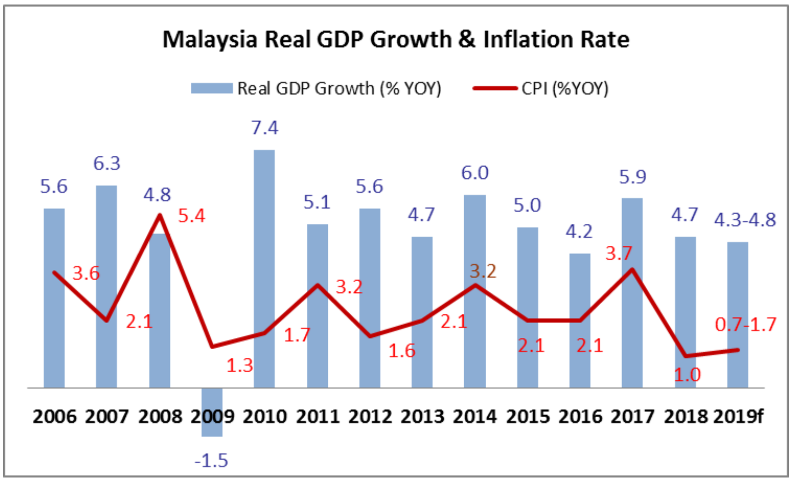
BNM Annual Report 2018: More moderate growth and price outlook

Trailing its earlier caution on downside risks to growth, BNM has trimmed this year's growth forecasts to 4.3-4.8% (2018: +4.7%). The midpoint forecast of 4.7% was below MOF's forecast of 4.9% back in November last year but in line with ours 4.7%. The private sector will remain the main growth pillar although it itself is expected to see more moderate expansion in the midst of growing challenges. BNM is also expecting a softer inflation outlook downgrading CPI forecast to 0.7-1.7% for 2019 (2018: +1.0%) suggesting a stable price outlook. Current account surplus is expected to narrow to RM28.0bn or 1.5-2.5% of GNI while there is no change to the fiscal deficit target of 3.4% of GDP for this year and 3.0% next. On monetary policy, BNM sounded not as dovish as the March policy statement, highlighting policy options including micro and macro prudential measures, in addition to measures to deepen the domestic financial markets, implying OPR is not the only tool in its policy priority of ensuring an accommodative monetary policy stance to support growth. We are maintaining our view that a potential OPR cut remains on the table amid looming downside risks to growth.

2019 Growth Prospects

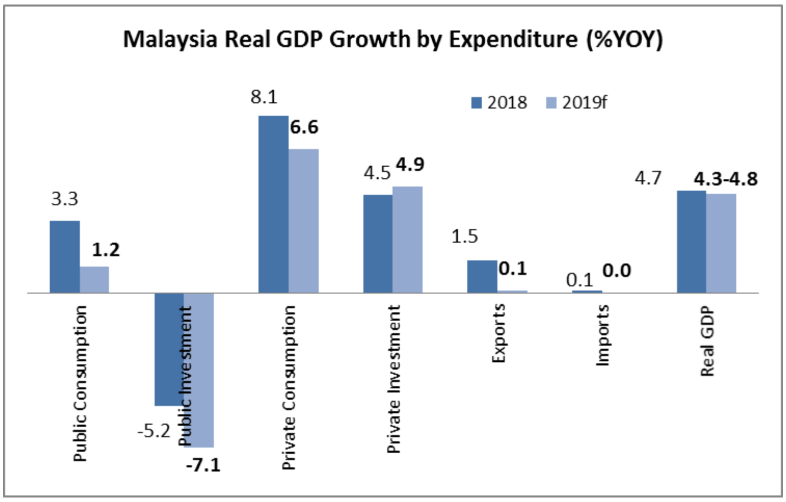
Revised full year 2019 growth forecast of 4.3-4.8% reflects acknowledgement of downside risks

BNM provided an update on the latest macroeconomic outlook in conjunction with the release of its Annual Report 2018. **The Malaysian economy is expected to expand at a slightly slower pace of 4.3-4.8% YOY in 2019** (2018: +4.7%), amid softer growth across all sectors but the private sector will remain firmly in the driver seat as the public sector consolidates, and as exports moderate on the back of a more challenging external environment.



Source: BNM Annual Report 2018

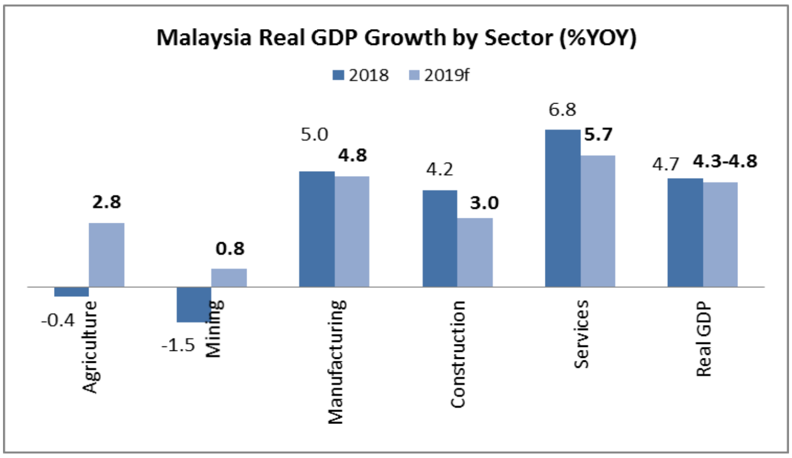
The forecast range of 4.3-4.8% (mid-point 4.7%) marked **a downgrade from the 4.9% growth projected by MOF** last November**,** and we believe this reflects BNM's acknowledgement of downside risks to growth taking into account various global risk factors of which some have escalated since. Note that forecasts for all demand-side components have been downgraded from the official forecasts released in November last year. **The mid-point growth forecast of 4.7% by BNM is also a tad more bearish than earlier MOF estimate of 4.9% but is in line with our in house projection of 4.7% for 2019.**



Source: BNM Annual Report 2018

Domestic demand will be the main growth pillar amid muted exports

Domestic demand is expected to be biggest growth driver, contributing 4.1ppt to the 4.7% expected growth this year. Inventories is expected to contribute the remaining 0.6ppt as nil contribution is expected of the external sector. Domestic demand is expected to continue expand albeit at a much softer pace of 4.4% YOY in 2019 (2018: +5.6%), of which the private sector will be the main pillar, growing 6.2% YOY and contributing 4.5ppt to overall growth supported by stable labour market condition, continued wage growth, and government measures to alleviate rising cost of living. This shall offset the 1.8% YOY contraction in public sector activities, shedding 0.4ppt from overall GDP growth, as the government continue to slash spending (+1.2% vs +3.3%) and deeper cut back on investment (-7.1% vs -5.2%) amid ongoing rationalization and reform effort. **External trade are expected to turn in dismal,** with a minute 0.1% YOY increase in exports (2018: +1.5%) and flat imports (2018: +0.1%) amid prospects of weakening global demand and weak commodity prices. Manufacturing exports are expected to see more moderate growth (+4.8% vs +9.1%) following slower demand from major trading partners while commodity exports are expected to contract weighed down by weaker commodity prices and lower crude oil production.



Source: BNM Annual Report 2018

Turnaround in commodity related sectors to cushion slower growth in manufacturing, services and construction

On the supply side, **all sectors are expected to register positive growth in 2019 with noteworthy rebounds in commodity-related sectors while value-added in the manufacturing, services and construction sectors are expected to see easier expansion.** The agriculture sector is expected to turn around with a 2.8% YOY increase (2018: -0.4%) driven by higher palm oil output on the back of recovery in yield and increase matured hectarage. Meanwhile, the rebound in the mining sector (+0.8% vs -1.5%) is expected to be driven by recovery in natural gas production in East Malaysia following the surprised outage this year.

Nonetheless, the **services and manufacturing sectors will remain the key growth driver,** collectively contributing 4.3ppt to overall GDP growth in 2019. The services sector is expected to increase more moderately by 5.7% YOY (2018: +6.8%), driven by the wholesale & retail, food & beverages, ICT, and financial subsectors. Meanwhile, the manufacturing sector is expected to grow 4.8% YOY in 2019 (2018: +5.0%), underpinned by continuous expansion in the primary-related industries, and operationalization of the new oil refinery and petrochemical facilities in Johor. Last but not least, growth in the construction sector is expected to taper off to 3.0% YOY in 2019 (2018: +4.2%), sharply lower than the quicker growth of 4.7% projected earlier by MOF, due to reviews and delays in infrastructure projects and softer activities in residential and non-residential construction amid the oversupply situation.

Inflation

Flattish inflation outlook of 0.7-1.7% in 2019

Headline inflation forecast has been reduced to 0.7%-1.7% in 2019 (previous MOF forecast 2.0-3.0%), marking its second time of downgrade and a massive 180bps cut from its first forecast of 2.5-3.5%. This came **closer to our CPI forecast of 1.0% for 2019 (2018: +1.0%)**, and suggests very stable inflation outlook this year. Cost pass-through inflation from domestic cost factors are expected to be offset by anticipated lower global oil prices and the implementation of price ceiling for domestic retail pump prices.

Labour Market

Stable labour market supported by continued employment and income growth

Labour market condition is expected to remain stable and supportive of growth. **Unemployment rate is expected to remain relatively steady in the range of 3.3-3.5% in 2019** (2018: 3.4%) supported by continued employment and income growth. A report by the Malaysian Employers Federation (MEF) showed employers expect salary increment to sustain a 4.9% increase in 2019, unchanged from the pace in 2018.

Monetary Policy

Monetary policy will continue to focus on ensuring sustainable growth and price stability…and a broad range of policy options are available

On the monetary policy front, BNM reiterated that the policy focus in 2019 will be on supporting steady growth of the Malaysian economy amid relatively low inflation. While growth of the domestic economy is expected to be sustained, there remains downside risks to the Malaysian economic outlook. The report also mentioned that the MPC is cognizant of challenges emanating from potential continued volatility in global capital flows, even though it highlighted that risks of financial imbalances are expected to remain contained. **A point to note is that BNM mentioned the availability of a broad range of policy options (monetary policy, micro- and macro-prudential measures) that would provide the flexibility in managing**

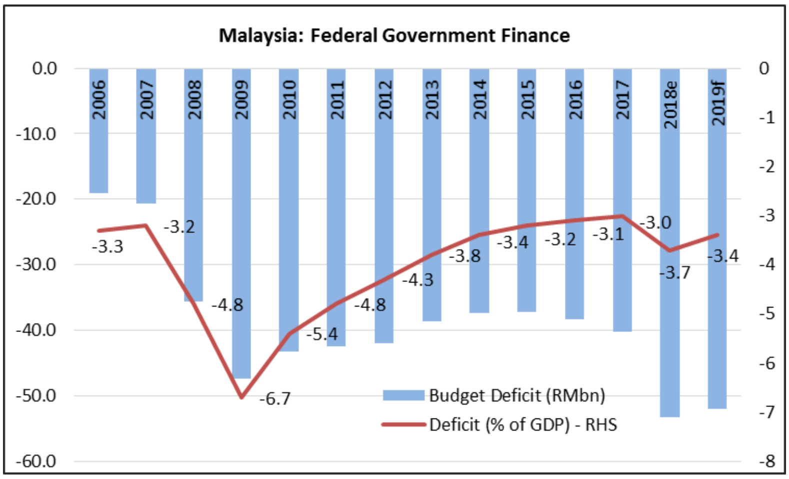
emerging risks, and that it would not "overburden" any single policy tool, suggesting OPR is not the only tool of the central bank to ensure growth sustainability.

Fiscal Policy

No change to medium term budget deficit target of 3.4% and 3.0% of GDP for 2019 and 2020 respectively

The focus of fiscal policy in 2019 will be on strengthening the Government's fiscal position via gradual fiscal consolidation, reducing debt and liabilities on top of promoting economic inclusiveness. **The government's medium term fiscal target remained unchanged at 3.4% of GDP for 2019 and 3.0% for 2020.** This will be attained via a three-pronged approach namely (1) enhancing expenditure effectiveness through zero-based budgeting; (2) diversify and broaden revenue base championed by The Tax Reform Committee; and (3) holistic and transparent debt management via Debt and Liabilities Management Committee.

On this note, **total federal government debt increased 7.9% YOY to RM741.1bn as at end-December 2018** (Dec-17: +5.9% YOY to RM686.8bn), representing 51.8% of GDP (2017: 50.8% of GDP), remaining below the 55% self-imposed ceiling. **The government is committed to reduce its debt level, projecting that total debt including contingent and leased payment to taper off to 73.5% of GDP by end-2019** (end-2018: 74.6%; end-2017: 80.3%). The bulk of the debt (97%) is Ringgit-denominated borrowings, with the remaining from offshore borrowings (mainly USD) suggesting minimal exposure to foreign currency risk.



Source: BNM Annual Report 2018

Balance of Payments

Current account surplus expected to narrow a 2nd straight year to RM28.0bn (1.5-2.5% of GNI) this year

Current account surplus is expected to narrow for the 2nd straight year, to RM28.0bn or 1.5-2.5% of GNI in 2019 (2018: RM33.5bn or 2.4% of GNI). The smaller surplus for 2019 was **mainly a result of smaller surplus in the goods account (RM116.2bn vs RM121.4bn) arising from slower increases in exports** and slightly bigger deficit in the income account. The income account is expected to register a bigger deficit of RM70.0bn in 2019 (2018: RM69.1bn deficit) due to higher profits, dividends and interests accruing to MNCs operating in Malaysia. The secondary income account will also see sustained deficit as a result of continued outward remittances by foreign workers. **Meanwhile, deficits in the services account is also expected to edge up slightly to RM19.8n in 2019 (2018: RM19.7bn deficit)** as a result of continued deficit in transportation as well as professional and technical services. Overall, surpluses in the goods account is expected to offset continued deficits in the services and income accounts.

Balance of Payments (RM billion)

	2014	2015	2016	2017	2018e	2019f
Balance on Goods	113.33	109.22	102.05	116.78	121.36	116.2
Balance on Services	-10.71	-20.63	-18.92	-22.82	-19.70	-19.8
Primary Income	-36.62	-32.11	-34.59	-36.35	-49.38	-50.2
Secondary Income	-17.44	-21.33	-18.63	-17.32	-18.78	-18.2
Balance on Current Account	**48.55**	**35.16**	**29.91**	**40.28**	**33.51**	**28.0**
Capital Account	0.34	-1.14	0.10	-0.03	-0.11	-
Financial Account	-79.95	-55.35	-0.25	-4.73	18.61	-
Direct Investment	*-17.97*	*-1.81*	*13.79*	*16.17*	*11.34*	-
Portfolio Investment	*-39.35*	*-26.12*	*-14.20*	*-15.36*	*-44.40*	-
Financial derivatives	*-0.98*	*-0.66*	*-0.80*	*-0.20*	*0.97*	-
Other Investment	*-21.65*	*-26.76*	*0.96*	*-5.35*	*50.70*	-
Errors & Omissions	-5.45	*25.08*	-23.90	-19.11	-44.29	-
Overall Balance	-36.51	3.75	5.86	16.41	9.72	-

Note: p= Preliminary, f= Forecast
Source: Bank Negara Malaysia Annual Report 2018

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