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Malaysia:
BNM Annual Report 2008- Making The Right Moves

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Malaysia | BNM Annual Report 2008: Making The Right Moves

In conjunction with the release of BNM Annual Report 2008, a Q and A session with Bank Negara provided keen insights on how the central bank is evaluating current economic conditions in Malaysia in the wake of the global economic crisis that is spreading havoc around the world. Many pertinent issues were raised and addressed, and as a result, participants had the opportunity to better understand government approach in dealing with the ferocious global financial tsunami that will bear heavily on Malaysian economic growth in the near term.

Growth projection : More "ifs … ."

The overall tone on growth prospects of the Malaysian economy from the BNM was more subdued than had been anticipated earlier with a possibility of a technical recession particularly in the first half of 2009. BNM's macro projection is in line with forecasts provided by Finance Minister Dato' Seri Najib Tun Razak during the introduction of the second stimulus package in the second week of March. To recap, growth is anticipated to be in the range of -1% and 1% in 2009 (2008: +4.6%) on account of a sharp deterioration in external trade that will reduce net exports coupled with moderating consumer spending that will drag down domestic demand. Our numbers are in line with the BNM's although we foeresee a slight downside risk to growth.

Table 1: GDP growth (%)

		MOF*	BNM	MARC
	2008	2009	2009	2009
GDP	**4.6**	**3.5**	**-1 to +1**	**-1.5**
Aggregate Demand	6.9	5.8	2.9	2.7
Private Expenditure	7.1	na	-0.3	-0.2
Consumption	8.4	4.9	3.5	2.8
Investment	1.5	1.9	-17.7	-14.0
Public Expenditure	6.5	na	11.4	10.1
Consumption	11.6	6.3	7.3	9.7
Investment	0.7	13.4	16.6	10.5
Exports	1.5	-1.5	-16.6	-10.6
Imports	2.2	0.3	-14.9	-10

Source: BNM & MOF

** as of November 2008*

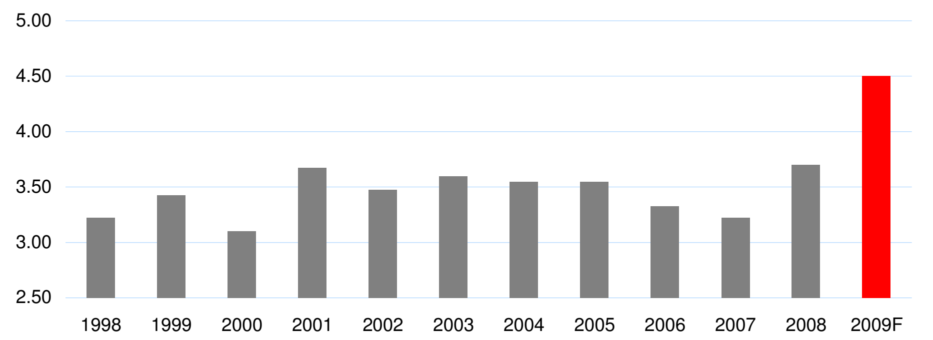
BNM made an important point that its growth forecast is based on the anticipation of weak global economic conditions which "will be partially offset by the implementation of policy measures to support domestic demand". Therefore, speedy implementation of both stimulus packages combined with meaningful improvement in global economic conditions are necessary to enable Malaysia achieve the projected growth rate. Should any of these factors not materialise, a possibility of having a bigger contraction in the economy cannot be ruled out.

Our base case GDP growth forecast of -1.5% assumes the likelihood that global trade as well as investment will take time to recover. Therefore, a strong net export contribution will be absent in the next few quarters, causing the overall growth to be slightly lower than government's projection. However, we believe domestic demand will somewhat be supported by measures introduced by the government in its stimulus packages.

We think the BNM's forecast of a deep 17.7% contraction in private investment for 2009 is realistic considering waning global demand compunded by acute credit crunch that will lead to massive cuts in business spending plans. In the past two downturns in 1998 and 2001, private investment fell by 55.2% and 15.7% respectively.

As for private consumption, while we do not foresee a collapse in spending, growth may not able to hold up above 3% as BNM projects as rising number of job losses will likely lead to an increase in unemployment to about 4.5% in 2009. In addition, the impact of last year's high inflation is still pushing consumers away from the High Street.

Chart 1 **Unemployment rate (%)**



Source: CEIC & MARC Economic Research

Hands off the exchange rate unless

No change on BNM stance on the Ringgit. The central bank reiterated that it will let market to determine the value of the currency and will not impose a band for the Ringgit to trade but cautioned on the importance of the Ringgit to move in an orderly manner to facilitate trade and investment. However, volatility of the Ringgit beyond an acceptable level may prompt BNM to take necessary measures.

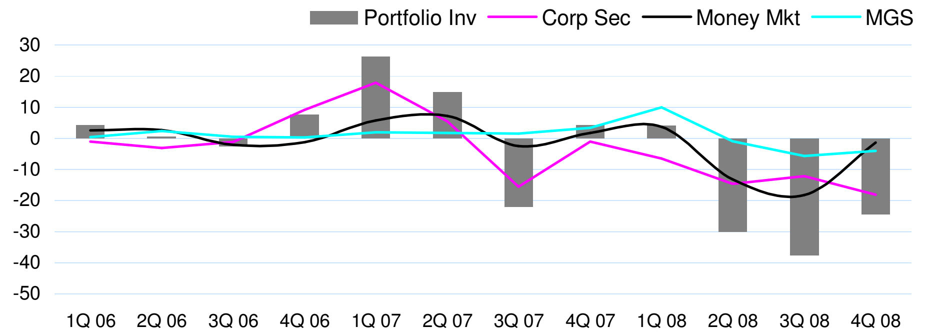
The statement convinces us that the Ringgit's sharp depreciation against the US dollar in recent months is not a major concern for the BNM. In fact, the authority pointed out that in terms of real effective exchange rate, the Ringgit barely depreciated by 1.5% in 2008.

Reading between the lines, we think the BNM is more optimistic about Ringgit performance in the medium term. The authority pointed out that the weakness of the Ringgit was largely due to the deleveraging process taking place amid rising risk aversion among international investors rather than weakness in Malaysia's economic fundamentals. Similarly, we foresee the Ringgit to slowly regain its strength against the USD as soon as a glimmer of hope for global economic recovery starts to emerge. We are of the opinion that the Ringgit will have more upward bias in the immediate term because of the following reasons:

- Strength of USD will start to wane as soon as inklings of positive developments in advanced countries begin to gather pace. These could include an increase upward momentum in housing starts, home sales and re-sales in the US and signs of economic bottoming in China.
- Sharp downward momentum in the Malaysian economy has been discounted by financial markets, leading to less capital outflows. Portfolio net outflows have slowed to RM24.4 billion in the 4Q2008, compared to RM37.6 billion in the preceding quarter.

As such, we are expecting the Ringgit to be in the range of RM3.50 and RM3.65 in the next six months.

Chart 2 **Net portfolio investment (RM Billion)**



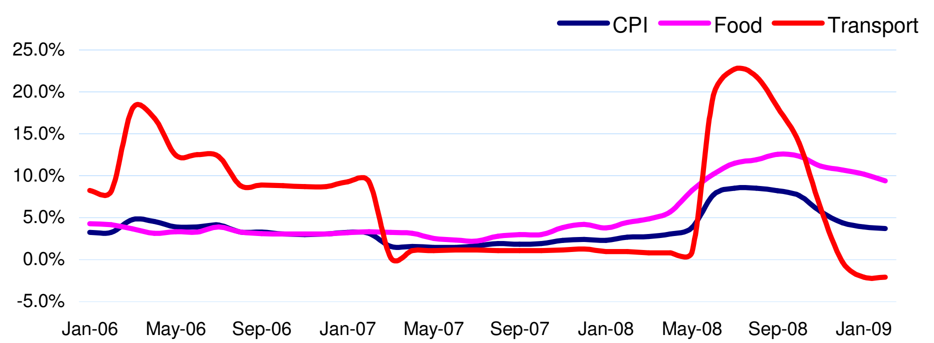
Source: CEIC

Inflation will soften largely on account of high base effect

BNM is projecting a moderation in headline inflation to between 1.5% and 2% in 2009 in view of the continued weakening in global energy and food prices leading to slowing global inflation. According to the BNM, as global commodity prices are expected to continue to decline in 2009, Malaysia's CPI is expected to grow at a much slower pace.

We agree with the overall assessment although we anticipate a slight rebound in commodity prices in 2009. This is in view of the downward overshooting in prices of both crude oil and crude palm oil. Notwithstanding this, we predict the CPI inflation to register an average growth of 1.2%, slightly lower than the government's forecast due to negative growth in the 2H2009, largely on account of high base effect.

Chart 3 **Consumer price index (CPI) Y-o-Y%**



Source: CEIC

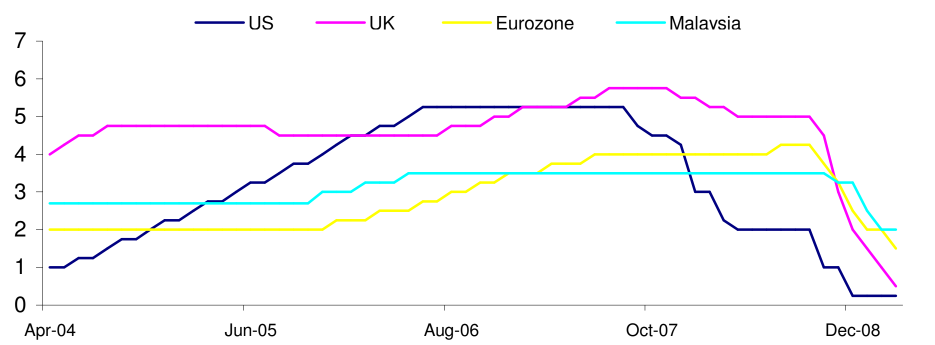
Monetary Policy: OK for now but will respond only in the worst case scenario

BNM views that a prolonged period of low interest rate may not be appropriate as it will hamper the effectiveness of monetary policy and could create a bubble economy as in the US. At the same time, there is a need to provide real positive returns to savers. More critical to the economy, according to BNM, are the availability of credit to businesses and individuals rather than the cost of credit.

We agree on that score as low interest rates will not necessarily lead to higher lending by banking institutions. This can be clearly seen from the experience in the world's largest economy – the United States – where zero interest rate has not prevented banks from hoarding cash amid rising risk aversion.

We think BNM will maintain its overnight policy rate (OPR) at the present level of 2% in the 1H2009 as it assesses the impact of previous rate cuts and government's stimulus packages on the economy. There is however less certainty in the direction of the OPR in the 2H2009: Should economic numbers turn out worse than expected by the end of the 1H2009, we foresee another rate cut by 25 to 50 basis points particularly if inflation starts to register negative growth in the period.

Chart 4 **Policy rates (%)**

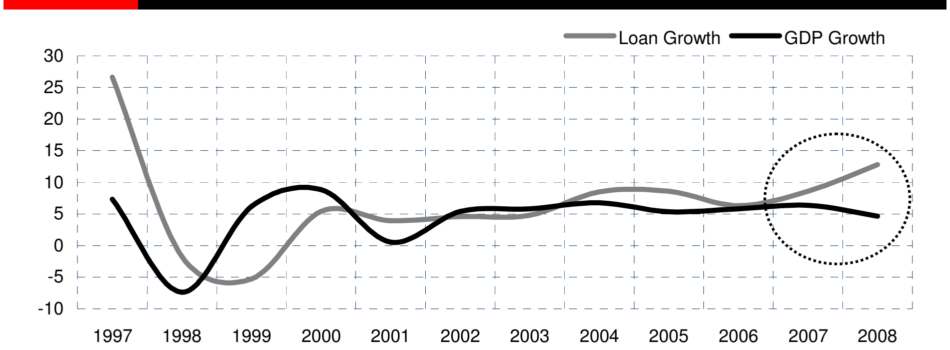


Source: Bloomberg

Plus point is the strength of banking sector but overstretched customers may push up NPL

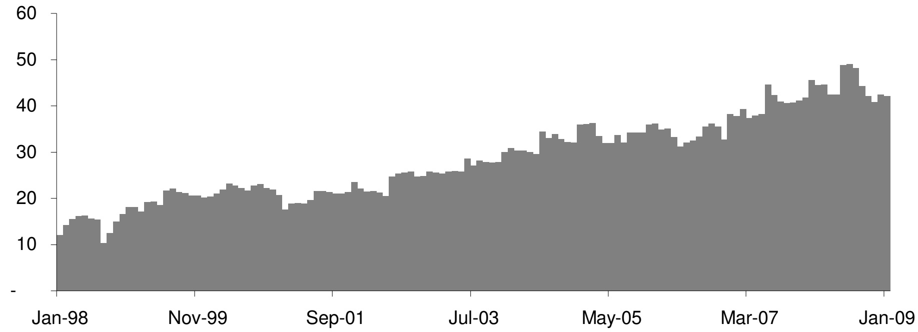
BNM highlighted the strength of the banking sector which has remained resilient despite the ongoing global financial turmoil. Last year's statistics were impressive but will not likely to be repeated in 2009. At the end of 2008, loan growth accelerated to 12.8% from 8.6% in the preceding year on account of broad-based expansion in household and business segments. Scrutinizing the numbers, we see household loan expansion came on the back of strong lending to residential properties and purchases of passenger cars.

Chart 5 **Rising loan growth amid sub par GDP growth**



Source: CEIC

Chart 6 **Capital in excess of 8% (RM Billion)**



Source: MARC Economic Research

For this year, we anticipate a minuscule expansion in loans, if there is any at all, due to the tightening of banks' lending criteria following widespread impact of global financial crisis. Therefore, BNM is giving more priority to the availability of credit rather than the cost of credit.

In this regard, Corporate Debt Restructuring Committee (CDRC), which was set up in 1997/98 crisis, will be reactivated to restructure corporate debts and preempt potential defaults. Apart from that, the setting up of Financial Guarantee Institution (FGI) to guarantee bonds would enable companies, particularly small-to-medium enterprises, to tap the bond market with significantly enhanced credit rating (FGI will be accorded a sovereign status).
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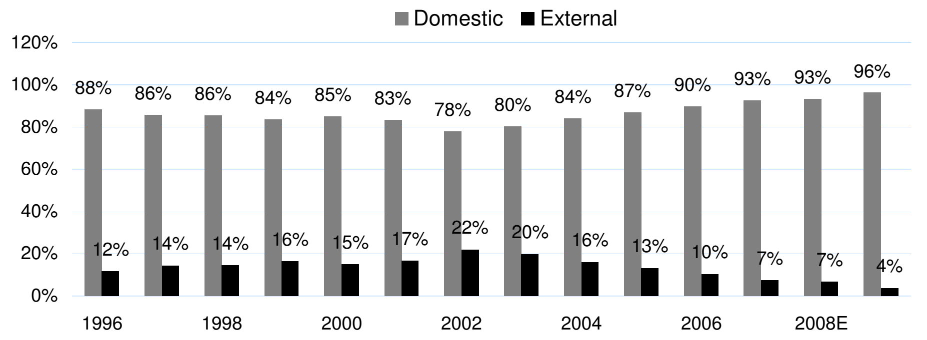
Household debt, although has been declining in the past two years, is still above 60% of GDP, a proportion that has raised some eyebrows among economists. We feel uneasy as consumers, in our view, are becoming more dependent on credit to finance their expenses. However, the BNM showed various statistics to convince that an establishment like the Credit Counseling and Debt Management (AKPK), which was set up in 2006, has been highly successful in assisting consumers to sort of their financial positions. For instance, in 2008, the number of financial counseling handled by AKPK rose from 17,706 to 29,489 while debt management program climbed from 7,614 cases to 11,958 cases. Debt restructuring or rescheduling is critical as it alleviates consumers' burden and subsequently improve disposable income.

Sovereign rating: Do we need to bother?

The million dollar question was raised whether BNM is concerned about possible rating actions (downgrade) by international credit rating agencies (CRA). This is in view of the fact that Fitch has downgraded Malaysia's local currency outlook to negative from stable in February this year. The answer from BNM was an emphatic no, because of disappointment with the actions of the big three during the Asian Financial Crisis a decade ago. During that time, Malaysia's sovereign rating was downgraded a few notches without accurately judging the country's fundamentals. Nevertheless, with the help of BNM, after a series of road shows, Malaysian government managed to convince international investors about the underlying strength of the economy and consequently was able to raise USD1 billion worth of dollar denominated sovereign bonds in 1999.

Similarly, the current situation does not call for a downgrade in our sovereign rating. Firstly, a big chunk of the government debt (>90% of total debt) is domestically funded. Secondly, the government has been actively paring down its debt, resulting in a record low of 41% of GDP. Given this, the government has the capacity to gear up its balance sheet in order to support the economy in the current adverse economic climate.

Chart 7 | **Sources of government debt**



Source: CEIC & MARC Economic Research