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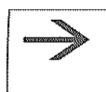
Ratings outlook a potential gamechanger?

Fitch's outlook revision based on 'the weakening public finances'



by MEOR AMRI MEOR AYOB

ON July 30, Fitch Ratings (Fitch) revised Malaysia's credit rating outlook to Negative from Stable while maintaining the long-term foreign and local currency issuer default ratings at A- and A. However, approximately two weeks later, another international credit rating agency, Moody's Investors Service (Moody's) reaffirmed the credit rating of Malaysia at A3 and maintained the outlook at Stable, a view which differed from that of Fitch.

According to Fitch, the outlook revision was based on "the weakening public finances as the prospects for budgetary reform and fiscal consolidation have worsened since the government's weak showing in the recent general election".

Malaysia's debt-to-gross domestic product (GDP) ratio has deteriorated from the pre-global financial crisis level of 39.8% in 2008 to 53.3% at the end of 2012. Malaysia has a self-imposed fiscal ceiling of a 55% debt-to-GDP ratio.

As swift and decisive actions were taken by the government to resuscitate the ailing economy, Malaysia has avoided the prolonged economic contraction experienced by some advanced economies. As a result, Malaysia's GDP achieved a stellar growth of 7.4% in 2010 from a contraction of 1.5% the preceding year.

Meanwhile, the Moody's reaffirmation of Malaysia's credit rating was based on its moderate economic resilience, supported by a highly-open, medium-sized economy and a diversified external sector. Additionally, the stable outlook was attributed to prospects for economic growth as well as to a formidable foreign exchange reserves buffer as demonstrated by its relatively strong external position. For instance, the external debt-to-GDP ratio has improved from 33% in 2009, at the peak of the global financial crisis, to 27% at the end of 2012; and the foreign exchange reserves-to-external debt ratio has increased from 1.42 times to 1.69 times during the same period.

Malaysia's foreign exchange reserves have gained further ground over the last five years (2008 to 2012) from RM317.5 bil to RM427.2 bil, an increase of approximately 34.6%. This is due to Malaysia's sustained current account surplus. Armed with a healthy foreign exchange reserves buffer, Malaysia has been shielded from the adverse effects of the capital flight of foreign funds from the region due to the US Federal Reserve's quantitative easing (QE) concerns, which rather severely affected Malaysia's neighbours. The Indian rupee has depreciated by a substantial 19.3% year-to-date (YTD) (as of Sept 6), while the Indonesian rupiah has depreciated 14.1% YTD (as of Sept 6) against the US dollar (USD). During the same period, the Malaysian ringgit has depreciated only 8.8%, from 3.0580 to 3.3285, against the US dollar.

In its latest release, Bank Negara Malaysia (BNM) announced that the foreign reserves of Malaysia currently stand at RM428.1 bil (equivalent to US$134.8 bil) as of Aug 30, which represents a slight increase on last year's balance of RM427.2 bil (equivalent to US$139.7 bil).

In terms of USD, the slight decrease of US$4.9 bil further proved that BNM has not exhausted its warchest in the face of foreign funds' withdrawal from Malaysia.

Since May, when the Fed first hinted to the market at its plan to taper the size of its QE programme, which stood at US$85 bil a month, the foreign holdings of Malaysian Government Securities (MGS) have gradually decreased to RM137.9 bil in June and to RM125.5 bil in July this year. The MGS foreign holdings for June and July amounted to approximately 46.8% and 41.4% of total outstanding MGS. Foreign holdings of MGS had reached their peak of around 48.3% in April this year. So far, the withdrawal of foreign funds has been in an orderly manner and has not caused massive shock to Malaysia's financial system, unlike during the Asian financial crisis in 1997. Market players are awaiting the August data to determine the extent and ramifications of Fitch's outlook downgrade on the level of foreign holdings in MGS. Ironically, instead of experiencing a yield increase from the day Fitch revised its outlook on Malaysia (i.e. a fall in the price of the MGS paper), the 10-year MGS yield has actually strengthened from 4.03% to 3.92% as of Sept 6.

To address the concerns of deteriorating public finances raised by Fitch, Prime Minister Datuk Seri Najib Razak has announced a RON95 petrol price hike of 20 sen to RM2.10 per litre, which took effect on Sept 3.

The government will re-evaluate and sequence some public sector projects that have high import components and give priority to projects with a low import content and high multiplier effects.

The move is aimed at preserving the current account balance, which has deteriorated to 6.1% (RM57.3 bil) of GDP as of end-2012 from 17.1% (RM131.4 bil) in 2008. In the second quarter of 2013, it further dwindled to RM2.6 bil. The petrol subsidy cut was hailed by analysts and economists alike.

Apart from the fiscal perspective, Malaysia still has room to manoeuvre in monetary policy. Should domestic economic conditions change abruptly for the worse, BNM has the ability to reduce its benchmark overnight policy rate (OPR) from the current 3%, the same move taken by Thailand's central bank in May this year.

Conversely, if foreign outflows become too drastic, to a point detrimental to the domestic economy, BNM has the option of raising the OPR to contain the outflows just as the Indonesian central bank has recently done. Therefore, with the OPR at 3% currently, the Malaysian benchmark interest rate is said to be at a sweet spot.

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	2008	2009	2010	2011	2012
External debt-to-GDP	31%	33%	28%	29%	27%
Foreign Reserves-to-external Debt (x)	1.34	1.42	1.45	1.64	1.69
Foreign reserves (RM mil)	317,468	331,301	328,670	423,358	427,231

	2008	2009	2010	2011	2012
Current account (RM mil)	131,414	110,727	87,183	102,426	57,348
Current account / GDP	17.1%	15.5%	10.9%	11.6%	6.1%