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Malaysia: Country Risk Insight

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In a nutshell

- As a country, Malaysia's key strength lies in its enviable track record of economic resilience, commendable monetary and banking conditions, and healthy (albeit moderating) external finances in recent years. These helped give Malaysia a stronger standing vis-à-vis its regional peers. Notwithstanding this, major challenges for the country include the need to further strengthen the federal government's fiscal position and address overstretched household balance sheets.

- Malaysia's economic strength is underpinned by sound and proactive macroeconomic policies which have led to increasing economic diversification over the years. While manufacturing remains key in propelling exports, the services sector has now expanded to almost 60% of gross domestic product (GDP). Malaysia's vibrant economy is also supported by credible institutions that over time have strengthened its competitiveness, as evidenced by its rising ranking in World Economic Forum's (WEF) Global Competitiveness Index (GCI).

- The inflationary landscape has also remained favourable over the years, with inflation capped mostly below its long-term trend of 4%. Bank Negara Malaysia (BNM), the central bank, played a critical role in balancing the risks surrounding the outlook for domestic growth and inflation, and avoided excessive financial imbalances. The banking system, the largest component of the financial system, remains strong and well-supervised with capitalisation well above required levels.

- Malaysia's external finances remain healthy, despite some moderation in recent years. The economy continues to generate current account (CA) surpluses, although they have narrowed significantly as a percentage of gross national income (GNI) from levels registered during the 2008/2009 Global Financial Crisis (GFC). Meanwhile, offshore borrowings, i.e. foreign currency-denominated borrowings, stood at 34.3% of GDP, a level that is not expected to pose serious risks. In addition, the federal government's share of total offshore borrowings is at a healthy 4.6% as at end-4Q2014.

- Malaysia's major challenges revolve around addressing its fiscal position and debt level, which have slowly improved in recent times. The budget deficit, having surged in the wake of the GFC, has now been halved from 6.7% of GDP in 2009. Measures to cut subsidies have also been introduced, despite their unpopularity. However, achieving a balanced budget by 2020 would remain challenging, especially in an environment of low commodity prices. Federal government debt also remains a thorny issue, although still below the self-imposed threshold of 55% of GDP. Rising contingent liabilities is another issue that needs to be addressed.

- An overstretched household balance sheet is posing a risk, especially on the lower-income households. While the pace of increase in the quantum of debt has moderated in recent years, at the aggregate level, household debt remained elevated at 87.9% of GDP in 2014. Indeed, although mitigated by healthy financial assets, household indebtedness will likely exert pressure on private consumption if the economic cycle takes a turn for the worst. Softer economic growth and low commodity prices will also crimp consumers' spending power.

Table 1: Selected economic indicators

	2009	*2010*	*2011*	*2012*	*2013*	*2014*
Real GDP growth (%)	*-1.5*	*7.4*	*5.2*	*5.6*	*4.7*	*6.0*
Current account (% GNI)	*15.8*	*11.3*	*11.9*	*6.0*	*4.2*	*4.8*
International reserves (USD bn)	*96.7*	*106.5*	*133.6*	*139.7*	*134.9*	*115.9*
Redefined External debt (% GDP)	*54.5*	*54.5*	*60.7*	*63.9*	*70.6*	*69.6*
- of which Offshore Borrowings (% GDP)	*32.6*	*28.5*	*29.1*	*27.3*	*32.8*	*34.3*
Fiscal balance (% GDP)	*-6.7*	*-5.4*	*-4.8*	*-4.5*	*-3.9*	*-3.5*
Government debt (% GDP)	*50.8*	*51.1*	*51.5*	*53.3*	*54.7*	*54.5*
Inflation rate (%)	*0.7*	*1.7*	*3.2*	*1.7*	*2.1*	*3.2*
Unemployment rate (%)	*3.7*	*3.3*	*3.1*	*3.0*	*3.1*	*2.9*

Source: BNM, CEIC, MARC Economic Research

Key Strength

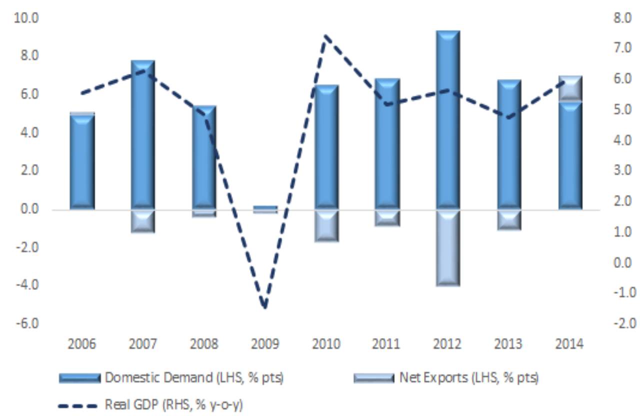
Economic Resilience

Malaysia has an enviable track record of economic resilience that continues to be underpinned by sound and proactive macroeconomic policies. Over the 2005-2014 period, real GDP grew at an average rate of 5.0%, even after taking into account the recession in 2009. (Compared with the regional economies – Thailand, Indonesia, Singapore and the Philippines – which grew by an average of 5.1% in the corresponding period, Malaysia's growth performance can be considered decent.)

Growth performance since the GFC has been and continues to be primarily domestic-driven as the external sector remains in a relatively underperforming mode. Malaysia's economic resilience is due in part to the successes of its economic diversification efforts, thanks to credible institutions and proactive practical policies. It is also due in part to the fact that it is among the most globally competitive nations in the world. In the 2014-2015 edition of the WEF's Global Competitiveness Report, Malaysia's ranking on the GCI climbed to number 20 from 24 previously. Malaysia managed to stay ahead of Thailand, Indonesia and the Philippines in the GCI in most years (refer to Chart 4).

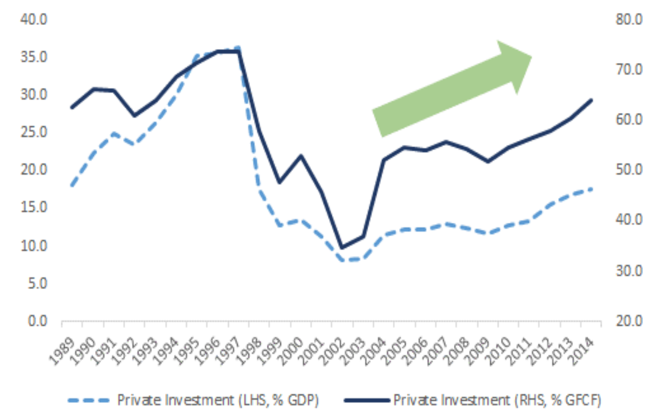
While economic growth is expected to soften to 4.7% in 2015 (our in-house forecast) due to decelerating domestic demand and moderating pace of export performance, over the medium term, we expect GDP growth to average around 5%. This is premised on an expected recovery in domestic demand, particularly in private consumption which will be supported primarily by a stable labour market and easy credit. In addition, the ongoing government-led Economic Transformation Programme (ETP), which is also part of current economic diversification efforts, should help keep Malaysia's economic growth momentum on track. Judging by the current momentum, the private investment ratio to GDP is expected to climb further to 20% in the next few years, supporting overall headline growth.

Chart 1: Contribution to GDP growth – domestic demand and net exports



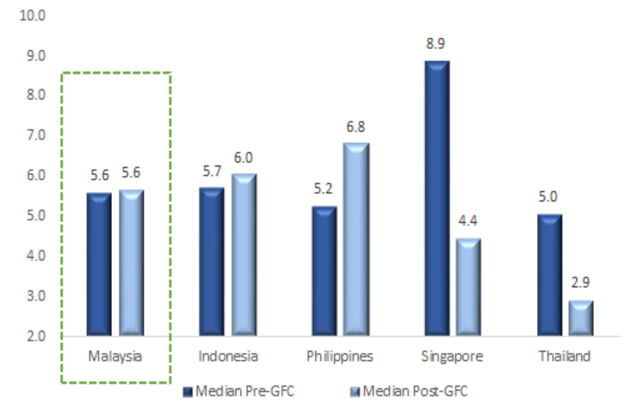
Source: CEIC, MARC Economic Research

Chart 2: Private investment (% GDP and % Gross Fixed Capital Formation)



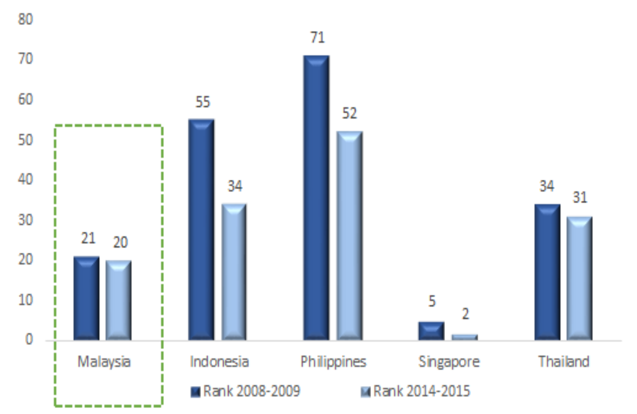
Source: CEIC, MARC Economic Research

Chart 3: Median GDP growth pre- and post-GFC for selected regional economies



Source: CEIC, MARC Economic Research

Chart 4: WEF's GCI rank for selected regional economies (2008-2009 vs 2014-2015)



Source: WEF, MARC Economic Research

Commendable monetary and banking conditions

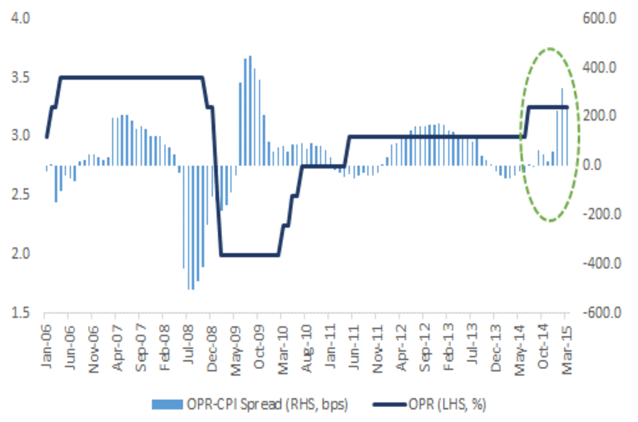
BNM, the central bank, has managed to keep well balanced the risks surrounding the outlook for domestic growth and inflation and avoid financial imbalances. Inflation has been tame, a reflection of BNM's sound monetary policy management. While recent developments point to stronger price pressures in the near term due to subsidy rationalisation measures (i.e. the abolishment of the sugar and fuel subsidies), we do not anticipate it to last more than one to two years. However, for 2015, we anticipate inflation to remain within the range of 3.0%-3.5%, despite lower global crude oil prices. This is due to expectations of a more inflationary environment on account of several developments – mainly the implementation of the Goods and Services Tax (GST) and a possible further rationalisation of non-fuel subsidies.

The Malaysian banking system, the largest component of the financial system, remains strong and well supervised. Since late 2010, BNM's series of macroprudential policies have been introduced not in a vacuum but in concert with a package of monetary, fiscal, regulatory, supervisory and long-term structural measures. The targeted macroprudential policies have to some extent dampened the growth of credit, as well as household debt, although the ratio to GDP for the latter remains high (2014: 87.9%).

As for overall lending growth in the banking sector, we expect it to continue moderating in 2015 on account of slower economic growth and BNM's past macroprudential measures which continue to have an impact. We also expect lending standards to be tightened further going forward. Overall loan growth will likely be in the range of 8.0% - 9.0% in 2015, with the pace of business loans growth to likely stabilise within the 6.0% - 7.0% range. Against the backdrop of expected slower GDP growth in 2015, and as a consequence lower corporate earnings, we foresee bank asset quality deteriorating slightly.

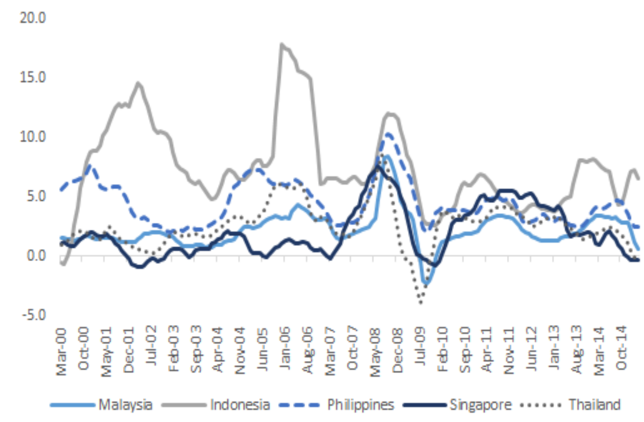
The asset quality of Malaysian banks continued to improve in 2014. While improvements in asset quality in the past were attributed to strong credit growth offsetting the increase in impaired loans, this is no longer the case. Even though overall lending growth moderated in 2014, the ratio of net impaired loans to net total loans actually fell to 1.2% in the same year, compared to the post-GFC high of 2.3% recorded in 2010. In addition, provisions set aside by banks cover more than 100% of all impaired loans. The Malaysian banking system remains highly capitalised overall; in 2014, the Total Capital Ratio and Tier-1 Capital Ratio of the banking system stood at 15.2% and 13.3%, respectively. The Malaysian banking sector also remains profitable overall; in 2014, the sector achieved annualised return on assets (ROA) and return on equity (ROE) of 1.5% and 15.2%, respectively.

Chart 5: OPR and OPR-CPI spread



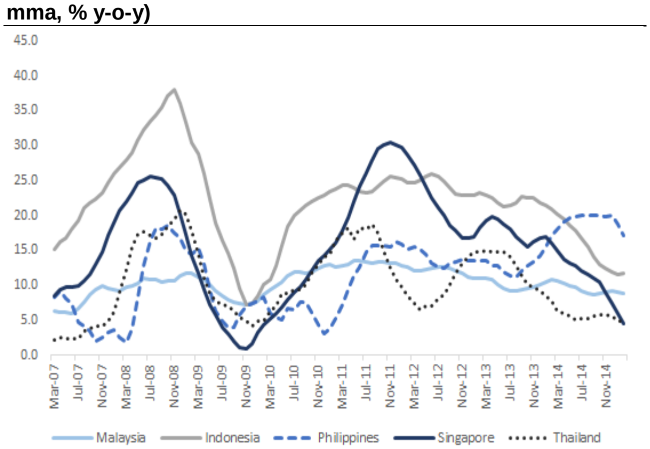
Source: CEIC, MARC Economic Research

Chart 6: Inflation rate for selected regional economies (3-mma, % y-o-y)



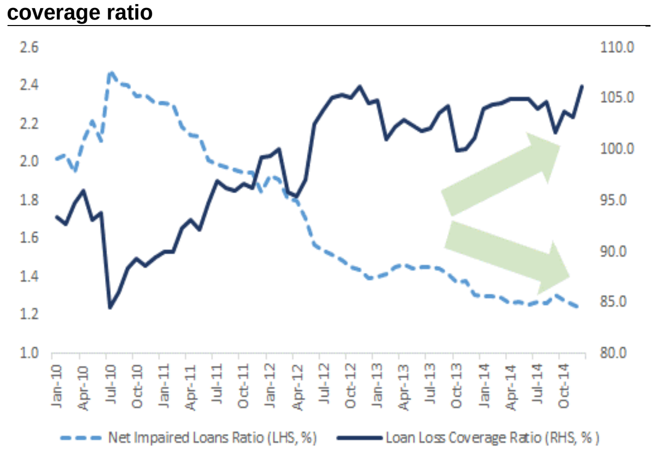
Source: CEIC, MARC Economic Research

Chart 7: Lending growth for selected regional economies (3-mma, % y-o-y)



Source: CEIC, MARC Economic Research

Chart 8: Malaysia's net impaired loans ratio and loan loss coverage ratio



Source: BNM, CEIC, MARC Economic Research

Healthy external finances

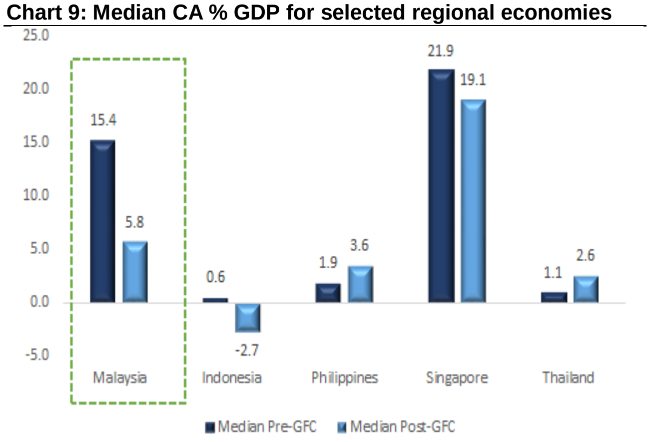
Malaysia's external finances remain commendably healthy, despite some moderation in recent years. While the Malaysian economy continues to generate CA surpluses, the surpluses as a percentage of GNI have narrowed significantly from levels registered during the GFC years of 2008-2009. For example, the CA surplus as a percentage of GNI stood at 4.8% in 2014, compared to 17.6% in 2008. Considering that the global economy continues to struggle, it is unlikely that external demand will strengthen significantly in 2015, even though a weaker ringgit (RM) may have a positive impact on Malaysia's trade balance, to boost the CA surplus. We concur with the government's view that, at an average crude oil price of USD55 per barrel in 2015, Malaysia's CA balance in the balance of payments will moderate to 2.0%-3.0% of GNI.

Notwithstanding this, Malaysia's narrowing CA balance, even before the collapse of crude oil prices, should not be seen in a totally negative light because it reflects the strong surge in private investment and investment projects when viewed from a savings-investment perspective. In fact, the International Monetary Fund (IMF) estimates that roughly two-thirds of Malaysia's CA adjustment during the 2011-2013 period resulted from the strong surge in private investment and investment projects related to the government's ETP. This certainly bodes well for Malaysia's medium-term growth as it should lead to improved growth sustainability over the medium term.

Malaysia's total external debt (re-defined) as a percentage of GDP stood at 69.6% as at end-2014, with medium- and long-term external debt making up 51.6% and short-term external debt making up the balance of 48.4%.

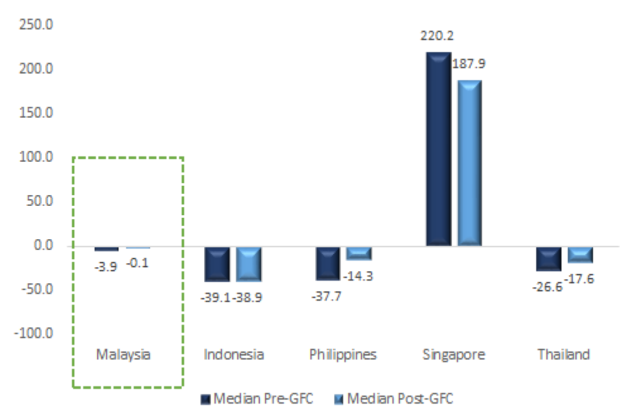
Meanwhile, offshore borrowings, i.e. foreign currency-denominated borrowings, stood at 34.3% of GDP, a level that is not expected to pose serious risks. While a large proportion (42.6%) of offshore borrowings is made up of short-term debt, this is due largely to banking sector activity. The federal government's share of total offshore borrowings is at a healthy 4.6% (end-4Q2014). With the share of public enterprises included, total public sector offshore borrowings rise to 25.4% of total offshore borrowings. However, with the borrowings being medium- and long-term in nature, liquidity risks are low. Meanwhile, the latest data shows that Malaysia's net international investment position in 2013 stood at -4.8% of GDP, an improvement from a decade earlier (2004: -26.8%). We believe that BNM's foreign exchange reserves, which stood at USD115.9 billion as at end-2014, remain adequate as a buffer against capital outflows and can provide a cushion against market volatility. In the event that commodity prices fall further in 2015, and with BNM unlikely to raise the Overnight Policy Rate (OPR) from the current 3.25% because of slower GDP growth in the later part of the year, capital outflows could persist in 2015 and exert additional pressure on the RM.

Chart 9: Median CA % GDP for selected regional economies



Source: CEIC, MARC Economic Research

Chart 10: Median IIP % GDP for selected regional economies



Source: CEIC, MARC Economic Research

Major Challenges

Government fiscal position

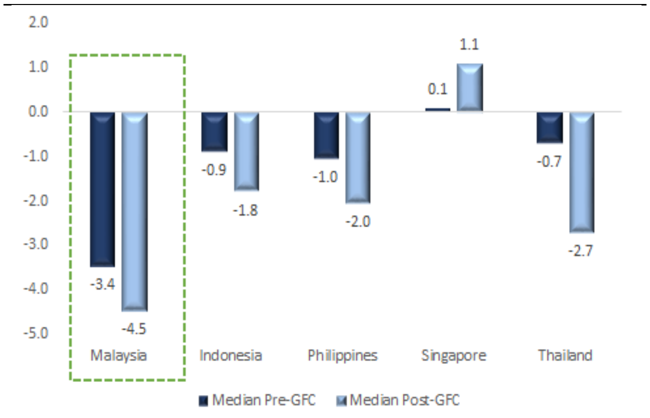
Malaysia's persistent annual fiscal deficits and rising government debt as well as federal government guarantees are major concerns. The fiscal balance has been in deficit since 1998, and this has placed a constraint on Malaysia's sovereign rating. Post-Asian Financial Crisis, the budget deficit fell to as low as 3.1% of GDP in 2007 but rose to 6.7% of GDP in 2009 during the GFC. Since then, the ratio has started to trend downwards (2014: 3.5% of GDP), and the government's target is to achieve a balanced budget by 2020. It is important to remember that the government has shown commitment to deal with the situation, and that it in fact managed to achieve its 2014 budget deficit target against a backdrop of global uncertainties. The government's overall financial performance has also been respectable. In 2014, revenue grew 3.4%, faster than expenditures, which grew 2.4%. Despite these and other positive developments - fuel subsidies have been abolished, and the GST was implemented on 1st April 2015 – however, questions remain over whether a balanced budget is achievable by 2020, especially after the collapse of crude oil prices in 2014.

That the government has had to revise Budget 2015 after the steep fall in crude oil prices in 2014 drives home the point the dangers of being over-dependent on the oil and gas sector for revenue. The 2015 budget deficit target was revised upwards to 3.2% of GDP from the original target of 3%, and the operating expenditure was cut by almost 5%, while the development expenditure was kept unchanged. Meanwhile, the real GDP growth target for 2015 was revised downwards by 50 basis points, from 5.0%-6.0% to 4.5%-5.5%. That Malaysia's proven oil reserves are expected to last just about another 15 years is a very uncomfortable fact. While moves are in place, and have been for quite a while, to reduce the economy's over-dependence on the oil and gas sector, the results of such a strategic move cannot be enjoyed immediately. As such, it is likely that continued volatility of crude oil prices would have a significant impact on the government's fiscal health, as well as the long-term development prospects of the economy.

Meanwhile, the federal government debt level has been sustained at near the self-imposed threshold level of 55% of GDP (2014: 54.5%; 2013: 54.7%). A major portion of government debt continues to be made up of ringgit-denominated debt (2014: 97.1%; 2013: 96.9%). As such, risks associated with the high debt level are mitigated by the currency composition of the debt. On the other hand, as non-resident investors hold a significant portion of total outstanding Malaysian Government Securities (end-December 2014: 44.1%), the high non-resident holdings may become an important source of risk in the event of a large-scale portfolio adjustment. The percentage of government (re-defined) external debt to total external debt has meanwhile declined to 22.6% in 2014 from a high of 24.8% in 2012.

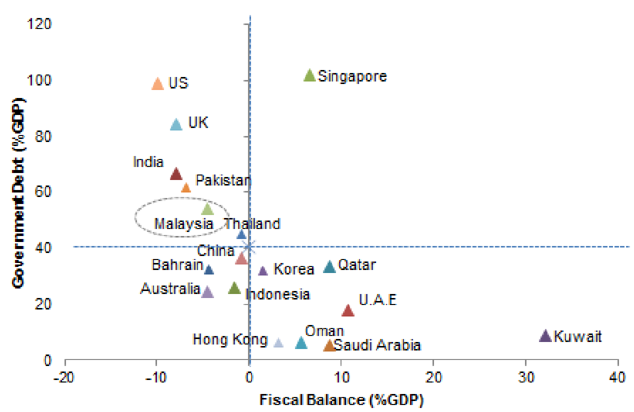
Another risk is the high level of federal government guarantees; this nearly tripled from RM55.7 billion at end-December 2005 to around RM172 billion in 2014. As a percentage of GDP, it climbed from 10.2% to 16.1%, i.e. an increase of 5.9 percentage points. The federal government's guarantees are mainly associated with mega-project investments, which are expected to help boost Malaysia's growth potential going forward. While this is a good thing, risks associated with the speed at which the level of federal government guarantees have risen, as well as the current level, are stoking investors' concerns.

Chart 11: Median fiscal balance for selected regional economies



Source: CEIC, MARC Economic Research

Chart 12: Fiscal balance and government debt metrics for selected countries (5-year median)



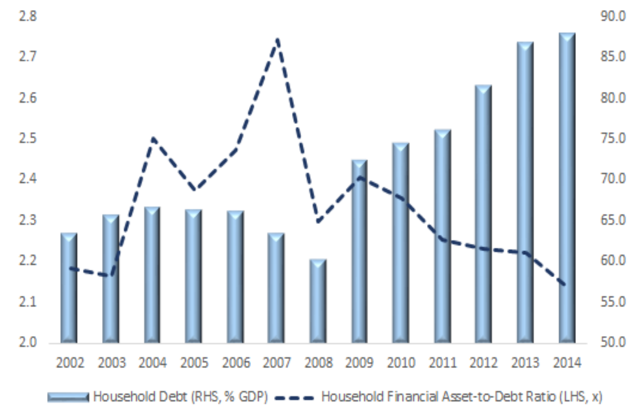
Source: IMF WEO Database, MARC Economic Research

Overstretched household balance sheet

Malaysia's overstretched household balance sheet is another concern. While the pace of increase in the amount of debt has moderated in recent years, at the aggregate level, household debt remained elevated at 87.9% of GDP in 2014 (2013: 86.7%). In addition, about half of the total debt in 2014 (50.5%) belongs to those with incomes of less than RM5,000 per month, who would presumably have minimal savings. Although the amount of financial assets remained relatively healthy at 2.2 times of total debt, the distribution of these assets may not favour the low-income group. Overall, the high level of household debt, when juxtaposed against a relatively low GDP per capita and household income, is a genuine concern. It heightens the risk of further deterioration in household balance sheets that could materially affect Malaysia's future growth trajectory.

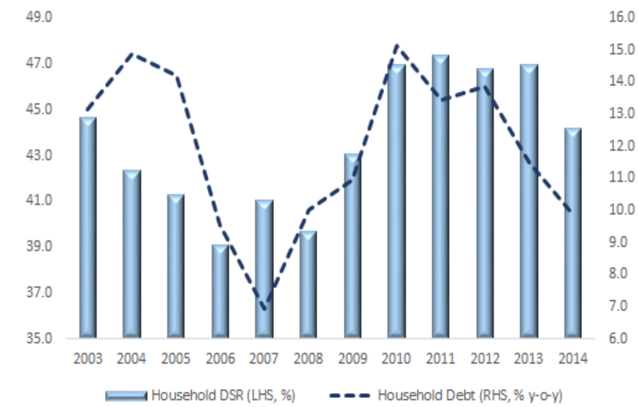
Not all is gloomy. A large proportion of household debt (60%) is used for asset and wealth accumulation; of this, 75% is for housing loans. Since nearly 70% of property loans have been contracted at variable rates, a rise in interest rates could lead to a slight rise in financial sector risks, though not systemic risks, and BNM's stress tests are indicative of this. In addition, the household debt-to-GDP ratio may have already hit its peak in the current cycle, thanks to BNM's macroprudential policies, and we anticipate the pace of household lending growth to slow down to below 10% in 2015.

Chart 13: Household financial assets-to-debt and debt-to-GDP ratios



Source: BNM, CEIC, MARC Economic Research

Chart 14: Household debt-service ratio and household debt growth



Source: BNM, CEIC, MARC Economic Research

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