# Economic Research

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MALAYSIAN RATING CORPORATION BERHAD
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## *Malaysia's 2014 Report Card and Risk Assessment*

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## In a nutshell

- The Malaysian gross domestic product (GDP) growth accelerated to 6% in 2014 (2013: 4.7%), buoyed mainly by domestic demand which grew 6%, albeit slower than its pace in 2013 (7.4%). It contributed 5.6 percentage points to the headline GDP growth (2013: 7.4 percentage points), followed by net exports which added 1.4 percentage points, the first positive contribution since 2006. Domestic demand was largely supported by the sustained growth in private consumption (2014: 7.1%; 2013: 7.2%) and private investment (2014: 11.0%; 2013: 13.1%). Consumer spending picked up strongly in 4Q2014 (7.8% versus 6.7% in 3Q2014) due to improved sentiment on the back of lower pump prices since December 2014 and the rush to spend prior to the implementation of the Goods and Services Tax (GST) in April this year. Private investment also rebounded, registering an 11.2% expansion, almost double the pace recorded in the preceding quarter. On the whole, 4Q2014 GDP has surprised on the upside, registering a 5.8% growth, beating the market consensus of a 5.1% expansion. The stronger-than-expected GDP growth in 2014 is a credit positive from a sovereign rating point of view.

- Notwithstanding this, net exports contracted 9.8% in 4Q2014, reversing its trend of positive growth in the preceding three quarters. The current account (CA) of the balance of payments (BoP) declined in tandem to RM6.1 billion or 2.2% of GDP (3Q2014: 2.8% of GDP). The shrinking CA surplus was mainly due to increasing services and primary income deficits in 4Q2014. For the whole of 2014, CA surplus actually rose to RM49.5 billion (4.6% of GDP) from RM39.9 billion (4% of GDP) in 2013. However, the prospects look less favourable in 2015 as the sharp decline in crude oil prices and slower nominal GDP growth anticipated for this year will add pressure on the CA balance and its ratio to GDP. Coupled with the expected federal government budget deficit of circa 3.2% for this year, Malaysia's CA-debt metrics looks less positive when compared with countries of comparable ratings.

- The capital and financial account (CFA) of the BoP also shows significant outflows of capital in the final quarter of 2014, following the sharp decline in crude oil prices that triggered fears of a further deterioration in government finances. The CFA recorded an outflow amounting to RM24.1 billion in 4Q2014 (3Q2014: -RM2.8 billion), mainly on account of outflows of portfolio capital and other investments by RM20.3 billion and RM4.1 billion, respectively. The less-favourable prospects of Malaysia's financial markets are reflected in the drop in the benchmark equity market index (FBM KLCI) to 1,673.94 points from a peak of 1,892.65 points on 8 July 2014. The yields of the 10-year Malaysian Government Securities (MGS) also climbed to above 4.0% in recent times due to the sell-offs by foreign investors as they feared reliving the experience of the last recession in 2009. Going forward, the anticipated further decline in CA surplus and a possible rate hike in the United States (US) will continue to exert downward pressure on the ringgit (MYR) because of possible further outflows of capital.

- The inflationary landscape has improved slightly in 4Q2014 on the back of lower pump prices following the removal of fuel subsidies which resulted in the price reductions of RON95, RON97 and diesel since December 2014. Waning domestic demand also contributed to softer Consumer Price Index (CPI) growth, which on average rose by 2.8% year-on-year (y-o-y) in 4Q2014 (3Q2014: 3.0%). Notwithstanding this, Malaysia's overall inflation rate accelerated to 3.1% in 2014, one percentage point higher when compared with the preceding year. Going forward, with an expectation of weak crude oil prices in 1H2015, the reduction in electricity tariffs between March – June 2015 and slower consumer spending anticipated post-GST, the inflation rate will likely be in the region of 3.0%-3.5% in 2015, almost the same as in 2014 but lower than our initial estimate of 4%-4.5%. While the reductions in pump prices and electricity tariffs will alleviate some of the cost pressures in the economy, they might not likely be sufficient to boost private consumption in 2015 as consumers will be hit by higher prices due to the implementation of the GST and weaker MYR against the US dollar (USD).

- The fact that Malaysia has successfully achieved its budget deficit target of 3.5% of GDP in 2014 despite various global uncertainties is credit positive. The government's overall financial performance was respectable, considering that the deficits were as high as 6.7% of GDP during the trough of the recent economic cycle. Revenue in 2014 grew 3.4%, while expenditures rose 2.4%, resulting in a budget deficit of RM37.4 billion. Government debt also remained below the self-imposed 55% of GDP in 2014 (54.5%), slightly lower than in 2013 (54.7%), with a major chunk of it (97.1% in 2014) comprising MYR-denominated debt (2013: 96.9%).

- Another positive is the fact that the government's offshore borrowings as a percentage of total government debt have declined to 2.9% from 6.4% during the recession in early 2009. The percentage of government external debt to total external debt (redefined external debt) has also declined to 22.6% in 2014 from a high of 24.9% in 2012 (2013: 22.7%) due to lower foreign holdings of government securities in 4Q2014.

- Although the scenario looks less favourable going forward as government revenue is set to decline on the back of lower crude oil prices (30% of revenue is contributed by oil and gas proceeds) and slower growth of nominal GDP in 2015, the risk of further deterioration is mitigated by respectable medium-term economic growth prospects, given the well-diversified economy. Nominal GDP growth has decelerated to 5.5% year-on-year (y-o-y) in 4Q2014 from an average of 10.5% in 1H2014. In the past 20 quarters, nominal GDP grew at an average of 8.6% y-o-y, and based on our estimates, nominal GDP needs to grow by an average of 7% in 2015 to achieve a budget deficit target of 3.2% (assuming a deficit of RM37 billion as estimated by the MoF in the Revised Budget 2015). Notwithstanding this, the overall budget deficit trend is encouraging, declining from 6.7% of GDP in 2009 to 3.5% in 2014.

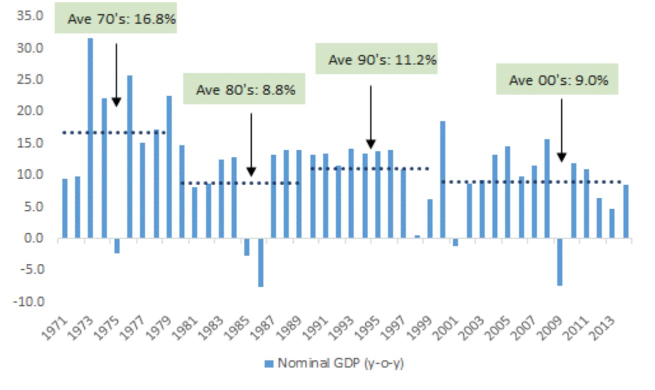
- We view the weakness in real GDP growth in 2015 as a mere cyclical phenomenon, not a change in economic fundamentals. Our forecast of a 4.7% real GDP growth is on account of slower consumer spending growth which we anticipate to decelerate to roughly 5.5% due to stronger price increases in 2H2015. Our view of slower private consumption growth in 2015 is also premised on the recent performance of Malaysia's Institute of Economic Research's (MIER's) Consumer Sentiment Index (CSI) that show the index remaining below the 100-point threshold for the second consecutive quarter in 4Q2014. It also marked the second lowest reading in the past six years. GDP growth might also be affected by lacklustre external demand, following lingering uncertainties in Euro-region economies as well as the continuing weakness of the Japanese economy. A moderation in China's growth will also add to the uncertainty of global trade performance in 2015. That said, the current strong recovery of the US economy and a rebound in other advanced economies in the medium term will help Malaysia register an average real GDP growth of 5%, in our view.

- On the whole, the strong economic performance of 2014, as reflected by the robust real GDP growth and a lower budget deficit, is credit positive for Malaysia. Although we do not anticipate a repeat of such a stellar performance in 2015, we do not feel the expected deterioration in 2015 will affect Malaysia's long-term economic fundamentals, unless crude oil prices remain depressed for a considerable period. A temporary increase in both the budget deficit and government debt will not tarnish its long-term economic performance as the government's efforts to alleviate these imbalances will likely yield positive results in the near future. The government's dependence on external financing is minimal, and as the government has no history of default, this should limit the risk of sovereign stress in the medium term. Economic strength is also backed by the strong development of institutions that support its competitiveness, and this is reflected in the country's persistently favourable rankings in the World Economic Forum's (WEF) Global Competitiveness Index.

- Although the leverage position in the household sector will likely continue in the near term (household debt stood at an estimated 87.7% of GDP in 2014), it will not likely pose a systemic risk in the near term, in our view. We foresee it as already hitting the peak in the current cycle as Bank Negara Malaysia's (BNM) past measures will continue to cap household debt growth from accelerating further. The existence of a decent amount of financial assets (although its distribution is not disclosed by the regulator) will partly cushion the impact of any significant correction in the financial market, such as an unexpected drop in property prices. While the slowdown in household debt growth that is induced by BNM's measures might affect consumer spending growth in the near term, it will alleviate fundamental imbalances in the financial sector. We do not anticipate a hard landing in the household sector, but we remain cautious of its slowdown in 2015. Interest rate normalisation in the US, which could increase the outflow of capital from Malaysia's financial markets, might not cause long-term damage to the economy. The depreciation of the MYR over an extended period will likely support Malaysian exporters in the medium term, cushioning the impact of a weaker domestic economy.

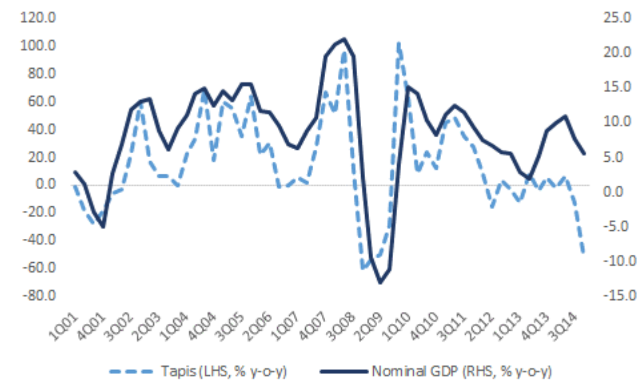
- Our outlook is based on the assumptions that the current distortion in global crude oil prices will be partially corrected and that prices in the medium term will be in the range of USD65-75 per barrel. It also assumed that policies will continue to support Malaysia's real growth target in the medium term, and the CA position will not deteriorate excessively to the point of reaching a sustained deficit in the medium term.

**Chart 1: Nominal GDP growth and LT average**



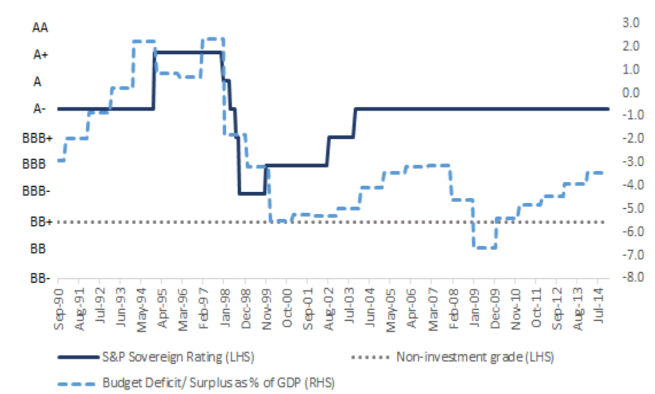

*Source: CEIC, MARC Economic Research*

**Chart 2: Annual change in Tapis price and nominal GDP**



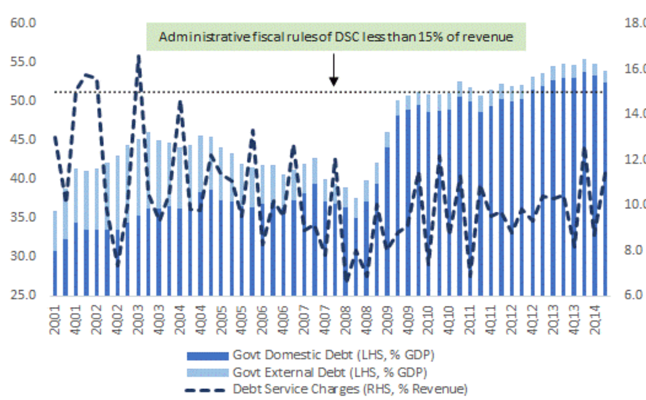

*Source: Bloomberg, CEIC, MARC Economic Research*

**Chart 3: Budget deficit and S&P sovereign rating for Malaysia**




*Source: CEIC, S&P, MARC Economic Research*

**Chart 4: Government debt and debt service charges**




*Source: CEIC, MARC Economic Research*

**Table 1: Analysis of nominal GDP growth and budget deficit**

| Nominal GDP Growth (%y-o-y) | Budget Deficit (%GDP) | | | |
|---|---|---|---|---|
| | Based on revised Budget 2015 (RM37 billion) | Unchanged from 2014 (RM37.4 billion) | 2% higher than budgeted | 1% lower than budgeted |
| 4% | 3.3% | 3.4% | 3.4% | 3.3% |
| 5% | 3.3% | 3.3% | 3.4% | 3.3% |
| 6% | 3.3% | 3.3% | 3.3% | 3.2% |
| 7% | 3.2% | 3.3% | 3.3% | 3.2% |
| 8% | 3.2% | 3.2% | 3.3% | 3.2% |
| 9% | 3.1% | 3.2% | 3.2% | 3.1% |

*Source: CEIC, MoF, MARC Economic Research*

**Table 2: Real GDP Growth**

| Growth (%y-o-y) | 2010 | 2011 | 2012 | 2013 | 2014 | | | MARC 2015F |
|---|---|---|---|---|---|---|---|---|
| | | | | | 3Q2014 | 4Q2014 | YEAR | |
| GDP | 7.4 | 5.2 | 5.6 | 4.7 | 5.6 | 5.8 | 6.0 | 4.7 |
| Domestic Demand | 7.7 | 8.1 | 10.7 | 7.4 | 4.9 | 5.9 | 6.0 | 5.3 |
| Private Consumption | 6.9 | 6.9 | 8.2 | 7.2 | 6.7 | 7.8 | 7.1 | 5.5 |
| Public Consumption | 3.4 | 16.2 | 5.0 | 6.3 | 5.2 | 2.7 | 4.4 | 3.3 |
| Private Investment | 18.4 | 9.4 | 22.8 | 13.1 | 6.8 | 11.2 | 11.0 | 8.4 |
| Public Investment | 4.9 | 2.6 | 14.6 | 2.2 | -8.9 | -2.1 | -4.9 | 1.4 |
| Real Exports | 11.1 | 4.5 | -1.8 | 0.6 | 2.8 | 1.5 | 5.1 | 3.3 |
| Real Imports | 15.6 | 6.2 | 2.5 | 2.0 | 2.2 | 2.6 | 3.9 | 4.9 |

*Source: CEIC, MARC Economic Research*

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