APAC Economic Perspectives

Malaysia by the Numbers (May 2016)

Economics

Asia Pacific

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It's not about the money, money, money.

Central Banks, by and large, influence inflation and growth in an economy by attempting to manipulate money and credit growth. Money growth (by any measure, see page 21) has slowed significantly in Malaysia, but Bank Negara has not eased policy by cutting rates. We believe recent changes in the drivers of slow money growth could change this – we revise our year-end policy rates forecast in 2016 to 3.0% and in 2017 to 2.75%.

Money growth initially slowed by outflows

The stated aim of Bank Negara's monetary policy is to maintain price stability, while supporting growth. Bank Negara's method of achieving this aim is to set its policy rate at a level at which the rate of money and credit growth is supportive of low and stable inflation and growth. A precipitous drop in broad money (M3) growth from over 6% in August 2015 (low, but within the realms of normality) to sub 1% in April does not indicate that money growth is supportive of either. Why didn't BNM cut rates? We think this is because, initially at least, the slowdown in broad money growth was driven by capital outflows rather than slowing domestic credit (figure 2). Cutting interest rates, at the risk of destabilising the currency further and encouraging deposit flight, might have been viewed as counterproductive policymaking (see our previous work).

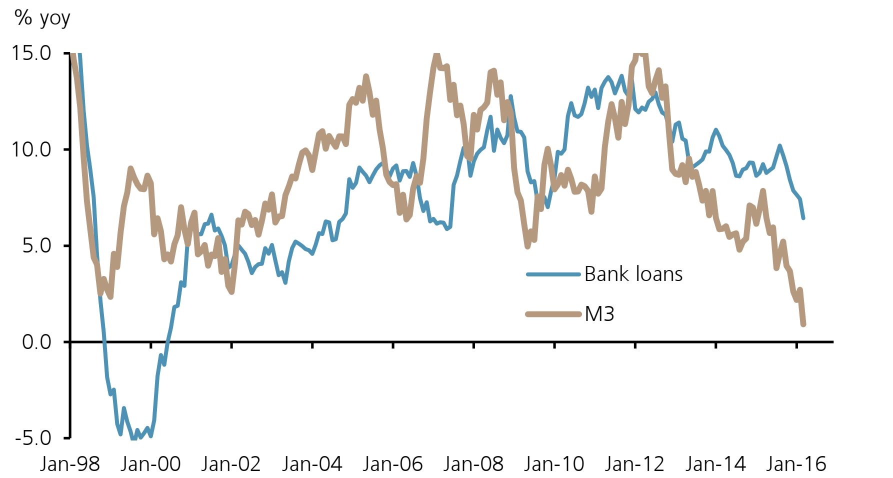
Bank Negara to ease policy: It's all about credit growth

These dynamics changed in Q1. Outflows are now less of a drag on money growth (see figure 2) and the currency is more stable. More importantly, lower broad money growth is being delivered by a slowdown in credit growth. Bank loan growth has slowed from above 10% yoy in August to just 6.4% yoy in March, the slowest pace of lending growth since 2007. This is important - credit growth is a key channel through which monetary policy spurs growth and inflation in an economy. Inflation is already likely to be lower than previously anticipated given fuel price cuts administered in early 2016 (we revise our inflation forecast to 2.3% from 3.2% for 2016). We think a continuation in these trends, which we would expect as the credit cycle matures, would likely encourage Bank Negara to cut interest rates. We revise our policy rate forecast in 2016 to 3.0% from 3.25% and in 2017 to 2.75% from 3.25%, implying a 25bps rate cut this year and a 25bps cut next year.

Will the government ease policy too?

The incumbent government in Malaysia must call an election by August 2018 (though they can call it earlier). Elections can sometimes be associated with looser fiscal policy (see Figure 3) - in the 12 months preceding the May 2013 election the fiscal deficit increased from 2.6% of GDP to 6.0% of GDP. So we see a possibility that the looming 2018 election could lead to easier fiscal policy in Malaysia, particularly given that, based on data from the Merdeka Centre for Opinion Research, the government's approval rating is well below levels that delivered only a narrow victory at the last election. However, looser fiscal policy would be a big step change from current policy – the government has consistently consolidated the deficit, even in spite of lost oil income, over this term. It is unclear whether the government would be willing to undermine its fiscal credibility at the risk of jeopardising investor confidence or Malaysia's credit rating. As such we don't look for a wider deficit from the 2017 budget. However, oil prices have risen from the revised 2016 budget assumption of $30-35. Assuming elevated prices persist, we estimate this creates MYR7-9bn worth of "wiggle room" that the government could spend without derailing deficit consolidation. We believe this could provide a small stimulus to growth.

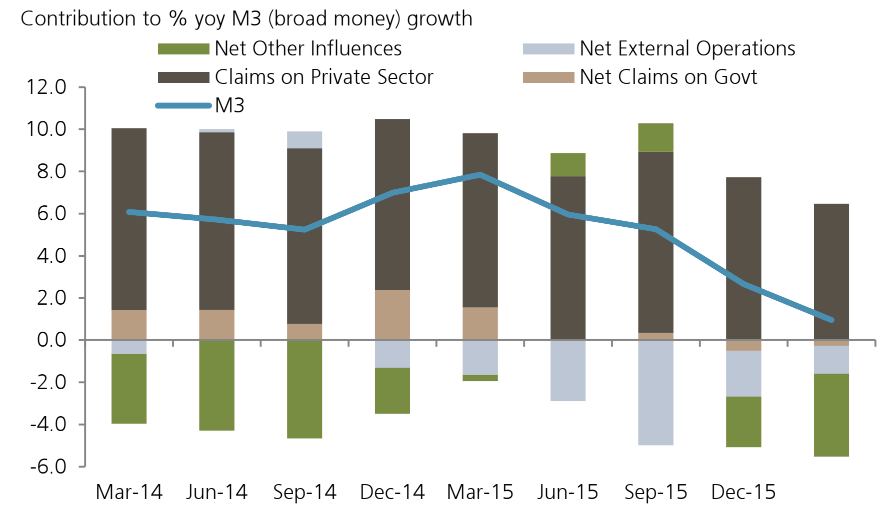
Figure 1: Loan growth has become a key driver of the slowdown in M3…



Source: UBS, Haver, CEIC

The stated aim of Bank Negara's monetary policy is to maintain price stability, while supporting growth. Money and credit growth are key transmission mechanisms of monetary policy. Money supply (M3) growth started dropping below historical norms around June 2015 as outflows accelerated. Only as of early 2016 has credit growth shown clear weakness.

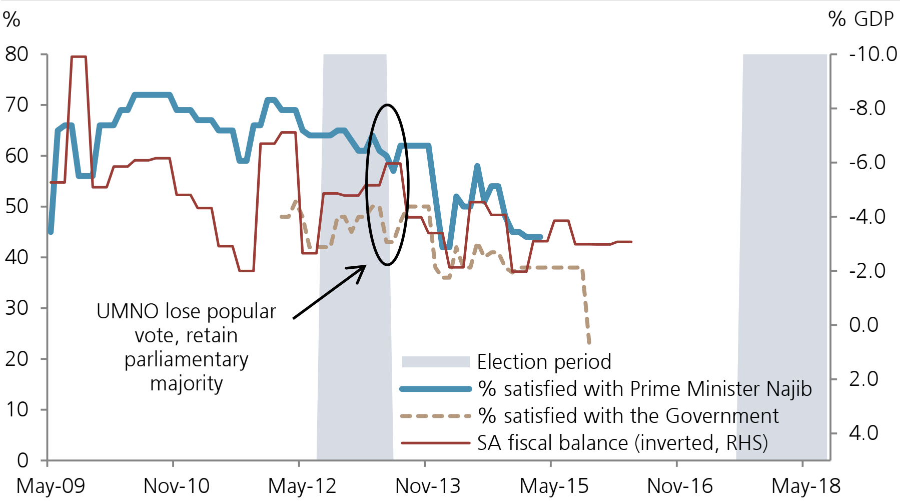
Figure 2: … while previously the drivers were capital outflows



Source: UBS, Haver, CEIC, BNM

Capital outflows (net external operations) were a heavy drag on M3 growth in Q3. This effect has diminished in Q1, and sluggish M3 growth is instead being driven by weak domestic credit (claims on private sector). Bank Negara could react to this latter dynamic with easier policy given that growth is already slowing and the inflation outlook is relatively benign.

Figure 3: The government faces an uphill battle ahead of the 2018 election



Source: UBS, Haver, CEIC, Merdeka Centre for Opinion Research

In the 12 months preceding the May 2013 election the fiscal balance deteriorated from -2.6% of GDP to -6.0% of GDP. This may have helped to lift the government approval rating from 42% to 50% - delivering close-fought victory for UMNO. With a bigger hill to climb ahead of 2018 (the most recently published polls put the government approval rating at just 23%) we see a growing risk that the government opts for stimulus.

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Our guide to Malaysia monthly data - what the numbers are, what they mean, and our outlook going forward:

UBS Research THESIS MAP

PIVOTAL QUESTIONS

Q: Will growth keep slowing?

We believe domestic demand in Malaysia is likely to remain soft given high consumer leverage and the maturing credit and commodity cycles. Slow credit growth should help to deliver lower investment and consumption growth in line with our forecasts. We think external pressures – higher rates, weak global growth – should continue to exert a drag in 2017.

Q: Will fiscal policy be eased?

With the 2018 election beginning to loom on the horizon, we believe there will be mounting pressure on the incumbent government to improve their approval ratings by expanding the deficit and including populist policies in the next budget (due to be announced in October 2016). Our base case remains for the government to stick to its prudent fiscal consolidation targets for the foreseeable future – but the risk of deficit expansion remains. That risk is somewhat mitigated because the government has a little more revenue to play than expected with given the rally in oil prices above their revised budget assumption (of $30-35 per barrel).

Q: Will monetary policy be eased?

We look for policy rates to be cut to 3.0% by year end 2016 and 2.75% by end 2017, implying one rate cut this year and one rate cut next year. The driver of easier policy is the slowdown in domestic credit growth. Given Bank Negara Malaysia's relatively low growth forecast (of 4.0-4.5% for 2016) and moderate inflation outlook (2.0-3.0%), we anticipate it will act to mitigate the downside risks to inflation and growth posed by slow credit growth.

WHAT'S PRICED IN?

Consensus sees a climb higher in growth to 4.5% yoy by year-end. BNM foresees growth in the 4.0-4.5% range. We are more pessimistic, looking for growth to slow to 3.8% on average in 2016E and continuing to slow to 3.6% into 2017E.

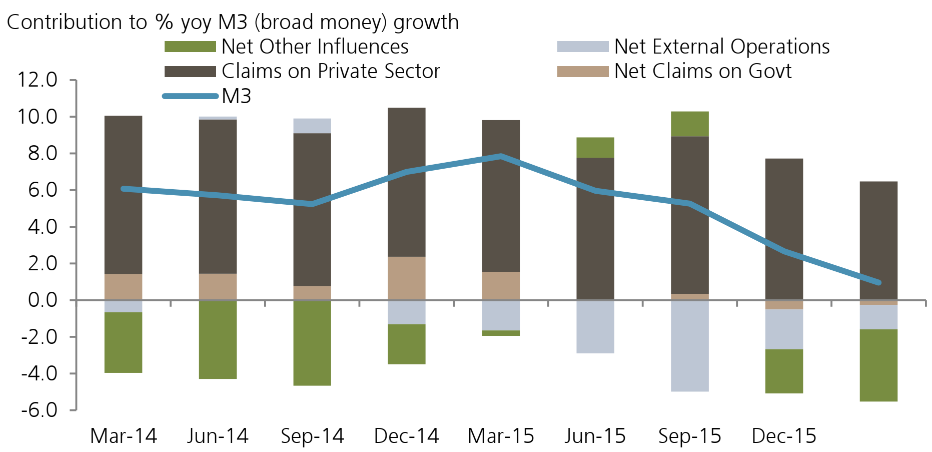
UBS VIEW

We expect the credit cycle to depress domestic demand and act as a drag on real GDP growth in 2016 and 2017 in Malaysia. External headwinds from higher U.S. rates and slower Chinese growth should exacerbate the slowdown.

EVIDENCE

Credit growth has slowed sharply, indicating a period of debt consolidation may be commencing. The credit cycle should drag on growth, at the same time that investment is being cut by the oil and gas industry and external headwinds from slower Chinese growth persist.

Weak money growth is now being driven by slow credit growth



Source: UBS, Haver, CEIC, Bank Negara

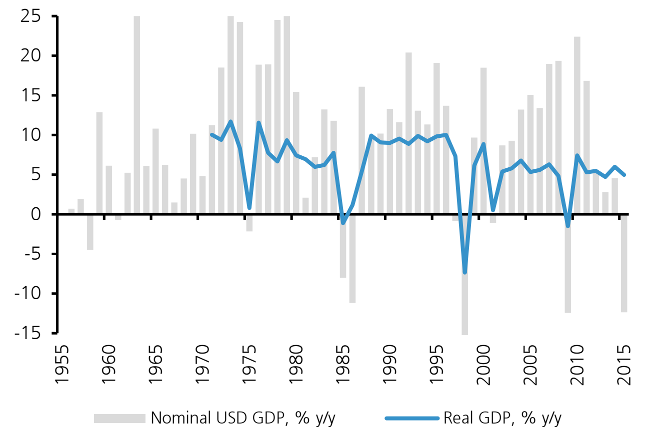
Gross Domestic Product

- *What the numbers say:* Real GDP growth slowed to 4.2% on the year in Q1 2016, continuing its slowdown for over a year now, from a peak of 6.5% y/y in Q2 2014. Seasonally adjusted quarterly growth slowed to 1% in Q1. In nominal terms, the economy grew 4.9% y/y, close to the growth in Q3 and Q4 of 2015 but well below 10.5% in H1 2014. On the demand side, private consumption improved marginally to 5.3% y/y while investment growth dropped further to 0.1% y/y (from 4.2% in Q3 2015), a 1.5% SA q/q drop from 3.9% in Q3. On the supply-side, manufacturing slowed and agriculture contracted while construction improved. Services improved marginally, but remain low compared to pre-2015 levels.

- *What they mean:* GDP is the broadest measure of economic activity. It is strongly correlated with the profit cycle and provides important clues about inflation and the direction of policy. Strong GDP often suggests policy will tighten; weak GDP implies a policy bias for pro-growth.

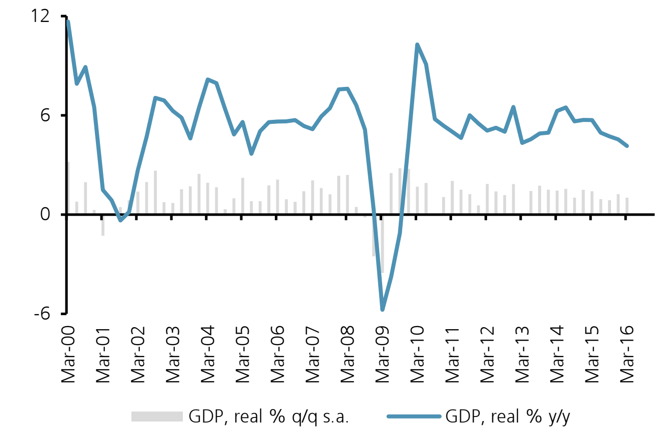
- *12-month outlook:* Momentum remained weak in the Malaysian economy in Q1 – we anticipate this will persist due to the weak global environment, maturing credit cycle, low oil prices and rising US rates. We look for 3.6% real GDP growth in 2016, and 3.4% in 2017.

Figure 4: Real GDP – long run



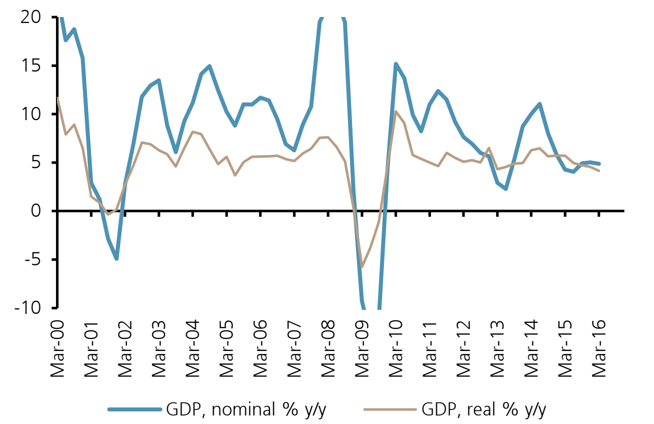
Source: UBS Estimates, CEIC, Haver

Figure 5: Real GDP – decade to date



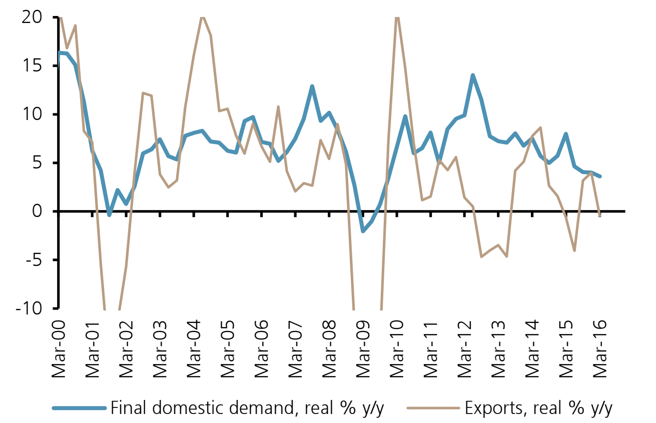
Source: UBS Estimates, CEIC, Haver

Figure 6: Real and nominal GDP growth



Source: CEIC, UBS

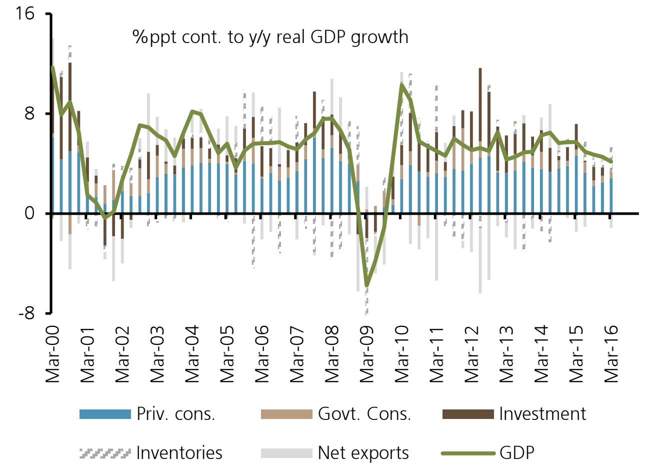
Figure 7: Real GDP – final domestic demand and export growth



Source: CEIC, UBS (Final Domestic Demand = Consumption + Fixed Investment)

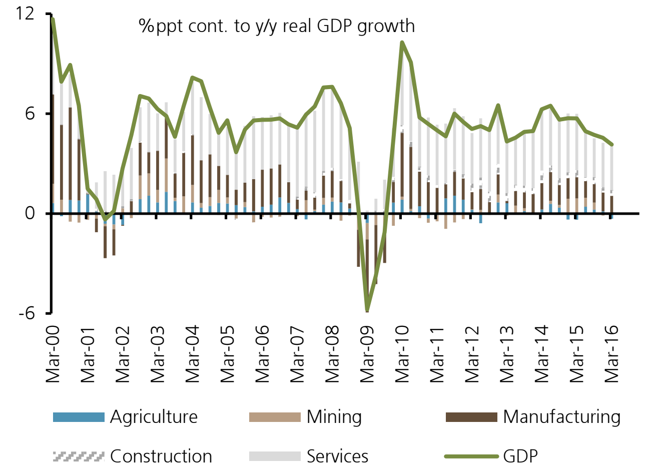
Gross Domestic Product, continued

Figure 8: Real GDP – expenditure contribution to growth



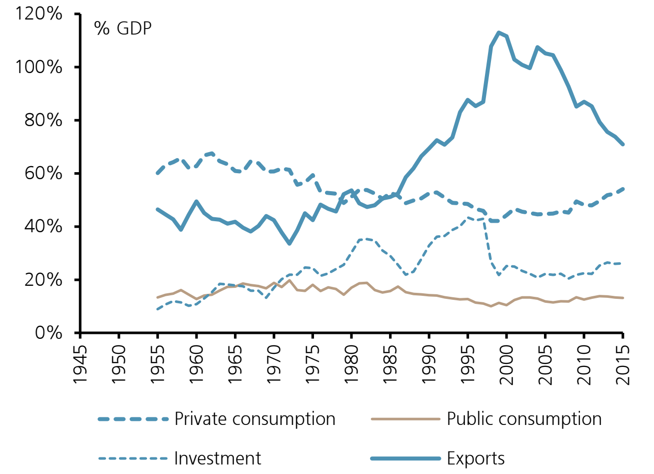
Source: Haver, CEIC, UBS

Figure 9: Real GDP – value added contribution to growth



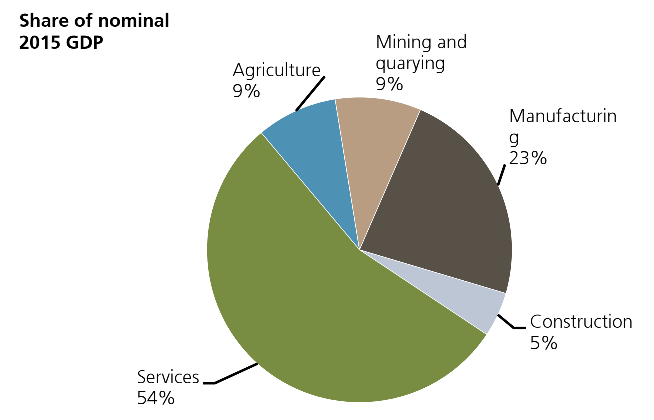
Source: Haver, CEIC, UBS

Figure 10: Nominal GDP - expenditure shares



Source: Haver, CEIC, UBS

Figure 11: Nominal GDP – value added shares

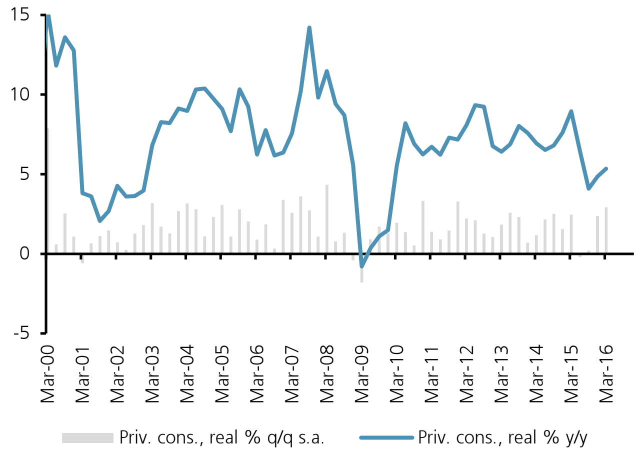


Source: Haver, CEIC, UBS

Private consumption expenditure

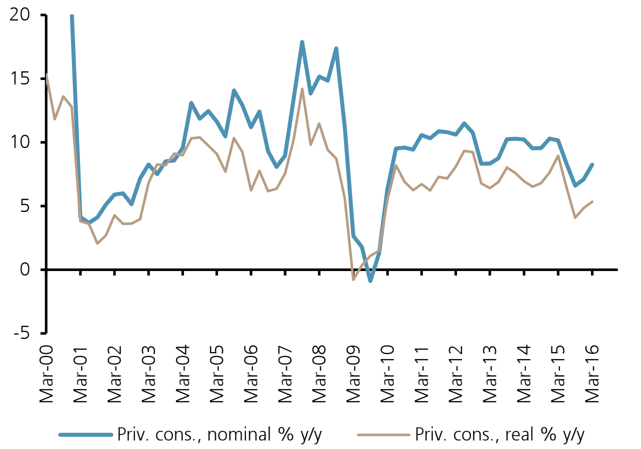
- *What the numbers say:* Real private consumption growth shows signs of improvement, as it improved to 5.3% y/y in Q1 from 4.1% in Q3 2015, but still below 7% in 2014. Seasonally adjusted growth on the quarter showed that momentum picked up to 2.9% (from a low of -0.2% in Q2 – which was likely weak due to GST implementation). In nominal terms, growth was at 8.2% y/y in Q1, close to the growth in Q2 2015. Consumer confidence looks to have bottomed, picking up in Q1 after all-time lows were reached in Q4 2015. Further, passenger car sales look to have bottomed and may be beginning to pick up.
- *What they mean:* Consumption equates to 50% of Malaysian nominal GDP, a share above that of Singapore but below most other countries in the region. Consumption is a key determinant of trend headline GDP growth.
- *12-month outlook:* While there are some signs of a recovery in consumption after weakness in 2015 we expect consumption to remain soft in 2016 and 2017 due to high household indebtedness and slower income growth.

Figure 12: Consumption cycle – real private consumption



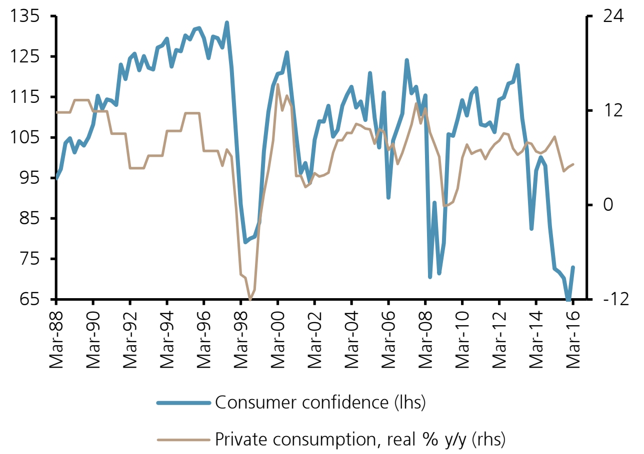
Source: Haver, CEIC, UBS

Figure 13: Real and nominal private consumption



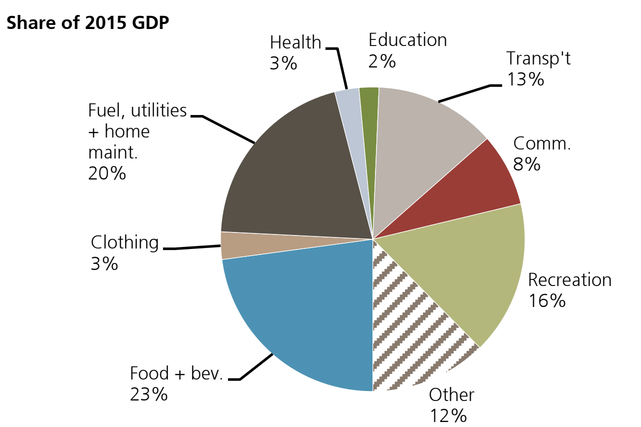
Source: Haver, CEIC, UBS

Figure 14: Real consumption growth and consumer confidence



Source: Haver, CEIC, UBS

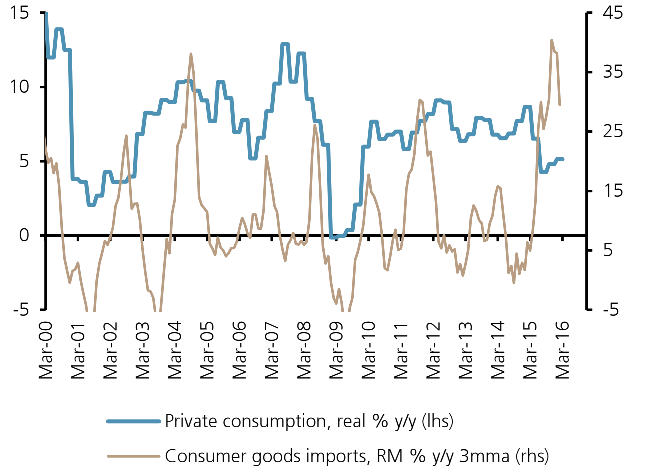
Figure 15: Composition of nominal consumption



Source: Haver, CEIC, UBS

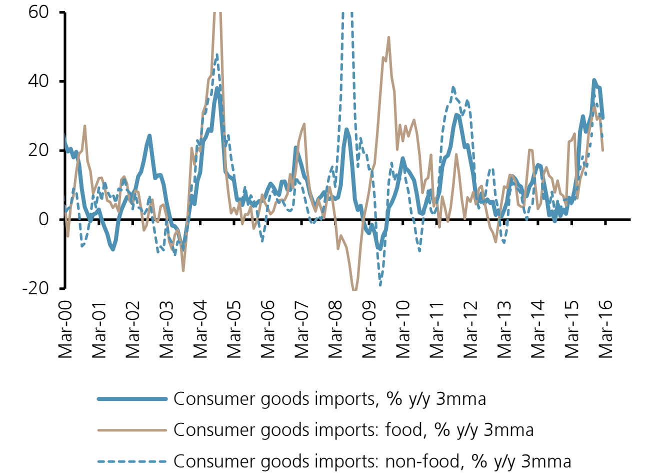
Private consumption expenditure, continued

Figure 16: Private consumption and consumer goods imports



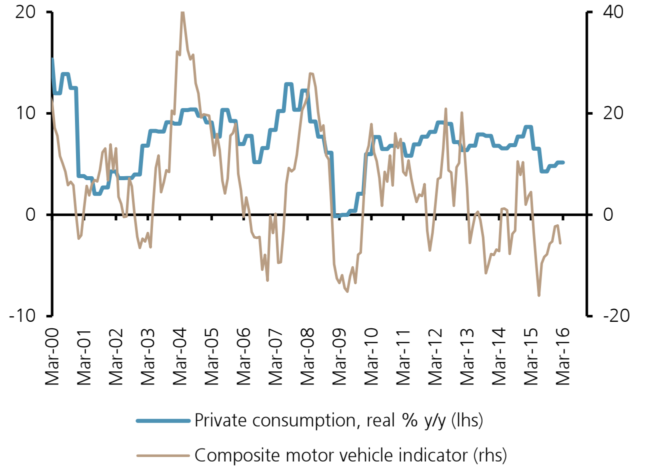
Source: UBS, CEIC

Figure 17: Consumer goods imports by type



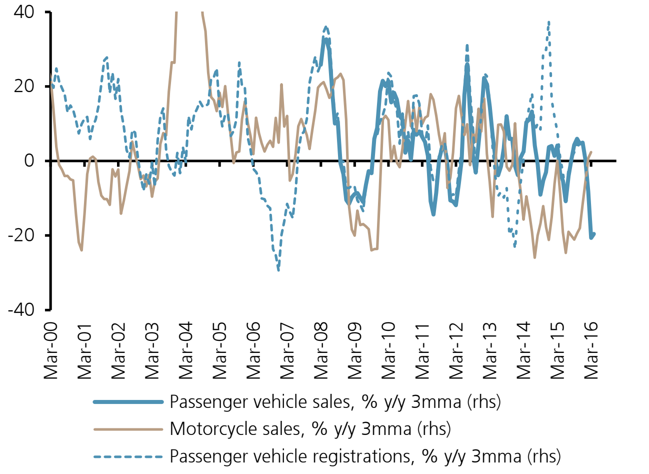
Source: UBS, CEIC, Note: imports measured in nominal ringgit terms.

Figure 18: Private consumption and motor vehicle sales



Source: UBS, CEIC. Composite indicator is a registration-volume weighted average of motorcycle sales, passenger car registrations and, latterly, passenger vehicle sales.

Figure 19: Passenger vehicle and motorcycle sales/registrations

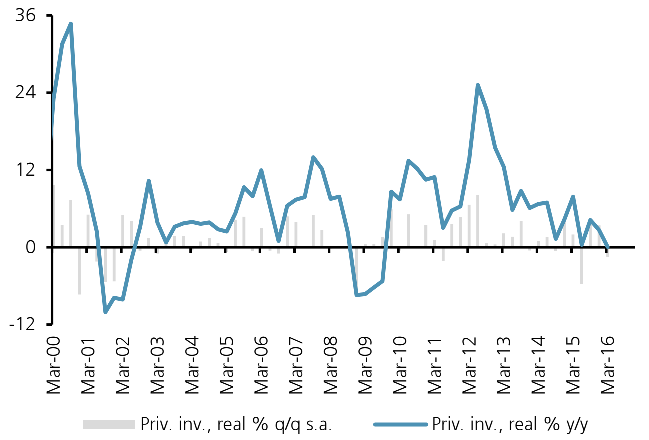


Source: UBS, CEIC

Investment

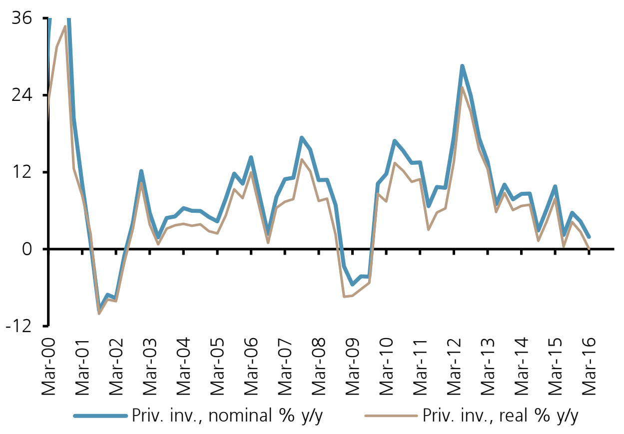
- *What the numbers say:* Real investment dropped to 0.1% y/y in Q1 2016 from 4.2% in Q3 2015. Seasonally adjusted on the quarter growth fell 1.5% from above 3% growth in Q3 and Q4. Nominal investment increased only 1.9% y/y and 2.6% seasonally adjusted q/q. Measures of capacity utilisation suggest spare capacity is increasing while surveyed confidence has picked up a little of late, but remains low.
- *What they mean:* High savings and investment ratios have long been the key ingredient to sustained high growth in Asia. Asia's investment to GDP ratio averages around 25% of GDP, which means Malaysia is above average. Investment is a key driver of employment and income growth. While not as large as private consumption, it can have a larger impact on the economic cycle due to higher volatility.
- *12-month outlook:* Private investment will likely remain weak in 2016 for several reasons – oil and gas companies cutting back, the slowing credit cycle, and companies' purchasing power for capital goods imports is diminished given currency weakness. This ties in with the data – confidence remains low, while leading indications suggest a slowdown. A normalisation in Malaysia's elevated investment share of GDP could be a drag on growth in the longer term.

Figure 20: Real investment



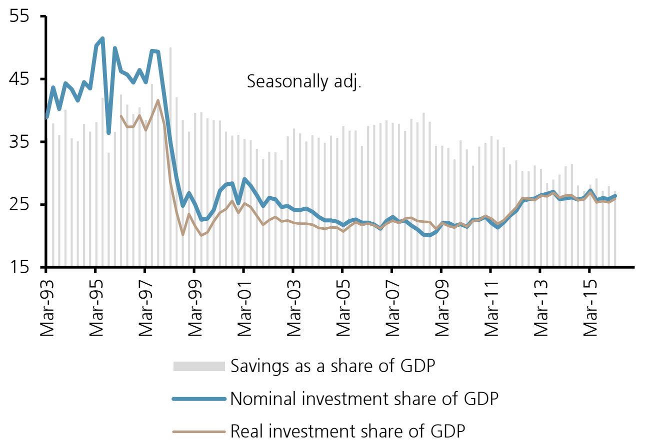
Source: UBS, CEIC, Haver

Figure 21: Real and nominal investment



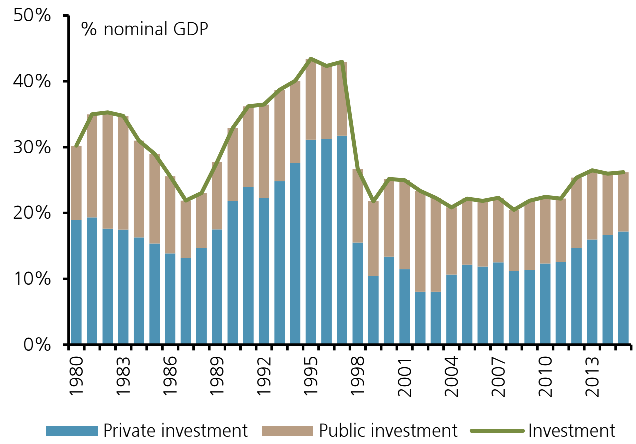
Source: UBS, CEIC, Haver

Figure 22: Investment and saving



Source: UBS, CEIC, Haver

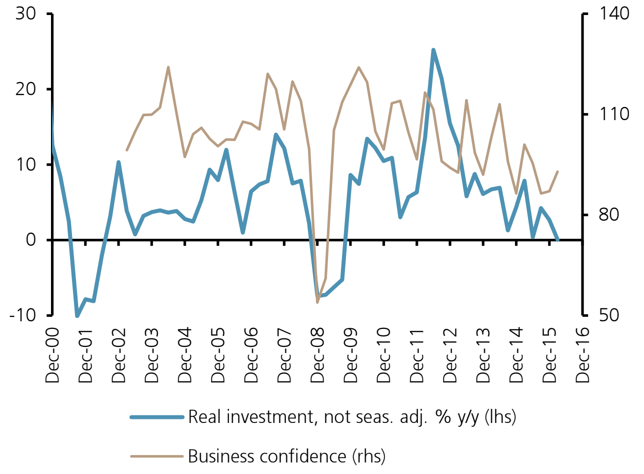
Figure 23: Investment by source



Source: UBS, CEIC, Haver

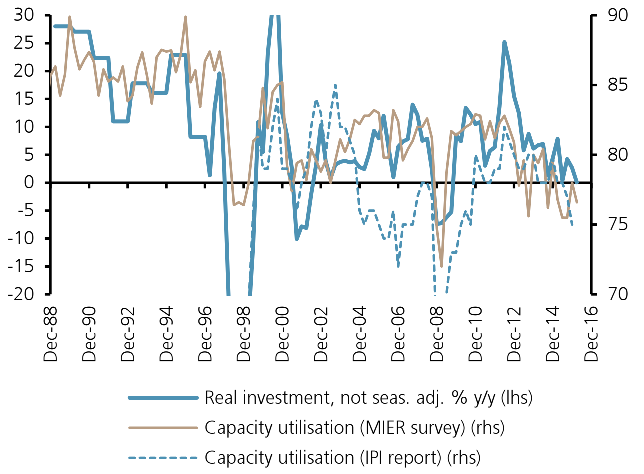
Investment, continued

Figure 24: Investment and business confidence



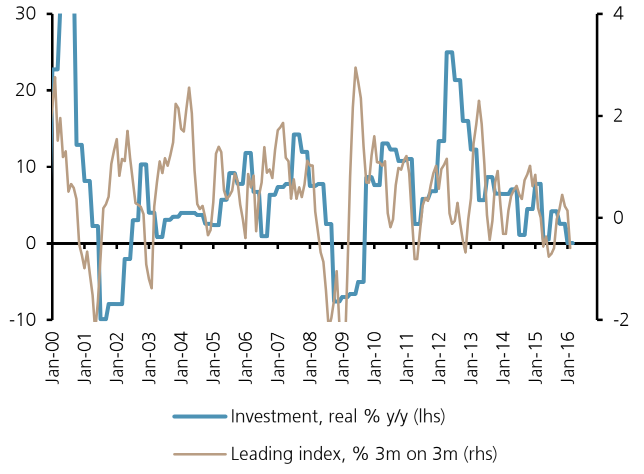
Source: UBS, CEIC, Haver

Figure 25: Investment and capacity



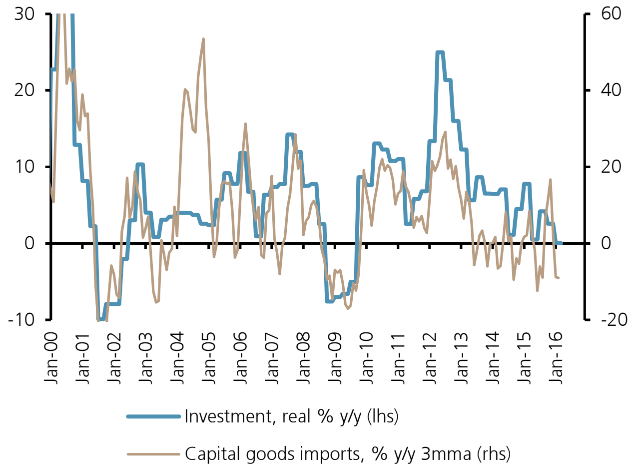
Source: UBS, CEIC, Haver

Figure 26: Investment and Stat. Malaysia's leading index



Source: UBS, CEIC, Haver

Figure 27: Investment and capital goods imports



Source: UBS, CEIC, Haver

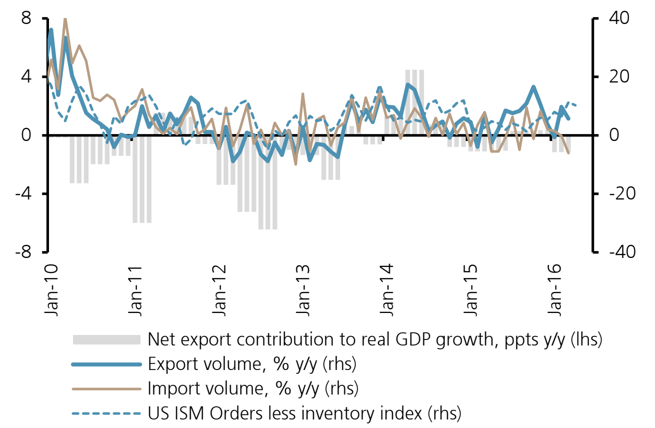
Trade

- *What the numbers say:* In real terms, net exports stopped dragging the economy in Q3 2015 but contracted again in Q1 (contributing -1.2%), compared with a contribution of 0.3% in Q3 and Q4. Momentum is weak, contracting 3.3% q/q in real terms and 2.4% q/q in nominal terms. Exports in ringgit terms have been volatile but strong, up 6.7% y/y in February and 0.2% y/y in March (in volume terms at 9.8% and 5.7%, respectively). Imports in MYR terms have also been volatile, up 1.6% y/y in February and down 5.5% in March.

- *What they mean:* Exports are a key source of income for Asia and are a primary determinant of the Asian business cycle. Trade links producers and consumers in one country with another, forming a channel through which income and confidence dynamics can be transmitted. The impact of these linkages on the broader economy depends both on the net trade position and on the share of the economy engaged in trade-related activities. The share of Malaysia's economy exposed to trade is relatively high in an Asian and global context.

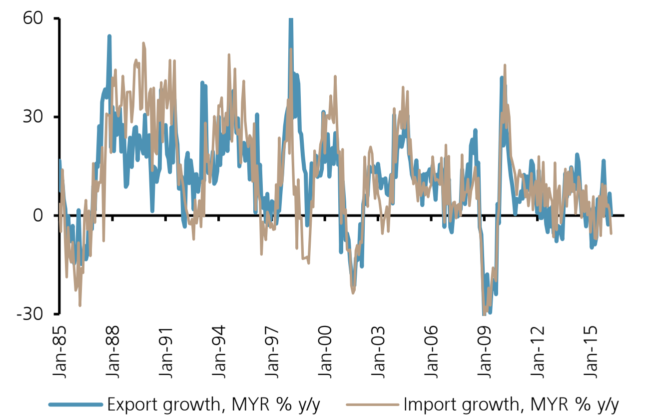
- *12-month outlook:* In real terms a weaker external environment (slower China growth) should keep export growth lacklustre, but in nominal ringgit terms exports yoy should see a diminishing translation boost from currency weakness. Import demand is likely to be weighed down by slow domestic demand, but in nominal terms may also pick up due to ringgit weakness.

Figure 28: Trade volumes, GDP growth cont. and lead indicators



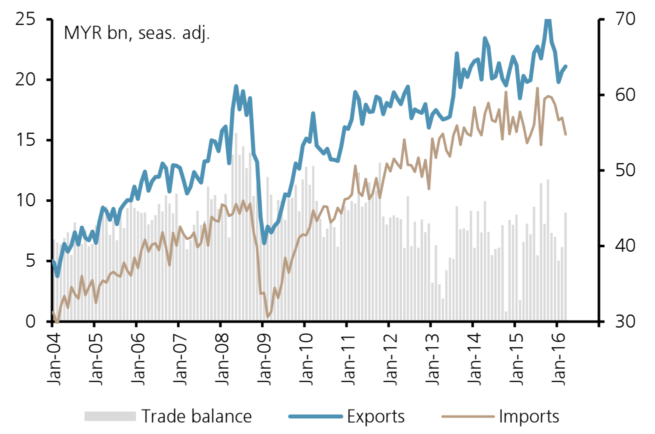
Source: UBS, CEIC, Haver

Figure 29: Nominal trade growth cycle



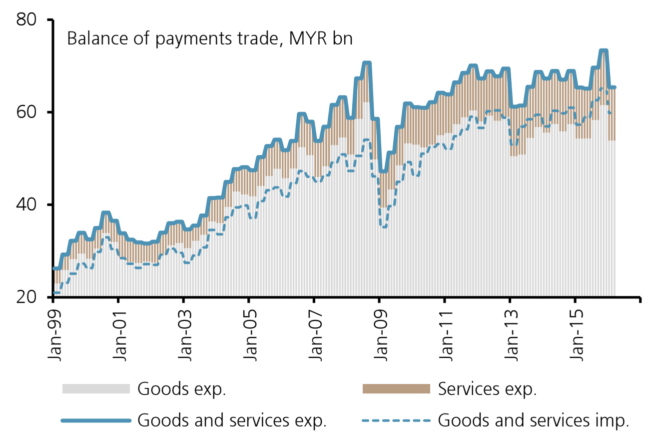
Source: UBS, CEIC, Haver

Figure 30: Monthly goods export and imports



Source: UBS, CEIC, Haver

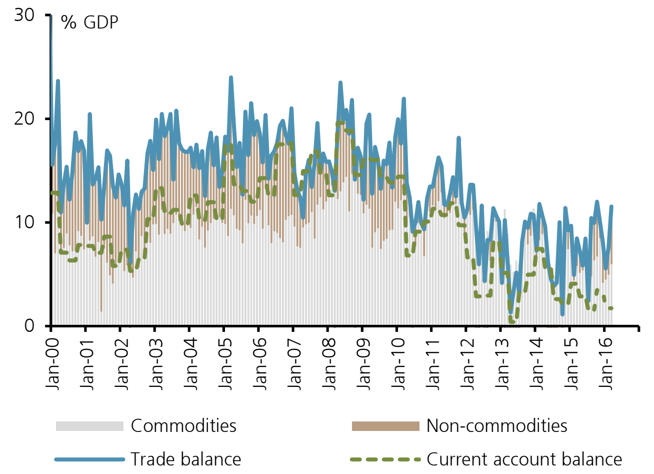
Figure 31: Quarterly goods and services exports and imports



Source: UBS, CEIC, Haver

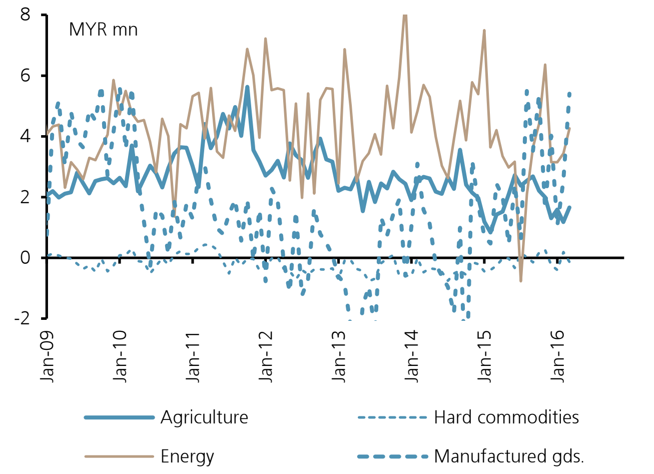
Trade, continued

Figure 32: Trade and current account balances



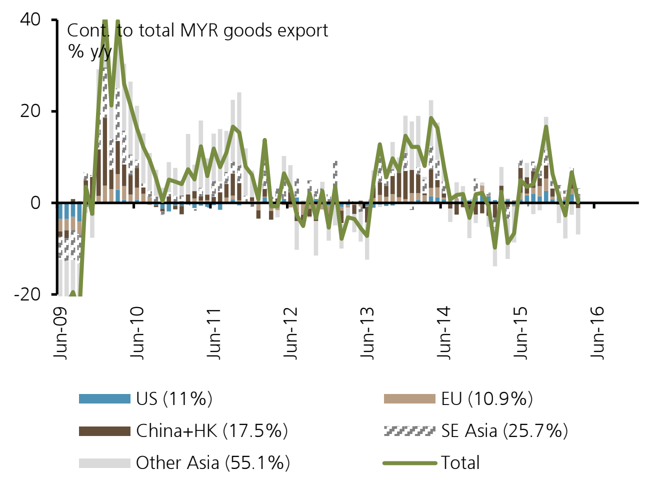
Source: UBS, CEIC, Haver

Figure 33: Trade balances by sector



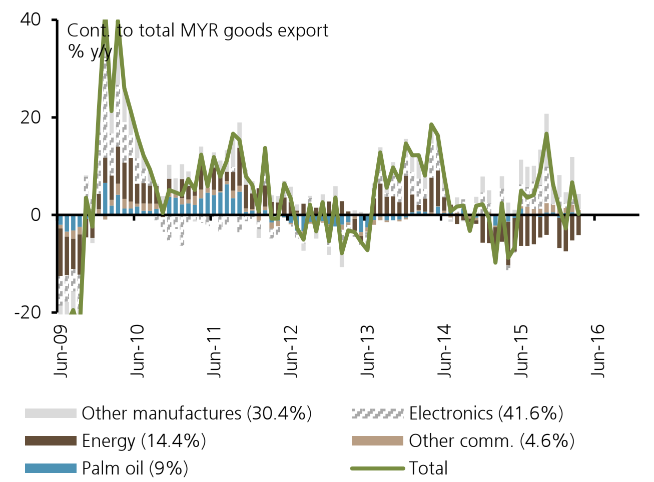
Source: UBS, CEIC, Haver

Figure 34: Export growth cont. by destination market



Source: UBS, CEIC, Haver

Figure 35: Export growth cont. by product



Source: UBS, CEIC, Haver

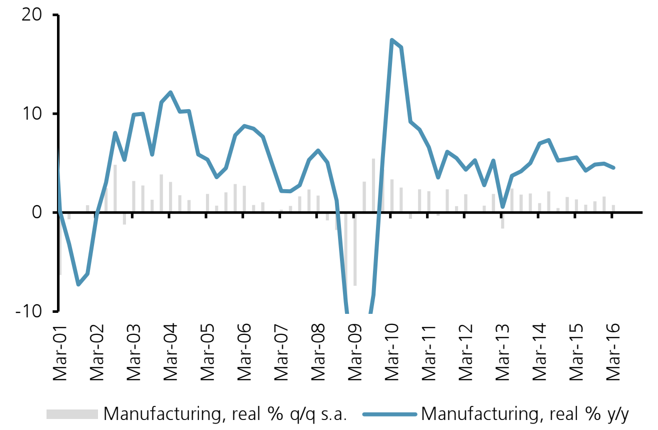
Industrial sector

- *What the numbers say:* Mining grew just 0.3% y/y in Q1 (after -1.3% in Q4 2015). However, seasonally adjusted momentum improved to 1.6% q/q after being a drag for three quarters. In nominal terms it grew 2.2% q/q. Real manufacturing growth slowed to 4.5% y/y after improving to 5% in Q4. Industrial production data has been weak in Q4 2015 and Q1 2016, despite improving marginally in Q1. It averaged 2.9% y/y in Q4, 3.3% in Q1 and 2.8% in March.

- *What they mean:* In Malaysia, both mining and manufacturing are important contributors to the industrial sector. Malaysia's mining (oil and gas) sector is more important for its contribution to nominal growth than real growth. The manufacturing sector is much more important for volatility in real GDP growth. Swings in manufacturing explain most of the employment cycle and the profit cycle. Hence, this should be tracked closely to assess if profits margins are rising or falling, employment is likely to turn up/down, and pressures on producer prices. In fact, you can generally assume that the manufacturing cycle reflects the profit cycle.

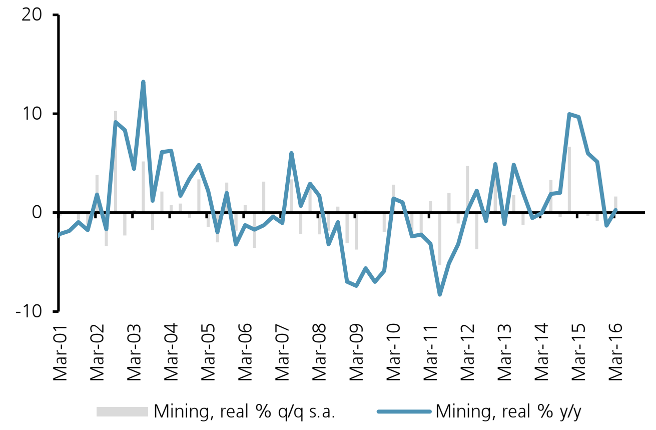
- *12-month outlook:* We expect weakness in the mining sector to be ongoing while a slower growth rate in the manufacturing sector of the economy should continue in light of credit cycle headwinds and sluggish global demand.

Figure 36: Manufacturing value added volume growth



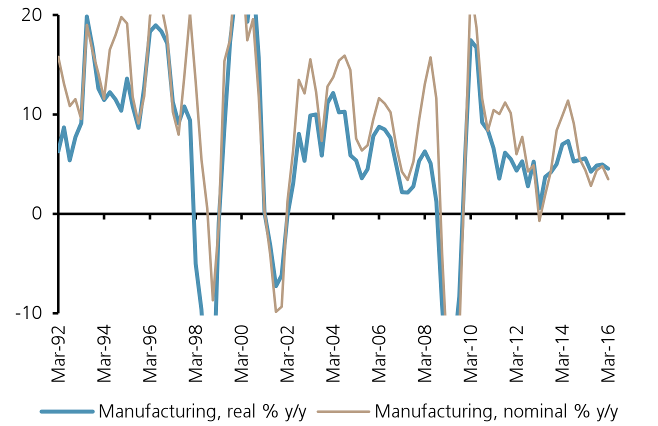
Source: UBS, CEIC, Haver

Figure 37: Mining value added volume growth



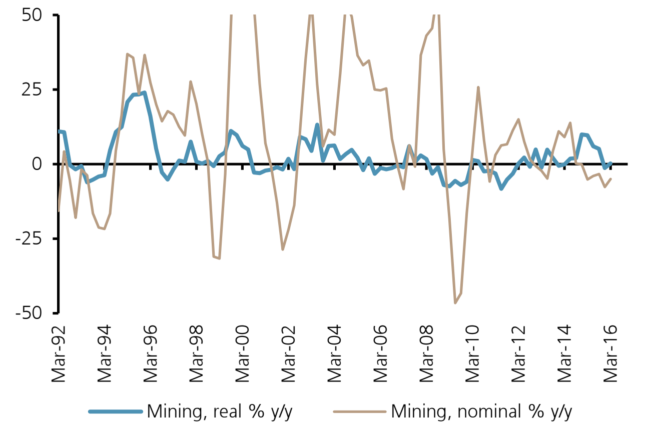
Source: UBS, CEIC, Haver

Figure 38: Manufacturing value added real and nominal



Source: UBS, CEIC, Haver

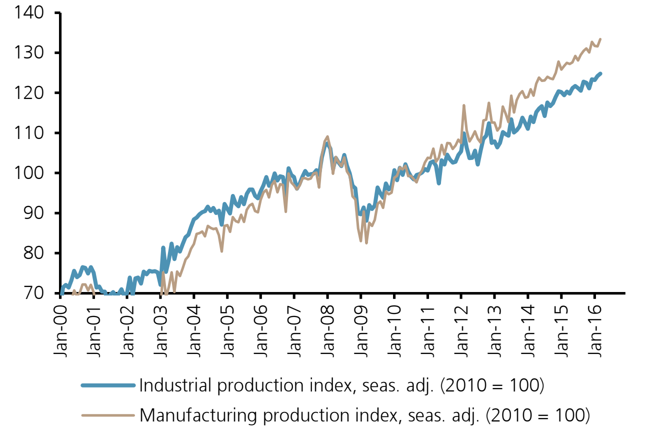
Figure 39: Mining value added real and nominal growth



Source: UBS, CEIC, Haver

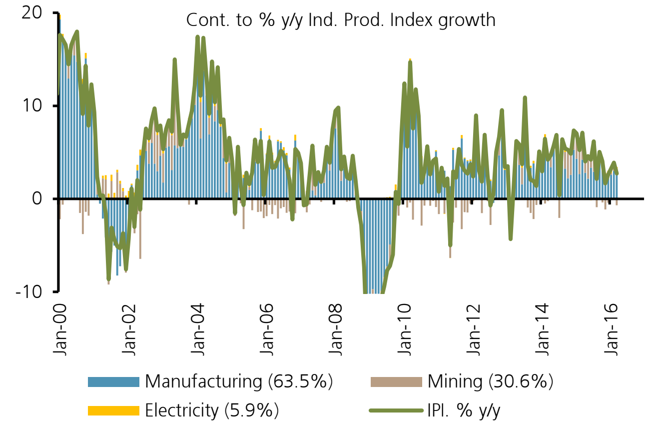
Industrial sector, continued

Figure 40: Industrial and manufacturing output indices



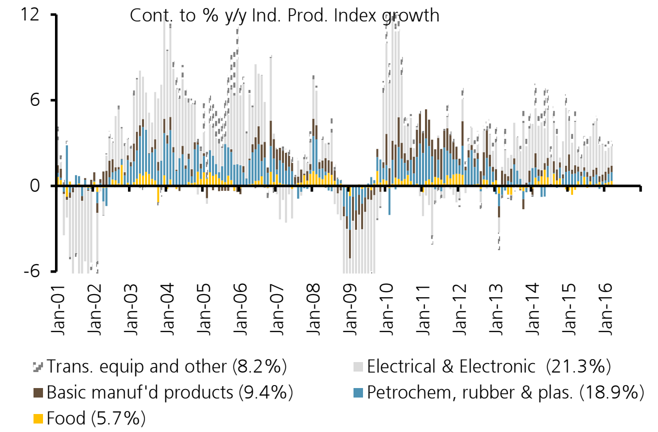
Source: CEIC, Haver, UBS

Figure 41: Industrial Production Index (IPI) growth by sector



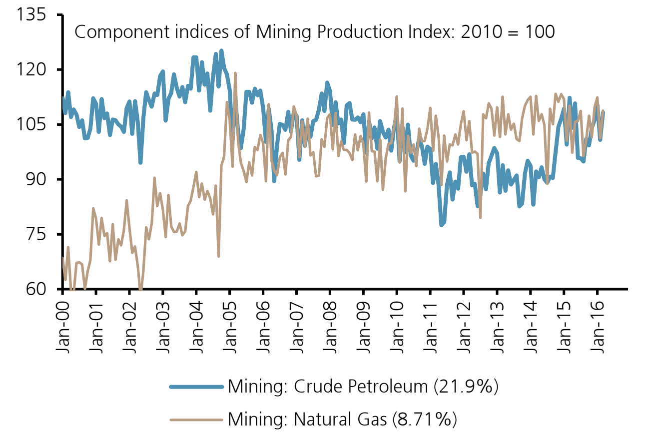
Source: CEIC, Haver, UBS. Note: figures in brackets denote 2005 index weight.

Figure 42: Manufacturing output growth cont. by sector



Source: CEIC, Haver, UBS. Note: figures in brackets denote 2005 index weight.

Figure 43: Mining output by sector

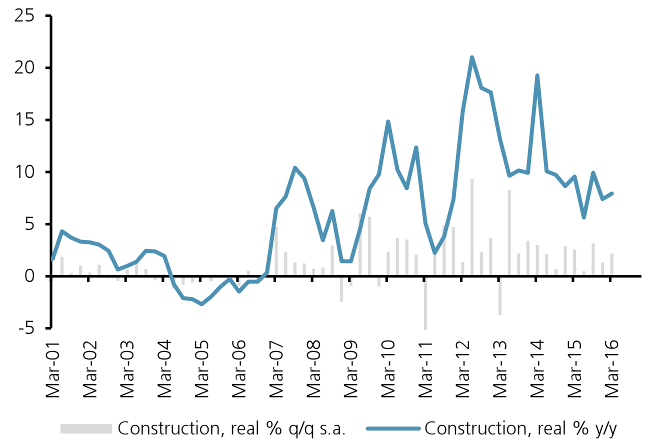


Source: CEIC, Haver, UBS. Note: figures in brackets denote 2005 index weight.

Construction sector

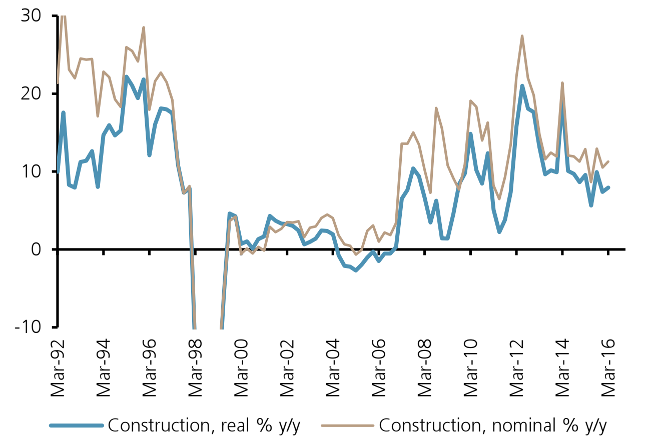
- *What the numbers say:* Construction activity improved in Q1 to 7.9% y/y, but is below 9.9% in Q3 2015. On a seasonally adjusted q/q basis, this equates to growth of 2.2% in Q1 after 3.2% in Q3. Looking forward, construction of office space has recovered but residential home construction remains very low – new sales look to have bottomed but remain low.
- *What they mean:* As a sector of the economy, construction is small. However, construction spending by all sectors of the economy means that construction is an important part of investment expenditure.
- *12-month outlook:* We expect headwinds from the credit cycle to dampen property buyers' enthusiasm, which should slow construction work. The downswing may be exacerbated by lower oil sector spending and government cutbacks.

Figure 44: Real construction value added growth



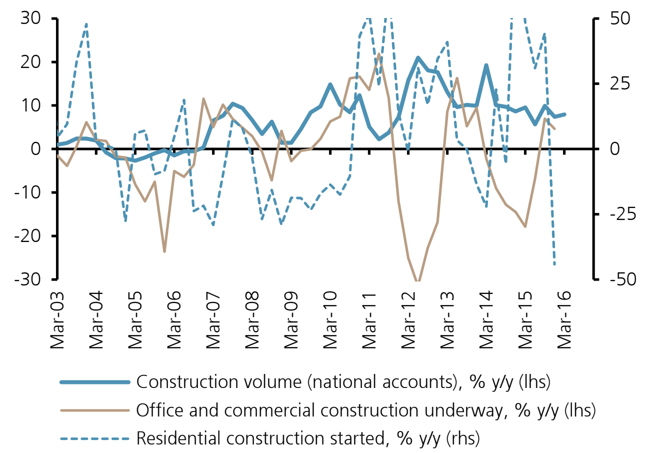
Source: CEIC, Haver, UBS

Figure 45: Real and nominal construction value added growth



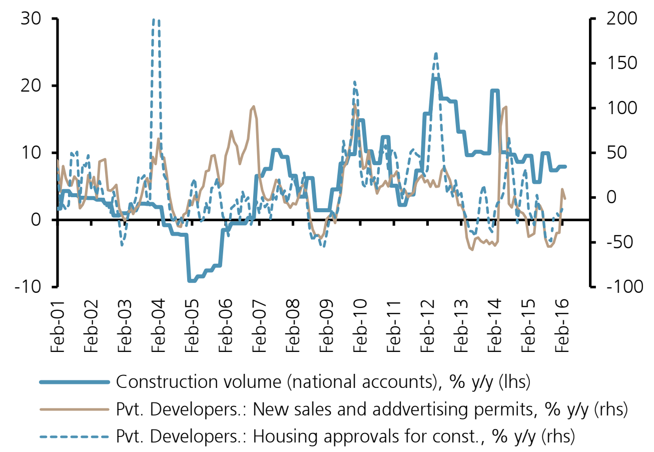
Source: CEIC, Haver, UBS

Figure 46: Office and residential construction



Source: CEIC, Haver, UBS

Figure 47: Private developer permits and advertising

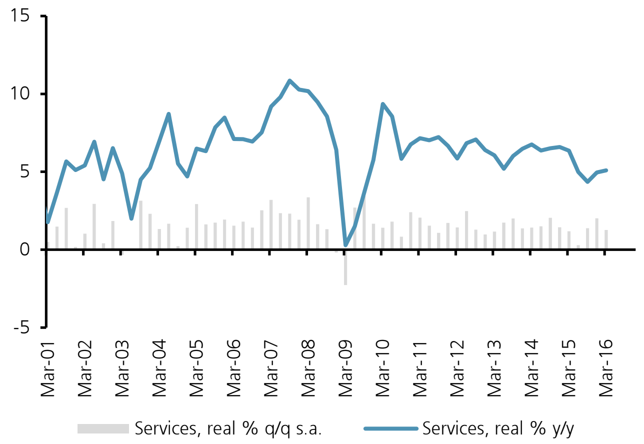


Source: CEIC, Haver, UBS

Service Sector

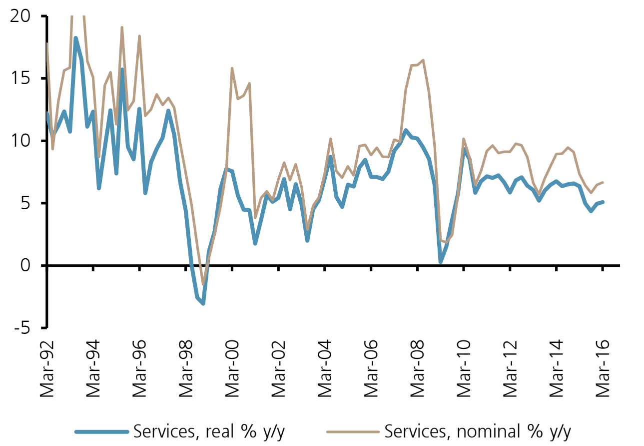
- ***What the numbers say:*** Growth in real services was up at 5.1% y/y in Q1 after slowing in Q3 to just 4.4% – the slowest growth seen since 2009. Momentum looks reasonably robust, adding 1.3% in seasonally adjusted real terms on the quarter, after Q3 and Q4 registered 1.4% and 2%, respectively. Indicators such as retail sales and wholesale sales indicate that services may not yet have fully recovered after the introduction of GST. Tourism arrivals in December 2015 were stronger than usual; we anticipate strong tourism may continue given favourable currency moves for tourists.
- ***What they mean:*** The service sector is the largest sector in the economy. It includes logistics, finance, government and trade. Typically, because of limited inventory and capital investment needs, the service sector experiences relatively stable growth.
- ***12-month outlook:*** We think services growth is likely to be undermined by a maturing credit cycle, depleted commodity income and government cutbacks. Weakness could be offset to some extent by stronger tourism receipts.

Figure 48: Real services value added growth



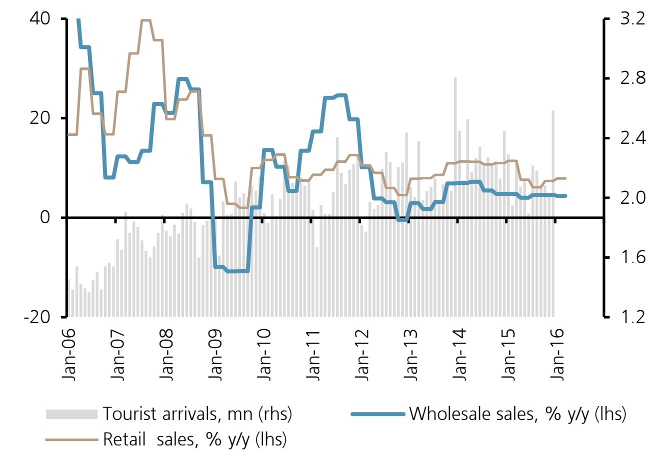
Source: CEIC, Haver, UBS

Figure 49: Real and nominal services value added growth



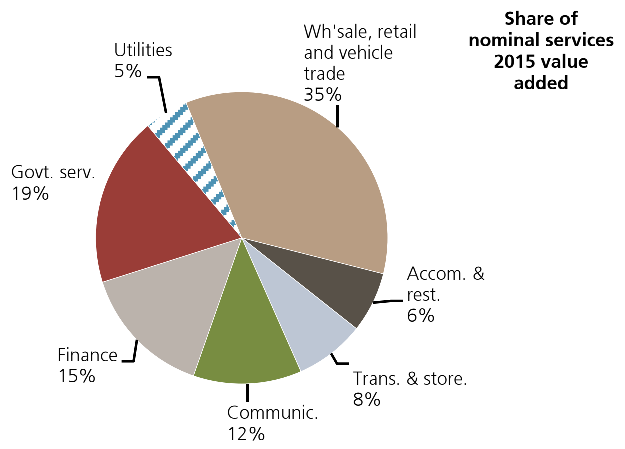
Source: CEIC, UBS

Figure 50: Wholesale, retail and tourist activity



Source: CEIC, Haver, UBS

Figure 51: Contributions by sectors to services value added

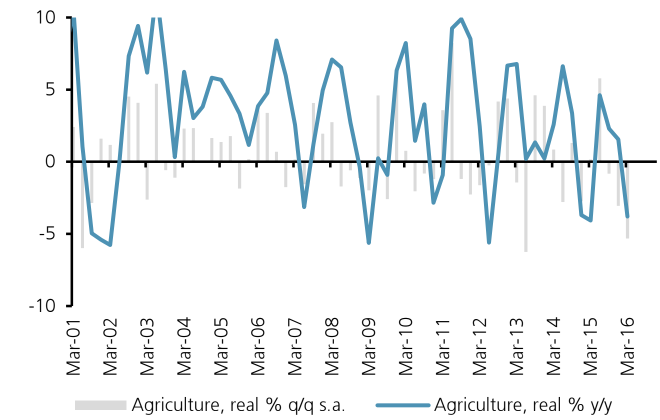


Source: CEIC, Haver, UBS

Agriculture/plantation Sector

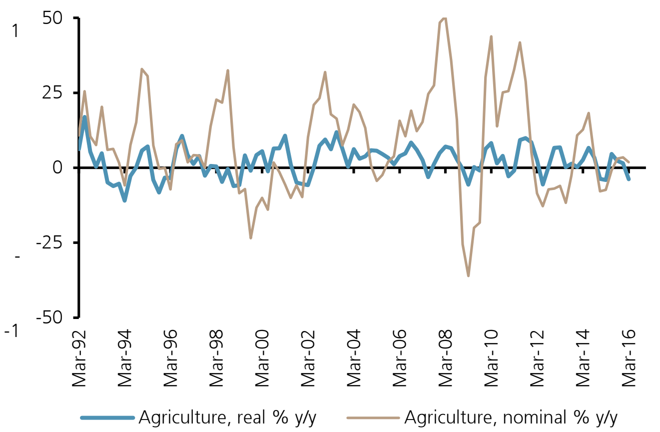
- *__What the numbers say:__* Agriculture growth tends to be volatile and Q1 was no exception. Agriculture contracted 3.8% y/y in Q1, as per the national accounts data, down from a growth of 1.5% in Q4. Momentum looked weak – shrinking 5.3% q/q seasonally adjusted in Q1 and 3.1% in Q4. In nominal terms it grew 1.9% y/y, continuing the positive growth since Q3 2015, which came after three quarters of contraction.
- *__What they mean:__* The agricultural sector accounts for 9% of the economy, but is important to capital markets because of the palm oil crop. Malaysia accounts for a little over 40% of global palm oil supply, with Indonesia accounting for most of the rest.
- *__12-month outlook:__* The sector is a volatile one but the contraction in Q1 is consistent with ASEAN agriculture weakness due to El Niño. Agricultural prices are low but recovering along with other commodity prices.

Figure 52: Agricultural output real value added growth



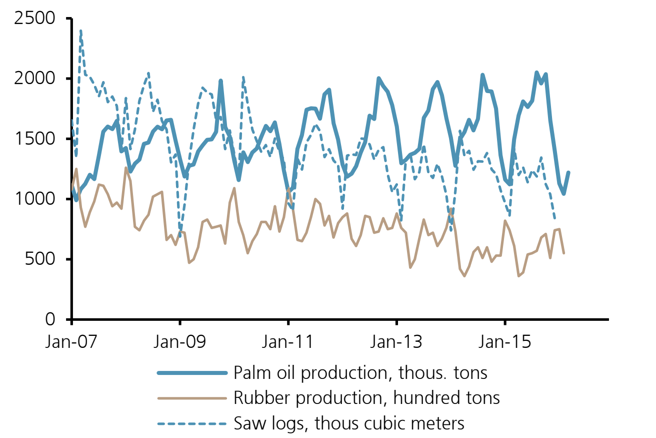
Source: CEIC, Haver, UBS

Figure 53: Agricultural real and nominal value added growth



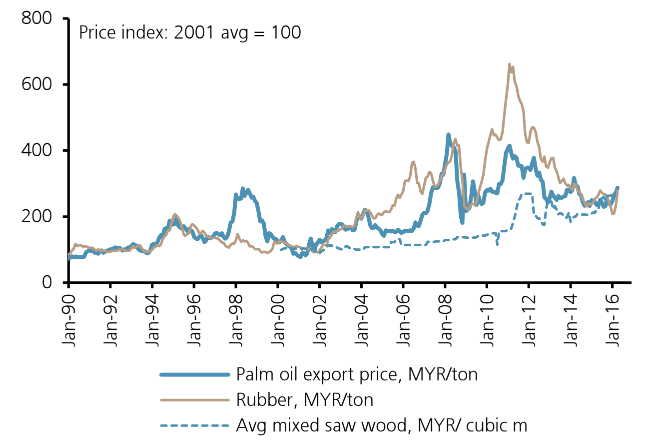
Source: CEIC, Haver, UBS

Figure 54: Key agricultural commodity production volumes



Source: CEIC, Haver, UBS

Figure 55: Key agricultural commodity production prices



Source: CEIC, Haver, UBS

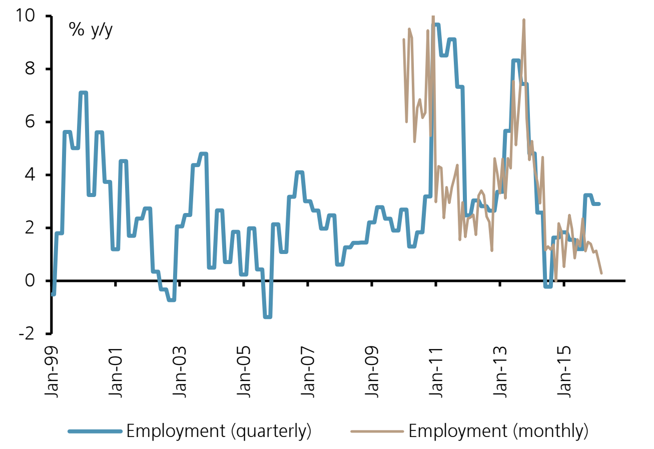
Labour market

- *What the numbers say:* While volatile, wage growth has remained fairly robust. Employment growth has nose-dived but the volatility of data in recent years reduces our confidence in the apparent trend. Unemployment has picked up over the last 9 months to 3.5%, the highest in around six years.
- *What they mean:* Strong employment growth usually coincides with strong consumption and investment. The unemployment rate is important to look at because it is a rough measure of slack in the economy and is watched closely by governments and central banks. High unemployment tends to be associated with a bias for pro-growth policies, in part for political reasons.
- *12-month outlook:* Volatility in labour market data increases our caution over interpreting trends in the data – however it does appear that slack in the Malaysian labour market is increasing as unemployment rises and employment growth slows. We expect this slack to undermine wage growth ahead.

Figure 56: Unemployment Rate

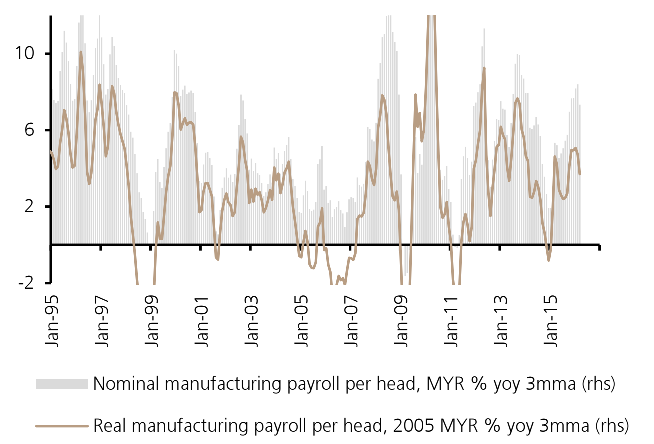
Source: CEIC, Haver, UBS

Figure 57: Employment growth



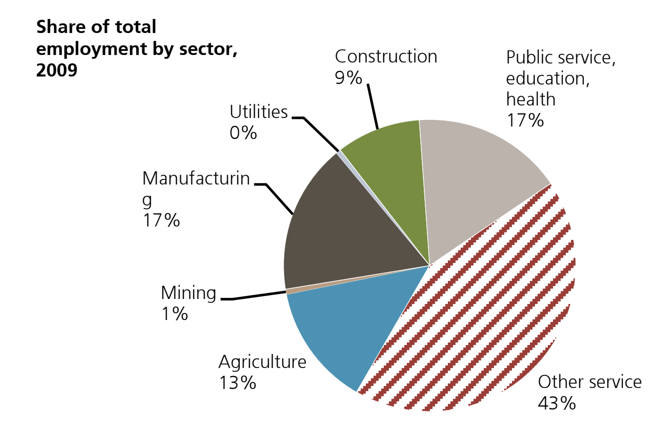
Source: CEIC, Haver, UBS

Figure 58: Manufacturing wage growth



Source: CEIC, Haver, UBS

Figure 59: Employment by sector



Source: CEIC, Haver, UBS

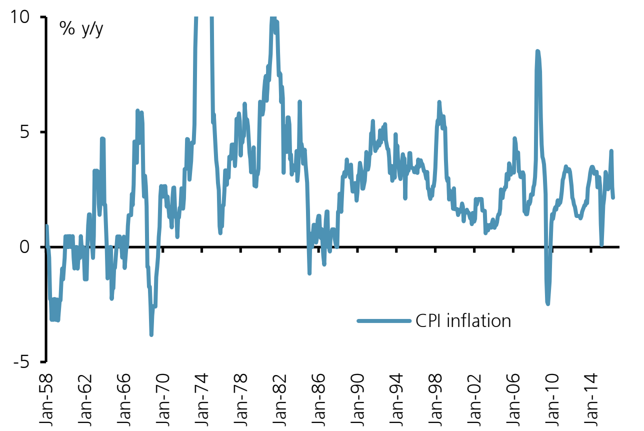
Inflation

- *What the numbers say:* Volatility in the oil price, and subsequently in the fuel price under the new floating mechanism, has resulted in volatile inflation. Given the implementation of GST of 6% we anticipated a large jump in inflation in April. Instead prices look to have adjusted more gradually to a peak of 4.2% y/y in February, before moderating to 2.1% in April. CPI would have dipped further were it not for recent increases in oil (and therefore fuel) prices. At current oil prices it is likely that the price of fuel may have to be raised again soon.

- *What they mean:* Malaysian inflation has tended to be moderate in an international context. Bank Negara Malaysia does not have an inflation target, but price stability features strongly in the policy mandate. Inflation provides critical hints about the direction of monetary policy. High inflation, when combined with above-trend economic growth and low unemployment, typically provokes monetary tightening; whereas low inflation when coupled with below-trend economic growth and high unemployment tends to produce the opposite policy.

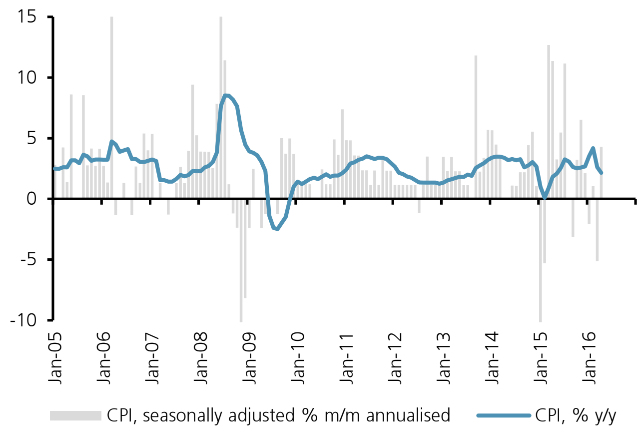
- *12-month outlook:* CPI inflation will likely fall from here in 2016 due to GST base effects. We anticipate inflation to remain moderate in 2017 as oil prices gradually rise. Currency weakness is likely to push prices up – but we think weak domestic demand will keep a lid on this effect through 2016. We look for 2.3% inflation in 2016E and 2.4% in 2017E.

Figure 60: Inflation cycle



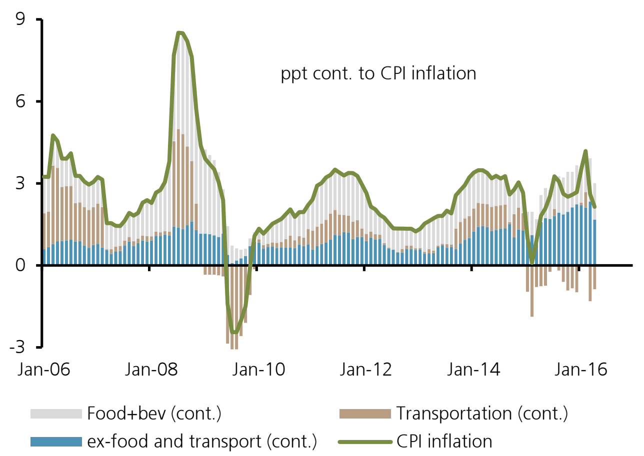
Source: UBS, CEIC, Haver

Figure 61: Seasonally adjusted inflation



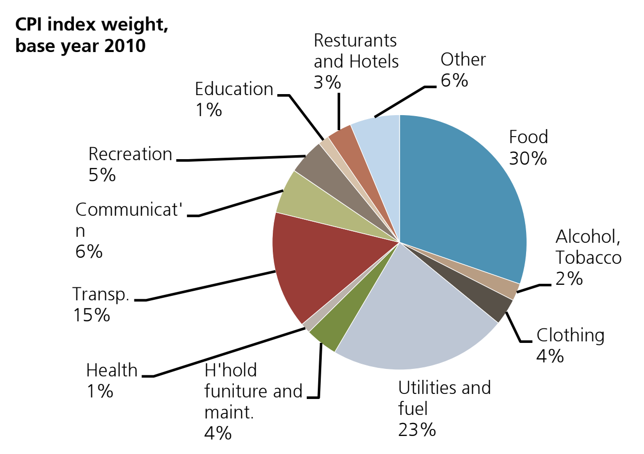
Source: UBS, CEIC, Haver

Figure 62: Contributions to CPI inflation



Source: UBS, CEIC, Haver

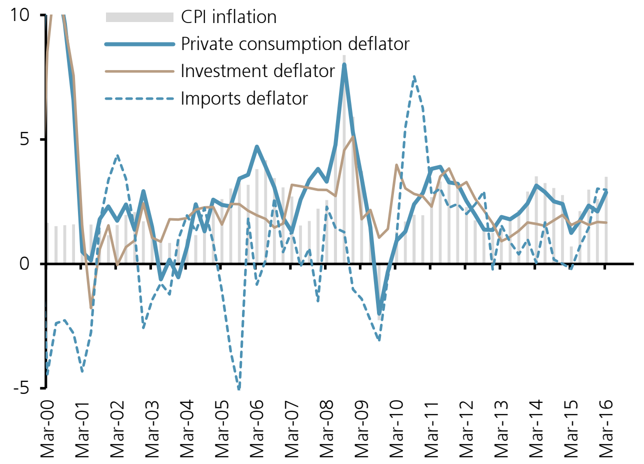
Figure 63: CPI weights



Source: UBS, CEIC, Haver

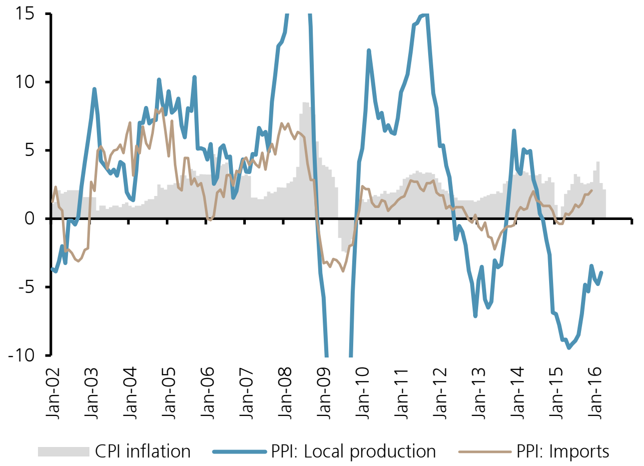
Inflation, continued

Figure 64: CPI and GDP deflators



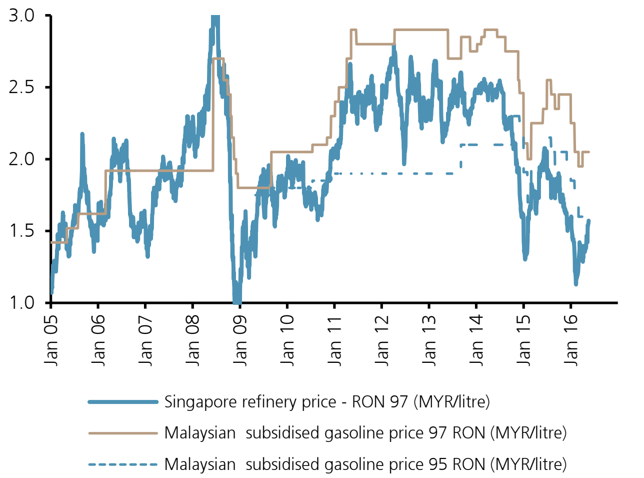
Source: UBS, CEIC, Haver

Figure 65: PPI inflation by source



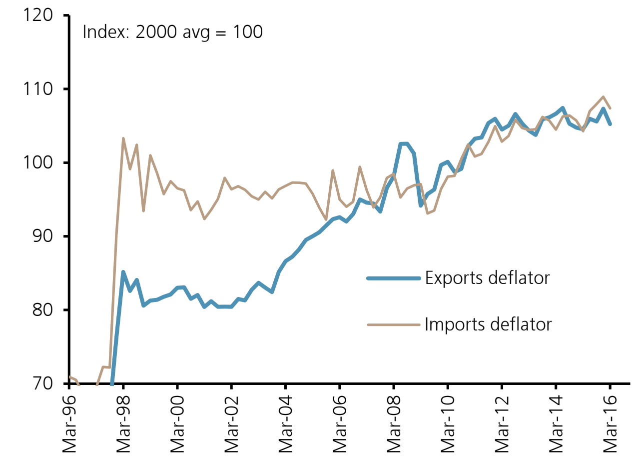
Source: UBS, CEIC, Haver

Figure 66: Fuel prices



Source: UBS, CEIC, Haver

Figure 67: Terms of trade



Source: UBS, CEIC, Haver

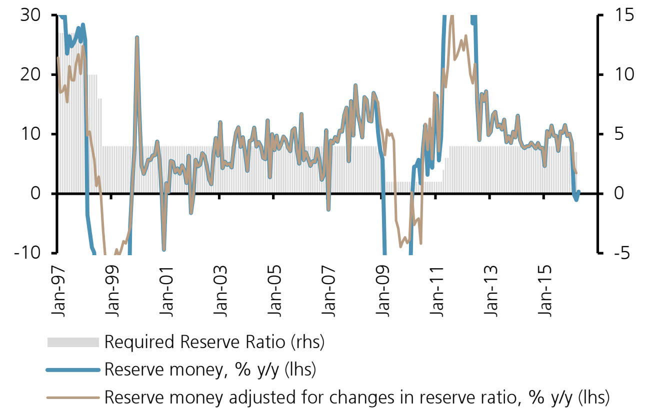
Money and Banking

- *What the numbers say:* Narrow (M1) and broad (M3) money growth has been volatile since 2015, falling sharply of late. M1 growth contracted in March (-1.7% y/y), for the first time since 1999. The trend looks consistent with slower credit growth. In aggregate, bank loans slowed to just 6.4% in March from 10.2% in July 2015. Bank loans to corporate in end-2015 picked up to nearly 12%, but this seems likely due to corporate borrowing to cover USD debt. It has slowed thereafter, along with household credit growth. The BNM measure of loans-to-deposits reached a high of 90.4% in August, before moving down to 87.7% in March. BNM cut the RRR from 4.0% to 3.5% in January to help liquidity in the banking system.

- *What they mean:* Money and credit are pro-cyclical and correlate strongly with inflation in the long term. Part of base money growth is driven by foreign reserve accumulation. Foreign reserves are also an important macro prudential indicator and in Asia a key source of changes in base money. Thus, rising foreign reserves necessarily mean upward pressure on domestic liquidity conditions.

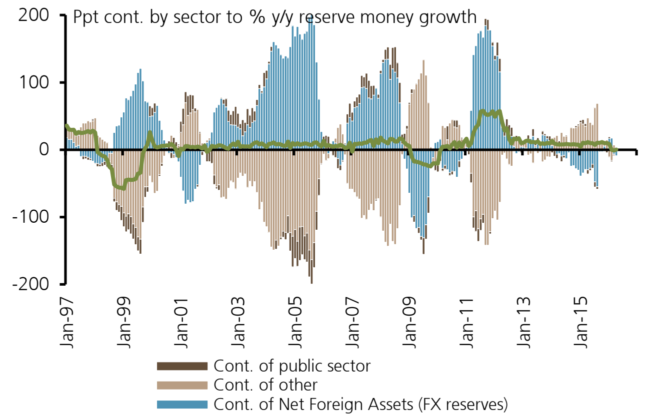
- *12-month outlook:* Bank Negara's prudent interest rate policy should mean that rising global interest rates may be less of an issue for Malaysia than for some emerging economies. Credit growth has been strong, but not extreme, and loan to deposit ratios remain below 100%. Even so, we believe the credit cycle in Malaysia, as elsewhere, is maturing. The sharp contraction in money supply growth and the slowdown in bank credit are symptomatic of these effects and should drag on growth, in our view.

Figure 68: BNM reserve money growth



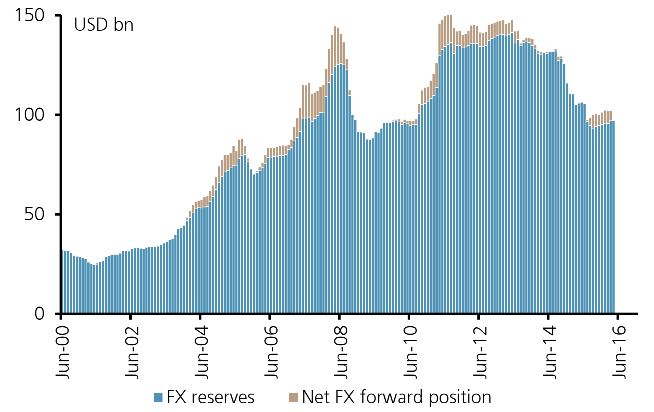
Source: UBS, CEIC, Haver

Figure 69: Contribution to reserve money growth



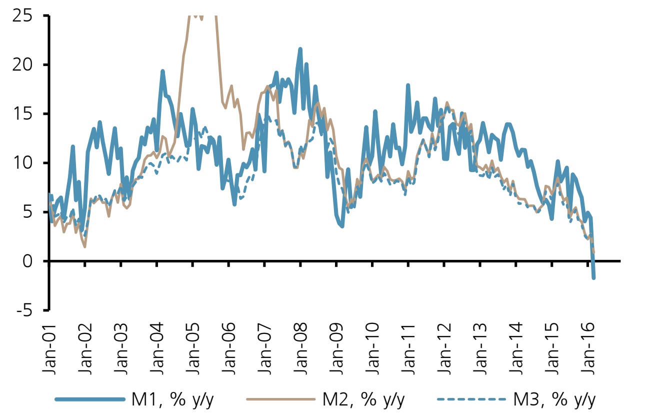
Source: UBS, CEIC, Haver

Figure 70: BNM foreign exchange reserves



Source: UBS, CEIC, Haver

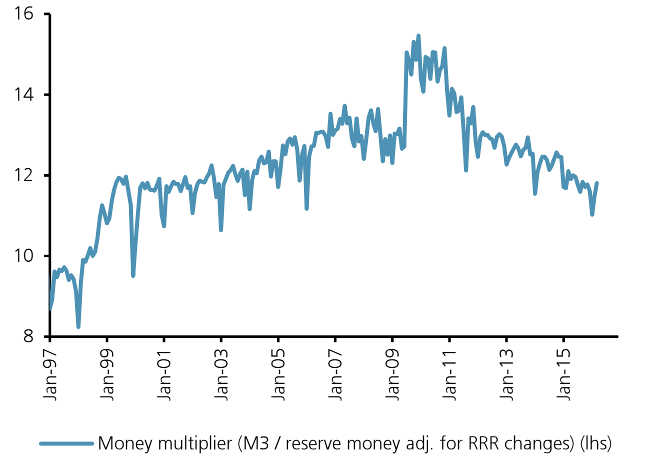
Figure 71: Money supply growth



Source: UBS, CEIC, Haver

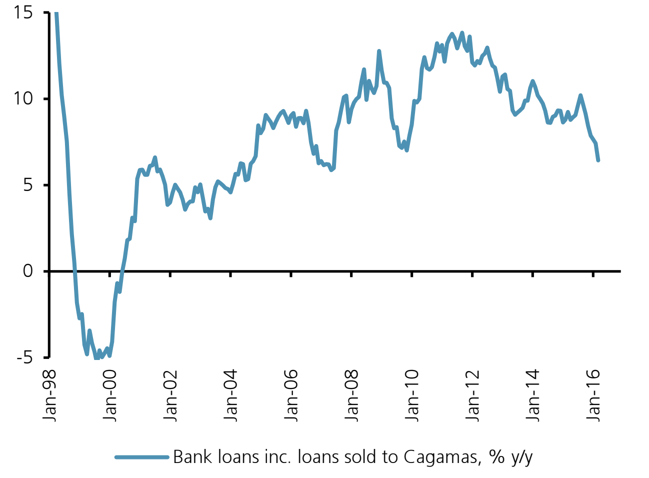
Money and Banking, continued

Figure 72: Money multiplier



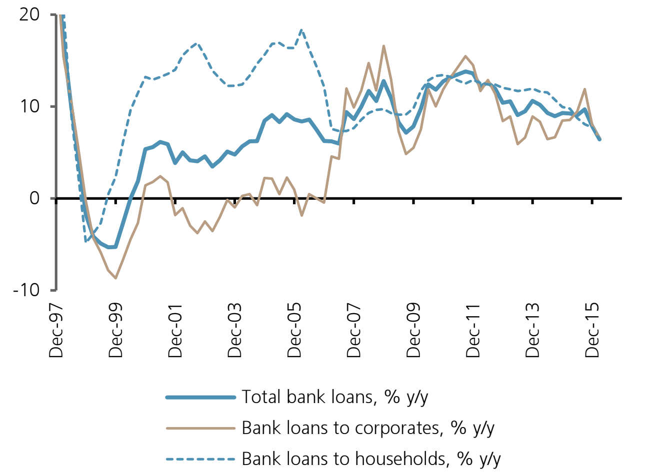
Source: UBS, CEIC, Haver

Figure 73: Banking system loan growth



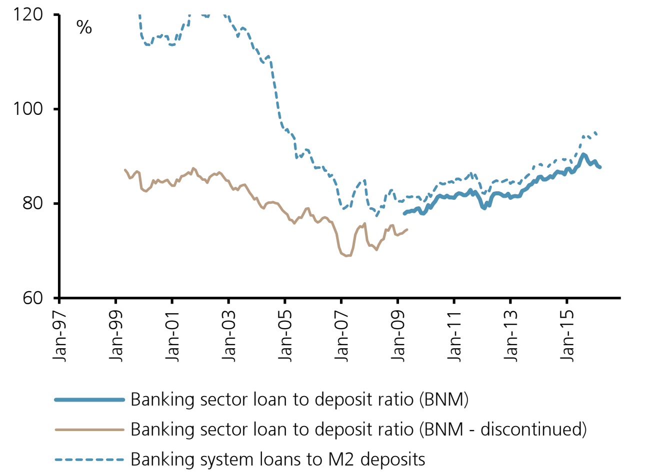
Source: UBS, CEIC, Haver

Figure 74: Bank loan growth by type



Source: UBS, CEIC, Haver

Figure 75: Loan to deposit ratios

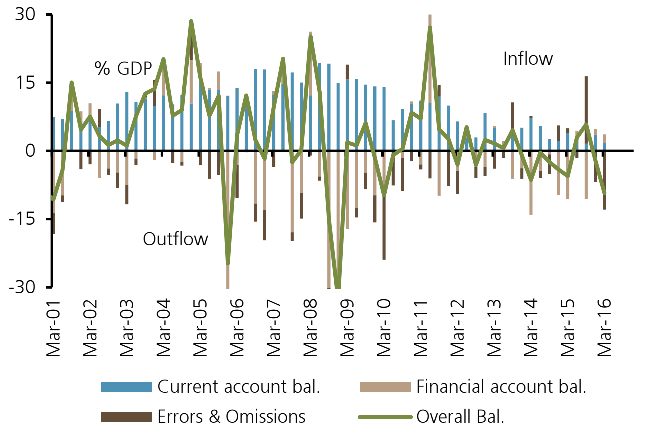


Source: UBS, CEIC, Haver

Balance of Payments

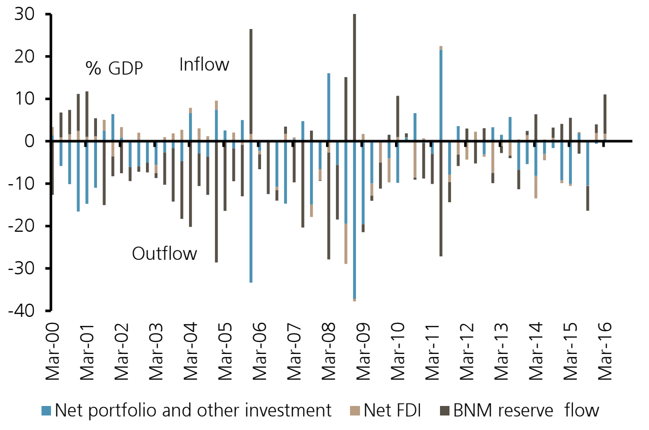
- *What the numbers say:* Malaysia's current account shrank in Q1 to 1.7% of GDP from 3.5% in Q4 2015. The surplus in Q1 was hit largely by a weaker trade balance. External debt picked up by around USD 12bn to USD 206bn in Q1 from Q4 2015.
- *What they mean:* The balance of payments includes information on the real economy's competitive position – the current account. It also shows the capital flows into and out of the economy – signalling if the economy has excess or insufficient savings to fund investment. If a central bank is intervening to stabilise a currency, current account and capital flow data will signal the strength and direction of pressures on the currency.
- *12-month outlook:* Malaysia's current account surplus has proven resilient, remaining in surplus despite a loss in oil income. This is, in part, due to a slowdown in domestic demand in light of lost oil income and credit cycle headwinds.

Figure 76: Current and financial account balances



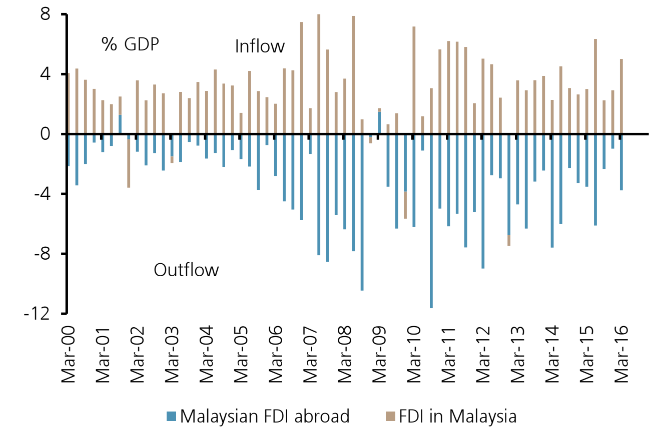
Source: UBS, CEIC, Haver

Figure 77: Net financial flows



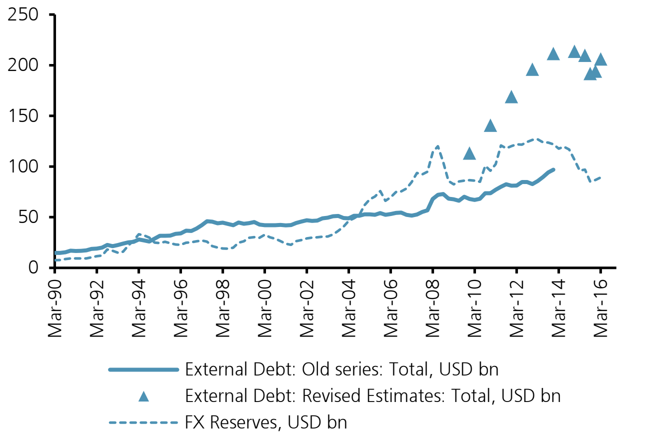
Source: UBS, CEIC, Haver

Figure 78: FDI flows by source



Source: UBS, CEIC, Haver

Figure 79: External debt and BNM foreign currency assets

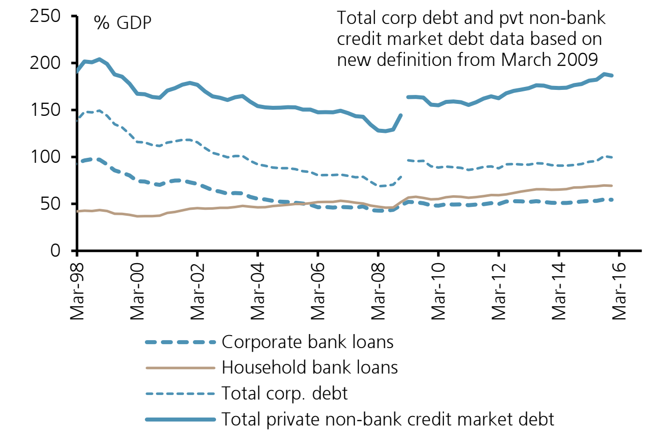


Source: UBS, CEIC, Haver

Household and corporate finances

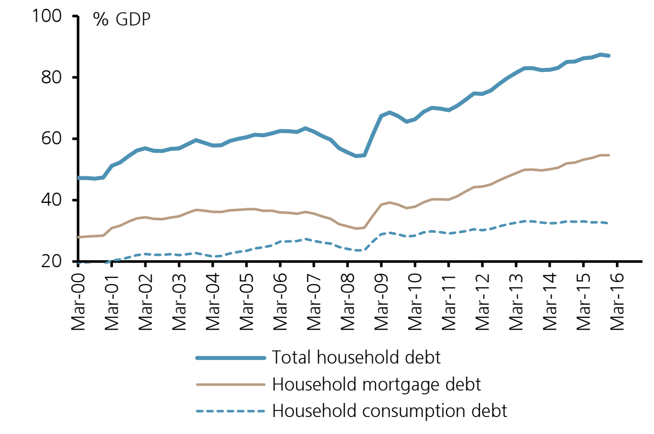
- *What the numbers say:* Malaysia's corporate sector deleveraged after the Asian crisis, while the household sector's debt to GDP increased. Recently, household mortgage debt has accelerated once more to reach 54.6% of GDP, while total household debt stands at 87.1% of GDP. Malaysia's stock of FDI held abroad has risen from 12% of GDP in 2004 to 57.4% in 2015, while the net international investment position swung to positive 10ppts of GDP in 2015 (from a small deficit in 2014).
- *What they mean:* The state of household and corporate balance sheets determines the ability of households and corporates to withstand financial and economic shocks. A high level of debt to GDP tends to imply higher risk than low credit to GDP levels.
- *12-month outlook:* The credit cycle is maturing. Diminishing marginal returns have set in for household borrowing – most obviously in the form of the policy reaction. We think that will likely continue to play out.

Figure 80: Household and corporate debt



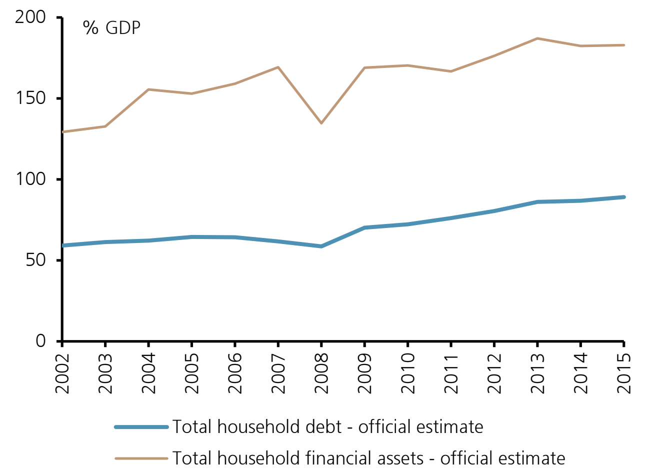
Source: UBS, CEIC, Haver

Figure 81: Household debt



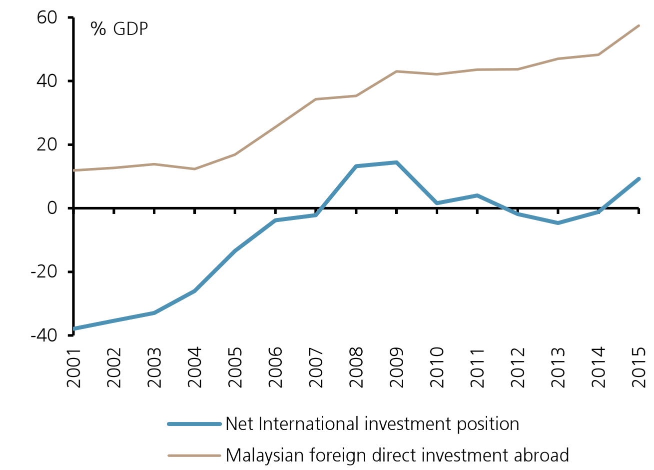
Source: UBS, CEIC, Haver

Figure 82: Household financial assets and liabilities



Source: UBS, CEIC, Haver

Figure 83: Corporate investments abroad

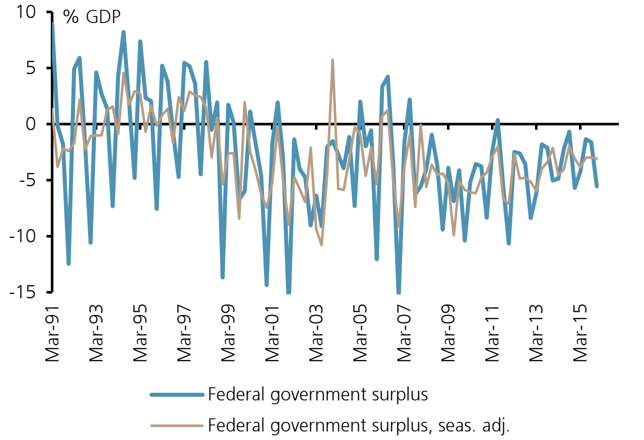


Source: UBS, CEIC, Haver

Fiscal policy

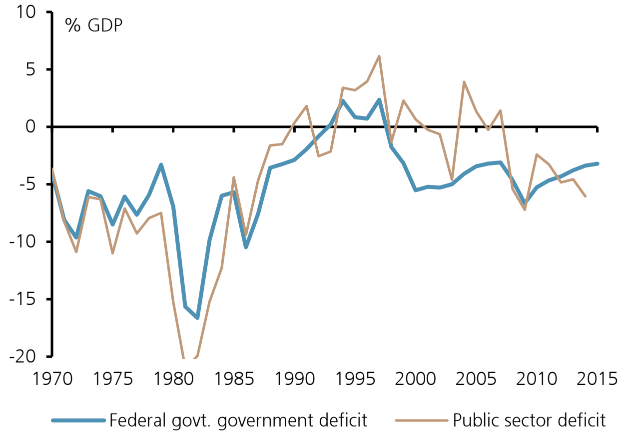
- *What the numbers say:* The federal government budget balance deteriorated to -5.6% of GDP in Q4 from -1.6% in Q3, but seasonally adjusted the balance was steady at around -3.0% of GDP. Commodity linked revenues have fallen to just 21.5% of total revenues, from 32.2% in Q1 2015, and from 6.4% of GDP to just 4%.
- *What they mean:* Governments typically try to provide infrastructure and services where markets are unable or unwilling to participate appropriately. In doing so, governments may attempt to replace deficient private sector demand or may compete with the private sector for resources, bidding up the price of money or materials.
- *12-month outlook:* The 11th Malaysia Plan lays out a deficit reduction roadmap as far as 2020 – with the target deficit at just -0.5% of GDP (although comments by Prime Minister Najib have suggested -1% of GDP is a more attainable aim). The deficit target for this year is 3.1% of GDP. Oil and gas revenue losses have taken a toll on federal finances, but much of the shortfall has been made up by GST revenues and subsidy cuts.

Figure 84: Federal government budget deficit



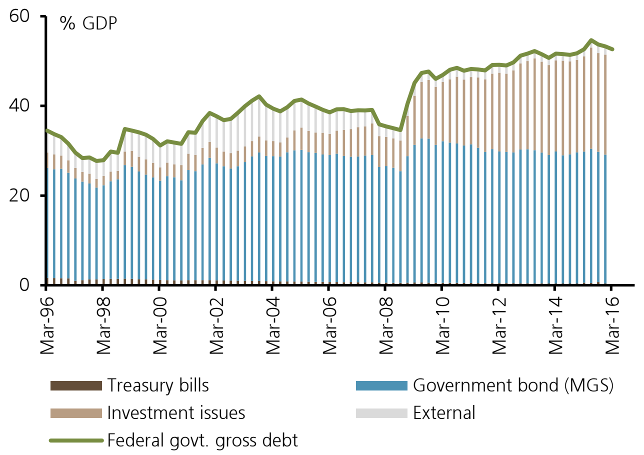
Source: UBS, Haver, CEIC

Figure 85: Federal government and public sector deficits



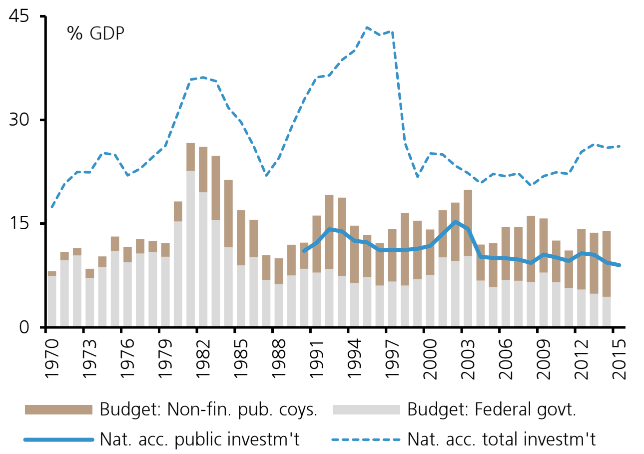
Source: UBS, Haver, CEIC

Figure 86: Federal government gross debt



Source: UBS, Haver, CEIC

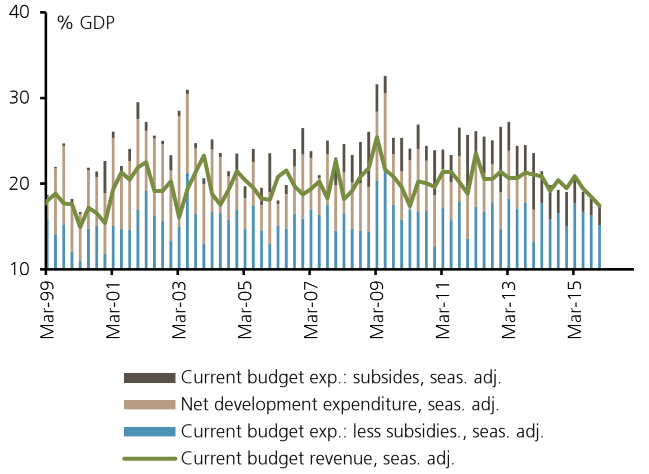
Figure 87: Federal and public sector budget development expenditure against national accounts public and total investment



Source: UBS, Haver, CEIC

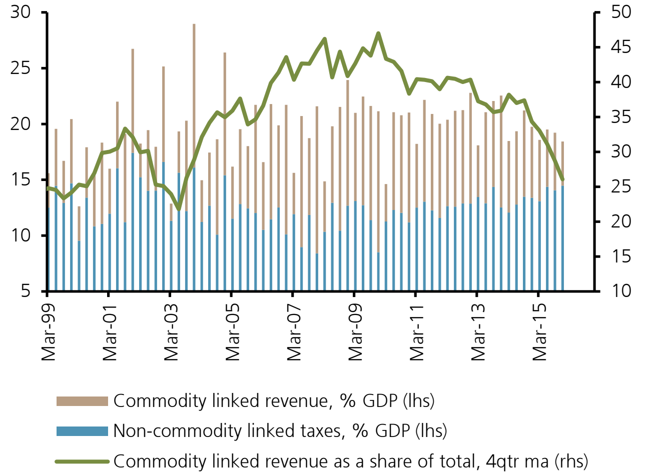
Fiscal policy, continued

Figure 88: Federal government budget revenue and expenditure



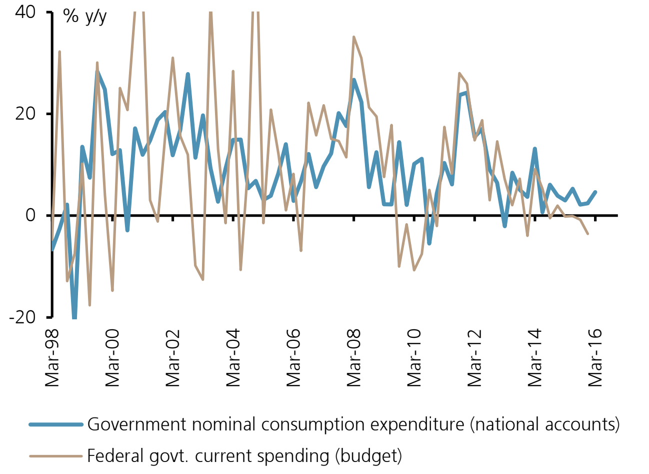
Source: UBS, Haver, CEIC

Figure 89: Federal government revenue by type



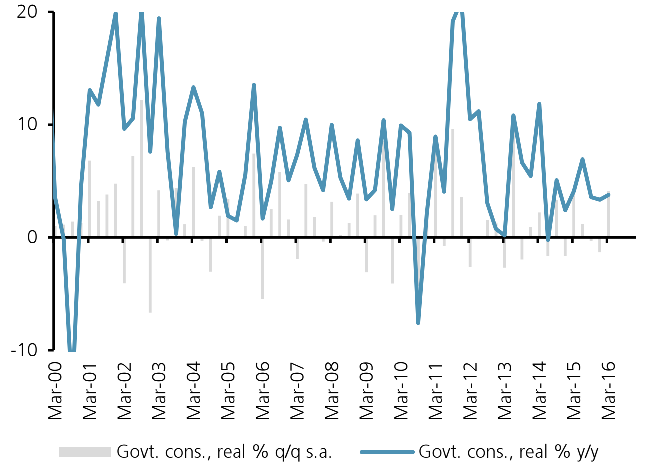
Source: UBS, Haver, CEIC

Figure 90: Nominal government current spending (national accounts and federal government budget basis)



Source: UBS, Haver, CEIC

Figure 91: Real government spending (national accounts basis)

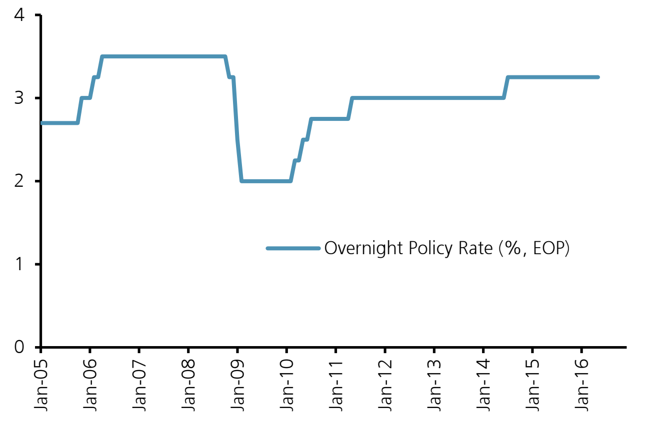


Source: UBS, Haver, CEIC

Monetary policy

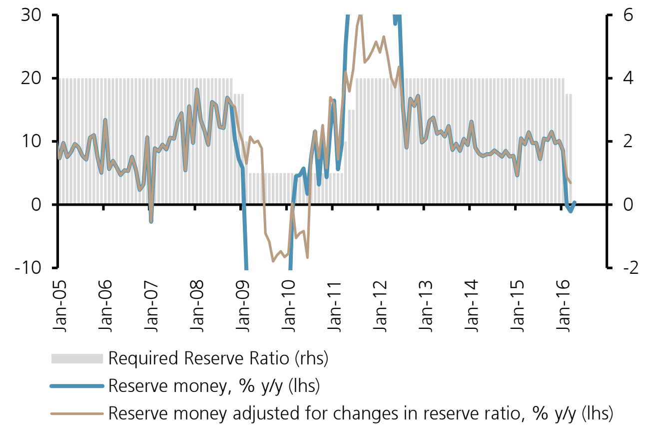
- *What the numbers say:* Bank Negara Malaysia has kept policy rates on hold for close to two years now. Latest policy statements have described the stance as supportive and accommodative for the economy – but acknowledged downside risks in global economic and financial environments.
- *What they mean:* Monetary policy settings are a critical determinant of money growth along with the internal and external value of the currency. Monetary policy can also provide relief from (or cause) tight liquidity conditions in financial markets.
- *12-month outlook:* We expect Bank Negara to cut policy rates by 25bps this year from 3.25% to 3.0% and by 25bp next year to 2.75% off the back of slowing credit growth increasing the downside risks to growth and inflation.

Figure 92: Bank Negara Malaysia overnight policy rate



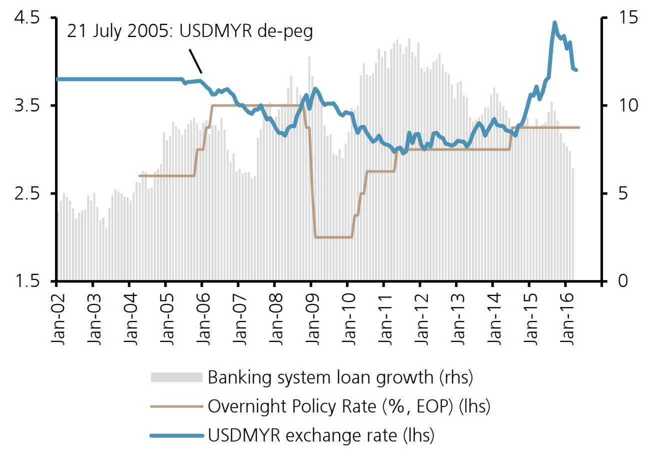
Source: UBS, CEIC, Haver

Figure 93: Banking system Required Reserve ratio and BNM reserve money growth



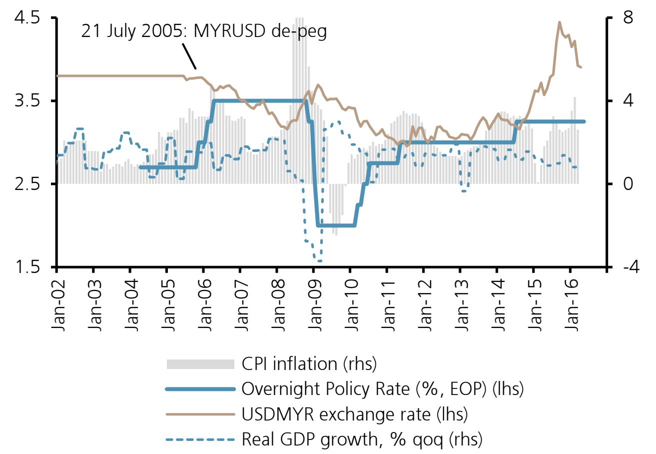
Source: UBS, CEIC, Haver

Figure 94: Exchange rate, policy rate and bank credit



Source: UBS, CEIC, Haver

Figure 95: Exchange rate, policy rate, inflation and GDP

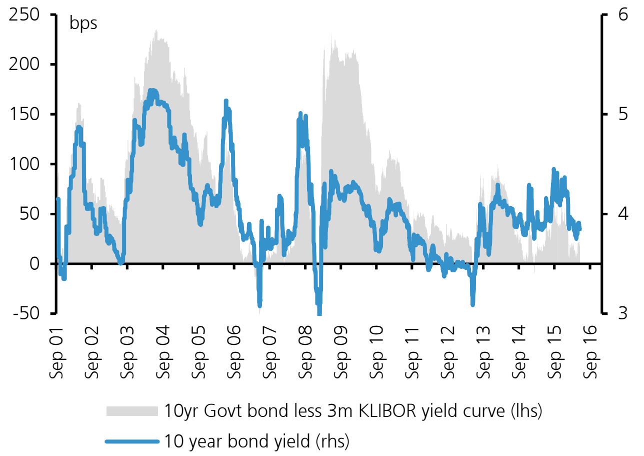


Source: UBS, CEIC, Haver

Interest Rates

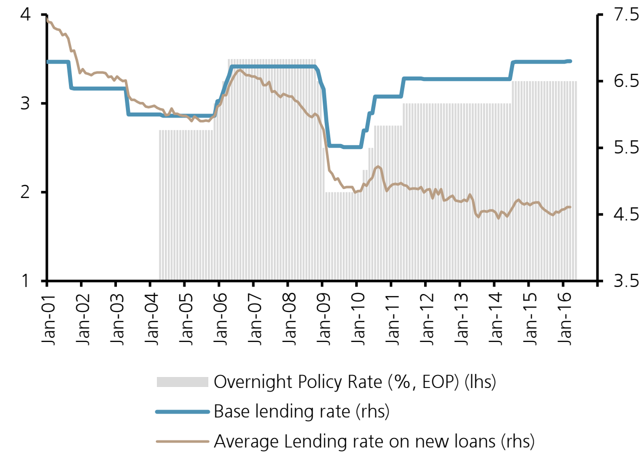
- ***What the numbers say:*** Interest rates in Malaysia picked up in 2015, reflecting expectations of rising global interest rates, increased volatility in financial markets, and capital outflows, but have moderated more recently. Rates are moderate in a historical context, and have recently risen more slowly than during the 2008 financial crisis or the 2013 taper-tantrum.
- ***What they mean:*** Low interest rates are often used to stimulate economic growth via different channels; e.g., portfolio shifts in assets, asset price appreciation, reduced debt-service burden, lowering the cost of finance for investment or durable consumption, etc.
- ***12-month outlook:*** Malaysian money markets have continued to function, despite some currency turmoil. We find this encouraging – and look for rates not to spike higher as a result of currency weakness but to remain moderate through 2016. Policy rate cuts should deliver lower interbank rates in the second half of 2016.

Figure 96: Government bond yield and yield curve



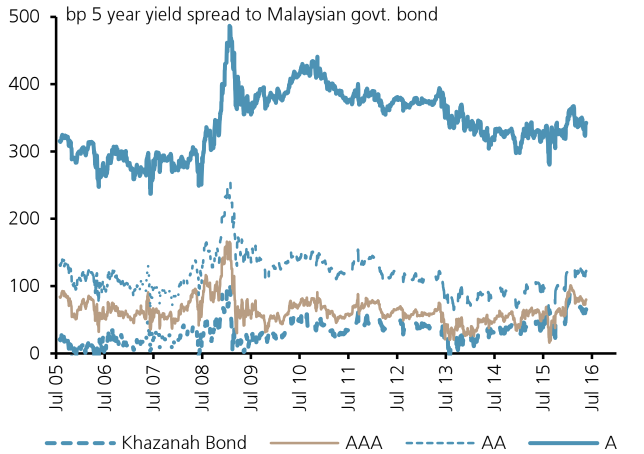
Source: UBS, CEIC, Haver

Figure 97: Bank lending rates and overnight policy rate



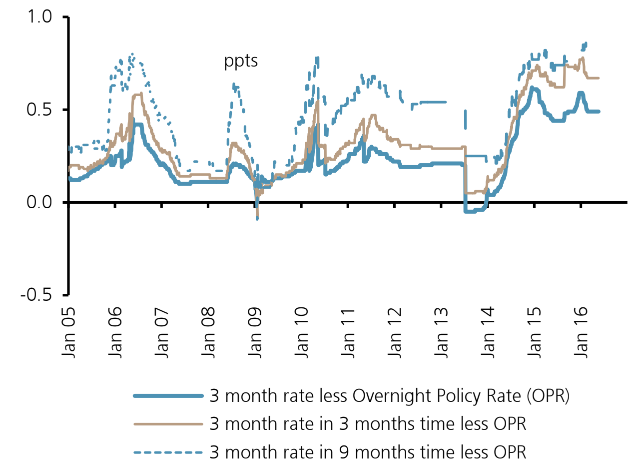
Source: UBS, CEIC, Haver

Figure 98: Spreads of selected Malaysia credits to MGS



Source: UBS, CEIC, Haver

Figure 99: Spread of implied forward rates to OPR

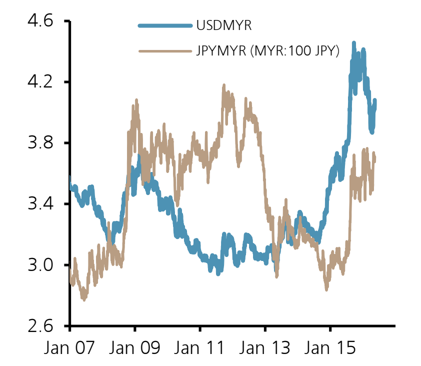


Source: UBS, CEIC, Haver

Exchange Rate

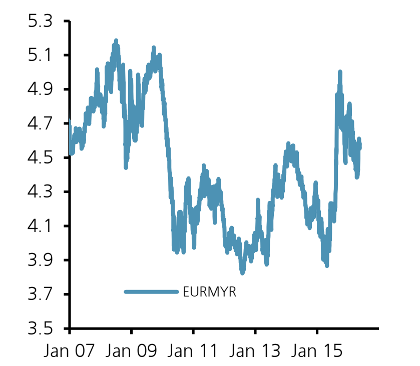
- *What the numbers say:* The ringgit effective exchange rate depreciated sharply in 2015 on investor concerns over lower oil prices and due to some political risks. Recently the ringgit has shown more stability against the dollar and in NEER and REER terms.
- *What they mean:* Obviously exchange rates affect inflation and trade. However, one of the reasons to look at exchange rates in Asia is because most central banks like to "lean against the wind" and in doing so affect domestic liquidity conditions. Many Asian central banks, BNM included, buy US dollars (increasing foreign reserves) when their currencies are under pressure to appreciate and this causes the domestic money supply to expand, which then must be sterilized, usually with central bank debt or by adjusting reserve requirement ratios on deposits. The process flows in the other direction when currencies are under pressure to depreciate.
- *12-month outlook:* We anticipate that the rebound in the ringgit may prove short-lived and look for a return to weaker levels seen in late 2015. We look for USDMYR at 4.40 at YE 2016E and 4.60 YE 2017E.

Figure 100: USDMYR and JPYMYR



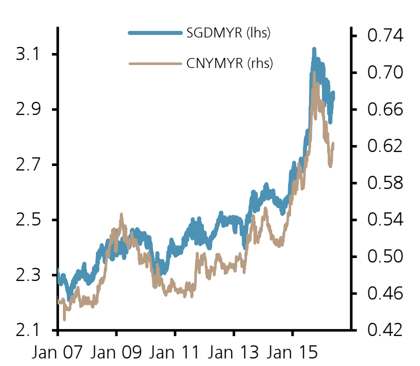
Source: Bloomberg, UBS

Figure 101: EURMYR



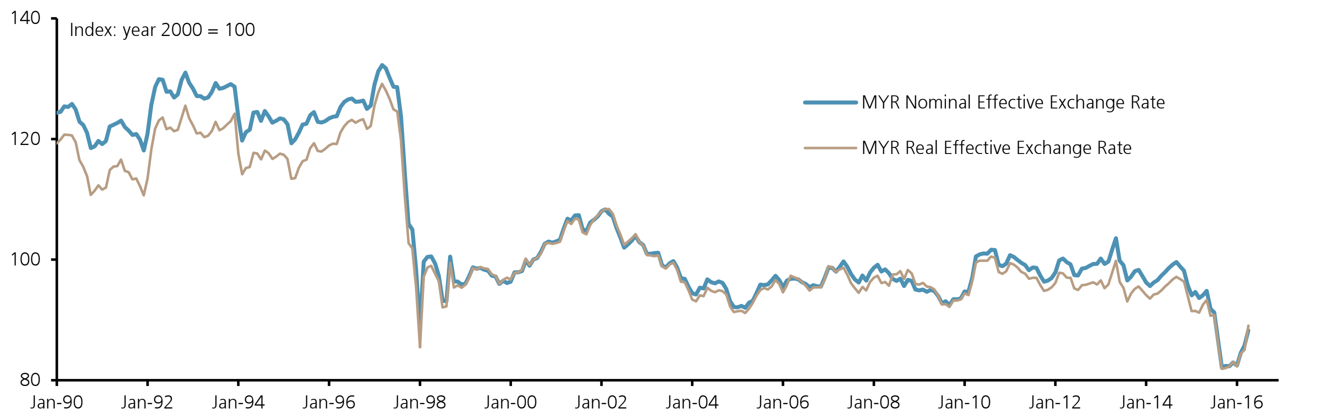
Source: Bloomberg, UBS

Figure 102: SGDMYR and CNYMYR



Source: Bloomberg, UBS

Figure 103: Ringgit real and nominal effective exchange rates

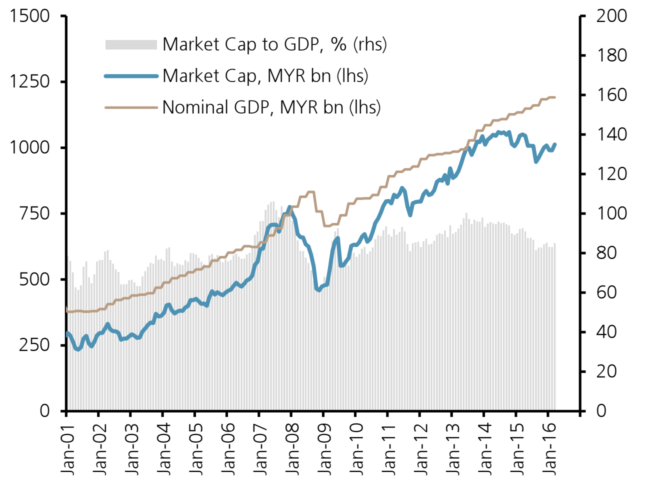


Source: CEIC, Haver, UBS Estimates

Asset Markets

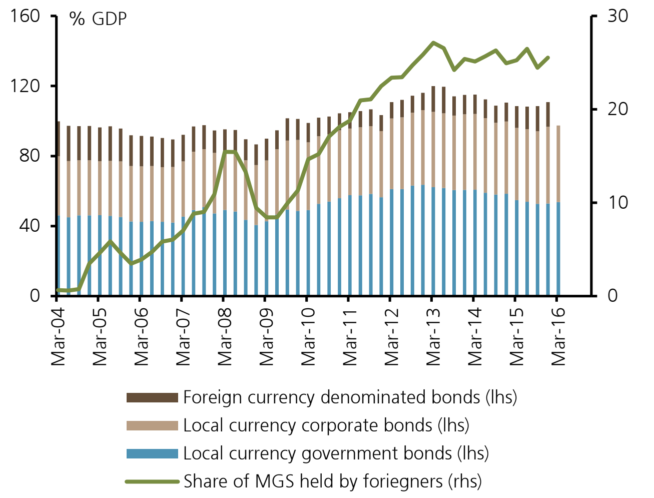
- *What the numbers say:* Malaysian equity market asset values have fallen back recently, on concerns about the currency and external weakness. House prices have stabilised, both in real and nominal terms.
- *What they mean:* Stock markets and other asset prices are among the best forward-looking indicators for economic growth and profits. A sustained rise in stock markets can also have significant effects on consumption and investment via wealth effects for consumers and lower cost of capital for firms. Property prices can have a similar effect, with residential property valuations particularly relevant for household balance sheets.
- *12-month outlook:* In part because of the excess of income over spending (the current account surplus) Malaysian asset markets have shown defensive qualities which are desirable when global growth and confidence is under pressure – recently asset markets have held up better than the currency has. We expect 2016 to be a difficult year for asset prices, given credit cycle headwinds and a slower external outlook.

Figure 104: Stock market capitalisation relative to GDP



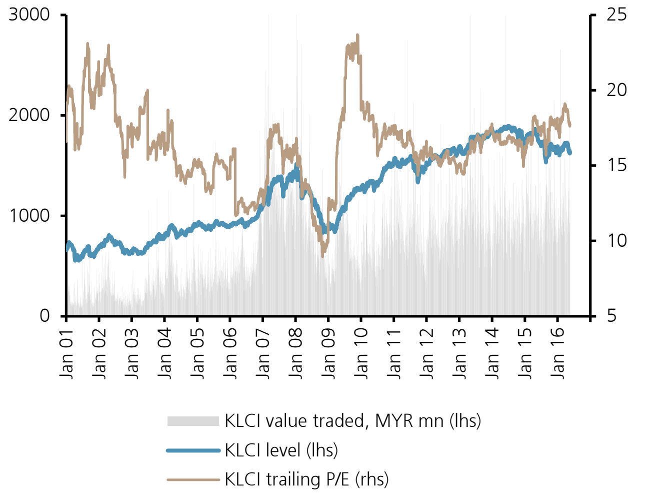
Source: Bloomberg, Haver, UBS

Figure 105: Bond market capitalisation to GDP



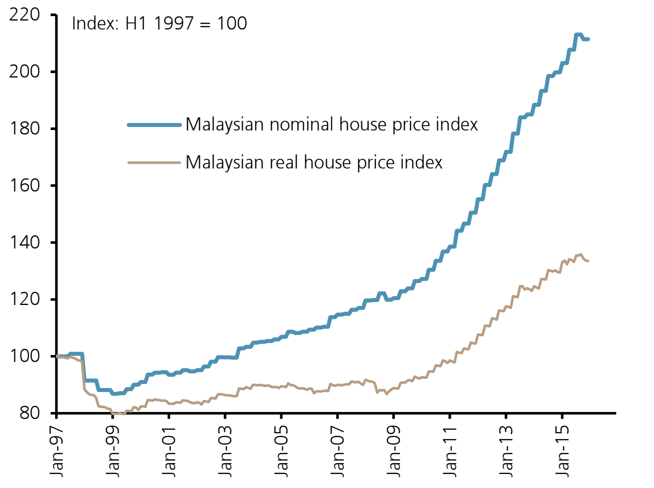
Source: Bloomberg, UBS

Figure 106: Stock market index, activity and valuation



Source: Bloomberg, UBS

Figure 107: House prices

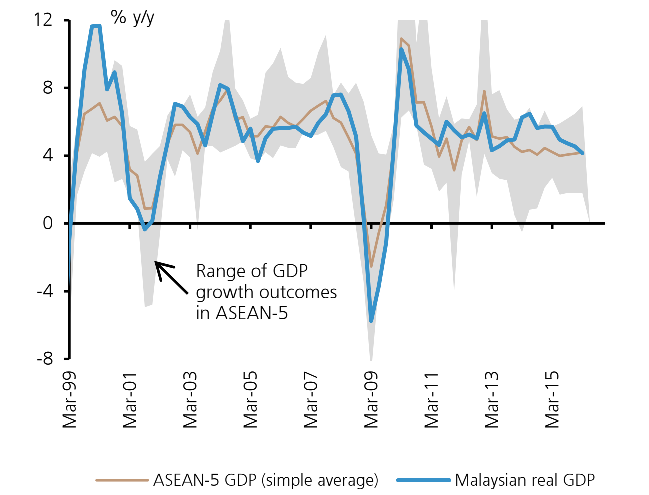


Source: Haver, UBS

Malaysia in Context

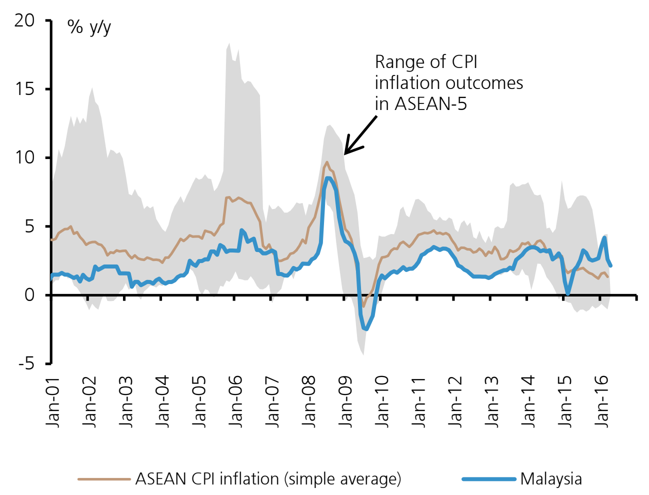
- *What the numbers say:* Malaysia's export exposure makes it one of the more cyclically volatile economies in ASEAN. Usually, it is not as volatile as Singapore and not much more volatile than Thailand. However, given that it is ASEAN's biggest energy exporter, we believe Malaysia is likely to face greater volatility than its peers in 2016. Due to prudent monetary policy settings, Malaysia has typically experienced inflation below the ASEAN average.
- *What they mean:* Malaysia's relative performance in terms of inflation, growth and external exposure conditions financial market expectations for future relative performance.
- *12-month outlook:* Having recovered more than most peer economies from the recent dip in growth during 2013, Malaysia is falling toward the bottom of the pack in 2015 on lower oil prices, fiscal prudence, and credit cycle dynamics.

Figure 108: Malaysian real GDP against ASEAN average



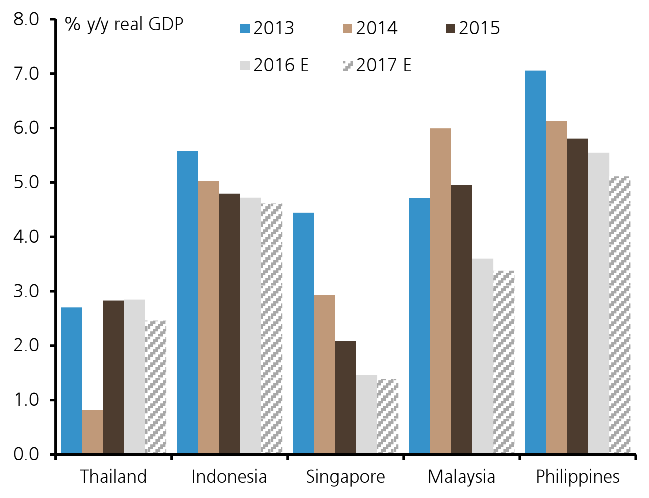
Source: Haver, UBS

Figure 109: Malaysia CPI inflation against ASEAN average



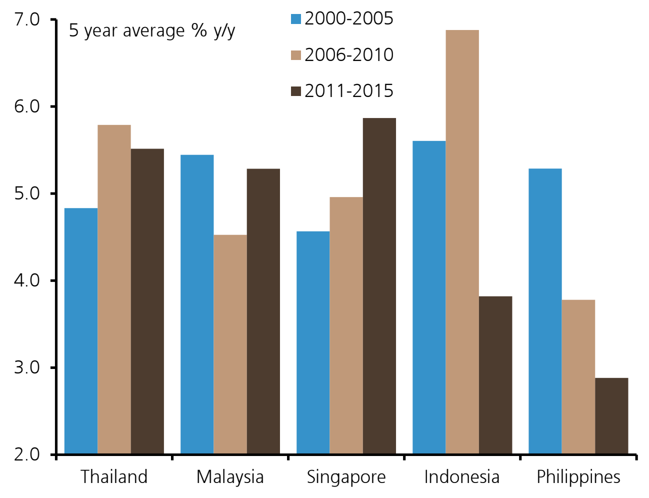
Source: CEIC, UBS

Figure 110: UBS growth forecasts



Source: UBS estimates, CEIC, Haver

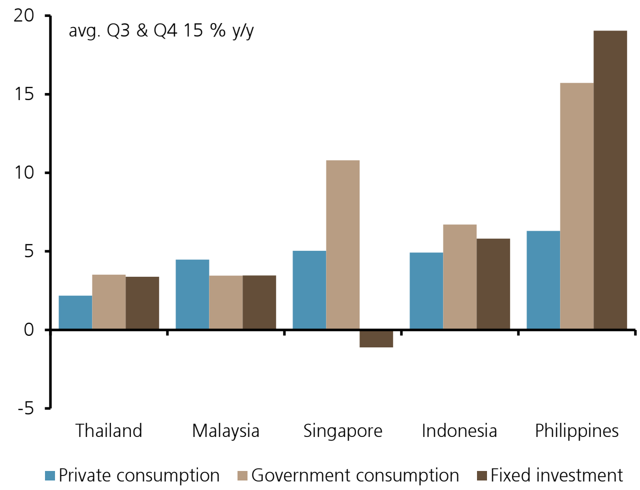
Figure 111: ASEAN-5 average real GDP growth rates



Source: UBS, CEIC

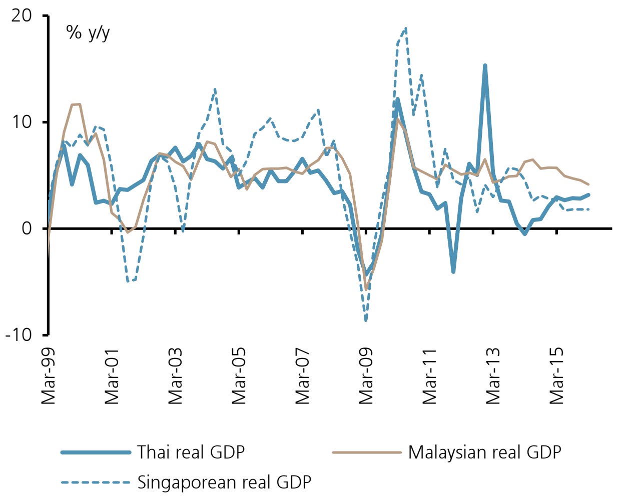
Malaysia in Context, continued

Figure 112: Domestic growth across ASEAN



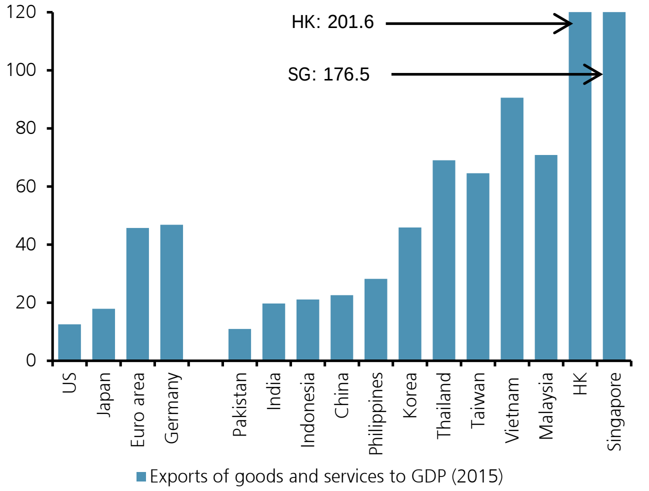
Source: CEIC, Haver, UBS

Figure 113: M'sian GDP growth vs. S'pore and Thailand



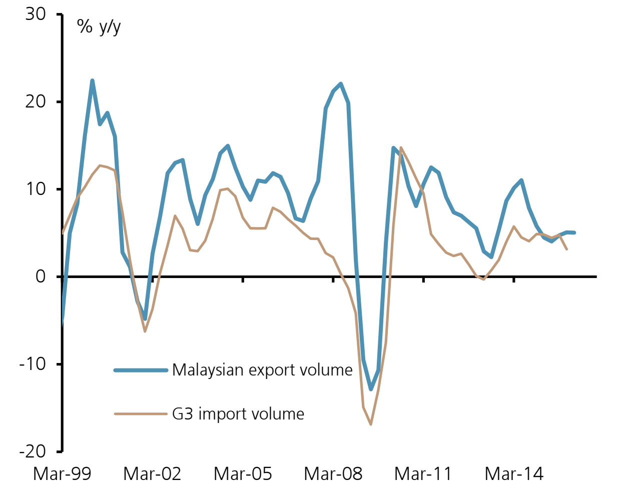
Source: CEIC, Haver, UBS

Figure 114: External exposure



Source: CEIC, Haver, UBS

Figure 115: Malaysia exports and G3 import demand



Source: CEIC, Haver, UBS

Malaysia: Macroeconomic data and forecast

	2009	2010	2011	2012	2013	2014	2015E	2016E	2017E
National Accounts (% y/y)									
Nominal GDP, MYR bn	734.4	821.4	911.7	971.3	1,018.8	1,106.5	1,157.1	1,201.4	1,282.0
Nominal GDP, USD bn	208.3	255.1	298.0	314.4	323.5	338.0	308.1	287.8	280.2
GDP per capita, USD	7,417.9	8,923.1	10,253.0	10,650.4	10,812.6	11,047.3	9,940.5	9,157.1	8,798.7
Real GDP	-1.5	7.5	5.3	5.5	4.7	6.0	5.0	3.6	3.4
Real Consumption: Private	0.6	6.9	6.9	8.3	7.2	7.0	6.0	6.7	4.7
Real Consumption: Government	4.9	3.4	16.2	5.4	5.8	4.3	4.4	4.4	2.3
Real Gross Capital Formation	-2.7	11.9	6.3	19.0	8.1	4.8	3.7	3.8	3.8
Domestic Demand incl. Stock	-1.6	11.1	7.1	10.6	6.3	5.3	5.9	6.0	3.8
Net Exports of Goods & Services*	-0.2	-1.7	-0.9	-3.6	-1.0	1.2	-0.4	-1.8	-0.2
Financial Markets									
Exchange Rate - MYR/USD, year-end	3.42	3.08	3.17	3.06	3.28	3.50	4.29	4.40	4.60
Exchange Rate - MYR/USD, year-average	3.53	3.22	3.06	3.09	3.15	3.27	3.76	4.18	4.58
Policy rate (End of Period)	2.00	2.75	3.00	3.00	3.00	3.25	3.25	3.00	2.75
Balance of Payments (US$ bn)									
Exports (US$ bn)	156.6	198.7	228.2	227.6	228.4	233.8	198.1	172.0	178.9
Exports (US$, % y/y)	-21.4	26.9	14.8	-0.2	0.3	2.4	-15.3	-13.1	4.0
Imports (US$ bn)	123.0	164.2	187.7	196.7	205.9	208.5	178.1	158.9	162.2
Imports (US$, % y/y)	-21.2	33.5	14.3	4.8	4.7	1.3	-14.6	-10.8	2.1
Trade Balance (US$ bn)	33.6	34.4	40.4	30.9	22.5	25.3	19.9	13.1	16.7
Current Account (US$ bn)	31.4	25.6	32.5	16.3	11.2	14.8	9.0	1.8	3.9
Current Account (% of GDP)	15.1	10.1	10.9	5.2	3.5	4.4	2.9	0.6	1.4
FDI	-6.3	-4.3	-3.1	-7.9	-2.0	-9.7	-2.0	0.0	2.0
Other Capital Flows	-16.5	-1.9	10.3	0.6	-4.7	-14.8	-27.0	-1.8	-5.9
Balance of Payments	3.9	-0.8	31.0	1.3	4.5	-9.7	-20.0	0.0	0.0
FX Reserves	96.7	106.5	133.6	139.7	134.9	115.9	95.3	95.9	95.9
Prices and Money (% y/y)									
Consumer Prices, year-average	0.6	1.7	3.2	1.7	2.1	3.1	2.1	2.3	2.4
M3 (% y/y, Average of Period)	7.4	8.1	10.9	13.3	8.3	5.9	5.2	3.5	4.0
Credit, year-average	8.8	11.4	13.2	12.0	10.0	9.5	9.0	6.0	5.0
Fiscal Accounts (% of GDP)									
Revenue	21.6	19.4	20.3	21.4	20.9	19.9	18.9	18.5	18.2
Interest Payments	1.9	1.9	1.9	2.0	2.0	2.0	2.1	2.0	2.0
Non-Interest Spending	26.1	22.8	23.1	23.7	22.7	21.3	20.4	19.6	19.3
Overall Balance	-6.4	-5.3	-4.7	-4.3	-3.8	-3.4	-3.3	-3.1	-3.1
Primary Balance	-4.5	-3.4	-2.7	-2.3	-1.7	-1.3	-1.2	-1.1	-1.1
Public Debt (% of GDP)									
General government	49.3	49.6	50.0	51.7	52.1	50.8	50.5	50.6	51.0
External	1.9	2.0	2.0	1.7	1.6	1.5	1.6	1.5	1.4
Domestic	47.4	47.5	48.0	49.9	51.4	51.2	48.9	49.1	49.6
Total public sector debt	68.6	68.8	69.3	71.1	72.6	72.4	70.1	70.4	70.8
External Debt (US$ bn)									
Total external debt (Old series)	66.0	70.5	84.1	81.8	101.0	N/A	N/A	N/A	N/A
Public (Old series)	25.4	27.1	28.7	26.8	29.6	N/A	N/A	N/A	N/A
Private (bank and non-bank) (Old series)	40.6	43.5	55.4	55.0	71.4	N/A	N/A	N/A	N/A
Short-term (Old series)	22.0	24.7	33.9	30.1	40.7	N/A	N/A	N/A	N/A
Medium- and Long-term (old series)	44.1	45.9	50.2	51.7	60.3	N/A	N/A	N/A	N/A
Total external debt (new series)	110.2	134.8	175.6	194.9	221.1	228.4	213.5	N/A	N/A
Short-term (new series)	47.2	59.2	83.8	91.8	107.5	111.0	90.1	N/A	N/A
Medium- and Long-term (new series)	63.0	75.6	91.8	103.1	113.5	117.4	123.4	N/A	N/A
Credit Ratings									
Moody's	A3	A3	A3	A3	A3	A3	A3	A3	N/A
S&P	A-	A-	A-	A-	A-	A-	A-	A-	N/A
Fitch	A-	A-	A-	A-	A-	A-	A-	A-	N/A

Source: CEIC, Bloomberg, UBS estimates; * Contribution to GDP growth

Notes:

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