Economic Research

KDN No.: PP14787/11/2012(030811)

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

Vol.: ER/003/2015

The 2014 BNM Annual Report

Economics Team Led By

Nor Zahidi Alias
Chief Economist
+603 2082 2277
zahidi@marc.com.my

Please read the disclaimer on the last page of this report

www.marc.com.my

16 March 2015

In a nutshell

- The uneven prospects of the global economy, relatively low commodity prices and softer domestic demand expected for 2015 have led Bank Negara Malaysia (BNM) to become less sanguine in its economic assessment, projecting a gross domestic product (GDP) growth of between 4.5%-5.5% (2014: 6%), in line with the revised projection by the Ministry of Finance (MoF) in January 2015. Growth is once again anticipated to be supported by domestic demand despite the expected moderation in private consumption (6%) and private investment (9%). MARC concurs with BNM's outlook amid lackluster external demand and decelerating domestic demand growth amid rising inflationary pressure expected in 2H2015 and tighter lending standards, which will likely drag real GDP growth to less than 5% in 2015 (Our forecast: 4.7%).

- Malaysia's moderating GDP growth is good news for inflation in 2015. With consumer spending momentum weakening, BNM expects inflation to be in the region of 2-3% (2013: 3.2%) even after taking account of the possible upward pressure in prices post Goods and Services Tax (GST) in April this year. The high base in 1H2014 and the relatively low fuel prices since December 2014 will also take some of the upward pressure off headline Consumer Price Index (CPI) growth. As a whole, MARC agrees with the assessment but anticipates inflation to be higher post GST as experiences in other countries tend to show increasing profiteering activities at least for a short period. On balance, MARC foresees the CPI growth to be in the range of 3-3.5% in 2015, slightly higher than BNM's forecast.

- Based on BNM's assessment, the overall economic landscape is still supported by a healthy banking sector with capital ratios surpassing the levels required under Basel III. Overall loan growth remained resilient in 2014, albeit somewhat moderated from the level in 2013, and was spearheaded by lending for residential property purchases as property values remained relatively high, although growth in prices of residential homes has somewhat softened to 4.6% in 3Q2014 (4Q2013: 9.6%). Macro-prudential measures by BNM continued to dent consumer demand for credit cards, passenger cars and personal loans in 2014 (1.2%, 2.3% and 3.9% respectively) but have not impacted the demand for residential property loans significantly (2014: 13.3%).

- As for development financial institutions (DFI), MARC takes comfort from the fact that their overall lending growth continued to trend downward, moderating to 7.1% as of end-2014 (2013: 7.2%). Notably, growth of loans for consumption credit continued to decelerate to 7.4% (2013: 8.8%), from as high as 35.4% in 2008. On a compound annual growth rate (CAGR) basis, total credit growth moderated from as high as 16.8% in 2005-2009 to a mere 8.3% in 2010-2014. Another loan segment – personal financing – extended by non-bank financial institutions (NBFI) also grew significantly slower by 5.3% in 2014, down from 13.9% in the preceding year. In addition, new personal financing facilities approved by NBFIs had declined by 31.3% in value terms in 2014, while the average financing amount disbursed by them dropped to less than RM30,000 per facility in 2014, as compared to the earlier period where the disbursements were up to RM300,000 per facility.

- The issue of household indebtedness continues to hog the limelight. Although its growth moderated to 9.9% in 2014, its ratio to GDP climbed further to 87.9% (2013: 86.7%). On this matter, we are consoled by the fact that a large portion of household indebtedness – roughly 60% - was used for housing wealth and asset accumulation. In addition, there were continued improvements in default rates of new housing loans and new borrowings are of higher quality, with 50% of new loans approved with debt-service ratios (DSR) of below 40%. However, we still view with concern that the bulk of household debt (50.5%) belonged to households with income levels of RM5,000 and below per month, who will likely have minimal savings. Notwithstanding this, MARC notes that it has become the norm for countries with relatively young demographics to have considerably higher household debt (i.e. Singapore: 76.3% of GDP, Thailand: 83.5% of GDP) than other economies.

- MARC foresees that more selective macro-prudential measures could be introduced by the BNM to ensure softer property loan growth in the near and medium term, although weaker economic growth in itself will reduce borrowers' appetite for debt accumulation in 2015. In addition, souring business and consumer sentiment will also lead to stricter lending standards going forward. MARC feels that more stringent measures could be introduced to address strong property lending given that total exposures of financial institutions to the property sector continued to climb to 23% of total financial system assets (2013: 21.9%) and home prices continued to remain elevated (estimated 6.6 times of household median income). Adding to the concern is the amount of household financial assets which, although it continued to rise in 2014, has declined in terms of its ratio to household debt to 2.1 times, down from the peak of 2.7 times in 2007. The ratio of liquid financial assets to household debt also continued to drop to 1.5 times from as high as 1.8 times in 2007.

- While total outstanding domestic and external borrowings by non-financial businesses continued to grow in 2014 (6.8%; 2013: +10.4%), BNM's stress tests showed that the solvency positions of the firms tested remain intact even after discounting the effect of higher asset valuation arising from a weaker ringgit. This suggests that most Malaysian firms have adequate revenue generating assets to cover potentially high foreign currency liabilities. Separately, we concur with BNM's findings that the overall leverage (based on debt-to-equity ratio) of the Malaysian business sector remains intact and stood below the level observed prior to the Global Financial Crisis (GFC). Notwithstanding this, our calculations (based on the median, average and total debt weighted debt-to-earnings before interest and tax or EBIT) suggest that a large proportion of corporate debt is concentrated in a few big and highly leveraged corporations.

- MARC views the BNM's commitment to ensure the smooth implementation of the Basel III Liquidity Coverage Ratio (LCR) as a positive move. Under the rules, the minimum LCR requirement by June 1, 2015 was 60% and this will be increased in stages until 100% by 2019. The decision to reclassify certain liquid assets such as the Statutory Reserve Requirement (SRR) balances as part of the Level 1 High-Quality Liquid Assets (HQLA) is also positive as it eases the concerns on banks' meeting the liquidity requirements. This has reduced the upward pressure on the Kuala Lumpur Interbank Offered Rate (KLIBOR) rates which have been on the uptrend in the past few months. From a macro point of view, the LCR framework will further minimise the risk of a credit crunch in the economy and hence reduce the probability of systemic risk.

- On interest rates, we once again sense that BNM is not in favour of changing its current course at this juncture due to a more benign macro outlook for 2015. From the officials' rhetoric, MARC is of the view that the upside cycle of the Overnight Policy Rate (OPR) is over for now, as risks to growth increases and inflation expectation declines on the back of weaker domestic demand going forward. Meanwhile, the downside risk of the OPR is limited by high household indebtedness. Moreover, interest rate cuts in major Asian countries (India, China, South Korea and Australia) also signal a new trend of a more accommodative monetary stance emerging in the region. Against this backdrop, MARC is of the view that the OPR will not likely budge from the current level of 3.25% in 2015.

- MARC views the challenge of managing capital flows to build up as the year progresses in view of the possible interest rate hike in 2015 in the United States (US). Given the scenario, the prospects of a stronger US dollar (USD) will continue to drive local bond yields up and increase the outflow of portfolio capital to USD-denominated assets. Net portfolio outflows have already surged to RM37.9 billion in 2014 from a mere RM3 billion in 2013. Coupled with concerns on some of the macro issues (i.e. shrinking current account surpluses, wider than initially projected budget deficits), appetite for ringgit-denominated assets will likely remain lacklustre, exerting pressure on the ringgit. Mitigating this, however, is the relatively resilient and diversified economy, which on balance is unlikely to cause a major shift in the trend of foreign holdings of government debt such as Malaysian Government Securities (MGS).

- Overall, MARC views BNM's assessment on the prospects of the economy and the mitigating factors that can reduce the risk posed to the financial system as realistic, although our concern remains on the effectiveness of the measures meant to induce further deleveraging in the household sector. Notwithstanding this, the probability of systemic risk is contained by a resilient banking system and greater supervision through the adoption of Basel III requirements. In addition, the strong level of international reserves and greater coordination among central banks will be mitigating factors. On the whole, the government's dependency 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.

Introduction

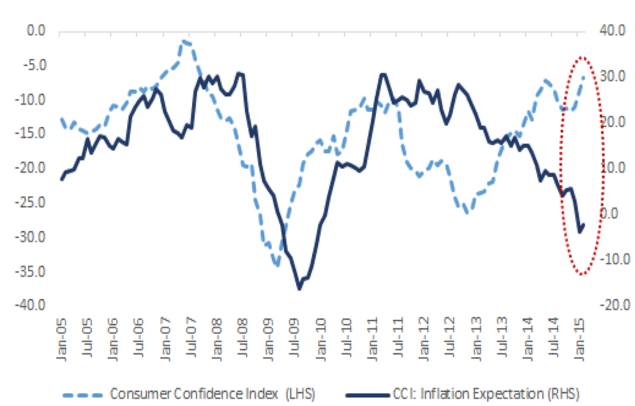
- In its Annual Report and Financial Stability and Payment Systems Report released on March 11, 2015, the BNM acknowledged the prospects of a more benign Malaysian economy amid challenges arising from the ongoing global economic uncertainties in some advanced economies as well in major Asian economies such as China and India. Besides reviewing the financial sector's (banks and non-bank financial institutions) performance in 2014, the BNM also addressed issues such as household and corporate indebtedness, the new liquidity framework and issues on capital flows. MARC proffers below some of its thoughts on the key takeaways from the presentations made by senior BNM officials.

Prospects for the global economy in 2015

- The BNM acknowledged the impact of recent economic developments in the US, euro zone, Japan and China which, on balance, has tilted prospects towards the downside. The lackluster performance of the euro economy was recently magnified by the negative sentiment amid speculations that Greece may exit the euro bloc following the change in the country's political regime. The growth of the region as a whole remained inspiring as reflected by 4Q2014 real GDP statistics (+0.3%), albeit slightly stronger than the earlier quarter (0.2%). An increasing prospect of a sustained deflation is also exerting intense pressure on future growth. With an average inflation rate of -0.4% in the past two months, the euro zone economy is way off its inflation target of circa 2% as envisioned by the European Central Bank (ECB).

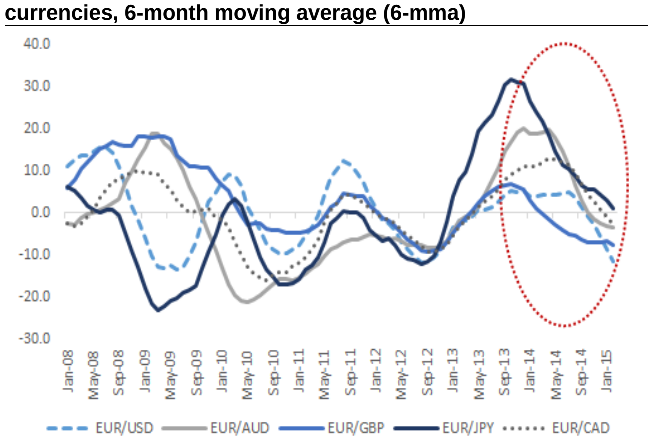
- Aside from problems entailed by Greece's potential exit, however, the economic prospects of the euro zone may not be as gloomy as it appears, especially after the ECB finally decided to embark on an aggressive Quantitative Easing (QE) policy amounting to EUR1.1 trillion to avert a sustained deflationary spell that could put the region's economy in an abyss. What is rather encouraging is the momentum in the overall economic sentiment, which showed a rebound in consumer sentiment in the two months to February 2015, despite the chaos that emerged as a result of renegotiations of Greece's debt payment. The rebound in consumer inflation expectations from -3.6% to -2.3% in February also signals better prospects going forward. While we do not foresee a sharp improvement in the euro economy this year, we expect an encouraging trend to emerge in both business and consumer segments in 2015.

Chart 1: Euro area consumer sentiment and inflation expectation



Source: European Commission, MARC Economic Research

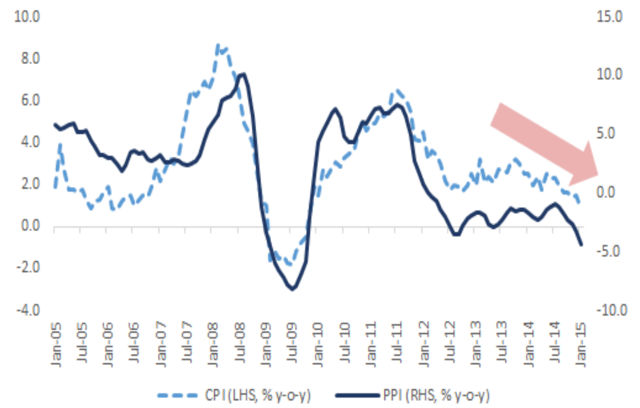
Chart 2: Annual change in the euro against selected major currencies, 6-month moving average (6-mma)



Source: Bloomberg, MARC Economic Research

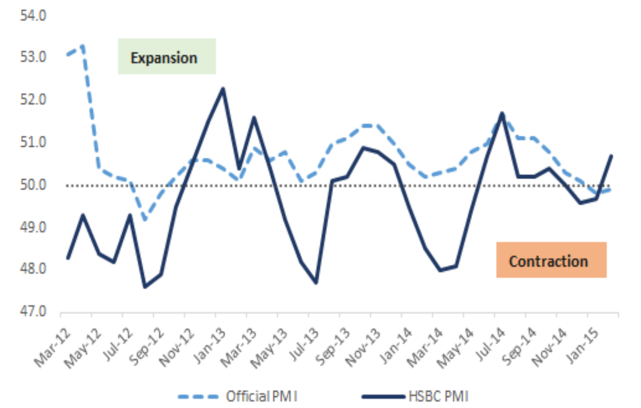
- As for China, the recent rhetoric from the officials on the new growth target of 7% suggests that policymakers are continuing to manoeuvre the economy for a soft landing. The moves by the People's Bank of China (PBOC) to soften the blow on the headline GDP growth through monetary accommodation in November 2014 and in January and early March 2015 are positive steps when seen from a broad macro perspective. While we do not expect headline GDP growth to decelerate to below 7% this year, the downward pressure on inflation calls for such monetary intervention by the PBOC in our view. With producer prices continuing to be in negative territory, a trend that has persisted since March 2012, and the CPI registering a growth of less than 1% in January 2015, more fiscal and monetary policy manoeuvring can be expected in China in 2015 as policymakers work to sustain its headline growth within the 7% range. Against this backdrop, we foresee a more positive impact of China's sustained economic growth momentum on other Asian economies, especially trade-dependent countries such as Singapore and Malaysia. The latest HSBC manufacturing Purchasing Managers' Index (PMI) reading of 50.7 in February, the strongest pace in seven months, suggests that economic momentum has started to improve and will likely continue to do so if supported by additional measures from policymakers.

Chart 3: China's consumer and producer inflation



Source: CEIC, MARC Economic Research

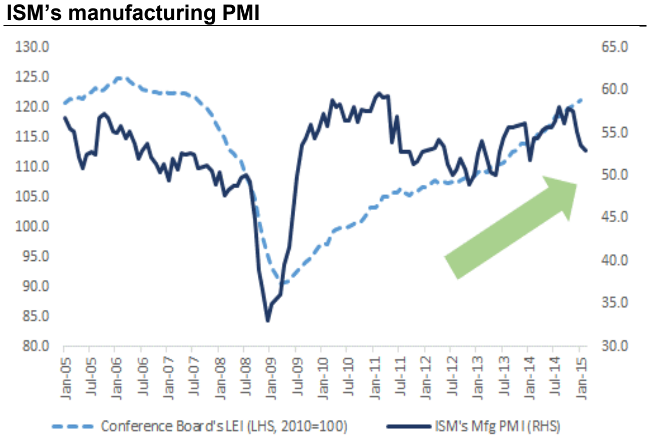
Chart 4: China's official and HSBC manufacturing PMI



Source: Bloomberg, MARC Economic Research

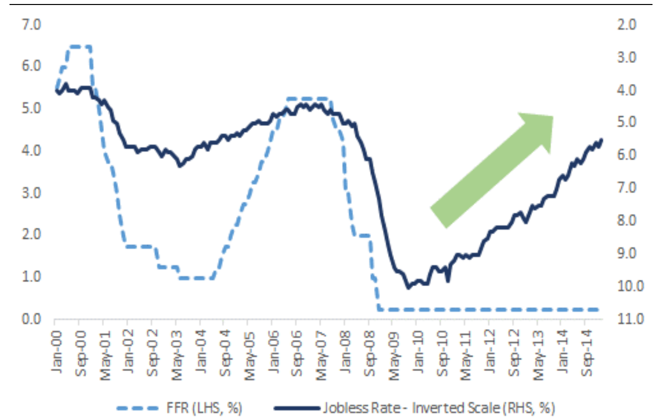
- The US economy is cruising along nicely with the employment outlook continuing to improve on the back of sustained production and better business conditions. The jobless rate continued to hover below 6% (February: 5.5%) and will probably be heading towards the level considered as full employment of between 5-5.5%. February's non-farm payroll statistics were encouraging (+295K) and affirms the strength of the labour market amid rising production and improving business conditions. Although there are other contentious issues with regard to the labour market (underemployment, wage growth, etc), the US Federal Reserve (Fed) is already signalling an impending rate hike in 2015, implying increasing confidence among policymakers on the overall strength of the economy going forward. Taking into account the PMI statistics, employment numbers and other leading indicators, we concur with the Fed's projection of a 2.6%-3% GDP growth for 2015.

Chart 5: US Conference Board's Leading Indicator Index and ISM's manufacturing PMI



Source: Bloomberg, CEIC, MARC Economic Research

Chart 6: Jobless rate and Fed Funds Rate



Source: CEIC, MARC Economic Research

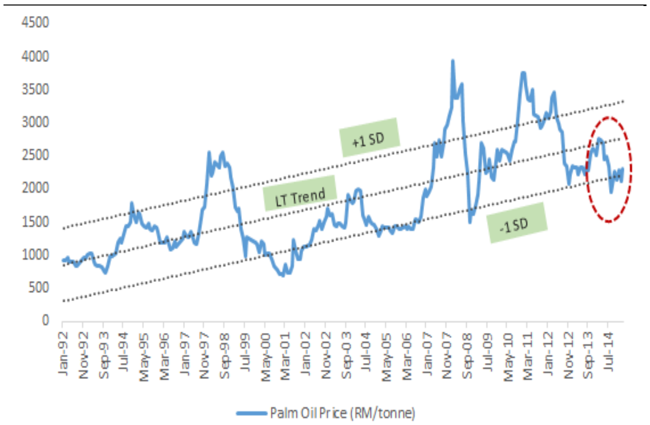
Malaysia – decelerating domestic and external demand

- Waning prospects of the global economy, relatively low commodity prices and softer domestic demand expected for 2015 have led the BNM to become less sanguine in its economic assessment, projecting a GDP growth of between 4.5%-5.5% (2014: 6%), in line with the revised projection by the MoF in January 2015. Growth is anticipated to be primarily driven by the domestic economy, led by private consumption (6%) and private investment (9%) as exports take a back seat, expanding by a slower pace of 3% according to the BNM. Private consumption will be supported by steady labour market conditions and relatively easy access to credit while private investment will be sustained through broad capital expenditures despite a slowdown in the oil and gas sector, according to the officials.

- The negative trade contribution is generally premised on the prospects of a weaker global economy amid problems in the euro zone, a moderation in China's GDP growth and softer Japanese economy despite the increasing strength of the US economy. Lackluster global demand and generally low prices of commodity products are expected to drag Malaysia's export growth in 2015. With crude oil prices expected to remain relatively weak (our forecast: USD65-75 per barrel by 2H2015), and palm oil prices remaining below its long-term trend of RM2,700 per tonne, Malaysian net exports are not likely to provide a boost to headline GDP growth as it did in 2014 (contribution 2014: 1.4 percentage points).

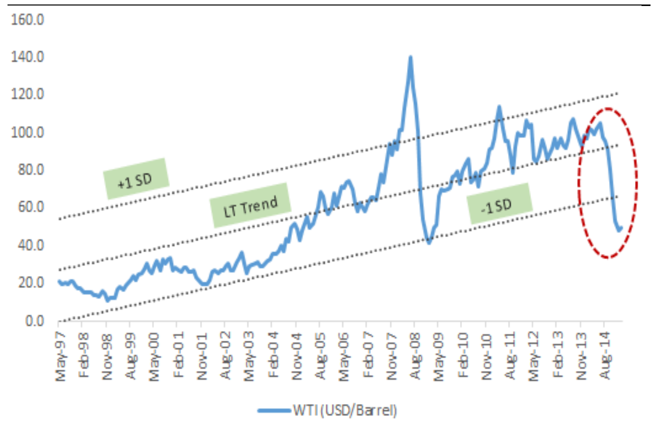
- MARC concurs with BNM's macro outlook amid lackluster external demand but expects sharper deceleration in domestic demand due rising inflationary pressure expected in 2H2015 and tighter lending standards. While inflation is expected to remain benign in 1Q2014, the implementation of GST will likely cause a spike in prices in 2H2015. This, coupled with tighter lending standards, is expected to lead to slower consumer spending, with an expansion of circa 5.5% in our view (2014: 7.1%). Consumer sentiment has already weakened in the past few quarters, based on the Malaysian Institute of Economic Research (MIER) sentiment index which dropped to a one-year low in 4Q2014. Similarly, its business condition index has also slipped to the lowest level since the recession in 2009. While private investment will continue to benefit from capital spending, particularly in mega projects, its pace of growth will moderate after recording double-digit expansions in the past few years.

Chart 7: MPOB CPO prices with long-term trend and standard deviations



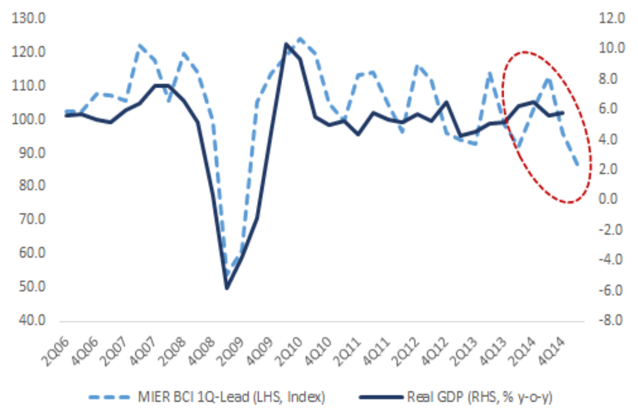
Source: Bloomberg, MARC Economic Research

Chart 8: WTI with long-term trend and standard deviations



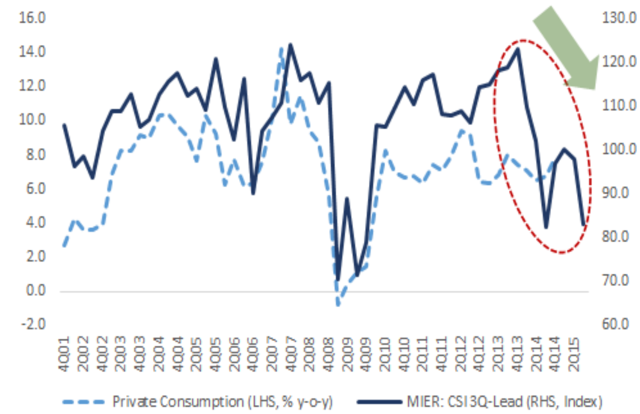
Source: Bloomberg, MARC Economic Research

Chart 9: MIER BCI 1Q-Lead and real GDP growth



Source: CEIC, MARC Economic Research

Chart 10: MIER CSI 3Q-Lead and private consumption growth



Source: CEIC, MARC Economic Research

Table 1: Real GDP growth – demand side

Growth (%y-o-y)	*2010*	*2011*	*2012*	*2013*	*2014*	*MARC 2015F*	*BNM 201F*
GDP	*7.4*	*5.1*	*5.6*	*4.7*	*6.0*	*4.7*	*4.5 - 5.5*
Domestic Demand	*7.7*	*7.9*	*10.6*	*7.6*	*6.0*	*5.3*	*6.0*
Private Consumption	*6.9*	*6.8*	*7.7*	*7.6*	*7.1*	*5.5*	*6.0*
Public Consumption	*3.4*	*15.8*	*5.1*	*6.3*	*4.4*	*3.3*	*2.7*
Private Investment	*18.4*	*10.5*	*21.9*	*13.6*	*11.0*	*8.4*	*9.0*
Public Investment	*4.9*	*1.0*	*17.1*	*0.7*	*-4.9*	*1.4*	*5.1*
Real Exports	*11.1*	*4.6*	*-0.1*	*-0.3*	*5.1*	*3.3*	*3.0*
Real Imports	*15.6*	*6.1*	*4.7*	*1.9*	*3.9*	*4.9*	*4.0*

Source: CEIC, BNM, MARC Economic Research

Inflation and interest rates

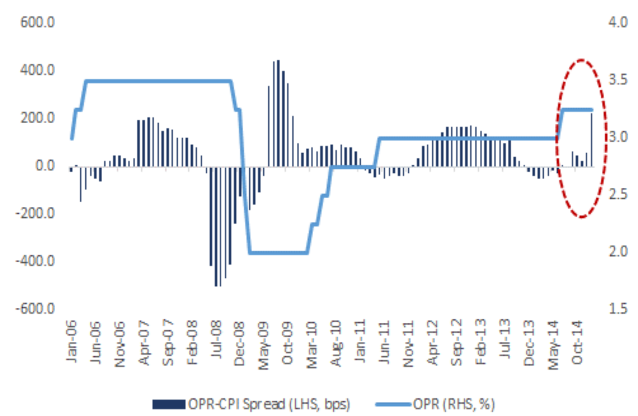
- Malaysia's moderating GDP growth is good news for inflation in 2015. With consumer spending momentum weakening, BNM expects inflation to be lower, in the region of 2-3% (2014: 3.2%), even after taking account of the possible upward pressure in prices post GST in April this year. The high base in 1H2014 and the relatively low fuel prices since December 2014 will also take some of the upward pressure off headline CPI growth. The government's decision to reduce the electricity tariff between March and June 2015 will also prevent inflation from accelerating. As a whole, MARC agrees with the assessment but anticipates inflation to be higher post GST as experiences in other countries tend to show increasing profiteering activities at least for a short period. On balance, MARC foresees the CPI growth to be in the range of 3-3.5% in 2015, slightly higher than BNM's forecast.

- Having said that, however, BNM will likely monitor price developments very closely post GST implementation. The good news is the government is already prepared with proper measures to prevent prices from accelerating (i.e. enforcement of the Price Control & Anti Profiteering Act 2011, the Price Reduction Campaign etc). Moreover, based on officials' rhetoric, a perceived transitory price development that may happen post GST will not call for monetary intervention from the BNM.

- On interest rates, we once again sense that BNM is not in favour of changing its current course at this juncture due to a more benign macro outlook for 2015. From the officials' rhetoric, MARC is of the view that the upside cycle of the OPR is over for now, as risks to growth increases and inflation expectation declines on the back of weaker demand going forward. Meanwhile, the downside risk of the OPR is limited by high household indebtedness. Moreover, interest rate cuts in major Asian countries (India, China, South Korea and Australia) also signal a new trend of a more accommodative monetary stance emerging in the region.

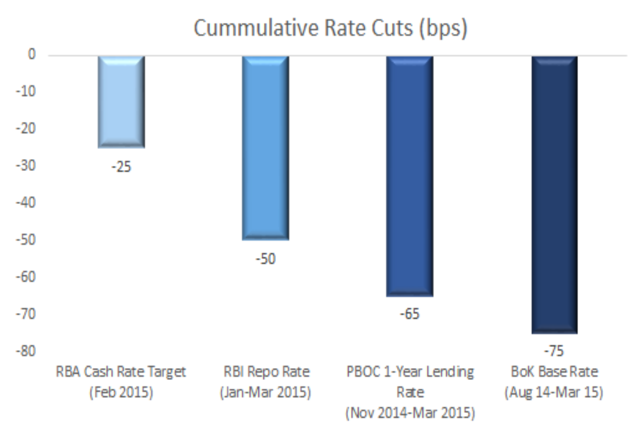
- Concerns over the possibility of a rate hike in the US which would narrow the gap between Malaysian and US interest rates will not likely induce the BNM to respond as it did in 2006. This is due to the fact that only the US is on the opposite cycle where interest rates need to be raised after six years of an ultra-accommodative policy. Other advanced economies – save for UK – will likely maintain their accommodative stance in order to protect their growth in 2015. Against this backdrop, MARC is of the view that the OPR will not likely budge from the current level of 3.25% in 2015.

Chart 11: OPR and OPR-CPI Spread



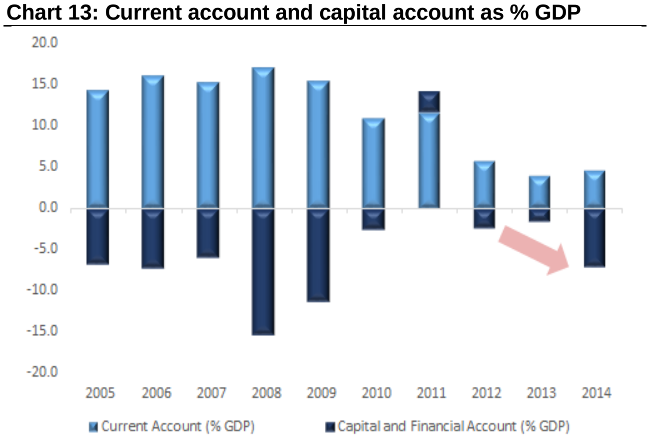
Source: CEIC, MARC Economic Research

Chart 12: Regional rate cuts (Australia, India, China, South Korea)



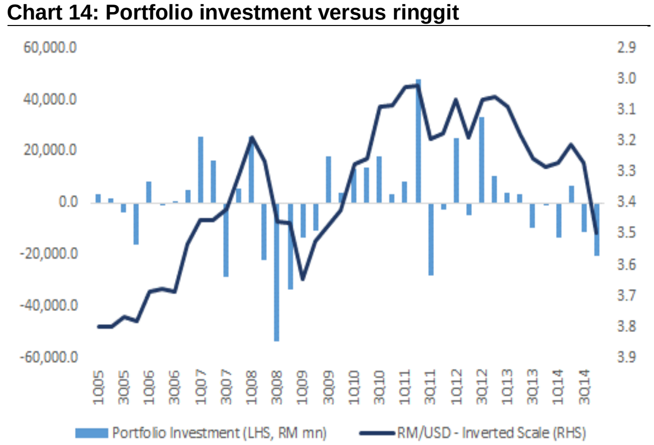
Source: CEIC, MARC Economic Research

Chart 13: Current account and capital account as % GDP



Source: CEIC, MARC Economic Research

Chart 14: Portfolio investment versus ringgit



Source: CEIC, MARC Economic Research

Performance of banking and non-banking financial institutions

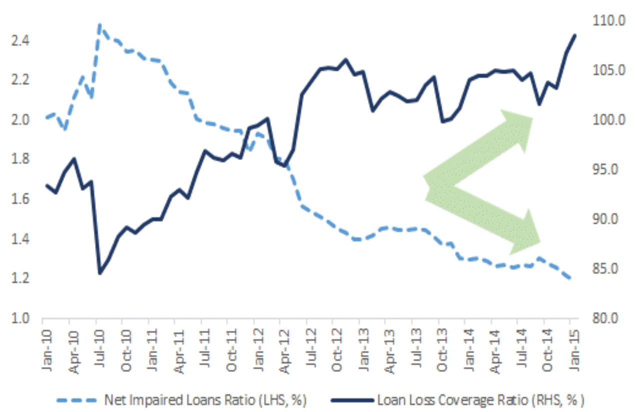
- Based on BNM's assessment, the overall economic landscape is still supported by a healthy banking sector with capital ratios surpassing the levels required under Basel III. The capital position of the banking sector remained solid in 2014 with a Total Capital Ratio of 15.2%, Tier 1 capital ratio (Tier 1) of 13.3% and Common Equity Tier 1 capital ratio (CET1) of 12.6%, well above the minimum requirements of 10.5%, 8.5% and 7.0% respectively under Basel III guidelines.

- Supervision and regulation are strong, and Malaysia's banking system remains sound. BNM's targeted macro-prudential policies have been somewhat successful in dealing with high credit growth rates in some segments, although for the household segment as a whole, the ratio to GDP remains high. The asset quality of Malaysian banks continued to improve in 2014. While improvements in asset quality in the past were attributed to strong credit growth, offsetting the increase in impaired loans, this is no longer the case.

Even though overall lending growth has moderated, the ratio of net impaired loans to net total loans has fallen to 1.2% in 2014, compared to the post-GFC high of 2.3% recorded in 2010. In addition, provisions set aside by banks covered more than 100% of all impaired loans.

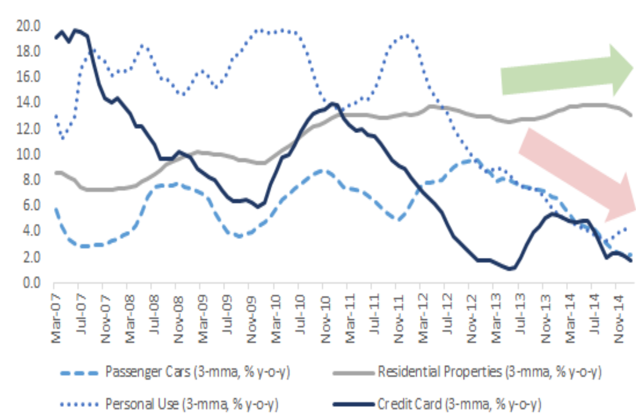
- Overall loan growth remained resilient in 2014, although somewhat moderated from the level in 2013. Growth was spearheaded by lending for residential property purchases as property values remained relatively high, although growth in prices of residential homes somewhat softened to 4.6% in 3Q2014 (4Q2013: 9.6%). Macro-prudential measures by BNM continued to dent consumer demand for credit cards, passenger cars and personal loans in 2014 (1.2%, 2.3% and 3.9% respectively) but have not impacted demand for residential property loans (2014: 13.3%). Judging by the slower momentum of the economy going forward, we expect overall loan growth to slide further to 8-9.0% in 2015 (2014: 9.3%) as banks tighten their lending standards to protect their asset quality and demand continues to soften amid souring business and consumer sentiment. That said, however, with the relatively high levels of home prices, we anticipate property loan growth to remain resilient in 2015.

Chart 15: Net impaired ratio and loan loss coverage ratio



Source: BNM, CEIC, MARC Economic Research

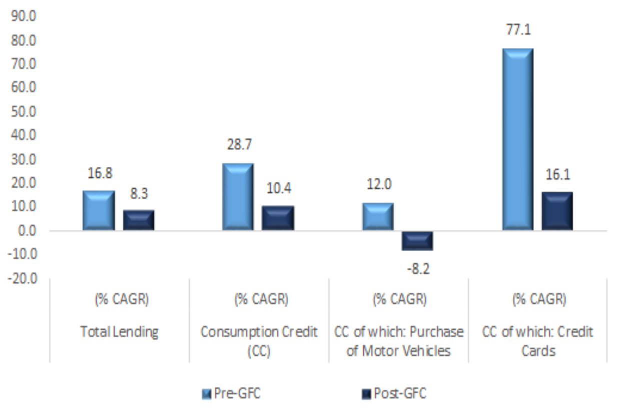
Chart 16: Lending growth by purposes



Source: BNM, CEIC, MARC Economic Research

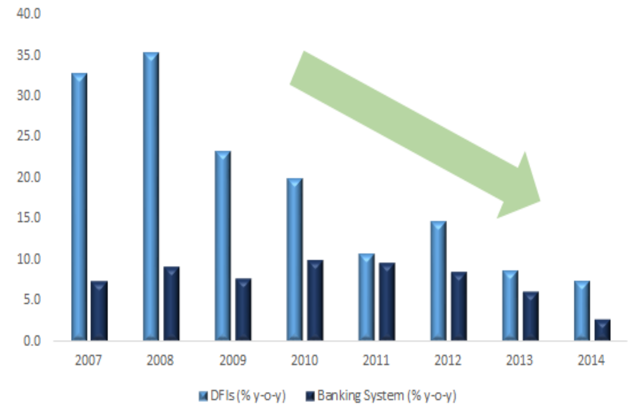
- As for the DFIs, MARC takes comfort from the fact that their overall lending growth continued to trend downward, moderating to 7.1% as of end-2014 (2013: 7.2%). Notably, growth of loans for consumption credit continued to decelerate to 7.4% (2013: 8.8%), from as high as 35.4% in 2008, although their proportion to total loans was broadly unchanged at 50.3% of the total loan book (2013: 50.1%). On a CAGR basis, total credit growth moderated from as high as 16.8% in 2005-2009, to a mere 8.3% in 2010-2014. Another loan segment – personal financing – extended by the NBFIs also grew significantly slower by 5.3% in 2014, down from 13.9% in the preceding year. The NBFIs, however, remained the largest loan provider for this segment with a share of close to 60% of total personal financing to households. In addition, new personal financing facilities approved by NBFIs had declined by 31.3% in value terms in 2014, while the average financing amount disbursed by them dropped to less than RM30,000 per facility in 2014, as compared to the earlier period where the disbursements were up to RM300,000 per facility.

Chart 17: Lending growth by DFIs (on a CAGR basis) – total and for consumption credit



Source: BNM Financial Stability and Payment Systems Report (various issues), MARC Economic Research

Chart 18: Growth in consumption credit by DFIs and banking system



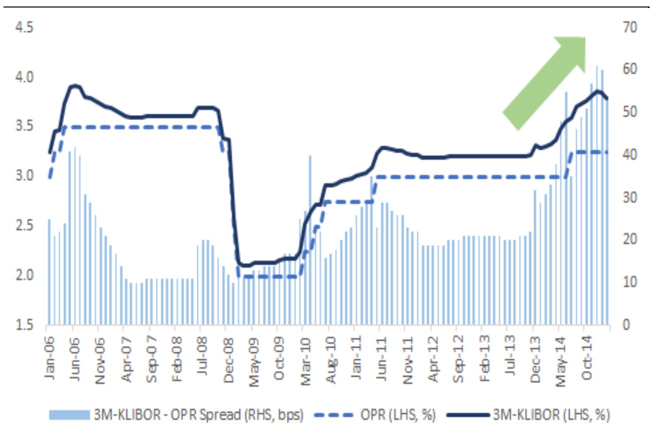
Source: BNM Financial Stability and Payment Systems Report (various issues), CEIC, MARC Economic Research

New liquidity framework

- In line with BNM's plan to implement the Basel III reform package which comprises measures to further strengthen the existing capital and liquidity standards for banking institutions in Malaysia, the central bank has reaffirmed the timeframe for its implementation. The LCR will be introduced in June 2015 and be fully implemented by 2019. The combined LCR, Net Stable Funding Ratio (NSFR) and liquidity risk management standards will be part of the framework that will ensure sufficient liquidity in the banking system.

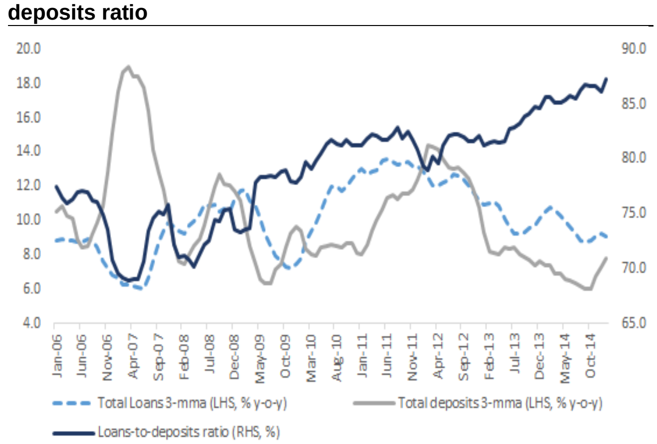
- MARC views the BNM's commitment to ensure the smooth implementation of the Basel III LCR as a positive move. Under the rules, the minimum LCR requirement by June 1, 2015 was 60% and this will be increased in stages until 100% by 2019. The decision to reclassify certain liquid assets such as the SRR balances as part of the Level 1 HQLA is also positive as it eases the concerns on banks' meeting the liquidity requirements. This has reduced the upward pressure on the KLIBOR rates which have been on the uptrend in the past few months. From a macro point of view, the LCR framework will further minimise the risk of a credit crunch in the economy and hence reduce the probability of systemic risk.

Chart 19: 3M-KLIBOR, OPR and KLIBOR-OPR spread



Source: CEIC, MARC Economic Research

Chart 20: Loans and deposits growth versus loans-to-deposits ratio



Source: BNM, CEIC, MARC Economic Research

Contentious issue of high household and corporate debt

- The issue of household indebtedness continues to hog the limelight. While some of the measures imposed by the BNM in the past few years (lower LTV, shorter repayment periods, removal of Developer Interest Bearing Scheme) have successfully resulted in slower expansion of household loan growth in 2014 (9.9% versus 11.5% in 2013), its ratio to GDP climbed further to 87.9% (2013: 86.7%), one of the highest in the region. The ratio has been above 80% since 2012 amid strong increases in property prices that induced strong demand for residential property loans.

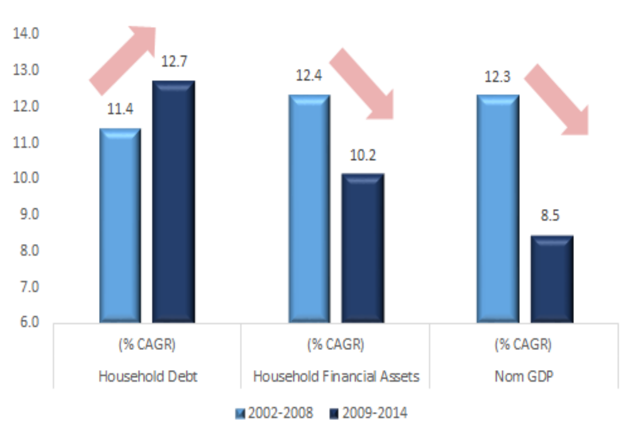
- On this issue, BNM reiterated its view that household financial assets remain sufficient at more than two times of the amount of debt. In addition, liquid financial assets – the assets that can quickly be resorted to when facing financial stress – remain comfortable at 1.5 times the amount of household obligations. The financial stress test as reflected by vintage analysis also suggests that the financial sector will not be in distress even if there is an increasing amount of default in housing loans by households.

- On this matter, we are consoled by the fact that a large portion of household indebtedness – roughly 60% - was used for housing wealth and asset accumulation (housing loans, non-residential property) and for investments in equities and mutual funds. In addition, there were continued improvements in default rates of new housing loans and new borrowings are of higher quality, with 50% of new loans approved with DSR of below 40%. However, we still view with concern the household assets-to-debt ratio which has declined in the past few years as the increase in household asset value has not kept pace with the increase in household debt in the period after the GFC in 2009. Although the amount of financial assets continued to rise in 2014, its ratio to household debt has declined to 2.1 times, down from the peak of 2.7 times in 2007. The ratio of liquid financial assets to household debt also continued to drop to 1.5 times from as high as 1.8 times in 2007. Notwithstanding this, MARC notes that it has become a norm for countries with relatively young demographics to have considerably higher household debt (i.e. Singapore: 76.3% of GDP, Thailand: 83.5% of GDP) than other economies.

- MARC foresees more selective macro-prudential measures could be introduced by the BNM to ensure softer residential property loan growth in the near and medium term, although weaker economic growth in itself will reduce borrowers' appetite for debt accumulation in 2015. In addition, souring business and consumer sentiment will also lead to stricter lending standards going forward. MARC feels that more stringent measures could be introduced to address strong property lending given that total exposures of financial institutions to the property sector continued to climb to 23% of total financial system assets (2013: 21.9%) and home prices continued to remain elevated (estimated 6.6 times of household median income). As such, the balancing act to avert a sharp residential property market slowdown and to prevent further escalation in household debt is becoming more challenging for the BNM. On the one hand, excessive measures to curb lending to the residential property sector will risk a deep correction as seen in 1997 in Malaysia and, more recently, in Singapore. On the flip side, failing to cap lending growth in the sector will increase future downside risk, especially if interest rates start to rise at some point of the economic cycle.

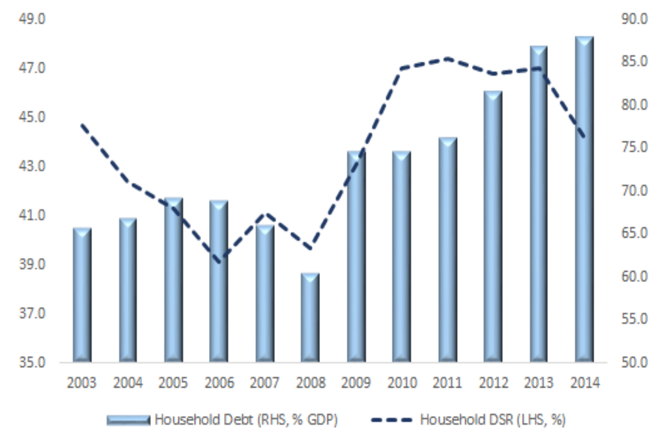
- As for the corporate sector, while total outstanding domestic and external borrowings by non-financial businesses continued to grow in 2014 (6.8%; 2013: +10.4%), BNM's stress tests show that the solvency positions of the firms tested remain intact even after discounting the effect of higher asset valuation arising from a weaker ringgit. This suggests that most Malaysian firms have adequate revenue generating assets to cover potentially high foreign currency liabilities. Separately, we concur with BNM's findings that the overall leverage (based on debt-to-equity ratio) of the Malaysian business sector remains intact and stood below the level observed prior to the GFC. Notwithstanding this, our calculations (based on the median, average and total debt weighted debt-to-EBIT) suggest that a large proportion of corporate debt is concentrated in a few big and highly leverage corporations.

Chart 21: Household debt, household financial assets and nominal GDP growth on a CAGR basis



Source: BNM, CEIC, MARC Economic Research

Chart 22: Household debt as % GDP and debt service ratio



Source: BNM, CEIC, MARC Economic Research

Challenges relating to managing capital flows

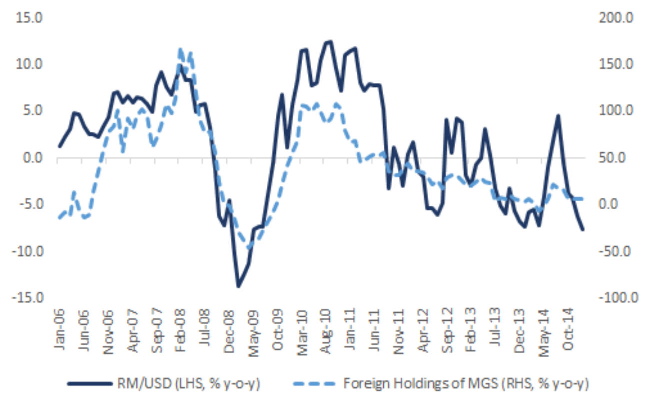
- With the US Fed likely to commence its first interest rate hike this year following the improvement in labour market conditions and a more favourable economic outlook, a change in the trend of capital flows will likely occur in the near term, causing some repercussions on the financial market. In particular, Malaysia will likely be affected due to the expected reversal of the portfolio capital which has flowed in over the past few years, especially in the government bond segment. Foreign holdings of MGS reached the peak of 49.5% of total outstanding MGS in May 2013 before declining to 43.8% recently.

- Two primary factors that can heavily influence portfolio capital movement from the Malaysian shores are: (1) how aggressive the Fed is perceived as when it undertakes its first interest rate hike; and (2) how much more downside there is for global crude oil prices. The first factor relates to the strength of the USD which is anticipated to benefit from the Fed's move. Based on historical data, the current USD upward cycle is merely halfway through a typical USD cycle in the past – meaning that there will likely be another one or two years of a general uptrend of the USD against major currencies. This will have critical implications for the ringgit's performance against the greenback going forward.

- The second factor relates more to the impact of crude oil on the overall macro performance of the Malaysian economy. A recovery in crude oil prices will generally be positive for Malaysian exports and its current account balance as well as the government's budgetary position. This will in turn, ease the pressure on the ringgit against the greenback. A reverse scenario will be negative for the ringgit, and when combined with the prospects of an interest rate hike in the US, will induce more asset managers to shift away from ringgit-denominated assets in favour of the USD.

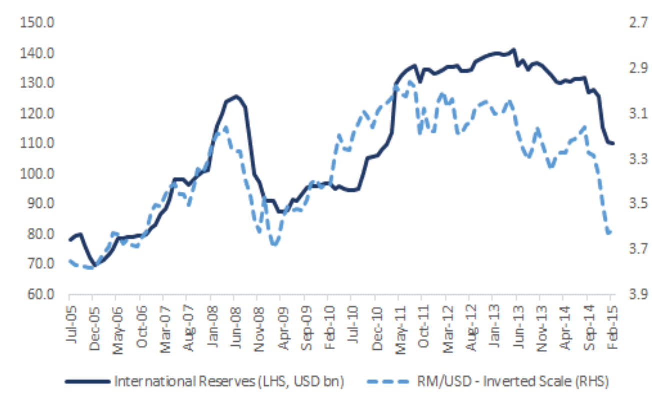
- MARC views that the prospects of a stronger USD will continue to drive local bond yields up and increase the outflow of portfolio capital to USD-denominated assets. Net portfolio outflows have already surged to RM37.9 billion in 2014 from a mere RM3 billion in 2013. Coupled with concerns on some of the macro issues (i.e. shrinking current account surpluses, wider than initially projected budget deficits), the appetite for ringgit-denominated assets will likely remain lacklustre, exerting pressure on the ringgit. Mitigating this, however, is the relatively resilient and diversified economy, which on balance is unlikely to cause a major shift in the trend of foreign holdings of government debt such as MGS.

Chart 23: Annual change in foreign holdings of MGS and ringgit



Source: CEIC, MARC Economic Research

Chart 24: Ringgit and International Reserves



Source: CEIC, MARC Economic Research

THIS PAGE IS INTENTIONALLY LEFT BLANK

THIS PAGE IS INTENTIONALLY LEFT BLANK

Published and Printed by:

MALAYSIAN RATING CORPORATION BERHAD (Company No.: 364803-V)
5th Floor, Bangunan Malaysian Re, No. 17, Lorong Dungun, Damansara Heights, 50490 KUALA LUMPUR
Tel.: +603 2082 2200 Fax: +603 2094 9397 E-mail: marc@marc.com.my
Homepage: www.marc.com.my