Thematic – How Russia-Ukraine conflict will impact Malaysia

Chief Economist/Head of Research
Dr. Anthony Dass
anthony-dass@ambankgroup.com

Economist
Azri Azhar
azri.azhar@ambankgroup.com

Economist
Muhamad Farid Anas bin Johari
muhamad-farid-anas.j@ambankgroup.com

Highlights

- *The war is a high-risk gamble on the part of Russian President Vladimir Putin as the Ukrainian government and citizens will be more determined to lean towards the West. Ukraine may regain full control of its territories only in the post-Putin era — and it is uncertain when that era will begin.*

- *Putin's reassessment of the post–Cold War order is expected to continue irrespective of the Ukraine invasion's outcome. This crisis is one step in a long game, which is our base case scenario. And there is also an upside risk for a nuclear war in Europe.*

- *Narratives from the Russian invasion: (1) risk of a power shift from nuclear power to nuclear tension; (2 global supply chains disruption to continue; (3) possibility of a 1973-like oil shock; (4) complications for global central banks, and; (5) cyberattacks.*

- *This conflict still has a strong impact on the Asean region, especially the agriculture and power segments, but the main concern is the surging inflation induced by the global energy market. Besides rising prices, the region will also feel the knock-on impact on its economic growth directly and indirectly – causing a 5%–-15% cut in their current GDP outlook, depending on the exposures and policy measures.*

- *On the Malaysian front, as an open economy: (1) the severity on growth will depend on whether the war ends up on a nuclear war path or not; (2) there will be upwards pressure on living costs; (3) a well-scripted tighter monetary policy could be thrown out; and (4) limited pressure on our fiscal balance.*

- *The bond market's reaction so far is pointing towards the risk off stagflation. The US Treasury yield curve is seen flattening and the spread between our MGS and UST is also showing a declining trend. Underpinned by the ongoing uncertainties, nominal yields are expected to trend downwards due to a greater appetite for safe-haven assets.*

- *And the real yields will remain depressed owing to rising inflation expectations, portending weaker growth. On that note, the risk of stagflation is becoming far more glaring in the current scenario.*

- *As for equity markets, the fall was a knee-jerk reaction to the Russia-Ukraine conflict. The markets are expected to tread in choppy waters before discounting this development and stage a sharp rebound. In the past, markets tend to generally overreact to geopolitical risks.*

- *But as events unfold over time, there is a realisation that the situation might get diffused. The rallies in equity markets could turn much sharper. They will recover lost ground and trend higher after more clarity on the event.*

- *In the meantime, investment decisions must be taken based on the fundamental and economic scenario both in Malaysia and globally. The worst is yet to be fully discounted — a nuclear war. Should there be some positive clarity, a rebound is envisaged but it may not be a sharp V-shaped movement.*

A. Narratives from the Russian invasion

1. Risk of power shift from nuclear power to nuclear tension

- A big worry is a potential risk of a nuclear tension following:
  1. Hard-hitting economic sanctions and strong statement from the EU
  2. The 27-nation EU for the first time in its history has decided to supply weapons to Ukraine (€450mil or US$507 mil)
  3. A major shift for Germany's defence policy with a committed €100bil (US$113bil) or more than 2% of its GDP in military spending
  4. Construction of new gas terminals by the Germans
  5. Belarus will renounce its non-nuclear and neutral status and allow Russia to position nuclear weapons permanently
  6. Threat to other former Soviet states
  7. Use of short-range nuclear weapons to achieve Russia's objectives
  8. Risk of using medium-range nuclear weapons on neighbours who support Ukraine militarily, diplomatically or politically
  9. Involvement of the US in its commitments to defend NATO allies should nuclear war breaks out.

- By shifting to nuclear weapons, it offers an alternative way to raise pressure on both Ukraine and its backers to seek a settlement on Ukraine's status.

- A nuclear war in Europe risks escalation into a world war as geopolitical tension will erupt in other regions including Asia. Whether by design or mistake, nuclear war risks strong miscalculation. It will make things extremely dangerous with severe economic consequences to the global economy which is still reeling from the Covid-19 pandemic.

- There is now more downwards revision to the global GDP for 2022. Our base case projection of 4.3% now risks being lowered by about 10%–20% to hover between 3.5% and 4.0%. Much of the downgrade will depend on the potential incoming data following the impact from the sanctions.

2. Global supply chain disruptions will continue

- Global economy has yet to come out from the supply chain disruptions due to the pandemic. The health crisis is still playing out on the supply chain, resulting in a still high inflationary outlook.

- Now, with the Russian invasion, it will add further disruptions on global supply chains across industries, from energy to agriculture, technology, aviation and automobiles.

- The strong sanctions accompanied by shipping companies boycotting Russian products will raise transportation costs by air and sea at least by 3x–4x. This would have a material impact either directly or indirectly, thus hurting business margins, transfer pricing that will fuel cost inflation pressure, hurting demand and job markets.

- The cost of doing business will rise from the impact of higher oil and natural gas prices, a spike in raw materials and commodity prices, disruptions from a potential cyberwar and impact from the strong sanctions that include SWIFT. All these will slash profits of manufacturers, distributors and retailers. Those who are just recovering from the adverse impact of the pandemic risk sinking again.

- Even with partial or total transfer pricing to consumers, the adverse impact will remain significant to businesses as they will become vulnerable to slower demand. Households are still recuperating from the pandemic impact.

- The current scenario points to higher risk of bankruptcies, delinquencies, NPLs, upwards pressure on inflation and living cost, and more M&As and restructuring.

- It also means the global economy is heading for a new economic landscape. The pandemic and the start of the end of a post-Cold War global order means more businesses would be reshoring.

3. Will there be an oil shock like in 1973?

- Russia plays an outsized role in global energy markets as the third-largest oil producer. It exports 5 million barrels of oil per day, accounting for about 12% of the global oil trade. Some 60% goes to Europe and another 20% to China.

- This conflict has pushed Brent oil price past US$100 a barrel for the first time since 2014. Initial views suggested the possibilities for Brent to touch US$120 a barrel in the near term driven by the ongoing tension plus the "supply shock" impact driven by supply chain disruptions in the energy market. It raised fears of an oil shock similar to the 1973 Yom Kippur war in the Middle East.

- While there is a chance that Brent crude oil could trend higher in the short-term, such upside pressure on oil prices would soften if there is a coordinated strategic petroleum reserve release by the USand its allies.

- In recent coordinated efforts, all 31 member countries of the International Energy Agency agreed to release 60 million barrels of oil from their strategic reserves — half of that from the US. Such positive move sends a strong message to oil markets that there will be "no shortfall in supplies".

- Hence, the global oil market should tip back to a surplus, mostly likely in 2Q22. This will unwind the current upward price pressures. Oil price could come back to around US$90–US$100 a barrel in 2Q22 and in 2H22 to hover around US$75–US$85 a barrel.

- Thus, the current oil shock in the base-case scenario will not be as severe as the 1973 oil shock. However, if this conflict turns into a nuclear warfare, the outcome of the oil price will more likely be on an upside volatile trend.

4. Complications for global central banks

- Year 2022 started with an uneven global economic recovery outlook added with inflationary pressure that was expected to ease by mid-2022. Such view now appears to be remote following the Russian invasion. This conflict with Ukraine resulted in a supply shock that has reduced the capacity of the global economy to produce goods and intensified the pressure on inflation.

- The Russian attack has now also complicated central banks' tightening plans. Global central banks will now have to take stock of the unfolding conflict in Ukraine and how it will influence the economy and their plans to shift to a tighter monetary policy. Expectations are that the policymakers could slow down their plans in rolling back their tightening monetary measures that include raising policy rates.

- Oil and commodity price shocks and possibilities of a 10–20% downgrade for 2022 on global GDP projected at 4.4% are clear risks factors. With inflation expectations to rise further, there will be a "wage-price spiral" – demand for higher salary and wages to compensate for the higher living cost that is affecting many consumers.

- Besides, the impact from the unfolding situation in Ukraine on the medium-term economic outlook needs consideration to determine the appropriate pace to raise interest rates. There is a need to now think through the unexpected new dynamics "stagflation". It is an echo we heard during the 1973 oil shock which was also driven by the geopolitical crisis due to the Yom Kippur war in the Middle East.

Fed needs to rethink robustness of interest rate hike n 2022

- The US Fed is expected to remain firm on raising interest rates in 2022. It is likely to reach a tipping point where this situation could start to impact confidence. It is already affecting the financial markets. However, the Fed needs to examine closely the current unsettling conflict in Ukraine.

- The policymakers will need to think through on the possible outcomes from this conflict – could it possibly lead to a nuclear war – and the implication that it has to potentially slow down growth and exacerbate inflation.

- A high oil price is another obvious risk that will weigh on consumer spending and at the same time fuel inflation. More so with no clear clue as to how Russia will react to the hard sanctions and statements from the EU. And the underlying inflation is strong and broadening, supported by a tight labour market. This is a clear setting for rates to be raised.

- The Fed is unlikely to derail its tightening plans. Rate hikes will still continue should the incoming data support it. Besides, the immediate economic risk appears larger for Europe than the US. Still, the Fed is expected to be less aggressive – looking at four rate hikes in total for 2022 each with 25bps starting in March with intermittent pause to examine the situation. Previously, our view was 6 hikes starting with a 50bps in March and settling at 1.75% end 2022.

- The less aggressive rate hikes by the Fed is to avoid what a repeat of the 1970s crisis. The US Fed raised interest rates to 10% by 1978 and that led to a deep recession. The Bank of England pushed up interest rates to 17% that saw a sharp economic decline.

- It will be tough for the Fed alone to address rising inflation via global supply bottlenecks, higher living costs and wages accompanied with slower growth. Its fiscal policy will ultimately have to take most of the burden. It will have to shield the most vulnerable from the impact of higher prices.

- Government spending cannot amend the effects of higher commodity costs. But it can ensure it is shared among the whole of society rather than leaving just certain segments to suffer the combined impact of higher food and fuel prices. And in the medium term, the invasion will shift the composition of government spending. It is likely to end the post-cold war "peace dividend". Defence investment will rise to an already long list of priorities for government spending.

The ECB will have to take 'baby steps'

- The ECB is expected to take a cautious response to the economic uncertainty caused by the Russian invasion of Ukraine, as the conflict threatened to increase inflation and choke growth in the region. The Ukraine conflict is weighing negatively on both supply and demand conditions and raise medium-term inflation outlook risk on both sides.

- Significant uncertainties about the future level of inflation and economic growth have caused the ECB to "adjust policy carefully" with the aim to avoid suffocating the recovery and cement progress towards price stability.

- The present environment does not permit the ECB to pre-commit on its future policy steps. Such commitments can appear once the current conflict or situation becomes clearer. Thus, the ECB will need to take "baby steps" – focusing on necessary measures by using the available tools to shore up confidence and stabilise the financial markets.

- The ECB is expected to refrain from giving an end date to its asset purchase programme on 10 March. And the earlier view of a two 25bps hike in 2H22 will be pushed into 2023.

5. Cyberattacks

- Tensions between Russia and the West escalated with the US and its allies moving to block some Russian banks from the SWIFT international payment system and placed strong sanctions on the Russian central bank's international reserves.

- Retaliatory cyberattacks are high on the cards from Russia or its supporters. Among the tactics that they are preparing for are ransomware and malware attacks; denial-of-service (DOS) attacks that take down websites; and data wiping and theft, possibly simultaneously.

- Global banks are already top targets for cyberattacks even during peacetime. They have stepped up their network monitoring, drilling for cyberattack scenarios, searching their networks for threats and lining up extra staff in case hostile activity surges.

- While banks must prepare for retaliatory cyberattacks, corporates must also take immediate additional precautions. They need to protect their networks in light of what is quickly becoming a major war in Europe. Cyberattacks can impact businesses' finances, reputation, operations, valuation, and staff.

B. Strong impact on Asean

- Both Russia and Ukraine have few economic ties with the 10-nation Asean bloc (Chart 1). Russia exposure is low at 0.53% and Ukraine is 0.1% in Asean. As for FDI investment, it is extremely low with a 0.046% exposure to Russia and 0.003% to Ukraine.

- Despite having a low exposure, this conflict still has a strong impact on Asean. The agriculture players will feel the impact as Asean imports 9.7% of its fertilizers from Russia, after China and Canada. Disruptions to fertilizer supplies will raise prices and hamper productivity.

- The electronics segment will be impacted, especially Vietnam. About US$1.5 billion worth of their exports in the form of electrical machinery and equipment, including smartphones, go to Russia. There are risks of losing this income should the US impose a "foreign direct product rule" on Russia just like on China's Huawei.

- Asean imports wheat, oats, and other cereals from Ukraine. These make up 9.21% of total trade. And another 3.9% of these items come from Russia. This region is the 3rd largest buyer of cereal from a combined Ukraine and Russia, following high consumption of wheat products. Supply disruptions and a rise in transportation cost from Russia and Ukraine will fuel food inflation and hurt the people's buying power.

- Most of the agricultural products from Russia and Ukraine are exported via Black Sea ports. With a risk premium due to this conflict, overall transportation cost will increase. Besides the port issue, supply disruptions from Ukraine's crops owing to the war will add upwards pressure on food prices.

- Another source of inflationary pressure stems from the global energy market. Oil and gas prices were elevated even before Russia's invasion. Following the invasion, oil and gas prices surged further. The upside to oil and gas prices is expected to stay in the near term. So, further upwards adjustments to inflation forecasts and to the economic growth is needed as it will impact household spending. The impact of higher oil prices will vary across Asean.

- Besides rising prices, Asean will also suffer a knock-on impact on its economic growth directly and indirectly, which could result in a 5%–15% reduction in their current GDP outlook, depending on the exposures and policy measures.

- On the political front, Asean maintains its centrality mantra. It has tried to distance itself from superpower dramas. Russia has made its presence in Asean during the Covid-19 pandemic. Moscow engaged in so-called vaccine diplomacy by offering its Sputnik V vaccines to countries like Vietnam and the Philippines. Also, Russia and Asean held their first joint naval exercise, which included warships from seven Asean member states.

- Arms have been Russia's most vital contribution to Asean. Russia was the biggest arms supplier between 1999 and 2018, accounting for 26% of the region's total. But Russian arms deals took a hit recently. It could be partly due to the possibility of US sanctions on countries that deal in weaponry from Moscow. Indonesia has cancelled its 2018 deal to buy Russian Su-35 jet fighters and signed with France Rafale jets and purchased F-15 jets from the US (Chart 2).

- Another source of concern for Asean is China. Beijing may take this opportunity to increase its activities in the South China Sea while the world focuses on Ukraine. It will not be surprising if China tried something that may be provocative and see how the international community reacts. Such advantage now risks a potential conflict.

C. Impact on Malaysia

Nuclear war or not will determine the severity on GDP

- Malaysia, an open economy, is recovering from the impact of the Covid-19 pandemic. Just like the rest of the world, the domestic economy is entering a stage where Covid-19 is becoming endemic. And structural changes are expected to take place – fundamental alterations in people's behaviour, company operations, public opinion and government approaches – as what happened after the 1930s Great Depression.

- Prior to the Russian invasion, in line with an improving global GDP outlook at 4.4%, the Malaysian economy is projected to grow by 5.6% (base case) with an upside of 6.0% and downside of 4.8%. The base-case growth would be supported by exports, firm commodity prices, FDIs, better vaccination, a low base and domestic activities benefitting from the RM530 billion stimulus measures and Budget 2022.

- But the outlook for 2022 now risks a downside revision following Russia's invasion. A downwards revision to 2022 GDP outlook depends much on the outcome of this conflict, whether it will end up with a nuclear war on Ukraine. If Russia attacks Ukraine with nuclear weapons, NATO countries would most likely respond on the grounds that the nuclear weapons cross borders and affect the countries surrounding Ukraine.

- NATO could respond either by using conventional forces on Russian strategic assets or respond in kind using nuclear weapons as it has several options available. The US has around 150 B-61 nuclear gravity bombs stationed in five NATO countries – Belgium, Germany, the Netherlands, Italy, and Turkey – while the US, UK, and France also have long range capability for nuclear attacks under NATO auspices.

- The ongoing conflict is expected to reduce our global GDP outlook by 10%–20% from the direct and indirect impact of this conflict. This is based on the scenario of a "no widespread nuclear war" in Europe. A downwards revision would be driven by high oil and energy prices, rising inflation, drop in confidence and supply chain disruptions.

- The high oil prices will increase Malaysia's Budget 2022 revenue from RM234.bil based on Brent at US$67 a barrel to between RM236.4bil and RM243.9bil based on Brent at US$75–US$100 a barrel. This would translate to a jump from the Budget 2022's revenue projection by between 1.0% and 4.2%. Malaysia would also benefit from higher CPO prices.

- But such high increase in revenue will be accompanied by higher costs. A spike in oil and commodity prices will add pressure on inflation, especially cost push. Upwards pressure on our inflation is partly due to domestic factors such as labour shortages, local supply chain disruptions from the end-2021 floods and the pandemic, and control of approved import permits for certain food items.

- Besides, the rise of prices in global commodities and other products also contributes to inflationary pressures. The Ukraine conflict certainly has an impact on fuel-imported inflation. What more if this conflict turns into a nuclear war, involving Europe, one of our biggest trading partners.

- Accompanied the rising inflationary pressure is the rising living cost. Already, living cost has been on the uptrend due to the pandemic. Added with the current Ukraine conflict, it will elevate further. The pressure will intensify should the conflict becomes a nuclear war.

- In this context, it will be difficult for BNM alone to address rising inflation. Its fiscal policy will ultimately have to take most of the burden. It will have to shield the most vulnerable from the impact of higher prices. Subsidies are likely to increase, eating into the additional revenue enjoyed from Brent and CPO.

- Government spending will need to ensure that it is shared among the whole of society rather than leaving just certain segments to suffer the higher living cost from the impact of higher food and fuel prices. Following the invasion, a shift in the composition of government spending is likely to take place with a greater emphasis on defence as the post-cold war "peace dividend" comes to an end.

- Besides, external headwinds, domestic noises will continue to have some impact on the economy. A pull-back on confidence, slower investment, rising bankruptcies and delinquencies, upwards pressure on NPLs, surprise provisioning, slower loans growth with focus on capital preservation, and ratings downgrade risk are expected to weigh on the economic outlook.

- Will there be an upside or downside revision to the 2022 GDP outlook? Based on the developments in the Ukraine conflict, the current trend shows more downwards revision to the domestic GDP. A "no" nuclear war with the conflict ending fast (in less than a month) should keep our economic momentum unchanged. Our earlier projection of 5.6% as the base case should hold.

- The real challenge is if this conflict is prolonged. The economy will be impacted from both the direct and indirect effects. Compounding all factors (external and domestic), the base case growth target could be around 4.5%–5.0%.

- And a bigger downwards revision would be needed should the Ukraine conflict turns into a nuclear war. Should that happen, there are growing risks for more geopolitical tensions to arise, including in Asia. Such outbreak would be severely damaging and could result in a global recession. Malaysia is unlikely to escape from a negative growth.

Upwards pressure on living cost

- The ongoing crisis in Ukraine has roiled commodity markets and threatened global food security, including Malaysia. Already the fallout from the Covid-19 pandemic and other factors drove food prices high. Poor harvests in South America, strong global demand, and supply chain issues have reduced grain with oilseed inventories seeing prices reach their highest levels since 2011–2013.

- Besides, vegetable oil prices reported record levels due to the shortage from the South American soybean crop, reduced palm oil supplies due to harvest problems in Malaysia, and sharply increased use of palm and soybean oil for biodiesel production. Prices of key energy-intensive inputs like fuel, fertilizer and pesticides have also been at near-record levels.

- Russia's invasion will add further upwards pressure on global markets. It will have negative impact on short-term global grain supplies. Disruptions in natural gas and fertilizer markets will lead to adverse impacts on producers, especially those entering a new planting season. This would push up the already-high food price inflation with serious consequences.

- And with skyrocketing agricultural prices, there is the risk that some countries may insulate domestic producers by restricting exports. This happened in 2007–08 and 2010–11. Such "beggar-thy-neighbour" policies can have harmful effects on importing countries.

- In this context, we can expect retail food inflation to rise. We foresee a further increase in chicken prices because of higher chicken feed prices, namely corn, soybean, and palm oil, which are the main ingredients.

- There is a high risk for chicken farms to suffer and incur losses despite the current subsidy amounting to more than RM500 million, based on previous operating costs. If left unattended, many poultry farm would go bankrupt or switch to other businesses that are more viable, leading to a potential chicken supply shortage crisis and further rise in prices.

- The risk of indirect impact of higher other retail food prices is high. An increase in oil prices would affect the logistics costs. Supply chain disruptions will affect certain raw materials and operating costs. Factories and wholesalers are likely to raise their selling prices. Already many MSMEs are still struggling from the pandemic. The current Ukraine crisis only adds more woes on the MSMEs.

- Potential transfer pricing by factories and wholesalers to the retail traders remains high. This would then lead to a pass-through effect to the consumers. Higher retail pricing will have a more significant impact on the B40 and M40 groups who are still reeling from the pandemic impact.

- In 2020, Malaysia reported an additional of 12.5% of households with income of less than RM2,500. Looking at the M40 group with income of between RM4,850 and RM10,959, about 20% has moved to the B40 group. The rich or those in the T20 group were also affected from this pandemic where 12.8% has shifted to the M40 group.

- And the number of poor households rose to 639,800 in 2020 from 405,400 households in 2019. Absolute poverty increased from 5.6% in 2019 to 8.4%. The number of hard-core poverties rose from 0.4% or 27.2 thousand households in 2019 to 1% which involved 78,000 households.

- For 2022, average headline inflation is expected to stay elevated. The initial view of inflation to remain moderate as the base effect from fuel inflation dissipates may not hold true should oil prices and commodity prices stay high. Besides, upwards pressure would come from higher transportation cost, logistics costs and supply chain related disruptions.

- On that note, the 2022 headline inflation projection of 2.6% (base case) is more likely to reach 2.8% with the upside at 3.0% (previously was 2.8%). But the headline could surpass the 3% level and head much higher should the conflict in Ukraine escalate, potentially leading to a nuclear war and opening the door for more geopolitical risk in other parts of the region. Under such circumstances, the upside to inflation could reach double digits or even higher.

A well-scripted tighter monetary policy could be thrown out

- This new level of uncertainty puts global central banks, including Bank Negara Malaysia (BNM), in a more cautious mode. They are likely to settle at the margins for a less aggressive policy tightening than before. This conflict threatens to increase inflation and choke growth in Europe that would have knock-on effects on global economy including Malaysia

- A well-scripted monetary policy by the central banks towards an aggressive monetary policy tightening strategy post-pandemic has been thrown into doubts by the Ukraine conflict. It has certainly led to greater confusion that is being felt differently across the globe. BNM is no exception in this case.

- BNM and other global central banks could face near-term risks that include a near immediate spike in the crude oil price, surpassing the US$100 a barrel plus spike in commodity prices, rising transport costs, growing risk premium, fear of a potential nuclear war outbreak in Europe, and longer-term uncertainties of what this war could do to confidence, investment, trade, and the financial system globally. It looks certain that this conflict will end the "peace" post-cold War.

- And underpinned by significant uncertainties on the future level of inflation and the overall economic growth dynamics, plus coming out from the strong impact of the pandemic with an uneven recovery, the domestic economy risks experiencing rising bankruptcies, delinquencies, surprise provisioning as the economy starts to roll back some of its stimulus measures such as the moratorium. It is more worrying with rising living cost, challenging job market, and the increasing number of Malaysians being downgraded from T20 to M40 and M40 to B40 while hurting the B40.

- A combination of both the external and domestic challenges would pose headwinds on the overall business and consumer confidence as well as the economy. With a downside revision on the economic growth and upwards adjustment on inflation in 2022, this setting of "stagflation" cannot be easily resolved using the standard monetary policy strategies, especially with inflation being driven from the cost-push pressures more than demand-pull.

- Under the current climate of uncertainties where the inflation pace is expected to surpass expectations in the near term and more downside risk to growth, there is a greater need for a prudent monetary management. Any steps taken towards monetary policy adjustments should be smaller.

- Hence, BNM is more likely to adjust its policy carefully to avoid economic suffocation. Any decision to adjust will be data-driven while considering the current ongoing external climate and domestic noises.

- The current policy rate is likely to stay unchanged in 1H22, with now a 60% chance (previously 90%) for a 25bps rate hike in 2H22 and placing a 40% chance of OPR remaining unchanged in 2022.

- Should the Ukraine conflict turn into a nuclear war that drags Europe into the picture, this is expected to heighten geopolitical tensions in other parts of the world, including Asia. An outbreak of geopolitical tensions in other parts of the world would fire up inflation and pour ice-cold water on the economic growth, globally including Malaysia.

- Under such scenario, it will complicate the monetary policy. The fiscal and non-monetary measures will have to take the lead with the monetary policy complementing it, a similar behaviour from the Covid-19 pandemic.

Limited pressure on our fiscal balance

- Budget 2022 projected a fiscal revenue of RM234.0bil based on the Brent crude oil price projection of US$67per barrel. Petroleum-related revenue is expected to generate RM43.9bil or 18.8% of total revenue. And our dependency on oil revenue is envisaged to ease from 24.9% of total revenue in 2020, to 19.2% of total revenue in 2021.

- On the expenditure side, Budget 2022 projected it at RM233.5bil. Subsidies amount to RM17.4bil, making up 7.4% of the total operating expenditure (RM16.7bil or 7.6% of total operating expenditure in 2021).

- The current Ukraine conflict resulted to a sharp spike in oil and commodity prices. It would certainly. Higher Brent oil price a barrel bodes well as it will increase the government revenue. For every US$1 increase in Brent crude oil price, the additional amount collected would be around RM300 million. It would add into the revenue coffers around RM10bn. It means the overall government revenue should increase to around RM244 billion, up 4.2% from the initial projection.

- On the same token, the rise in oil and commodity prices comes with a cost. With the already rising living cost, there current surge in Brent oil prices and commodity prices if left unchecked will further add upwards pressure on households living cost and businesses bottom line if left unchecked.

- This would mean a need to raise the level of subsidy to help ease some pressure for both the households and businesses. So, the RM17.4bn subsidy budget in Budget 2022 based on a Brent oil price at US$67 a barrel would increase.

- Should the government decide to maintain the current pump price for RON95 (RM2.05 per litre) and diesel (RM2.15 per litre) to help address the woes of both businesses and households, our estimation showed for RON95 subsidy alone, they will have to cough out an additional RM8.3bn assuming Brent oil price a barrel is at US$100.

- And increase in subsidies for non-fuel segment by about 10% - 20% from current RM1.7 billion would translate to RM1.9 billion – RM2.0 billion, a maximum increment of RM0.3bn assuming this assumption holds. Higher overall subsidies by between RM8.5bn – RM8.6bn would raise the total expenditure to RM242.1bn.

- So, the difference between the new revenue and expenditure would be around RM2bn (Budget 2022 was RM0.5bn). This would now translate into an estimated fiscal deficit of around 5.9% - 6.0% of GDP (Budget 2022 is 6.0% of GDP) on the assumption that the real GDP grows by 6.0% based on Budget 2022's estimate. On that note, there is no real material damage on our fiscal deficit/GDP projection.

- But the real challenge will come should this conflict turn into a nuclear war that heightens the global geopolitical tension. Under such circumstances, the fiscal deficit/GDP is likely to raise just like how the world witnessed during the Covid-19 pandemic to address the domestic economy. How much it will rise depends on the expenditure hike and GDP contraction.

Bond market suggests risk of stagflation

- The Russian invasion has led to a sharp demarcation in pricing in three different scenarios. One, where the conflict in Ukraine, sanctions, and the risk of escalation hit economic activity. Second, where the underlying growth is robust enough to warrant higher rates. Third, which is hardly being talked about is, the risk of a potential nuclear war.

- The stagflation risk has gained momentum — rising inflation and slower economic growth. This is a scenario where all central banks would want to avoid.

- The last time such a stagflation situation took place was during the 1973 oil shock — also driven by the geopolitical risk due to the Yom Kippur war in Middle East.

- While the economic impact of the conflict will take some time to work out, there is a growing risk of stagflation, on the combined surge in energy price and hit to confidence. More so if a nuclear war erupts in Europe. Inflation will jump and the economy will be hit.

- In the bond markets, the narrowing of the yield differences between the short and long-term yields, suggests that economic growth is expected to slow down. The US Treasuries spread between the 10- and 2-year duration proves this point as the spread trend seemed to be on the downside. In early January, the spread was 86bps, and it fell to 62bps on 1 February 2022 and further dropped to 38bps during the day Russia formally attacked Ukraine.

- But with crude oil prices topping US$100 a barrel and an array of commodities from wheat and corn to steel spiking, no respite from these inflation pressures appears in sight. Still, the number of rate hikes by the Fed has been lowered despite future expectations for higher inflation remains.

- The Fed is now expected to hike rates around four times from previously six in 2022. The policy rate should settle at 1.00% with two more hikes in 2023 to top at 1.50%. In 2024, rates are expected to fall. In the case of BNM, the policy rate at best is expected to be raised by 25bps in 2H22 with a 60% chance and 40% chance of maintaining it. Much will depend on the outcome of external headwinds and domestic noises.

- Besides, bond yields have fallen in the face of rising inflation expectations. This indicates that real (inflation-adjusted) yield has been declining. The five-year TIPS real yield has fallen to minus 1.70% from minus 0.85%. The 10-year TIPS real yield slid to minus 0.97% from minus 0.57% and then minus 0.42% in mid-February.

- On the same tone, Malaysia's real yields for MGS5 slipped to plus 0.99% from plus 1.03% before the Russian invasion. Real MGS10 year yield fell to plus 1.37% from plus 1.41% before the Ukraine conflict emerged.

- In the near term, underpinned by the ongoing uncertainties, nominal yields are expected to trend downwards due to greater appetite for safe-haven assets. And the real yields will remain depressed owing to rising inflation expectations, portending weaker growth. On that note, the risk of stagflation is becoming far more glaring in the current scenario.

- The risk of the yields to trend downwards further remains high. This can happen should the Ukraine conflict turn into a nuclear war that will drag Europe into the picture.

Equities to remain choppy in near term

- The heavy new round of sanctions on Russia by the US and its allies are likely to push oil prices and inflation even higher. That could be a challenge for the US Fed and other central banks, including BNM, to consider interest rate hikes and add to tighter financial conditions in general.

- A key factor that needs close attention is energy — a big driver of inflation. If oil prices get high enough, they can choke the economy. Sanctions on Russia's banking system and other hard sanctions by the US and other countries do not appear to be causing a broad stress in financial markets. And even though the US did not directly sanction Russian energy, the measures taken will reduce Russia's oil flows onto the market.

- Moscow is one of the world's largest energy producers, exporting about 5 million barrels a day. It is also a major exporter of natural gas, accounting for more than a third of Europe's supply. Whatever happens with oil will reverberate across all the other markets even though the sanctions so far are not aimed at restricting oil. They are restricting activities by buyers and financiers of oil.

- Russian supplies will be disrupted, but whether they're manageable will really be determined by events and by the risks buyers and suppliers are willing to take. At this point, the appetite is in safe-haven instruments, as reflected by yields that are coming down, while gold and silver prices are gaining.

- As for equity markets, the fall was a knee-jerk reaction to the Russia-Ukraine conflict. The markets are expected to tread in choppy waters before discounting this development and stage a sharp rebound.

- In the past, markets tend to generally overreact to geopolitical risks. For instance, Iran's invasion of Kuwait in 1990 saw a sharp correction in markets, and oil prices doubled. Equity markets returned to the peak level four months later.

- The Kargil confrontation between India and Pakistan also saw a sharp correction in the markets in mid-1999. But markets rallied sharply after realizing that this would be a short conflict.

- It is evident here that markets typically react with heightened volatility on expectations of a negative event, and even when the event unfolds. But as events unfold over time, there is a realisation that the situation might get diffused. The rallies in equity markets turn much sharper. The markets will recover their lost ground and trend higher after more clarity on these events.

- We expect the Russia-Ukraine standoff to continue in some form or other, and one should closely track the developments. The danger to markets is if this turns into a nuclear war. It will shatter the market with buying in safe-haven assets.

- In the meantime, investment decisions must be taken based on the fundamental and economic scenario both in Malaysia and globally. The worst is yet to be fully discounted — a nuclear war. Should there be some positive clarity, a rebound is envisaged but it may not be a sharp V-shaped movement.

- While the near-term scenario will continue to be choppy, the current correction provided an interesting entry opportunity for long-term investors. However, they must be mindful of the inflationary impact on corporate earnings, which might see some pressure over the next few quarters.

Appendix

Table 1: Global, US, Euro, Asean (% share Malaysia's trade exposure)

Country	Malaysia's trade exposure (%)
Global	1.2*
The US	10.0
Euro	11.7
ASEAN	15.9

Source: Department of Statistics Malaysia, CEIC, AmBank Research
**Estimated Malaysia's trade share in global context*

Table 2: GDP: Global, US, Euro, Asean (1% impact on Malaysia's GDP)

	Global	The US	Euro	Russia	Ukraine
Global		1.25	0.96	0.85	0.28
The US	0.78		0.69	0.63	0.15
Euro	1.03	1.44		0.84	0.98
Russia	0.87	1.02	1.13		0.86
Ukraine	0.18	0.15	0.62	0.53	
ASEAN	1.98	2.75	2.21	3.66	-1.28
Malaysia	1.61	2.02	1.46	1.32	0.31

Source: CEIC, AmBank Research

Table 3: Government estimated fiscal balance

	2022 (Based on Budget)	2022 (Estimation)						
Brent Price (US$/barrel)	67	70	75	80	85	90	95	100
Overall Revenue	234,011	234,911	236,411	237,911	239,411	240,911	242,411	243,911
Operating Expenditure	233,500	233,800	233,800	235,377	237,045	238,714	240,381	242,050
Dev. Expenditure	75,600	75,600	75,600	75,600	75,600	75,600	75,600	75,600
Loan Recoveries	600	600	600	600	600	600	600	600
COVID-19 Fund	23,000	23,000	23,000	23,000	23,000	23,000	23,000	23,000
Current Balance	511	1,111	2,611	2,534	2,366	2,197	2,030	1,861
Net Dev. Expenditure	75,000	75,000	75,000	75,000	75,000	75,000	75,000	75,000
Overall Fiscal Balance	-97,489	-96,889	-95,389	-95,466	-95,634	-95,803	-95,970	-96,139
NGDP	1,637,800	1,637,800	1,637,800	1,637,800	1,637,800	1,637,800	1,637,800	1,637,800
Fiscal Balance per GDP	-6.0	-5.9	-5.8	-5.8	-5.8	-5.8	-5.9	-5.9

Source: MoF/CEIC/AmBank Research

Table 4: On the Subsidy estimation

Brent Price (US$/barrel)	80	85	90	95	100
Potential additional RON95 subsidy	1,577	3,245	4,914	6,581	8,250
Potential additional non-fuel subsidy	300	300	300	300	300
Overall Subsidy	1,877	3,545	5,214	6,881	8,550

Table 5: Malaysia's exports by Top 10 products exposure to Russia

No	Malaysia's Top 10 Exports to Russia	RM thousands	Share per Exports to Russia	Share per Malaysia's GDP
1	Electrical Machinery and Equipment	924,634.55	23.99	0.06
2	Rubber and Articles Thereof	867,334.93	22.50	0.06
3	Nuclear Reactors, Boilers, Machinery	646,907.70	16.78	0.04
4	Animal or Vegetable Fats and Oils	267,780.84	6.95	0.02
5	Cocoa and Cocoa Preparations	184,308.24	4.78	0.01
6	Miscellaneous Edible Preparations	109,669.40	2.85	0.01
7	Miscellaneous Chemical Products	102,194.32	2.65	0.01
8	Soap, Organic Surface-Active Agents	91,267.22	2.37	0.01
9	Optical, Photographic, Cinematographic	80,593.60	2.09	0.01
10	Essential Oils and Resinoids	67,483.44	1.75	0.00
	Overall Exports from Russia	**3,854,790.48**		**0.25**

Source: DOSM

Table 6: Malaysia's Imports by Top 10 products exposure to Russia

No	Malaysia's Top 10 Import from Russia	RM thousands	Share per Imports from Russia	Share per Malaysia's GDP
1	Mineral Fuels	3,573,030.26	72.53	0.23
2	Fertilisers	659,586.77	13.39	0.04
3	Animal or Vegetable Fats and Oils	108,364.52	2.20	0.01
4	Aluminium and Articles Thereof	105,774.98	2.15	0.01
5	Pulp of Wood	70,220.73	1.43	0.00
6	Nickel and Articles Thereof	58,664.94	1.19	0.00
7	Fish and Crustaceans	39,929.04	0.81	0.00
8	Inorganic Chemicals	39,917.90	0.81	0.00
9	Paper and Paperboard	34,391.70	0.70	0.00
10	Electrical Machinery and Equipment	26,738.11	0.54	0.00
	Overall Imports from Russia	**4,926,289.28**		**0.32**

Source: DOSM

Table 7: Malaysia's exports by Top 10 products exposure to Ukraine

No	Malaysia's Top 10 Exports to Ukraine	RM thousands	Share per Exports to Ukraine	Share per Malaysia's GDP
1	Animal or Vegetable Fats	259,726.82	35.39	0.02
2	Rubber and Articles Thereof	164,243.83	22.38	0.01
3	Electrical Machinery and Equipment	136,299.81	18.57	0.01
4	Articles of Iron or Steel	37,390.36	5.09	0.00
5	Soap, Organic Surface-Active Agents	33,056.54	4.50	0.00
6	Nuclear Reactors, Boilers	19,396.26	2.64	0.00
7	Cocoa and Cocoa Preparations	12,829.03	1.75	0.00
8	Essential Oils and Resinoids; Perfumery	12,385.72	1.69	0.00
9	Organic Chemicals	9,782.52	1.33	0.00
10	Miscellaneous Edible Preparations	9,777.30	1.33	0.00
	Overall Exports to Ukraine	**733,886.42**		**0.05**

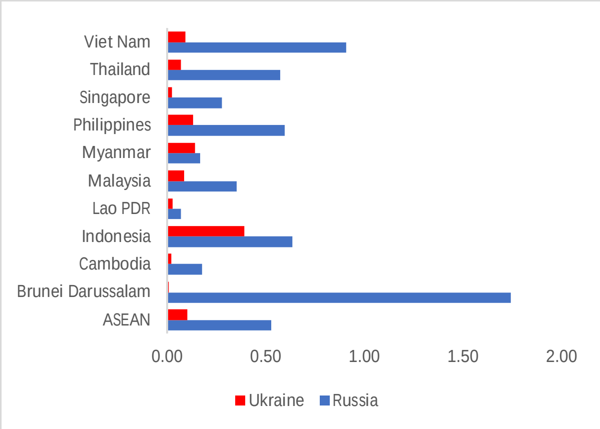
Source: DOSM

Table 8: Malaysia's Imports by Top 10 products exposure to Ukraine

No	Malaysia's Top 10 Imports from Ukraine	RM thousands	Share per Imports from Ukraine	Share per Malaysia's GDP
1	Animal or Vegetable Fats	390,914.59	53.80	0.03
2	Residues and Waste from Food	67,985.97	9.36	0.00
3	Cereals	65,384.23	9.00	0.00
4	Dairy Produce; Birds' Eggs	40,806.90	5.62	0.00
5	Iron and Steel	36,333.30	5.00	0.00
6	Edible Vegetables and Certain Roots	33,961.98	4.67	0.00
7	Wood and Articles of Wood	33,638.97	4.63	0.00
8	Products of The Milling Industry	21,408.85	2.95	0.00
9	Nuclear Reactors, Boilers	5,403.73	0.74	0.00
10	Electrical Machinery and Equipment	3,192.96	0.44	0.00
	Overall Imports from Ukraine	**726,670.74**		**0.05**

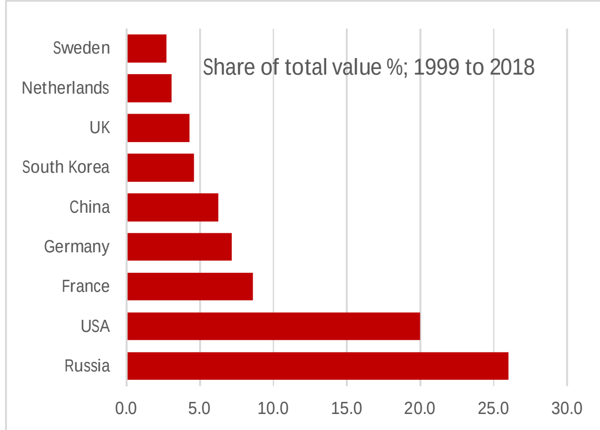
Source: DOSM

Chart 1: Asean trade exposure to Ukraine and Russia (%)



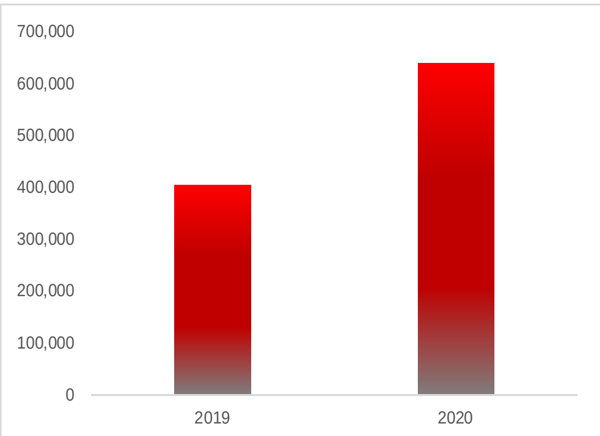
Source: ASEANstats

Chart 2: Major arms suppliers to Southeast Asia



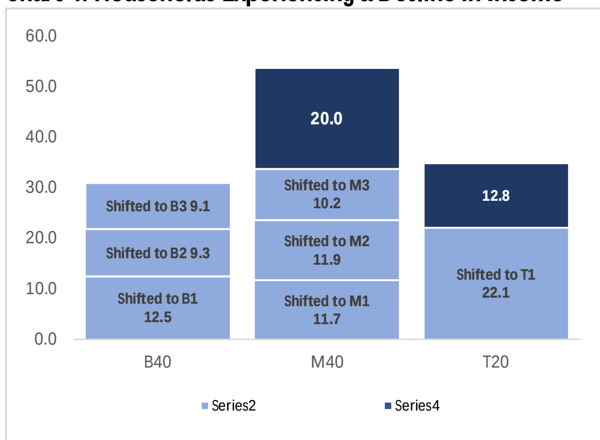
Source: Stockholm International Peace Research Institute

Chart 3: Poor Households



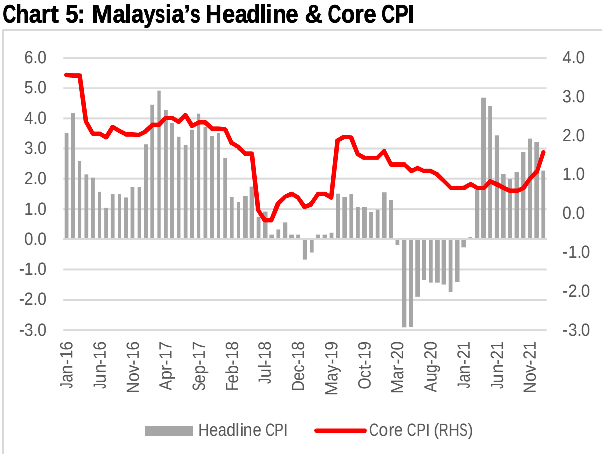
Source: Department of Statistics Malaysia, AmBank Research

Chart 4: Households Experiencing a Decline in Income



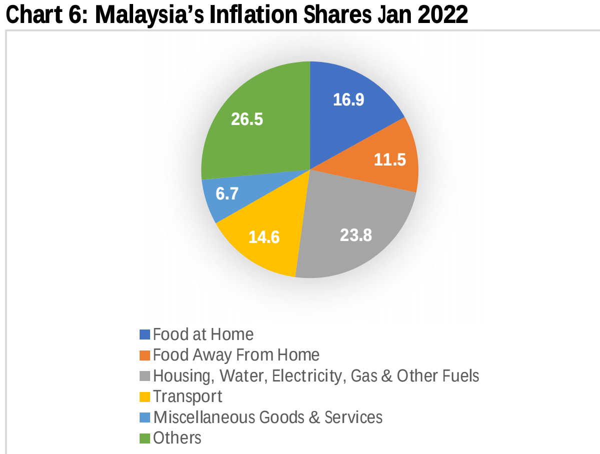
Source: Department of Statistics Malaysia, AmBank Research

Chart 5: Malaysia's Headline & Core CPI



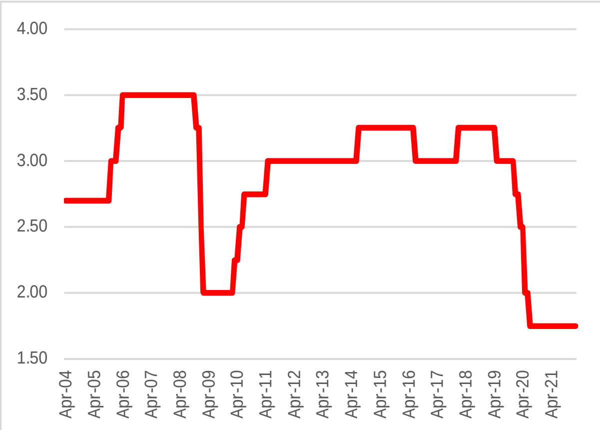
Source: CEIC, AmBank Research

Chart 6: Malaysia's Inflation Shares Jan 2022



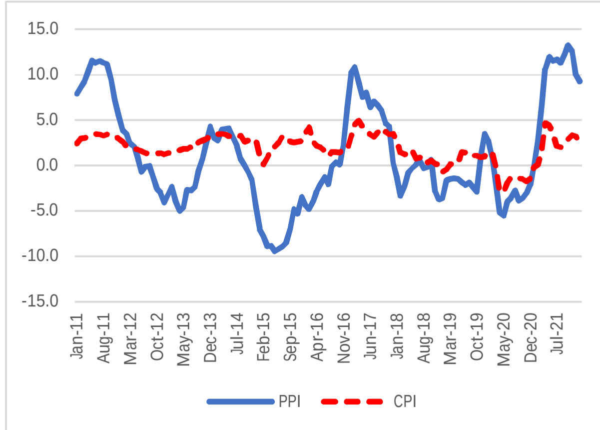
Source: CEIC, AmBank Research

Chart 7: Overnight Policy Rate



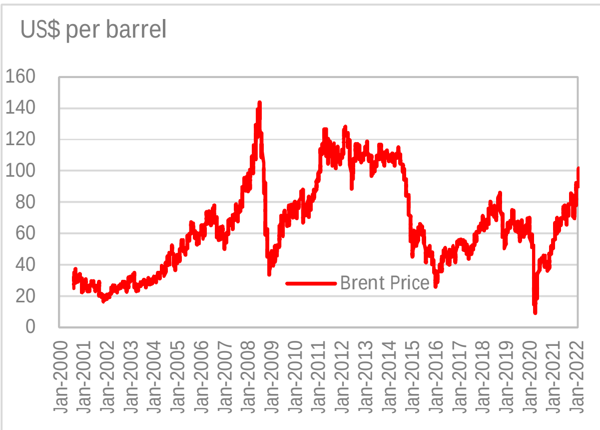
Source: CEIC, AmBank Research

Chart 8: Malaysia's CPI vs. PPI



Source: CEIC, AmBank Research

Chart 9: Brent Price

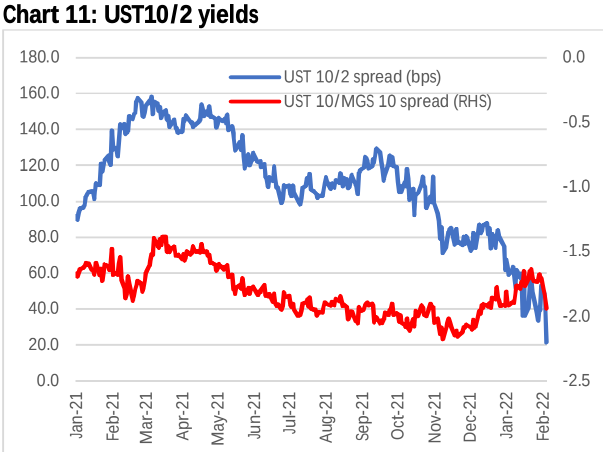


Source: CEIC, AmBank Research

Chart 10: FAO Food Price Index

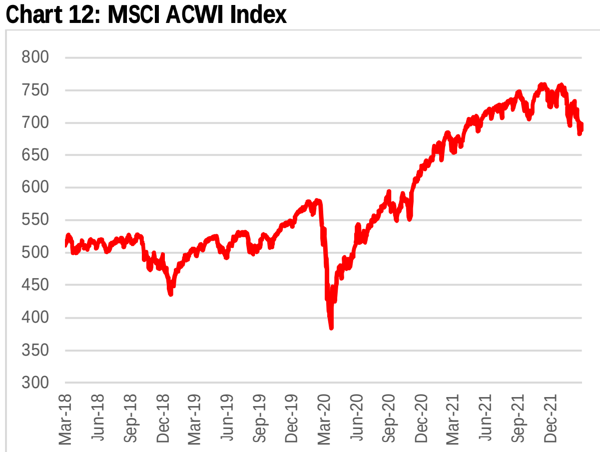
Source: CEIC, AmBank Research

Chart 11: UST10/2 yields



Source: Bloomberg/AmBank Research

Chart 12: MSCI ACWI Index



Source: MSCI/AmBank Research

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