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Malaysia Macro View

Prospects 2014: Resistance from Rebalancing

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- **Domestic demand headwinds on rebalancing away from public spending and debt-fueled consumption** — With pre-elections stimulus behind us and Fed taper inevitable, 2014 could be a year of growth rebalancing. Domestic rebalancing is likely to be evident on two fronts. [1] Fiscal consolidation is likely to take centre stage, with a top-down assessment of fiscal multipliers suggesting the 0.5%pt reduction in the Federal government fiscal deficit will shave 0.8-0.9%pts off GDP growth and possibly more if cuts in broader public sector spending are included. [2] The shift away from leverage-driven private consumption, as household debt has risen further to 84.3% of GDP, may prompt further credit tightening, particularly on car loans. These forces could pose headwinds to domestic demand in the near term and our 5% GDP growth forecast for 2014 (2013F: 4.5%) will hinge increasingly on an exports recovery, particularly in the G3.

- **G3 recovery will matter more for Malaysia's exports prospects than before** — With more moderate growth in regional economies, tepid commodity prices, possible erosion of competitiveness from subsidy rationalization, and domestic cost normalization (though offset by weaker MYR), positive income effects from a broadening G3 recovery will become increasingly important for export and growth prospects. Fortunately, Malaysia has yet to see a significant decline in the sensitivity of exports to G3 domestic demand in recent years. The exception is US-bound exports, which reflects the failure of tech capex spending to pick up thus far, though there are hopes that this may improve in 2014.

- **Current account surplus may stabilize on slower domestic demand and tepid export recovery** — We expect the current account surplus to widen to 4.4% of GDP from 3.7% this year as the fall in public and private savings rates is gradually arrested by fiscal and macroprudential tightening. The lagged impact of earlier MYR weakening may also help net-exporting sectors in the very near term, though offset by domestic cost normalization, likely resulting in a moderate net export recovery.

- **Cost-push inflation above 3% need not provoke monetary tightening near term** — Gradual but frontloaded subsidy rationalization should continue, with a further 10sen/litre hike possible by end 2013, pushing headline inflation above 3% by 1H14, but with BNM viewing the 5-5.5% official growth forecast for 2014 at near potential growth, rate hikes are unlikely until growth uncertainties subside. Our base case anticipates that BNM may tolerate inflation at 3.1-3.3% in 1Q14 before hiking 25bps in May and again in July in anticipation of inflation breaching 3.5% from Jul-Aug, though the risk is that hikes are delayed to 2H14 or beyond. Apart from uncertainties in external demand, other considerations that may shape monetary policy action in 2014 include [1] concern over household debt servicing ratios of households and [2] the inflationary impact of 6% GST in Apr 2015, which we think could add up to 1.4%pt to headline inflation in 2015.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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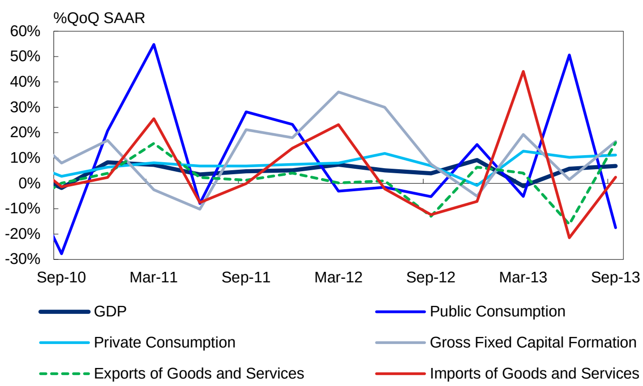
Prospects 2014: Resistance from Rebalancing

Rebalancing Could Pose Headwinds to Domestic Demand

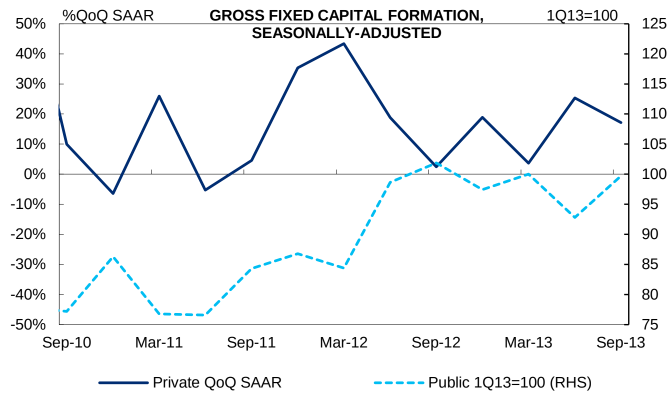
Despite the acceleration in 3Q13 GDP momentum, signs of headwinds to domestic demand were evident in the data. While private consumption accelerated slightly in sequential terms (3Q: 11.2%QoQ SAAR, 2Q: 10.2%), public consumption has begun to correct from the 2Q surge in the run-up to elections (3Q: -17.5%QoQ SAAR, 2Q: +50.6%). Imports of goods and services also only managed to eke out 2.4%QoQ SAAR in growth after plunging 21.5% in 2Q. Meanwhile though headline gross fixed capital formation saw a 16.4%QoQ SAAR surge (2Q: 1.5%), our estimates suggest that sequential growth in private investments is slowing (3Q: 17.1%QoQ SAAR, 2Q: 25.4%) while the expansion in public investments has only brought 3Q levels back to around 1Q levels after the dip in 2Q. This corroborates signs from recent monthly import and IP data – excluding transport equipment, imports of capital goods have fallen to the lowest levels in 20 months. Meanwhile, even as production of export-oriented industries picked up in 3Q, those of domestic-oriented industries saw two straight months of sequential decline up to Aug.

Figure 1. Despite the sequential expansion in 3Q13 GDP, signs of slowing domestic demand have appeared



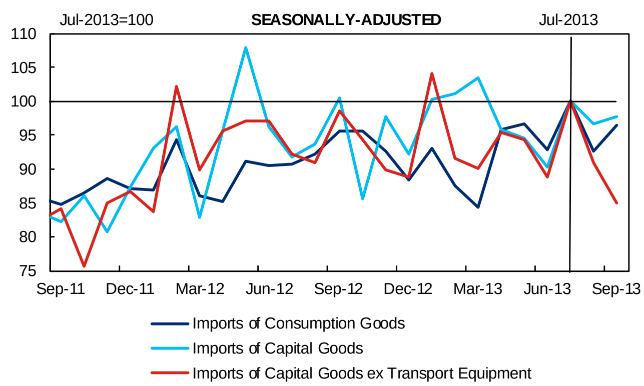
Source: Department of Statistics, Citi Research

Figure 2. Private investments are slowing while the expansion in public investments has only brought 3Q levels back to around 1Q levels



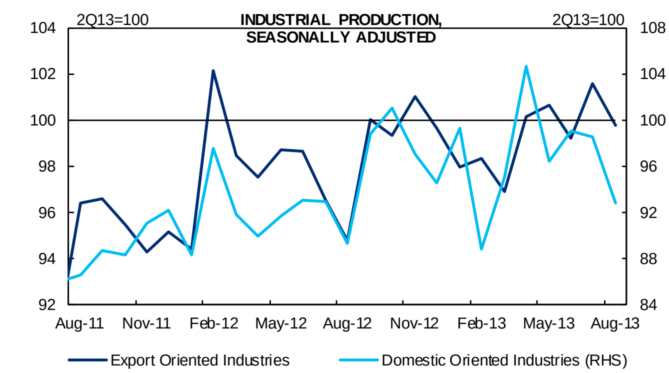
Source: CEIC, Citi Research

Figure 3. Imports of capital and consumption goods have fallen off since July



Source: CEIC, Citi Research

Figure 4. IP of domestic-oriented industries have seen two straight months of sequential decline

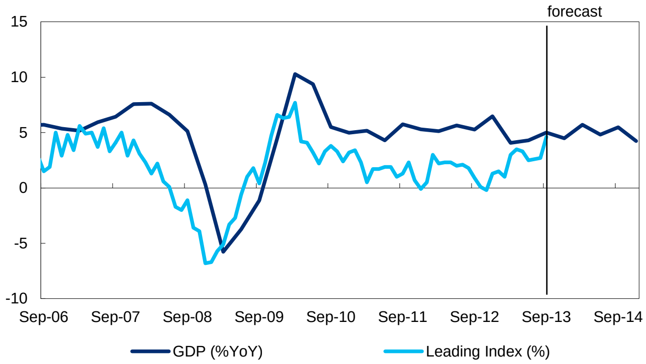


Source: CEIC, Citi Research

While base effects may weigh on YoY comparisons near term, leading indicators suggest that growth momentum may accelerate into 4Q in tandem with a continued rebound in private investments post-elections and perhaps net exports as well. The official composite Leading Index (LI), which has

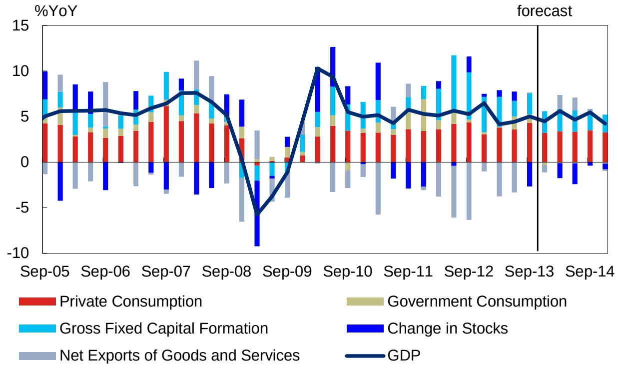
historically led GDP growth by 3-6 months, surged strongly in Sep. A deeper look at the components of the LI showed that the increase in Sep was not just due to accommodative financial conditions, evident in the strong increases in Real M1 Money Supply and the Bursa Malaysia Industrial Index, but importantly Real Imports of Other Basic Precious and Other Non-ferrous Metals and New Companies Registered – signs of a pick-up in private investment momentum.

Figure 5. Leading indicators suggest that growth momentum may accelerate into 4Q…



Source: CEIC, Citi Research

Figure 6. …in tandem with a continued rebound in private investments post-elections and perhaps net exports



Source: Haver, Citi Research

Evidence of export momentum appears more mixed – within the LI, Real Imports of Semiconductors (used to produce E&E exports) have been broadly flat since Jun, although most global and regional tech leading indicators remain supportive. As at Oct, six out of eight tech indicators that we track which are currently available registered sequential increases. The US Empire State Manufacturing Future Tech Spending survey for example indicates fairly healthy sentiment on tech capex spending, though this has yet to be reflected in actual US tech capex spending.

Figure 7. Most tech leading indicators remain fairly supportive

	US New Orders for Computers & Electronic Products	PPI for Semicon & Related Device Mfg	US Shipment-Inventories Ratio for Computers & Electronic Products	US ISM Mfg PMI	US NASDAQ	US Semicon Book-to-Bill Ratio	Taiwan Electronics Products Export Orders	Taiwan Information & Communication Products Export Orders	Singapore Electronics New Export Orders PMI	NY Fed Empire State Mfg Survey: Future Tech Spending	Number of Categories Rising Sequentially
	USD mn, SA	Dec-98=100			2/5/71=100		2006=100, SA	2006=100, SA			
Jan-13	20,910	39.2	0.604	53.1	3,142.13	1.11	106.9	109.4	50.4	5.4	6
Feb-13	20,716	39.1	0.598	54.2	3,160.19	1.10	100.1	103.1	53.2	11.1	4
Mar-13	20,595	38.8	0.620	51.3	3,267.52	1.11	100.1	95.7	52.5	18.3	4
Apr-13	21,541	39.4	0.598	50.7	3,328.79	1.08	101.7	102.8	53.1	12.5	6
May-13	22,236	39.8	0.585	49.0	3,455.91	1.08	101.3	102.9	53.3	11.4	5
Jun-13	22,069	39.8	0.588	50.9	3,403.25	1.10	103.9	104.1	51.7	-3.2	5
Jul-13	21,460	39.6	0.584	55.4	3,626.37	1.00	104.7	104.4	51.3	10.9	4
Aug-13	20,470	39.7	0.598	55.7	3,589.87	0.98	105.9	105.6	54.0	4.8	6
Sep-13	20,802	39.5	0.597	56.2	3,771.48	0.97	107.8	117.1	51.7	11.8	6
Oct-13		39.5		56.4	3,919.71	1.05	112.3	109.8	52.2	12.1	6
Nov-13										13.2	1

Source: Haver, CEIC, Citi Research

After relying increasingly towards domestic demand driven growth in much of the last decade, our 5% GDP forecast for 2014 (2013F: 4.5%) will hinge increasingly on a pick-up in net exports, particularly to the developed markets, as domestic demand faces headwinds from two fronts. [1] Fiscal

consolidation is likely to take centre stage, with a top-down assessment of fiscal multipliers suggesting that the 0.5%pt reduction in the federal government fiscal deficit will shave 0.8-0.9%pts off GDP growth and possibly more if cuts in broader public sector spending are included. [2] The shift away from leverage-driven private consumption, as household debt has risen further to 84.5% of GDP, may prompt further credit tightening, particularly on car loans.

Austerity Unlikely to Leave Growth Untouched

Updated fiscal data till Sep shows the ambitious 2013 fiscal deficit target of 4% of GDP could be challenging to meet. The Jan-Sep fiscal deficit stands at RM24.8bn or 63% of the downwardly revised target of RM39.2bn, with revenues only 69.1% of the revised Budget target of RM220.4bn (vs the 10-year average of 70% of full year revenues typically collected in the first nine months of the year). Meanwhile, Jan-Sep expenditure is 68.2% of the revised target of RM259.7bn (vs 67% historically in the same period). A linear extrapolation based on the historical revenue and spending patterns would yield a deficit of RM46.8bn (4.7% of GDP). This is an improvement from the over 5% of GDP deficit projection based on Jan-Aug data and suggests that fiscal belt tightening picked up momentum in Sep. Nonetheless with just three more months left to the close of the year, it does suggest that the 4% deficit target could be challenging to meet, though fiscal slippage should be contained via a mix of spending cuts and revenue enhancements, likely bringing the actual 2013 deficit closer to 4.2% of GDP.

Figure 8. A linear extrapolation based on the historical averages suggests a shortfall in full year revenues and overshoot in spending

		YTD Sep-2013	Full Year Estimate Implied by Historical Average	Revised Budget 2013	Original Budget	More Likely Scenario
Revenue	RM bn	152.3	217.5	220.4	208.7	219.0
	YTD Sep-2013 as % of Full Year		*70.0*	*69.1*	*73.0*	*69.5*
Expenditure	RM bn	177.1	264.3	259.7	248.6	260.5
	YTD Sep-2013 as % of Full Year		*67.0*	*68.2*	*71.2*	*68.0*
Fiscal Balance	RM bn	-24.8	-46.8	-39.3	-40.0	-41.5
	% of GDP		*-4.7*	*-4.0*	*-4.0*	*-4.2*

Source: MoF, CEIC, Citi Research

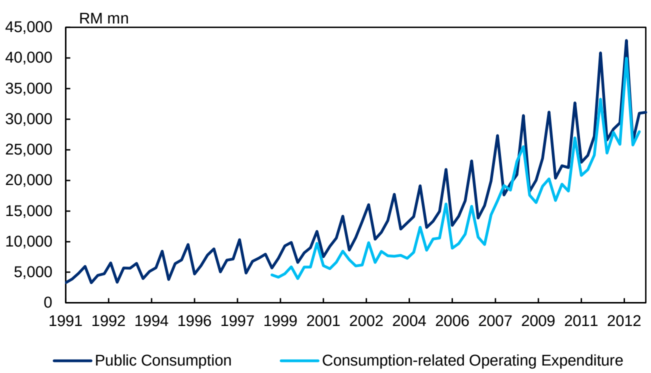
Into 2014, the Budget targets a further 0.5%pt reduction in the federal government's fiscal deficit (vis-à-vis the Budget target) to 3.5% of GDP next year from a projected 4% this year, which is to be achieved mainly through cuts in subsidies and development expenditure – our base case is for another 10 sen/liter hike in subsidized fuel prices before the start of 2014 followed by another 20 sen/liter hike before 2H14. Including the state and local governments and non-financial public sector enterprises (NFPEs), the consolidated fiscal public sector deficit is projected to see an even larger 4.1%pt drop to 9.4% of GDP in 2014 from an estimated 13.5% this year in 2013 (2012: 4.5%).

With public consumption and investments accounting for 24.3% of GDP (as of 2012), austerity would inevitably impose a drag on growth. The projected 0.5%pt cut in the fiscal deficit could impose a drag of around 0.6-0.9%pt of GDP, based on both bottom-up and top-down estimations. The fiscal drag may in turn reduce revenue collections and increase the chance of fiscal slippage on top of the effect of a smaller denominator raising the deficit to GDP ratios.

From a bottom-up approach, we see three main sources of fiscal drag, amounting to 0.8-0.9-pts of GDP: [1] falling public consumption on operating expenditure cuts (around 0.4%pts of GDP); [2] weaker private consumption on lower discretionary incomes from higher fuel prices, though partly cushioned by enlarged BR1M handouts (0.1-0.2%pts); and [3] headwinds to public investments from lower development spending (0.3%pts).

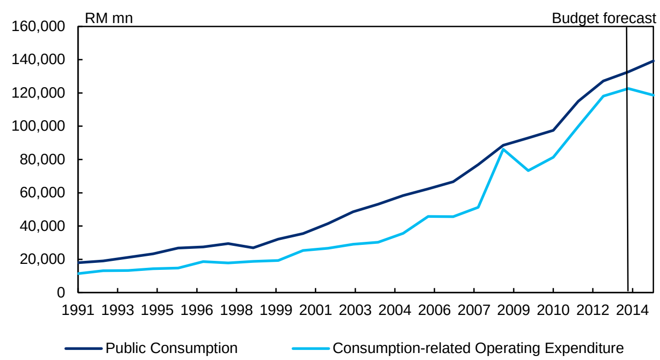
Given the extent of clawbacks to subsidies, we are skeptical on the Budget forecast of an *acceleration* in nominal public consumption. Our measure of public consumption-related operating expenditure – comprising emoluments, pensions and gratuities, as well as subsidies – generally tracks nominal public consumption fairly well. With this measure projected to decline 3.3% into 2014 – amounting to a drag of about 0.4% of nominal GDP – we think the official forecast of an *acceleration* in 2014 nominal public consumption growth to 5% from 4.3% in 2013E looks questionable – unless it implicitly assumes another civil servant bonus is on the cards in 2014. **Assuming that a RM1 decline in this measure of operating expenditure results in a RM1 decline in nominal public consumption, we estimate that the official public consumption deflator forecast would also imply a real GDP drag of about 0.4%.**

Figure 9. Our measure of consumption-related operating expenditure generally tracks nominal public consumption fairly well…



Note: Data is quarterly. Consumption-related operating expenditure comprises emoluments, pensions and gratuities, and subsidies.
Source: CEIC, MoF, Citi Research

Figure 10. …and is projected to fall in 2014, but the government expects nominal public consumption growth to *accelerate*



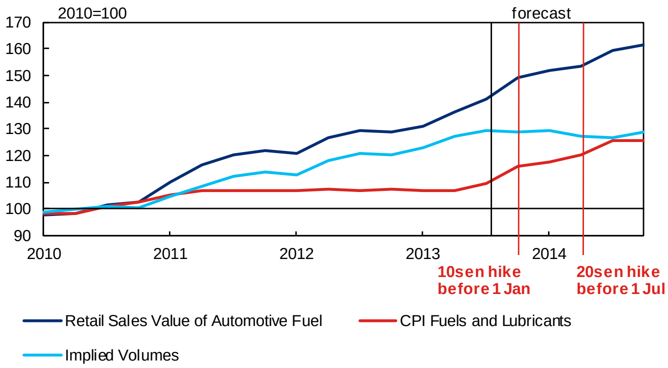
Note: Data is annual. Consumption-related operating expenditure comprises emoluments, pensions and gratuities, and subsidies.
Source: CEIC, MoF, Citi Research

Private consumption is likely to be hit by the erosion of discretionary incomes as fuel prices rise. 77.8% of Malaysian households own a car and 66% own a motorcycle or scooter, and based on the Household Expenditure Survey, we estimate that the share of fuels and lubricants in private consumption was around 8.4% (or RM31.9bn), or 4.0% of nominal GDP in 2010, rising to RM42.9bn or 8.7% of private consumption or 4.5% of GDP by 3Q13. Our base case for a 10sen/litre hike before 1st Jan 2014 and another 20sen/litre hike around Jun 2014 would be equivalent to full year average hikes of 20sen/litre, or a 9.5% hike in prices from current levels of RM2.10/litre for RON95. Factoring in these price increases and seasonal patterns in fuel sales volumes would raise 2014 nominal fuel consumption to around RM50bn (10.1% of private consumption or 5.2% of GDP), from RM44.5bn (9% of nominal private consumption and 4.6% of GDP) for 2013.

This increase in nominal fuel consumption would reduce incomes for spending on other items. **In real terms, consumption of fuel would rise by 0.2% of GDP, but at the cost of forgoing 0.5% of GDP in non-fuel consumption, for a net 0.3%pt of GDP drag, falling to 0.1-0.2%pts after factoring in attempts to cut back on fuel consumption, and offsets from the BR1M handouts.** This

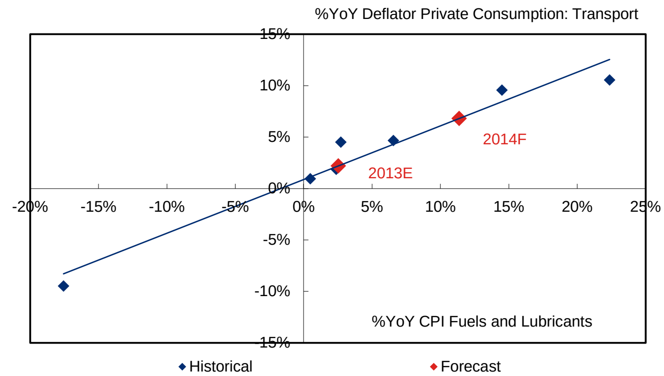
corresponds to the RM2bn of net declines of discretionary incomes (RM6.6bn of fuel subsidy cuts less RM4.6bn of BR1M handouts), or 0.2%pt of nominal GDP.

Figure 11. Fuel price hikes could potentially raise the nominal consumption of fuels and lubricants to RM50bn in 2014



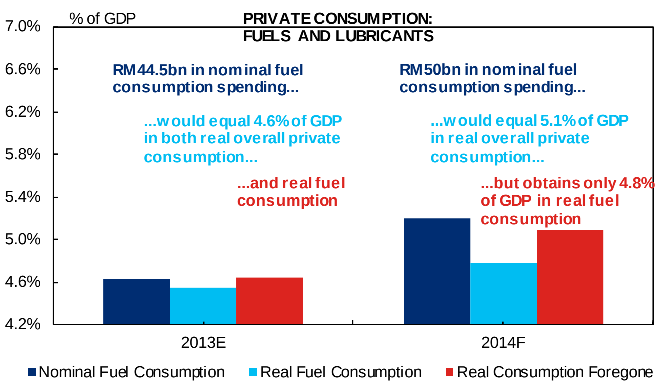
Note: We assume forecasted implied volumes follow seasonal patterns.
Source: CEIC, Citi Research

Figure 12. Higher prices of fuels and lubricants result in a higher deflator of private consumption of transport



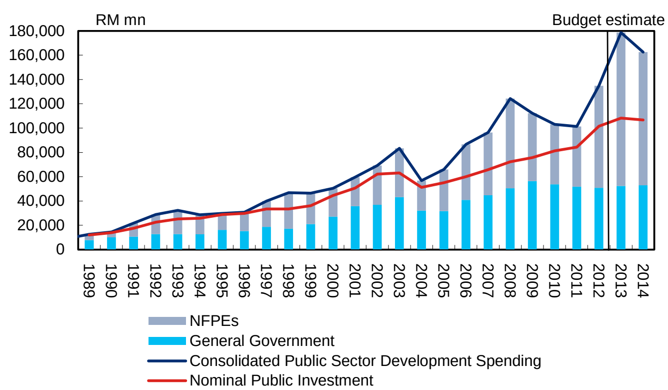
Source: CEIC, Citi Research

Figure 13. Consumers would have to forego more real non-fuel consumption to afford additional real fuel consumption



Note: Real fuel consumption is deflated with deflator of private consumption of transport while real consumption foregone is deflated with deflator of overall private consumption.
Source: CEIC, Citi Research

Figure 14. Curtailing of development spending is likely to have an impact on public investment



Source: CEIC, MoF, Citi Research

Finally, the curtailing of development spending is likely to have an impact on public investment, though this may already be reflected in the official forecasts. With nominal public investment GDP always coming in below the development expenditure of the overall consolidated public sector, this is very likely some combination of general government and NFPE spending. **With general government spending rising slightly into 2014 but NFPE spending to be pulled back, we suspect public investments could ease – which appears to already be reflected in the official forecast with an expected real decline of 2.7%, implying a 0.3%pt drag on real GDP growth.**

A top-down approach also suggests the overall drag from the 0.5% of GDP narrowing in the 2014 fiscal deficit could amount to about 0.8% of GDP. This is also the number suggested by a top-down estimate using fiscal multipliers calculated in a World Bank policy research working paper by Rafiq and Zeufack[1].

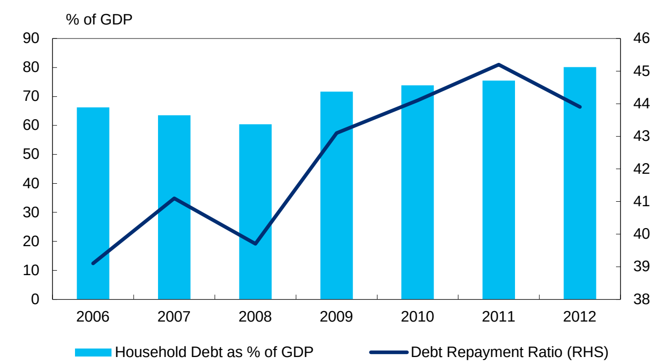
[1] Rafiq, Sohrab, and Zeufack, Albert. "Fiscal Multipliers over the Growth Cycle: Evidence from Malaysia" (2012), Policy Research Working Paper 5982. Poverty Reduction and Economic Management Unit, East Asia and Pacific Region, World Bank.

Their estimates suggest that increases in public investment have a larger multiplier effect on real output than public consumption and that these multipliers are different under recessionary and normal conditions. Rafiq and Zeufack produce peak median real output multipliers from public investment of around 2.7 during recessions and 2 during normal circumstances. Public consumption shocks are estimated to have negative multiplier values to real output during normal times, but have a positive short-run positive impact on real output with the multiplier peaking at around 2 after six months before dissipating completely after one year. **Overall, the fiscal drag should offset favourable base effects to growth in 2014 and, coupled with only a modest external demand recovery, bring growth to our 2014 GDP forecast of 5% (2013F: 4.4%) which is at the lower end of the Budget assumption and may thus pose some risks to the 2014 deficit target.**

Consumption Could Face Headwinds as Access to Credit Tightens…

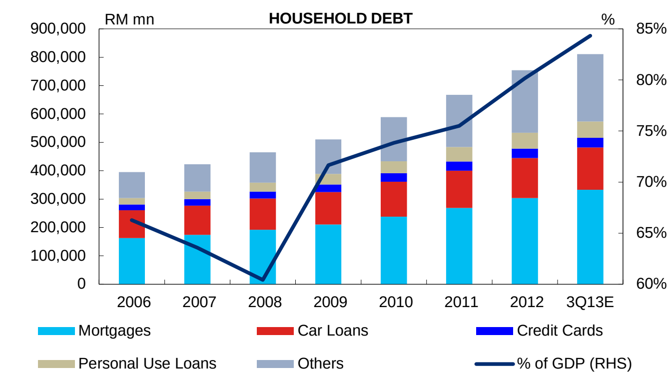
With credit conditions tightening, there may be increasing pressure to rebalance away from leverage-driven private consumption growth model. The rise in private consumption by 7%pts of GDP in the last decade was fuelled largely by a surge in household debt, including consumption credit, which rose 8%pt of GDP in the same period. The latest Financial Stability Review places debt service at nearly 44% of household incomes as of 2012, down from the peak of around 45% in 2011, This still remains uncomfortably high in our view, although we understand that figure is enlarged somewhat by the inclusion of early repayment of debt – excluding these pre-payments, the debt service ratio for new loans would be closer to the region of 30%.

Figure 15. Debt service accounts for nearly 44% of household incomes presently



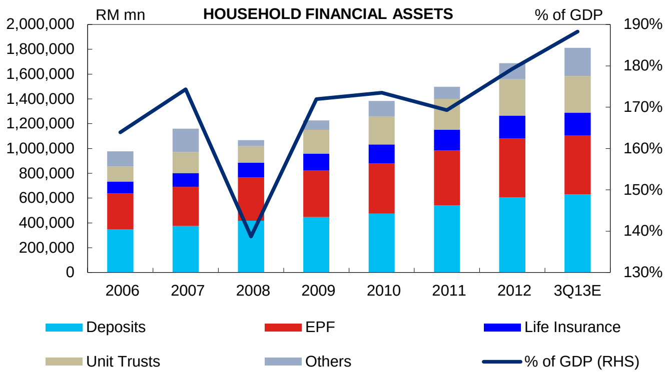
Source: Bank Negara Malaysia, Citi Research

Figure 16. Our estimates suggest that household debt is now up to about 84.3% of GDP as of 3Q13…



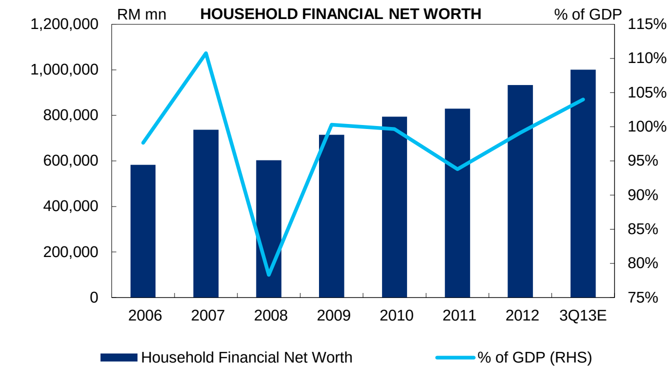
Source: CEIC, Citi Research

Figure 17. ...but this has likely been offset by an increase in household financial assets to about 188.3% of GDP...



Source: CEIC, Citi Research

Figure 18. ...raising household financial net worth to about 104% of GDP



Source: CEIC, Citi Research

Of some concern is that household debt appears to have continued creeping up despite the latest round of macroprudential tightening in July. In comments accompanying the announcement of the July round of tightening, Gov Zeti had revealed that household debt had climbed to 83% of GDP as of 1Q13 from 80.2% at end-2012 – our estimates suggest that household debt is now up to about 84.3% of GDP as of 3Q13, with the bulk of the increase coming from mortgages and car loans. For sure this has likely been offset by an increase in household financial assets to about 188.3% of GDP (2012: 179.3%), raising household financial net worth to about 104% of GDP (2012: 99.1%).

Figure 19. Household debt appears to have continued creeping up despite the latest round of macroprudential tightening in July

Announced	Measure to Curb Household Debt
Mar-11	Minimum income eligibility for new credit card holders set at RM24,000 per annum
	Cardholders earning RM36,000 per annum and less can only hold credit cards from a maximum of two issuers and the maximum credit limit extended to the cardholder shall not exceed two times their monthly income per issuer
Nov-11	Financial institutions required to assess a borrower's ability to afford financing facilities based on the borrower's income after statutory deductions for tax and EPF as well as all debt obligations
	Maximum tenure for vehicle financing applications set at nine years
	Financial institutions required to provide consumers with specific information on the total repayment amount and total interest cost as well as the impact of an increase in the financing rate to ensure that consumers understand the full implications of a borrowing decision
	Cooperatives Commission will impose requirements on responsible financing practices on credit cooperatives
Jul-13	Maximum tenure for financing extended for personal use set at 10 years
	Maximum tenure for financing granted for the purchase of residential and non-residentail properties set at 35 years
	Offering of pre-approved personal financing products prohibited

Source: Bank Negara Malaysia, Citi Research

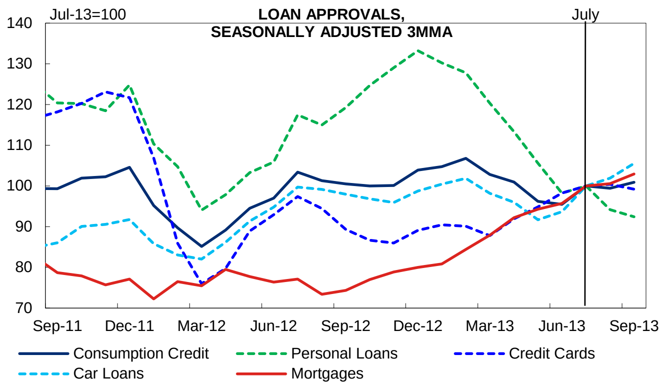
Notwithstanding the manageable aggregate household balance sheets, lending to vulnerable segments remains a source of concern. These vulnerable segments largely encompass those earning less than RM3,000/month – which we understand comprises roughly a fifth of household debt (or 16.7% GDP) – of which we understand that more than three quarters are civil servants borrowing from non-bank financial institutions such as credit cooperatives. Previous BNM studies had found that in the event of loss of income, the accumulated savings of this group would last them only three months without financial assistance.

If further macroprudential tightening is in the cards, mortgages and – more likely – car loans are probably next in line. The latest round of macroprudential tightening on household debt in July appears to have restrained a pick-up in consumption credit loan approvals from banks especially in credit cards, while personal loan approvals from banks continue to head south after peaking around

the end of last year. Corroborating our estimates however, mortgage approvals have remained on an upward trajectory despite the new measures in July limiting maximum mortgage tenures to 35 years. Meanwhile car loan approvals bottomed recently and have begun climbing, suggesting that the measures implemented at end-2011 limiting maximum car loan tenures to nine years saw only limited success in blunting car loan approvals.

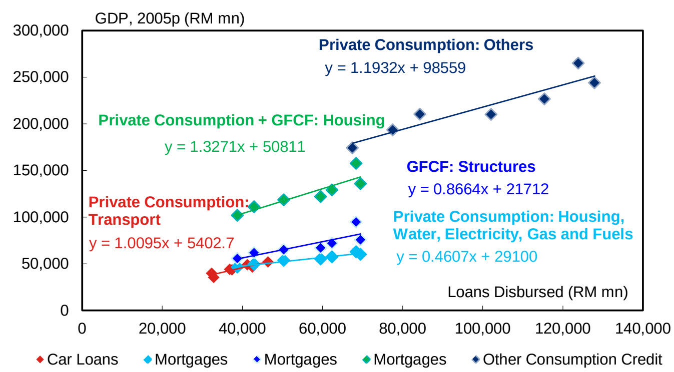
Tightening measures on car loans should have the least impact on growth while mortgages could hurt most. Simple linear regressions suggest that tightening on car loans could be the least damaging to growth, with every RM1 in car loans disbursed fueling RM1 in real private consumption of transport, i.e. a credit multiplier of 1. Other forms of consumption credit (including personal loans, credit cards, and loans for consumer durables) could have a larger credit multiplier of 1.2 times while mortgages should have the largest impact on growth with investments hit twice as hard as consumption, for an overall credit multiplier on growth (via both investments and consumption) of more than 1.3 times.

Figure 20. Macroprudential tightening in July appears to have helped restrain a pick-up in consumption credit loan approvals



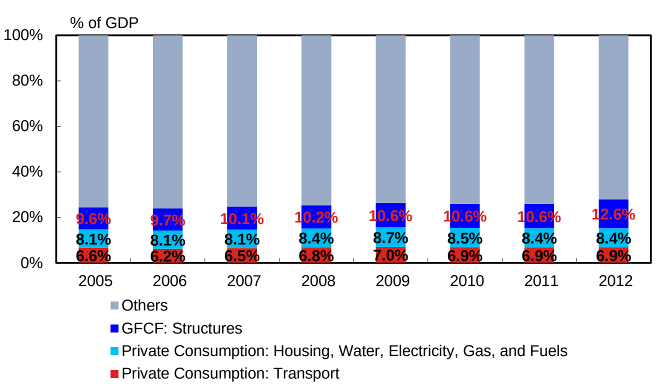
Note: Our measure of consumption credit includes personal loans, credit cards, car loans, and loans for consumer durables – mortgages are not included.
Source: CEIC, Citi Research

Figure 21. Tightening measures on car loans should have the least impact on growth while mortgages could hurt most



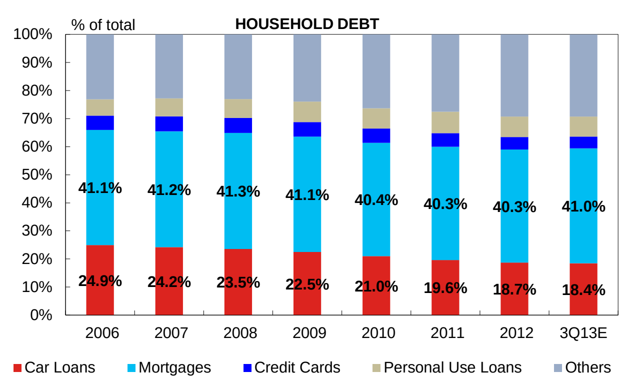
Note: We plot private consumption of transport against car loans disbursed and private consumption ex transport and housing against other consumption credit disbursed (personal loans, credit cards, and loans for consumer durables). We also plot private consumption of housing, water, electricity, gas and fuels; gross fixed capital formation of structures; and a combination of the two against mortgages disbursed.
Source: CEIC, Citi Research

Figure 22. Private consumption of transport accounted for only 6.9% of GDP...



Source: Citi Research

Figure 23. ...but our estimates suggest car loans constituted about 18.7% of household debt



Source: Citi Research

Tightening on car loans could also have the biggest bang for the buck in reducing household debt. Private consumption of transport accounted for only 6.9% of GDP in 2012 but car loans constituted about 18.7% of household debt – in other words, a household debt share-to-private consumption share ratio of 2.7 times. Mortgages are 40.3% of household debt, but the potential impact on GDP is also larger – while the precise GDP share of housing is not available, we note that private consumption of housing, water, electricity, gas, and fuels as well as gross fixed capital formation of structures together amounted to 21% of GDP in 2012 – implying a household debt share-to-private consumption share ratio of about 1.9 times.

Given the relatively favourable trade-off between deleveraging and growth, car loans are most likely next in line for tightening. As Budget 2014 measures show, the government remains focused on encouraging home ownership especially amongst lower-income groups – in any case, we suspect policymakers would prefer to pause and evaluate the impact of prohibiting Developer Interest Bearing Schemes (DIBS). Over the medium term, reducing the reliance on cars for transport could also encourage the use of public transport – especially in KL when the MRT is completed – and thus soften the impact of higher fuel prices.

Figure 24. The government remains focused on encouraging home ownership especially amongst lower-income groups

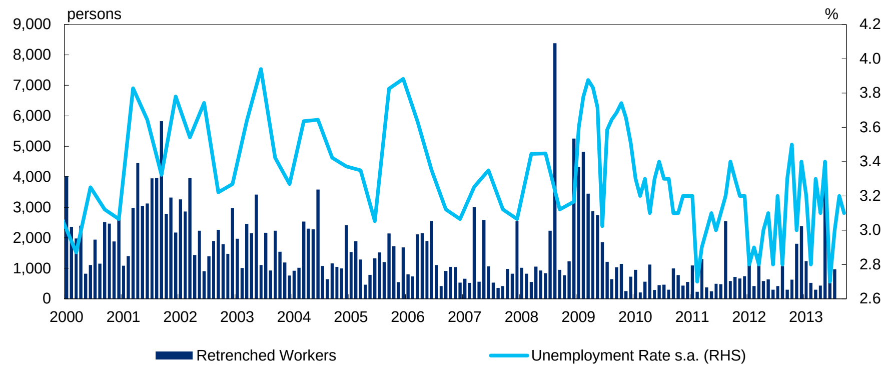
Budget 2014 Measures to Promote Home Ownership
RM578 million allocated to the National Housing Department (JPN) for the implementation of Program Perumahan Rakyat which involves the construction of 16,473 housing units, and RM146 million allocated for the JPN to construct 600 units for Program Perumahan Rakyat Disewa and Perumahan Rakyat Bersepadu.
RM1 billion allocated for PR1MA to provide 80,000 housing units. SPNB will build 26,122 units of affordable houses, comprising 15,122 units of affordable houses, 3,000 units Rumah Idaman Rakyat and 8,000 units of Rumah Mesra Rakyat.
New category of Rumah Mesra Rakyat introduced, with sales price between RM45,000 and RM65,000, for which the Government will provide a subsidy between RM15,000 to RM20,000 per unit.
RM300 million allocated for the Private Affordable Ownership Housing Scheme (MyHome) to encourage the private sector to build more low and medium-cost houses. The scheme provides a subsidy of RM30,000 to the private developers for each unit built. The scheme is for housing projects approved effective from 1 Jan 2014.
RM4 billion allocated to the Facilitation Fund as an initiative to promote private, high-strategic impact housing projects.
RM100 million allocated to 1Malaysia Maintenance Fund to improve comfort and beautify government-owned low-cost housing.
RM82 million allocated to rehabilitate 20 abandoned housing projects involving 8,197 houses.

Source: Budget 2014, Citi Research

…while Resilient Labour Market should also Limit the Pain

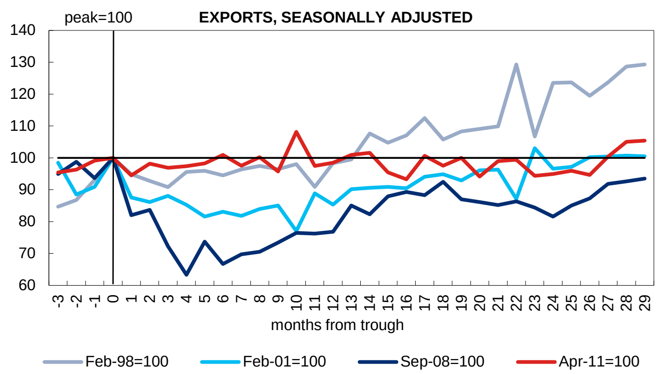
The drags to the consumer from credit tightening will be cushioned by the relatively resilient labour market. The seasonally-adjusted unemployment rate has averaged about 3.1% so far this year and remains relatively low, helped by the relatively mild export downturn which has helped resist job losses. Indeed seasonally-adjusted manufacturing employment appears to have been barely affected by the export softness and is now above the Mar-2011 pre downturn peaks.

Figure 25. The seasonally-adjusted unemployment rate has averaged about 3.1% so far this year with retrenchments at low levels.



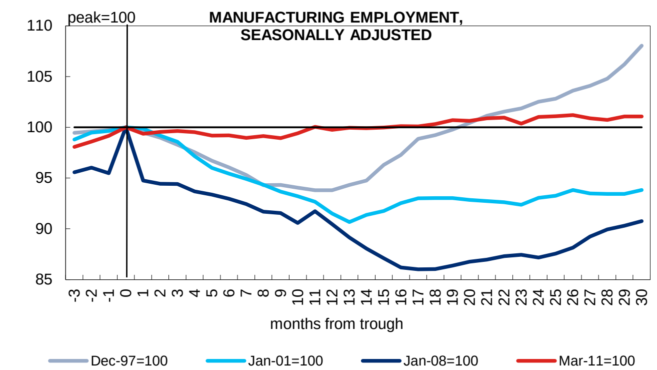
Note: Unemployment rate prior to 2009 is quarterly.
Source: CEIC, Citi Research

Figure 26. ...helped by the relatively mild export downturn which has helped resist job losses



Source: CEIC, Citi Research

Figure 27. Seasonally-adjusted manufacturing employment appears to have been barely affected by the export softness



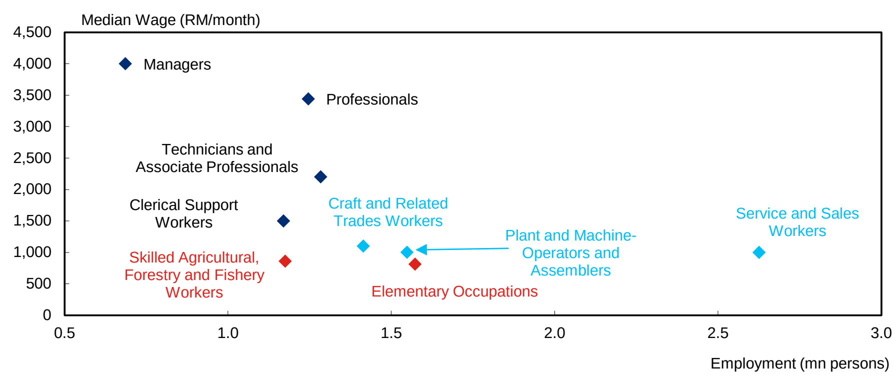
Source: CEIC, Citi Research

The full implementation of the minimum wage next year should also help raise wages for low-income workers on top of more generous BR1M handouts. While the minimum wage was implemented on 1 January 2013, a slew of deferments and relaxations were subsequently granted, which resulted in only a partial implementation of the measure. The government has thus recently announced that the minimum wage will be fully implemented on 1 January 2014 and has proposed a further tax deduction next year for employers on wage increases mandated by minimum wage policy to encourage compliance.

The government had previously estimated that about 3.2mn workers earning below RM700 a month would benefit from the minimum wage. This corresponded to about a quarter of the labour force of 12.7mn then. As of 2012, we note that median monthly wages in two occupational categories – skilled agricultural, forestry, and fishery workers (RM860) and elementary occupations (RM810) – remain under the minimum wage levels of RM900 in Peninsular Malaysia while another three occupational groups had median wages close to the minimum wage – craft and related trade workers (RM1,100), service and sales workers (RM1,000), and plant and machine-operators and assemblers (RM1,000). Assuming that 50% of workers in these five occupations are eligible for the minimum wage, this suggests **at least 32.8% of workers or 4.2mn workers stood to benefit from the minimum wage.**

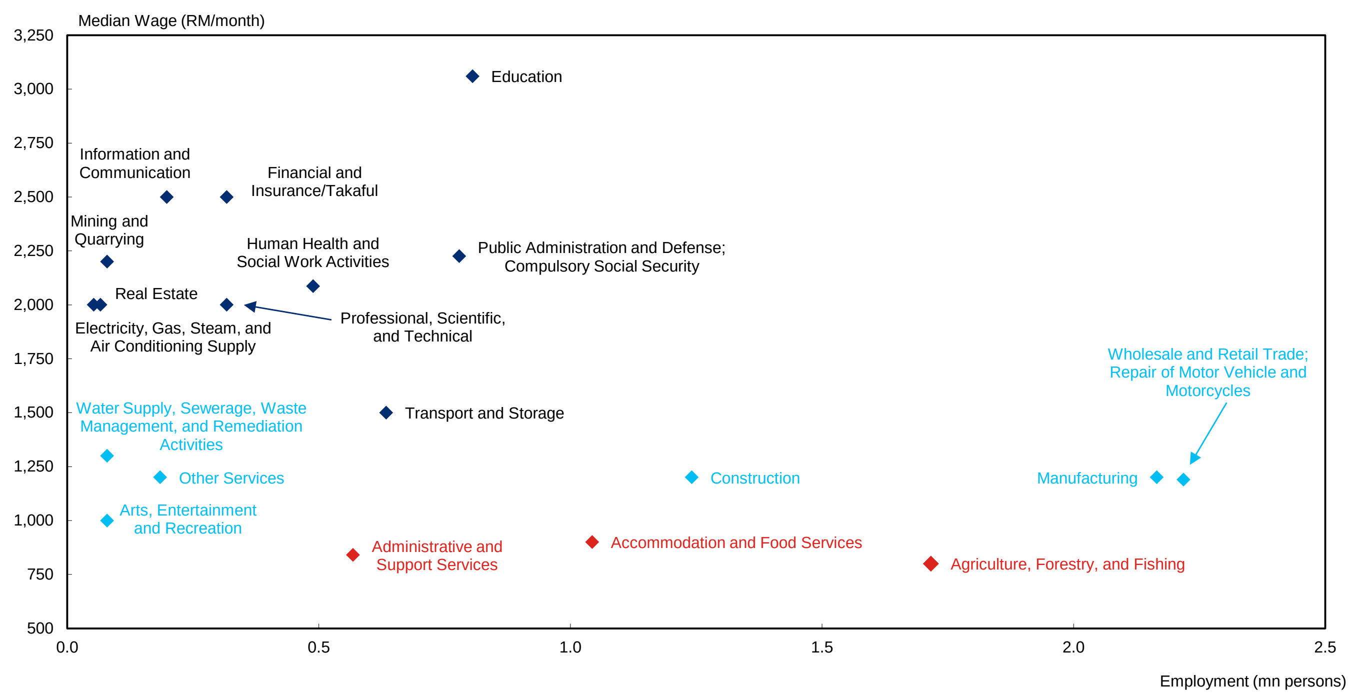
Sectoral median monthly wage data suggest that the sectors most affected by the minimum wage will be agriculture, forestry, and fishing (RM800); administrative and support services (RM840); and accommodation and food services (RM900). Sectors with median wages above but still relatively close to the minimum wage levels – arts, entertainment, and recreation; wholesale and retail trade; construction; and manufacturing – could be hit less hard. Our previous study on the impact of the minimum wage found that sectors accounting for 13-15% of GDP could see margins squeezed by the minimum wage (see Malaysia Macro View - Assessing the Impact of the Minimum Wage).

Figure 28. Our estimates suggest at least 32.8% of workers stood to benefit from the minimum wage



Note: Median wage as of 2012, employment as of 2Q13. Source: Department of Statistics, CEIC, Citi Research

Figure 29. Sectoral median monthly wage data suggest that the sectors most affected by the minimum wage will be agriculture, forestry, and fishing (RM800); administrative and support services (RM840); and accommodation and food services (RM900)

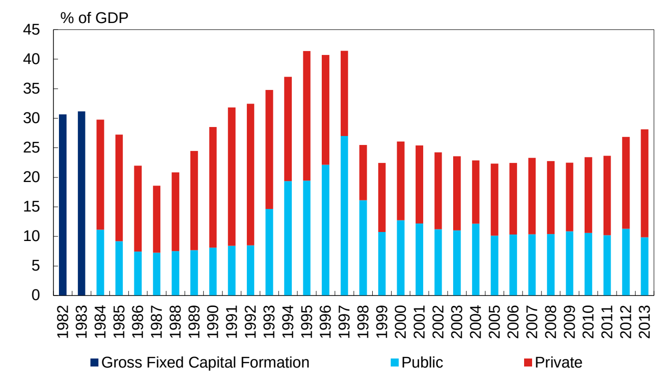


Note: Median wage as of 2012, employment as of 2Q13. Source: Department of Statistics, CEIC, Citi Research

Investments to Stay Resilient Despite Fiscal Consolidation, Helped by Returning FDI

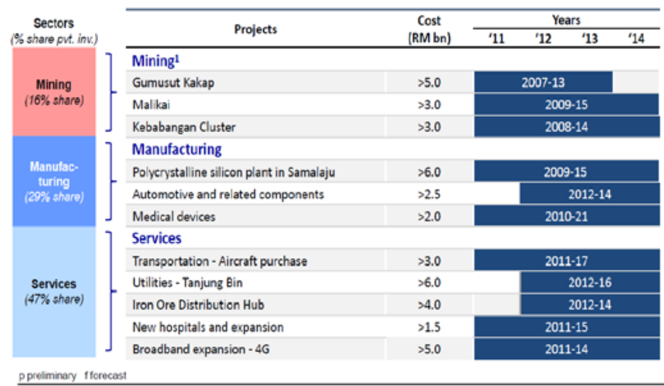
Counterbalancing these drags will be the relative resilience of private investment spending, which should offset the drag in public investment spending. Even in the absence of new projects, there remains a significant pipeline of implementation of previously approved private sector projects over the next 1-2 years, which should sustain investment growth in 2014. Earlier estimates by BNM suggest a pipeline of at least RM40bn of such projects implemented between 2011-2014, with almost half in services.

Figure 30. Investments continue to be driven primarily by the private sector while public investments have fallen



Note: 2013 refers to the first three quarters of 2013.
Source: CEIC, Citi Research

Figure 31. There remains a significant pipeline of implementation for previously approved projects over the next 1-2 years



Sectors (% share pvt. inv.)	Projects	Cost (RM bn)	Years ('11–'14)
Mining (16% share)	**Mining[1]**		
	Gumusut Kakap	>5.0	2007-13
	Malikai	>3.0	2009-15
	Kebabangan Cluster	>3.0	2008-14
Manufacturing (29% share)	**Manufacturing**		
	Polycrystalline silicon plant in Samalaju	>6.0	2009-15
	Automotive and related components	>2.5	2012-14
	Medical devices	>2.0	2010-21
Services (47% share)	**Services**		
	Transportation - Aircraft purchase	>3.0	2011-17
	Utilities - Tanjung Bin	>6.0	2012-16
	Iron Ore Distribution Hub	>4.0	2012-14
	New hospitals and expansion	>1.5	2011-15
	Broadband expansion - 4G	>5.0	2011-14

p preliminary f forecast

Source: Bank Negara Malaysia

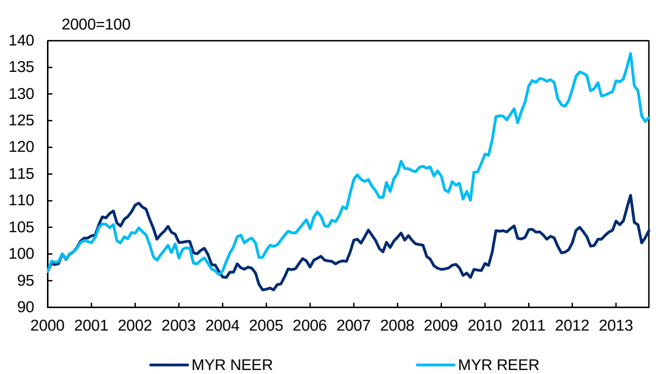
Reinforcing these previously approved projects will be signs of returning FDI interest. MIDA data shows foreign manufacturing investment approvals from Jan-Aug 2013 at 83% of full year 2012 approvals. Encouragingly, 81% of foreign investment approvals in Jan-Aug 2013 were in new greenfield projects (vs just 60.7% in 2012), which in absolute terms have already exceeded last year's levels. The larger proportion of greenfield projects could be interpreted as a sign of increasing investor confidence in our view, possibly helped by cost competitiveness as illustrated by the depreciation of the REER in recent months.

Figure 32. Foreign investment approvals by MIDA in new greenfield projects have already exceed last year's levels as of Aug

Manufacturing Investment Approvals	Jan-Aug 2013			2012		
	New	Exp/Div	Total	New	Exp/Div	Total
Number	282	181	463	473	331	804
Potential Employment	30,318	20,180	50,498	42,522	34,109	76,631
Total Capital Investment (US$ mn)	7,141	1,915	9,056	5,794	4,645	13,440
Domestic	2,513	845	3,359	4,644	1,960	6,604
Foreign	4,628	1,070	5,698	4,151	2,686	6,836

Note: Exp/Div refers to Expansion/Diversification. Source: MIDA, Citi Research

Figure 33. The MYR REER has depreciated in recent months



Note: BIS calculations. Source: Haver, Citi Research

MIDA investment approval data for the services sector also suggests foreign investment approvals as of Jun already amounted to 60% of last year's levels, boosted by investments in global operations hubs, transport, hotels and tourism, and healthcare – tradable services which could be potentially positive in narrowing Malaysia's services deficit in the current account. Meanwhile we note that the share of potentially unproductive real estate investment has declined for both domestic and foreign investors.

Figure 34. MIDA investment approval data for the services sector also suggests foreign investment approvals as of Jun already amounted to 60% of last year's levels

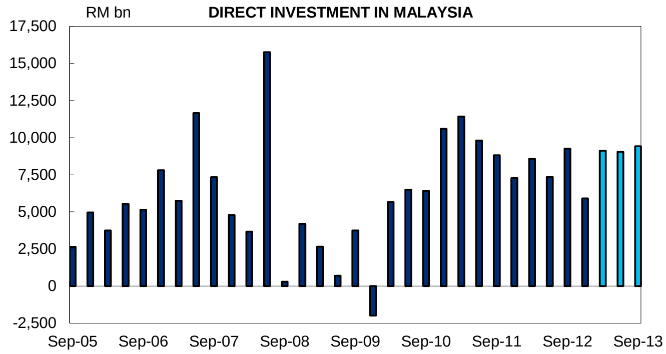
Sub-sectors	No.of Projects		Total Investment (US$ mn)		Domestic Investment (US$ mn)		Foreign Investment (US$ mn)	
	Jan-June 2013	2012	Jan-June 2013	2012	Jan-June 2013	2012	Jan-June 2013	2012
Regional Establishments	79	111	211.1	665.3	18.1	168.2	193.0	497.0
Global Operations Hub	3	8	1,396.4	1,441.7	0.0	15.9	1,396.4	1,425.8
Support Services	69	114	580.1	1,092.2	515.0	839.5	65.1	252.7
MSC Status	89	213	324.0	954.8	226.2	724.9	97.8	229.9
Transport	35	68	1,930.4	2,853.1	1,777.3	2,777.4	153.1	75.7
Real Estate*	661	1,704	7,709.9	19,208.1	7,707.4	18,775.0	2.6	433.1
Utilities	N/A	N/A	1,328.9	4,106.5	1,328.9	4,106.5	0.0	0.0
Telecommunications	153	1,044	626.1	3,295.2	626.1	3,295.2	0.0	0.0
Distributive Trade	743	2,676	594.0	1,606.7	429.8	961.8	164.2	644.9
Hotel & Tourism	82	79	1,997.8	2,905.4	1,788.4	2,800.6	209.3	104.8
Financial Services	24	55	338.0	1,474.7	334.1	1,203.0	3.9	271.7
Health Services	13	6	416.9	111.0	337.1	111.0	79.8	0.0
Education Services	309	485	116.8	306.1	110.5	297.5	6.4	8.6
Others	8	11	53.9	147.6	31.4	119.4	22.5	28.2
TOTAL	2,268	6,574	17,624.2	40,168.4	15,230.2	36,196.0	2,394.0	3,972.4

Note: The original data is presented in MYR terms – for consistency, we convert to USD using exchange rates provided by MIDA for manufacturing approvals.
* – Preliminary, N/A – data not available
Source: MIDA, Citi Research

There are signs that the realization of these investment approvals has been on the rise in recent quarters. Balance of payments data showed that direct investments in Malaysia saw only a slight slowdown into 2Q before rising to their highest levels in nine quarters in 3Q – with direct investments in Malaysia for the first three quarters of the year at RM27.6bn vs RM31.1bn for the whole of 2012.

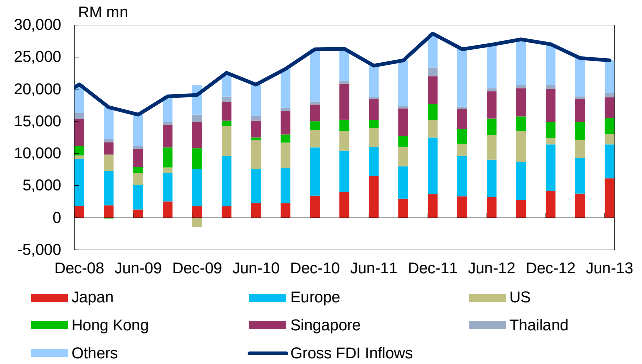
We think FDI could continue to see a pick-up – helped in the near term by Japanese investments and the lift from improving external demand. Given the heavy concentration of FDI in the manufacturing sector, it comes as no surprise that better prospects for external demand should be positive for FDI prospects. FDI from Japan is likely to play a greater role in the outperformance of FDI this and next year. Unlike the US and Europe which saw gross FDI inflows slow into 2Q, gross FDI inflows from Japan jumped to RM6.1bn in 2Q (1Q: RM3.8bn), such that 1H13 FDI inflows from Japan are now up about 50%YoY. Cyclical factors aside, the rise in Japanese FDI should be viewed within the broader structural context of a diversion of Japanese FDI from China towards ASEAN and, within ASEAN, an improvement in Malaysia's cost competitiveness position given the rise in wage costs in Indonesia and Thailand, reinforced by the recent depreciation of the MYR.

Figure 35. Direct investments in Malaysia saw only a slightly slowdown into 2Q before rising to their highest levels in nine quarters in 3Q



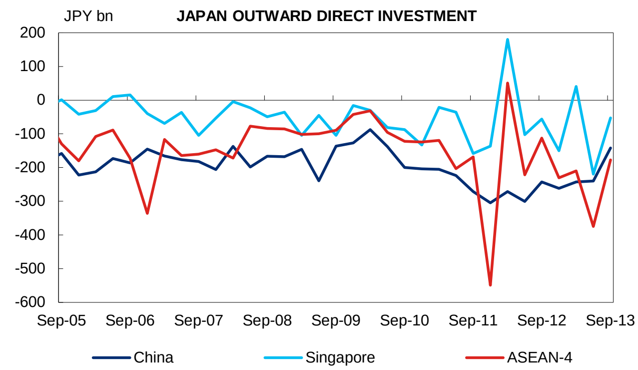
Source: CEIC, Citi Research

Figure 36. Unlike the US and Europe which saw gross FDI inflows slow into 2Q, gross FDI inflows from Japan jumped to RM6.1bn



Source: CEIC, Citi Research

Figure 37. Rise in Japanese FDI should be viewed within the context of a diversion of Japanese FDI from China towards ASEAN...



Note: A larger negative figure indicates a larger flow of direct investments out of Japan. Source: CEIC, Citi Research

Figure 38. ...and within ASEAN, an improvement in Malaysia's cost competitiveness position

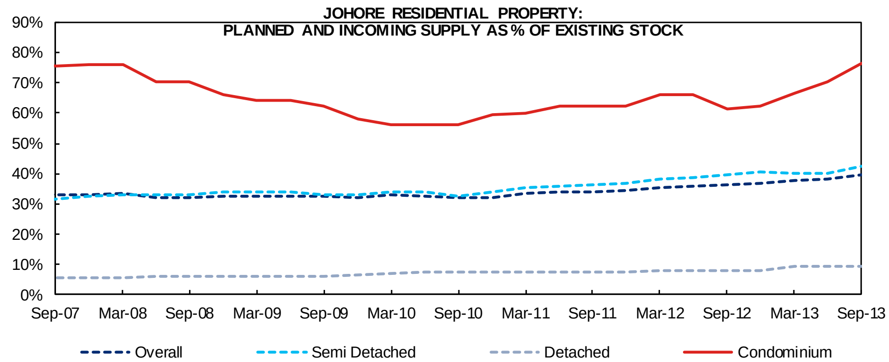
	FY2012	FY2010	FY2008
China	49.5	46.2	42
Thailand	30.1	19.8	19
Indonesia	21	4.5	9
Vietnam	18.1	10.5	17
Malaysia	15.9	11.9	14
India	7.9	6.7	11
Philippines	7.3	3.3	4

Note: Table shows % of Japanese firms currently doing business or considering starting business in the country citing high or rising labour costs as risks and problems. Source: JETRO

Meanwhile Iskandar has seen RM10bn in investments realized in 1H13 vs RM12.6bn committed in the same period. More recent figures in early November place total investment realization at RM56.3bn since 2006 – 44% of the RM129.4bn in committed investments. **Outside of Iskandar however, investment realization has been slow – the RM10bn realized in Iskandar in 1H13 accounts for almost 40% of the RM25.6bn realized in all five economic growth corridors for the first three quarters of the year.**

Nonetheless recent developments in Iskandar suggest a more cautious outlook in the near term may be warranted despite positive long-term prospects as economic integration with Singapore gathers steam. In addition to the recent announcement by the Sultan of Johore that the workweek in Johore (where Iskandar is located) will be adjusted to Sunday-Thursday starting next year, there are risks of overinvestment in residential property. Incoming and planned supply of condominiums in Johore have for example seen an upswing to about 76.4% of existing stock compared to other types of housing which have headed north more gently. **Ultimately, we think there needs to be a heavier emphasis on productive economic activities that capitalizes on Iskandar's comparative advantages, especially in manufacturing, which draws in the population base.**

Figure 39. Incoming and planned supply of condominiums in Johore have seen an upswing



Source: CEIC, Citi Research

Figure 40. The RM10bn realized in Iskandar in 1H13 accounts for almost 40% of the RM25.6bn realized in all five economic growth corridors for the first three quarters of the year

Corridor	RM bn		Major Projects in Progress
	Committed	Realised	
East Coast Economic Region (ECER) Corridor	22.8	3.7	Kuantan Port Expansion
			Kuantan Port City Development
			Malaysia-China Kuantan Industrial Park (MCKIP)
			Kuala Terengganu City Centre (KTCC)
			Kertih BioPolymer Park
			Automotive Industrial Hub, Pekan
Iskandar Malaysia*	12.6	10	Pinewood Iskandar Malaysia Studios
			Gleneagles Medini Hospital
			Double Tree Hilton
			Pegasus International School
Northern Corridor Economic Region (NCER)	7.2	7.2	Biotechnology Incubation Centre
			Aquaculture Development Complex, Selinsing
			Expansion Programme Edu Citi Tel
Sabah Development Corridor (SDC)	8.6	3	Sabah Oil and Gas Terminal (SOGT) and Sabah-Sarawak Gas Pipeline (SSGP)
			Sipitang Oil and Gas Industrial Park (SOGIP-Phase 1 SAMUR)
			Kimanis Power Plant
			International Technology and Commercial Centre (ITCC)
			Aeropod
			Sabah International Convention Centre (SICC)
			Sabah Agro Industrial Precinct (SAIP)
			Palm Oil Industrial Clusters (POIC) at Lahad Datu and Sandakan
Sarawak Corridor of Renewable Energy (SCORE)	2.2	1.7	Ferro alloy manufacturing plant
			Polycrystalline silicon manufacturing plant
TOTAL	53.4	25.6	

Source: MoF

While fiscal consolidation would hurt public investments as earlier noted, work on a number of key public projects with broader growth spillovers and multiplier effects look set to continue.

- **Work on the Klang Valley MRT Sungai Buloh-Kajang (SBK) line remains on schedule for completion in 2017.** Construction analyst Petrina Chong notes that the SBK line has achieved 16% completion, with the underground package at 18% completion and the elevated portion at 12%. With four tunnel boring machines having already commenced work since end-May and another six scheduled to be operational by 2014, tunneling progress on the SBK line should accelerate into 2014 before scheduled completion by mid-2015. Beyond the SBK line, the Sungai Buloh-Serdang-Putrajaya (SSP) line – valued at RM24.9bn, more than the RM22.2bn SBK line – is expected to receive Cabinet approval by year-end and physical construction could begin by Jul-2015. For details, please

see Malaysia Construction - On the Ground – Budget Expectations. Policymakers had previously estimated the GDP contribution of the MRT at roughly RM3bn this year or 0.3% of GDP, which would gradually increase over time to a cumulative RM21bn over seven years.

Figure 41. Work on the Klang Valley MRT Sungai Buloh-Kajang (SBK) line remains on schedule for completion in 2017

	Party(s) involved	Timeline
Proposal submitted to the government	MMC-Gamuda JV	Jan-10
First reports of the project surfaces in the newswires	Media	Jun-10
The project is mentioned in the Economic Transformation Programme and 2011 Budget	Government	Sep-Oct 2010
MRT Corp takes over as project and asset owner of KVMRT from Prasarana.	MRT Corp, Prasarana	1-Sep-11
The entire project is fully operational	MRT Corp, MMC-Gamuda JV, contractors	2030
Line 1: Sg Buloh- Kajang (SBK Line)		
Government approval received	Government	Dec-10
Detailed EIA report is published	ERE Consulting Group	Feb-11
Public display	MRT Corp, Public	Feb - May 2011
Prequalification rounds for elevated structures	Prasarana, MMC-Gamuda JV, contractors	Mar-11
Earthworks for Sungai Buloh depot awarded to Gadang (RM24m)	Gadang Holdings	10-Jun-11
Groundbreaking for Sungai Buloh, Semantan and Cochrane sites	Prasarana, MMC-Gamuda JV, contractors	8-Jul-11
Tenders start to open for all packages	MRT Corp, MMC-Gamuda JV, contractors	Sep-11
Packages V5 and V6 awarded to IJM and AZRB respectively for RM1.7bn	MRT Corp, IJM, AZRB	26-Jan-12
PDP Agreement signed with MMC-Gamuda	MRT Corp, PDP	10-Feb-12
Tunneling package awarded to MMC-Gamuda	MRT Corp, MMC-Gamuda JV	20-Mar-12
90% of project value awarded	MRT Corp, MMC-Gamuda JV, contractors	Oct-12
Fully operational	MRT Corp, MMC-Gamuda JV	31-Jul-17
Line 2: Sg Buloh- Serdang- Putrajaya (SSP Line)		
Announcement of alignment for Cabinet approval	Government, MRT Corp	4Q2013
Appointment of PDP	MRT Corp, PDP	4Q2013
Public Display (at least 6 months)	MRT Corp, Public	1H2014
Tender process for construction packages	MRT Corp, PDP, contractors	2H2014
Commencement of construction	MRT Corp, PDP, contractors	Mid 2015
Fully operational	MRT Corp, PDP, contractors	End 2020

Source: MRT Corp, Gamuda, Citi Research

- In the oil and gas sector, Petronas had noted earlier in June that it would have to accelerate its capex as only RM72bn or 24% of its five-year RM300bn capex plan had been spent between 2011 and Jan-2013 – despite the mining and quarrying sector (largely oil and gas) constituting almost 45% of overall GFCF in 2012. With a strong pipeline of domestic projects over the next five years, Petronas will continue to anchor oil and gas investments.

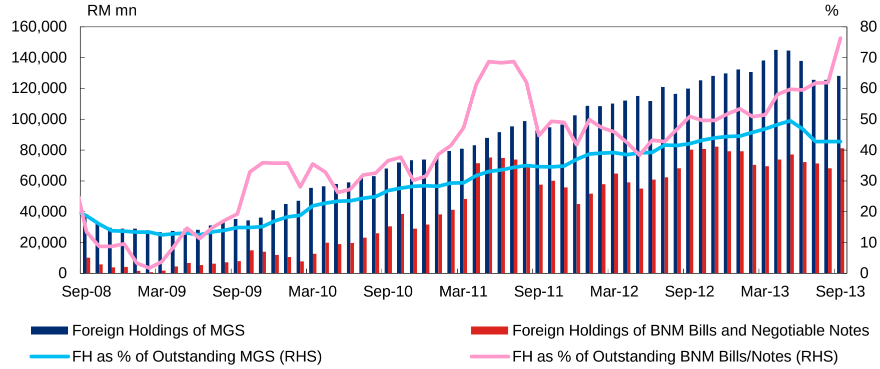
Figure 42. With a strong pipeline of domestic projects over the next five years, Petronas will continue to anchor oil and gas investments

PETRONAS Major Oil and Gas Projects in Malaysia in 2013	Description	Targeted Completion
Floating Liquefied Natural Gas 1 and 2 Projects (FLNG1 & 2)	The projects involve developing a floating liquefaction facility as a solution to monetise small, marginal and maturing gas fields in Malaysia	End-2015 and 2016
Gas Processing Plant Rejuvenation and Revamp (PRR)	The PRR involve facilities in Gas Processing Plant 2 (GPP2), GPP3 and the Kertih Compressor Station located in the GPP Complex, Kertih as well as the Export Terminal units in Kemaman, Terengganu	2015
Pengerang LNG Regasification Terminal	The facility will consist of a new land-based LNG Regasification Terminal with Receiving Facilities for LNG carriers to bring in imported LNG. The land acquisition is almost completed and detailed engineering design is still ongoing.	Mid-2016
Lahad Datu LNG Regasification Terminal	The project involves developing a land-based LNG Regasification Terminal to produce gas for power plants	Mid-2016
Kimanis Power Plant	The project involves a development of a 300MW gas-fired power plant in Kimanis to meet the growing demand for electricity in Sabah	Mid-2014
Lahad Datu Power Plant	The Lahad Datu Power Plant is a Combined Cycle Gas Turbine (CCGT) located at the Palm Oil Industrial Cluster (POIC) project in Lahad Datu, Sabah with a capacity of a 300MW gas-fired power plant.	
Refinery and Petrochemical Integrated Development (RAPID) Project	The RAPID project comprises a crude oil refinery as well as a naphta cracker petrochemical and polymer complex to be constructed in Pengerang, Johor	End-2016
Pengerang Power Plant	The project involves the development of a power plant with a capacity of 1,270MW to supply to the RAPID project as well as for exports	2017
Sabah Ammonia-Urea (SAMUR) Plant Project	The SAMUR plant will be located in Sipitang, Sabah, which will monetise gas from offshore Sabah to produce ammonia and granulated urea fertilisers. Construction already started in May 2012	Aug-15

Source: MoF, Citi Research

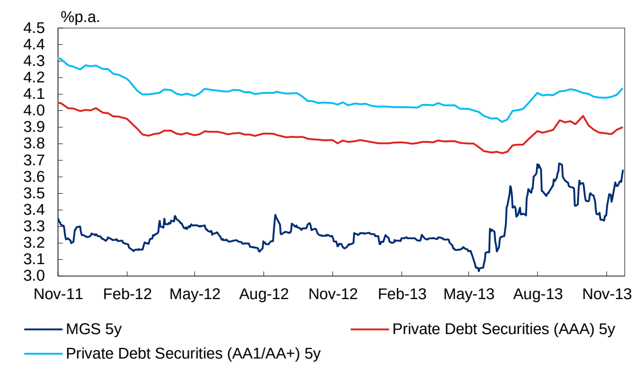
We see two risks to our otherwise constructive view on the investment outlook. First, Fed tapering could trigger another sharp reversal of portfolio inflows, hurting the funding of major projects, particularly given the increased dependence on the private debt securities market for funding over the past year. Foreign positioning in BNM bills and negotiable notes has surged to 76.3% of outstanding in Sep (Aug: 61.9%) while foreign holdings of MGS have moderated to 42.8% of outstanding (Aug: 42.7%) from the peak of 49.5% in May. Yields of private debt securities (PDS) have risen as MGS yields headed north, though spreads have narrowed. While ample domestic liquidity should moderate the increase in both sovereign and corporate bond yields, a sharper-than-expected rise in corporate bond yields may raise financing costs for investment projects. That said, dependence on the PDS market for funding appears to have moderated vs banks (where loan spreads would be more benchmarked to the cost of funds, including deposit rates and other short-term interest, which is in turn anchored by the accommodative Overnight Policy Rate). Since the start of 2013, corporates have raised just RM10.2bn from the private debt securities market, compared to a net increase in non-household loans (proxy for business loans) of RM30.2bn. Another possible mitigating factor be would foreign central banks' holdings of MGS amounting to around RM16bn or 12.4% of foreign holdings of MGS – a relatively stable source of foreign funding that is unlikely to see sharp sell-offs even when tapering starts.

Figure 43. Foreign positioning in BNM bills and negotiable notes has surged while foreign holdings of MGS have moderated



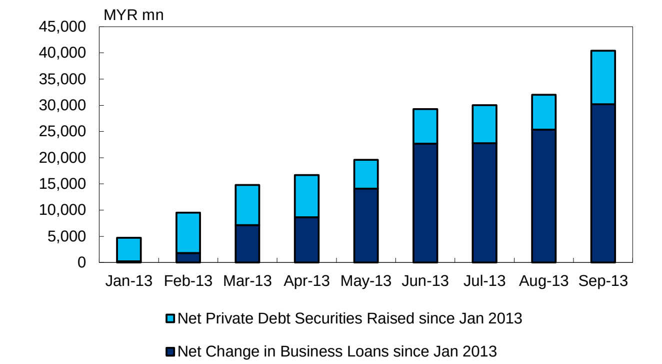
Source: CEIC, Citi Research

Figure 44. Yields of private debt securities (PDS) have risen as MGS yields headed north



Source: CEIC, Citi Research

Figure 45. Since the start of 2013, corporates have raised just RM10.2bn from the private debt securities market, with the bulk of business funding coming from banks.



Source: CEIC, Citi Research

Second, if current account pressures force the deferral of projects, though the risk appears to have subsided for now. While the government had announced in Sep that some investment projects with high import content and low multipliers could be delayed or rescheduled to alleviate pressure on the current account, the projects in question – likely politically unpopular ones of disputed economic value like the 100-storey Warisan Merdeka announced in Budget 2011 – could be restricted to those that have yet to start, which should therefore have minimal impact on growth. In fact, with the current account surplus improving in 3Q to 4% of GDP (2Q: 1.1%) and the promise of Chinese funding for major projects like the KL-Singapore High Speed Railway and Tun Razak Exchange (TRX), the pressure to defer projects has likely subsided for now.

On balance, despite these risks, we expect a continued rise in the fixed investment share of GDP, which at 28.1% as of the first three quarters of 2013 (in real terms) is the highest in more than a decade (2012: 26.8%) though still below the 30-40% levels in the early 1990s before the onset of the Asian Financial Crisis. Encouragingly, investments continue to be driven primarily by private investment, which at nearly 18.3% of GDP is now at the highest levels since 1996. In fact, public investments have fallen to 9.9% of GDP so far this year – the lowest since 1992.

G3 Recovery will Matter More for Malaysia's Exports

With these forces posing headwinds to domestic demand in the near term, overall growth prospects may hinge more heavily on an export recovery – particularly to the G3.

Exports May Have to Rely Less on Intra-Asian Trade…

With growth in Indonesia and China slowing, Malaysia can likely no longer rely on intra-Asian trade to prop up external demand. At face value, a slowdown in both these large regional economies could have a sizeable impact on Malaysia's goods exports, especially with China being Malaysia's largest export market (12.8% of exports as of September on 12-month rolling basis) and the export share of Indonesia rising (4.6%). The exposure of Malaysia's direct exports to China and Indonesia is substantial at 12.2% of GDP (four quarters up to 2Q13) – still smaller than its exposure to the G3 at around 21% of GDP, but larger than most ASEAN peers (ex Singapore).

Figure 46. The exposure of Malaysia's direct exports to China and Indonesia is substantial – but Malaysia's vulnerability may be exaggerated once indirect exports to the developed markets via China are taken into account

% of GDP	ID	MY	PH	SG NODX	SG DX	TH
Direct Exports to US	1.7	6.3	2.6	4.3	4.6	5.9
Direct Exports to EU	1.6	6.4	2.1	6.4	8.2	5.1
Direct Exports to Japan	3.2	8.3	3.9	3.0	3.2	6.0
Direct Exports to Indonesia		3.1	0.3	3.1	6.3	3.0
Direct Exports to China	2.4	9.1	2.2	6.1	8.3	6.8
Exports to China used for Processing (% of exports to China)	34.6	80.0	57.3	80.0	80.0	52.2
Exports to China used for Domestic Demand (% of exports to China)	65.4	20.0	42.7	20.0	20.0	49.9
Exports to China used for Domestic Demand	1.6	1.8	0.9	1.2	1.7	3.4
China's Exports to US (% of China's exports)	16.5	16.5	16.5	16.5	16.5	16.5
Indirect Exports to US via China	0.1	1.2	0.2	0.8	1.1	0.6
Total Direct and Indirect Exports to US	1.8	7.5	2.8	5.1	5.7	6.4
China's Exports to EU (% of China's exports)	15.3	15.3	15.3	15.3	15.3	15.3
Indirect Exports to EU via China	0.1	1.1	0.2	0.7	1.0	0.5
Total Direct and Indirect Exports to EU	1.8	7.5	2.3	7.2	9.2	5.6
China's Exports to Japan (% of China's exports)	6.9	6.9	6.9	6.9	6.9	6.9
Indirect Exports to Japan via China	0.1	0.5	0.1	0.3	0.5	0.2
Total Direct and Indirect Exports to Japan	3.2	8.8	4.0	3.3	3.7	6.2
Total Direct and Indirect Exports to G3	6.8	23.8	9.1	15.6	18.6	18.3
Direct Exports to Indonesia and Exports to China used for Domestic Demand		4.9	1.2	4.4	7.9	6.4

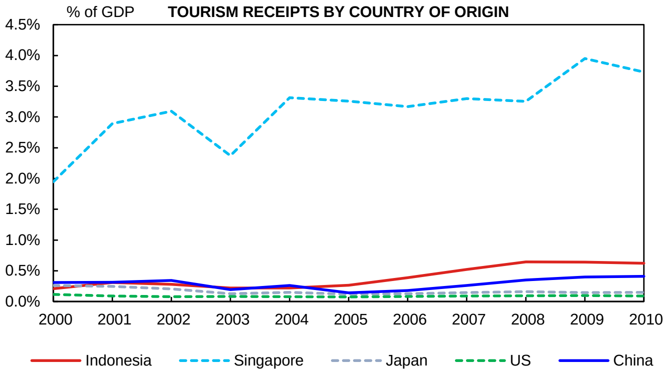
Note: Estimates are based on four quarters up to 2Q13. Source: RIETI, CEIC, Citi Research

However, these numbers may exaggerate Malaysia's vulnerability in merchandise trade to China and Indonesia. For one, Japan's Research Institute of Economy, Trade and Industry estimates that 80% of Malaysia's exports to China is really in intermediate products, likely predominately used to produce China's exports to the developed markets. **Once these indirect exports to the developed markets via China are taken that into account, our estimates suggest Malaysia's combined exposure to Indonesian and Chinese domestic demand is really only around 4.9% of GDP, vs 23.8% of GDP for the G3.**

A slowdown in China or Indonesia could also impact trade in services, such as tourism and transportation. Indonesia and China are somewhat significant tourist markets for Malaysia, with tourist receipts for these two around 1% of GDP as of 2012 compared to overall tourism receipts of 7.4% of GDP, though this could be offset by tourism from Singapore – Malaysia's largest tourist market at 3.7% of GDP – which will likely be helped by the rise in the SGDMYR cross rate. Meanwhile with China being Malaysia's largest export market, we estimate exports of

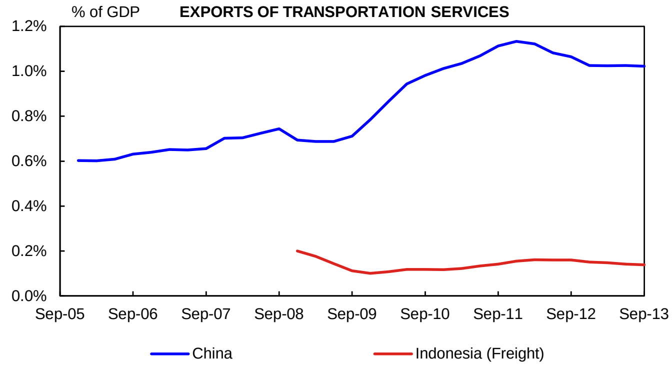
transportation services to China amount to about 1% of GDP while exports of freight transportation services to Indonesia are only about 0.1% of GDP.

Figure 47. Indonesia and China are somewhat significant tourist markets for Malaysia, but could be offset by Singapore



Note: Our estimates are on a 4-quarter rolling basis. Source: CEIC, Citi Research

Figure 48. We estimate exports of transportation services to China amount to about 1% of GDP



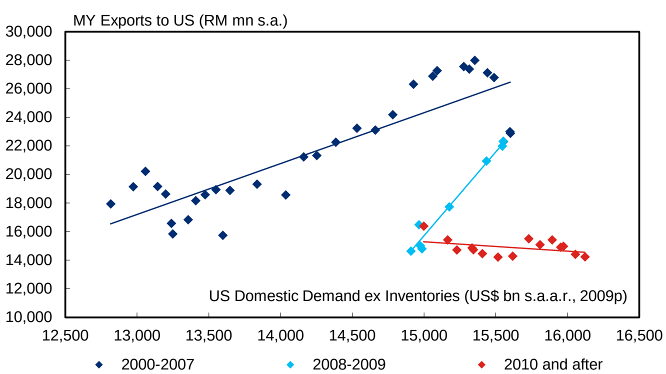
Note: Our estimates are on a 4-quarter rolling basis. Source: CEIC, Citi Research

…and More on a G3 Recovery

Positive income effects from a broadening G3 recovery could thus become increasingly important for exports and overall growth given the challenges on other fronts.

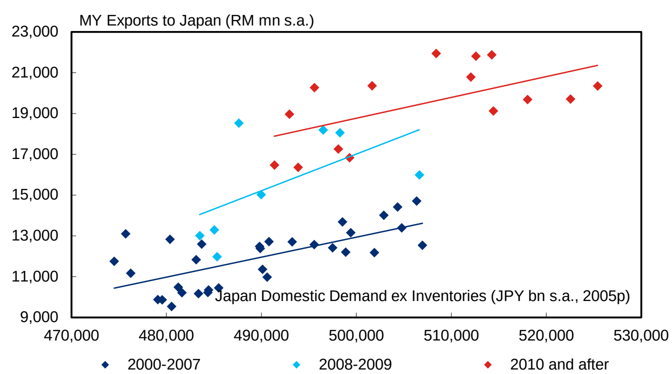
Concerns that a G3 recovery, even if it materializes, could have less pronounced growth spillovers on Malaysia's exports may be exaggerated. While a cursory examination suggests the linkage between domestic demand in the US and Malaysia's exports to the US has weakened after the Global Financial Crisis – the beta appears to have gone *negative* – it is hard to say the same for Japan and the EU. Exports to Japan appear to have undergone an upward shift relative to Japan's domestic demand while exports to the EU seem to have become more tightly linked to EU domestic demand.

Figure 49. The beta between Malaysia's exports to the US and US domestic demand appears to have gone negative



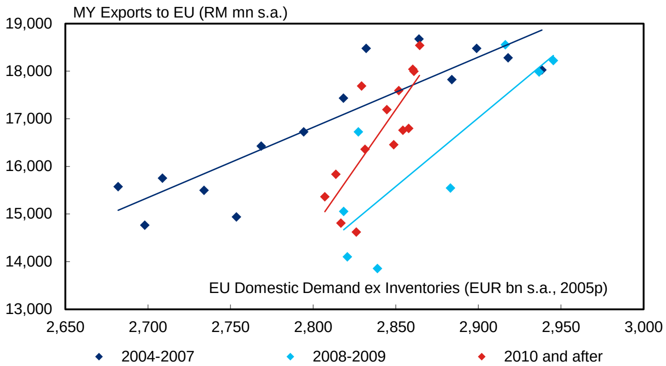
Source: CEIC, Citi Research

Figure 50. Exports to Japan appear to have undergone an upward shift relative to Japan's domestic demand



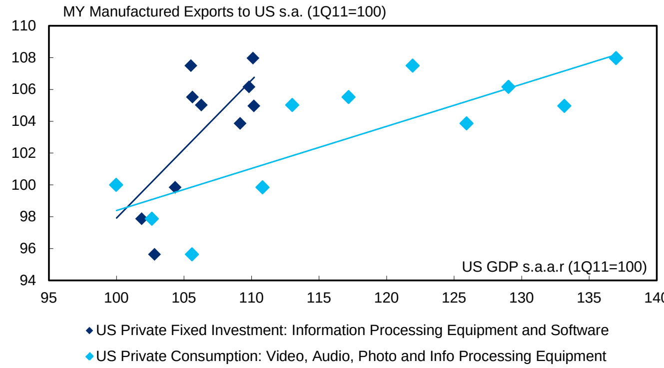
Source: CEIC, Citi Research

Figure 51. Exports to the EU seem to have become more tightly linked to EU domestic demand



Source: CEIC, Citi Research

Figure 52. Malaysia's manufactured exports to the US are more closely linked to US tech capex than consumer electronics demand



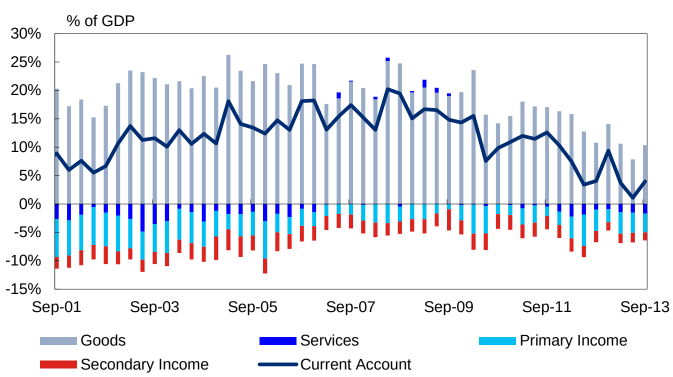
Note: We combine manufactured goods and machinery and transport equipment to obtain manufactured exports. Time period is 1Q11-3Q13
Source: CEIC, Citi Research

The negative beta between Malaysia's exports to the US and US domestic demand is likely to reverse as the US recovery broadens to encompass tech capex spending. Malaysia's manufactured exports to the US (a combination of manufactured goods and machinery and transport equipment) are more closely linked to US private investments in information processing equipment and software – no surprise as Malaysia's tech sector is more heavily geared towards the PC segment – but are less plugged into US demand for consumer electronics which has surged in the last three years[2].

Current Account Surplus Likely to Stabilize

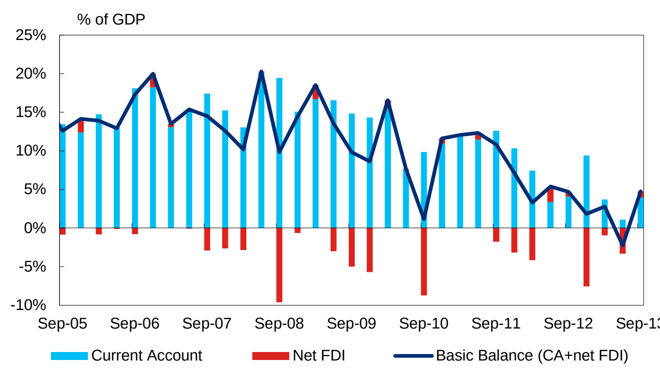
Given the drags to domestic demand and improving demand from G3, we expect the current account surplus to widen marginally to 4.4% of GDP next year from 3.7% this year, after stabilizing at 4% of GDP in 3Q13 (2Q: 1.1%).

Figure 53. The current account surplus rebounded in 3Q, led by the widening of the goods surplus...



Source: CEIC, Citi Research

Figure 54. ...which, with direct investments turning to net inflows, restored the basic balance to surplus



Source: CEIC, Citi Research

[2] A multivariate linear regression of the form:

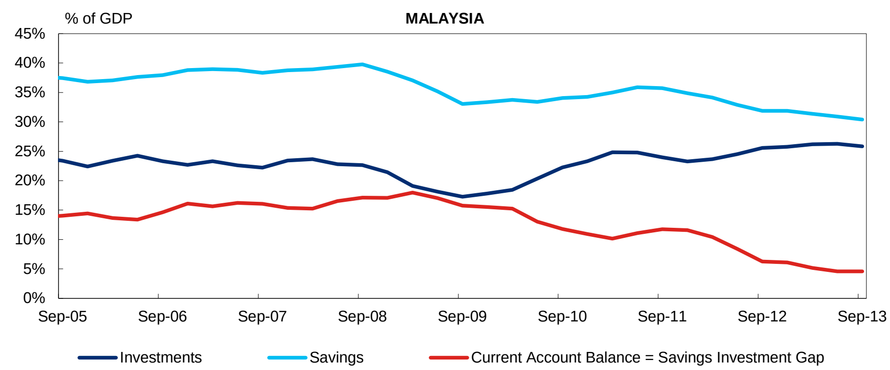
Malaysia's seasonally-adjusted manufactured exports to the US = α + β * US private investments in information processing equipment and software + γ * private consumption of video, audio, photo, and info processing equipment

yields a positive β coefficient and negative γ coefficient, i.e. a positive beta with tech capex and negative beta with tech consumption, using the time period 1Q06-3Q13

From a savings-investment (S-I) perspective, the current account widening will likely be supported by fiscal and macroprudential tightening gradually arresting the fall in public and private savings rates. As we have pointed out before (see ASEAN Macro View - Chartbook: Current Accounts – A Savings-Investment Perspective), the narrowing current account surplus since 2009 has been both a function of rising investments (since 2010) as well as falling savings, with the impact of latter likely larger than the former in the case of Malaysia. In the public sector, the falling S-I gap, reflected the 2009 economic stimulus packages, while ETP has also driven investments by public enterprises. The decline in the private sector S-I gap partly reflected lower private savings on falling commodity prices, aggravated by the debt-driven consumption binge.

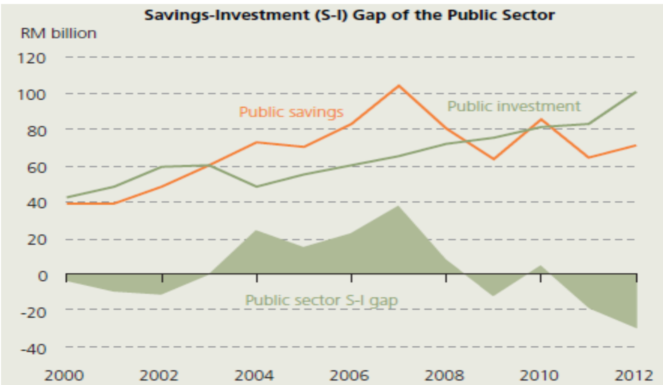
The lagged impact of earlier MYR weakening may also help net-exporting sectors in the very near term, though partly offset by domestic cost normalization. As we have elaborated previously (see Malaysia Macro View - Winners and Losers from MYR Weakness), many of the export sectors in manufacturing like E&E, petrochemicals and food/beverage should be significant beneficiaries of the weaker MYR. Even some services sectors with high export content – transport and storage, wholesale trade, and finance – should also benefit from the weaker MYR. Construction and real estate, being net importers, would be net losers. Overall, with sectors that are "net exporters" accounting for 84% of total value added, favourable competitiveness effects from the recent weakening of the MYR could have a modest lift to overall output, even if demand conditions do not change significantly.

Figure 55. The narrowing current account surplus since 2009 has been both a function of rising investments as well as falling savings, with the impact of latter likely larger than the former…



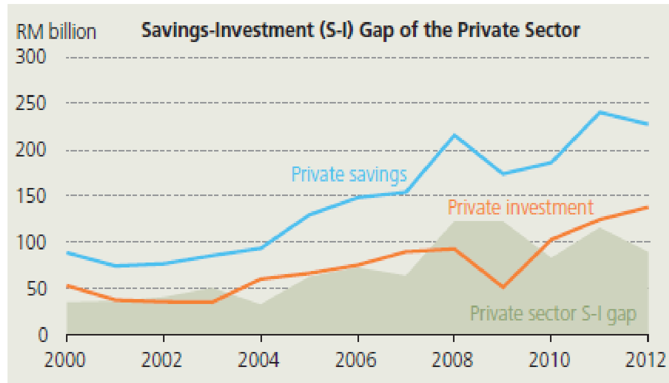
Note: We calculate the savings rate implied by investments and current account balances. Data is quarterly on a 4-quarter rolling sum basis.
Source: Source: CEIC, Citi Research Estimates

Figure 56. ...reflecting larger fiscal deficits in the public sector...



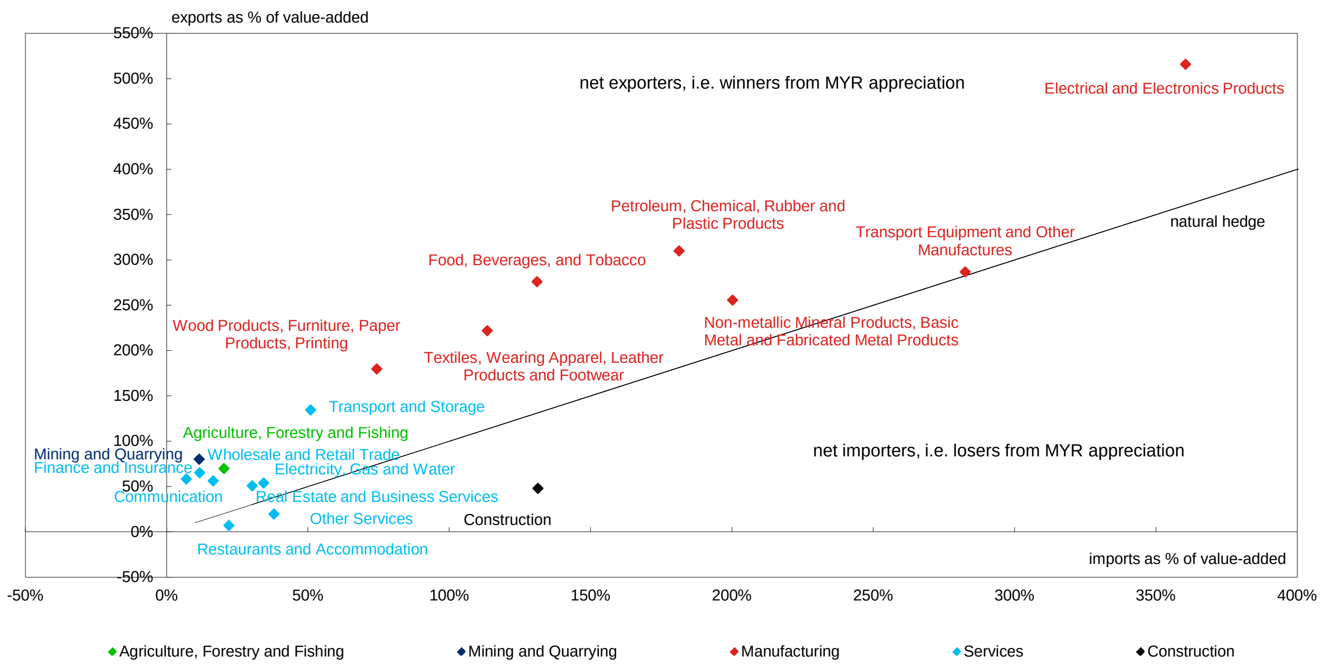
Source: Bank Negara Malaysia

Figure 57. ... and a tapering in private savings in recent years



Source: Bank Negara Malaysia

Figure 58. The lagged impact of earlier MYR weakening may also help net exporting sectors in the very near term

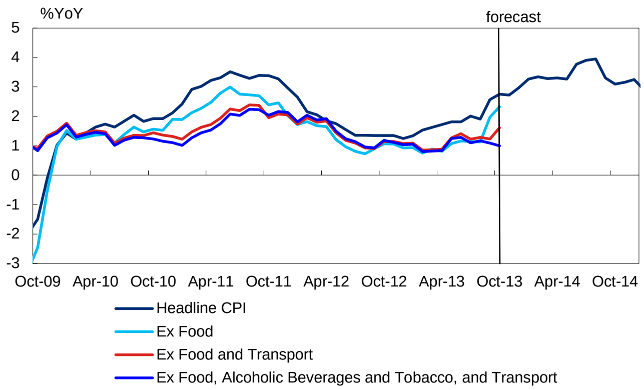


Source: Department of Statistics. Citi Research

“Steady” not “Strong” Growth Implies BNM in No Hurry to Hike Even if Inflation Breaches 3%

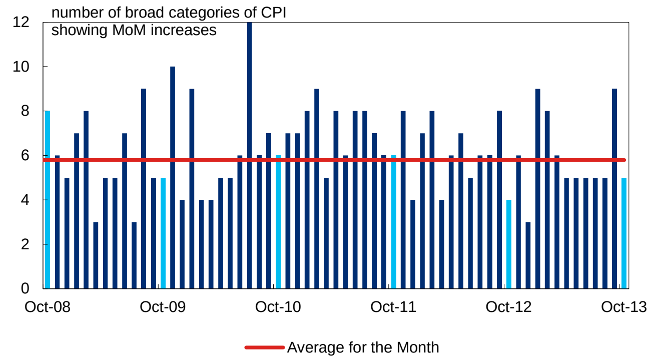
Despite a likely rise in headline inflation on subsidy cuts, we doubt BNM will be in a hurry to hike rates given few signs of demand-pull inflation pressure or second-round effects after the fuel price hike. While headline inflation continued to head up to 2.8%YoY in Oct after jumping to 2.6% in Sep on the fuel price hike, this appears to have been due to the 14% hike in the tobacco excise tax. Stripping out Food, Alcoholic Beverages and Tobacco, as well as Transport, inflation would in fact have continued falling to 1.1%YoY (Sep: 1.2%), corroborating BNM’s view of “moderate domestic demand pressures”. Meanwhile the breadth of inflation appears to be within or just below seasonal norms with 5 categories showing MoM increases (vs the seasonal average of 5.8), suggesting few second-round effects after the fuel price hike.

Figure 59. Stripping out Food, Alcoholic Beverages and Tobacco, as well as Transport, inflation would in fact have continued falling



Source: Department of Statistics, Haver, Citi Research

Figure 60. The breadth of inflation appears to be within or just below seasonal norms, suggesting few second round effects



Source: Department of Statistics, Haver, Citi Research

Going forward, our base case is for another 10sen/liter fuel price hike by year-end and for another 20sen/liter hike before 1st July 2014. As we had argued in our assessment of Budget 2014 (see Malaysia Macro View - Budget 2014: An Ambitious Austerity Agenda), we suspect policymakers will probably opt for gradual but somewhat more frequent and frontloaded hikes. **With the kick up from the tobacco excise hike, inflation may hit BNM's implicit tolerance threshold of 3% by year-end with a decisive breach coming in 1H14, especially if electricity tariffs are hiked in 1H14 as utilities analyst Petrina Chong expects** (see Malaysia Power Sector - 1H14 Outlook).

Nonetheless, recent comments from Gov Zeti suggest that BNM may be prepared to tolerate what it views as a "temporary" rise in inflation due to supply-side cost-push factors while the growth outlook remains uncertain. The MPC statement in early November had downplayed the inflationary impact of the fuel price hike and had in fact emphasized downward pressures on inflation – instead the MPC highlighted the moderation in domestic demand and uncertainties in the global environment (see Malaysia Macro Flash - BNM Stands Pat, Continues to Suggest No Hurry to Hike). The official 5-5.5% growth forecast also appears more an expectation of steady – rather than strong – growth, which continues to imply limited demand pull pressure, especially if capacity expansions from the investment drive have raised potential growth. BNM's studies have indicated that Malaysia's potential output growth has risen to 5.0-5.5%, from 4.5-5.0% in 2011.

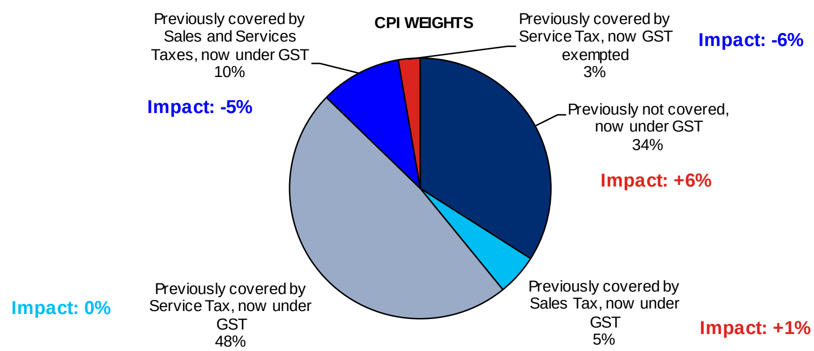
Apart from broader uncertainties in external demand and domestic demand, two other considerations may shape the outlook for monetary policy in 2014.

First, with household debt now in excess of 84% of GDP, BNM will likely be concerned over the debt servicing ratios of stretched households. As mentioned earlier, our estimates suggest that household debt is now up to about 84.3% of GDP as of 3Q13, with the bulk of the increase coming from mortgages and car loans, and we thus suspect mortgages and – more likely – car loans are probably next in line for tightening. With rates already normalized, BNM will likely tackle financial stability concerns with targeted macroprudential measures rather than rate hikes – especially as the former would largely stop only the flow of new borrowers, while the latter could hurt the stock of existing debtors by worsening debt-servicing ratios.

Second, the direct and second-round inflationary impact of 6% GST implementation in Apr 2015 has to be taken into account, especially when

interacting with further prospective fuel price hikes that year. As the GST will replace the current sales tax and services tax of 5-10%, the net inflation impact will likely fall short of 6%. The sales tax is levied on all goods sold or produced in Malaysia, with the exception of petroleum and exports, with a standard rate of 10% presently – for certain foodstuffs, timber, building materials, cigarettes and tobacco, and liquor and alcohol, a rate of 5% is imposed. Meanwhile the service tax is applicable to food and entertainment outlets, commercial and professional service providers, and many other services at a rate of 6%. At the same time, the list of GST-exempted goods and services includes categories both previously covered and not covered by the sales and services taxes. **While it is difficult to assess the precise inflationary impact of the GST given limited granularity in the CPI data, our estimates – using the CPI weights of affected goods and services and the overall impact of the GST after accounting for exemptions and the current coverage of the sales and services taxes – suggest that the initial MoM inflation impact could be around the range of 1-1.4%pt, not far off from official estimates of an addition of up to 1.8%pts to inflation in 2015.**

Figure 61. Our estimates using the CPI weights of affected goods and services suggest that the initial MoM inflation impact could be around the range of 1-1.4%pt.



Source: CEIC, Citi Research

Overall, while our base case anticipates that BNM may tolerate inflation at around 3.3% in 1Q14 before hiking 25bps in May and again in July in anticipation of inflation hitting 3.8-3.9% from Jun-Aug, rate hikes have likely become increasingly contingent over the growth outlook firming up, suggesting greater risk that hikes are delayed to 2H14 or beyond.

Key Economic Data and Forecasts

Figure 62. Malaysia - Key Economic Data and Forecasts

	2007	2008	2009	2010	2011	2012	2013E	2014F	2015F
Real Sector									
Real GDP (%YoY)	6.3	4.8	-1.5	7.4	5.1	5.6	4.5	5.0	4.9
Domestic Demand ex Inventory (%YoY)	9.9	6.6	0.3	7.7	7.9	10.6	7.3	5.8	4.7
Real Consumption: Private (%YoY)	10.4	8.7	0.6	6.9	6.8	7.7	7.4	6.5	4.7
Real Gross Fixed Capital Formation (%YoY)	10.4	2.4	-2.7	11.9	6.2	19.9	9.0	7.5	7.7
Consumer Prices (%YoY)	2.0	5.4	0.6	1.7	3.2	1.6	2.1	3.4	4.3
GDP (USD bn)	193.7	231.1	202.4	247.7	289.3	305.0	311.2	336.2	363.6
GDP Per Capita (USD)	7,123	8,393	7,255	8,664	9,987	10,398	10,407	11,022	11,730
Unemployment Rate (%)	3.2	3.3	3.7	3.2	3.1	3.0	2.9	2.9	2.9
External Sector									
Exports (%YoY, US$)	9.3	12.7	-21.1	26.9	14.9	-0.4	0.5	12.4	3.0
Imports (%YoY, US$)	12.1	6.7	-20.7	33.8	14.4	4.4	5.3	13.4	3.0
Trade Balance (US$ bn)	38.1	51.1	39.8	42.5	49.6	40.7	32.0	34.0	35.0
Current Account (% of GDP)	15.4	17.1	15.5	10.9	11.6	6.1	3.7	4.4	4.0
International Reserves ex. Gold (US$ bn)	101	92	97	106	134	140	137	135	140
USD-MYR (period average)	3.33	3.52	3.22	3.06	3.09	3.17	3.15	3.13	3.07
Other									
3-month KLIBOR fixing (%, average)	3.6	3.6	2.2	2.7	3.2	3.2	3.2	3.5	3.7
5-year MGS yield (%, average)	3.6	3.8	3.6	3.5	3.4	3.2	3.4	3.9	4.1
Fiscal balance (% of GDP)	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-4.2	-3.5	-3.0
Population (persons million)	27.2	27.5	27.9	28.6	29.0	29.3	29.9	30.5	31.0

Source: CEIC, Haver, Citi Research estimates

Figure 63. Interest and Foreign Exchange Rate Forecasts

		22-Nov	4Q13	1Q14	2Q14	3Q14	4Q14	In 3M	In 6M	In 12M
MY	Overnight Policy Rate	3.00	3.00	3.00	3.25	3.50	3.50	3.00	3.00	3.50
	3-Month Interbank Rate	3.21	3.21	3.20	3.45	3.70	3.70	3.20	3.36	3.70
	5-year MGS	3.63	3.60	3.70	3.80	3.90	4.00	3.67	3.76	3.96
	USD-MYR	3.22	3.10	3.12	3.14	3.14	3.14	3.11	3.13	3.14
US	Fed Fund Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
	10-Year Treasuries	2.78	2.56	2.70	2.95	3.15	3.25	NA	NA	NA

Source: Reuters, Citi Research estimates

Appendix A-1

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