Negara Malaysia estimates

Where is our growth coming from?

- Broad-based output expansion. Domestic demand still calling the shots.
- All economic sectors registered positive growth in 1H 2017.
- Services and manufacturing sectors are the dominant growth drivers.

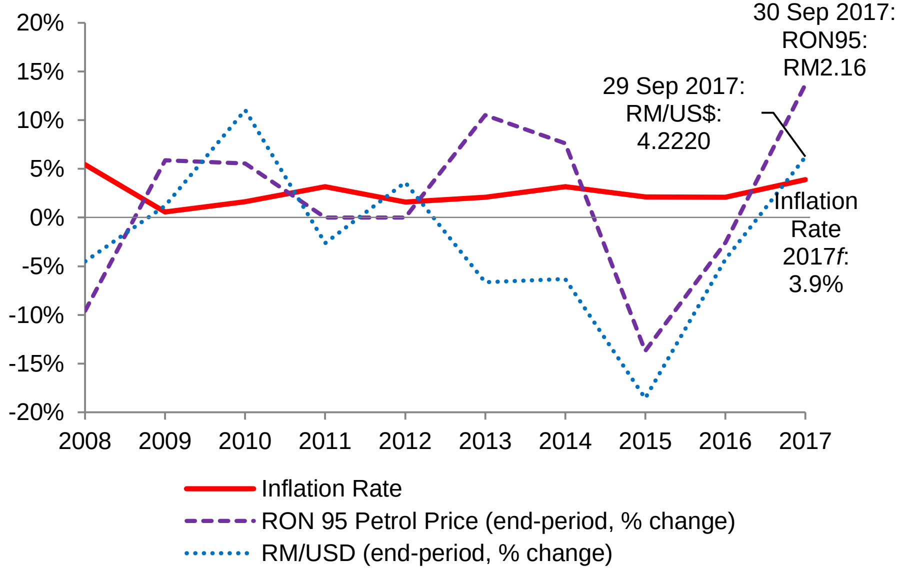
% change, 2010=100	**2015**	**2016**	**2017 1Q**	**2017 2Q**	**2017 1H**	**2017*e* (SERC)**	**2018*f* (SERC)**
GDP by demand component							
Private consumption (53.2%)	6.0	6.0	6.6	7.1	6.9	6.8	6.2
Private investment (16.9%)	6.3	4.3	12.9	10.7	10.0	9.2	8.3
Public consumption (13.1%)	4.4	0.9	7.5	3.3	5.3	5.1	4.0
Public investment (8.5%)	-1.1	-0.5	3.2	-5.0	-0.9	1.2	2.0
Exports of goods and services (70.4%)	0.3	1.1	9.8	9.6	9.7	9.9	6.7
Imports of goods and services (62.1%)	0.8	1.1	12.9	10.7	11.8	11.7	7.8
GDP by economic sector							
Agriculture (8.1%)	1.3	-5.1	8.3	5.9	7.1	6.0	4.0
Mining & quarrying (8.8%)	5.3	2.2	1.6	0.2	0.9	1.0	1.5
Manufacturing (23.0%)	4.9	4.4	5.6	6.0	5.8	5.7	5.5
Construction (4.5%)	8.2	7.4	6.5	8.3	7.4	8.0	9.0
Services (54.3%)	5.1	5.6	5.8	6.3	6.1	5.9	5.6
Overall GDP	**5.0**	**4.2**	**5.6**	**5.8**	**5.7**	**5.5**	**5.1**

Source: DOS, Malaysia; BNM; SERC
Parenthesis indicates % share to GDP in 2016

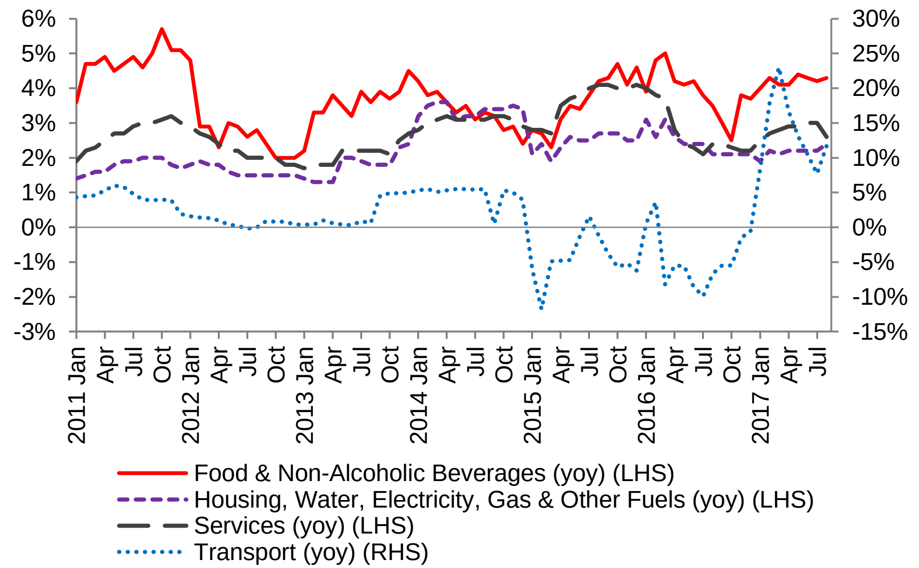
Inflation trends - Fuel price remains a big wild card...

- High fuel prices-inflicted cost price pressures along with other indirect costs such as the spillover effect of the weakening ringgit pushed inflation higher to 5.1% yoy in March.
- But, it had moderated from 4.3% in 1Q to 4.0% in 2Q and 3.2% in July before moving higher to 3.7% in August. CPI growth up 3.9% in 8M17.
- Inflation is expected to increase by 3.9% in 2017 and 2.5-3.0% in 2018.

Fuel price and exchange rate changes on inflation



Inflation is largely driven by food prices and volatile fuel prices

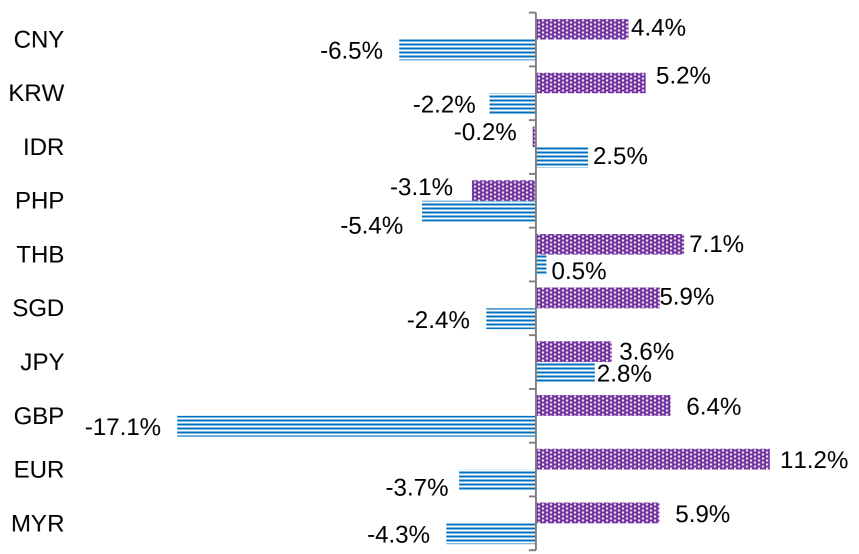


Source: BNM; DOS, Malaysia; SERC

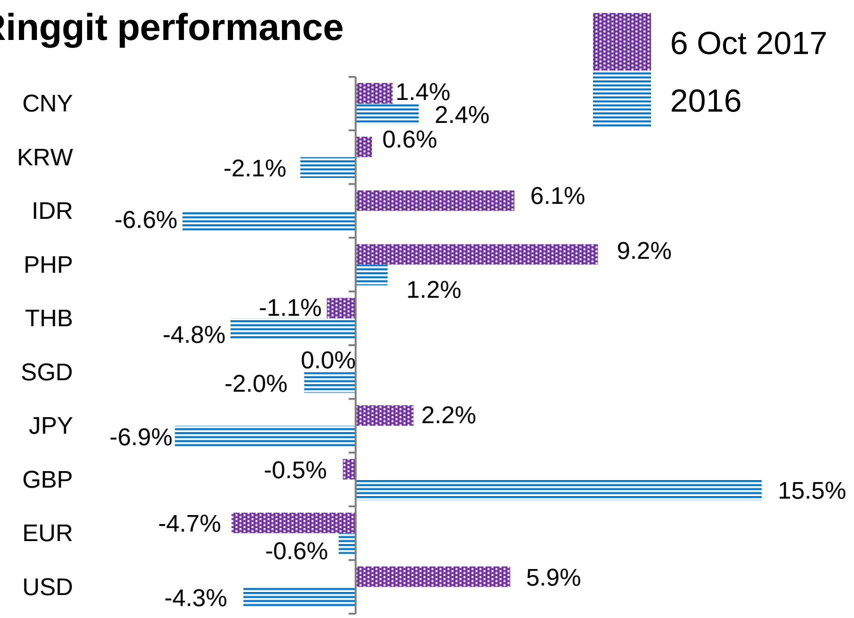
The ringgit does not reflect its fundamental value

- In REER terms, the ringgit has appreciated by 0.5% as of August this year (-15.0% in 2013-16).
- **Positive fundamentals**: Brightening economic growth prospects, firming commodity prices, the onshore ringgit stabilization measures, prospect of domestic interest rate normalization, continued current account surplus, accumulation of foreign reserves.
- **Counteract dampening factors**: Strong US dollar, higher US interest rates and yields, flows into the US dollar assets, geopolitical risks and developments in global financial markets.
- End-2017E: RM4.20/US$1; End-2018F: RM4.10-4.20/US$1

Regional currencies against USD



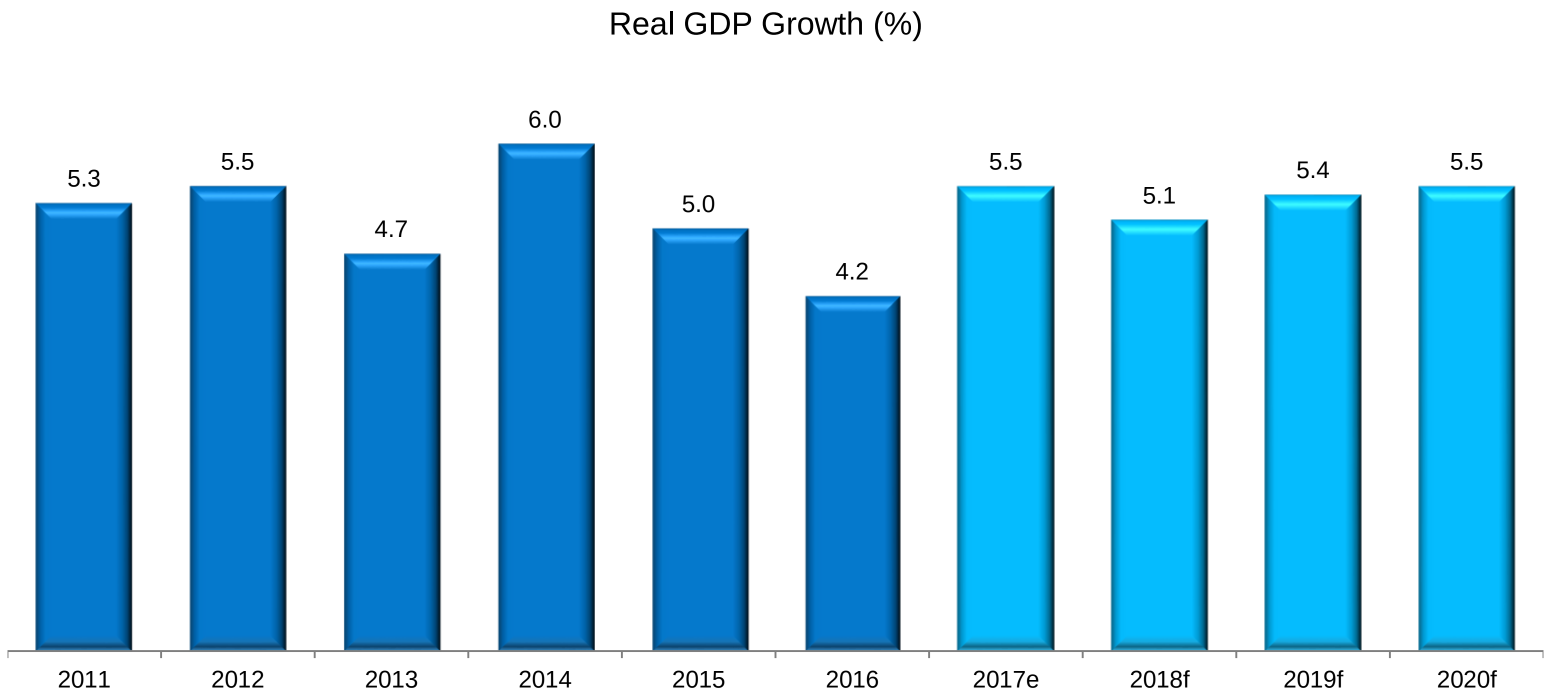
Ringgit performance



Source: Bank Negara Malaysia

Malaysia's medium-term economic outlook

- Medium-term growth prospects are positive (5.1% pa in 2016-20 vs. 5.3% pa in 2011-15).
- Domestic demand still dominant.
- Services, manufacturing and construction sectors remain key drivers of growth.
- Public infrastructure and transportation projects (rail, ports, highways) and investment in major economic sectors (manufacturing, services, mining and real estate).



Source: DOS, Malaysia; SERC

Can BNM afford to increase interest rates?

Policy environment

- Lingering uncertainties in global economic and financial environment
- Higher US interest rates and unwinding of the Fed's balance sheet
- Volatile capital flows and exchange rate

Growth, inflation and financial imbalances

- Is domestic economic growth strong enough?
- Domestic demand faces headwinds (high cost of living and weak consumer sentiment)
- Cost-induced inflation outweighs demand pressure
- Household debt to GDP eased to 85.6% at end-June 2017 (88.4% at end-2016; 89.1% at end-2015)
- Continue to monitor the risk of financial imbalances

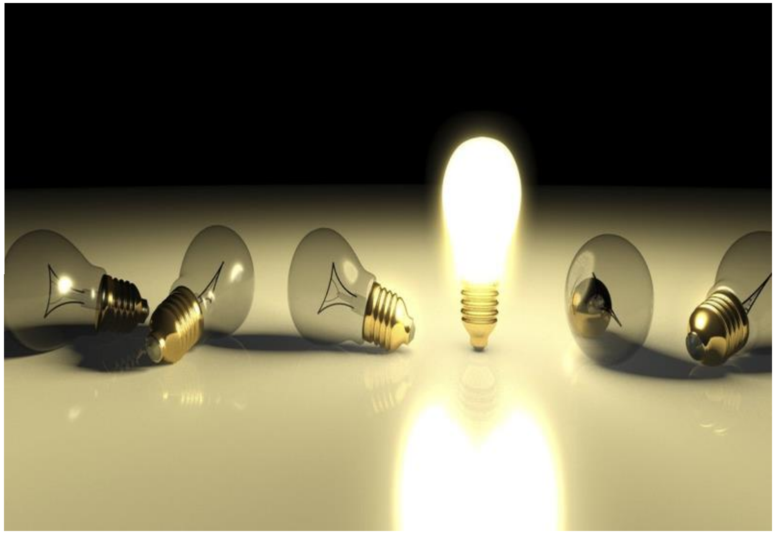
	2007	2008	2009	2010	2016	2017*e*	2018*f*
OPR	3.50%	3.25% ↓	2.00% ↓	2.75% ↑	3.00% ↓	3.00% =	3.25-3.50% ↑
GDP	6.5%	4.7% ↓	-1.7% ↓	7.4% ↑	4.2% ↓	5.5% ↑	5.1% ↓
Inflation	2.0%	5.4% ↑	0.6% ↓	1.6% ↑	2.1% =	3.9% ↑	2.5-3.0% ↓

BNM will face a tough yet decisive balancing act if the Fed takes more aggressive run of rate increases ahead

Section 3:

2018 Budget – Preparing for the future

BAJET 2018



2018 Budget: Prudent, responsible, forward-looking

Challenges in 2018

- Policy uncertainty and risks: the impact of Fed's Great Unwind and continued rate hikes; Trump's policy landscape, geopolitical tensions.
- Domestic economic and social issues: rising cost of living, high prices, housing affordability, employment opportunities for youth and graduates, high cost of doing business and compliance costs.

Fiscally responsible

- Further reduction in the budget deficit to estimated 2.8% of GDP in 2018 from 3.0% in 2017.
- Development expenditure is budgeted at RM49.5 billion in 2018 (estimated RM45.4 billion in 2017).

Tax break and financial incentives

- Least painful budget.
- Tax cut and reliefs for corporates, individuals and households.
- Higher BR1M, bonus for civil servants, special cash assistance for targeted groups.
- Capital allowances and incentives to spur investment in ICT.

Where 2018 Budget should focus on?

Driving competitiveness and productivity

- Competitive framework – tax structure and regulatory environment
- Unlocking high productivity and innovation is critical

Digital technologies and transformation

- Building a connected ecosystem
- Technology disruption

Rising global complexity

- Unpredictable policy shift in advanced economies
- Shifting hotspot of dominant economic power

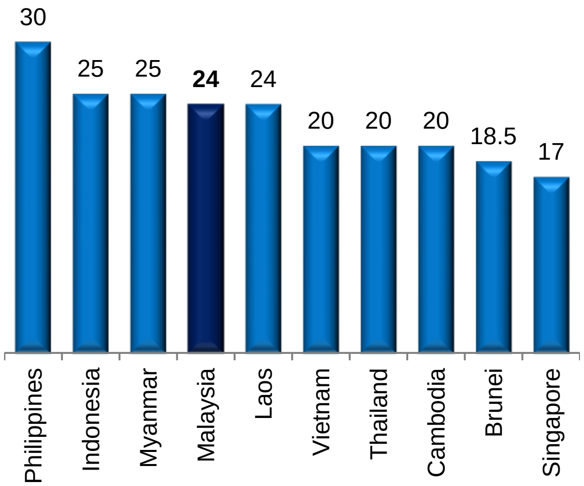
Ageing population

- Widening retirement savings gap
- Rapidly escalating healthcare expenditure

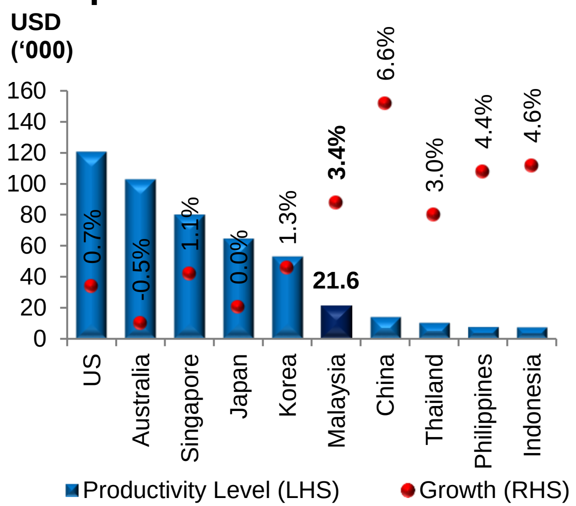
#1 Driving competitiveness and productivity

- Global competition to cut corporate tax heats up
- Malaysia's productivity growth is lagging behind
- Strategies and initiatives
  - ❑ Push for a competitive tax structure
  - ❑ Restructure and improve the management of foreign workers
  - ❑ Actively encourage the adoption of 4th Industry Revolution
  - ❑ Create dedicated pool of investment funds or align existing fund to drive 4th Industry Revolution agenda nationally

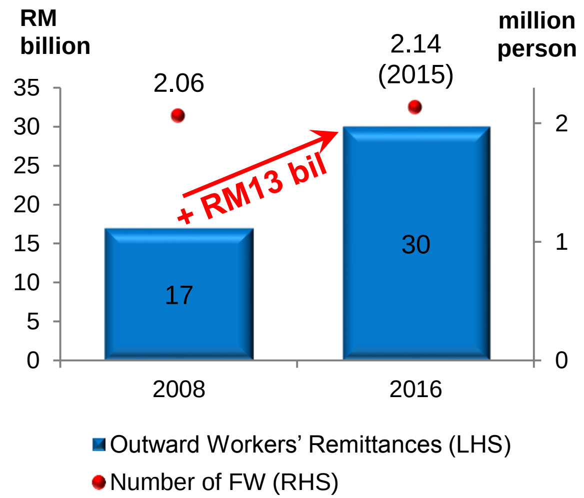
Regional corporate tax rate comparison



Regional labour productivity comparison in 2015



Higher FW remittances



Source: EY; MPC; BNM; EPU

What needs to be done?

Malaysia needs a competitive tax system

- Tax reform – a simpler, fairer system with lower rates and fewer brackets.
- Inaction in making Malaysia's tax system more competitive would have significant impact on our economy, businesses, investors and households.
- A lower corporate tax rate increases Malaysia's competitiveness. An increased flow of tax-free capital that will boost investments and production.
- Personal tax rate cut serves to increase disposable income of wage earners and households, and lift consumer purchasing power.
- The US is planning to slash its corporate tax rate from 35% to 20% while Britain's corporate tax rate is slated to fall 1% a year to reach 17% in 2020.

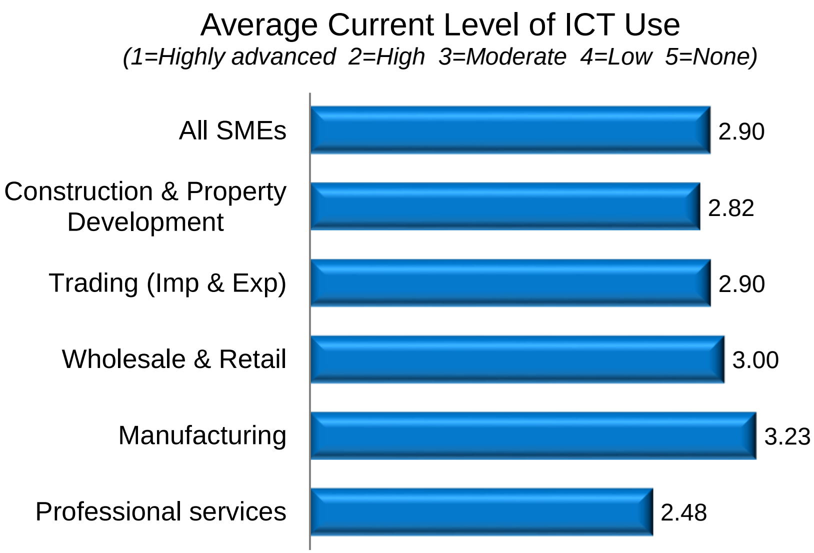
Cut in corporate & personal income tax rate

- Outright reduction in corporate tax rate by 1% to 23%.
- For SME, lower the tax rate to 17%. Increase the threshold level of chargeable income for the first-tier tax rate to RM1.0-2.0 million from the current RM500,000.
- Lower personal income tax rate by 1-2%.
- Higher tax reliefs and rebates related to children education, self-enhancement (education) and medical expenses.

#2 Digital technologies and transformation

- **Transport** – seamless connectivity, safety, reliability and speed
- **Connectivity/communication** – investment in ICT to scale benefits of digitalization, broadband speed and reliability of coverage
- **Space/housing**
- **Manufacturing for the future**
- **Consumer culture (taste, fashion and lifestyle)**

Moderately usage of ICT



Malaysia National E-Commerce Strategic Roadmap to double the e-commerce growth

	2015	2020 *business as usual*	2020 *with intervention*
e-Commerce contribution *(RM billion)*	68	114	170+
e-Commerce growth *(% CAGR)*	12.8 *2012-2015*	10.8 *2015-2020*	20.8 *2015-2020*

Source: National E-Commerce Strategic Roadmap; SERC

What needs to be done?

Shaping a connected and digital economy

- Digital economy is about speed, accountability and transparency and no barriers to entry.
- Build a vibrant national innovation system.
- Offer tax breaks and incentives to private players.
- Enhance the RM200 million WCGS (Working Capital Guarantee Scheme) to drive startups.
- Establish a Tecno-prenuer fund to promote innovation and new technology access initiative.

Harnessing the power of Industrial Revolution 4.0

- Only 30% have started to invest and leverage on modern technology.
- Targeted incentives and grants, investment capital allowance.
- High-tech Industrial Adjustment Fund to facilitate more manufacturers and SMEs to automate and embrace industrial Internet.
- Extend the current capital allowance of 200% on automation expenditure in terms of value and time limit.
- Raise the RM50,000 cap on double tax deduction on R&D expenditure for the period 2016-18.

What needs to be done?

Harnessing e-commerce's propulsion

- Expedite the implementation of initiatives and measures as outlined in the National eCommerce Strategic Roadmap.
- Develop a reliable and vibrant logistics delivery system as logistics remain a critical part of e-Commerce.
- Develop a Smart-delivery system that helps automate and scale delivery for SME merchants.
- Set up a Smartlogistic’s open, platform-approach will help SMEs finding the best cost-effective shipping rates and quickest delivery time depending on the product weight, destination and other variables.
- The entry of Alibaba into Malaysia’s e-commerce ecosystem must be made “inclusive” and spur domestic linkages via strategic collaborative partnership with domestic SMEs.
- To reduce tax barriers to enable Malaysians to play an active role in e-commerce, it is proposed that the purchase value of goods via the Internet or e-commerce in the DFTZ, to be exempted from tax, be raised from RM500 to RM1,200.

#3 Rising global complexity

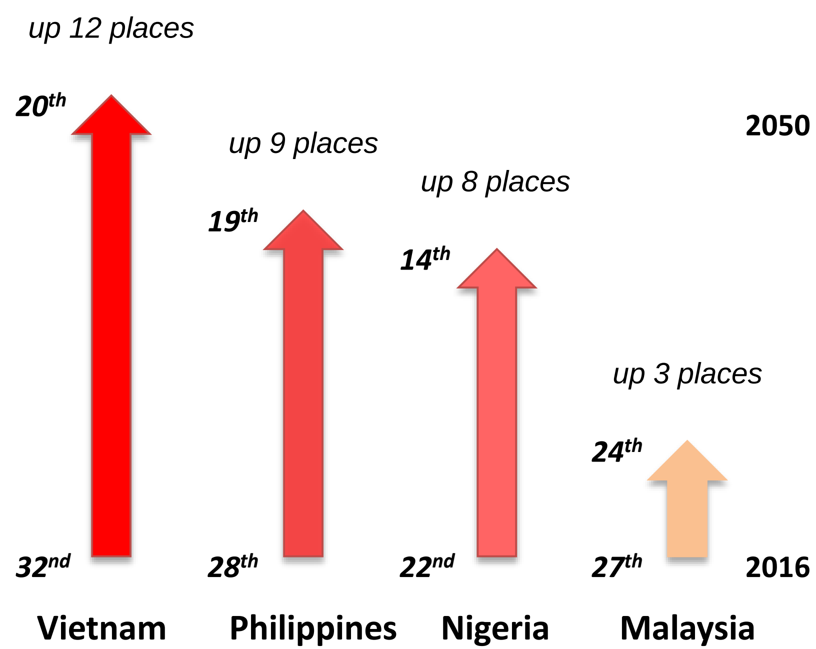
- According to PwC, emerging markets will continue to be the growth engine of the global economy.
- By 2050, China could be the largest economy in the world, with India in second place and Indonesia in fourth place. Malaysia will improve to 24th placing from 27th in 2016.

Emerging market will dominate the world's top 10 economies in 2050 (GDP at PPPs)

2016		2030		2050	
China	1	China	1	China	1
US	2	US	2	India	2
India	3	India	3	US	3
Japan	4	Japan	4	Indonesia	4
Germany	5	Indonesia	5	Brazil	5
Russia	6	Russia	6	Russia	6
Brazil	7	Germany	7	Mexico	7
Indonesia	8	Brazil	8	Japan	8
UK	9	Mexico	9	Germany	9
France	10	UK	10	UK	10
Malaysia	27	Malaysia	25	Malaysia	24

E7 economics G7 economies

Vietnam, the Philippines and Nigeria could make the greatest moves up the rankings by 2050



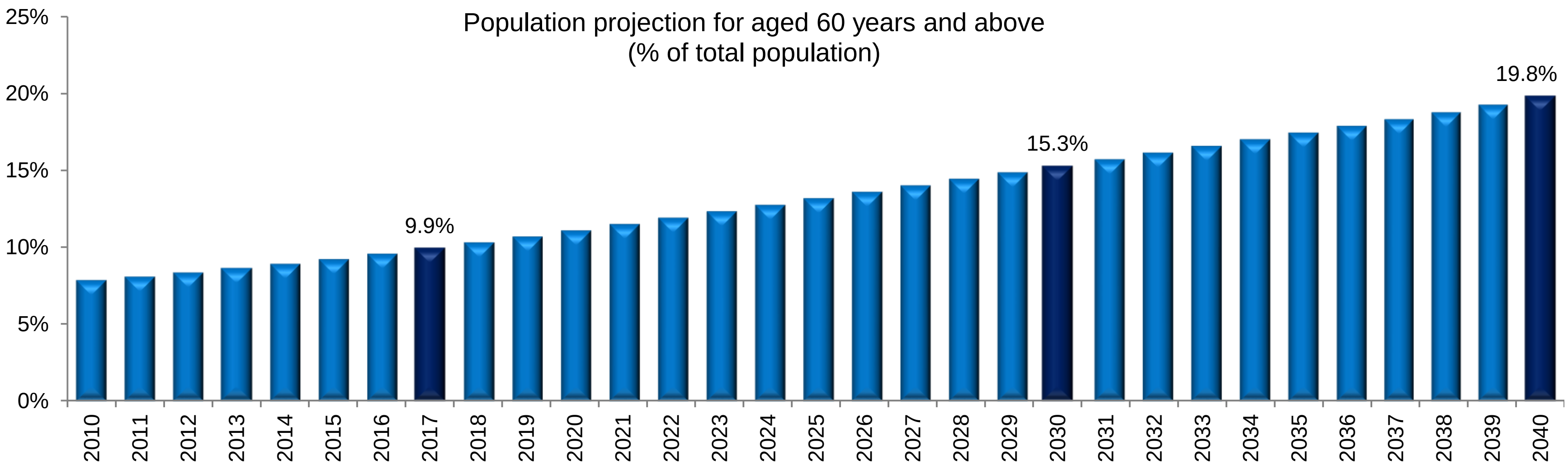
Average annual GDP growth rate, 2016-2050

Vietnam	Philippines	Nigeria	Malaysia
5.1%	4.3%	4.2%	3.5%

Sources: IMF for 2016 estimates, PwC analysis for projection 2050

#4 Ageing population

- Malaysia will become an ageing population by 2030 when 15% of our population will be aged 60 and above (9.3% or 3.0 million in 2016).
- The ageing population and lifestyle illnesses are drivers of growing healthcare expenditure; dampening productivity, deter investment and elderly people spend differently.
- Fiscal cost on healthcare, social protection and housing will be substantial for elderly population.
- The combined pressures of ageing and the retirement savings gap might redefine the concept of retirement into the future (tapered retirement).



Sources: DOS, Malaysia

What needs to be done?

Managing population ageing

- The fundamental approach and reform of public policies should cover the aspects of safer living community, preserving human capital asset, social welfare, healthcare services as well as a sustainable retirement income and pension scheme.
- The EPF can consider gives an additional dividend says 1% on the first RM50,000 of total accumulated EPF savings for employees aged 50 years and above.
- Long-term healthcare insurance system, part-funded by compulsory premiums for all those over the age of 45, and part-funded by national budget.
- With increasing life expectancy, it is proposed that the tax relief for private retirement scheme and annuity premium be increased to RM6,000 from RM3,000.
- Other policy changes to be considered include considering higher EPF contribution rate by employers to older employees, which most companies have capped at a fixed contribution rate and lower EPF contribution rate.

What needs to be done?

Mitigating rising healthcare cost

- Separate tax relief for medical insurance. Currently, the RM3,000 tax relief is combined for medical and education insurance.
- Separate individual tax relief of the current RM6,000 for KWSP contributions and life insurance so as to encourage individuals to take up insurance policies.
- Current GST exemption on life insurance to be extended to include medical or healthcare insurance.
- Aged-caring tax policy to encourage employers to provide better medical coverage for their employees. If a small business has fewer than 25 employees and provides health insurance, it may qualify for a small business tax credit of up to 50% to offset the cost of insurance.
- With rising costs of medical expenses for elderly parents, it is proposed that the tax relief for parents' medical expenses be increased to RM7,000 from RM5,000.
- Tax relief for medical expenses on chronic diseases be raised to RM8,000 from RM6,000.

Conclusion

1) The global economy is in a synchronized expansion of economic activities. It is a mutual reinforced economic upswing in both advanced and emerging economies.

2) Policy uncertainty will remain in 2018, and the risks include unexpected changes in monetary policies and the shrinking of the Fed's balance sheet, the financial-sector uncertainty in major economies, as well as geopolitical tensions. Pressures for protectionism are building up.

3) The Malaysian economy remains on track for expansion, firing on twin engines (2017E: 5.5%; 2018F:5.1%).

4) Strengthening policy space, addressing vulnerabilities, and enhancing international competitiveness by promoting investment, services, high-end manufacturing and FDI would also boost economic resilience and improve growth prospects.

5) Reaping digital technologies dividend requires the right policy mix and investments such as software and hardware investment, soft skills and the right ecosystem to harness information, communications and technology (ICT) and e-commerce to deliver increased productivity and growth.

Press Conference on

SERC's Quarterly Economy Tracker

Third Quarter of 2017

Q & A

社会经济研究中心

SOCIO-ECONOMIC RESEARCH CENTRE

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