# Economic Research

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## *The 2016 Bank Negara Malaysia Annual Report*

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

## In a nutshell

- The outlook of the economy presented by Bank Negara Malaysia (BNM) in its 2016 Annual Report is generally in line with MARC's expectations. Essentially, the global macroeconomic backdrop has slowly improved as reflected by major indicators such as purchasing managers' indices (PMIs) and inflation worldwide. However, rising political populism continues to re-define global economic risks. Of concern is the likelihood of trade protectionism measures, echoed by the United States (US) and United Kingdom (UK), which raises the possibility of trade friction among trading nations and hamper the prospects of global trade recovery. In addition, possible reactions by the US trading partners such as China – i.e. through weakening of the renminbi – would have negative ramifications on Asian export performance. Similarly, a weaker European trade performance would dent China's exports and affect the latter's appetite for Asian exports.

- BNM's forecast of a stronger gross domestic product (GDP) growth of 4.3%-4.8% for Malaysia is in line with our projected figure of 4.3%. We share the central bank's view of better prospects for the external sector in 2017 although we think it is too early to make a conclusive assessment on its impact on Malaysia's headline growth. Nonetheless, continuing support from domestic demand will help Malaysia achieve another decent year of real GDP growth. This is despite a below growth trend in private consumption following consumers' lack of exuberance as reflected in the consumer sentiment statistics. We anticipate private consumption growth to remain circa 5.8% in 2017, slightly lower than BNM's forecast of a 6.0% expansion. As for private investment, BNM's projection of a 4.1% growth for 2017 is lower than MARC's forecast of a 5.6% expansion.

- On inflation, BNM anticipates the Consumer Price Index (CPI) to grow at a faster pace of 3.0%-4.0% in 2017 on account of cost push factors as a result of stronger commodity prices, especially crude oil as well as the weaker ringgit against the US dollar (USD). We concur with such a forecast. The inflation rate, which already surpassed the 3%-mark in January 2017 would likely continue to remain higher than last year especially in 2H2017 due to, among others, the lower base in 2H2016. Besides the factors mentioned by BNM, further subsidy liberalisation measures, if undertaken in 2017, could add pressure on consumer prices. On balance, MARC foresees an average inflation rate of 2.8%-3.3% in 2017.

- Based on BNM's assessment, the banking sector remains generally healthy, with capital ratios surpassing the levels required under Basel III. With the banking system's Common Equity Tier-1 (CET1) ratio of 13.1%, Tier-1 Capital Ratio (Tier-1) of 14.0% and Total Capital Ratio (CAR) of 16.5% in December 2016, there is strong buffer for any unexpected losses. The banking sector's liquidity remained healthy with a loan-to-fund (LTF) ratio of 84.3% in December 2016 (2015: 83.0%). However, banks' access to cheap funding of customer deposits continued to tighten with the loan-to-deposit (LD) ratio rising to 89.8% in December 2016 (2015: 88.7%, 2014: 86.7%). Overall level of credit (bank and non-bank), although it remained above 100% of GDP (average 2007-2016: 124.1%), has continued to expand at a more moderate pace partly due to effective macroprudential measures implemented by BNM to address some macroeconomic imbalances in the past few years. As a result, loans growth by the banking system slipped to 5.3% from 7.9% in 2015, in line with the moderation in real GDP growth. MARC expects loans growth to remain circa 5%-6% in 2017, in tandem with a below trend real economic growth this year of 4.3%.

- BNM remains comfortable with a stable net impaired loans ratio at 1.2% as at end December 2016 (2015: 1.2%). On an absolute amount, however, gross impaired loans climbed by 6.0% year-on-year (y-o-y) in 2016 (2015: 4.2%) and by 14.8% since its trough in April 2015. In the household sector, the impaired loans ratio remained stable at 1.1% (2015: 1.1%) but noticeable increases can be seen in personal financing and purchases of non-residential properties segments (+19.9% y-o-y and +18.4% y-o-y respectively). Meanwhile, the impaired loans ratio of the business sector declined marginally to 2.4% (2015: 2.5%). Going forward, MARC does not expect the total impaired loans ratio to increase significantly judging by the prospects of a sustained economic momentum this year.

- The decline in the household debt ratio in 2016 – although quite minimal – augurs well with BNM's effort to alleviate Malaysia's macroeconomic imbalances in the household sector. On a y-o-y basis, household indebtedness grew at a slower pace of 5.4% in 2016 (2015: 7.3%), hence resulting in a slightly lower household debt-to-GDP ratio of 88.4% (2015: 89.1%). On the aggregate level, households' financial assets remained comfortable, at 2.1 times of household debt. MARC takes comfort from a more granular analysis of the distribution of debt by income groups by BNM. Accordingly, the proportion of household debt among the low-income group i.e. those with an income level of RM3,000 and below per month fell further to 22.2% of total household debt (2015: 22.8%; 2014: 24.3%). Notwithstanding this, the aggregate leverage of this group – defined as the ratio of outstanding debt-to-annual income – rose to 8.1 times from 7.7 times in 2015. As such, MARC concurs with BNM's view that the government's measures to improve the eligibility of lower-income earners for house financing should continue to be guided by sound affordability assessments.

- The domestic corporate sector continued to demonstrate a relatively healthy financial position on an aggregate basis, although pockets of vulnerabilities remained in the wake of low global crude oil prices, weaker global trade, and subdued consumer sentiment. The leverage position of Malaysian non-financial corporations improved further as of September 2016, with the median debt-to-equity (DE) standing at 43.6% (September 2015: 46.1%), well below the levels observed in Asian and emerging market peers. In addition, the debt service capacity of Malaysian firms has remained reasonably strong, as reflected by the median interest coverage ratio (ICR) of 9.4 times in the first nine months of 2016 (January-September 2015: 12 times), sharply higher than the prudent standard of 2.0 times, according to BNM. Nonetheless, increased credit risk has been observed in certain sectors namely in the oil and gas, automotive and real estate sectors. This is evidenced by rising debt-at-risk, with the proportion of firms with ICR less than 2.0 times having climbed to 7.7% of total corporate debt in the 12 months running through September 2016, up by 1.5 percentage points from the preceding year. On a positive note, the share of debt-at-risk for Malaysian non-financial corporations remained well below regional and emerging market peers, with firms having continued to maintain satisfactory debt servicing capacity and liquidity positions.

- MARC is of the view that the monetary policy space remains rather limited despite the fact that Malaysia's policy rate (Overnight Policy Rate or OPR) has been reduced only once since July 2016. At the current level of 3.0%, real interest rates are approaching zero percent or even negative as inflation is set to pick up in 2017. Despite this, MARC does not anticipate BNM to adjust the OPR in the near term as it could have ramifications on headline growth, capital outflows and the ringgit. Meanwhile, Malaysia's bond yields which reacted to the spike in US Treasury (UST) yields post-Trump's victory in November 2016, have since then stabilised at lower levels. Going forward, MARC foresees the 10-year Malaysian Government Securities (MGS) yield to remain in the range of 4.0%-4.5% as the market continues to digest rate hike expectations in the US as well as assessing Malaysia's overall economic performance in the face of further external risks and domestic challenges.

- MARC is of the view that issues relating to capital flows will continue to hog the limelight in the near term in view of uncertain global developments in 2017 (i.e. interest rate hikes in the US and political developments in Europe). Overall, MARC feels that the outflows of short-term capital from Malaysia's bond market (i.e. less than three years) will not have a material impact on the country's fundamentals. However, with the financial market still guessing the amount of short-term debt securities still held by foreigners after the recent outflows between September 2016 and February 2017, the anxiety in the financial market could persist in the near term. In the longer term however, MARC is of the view that a reduction in foreign holdings of short-term securities is a welcome development. Many studies have highlighted the negative repercussions of short-term capital flows in several economies such as Chile, Brazil and even Malaysia in the 1990s. As such, MARC feels that a new financial landscape of lower foreign holdings of Malaysian short-term debt securities is a welcome development going forward.

- With capital flows expected to remain volatile in 2017, the ringgit's movements would likely continue to be unpredictable in the near term. On a brighter side, the ringgit's volatility against the USD has so far been reduced by BNM's reminder on the prohibition of offshore foreign exchange (FX) transactions in the ringgit Non-Delivery Forward (NDF) market in November 2016. However, the downside risk of the ringgit can possibly arise from a correction in global crude oil prices and bond markets as well as an overreaction to an interest rate hike by the US Federal Reserve (Fed). As such, it is not surprising to see the ringgit remain within a narrow band around the present level (RM4.40-4.50/USD). However, going beyond global political and economic uncertainties, MARC anticipates a stronger ringgit of circa RM4.20 against the greenback.

## Prospects for the global economy in 2017

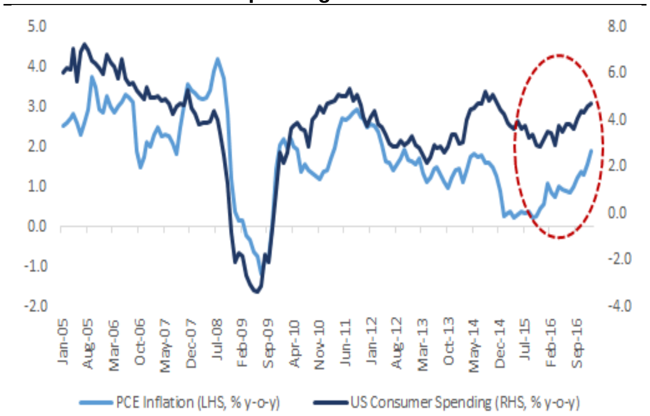
- BNM, in its Annual Report 2016, is more upbeat on prospects for the global economy in 2017 despite citing reservations over some global developments i.e. the possibility of trade protectionism and geopolitical risks in some countries. Major global economic indicators are flashing more positive signals that suggest a likelihood of further strengthening of major economies such as the US and China. These include the global PMI which has continued to ascend and inflation which is making a comeback.

- In the US, a strong labour market continues to underpin private consumption while business spending is slowly rebounding. The average increase in non-farm payrolls by 194K per month in the past six months and an average jobless rate of 4.8% within the period suggests that the US economy is operating at almost full employment. This has helped sustain consumer spending growth at 3.0% annualised pace in 4Q2016 (3Q2016: 3.0%) and contributed about 2.1 percentage points to headline growth during the same period.

- A rebound in capacity utilisation (CAPU) in the US also signals the likelihood of further improvement in business spending in the next few quarters, hence strengthening headline growth in 2017. CAPU has declined at a slower pace of 0.5% y-o-y in 4Q2016, compared to a 3.6% contraction in the same period in the preceding year, while business spending is no longer contracting after registering negative growths in the previous three quarters. Coupled with a sustained strength in the labour market, a continuing acceleration in business spending will likely boost real GDP growth to 2.0%-2.5% in 2017, in our view.

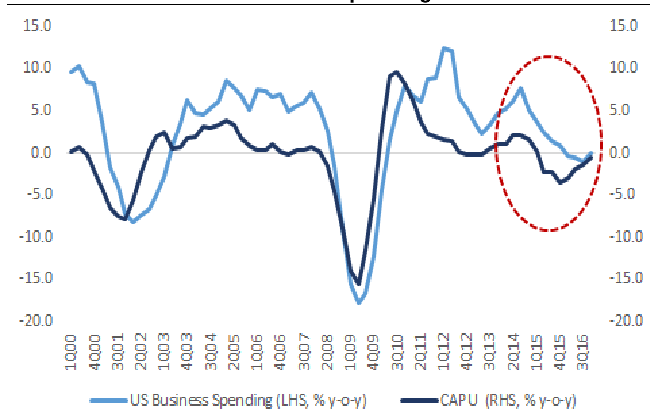
- Reflecting the tight labour market and a recovery in commodity prices, inflation is gathering pace with the Personal Consumption Expenditure (PCE) deflator heading towards the 2% targeted range (January 2017: 1.9%), compared with its recent low of 0.2% in September 2015. Such a development will likely induce the US Fed to raise interest rates again in the near term, after the hike in March, in order not to be behind the curve. Notwithstanding this, political development in Europe may prevent the Fed from being ultra-aggressive in its monetary normalisation in 2017. As such, we do not expect more than three rate hikes this year.

**Chart 1: US consumer spending and PCE inflation**




*Source: CEIC, MARC Economic Research*

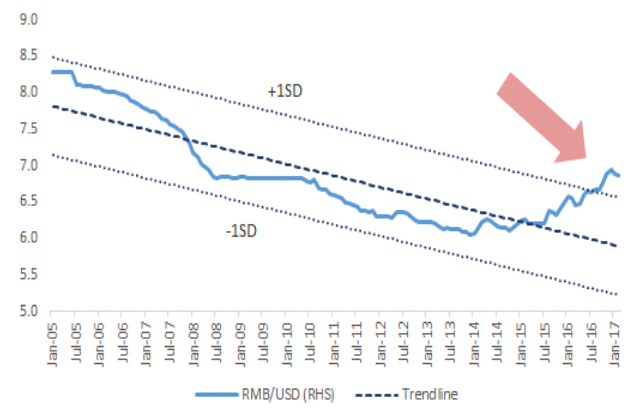
**Chart 2: US CAPU and business spending**




*Source: CEIC, MARC Economic Research*

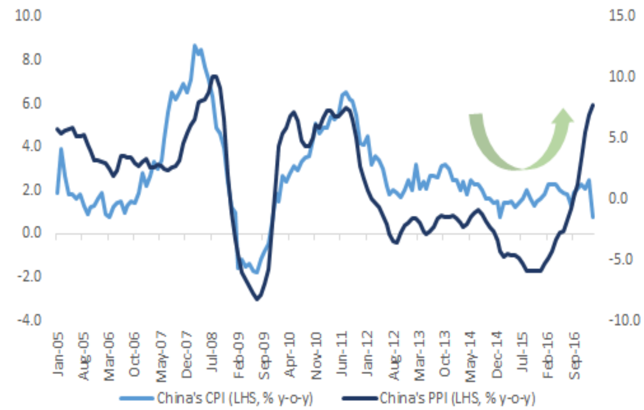
- A more stable Chinese economy will also strengthen the global economy in 2017. Latest statistics on China's PMIs show a continued recovery in manufacturing and services activities. Both manufacturing and services PMIs have rebounded by 2.6 and 1.5 points respectively since their recent trough. The pace of fixed asset investment expansion of nearly 9% in January and February 2017 also reflects a healthier trend (2016: 8.1%) while real home price increases since 2016 signal a more stable economy going forward. At the same time, the weaker renminbi would likely energise its export sector in the near term. In addition, the CPI inflation has accelerated to an average of 1.7% in the January-February period, up from a cyclical low of 1.3% in August 2016. Producer prices which experienced a long spell of deflation in 2012-2016 have rebounded to 7%-8% in January and February 2017, reflecting a recovery in commodity prices and a rebound in demand. Going forward, MARC feels that China's real GDP growth target of around 6.5% is within reach and a soft-landing of China's economy augurs well with global developments.

**Chart 3: Renminbi has depreciated beyond its long-term trend line**



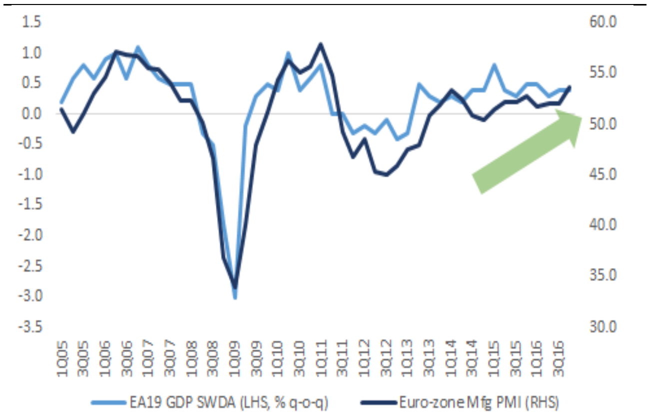

*Source: Bloomberg, MARC Economic Research*

**Chart 4: China's consumer and producer inflation**



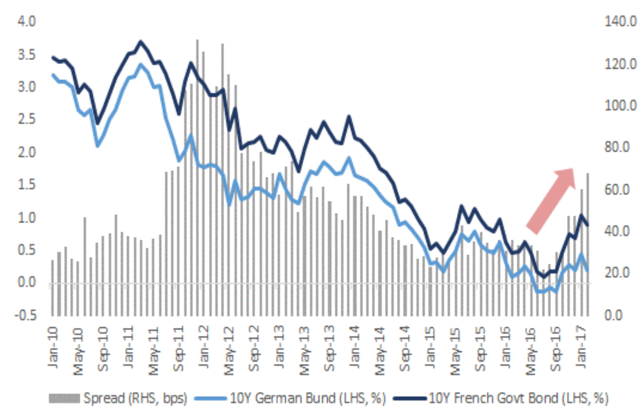

*Source: CEIC, MARC Economic Research*

**Chart 5: Euro-zone manufacturing PMI versus GDP growth**




*Source: Bloomberg, CEIC, MARC Economic Research*

**Chart 6: Rising 10Y German and French government bond spread due to political uncertainty**




*Source: Bloomberg, MARC Economic Research*

- The Euro-zone economy appears to be relatively stable, with headline GDP growth holding steady at 0.4% quarter-on-quarter (q-o-q) during the last three months of 2016, underpinned by a broad-based improvement in major European economies. A synchronised improvement in manufacturing and services activities as well as rising business confidence point to a sustained recovery in the near term. In particular, the composite PMI advanced 3.4 points from its recent trough in September 2016 to 56.0 in February 2017, the strongest level in almost six years. Similarly, the European Commission's Business Climate Indicator continued to ascend, rising to 0.8 point in each of the three months through February 2017, the strongest reading since mid-2011, from its low of 0.1 point in August 2016. Deflationary risks have dissipated somewhat, lifted by stronger energy prices, with the headline inflation having surged to 2.0% in February 2017, breaching the European Central Bank's (ECB) target of "close to, but below 2.0%", although core-prices remained relatively subdued at 0.9%. Accordingly, the ECB in its recent policy action reaffirmed its December's plan to reduce its monthly asset purchases programme to EUR60 billion per month from April and left its interest rates policy unchanged. It also noted the improvement in the economy and would continue to assess the sustainability of price increases accordingly over the near term.

- Although we remain positive on the region as a whole, the downside risks persist, particularly because of rising Euroscepticism in view of the multiple elections scheduled to be held in 2017. While the recent result of the Dutch parliamentary election has partly calmed the financial market, a victory for far-right leader Marine Le Pen in the upcoming French presidential elections in April and May, if materialises, may cause another round of global financial market volatility. In addition, the UK is expected to officially invoke Article 50 of the

Lisbon Treaty in late March, while Germany is also facing a rise in populist movement. Barring any financial shocks relating to political uncertainties, MARC expects the upward momentum in the economy to continue, albeit at a more moderate pace in the near term.

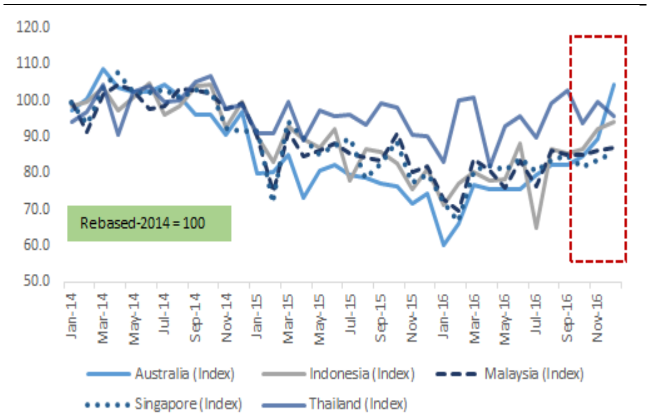
## Malaysia – bottoming of the external sector; continuing support from domestic activities

- According to BNM, Malaysia's real GDP growth is expected to be circa 4.3%-4.8% (2016: 4.2%) in 2017, a range that includes our forecast of a 4.3% expansion. While growth is once again anticipated to be supported by domestic demand, BNM foresees brighter prospects for external demand following the sustained strength of major economies (i.e. US, China). Stronger average commodity prices in 2017, as well as a rebound in overall demand, are expected to underpin Malaysia's external sector performance. Real exports are anticipated to grow by 2.2% while imports are foreseen to expand by 1.8% in real terms.

- We concur with BNM's assessment on the prospects of Malaysia's external sector for 2017. We envisage Brent crude oil prices to remain within the range of USD50 and USD60 per barrel in 2017 despite the recent softening in prices following higher US production. Notably, US crude oil production has climbed above 9.0 million barrels per day (mbd) since mid-February, up from 8.4-8.8 mbd between June and December 2016. At the same time, total rig counts in the US have almost doubled since hitting its trough in May 2016. Notwithstanding this, an upward momentum in exports (-4.7% in USD terms in 2016 as opposed to an average 14.9% contraction in 2015) augurs well with the brighter prospects that we envisage for 2017.

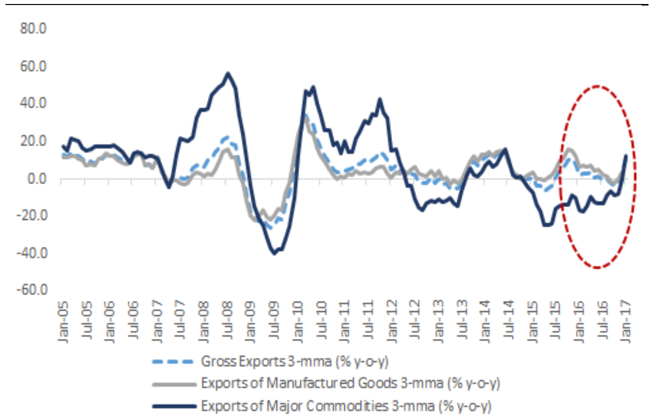
- In addition, we are of the view that Malaysian exports in 2017 will benefit from several developments. Firstly, a continuation of Organisation of the Petroleum Exporting Countries' (OPEC) agreement to restrict production after mid-2017 will generally be positive for global crude oil prices in 2017. The positive impact of higher crude oil prices on some economies (i.e. Saudi Arabia) in 1H2017 will likely induce OPEC members to sustain their production cut agreement in the near term. Secondly, a sustained demand for commodities from China will benefit global trade. Imports volume of iron ore, for instance, continued to grow by 13.4% y-o-y in February after a 7.5% growth in 2016. Thirdly, higher overall global natural gas prices, following a 62.1% rebound since its trough in February 2016 will also benefit Malaysia as 24.0% of the country's major commodity exports comes from the gas sub-sector and fourthly, better prospects for the global semiconductor sector suggest the likelihood of collecting higher export receipts in 2017 as the sub-sector accounts for roughly 18.4% of Malaysia's exports.

**Chart 7: Regional exports in USD terms; rebased 2014=100**




*Source: WTO, MARC Economic Research*

**Chart 8: Malaysia's exports of manufactured goods and major commodities**



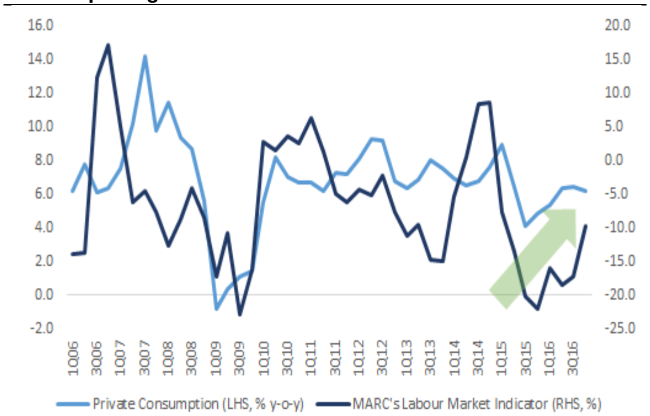

*Source: CEIC, MARC Economic Research*

- Exports of electrical & electronic products have rebounded in 2H2016 as reflected by the average monthly export receipts that grew by 14.6% when compared with the average monthly collection in 1H2016. The increase was more pronounced in the semiconductor sub-sector where the average export receipt rose by 16.5% from 1H2016. On a global scale, the prospects also look more promising, with the World Semiconductor Trade Statistics (WSTS) forecasting the worldwide semiconductor industry to grow by 6.5% in 2017, after a modest growth of 1.1% in 2016. Such a scenario augurs well with Malaysia's external sector in the near term.

- Adding to Malaysia's resilient headline growth in 2017 is the relatively stable domestic demand, underpinned by an improvement in labour market conditions as well as a slight recovery in the pace of investment. Private consumption – although expected to remain below growth trend this year – will remain an important support for the economy. Of note is a rebound in MARC's labour market indicator which signals an improvement in the labour market after a deterioration experienced between early-2015 and mid-2016 following significant retrenchments in the oil and gas-related industry. Adding to this, a continuing wage gain in the manufacturing sector, higher minimum wage and additional support from the government i.e. through 1Malaysia People's Aid (BR1M) will help private consumption to expand by a decent pace of 5.8% in 2017, in our view.

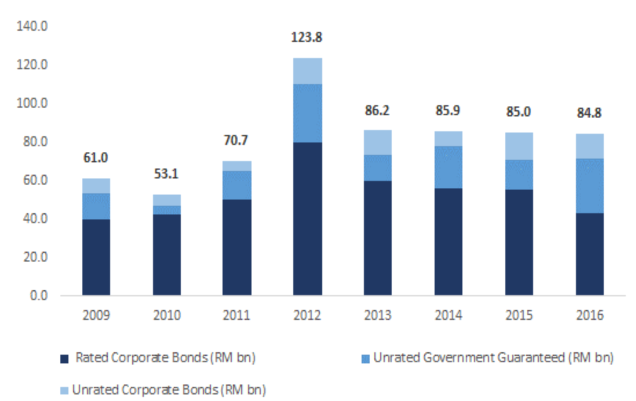
- Private investment will also provide a helping hand in 2017. Net foreign direct investment (FDI) in 2016 remained above RM40 billion, almost equal to the amount in the preceding year, compared to an average RM34 billion in 2012-2014. Going forward, MARC envisages net FDI to continue to be in the range of RM35 billion-RM45 billion per year as positive momentum from major economies such as the US and China will spur greater cross-border investments. Adding to the positive momentum, the government's huge infrastructure projects such as the Klang Valley Mass Rapid Transit 2 (KVMRT2), Light Rail Transit 3 (LRT3) and Refinery and Petrochemicals Integrated Development (RAPID) will accelerate the overall investment growth in 2017. Such activities have led to a sustained amount of corporate bond issuance in the past several years.

**Chart 9: MARC's labour market indicator and private consumption growth**




*Source: CEIC, MARC Economic Research*

**Chart 10: Malaysia's corporate bond issuance**




*Source: BPAM, MARC Economic Research*

**Table 1: Real GDP growth – demand side**

| Growth (%y-o-y) | 2012 | 2013 | 2014 | 2015 | 2016 | MARC 2017F | BNM 2017F | MoF 2017F |
|---|---|---|---|---|---|---|---|---|
| GDP | 5.5 | 4.7 | 6.0 | 5.0 | 4.2 | 4.3 | 4.3 - 4.8 | 4.0 - 5.0 |
| Domestic Demand | 10.7 | 7.3 | 5.9 | 5.1 | 4.4 | 4.7 | 4.4 | 4.9 |
| Private Consumption | 8.3 | 7.2 | 7.0 | 6.0 | 6.1 | 5.8 | 6.0 | 6.3 |
| Public Consumption | 5.4 | 5.8 | 4.3 | 4.4 | 1.0 | 1.4 | -0.2 | 0.4 |
| Private Investment | 21.4 | 12.8 | 11.1 | 6.4 | 4.4 | 5.6 | 4.1 | 5.8 |
| Public Investment | 15.9 | 1.8 | -4.7 | -1.0 | -0.5 | 0.9 | 1.5 | 1.1 |
| Real Exports | -1.7 | 0.3 | 5.0 | 0.6 | 0.1 | 2.4 | 2.2 | 2.5 |
| Real Imports | 2.9 | 1.7 | 4.0 | 1.2 | 0.4 | 2.8 | 1.8 | 2.6 |

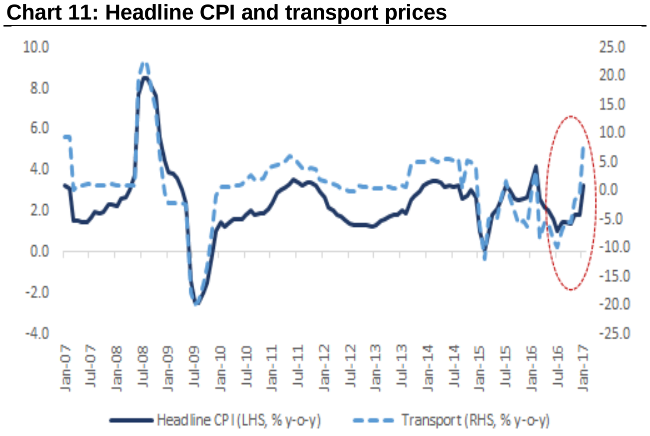
*Source: CEIC, BNM, MoF, MARC Economic Research*

## Higher consumer prices expected for 2017

- BNM anticipates Malaysia's inflation rate to grow at a faster pace of 3.0%-4.0% in 2017 on account of cost push factors as a result of stronger commodity prices, especially crude oil, as well as the weaker ringgit against the USD. MARC concurs with such a forecast. The inflation rate, which already surpassed the 3%-mark in January 2017 would likely continue to remain higher than last year especially in 2H2017 due to among others, the lower base in 2H2016. In 2H2016, the CPI grew at an average pace of 1.5%, lower than the 2.1% pace posted for the whole of 2016.

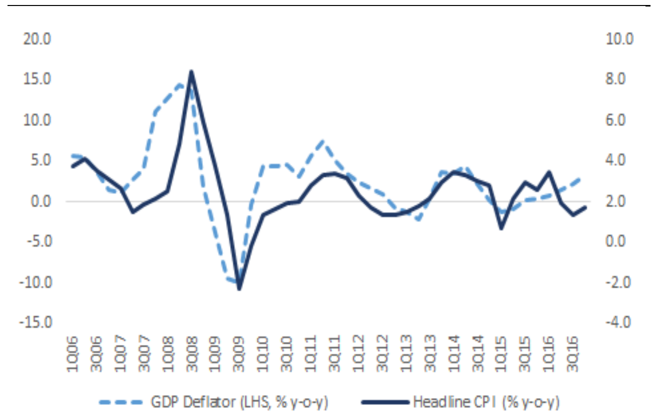
- Another inflation measure – the GDP deflator – has also picked up in 4Q2016, registering a growth of 3.2% from 2.2% in the preceding quarter. This marked its strongest pace since 2Q2014 which partly suggests an increase in general price levels in the Malaysian economy in the recent quarter. We anticipate the rebound in the transport sub-index of the CPI basket from the negative readings in the past several months to be sustained in the near term due to higher pump prices. Further subsidy liberalisation measures, if undertaken in 2017, could also exert upward pressure on consumer prices. On balance, MARC foresees an average inflation rate of 2.8%-3.3% in 2017.

**Chart 11: Headline CPI and transport prices**




*Source: CEIC, MARC Economic Research*

**Chart 12: GDP deflator and headline CPI**



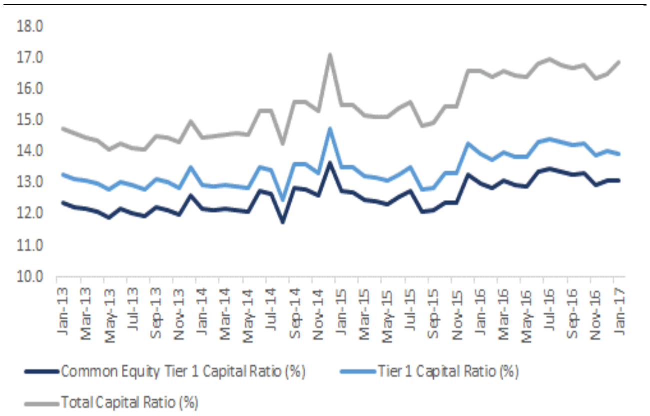

*Source: CEIC, MARC Economic Research*

## Commendable health of banking sector

- Based on BNM's assessment, the banking sector remains generally healthy, with capital ratios surpassing the levels required under Basel III. With the banking system's CET1 of 13.1%, Tier-1 of 14.0 % and total CAR of 16.5% in December 2016, there is strong buffer for any unexpected losses. The banking sector's liquidity remained healthy with a LTF ratio of 84.3% in December 2016 (2015: 83.0%). However, banks' access to cheap funding of customer deposits continued to tighten with the LD ratio rising to 89.8% in December 2016 (2015: 88.7%, 2014: 86.7%). The overall level of credit (bank and non-bank), although it remained above 100% of GDP (average 2007-2016: 124.1%), has continued to expand at a more moderate pace partly due to effective macroprudential measures implemented by BNM to address macroeconomic imbalances in the past few years. As a result, loans growth slipped to 5.3% from 7.9% in 2015, in line with the moderation in real GDP growth. MARC expects loans growth to remain circa 5%-6% in 2017, in tandem with a below trend real economic growth this year of 4.3%.

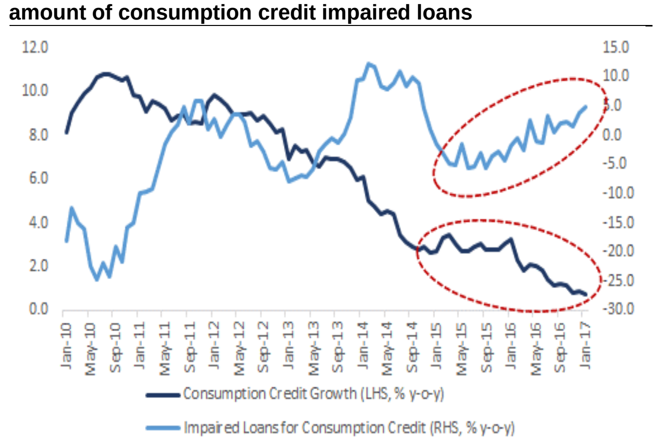
- BNM remains comfortable with the stable net impaired loans ratio at 1.2% as at end December 2016 (2015: 1.2%). On an absolute amount, however, gross impaired loans climbed by 6.0% y-o-y in 2016 (2015: 4.2%) and by 14.8% since its trough in April 2015. In the household sector, the impaired loans ratio remained stable at 1.1% (2015: 1.1%) but noticeable increases can be seen in personal financing and purchases of non-residential properties segments (+19.9% y-o-y and +18.4% y-o-y respectively). Meanwhile, the impaired loans ratio of the business sector declined marginally to 2.4% (2015: 2.5%). Going forward, MARC does not expect the total impaired loans ratio to increase significantly judging by the prospects of a sustained economic momentum this year. In addition, total provisioning coverage remained adequate, despite a declining loan-loss coverage ratio to 90.2% in 2016 (2015: 96.3%).

**Chart 13: Banking system capital positions**




*Source: BNM, CEIC, MARC Economic Research*

**Chart 14: Declining consumption credit growth but rising amount of consumption credit impaired loans**




*Source: BNM, CEIC, MARC Economic Research*

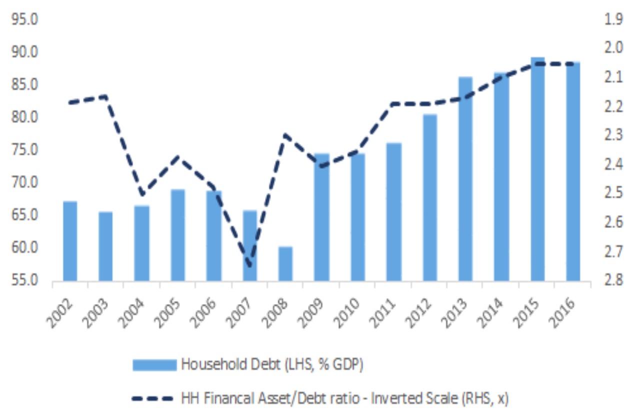
## Improvement in household balance sheet

- The decline in the household debt ratio in 2016 – although quite minimal – augurs well with BNM's effort to alleviate Malaysia's macroeconomic imbalances in the household sector. On a y-o-y basis, household indebtedness grew at a slower pace of 5.4% in 2016 (2015: 7.3%), hence resulting in a slightly lower household debt-to-GDP ratio of 88.4% in 2016 (2015: 89.1%). It is worth noting that the level of household debt partly reflects the age profile of the Malaysian population (median age: 28 years). As such, it may not necessarily lead to negative ramifications unless the economy performs abysmally in the near future. With an expected further improvement in the job market and steady wage increases, borrowers will not likely face difficulties in servicing their debt. This can be seen from BNM statistics which indicate that the debt-service ratio for 41% of newly approved loans remained below 40% in 2016.

- On the aggregate level, households' financial assets remain comfortable, at 2.1 times of household debt. MARC takes comfort from a more granular analysis of the distribution of debt by income groups by BNM. Accordingly, the proportion of household debt among the low-income group i.e. those with an income level of RM3,000 and below per month fell further to 22.2% of total household debt (2015: 22.8%; 2014: 24.3%). Notwithstanding this, aggregate leverage of this group – defined as the ratio of outstanding debt-to-annual income – rose to 8.1 times from 7.7 times in 2015. As such, MARC concurs with BNM's view that the government's measures to improve the eligibility of lower-income earners for house financing should continue to be guided by sound affordability assessments.

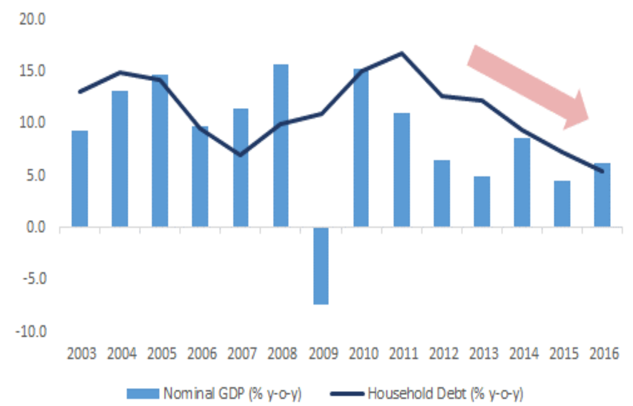
- The improvement in the household balance sheet has, however, come at a price for consumers. For instance, average consumption credit growth by the banking system had decelerated to 1.7% y-o-y in 2016 from an average 9.4% between 2010 and 2012. The decline in loans expansion provided by the banking sector was pronounced for the purchase of passenger cars which recorded an average growth of 0.4% in 2016 from an average 7.5% expansion between 2010 and 2012. The macroprudential measures also managed to crimp the growth of loans for purchases of residential properties to an average 10.3% in 2016 from 12.7% between 2010 and 2012.

**Chart 15: Household debt as % of GDP and financial assets-to-debt ratio**




*Source: BNM, MARC Economic Research*

**Chart 16: Household debt and nominal GDP growth**




*Source: BNM, MARC Economic Research*

## Healthy corporate balance sheet amid challenging operating environment

- The domestic corporate sector continued to demonstrate a relatively healthy financial position on an aggregate basis, although pockets of vulnerabilities remained in the wake of low global crude oil prices, weaker global trade, and subdued consumer sentiment. The leverage position of Malaysian non-financial corporations improved further as of September 2016, with the median DE standing at 43.6%, down from 46.1% in the same corresponding period previous year. Additionally, aggregate corporate leverage remained well below the levels observed in Asian and emerging market peers. While the median ICR of Malaysian non-financial corporations declined slightly to 9.4 times in the first nine months of 2016 (January-September 2015: 12 times), the debt servicing capacity of firms has remained reasonably strong and are well above the prudent standard of 2.0 times, according to BNM. It was further supported by sound liquidity positions of businesses, with the median cash-to-short-term debt (CASTD) ratio standing at 1.2 times during the same period (January-September 2015: 1.4 times).

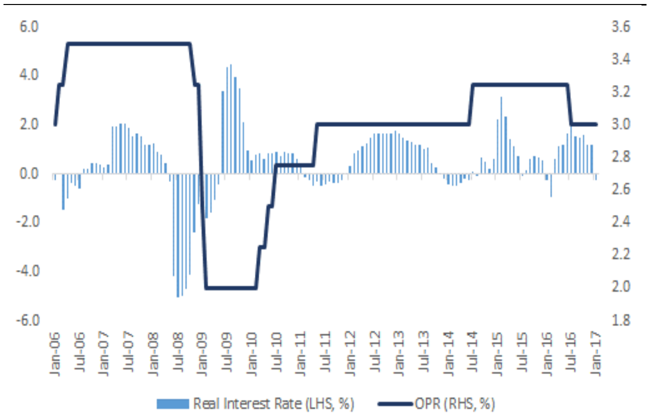
- Nonetheless, an increased credit risk has been observed in certain sectors, namely in the oil and gas, automotive and real estate sectors. This is evidenced by rising debt-at-risk, with the proportion of firms with ICR less than 2.0 times having climbed to 7.7% of total corporate debt in the 12 months running through September 2016, up by 1.5 percentage points from the preceding year. On a positive note, the share of debt-at-risk for Malaysian non-financial corporations remained well below regional and emerging market peers, with firms having continued to maintain satisfactory debt servicing capacity and liquidity positions.

## Interest rates

- MARC is of the view that the monetary policy space remains rather limited despite the fact that Malaysia's policy rate (OPR) has only been reduced once since July 2016. At the current level of 3%, real interest rates are approaching zero percent or negative as inflation is set to pick up in 2017. Past experiences suggest that the policy rate is normally adjusted to ensure positive real returns for savers. However, this time around, we do not anticipate BNM to adjust the OPR upward as it may lead to negative ramification on headline growth especially at a time when the economy is expected to register a below trend growth. At the same time, lowering the OPR would risk the economy experiencing another round of capital outflows and weaken the ringgit further at this juncture.

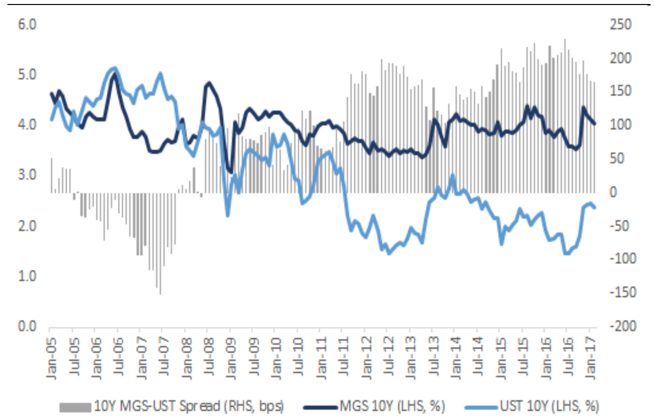
- On the other hand, Malaysia's bond yields which reacted to the spike in UST yields post Trump's victory in November 2016, have since then stabilised at lower levels. Following a 56 basis points (bps) jump in the 10-year UST yield in November (from end October 2016), the 10-year MGS yield spiked to 4.35% from 3.60% during the period. Since then, there has been some stability in the financial market. The 10-year UST has declined to 2.39% in February, leading to a flatter yield curve. Similarly, the 10-year MGS yield flipped back to 4.04% during the same period after hitting a peak of 4.46% in late November. The spread for Malaysia's 10-year minus 3-year also flattened to 74 bps as expectations of further rate hikes in the US shifted the short end yields. Going forward, we foresee the 10-year MGS yields to be in the range of 4.0% to 4.5% as the market continues to digest rate hike expectations in the US as well as assessing Malaysia's overall economic performance in the face of further external risks and domestic challenges.

**Chart 17: OPR and real interest rate**




*Source: CEIC, MARC Economic Research*

**Chart 18: 10Y UST and 10Y MGS**




*Source: Bloomberg, MARC Economic Research*

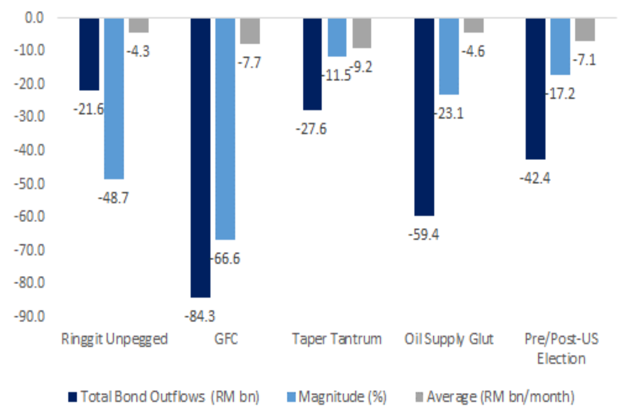
## Capital flows and the ringgit

- MARC is of the view that issues relating to capital flows will continue to hog the limelight in the near term in view of uncertain global developments in 2017 (i.e. interest rate hikes in the US and political developments in Europe). Recent statistics indicate that except for October, the Malaysian bond market experienced net foreign capital outflows every month between September 2016 and February 2017.

- Although the financial market's concerns over such outflows are understandable, MARC is of the view that this episode should be looked at through a different perspective. Notably, history shows that bond outflows that occurred in the past years i.e. post-unpegging of the ringgit in the second half of 2005 and during the Global Financial Crisis (GFC) in 2008-2009 far outweigh this recent episode in magnitude. During those episodes, foreign holdings as a percentage of outstanding Malaysian bonds, both government and corporates, fell by half and two-thirds respectively from 10% to 5% in the second half of 2005, and from 21% to 7% in 2008-2009. In absolute terms, total foreign holdings of Malaysian bonds dropped by roughly RM22 billion between July and December 2005 and by RM84 billion during the GFC. By contrast, the recent bond outflows amounted to about RM43 billion between August 2016 and February 2017 – only a 17% drop from the peak level of RM246 billion. As for government bonds, total foreign holdings slipped by six percentage points to 29% of outstanding government bonds in February 2017 from its peak of 35%.

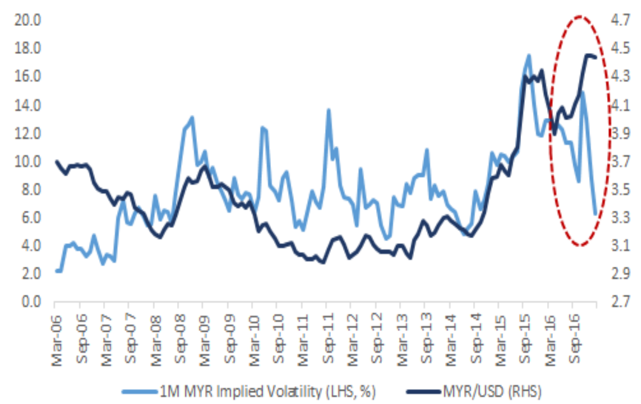
- Secondly, BNM's statistics reveal that the bulk of the bond outflows were indeed associated with a sell-down of short-term papers by foreign investors. For instance, about 70% of the total reduction in foreign holdings of government bonds (or RM15.2 billion) between November 2016-February 2017 involved papers with maturities of less than three years; foreign holdings of papers with maturities of three to five years accounted for 13%, while those with maturities of five years and more comprised another 17%. These outcomes explain why the spike in bond yields (especially for MGS) post-Trump's victory in the US presidential elections did not last for long. For example, the yield of the 10-year MGS, which rose to its peak of 4.46% in late-November 2016 (from 3.62% a day before Trump's victory), slipped to 4.04% by end-February 2017.

**Chart 19: Bond outflows**




*Source: CEIC, MARC Economic Research*

**Chart 20: Ringgit monthly average and 1-month implied volatility**




*Source: Bloomberg, CEIC, MARC Economic Research*

- MARC feels that the outflows of short-term capital from Malaysia's bond market (i.e. less than three years) will not have a material impact on the country's fundamentals. However, with the financial market still guessing the amount of short-term debt securities still held by foreigners after the recent outflows between September 2016 and February 2017, the anxiety in the financial market could persist in the near term. In the longer term however, MARC is of the view that a reduction in foreign holdings of short-term securities is a welcome development. Many reputable studies (i.e. by the International Monetary Fund or IMF, World Bank) have highlighted the negative repercussions of short-term capital flows in several economies such as Chile, Brazil and even Malaysia in the 1990s. As such, MARC feels that a new financial landscape of lower foreign holdings of Malaysian short-term debt securities is a welcome development going forward.

- With capital flows expected to remain volatile in 2017, emerging market currencies – the ringgit included – would likely continue to be unpredictable in the near term. On a brighter side, ringgit's volatility against the USD has so far been reduced by BNM's reminder on the prohibition of offshore FX transactions in the ringgit NDF market in November 2016. However, the downside risk of the ringgit can possibly arise from a correction in global crude oil prices and bond markets as well as an overreaction to an interest rate hike by the US Fed. As such, it is not surprising to see the ringgit remain within a narrow band around the present level (RM4.40-4.50/USD). However, going beyond global political and economic uncertainties, MARC anticipates a stronger ringgit of circa RM4.20 against the greenback.

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