Malaysian politics overshadows economics

Malaysia’s central bank will decide monetary policy just a few days prior to the government unveiling the budget for 2021. The second wave of the pandemic strengthens the case for more policy support but elevated political uncertainty casts a dark overshadow

Malaysia's Prime Minister Muhyiddin Yassin (2-L) arriving for a meeting at parliament building in Kuala Lumpur, Malaysia

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An eventful week for the Malaysian economy

Malaysia's central bank has started its two-day meeting today, with the policy decision out on Tuesday, 3 November, at 3 pm local time - just days ahead of the government's 2021 budget on Friday, 6 November.

> *Capping all the excitement about the additional policy stimulus, if any, could be an escalation of political risk.*

Despite the excitement about more fiscal stimulus, any escalation in the political risk could overshadow both of these policy events. And given the government's razor-thin majority in the parliament, the challenge to have the budget approved in parliament remains significant.

Just as some green shoots of recovery started to emerge from the most recent data, the second wave of the pandemic has started to widen its grip over the economy. This means much prolonged economic slump going well into 2021, so accommodative macro policy is definitely required.

The last thing the economy needs at this time is political uncertainty. And, there has been plenty of it since the state elections in Sabah in mid-September, especially in terms increased power struggle from within and outside the ruling coalition. The Budget vote will serve as a taste of confidence in the current government. Although Malaysia's King has urged lawmakers to refrain from politicising the Budget, we don't rule out this turning into yet another political crisis in less than a year.

Monetary policy – on hold or further cut

The central bank has cut its overnight policy rate by a total of 125 basis points to 1.75% in the first four meetings of this year. The decision to leave policy on hold in the last meeting in September was a signal towards an end of the easing cycle as the economy gained some traction. This is probably why the consensus for the current meeting is skewed towards rates keeping on-hold. However, there still is a slim minority calling for a 25bp policy rate cut.

We haven't pencilled in a rate cut for this meeting, though we don't think it will be an unwarranted move at all. The pandemic continues to deter both domestic and external demand. On the domestic front, the high unemployment and lack of confidence have been hindering the economy. Exports, so far the key driver of recovery, will likely be under fire from renewed lockdowns elsewhere in the world. A 17% YoY GDP contraction in 2Q was the worst in Asia. So will be about 12% contraction that we anticipate for 3Q and 9.3% fall for the entire year.

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While growth continues to take a hit from weak domestic demand, the persistently negative inflation trend offers the central bank sufficient room to cut rates further. Inflation dipped to -2.9% at the height of the first-wave in May, the second-worst in Asia after Thailand. It has recovered to -1.4% by September, though we don't see it turning a corner into positive territory anytime soon. Moreover, this has left Malaysia's real interest rates, defined as the policy rate minus the latest inflation rate, one of the highest in Asia – not a conducive backdrop for the recovery.

Among other arguments favouring further BNM rate cuts are limited leeway for fiscal policy easing, as discussed in the section below, as well as relatively resilient currency (Malaysian ringgit, or MYR) to the recent spike in political uncertainty, which should provide some comfort to the central bank in lowering rates.

Fiscal policy – a tight rope walk for government

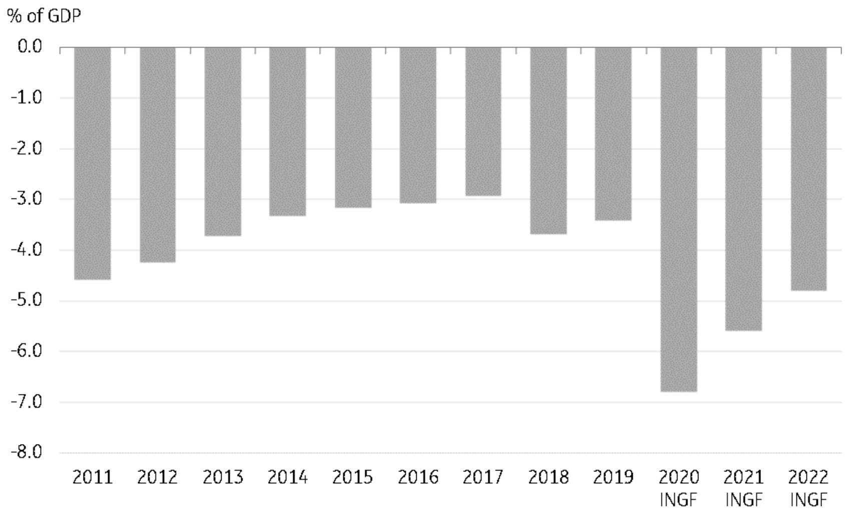
The upcoming budget has become a contentious political issue in view of the slim majority the coalition government holds. Yet, whether it offers additional stimulus remains a key question given the spending constraints imposed by the large fiscal stimulus rolled out earlier this year.

More stimulus in the forthcoming budget will further increase the government debt ceiling from 60% of GDP after it was raised from 55% earlier this year

Four packages from late February to early June included a huge stimulus worth about 19% of GDP, nearly half of which was on-budget (real) spending. Certainly, this will have swelled the overall fiscal deficit out of proportion; the market expectations are for more than doubling of deficit to over 7% of GDP from 3.4% in 2019.

More stimulus in the forthcoming budget will further increase the government debt ceiling from 60% of GDP after it was raised from 55% earlier this year. The actual debt as of June was just shy of this limit.

Fiscal deficit



Source: CEIC, ING

It's not the time for fiscal consolidation just yet, though any hopes of a lower fiscal deficit in 2021 will have to rest on the acceleration of GDP growth rather than reduced spending. While prime minister Muhyiddin Yassin would not want to jeopardise his political standing further by cutting spending, the expectation of a rebound in GDP growth next year is far-fetched. This makes it a tight-rope walk for the government. But, Malaysia's finance minister Zafrul Abdul Aziz has said it will be an expansionary budget.

Among the measures widely talked about include: Additional support for low-income earners, tax cuts, expansion of social protection, an extension of wage subsidies scheme for small and medium-sized enterprises, extended loan moratorium, and increase in healthcare spending.

There is also the talk about re-launching the goods and services tax, but we are sceptical of such of pro-cyclical measures.