# Economic Research

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MALAYSIAN RATING CORPORATION BERHAD
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## *The Malaysian economy - Performance and issues going forward*

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## In a nutshell

- Malaysia reported a higher-than-expected growth in 4Q2010, pushing the overall growth to 7.2% for 2010 against the market expectation of a 7% expansion (MARC: +7.2%). As anticipated, growth was supported by resilient domestic demand, while the external sector (net exports) dragged the economy down, slashing 1.6 percentage points from 4Q2010 growth as demand from abroad waned in the final quarter of 2010. For the whole of 2010, the economy was primarily driven by private consumption which added 3.6 percentage points to growth in 2010. Total investments, accounting for roughly one-fifth of the economy, also helped, adding 2 percentage points to the economy last year.

- Going forward, leading indicators such as the Organisation for Economic Cooperation and Development (OECD) composite leading indicators (CLI), which move in tandem with the growth of Malaysia's industrial production index (IPI) and yearly changes in the FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI), clearly signal a moderation in the growth momentum in the next few quarters. The slower growth will be mainly due to the high base effect in 2010 and the weakness in the export sector following lacklustre global demand for Malaysian exports. The good news, however, is that the US economy, which is highly correlated with the Malaysian economy, is anticipated to grow stronger than initially projected due to an expected rebound in capital spending which will offset the weakness in private consumption. We maintain our growth target for 2011 at 5.3%.

- There are several domestic issues that will bear down on Malaysian economic performance in the near term; high on the list is the way consumers respond to the rising cost of living in the wake of the anticipated higher food and petrol prices following the upsurge in global crude oil prices as well as the ongoing government subsidy-rationalisation efforts. Past experience shows that consumer sentiment takes a dive following sharp increases in petrol prices.

- A sudden about-turn in capital flows will also affect the financial market and the real economy, judging from the experience in 1997 and 2008. This is because an unstable financial market will normally affect the banking sector, which in turn would react by reducing credit extended to businesses. The impact of such practices usually ripples through the real economy, leading to cutbacks in capital spending and, in the worst-case scenario, causing businesses to lay off workers.

- With the recovery of the US economy expected to gain momentum and inflows of short-term capital to continue inundating the banking system, a hike in the overnight policy rate (OPR) and in the statutory reserve requirement (SRR) by Bank Negara Malaysia (BNM) cannot be ruled out. A hike in the SRR will likely dampen credit growth as banks adjust the amount of lending in response to higher cost of funds. Notwithstanding this, we think that a sharp drop in loan growth is not a likely scenario as banks continue to struggle to remain competitive. Margin compression will also induce them to continue extending loans to relatively safe sectors such as the household sector.

- The success in attracting private investments is another important factor that will determine Malaysia’s macro performance in the next few years. As the government is adamant about limiting its role in financing investments in Malaysia, the private sector is shouldering the responsibility to draw in investments, either locally or from abroad. From the updates which have been consistently disseminated by the Performance Management and Delivery Unit (PEMANDU), an entity that has been tasked to elevate private investments in the country, one can surmise that Malaysia is likely on the path to reinvigorating private investment activities which have dropped substantially since the 1997/98 Asian Financial Crisis (AFC).

- The budget deficit is another thorny issue that the government is trying to resolve. To be fair, the government has managed to slash the deficit down from 7% of gross domestic product (GDP) in 2009 to 5.6% in 2010. The persistent budget deficit has become a concern for two reasons: it affects the country’s sovereign rating (which is influenced by the outlook of the fiscal position in the medium and long term), and it limits the extent to which the government can utilise the resources in its coffers to undertake fiscal expansionary policies should there be a relapse in the global economy. We feel that Malaysia’s budget deficit is not significantly related to weak revenues. On the contrary, Malaysia’s revenue as a percentage of GDP is among the highest in the region.

## Good numbers for 2010, but momentum slowed in final quarter

Malaysia's 4Q2010 GDP growth came in at 4.8% year-on-year (y-o-y), above market expectations of 4.5%, pushing the year's overall expansion to 7.2%, in line with MARC's estimate of 7.2%. As anticipated, growth was supported by resilient domestic demand, which grew by 5.7% in 4Q2010 (5% in 3Q2010). Private consumption and total investment spearheaded the economy, growing by 6.5% and 9.2% respectively, despite moderating from their levels in the preceding quarter. The external sector (net exports), on the other hand, dragged growth down, slashing 1.6 percentage points from 4Q2010 growth as demand from abroad waned in the final quarter of 2010.

For the whole of 2010, growth was primarily driven by private consumption, which expanded by 6.6% and accounted for 53.3% of the economy. Private consumption was responsible for 50% of the growth (3.6 percentage points) in 2010, while total investments, accounting for roughly one-fifth of the economy, added two percentage points to the economy last year.

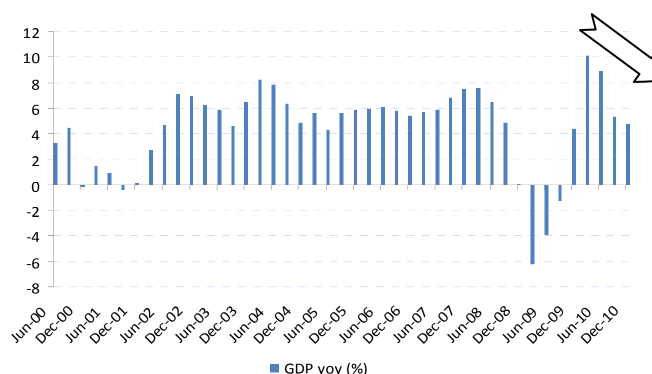
Overall, the growth momentum slowed for the third consecutive quarter after peaking in 1Q2010, primarily due to slower net exports which were adversely affected by lower exports of electrical and electronic (E&E) products following slower global chip sales. Going forward, global sales growth of semiconductor components is anticipated to remain lacklustre, as reflected by the single-digit expansion rates forecasted by the Semiconductor Industry Association (SIA) for 2011 (+6%) and 2012 (+3.4%).

**Table 1: Malaysia's GDP components' y-o-y growth rates**

| | 3Q2010 | 4Q2010 | 2009 | 2010 |
|---|---|---|---|---|
| **Real GDP** | **5.3%** | **4.8%** | **-1.7%** | **7.2%** |
| **Demand side** | | | | |
| Private consumption | 7.1% | 6.5% | 0.7% | 6.6% |
| Public consumption | -10.2% | -0.3% | 3.1% | 0.1% |
| Gross fixed capital formation | 9.8% | 9.2% | -5.6% | 9.4% |
| Exports | 6.6% | 1.5% | -10.4% | 9.8% |
| Imports | 11.0% | 3.3% | -12.3% | 14.7% |
| **Supply side** | | | | |
| Agriculture | 2.7% | -4.3% | 0.4% | 1.7% |
| Mining | -1.0% | -1.3% | -3.8% | 0.2% |
| Construction | 2.8% | 5.6% | 5.8% | 5.2% |
| Manufacturing | 7.5% | 6.2% | -9.4% | 11.4% |
| Services | 5.4% | 6.2% | 2.6% | 6.8% |

Source: Department of Statistics

**Chart 1: Malaysia's GDP growth (%)**



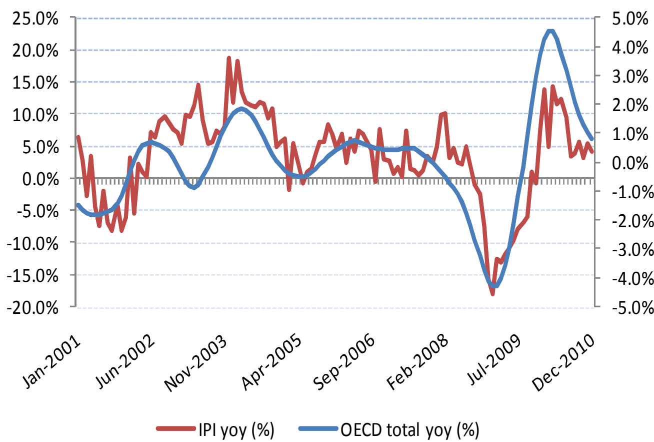

Sources: CEIC & MARC Economic Research

## Moderation sets in…

Given that global demand for Malaysia's exports is not expected to pick up substantially in the near term, the country's external sector will likely remain in the doldrums in the first half of this year. As imports are projected to exceed exports in 1H2011, net exports could potentially subtract certain percentages from GDP growth, leaving domestic demand to pick up the slack. However, renewed pressure on consumer prices will likely result in a slowdown of consumer activity on the high street in the near term as disposable incomes and purchasing power shrink. As such, we maintain our growth target for private consumption at 5.8% in 2011, reflecting the slower momentum in consumer spending.

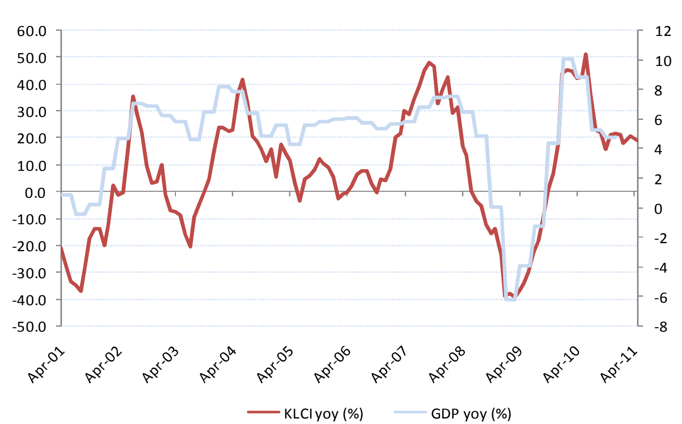
Total investments, having risen more than anticipated in 2010, will likely grow at a high single-digit pace as risk aversion continues to subside in the next few quarters. However, swift implementation of the investments outlined in the Economic Transformation Program (ETP) is critical in realising this outcome.

**Chart 2: OECD CLI and Malaysia's IPI growth (%)**




Sources: OECD, CEIC & MARC Economic Research

**Chart 3: GDP growth and FBM KLCI (%)**

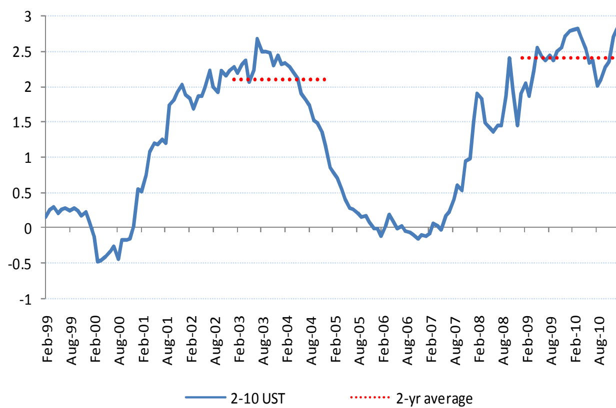



Sources: CEIC & MARC Economic Research

Overall, leading indicators, such as the OECD CLI, which move in tandem with the growth of Malaysia's industrial production index (IPI) and yearly changes in the FBM KLCI (see Charts 2 and 3) clearly signal a moderation in the growth momentum in the next few quarters, primarily due to the high base effect in 2010 and the weak export sector. As such, we maintain our GDP growth target for 2011 at 5.3%.

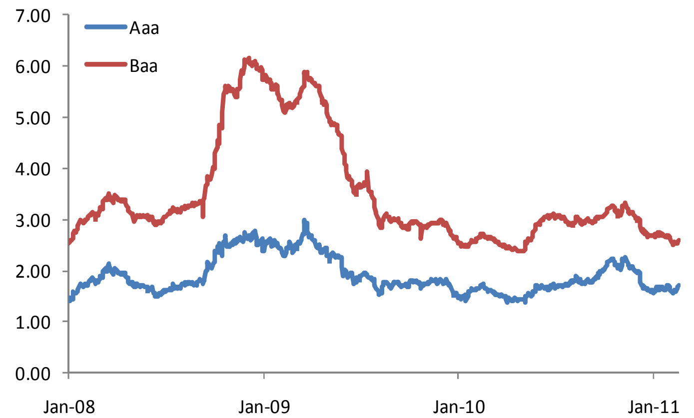
The good news, however, is that the US economy, which is highly correlated with the Malaysian economy, is anticipated to grow stronger than initially projected due to an expected rebound in capital spending that offset the weakness in private consumption. This view is also supported by recent trends in financial market indicators which have, over the years, been consistent in predicting the growth momentum of the world's largest economy (see Charts 4 and 5).

**Chart 4: Yield spread between 2- and 10-year Treasuries (%)**



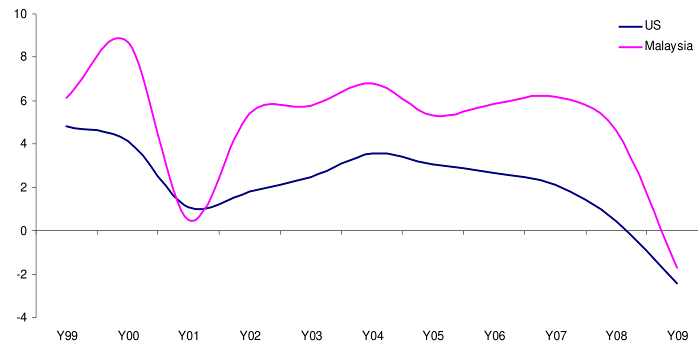

Sources: CEIC & MARC Economic Research

**Chart 5: Yield spread between corporate bonds and Treasuries (%)**




Sources: CEIC & MARC Economic Research

**Chart 6: Malaysian and US GDP growth (y-o-y%) moving in tandem**




Source: CEIC

## Pertinent issues going forward

Besides the headwinds from the global economy, a number of domestic factors will likely shape the overall performance of the Malaysian economy in 2011 and 2012. These include:

***How consumers respond to higher living costs***

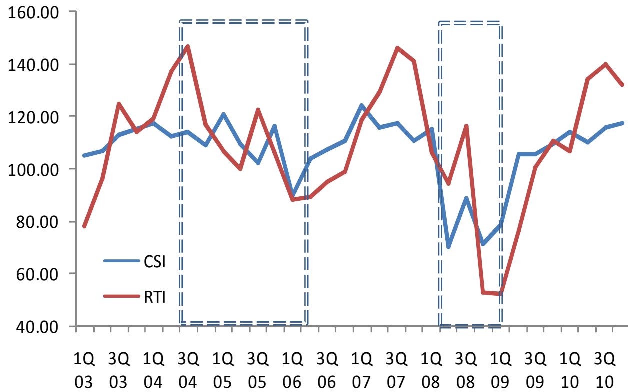
As the government continues to scale back subsidies by raising petrol prices (i.e. RON97), consumers will be affected in two ways: those who continue to use RON97 will incur higher fuel expenditure, and more importantly, prices of general goods and services will rise in tandem with the increase in petrol prices (although only the price of RON97 was markedly raised recently). Past experience shows that consumer sentiment takes a dive following increases in petrol prices (see Chart 7).

The risk of higher global crude oil prices has risen sharply following the unrest in the Middle East and North Africa (MENA) region since the fall of the governments of Zine El Abidine in Tunisia in January and Hosni Mubarak in Egypt this month. The violence that has spread to Libya and Bahrain in recent weeks has pushed Brent prices to as high as USD108 per barrel, and recent forecasts by oil analysts suggest that West Texas Intermediate (WTI) prices, after briefly hitting the USD100-per-barrel mark, may soon surpass it if the unrest continues in the near term. Although this would be a boon for oil-exporting Malaysia, consumers might be hit by rising fuel costs, hindering the government's efforts to drive private consumption in the near term.

Another possible outcome of higher living costs is the household sector's growing dependency on credit. As credit cards can be used as a source of financing living expenses (if other means of generating income are unavailable), it is no surprise, then, that the number of credit cardholders has escalated in recent years.

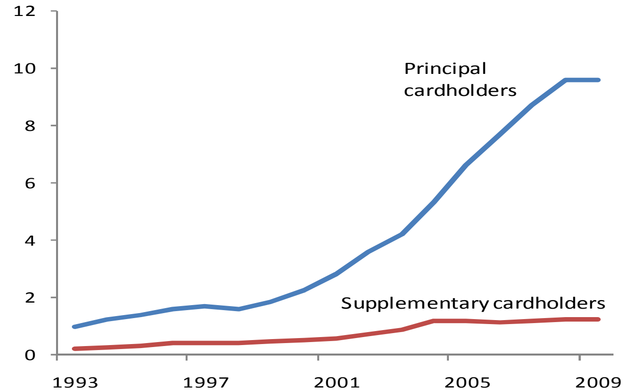
Since the new millennium, this number has increased at an exponential rate (see Chart 8), suggesting that users' leverage position is increasing. The fact that the ratio of household debt to GDP has remained over 60% since the beginning of the new millennium also indicates the dependency of households on debt to finance consumption and investment. Should, for some reason, rising household debt induce banks to scale back on their lending to consumers, private consumption could be drastically affected.

**Chart 7: Consumer Sentiment Index (CSI) and Retail Trade Index (RTI)**




Sources: CEIC & MARC Economic Research

**Chart 8: No. of principal and supplementary credit cardholders (mil)**




Sources: CEIC & MARC Economic Research

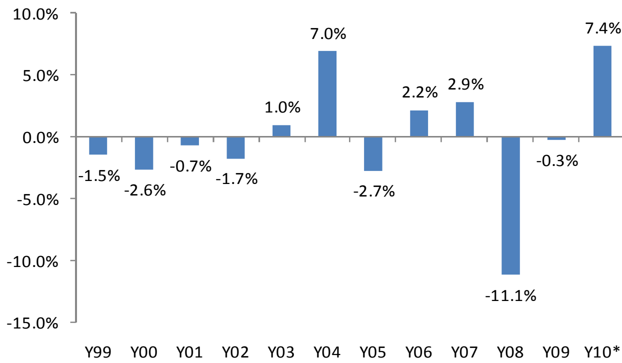
***Will there be sharp reversals of capital flows?***

Historical experience in 1997 and 2008 suggests that massive capital outflows (especially portfolio outflows) tend to have negative repercussions on not only the financial markets, but also the real economy. This is because an unstable financial market will normally affect the banking sector, which in turn would react by reducing credit extended to businesses. The impact of such practices usually ripples through the real economy, leading to cutbacks in capital spending and, in the worst-case scenario, causing businesses to lay off workers.

Not surprisingly, the recent inflows into the emerging economies (Malaysia included) have raised concerns among policymakers on how to deal with the swathe of liquidity in the system. In Malaysia's case, net portfolio inflows have grown to an astounding RM41.4 billion in the first three quarters of 2010, compared with the minuscule RM0.8 billion recorded in 2009 and the massive net outflow of RM84.4 billion in 2008.

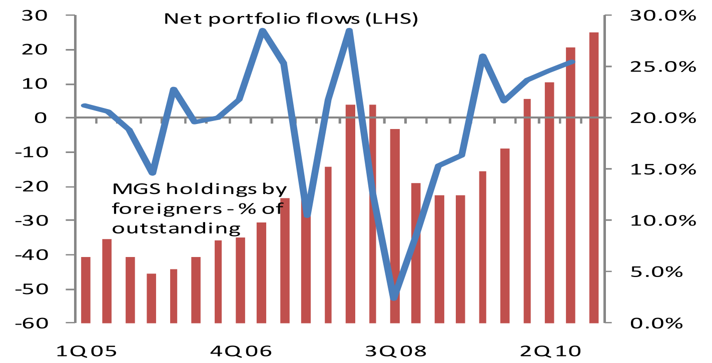
The risk of international investors withdrawing their investments from emerging economies cannot be underestimated as turmoil in the MENA region has raised risk aversion among portfolio managers. In addition, the US economy's better prospects have also induced asset managers to reconsider going back to investing in the US in the near term, as reflected in the recent performance of the MSCI World Index of equities in 24 countries which climbed 6.1% in the year to date, the best annual start in 13 years, compared with the MSCI Emerging Markets Index of shares in the BRIC (Brazil, Russia, India and China) bloc which lost 2.7% within the same period.

**Chart 9: Net portfolio flows as a percentage of GDP (%)**




Sources: CEIC & MARC Economic Research
Note: * = first three quarters of 2010

**Chart 10: Net portfolio flows (billion) and Malaysian Government Securities (MGS) holdings by foreigners (%)**



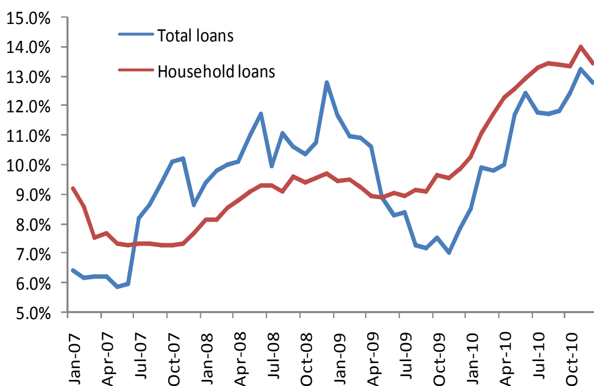

Sources: CEIC & MARC Economic Research

### *Will there be monetary tightening soon?*

Inflationary pressure is building up, although the consumer price index (CPI) has remained below 3% in terms of yearly growth in the recent months. With the expected recovery of the US economy and continuous inflows of short-term capital, hikes in the OPR and in the SRR by the BNM cannot be ruled out. Such moves will indubitably have an important bearing on the economy going forward.

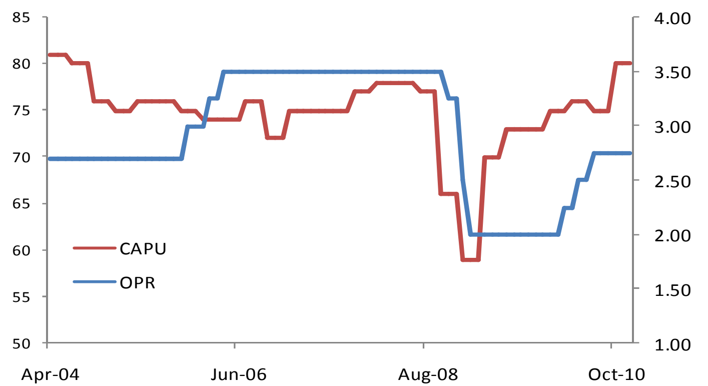
We maintain our OPR target of between 3.00% and 3.25% for 2011 as economic momentum picks up in 2H2011. While a possible hike in the SRR would usually dent credit growth as banks adjust the amount of lending in response to the higher cost of funds, a sharp drop in loans growth is not likely, as banks have to remain competitive and margin compression will likely induce them to continue extending loans to relatively safe sectors such as the household sector.

**Chart 11: Household and total loans growth (%)**




Sources: CEIC & MARC Economic Research

**Chart 12: Capacity utilisation (CAPU) rates vs. OPR (%)**




Sources: CEIC & MARC Economic Research

### *Will private investments provide a helping hand?*

As the government slowly withdraws from its role in financing investments in the country, the private sector will have to shoulder the responsibility of bringing in investments, either locally or from abroad. In 2010, private investments rebounded strongly, with foreign direct investments (FDI) amounting to an estimated RM21.4 billion (from barely RM5 billion in 2009) following a decline in risk aversion. Judging by the increasing number of manufacturing approvals and the 9.2% expansion in total investments in 4Q2010

(albeit slower than the 9.8% growth registered in the earlier quarter), private investments must have played an important role in supporting the overall economy in the past one year.

Going forward, growth in total investments hinges on the successful implementation of the projects outlined in the ETP. The latest statistics provide grounds for optimism - since October 2010, 37 entry-point projects worth RM80 billion have been announced that will generate approximately RM117 billion worth of gross national income (GNI) and create 36,000 jobs. From the updates which have been consistently disseminated by PEMANDU, one can surmise that Malaysia is likely on the path to reinvigorating private investment activities which have dropped substantially since the AFC. Given that total investments account for approximately 20% of the Malaysian economy, a high single-digit growth will provide some buffer against the externally induced contraction in economic activity.

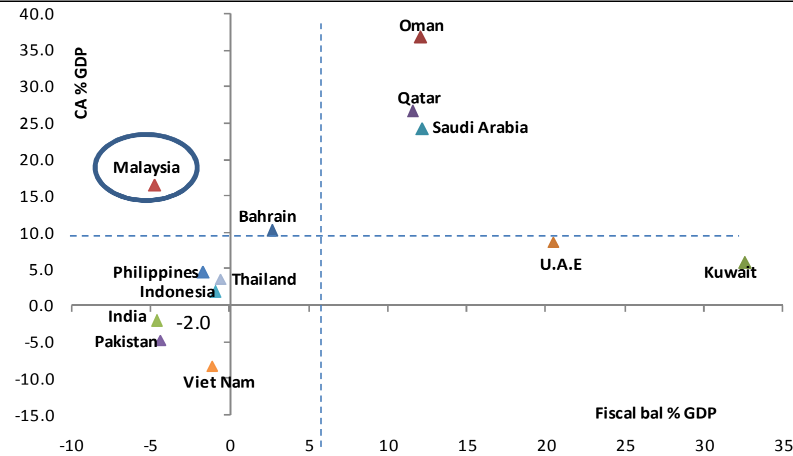
***What is the near-term trend for the budget deficit?***

Malaysia's budget deficit has been a thorny issue since the AFC as the country continued to register a negative budget gap in the last 12 years. An examination of the matrix of budget deficit and current account position (see Chart 13) reveals that Malaysia is in a less favourable quadrant compared with countries such as Saudi Arabia, Qatar and Oman. As such, major international rating agencies have closely monitored the development of the deficit in evaluating Malaysia's sovereign ratings.

To be fair, the government has slashed the deficit down from 7% of GDP in 2009 to 5.6% in 2010. For 2011, the target of reducing it further to 5.4% of GDP will likely be achieved or even surpassed if certain components of operating expenditure can be reduced. We opine that Malaysia's budget deficit is not so much a problem of weak revenues. In fact, Malaysia's revenue as a percentage of GDP is among the highest in the region, even higher than Singapore (see Chart 15). On the operating side, careful monitoring of the "supply and services" component could help to ease pressure on the expenditure side as there is nothing much that can be done to control the amount of emoluments at this point.

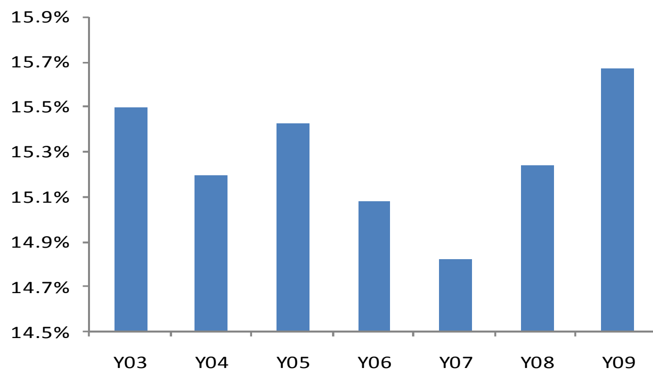
The persistent budget deficit has become a concern for two reasons: it affects the country's sovereign rating (which is influenced by the outlook of the fiscal position in the medium and long term), and it influences the extent to which the government can utilise the resources in its coffers to undertake fiscal expansionary policies should there be a relapse in the global economy.

**Chart 13: Selected countries' fiscal balance and current account matrix (%)**



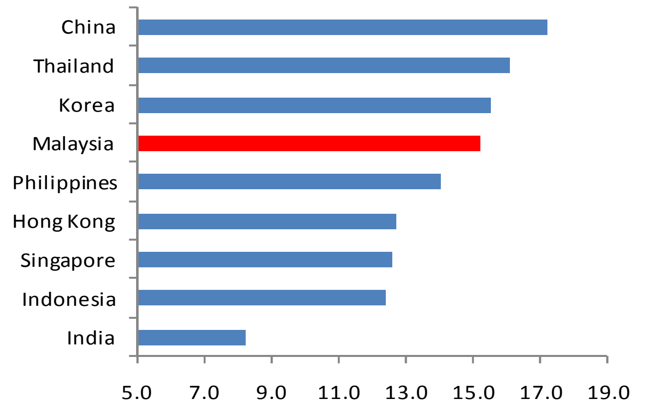

Source: CEIC
Note: dotted lines denote averages of five-year medians

**Chart 14: Malaysia's tax-to-GDP ratio (%)**




Sources: CEIC & MARC Economic Research

**Chart 15: Selected Asian countries' tax-to-GDP ratio (%)**




Sources: CEIC & MARC Economic Research

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