# Economic Research

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## *Country Risk Monitor: Malaysia*

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***Please read the disclaimer on the last page of this report***

## In a nutshell

- Malaysia has a track record of economic resilience that is underpinned by credible economic and monetary policy management. The economy continues to grow, albeit at a slower pace. In 2015, real gross domestic product (GDP) expanded by 5.0% year-on-year (y-o-y), slower than during the previous year (2014: 6.0%). The latest data show 1Q2016 GDP growth at 4.2% (4Q2015: 4.5%). With the global economic environment continuing to be plagued by uncertainties, we expect real GDP growth for full year 2016 to slow down to 4.4%. That Malaysia has managed to continue to grow against a backdrop of ongoing global uncertainties is due to the success of its economic diversification efforts. Economic institutions remain credible, and economic policies proactive and practical. Various government efforts to strengthen the external sector to ensure balanced and sustainable GDP growth are also expected to keep the economy on a positive growth trajectory.

- Given the important intermediation role played by the banking sector in the economy, the Malaysian banking system has been very well supervised, and remains strong and sound. It is highly capitalised, with the total capital ratio, tier-1 capital ratio (Tier-1) and common equity tier-1 capital ratio (CET1) standing at 16.4%, 13.8% and 12.9% respectively as of April 2016. Bank asset quality also remains sustained with the net impaired loans ratio standing at 1.2% and the loan loss coverage ratio stable at 93.9%. Going forward, however, bank asset quality will likely deteriorate slightly on account of slower economic growth. As household leverage is high, macro-financial risks are elevated. However, we do not expect the soundness of the banking system to be materially affected over the near to medium term.

- Malaysia's external accounts remain relatively sturdy. Persistent current account (CA) surpluses have churned out international reserves, which, together with a flexible exchange rate, continue to act as an important cushion against external shocks. International reserves as of May 31, 2016 stood at USD97.3 billion, equivalent to 1.2 times short-term external debt and sufficient to finance 8.0 months of retained imports. While the CA remains in surplus, Malaysia's external position has weakened somewhat as the surpluses as a percentage of gross national income (GNI) have narrowed considerably in the post-Global Financial Crisis (GFC) period. In 2015, Malaysia achieved a surplus of 3.0% of GNI, compared to 4.4% in the previous year. The latest quarterly data show Malaysia registering a CA surplus of 2.5% of GNI in 1Q2016, narrower than the 3.1% recorded in 4Q2015. One reason for this narrowing is that, when viewed from a savings-investment perspective, the task of driving growth has fallen to domestic demand. Oil market turmoil is another reason.

- Meanwhile, Malaysia continues to face fiscal risks as its fiscal balance has been in deficit since 1998. Indeed, public finances are Malaysia's weakest link. But there have been improvements. Thanks to ongoing fiscal consolidation efforts, its fiscal deficit in 2015 narrowed further to 3.2% of GDP (2014: -3.4%). However, lower petroleum-related revenues due to oil market turmoil, as well as lower income tax receipts because of slower GDP growth, are expected to make fiscal consolidation efforts more challenging. Tax from petroleum, for example, made up 5.7% of total government revenues in 2015, compared to 12.9% in 2014. Despite a more challenging fiscal environment, the government is keeping its fiscal deficit target at 3.1% of GDP in the recalibrated Budget 2016. With federal government debt and contingent liabilities as a percentage of GDP remaining elevated, the task of reducing public debt burden and improving affordability is also expected to become more challenging.

- Malaysia's high household debt is also a risk concern. The latest data show that as at end-2015, total household debt stood at 89.1% of GDP (end-2014: 86.8%), which is among the highest in the region. In addition, loans to the sector made up a significant 56.8% of total loans in the banking system as at end-2015, up from 55.1% at end-2011. Slower economic growth and rising living costs have magnified risks associated with high household debt. There have been positive developments, though. For example, household lending growth has slowed. In 2015, household loans growth in the banking system slowed to 7.3%, compared to 9.4% in 2014. While relatively healthy household financial buffers can help mitigate risks, the level of aggregate household sector financial assets is not a very accurate indicator of the sector's overall repayment resilience because of variation of level of financial asset ownership among households.

**Table 1: Selected economic indicators**

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| Real GDP growth (%) | 5.3 | 5.5 | 4.7 | 6.0 | 5.0 |
| Current account balance (% GNI) | 11.2 | 5.4 | 3.6 | 4.4 | 3.0 |
| Foreign exchange reserves (USD billion, end of period (e.o.p.)) | 133.6 | 139.7 | 134.9 | 115.9 | 95.3 |
| Redefined external debt (% GDP) | 58.9 | 62.0 | 68.4 | 67.5 | 72.1 |
| - of which offshore borrowings (% GDP) | 28.2 | 26.5 | 31.8 | 33.5 | 40.1 |
| - of which non-resident hldgs of RM debt securities (% GDP) | 17.9 | 23.0 | 22.5 | 20.2 | 18.3 |
| Fiscal balance (% GDP) | -4.7 | -4.3 | -3.8 | -3.4 | -3.2 |
| Total government debt (% GDP) | 50.0 | 51.6 | 53.0 | 52.7 | 54.5 |
| CPI inflation (% y-o-y, annual average) | 3.2 | 1.6 | 2.1 | 3.2 | 2.1 |
| Unemployment rate (%) | 3.1 | 3.0 | 3.1 | 2.9 | 3.2 |

*Source: BNM, DOS, CEIC, MARC Economic Research*

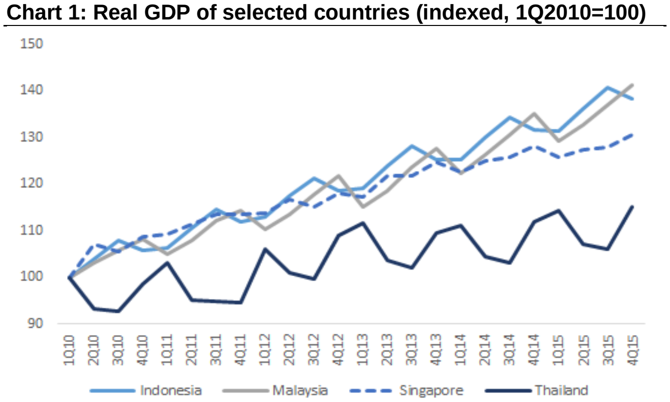
# Key Strengths

## Resilient economy with credible economic and monetary policies

The Malaysian economy continues to grow, spearheaded by private sector growth. The pace has slowed, though. In 2015, real GDP grew 5.0%, compared to 6.0% in 2014 and the average of 5.8% in the post-GFC (2010-2014) period. That Malaysia has managed to continue to grow against a backdrop of ongoing global economic and financial uncertainties is due to the success of its economic diversification efforts. Its relatively low growth volatility of just 0.5% is evidence of this. In addition, its economic institutions remain credible, and economic policies proactive and practical. It is among the most globally competitive nations in the world. In the 2015-2016 edition of the World Economic Forum's (WEF) Global Competitiveness Report, Malaysia ranked at number 18. It is also highly ranked in the World Bank's Doing Business 2016 report at number 18.

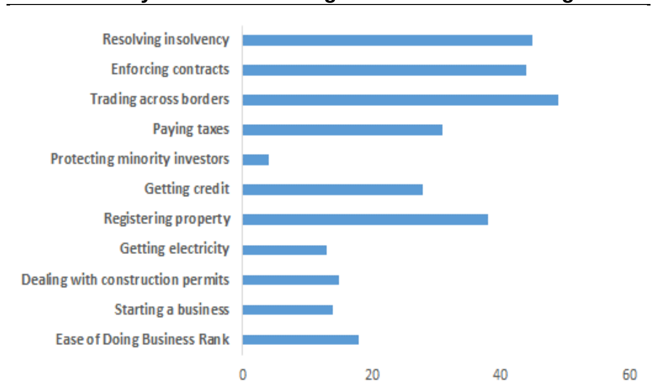
Notwithstanding this, with global headwinds emanating from a weaker Chinese economy and sluggish global trade, we expect real GDP growth to average around 4.4% in 2016, below its long-term potential. Growth will likely continue to depend on domestic demand, though consumer spending is expected to bear the brunt of higher prices resulting from cost-push factors in 2016. Going forward, we expect Malaysia to remain on a positive growth trajectory because it has, among other things, met the basic requirements to ensure competitiveness of the economy – namely institutions, infrastructure and macroeconomic environment. Malaysia's external position over the medium to long term is expected to be boosted by the following: (a) implementation of the ASEAN Economic Community (AEC); (b) leveraging on existing Free Trade Agreements (FTA); and (c) the Regional Comprehensive Economic Partnership (RCEP), now in the final rounds of negotiations.

**Chart 1: Real GDP of selected countries (indexed, 1Q2010=100)**




*Source: CEIC, MARC Economic Research*

**Chart 2: Malaysia: Ease of Doing Business 2016 ranking**




*Source: World Bank, MARC Economic Research*

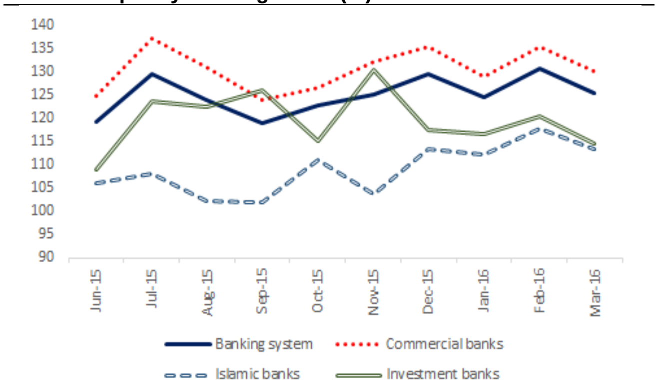
## Sound banking system

The banking system remains sound, thanks to a strong regulatory and supervisory framework. It is highly capitalised overall. As of April 2016, the total capital, Tier-1 and CET1 ratios stood at 16.4%, 13.8% and 12.9%, respectively. Liquidity also remains ample. In addition, the banking sector remains profitable overall. Meanwhile, bank asset quality remains sustained with the net impaired loans ratio standing at 1.2% and the loan loss coverage ratio stable at 93.9%.

The Malaysian banking system's impaired loans ratios for households and businesses are at the lowest points of 1.1% and 2.5% respectively (2014: 1.2% and 2.6%). Notwithstanding the system's currently low and stable impaired loans ratios, bank asset quality will likely deteriorate going forward on account of expected slower economic growth. With slower economic growth and rising living costs, risks associated with high household debt are expected to rise, despite the positive effects of past macroprudential policies. As of December 2015, impaired loans from the household sector made up 37.6% of total impaired loans in the banking system, slightly better than the 39.8% registered in December 2014. Household lending growth will likely be sustained at below 10% going forward, a positive development from the perspective of macro-financial stability.

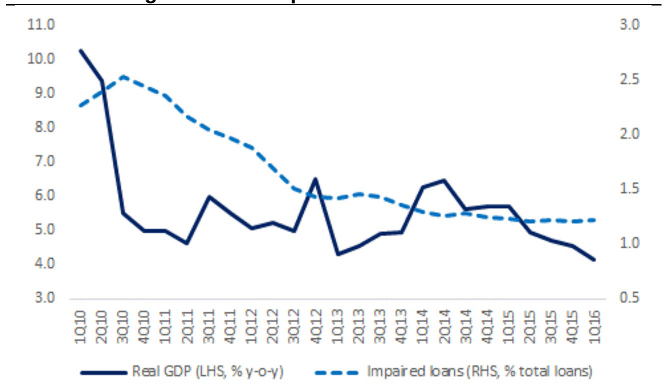
Although macro-financial risks have risen, the soundness of Malaysia's banking system is not expected to be significantly affected over the near to medium term. The regulatory and supervisory environment remain credible, and regular system-wide BNM stress tests and sensitivity tests reaffirm the capacity of Malaysian banks to withstand potential shocks to the debt servicing capacity of households and businesses. Such capacity is supported by banks' strong level of capitalisation and sound asset quality.

**Chart 3: Liquidity coverage ratio (%)**




*Source: BNM, MARC Economic Research*

**Chart 4: GDP growth and impaired loans**




*Source: CEIC, MARC Economic Research*

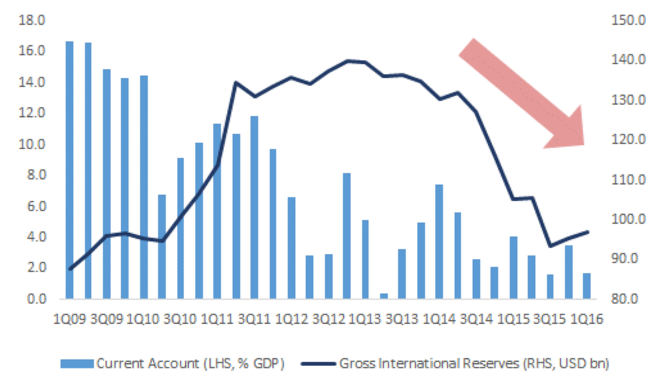
## Relatively sturdy external position

Malaysia's external accounts remain relatively sturdy, thanks to persistent CA surpluses. While the CA remains in surplus, Malaysia's external position has weakened somewhat as the surpluses as a percentage of GNI post-GFC have narrowed. In 2015, Malaysia achieved a surplus of 3.0% of GNI, compared to 4.4% in the previous year. The latest quarterly data show Malaysia registering a CA surplus of 2.5% of GNI in 1Q2016, narrower than the 3.1% recorded in 4Q2015. One reason for this narrowing is that, when viewed from a savings-investment perspective, the task of driving growth has fallen to domestic demand. Ongoing weak export performance partly due to oil market turmoil is another reason. Another important factor is Malaysia's falling export competitiveness.

The level of Malaysia's external reserves remains commendable. As of May 31, 2016, it stood at USD97.3 billion, sufficient to finance 8.0 months of retained imports and equivalent to 1.2 times short-term external debt. Malaysia's total external debt (redefined) is on an upward trend, and has nudged upwards its external vulnerability. As at end-2015, it stood at 72.1% of GDP, up from 52.9% at end-2010. Total offshore borrowings, equivalent to external debt as previously defined, have also increased quite substantially. At end-2015, it stood at 40.1% of GDP, up from 27.6% at end-2010. The latest available data show that the banking sector, with 45.6% of total offshore borrowings as at end-2015, has the largest share. It was followed by the public sector at 27.6%, and the non-bank private sector at 26.7%.

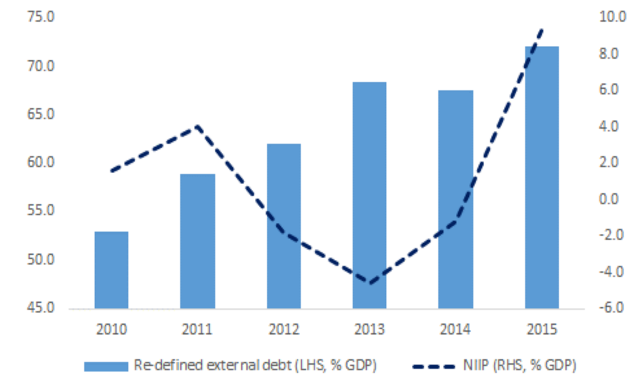
Notwithstanding rising external vulnerability, we are not too concerned as Malaysia's level of foreign exchange reserves remains adequate as buffer against capital flow volatility. In addition, Malaysia has a deep financial market, something that the authorities are working on to enhance further in the future. Malaysia is also a net creditor with a net international investment position (NIIP) of 9.3% of GDP, up from -1.2% of GDP in 2014.

**Chart 5: Current account balance and international reserves**




*Source: BNM, CEIC, MARC Economic Research*

**Chart 6: External debt (re-defined) and NIIP**




*Source: CEIC, MARC Economic Research*

# Major Risks

## Persistent fiscal deficit and high government debt

As Malaysia's fiscal balance has been in deficit since 1998, public finances are its weakest link. Thanks to ongoing fiscal consolidation efforts, its fiscal deficit in 2015 narrowed further to 3.2% of GDP (2014: -3.4%), the lowest since before the onset of the GFC.

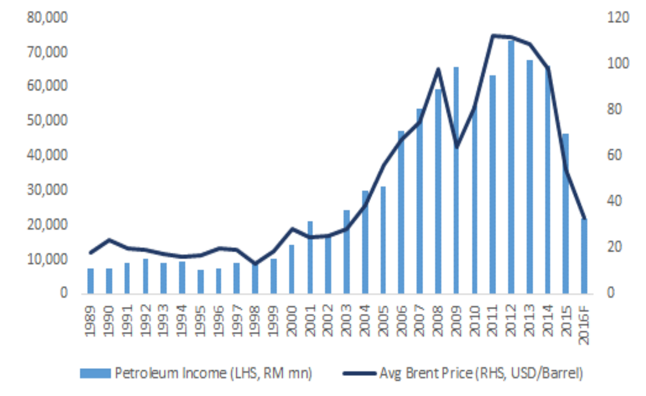
Going forward, lower petroleum-related revenues due to oil market turmoil, as well as lower income tax receipts because of slower GDP growth, are expected to make fiscal consolidation efforts more challenging. For example, tax from petroleum made up 5.7% of total government revenues in 2015, compared to 12.9% in 2014. Contribution from petroleum royalty also declined in 2015, falling to 2.3% from 3.0% previously. As expected, government revenue growth in 2015 contracted 0.7% (2014: +3.4%). Notwithstanding these challenges, the government is keeping to its fiscal deficit target of 3.1% of GDP in the recalibrated Budget 2016. We expect increased demands on the government to support the slowing economy to test its commitment to balance the budget by 2020.

Total government debt at end-2015 stood at 54.5% of GDP (2014: 52.7%). It should be noted that the self-imposed government debt ceiling of 55% of GDP as per the *Loan (Local) Act 1959* and *Government Funding Act 1983* only covers outstanding Malaysian Government Securities (MGS), Government Investment Issuance (GII), Islamic Treasury Bills (MTIB), and syndicated loans raised within the country. We estimate the total outstanding of all these debt instruments at circa 49% of GDP as at end-2015.

Meanwhile, federal government contingent liabilities, which are off-balance sheet expenditures, stood at RM177.7 billion (equivalent to 15.4% of GDP), more than triple the RM55.7 billion at end-2005. Its fast pace of growth and size are risk concerns.

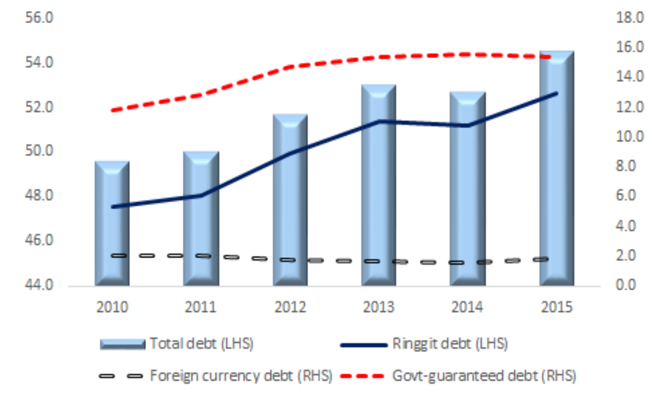
With federal government debt (and contingent liabilities) as a percentage of GDP remaining elevated, the task of reducing public debt burden and improving affordability is also expected to become more challenging as nominal GDP growth is likely to moderate in 2016. The bright spot is that a major portion of total government debt – 96.6% at end-December 2015 – is made up of ringgit-denominated debt, with non-resident investors holding 29.1%. As foreign currency debt makes up just 3.4% of total government debt, the government faces minimal exposure to exchange rate risk.

**Chart 7: Government petroleum income and Brent price**




*Source: Ministry of Finance, CEIC, MARC Economic Research*

**Chart 8: Government debt and contingent liabilities (% of GDP)**




*Source: CEIC, MARC Economic Research*

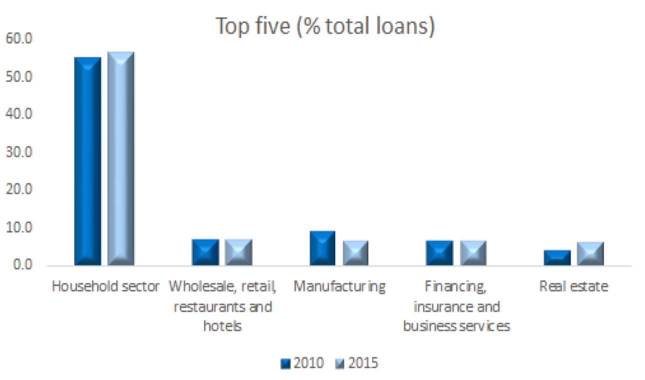
## High household debt

Malaysia's high household debt, a legacy of the post-2008 low rates world order, is a risk concern. The latest data show that as at end-2015, total household debt stood at 89.1% of GDP (end-2014: 86.8%), which is among the highest in the region. From a macro-economic stability perspective, a high household debt burden could dampen private consumption growth at a time when it is crucially needed to support domestic demand growth, more so when consumer confidence is already lacking. According to the Nielsen Global Survey of Consumer Confidence and Spending Intentions, Malaysia's consumer confidence remains at near an all-time low. In 1Q2016, its confidence index score stood at 79, just marginally above its historically low score of 78 recorded in 3Q2015.

With slower economic growth and rising living costs, the ability to service debt will come under pressure, leading to rising risks with implications on macro-financial stability. Loans to the household sector made up a significant 56.8% of total loans in the banking system at end-2015. As for impaired loans, the household sector contributed 37.6% towards the total in the banking system, slightly lower than the 39.8% recorded in December 2014.

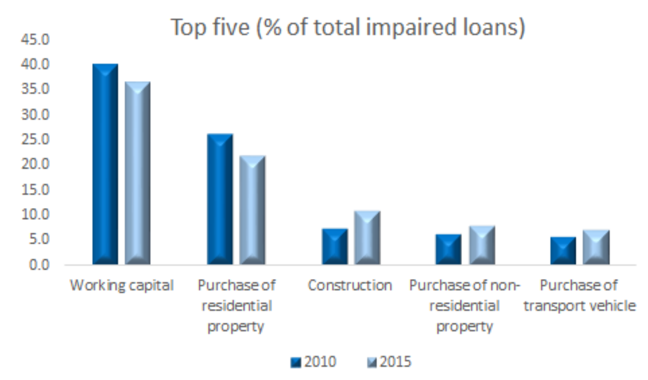
There have been positive developments, though. Past macroprudential policies have resulted in a moderation in the pace of household lending growth. In 2015, household loans growth in the banking system slowed to 7.3%, compared to 9.4% in 2014. Household financial buffers also remain relatively healthy, thus helping to mitigate risks. According to BNM, household financial assets were about twice the value of the household debt in 2015. However, it should be pointed out that the level of aggregate household sector financial assets is not a very accurate indicator of overall repayment resilience. That's because the level of financial asset ownership among households varies.

**Chart 9: Banking system loans - sectoral share**




*Source: BNM, MARC Economic Research*

**Chart 10: Impaired loans by purpose**




*Source: BNM, MARC Economic Research*

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