Economic Beat
midf RESEARCH

10 October 2014

MALAYSIA

A rating upgrade is unlikely

Following the recent fuel price hike, Moody's Rating Agency commented the move is credit positive. That has led to rising expectation that an upgrade to our current sovereign rating at A3 is imminent, given that the agency had already upgraded its outlook from "stable" to "positive" last November. We expect that, unless there are more strong measures towards fiscal consolidation to be announced in the Budget 2015, there will be no change to our sovereign credit ratings and outlook in the next 1-2 years.

A notch up in rating is tougher than an upgrade in rating outlook. In its recent statement, Moody's said that expectations of fiscal consolidation and reform, and macroeconomic stability are factors that would be important for any upgrade in Malaysia's rating outlook. These factors already led the credit rating agency to change Malaysia's rating outlook to "positive" from "stable" last November, mainly driven by the government's decision to reduce subsidies on fuel and sugar in Budget 2014 as well as the adjustment in electricity tariffs. Moody's added that further reforms will be necessary if the government were to meet its goal of achieving a balanced budget by 2020 and that the next fiscal test for Malaysia would come when Budget 2015 is tabled today. That implies to get a notch up from the current "A3" for both long- term currency and foreign currency debt requires bigger steps in fiscal reforms.

S&P and Fitch have yet to upgrade their assessment. Standard & Poor's Rating Services (S&P) has a "A" and "A-" rating on long-term local and foreign currency debt, respectively, with "stable" outlook on Malaysia held since 2011. It recently stated is likely to be maintained for the next 12 months, highlighting that the country's fiscal position and government debt profile has constrained the sovereign rating of the country. Meanwhile, Fitch Rating maintained its "negative" outlook on Malaysia in its assessment last July, having lowered it from "stable" a year ago, with long-term local and foreign currency debt rating of "A" and "A-" respectively. Fitch pointed out that the public finance is still relatively weak and debt stock is higher than the median of 50% of GDP among the "A" rating peers.

A single 'A' rating is already high given the size of deficits and debt as a % of GDP. At "A3" (Moody's) and "A-" (S&P and Fitch), we are at the lowest rank of single "A" rating classified as "low credit risk". If the risk is perceived no longer to be that low, the rating will slip into "BBB" or moderate credit risk category. It is not as straightforward to compare us with the rating peers – two or more countries may have same rating by one agency but other agencies may put them in different categories. For example, we are grouped together with Mexico and Peru at "A3" by Moody's but they are perceived to be riskier by S&P and Fitch which rated them at "BBB+. At the same time, it is worth to compare Malaysia with other regional peers that are mostly rated in the "BBB" category but perhaps have better or improving fundamentals. A quick look at several rating peers as well as some regional neighbours showed that we are almost looking like Philippines (similar government debt stock and deficit size relative to GDP against moderate current account surplus) but Philippines is rated at the lowest investment grade.

Table 1: Malaysia's rating peers.

Rating agency	Moody's	S&P	Fitch
Long-term foreign currency rating	A3	A-	A-
Peers	Malaysia Mexico Malta Peru	Malaysia Latvia Ireland Lithuania Slovenia Poland Botswana Curacao	Malaysia Latvia Ireland Lithuania Poland

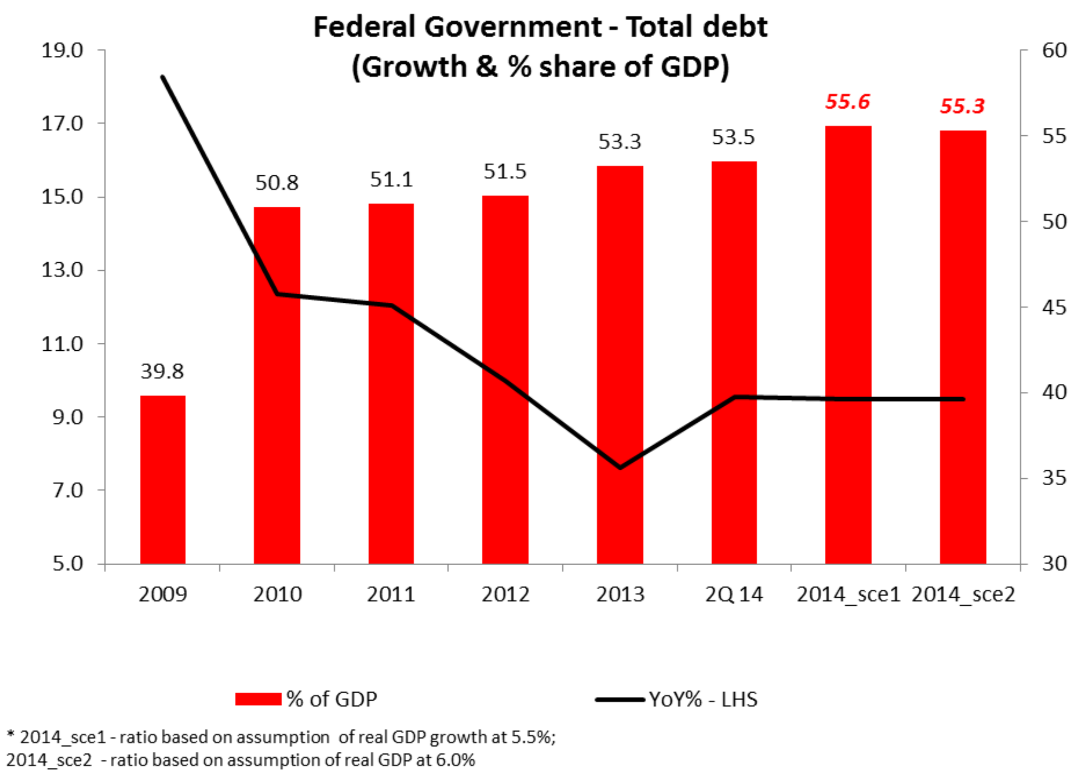
Table 2: A comparison against selected rating peers as well as regional peers (Data as at end-2013)

	Federal government's deficit (% of GDP)	Federal Government's debt stock (% of GDP)	Public sector's external debt stock (% of total debt)	Current account (% of GDP)	Rating on long-term foreign currency debt		
					Moody's	S & P	Fitch
Singapore	1.1	111.0	-	18.3	Aaa	AAA	AAA
South Korea	-0.9	43.8	23.9	6.7	Aa3	A+	AA-
China	-2.0	56.2	2.3	2.0	Aa3	AA-	A+
Malaysia	***-3.9***	***54.7***	***29.3***	***3.7***	***A3***	***A-***	***A-***
Peru	0.7	19.6	60.7	-4.5	A3	BBB+	BBB+
Mexico	-2.6	41.8	26.0	-2.1	A3	BBB+	BBB+
Thailand	-2.0	46.7	10.1	-0.7	Baa1	BBB+	BBB+
India	-4.5	66.0	7.2	-1.7	Baa3	BBB-	BBB-
Indonesia	-2.3	23.6	60.3	-3.3	Baa3	BB+	BBB-
Philippines	-1.4	53.3	24.9	3.5	Baa3	BBB	BBB-

Source: Official Statistics, Bank Negara, MIDFR estimates

Total government debt inched higher, may breach the 55% ceiling. Total debt grew faster by 9.5% YoY in the 2Q 14, after having trended downwards and reached 7.6% in 2013 and if this pace continues, our debt stock may breach the ceiling target of 55% of GDP even with a 6% real GDP growth (which translates to an estimated 8.3% nominal GDP growth using the same deflator as that for 2Q 14),. The ratio is not much different if we assume real GDP growth at 5.5%.

Chart 1: Federal government debt may surpass the 55% ratio-to-GDP ceiling target



Source: BNM, MIDFR estimates

Rising external debt is a concern as it raises government's external vulnerability position. External debt now accounts for 30.2% of total Federal Government debt. Most of the debt are foreign holdings of Ringgit-denominated debt amounting to RM151.6 billion or 90.5% of total external debt. If we were to include the debt of public enterprises which stood at RM82.4 billion at the end of 2Q 14, total external debt of the public sector is even bigger.

Chart 2: Federal Government's external debt inching higher

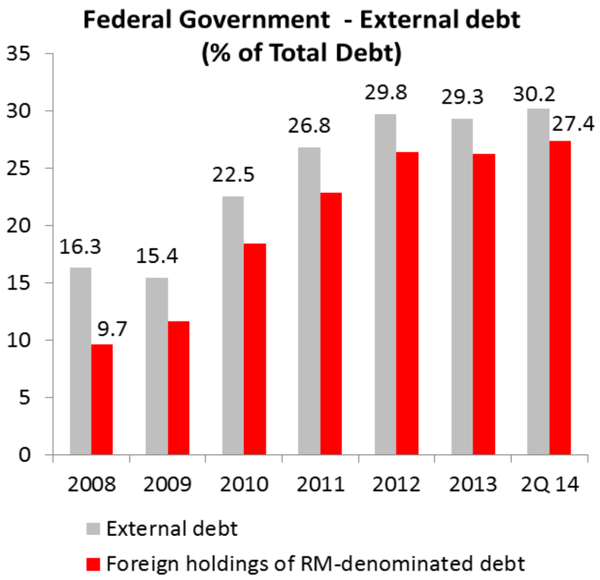
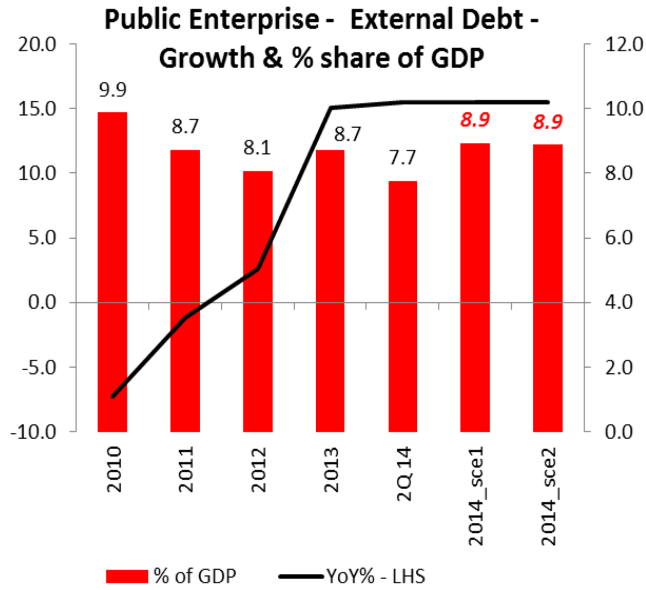


Chart 3: Total public external debt could be higher



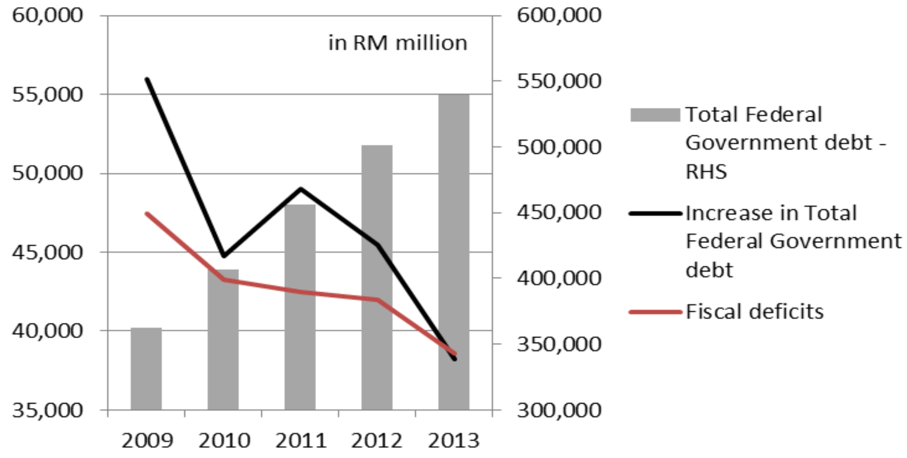
Source: BNM, MIDFR estimates

Fiscal consolidation is set to continue but at a very gradual pace. Thus far this year, fuel prices were hiked up by just 20sen, matching the hike last year, although percentage wise it is smaller at 9.5% against the 10.5% hike in the prices last year. That would only save the government some RM2-3 billion and there has yet to be a proper fuel subsidy rationalization plan. There may be some more upward adjustments in prices of controlled items or administered goods but the magnitude is unlikely to be as significant, indicating that fiscal consolidation is likely to be slow.

Accumulation of debt against likely gradual debt stock pare-down; needs much faster nominal GDP growth, Even if the government stick to its pledge of hitting 3.0% deficit-to-GDP ratio next year, as long as there is deficits, there will be new borrowings contributing to accumulation of debt. Looking at the historical trends whereby net new borrowings not much different from the fiscal deficits, we can expect that another 3% of GDP or worth of net new borrowings will be added to the debt stock, reflecting an increase of 6.5% YoY. As such, we need a much faster nominal GDP growth to keep the ratio below the 55% ceiling target.

Only significant or dramatic measures may change the rating agencies stance. When Moody's upgraded the outlook on Malaysia's sovereign credit rating on last November, it stated that "Significant consolidation of the government's fiscal deficits and the debt burden could trigger an upgrade." S&P commented last year after the release of Budget 2014 that Malaysia's slow fiscal consolidation stemmed from its relatively weak revenue structure and an inability to reduce high subsidies. Meanwhile, in a statement issued last July, Fitch warned that "Sustained heavy public sector deficits could increase the chances of the current account moving into deficit, which in turn could increase the possibility of disruptive volatility in portfolio capital flows." The vulnerability is compounded by the high household debt as well as public enterprise debt which are not captured in the Federal Government debt (hence, underestimating the true size of public sector's indebtedness).

Chart 4: With gradual fiscal consolidation, debt stock will continue to accumulate



Source: BNM, MIDFR estimates

Budget 2015 will continue to focus on well-being of Rakyat; stronger economic growth is expected to cushion all the painful adjustments. With most of the dramatic measures to cut spending, especially on subsidies and GST were mostly front-loaded in the last year's Budget announcement, there is little much left to convince the rating agencies of a stronger fiscal consolidation.

Appendix: The rating scales and description

Fitch	S&P	Moody's		Rating grade description (Moody's)
AAA	AAA	Aaa	Investment grade	Minimal credit risk
AA+	AA+	Aa1		Very low credit risk
AA	AA	Aa2		
AA-	AA-	Aa3		
A+	A+	A1		Low credit risk
A	A	A2		
A-	A-	A3		
BBB+	BBB+	Baa1		Moderate credit risk
BBB	BBB	Baa2		
BBB-	BBB-	Baa3		
BB+	BB+	Ba1	Speculative grade	Substantial credit risk
BB	BB	Ba2		
BB-	BB-	Ba3		
B+	B+	B1		High credit risk
B	B	B2		
B-	B-	B3		
CCC+	CCC+	Caa1		Very high credit risk
CCC	CCC	Caa2		
CCC-	CCC-	Caa3		
CC	CC	Ca		In or near default, with possibility of recovery
C	C			
DDD	SD	C		In default, with little chance of recovery
DD	D			
D				

MIDF RESEARCH is part of MIDF Amanah Investment Bank Berhad (23878-X).
(Bank Pelaburan)
(A Participating Organisation of Bursa Malaysia Securities Berhad)

DISCLOSURES AND DISCLAIMER