Economic Research

KDN No.: PP14787/11/2010(026023)

MALAYSIAN RATING CORPORATION BERHAD
(364803 V)

Vol.: ER/006/2010

BNM Annual Report 2009: Being ahead of the curve

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In a nutshell

- The growth outlook was upgraded, with gross domestic product (GDP) expected to expand between 4.5% and 5.5% in 2010, which is in line with our forecast of a 5.2% expansion. The economy is expected to benefit from stronger domestic activities and a recovery in external demand. Private consumption is anticipated to chalk up a respectable growth of 3.8%, but on the investment side, major support will come from the public sector, as private investment is anticipated to remain lacklustre.

- On the supply side, the manufacturing sector is expected to turn around and register a positive growth of 6.5%, following brisk domestic activities and a rebound in global demand for exports. The services sector will remain resilient, with growth projected to achieve 4.9% this year, buoyed by domestic consumption and trade-related activities. The construction sector is anticipated to grow by 3.7% on the back of implementation of stimulus measures, while the agriculture and mining sectors are expected to expand by 3.1% and 2.5% respectively.

- Inflation is not expected to be an issue in 2010 due to resource slack in the economy, as evidenced by low capacity utilisation of between 70% and 80%. Bank Negara Malaysia (BNM) foresees the inflation to be in the range of 2.0% and 2.5%. However, the central bank acknowledged that an increase in prices of certain administered goods may lead to a moderate rise in the consumer price index (CPI).

- The issue of capital outflow is not an immediate concern, as the BNM explained that such outflows are largely related to direct investments abroad. Malaysian companies are said to have taken advantage of the opportunities available in other countries to strengthen their business positions and balance sheets. Portfolio outflows, however, will be closely monitored by the central bank.

- The greater vigour with which the banks pursued the household sector is illustrated by the fact that household-sector loans accounted for a steep 68% of all loans granted in 2009 compared to 40% of loans granted in 2008 and 49% of loans granted in 2007. As long as the banks manage their risk, this development is not likely to be a near-term concern. However, that does not mean all is well. In fact, over the medium to long term, the increased orientation of banks' balance sheets towards the household sector may become a cause for concern for both the banking sector and the economy.

- Policy-rate normalisation will continue, following an assessment of a firm recovery of the economy. The level of the overnight policy rate (OPR) is guided by the estimated neutral rate which will be determined by, amongst others, the output gap, sources of inflation, and inflation expectations. With our estimated neutral rate of 3.5%, we envisage the OPR to end the year at 2.75% as the BNM balances the desire to prevent financial imbalances and the need to support economic growth.

- The ringgit exchange rate is expected to remain favourable in light of economic improvement in 2010. The anticipation of further increases in the OPR as the BNM embarks on interest-rate normalisation will be a major boost for the ringgit in the immediate term. The direction of the ringgit will also hinge on the financial market's reaction to the impending announcement of the New Economic Model by the Prime Minister on March 30.

Growth prospects: 2010 looks good so far

As expected, the BNM gave a more optimistic outlook for the economy in 2010, following more stable macro developments in the advanced countries as well as a turnaround in the emerging economies. Echoing the optimistic view of the government, the BNM also anticipates stronger GDP growth of between 4.5% and 5.5% in 2010, which is higher than the Ministry of Finance's (MOF) forecast of 2% to 3% during Budget 2010. The more-upbeat outlook is based on expectations of a firmer domestic demand which is expected to expand by 3.2% in view of stronger growth in private consumption as well as a recovery in the external sector following a rebound in global demand, particularly for semiconductors.

Table 1: Demand side

Growth	2007	2008	2009	MARC 2010F	BNM 2010F
GDP	6.2%	4.6%	-1.7%	5.2%	4.5% to 5.5%
Domestic demand	9.6%	6.8%	-0.4%	3.3%	3.2%
Consumption expenditure	9.6%	9.0%	1.4%	3.4%	2.4%
Private consumption	10.4%	8.5%	0.8%	3.8%	3.8%
Public consumption	6.5%	10.9%	3.7%	2.0%	-2.7%
Investment	9.6%	0.8%	-5.5%	2.9%	5.5%
Private investment	11.8%	0.8%	-18.5%	-1.2%	0.7%
Public investment	7.1%	0.7%	9.2%	6.2%	9.3%
Exports	4.5%	1.3%	-10.1%	9.5%	7.7%
Imports	6.0%	1.9%	-12.5%	11.5%	11.7%

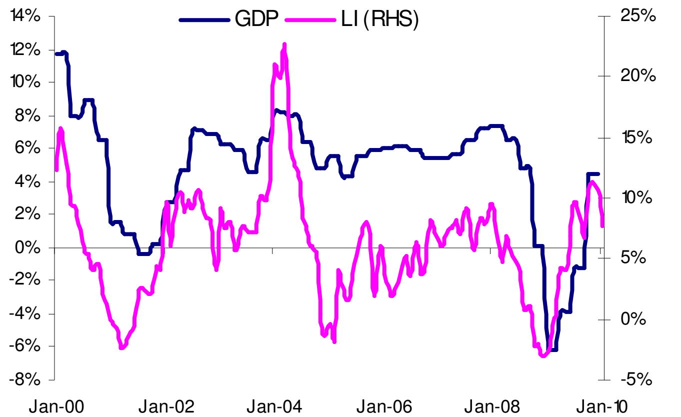
Sources: BNM & MARC Economic Research

Although private investment is expected to expand at a minuscule pace of 0.7%, public investment is anticipated to act as a buffer, leading to an overall expansion in investments by 5.5%. On the supply side, a U-turn in the growth of the manufacturing sector is expected to happen following a sharp improvement in the export sector. The services sector, which contributes significantly to economic growth, is anticipated to remain resilient, expanding by 4.9%, after posting a 2.6% growth in 2009.

Our view

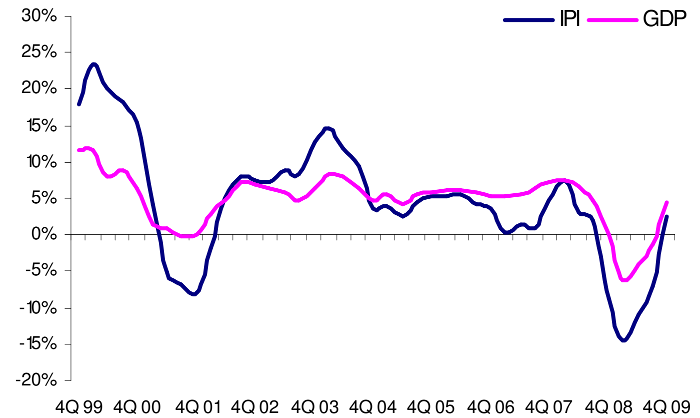
We concur with the BNM's view on the overall growth prospects of the Malaysian economy, which has since become more upbeat following continued improvement in the country's external trade performance, as well as the positive impact of the stimulus measures. Judging by several leading indicators that are used to gauge the strength of the economy (e.g. the Leading Index, the Industrial Production Index, the Consumer and Business Sentiment and Condition Indices), we feel that the growth in the first half of 2010 will surprise on the upside due to (1) the low base in the preceding year, as GDP contracted by 6.2% in 1Q2009; (2) stronger-than-expected growth in investment due to a pickup in public investment; and (3) more robust external trade performance following higher demand from emerging economies like China and India. We maintain our GDP growth forecast for 2010 at 5.2%.

Chart 1: GDP and the Leading Index (LI)



Sources: CEIC & MARC Economic Research

Chart 2: GDP and IPI



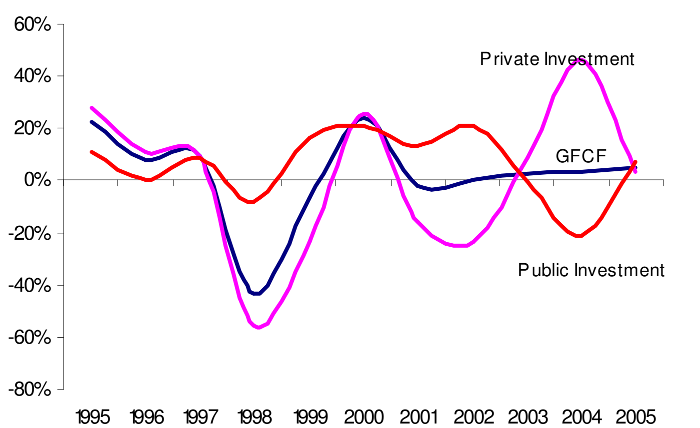
Sources: CEIC & MARC Economic Research

However, there are 'buts'…

While we opine that the BNM's growth forecast is within reach in 2010, we feel that consumer spending will have to strengthen further in order to achieve a sustained growth in the following year. For instance, in 4Q2009, the contribution from private consumption was only 0.9 percentage points, less than a quarter of the overall 4.5% growth recorded. From experience, we think the ratio should increase to at least half of growth, just as it did in past recovery cycles.

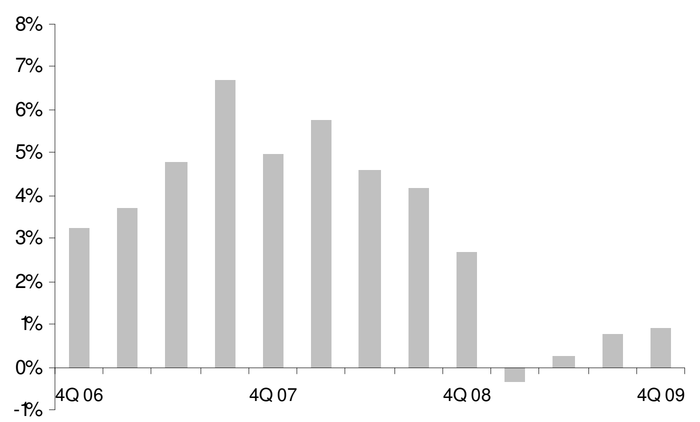
Notwithstanding this, public investment will likely provide a boost, judging by the turnaround in 4Q2009. Although private investment probably remained lacklustre in the final quarter of 2009, total investment expanded by a respectable rate of 8.2%, suggesting that the positive effect of public investment is slowly trickling into the economy at large. As for 2010, we concur with the BNM's view that public investment will be an important growth driver for total investment, as a certain degree of risk aversion persists among private investors. However, we feel that it is somewhat challenging to achieve a positive growth in private investment as projected by the BNM, judging by the impact of the global crisis on investors last year. Our argument for weaker private investment compared to the BNM's estimate is also based on the assumption that the dynamics of the current recovery is similar to the periods following the past two recessions where private investment continued to contract in the year immediately following a crisis or a slowdown.

Chart 3: Investment growth (1995-2005)



Sources: CEIC & MARC Economic Research

Chart 4: Private consumption's contribution to GDP

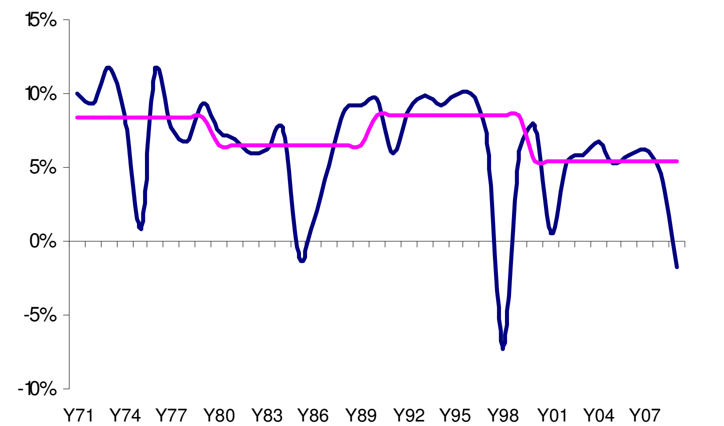


Sources: CEIC & MARC Economic Research

….and the challenge is to improve the long-term growth trajectory

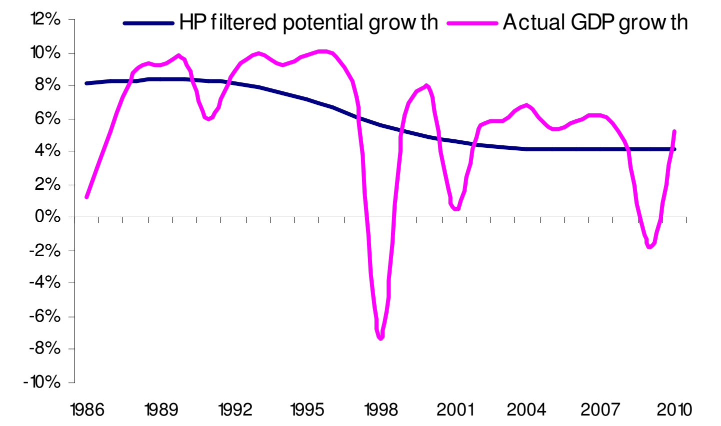
The real issue, however, is not about achieving the growth target for 2010. Rather, the long-term growth trajectory is the real challenge as policies are needed to revitalise investments in an effort to sustain respectable growth rates to enable the country to achieve the objective of becoming a high-income country (defined as having per-capita income of at least US$15,000 per annum). Our rationale for being concerned about the prospects of long-term growth is based on Malaysia's experience of recording slower average growth of 5.4% from 2000 to 2008 despite registering a robust average growth of 7.0% in the two years following the 1998 recession. This happened because of a rapid decline in investment, particularly private investment.

Chart 5: Average growth (1970s, 1980s, 1990s, 2000s)



Sources: CEIC & MARC Economic Research

Chart 6: Long-term growth trajectory



Sources: CEIC & MARC Economic Research

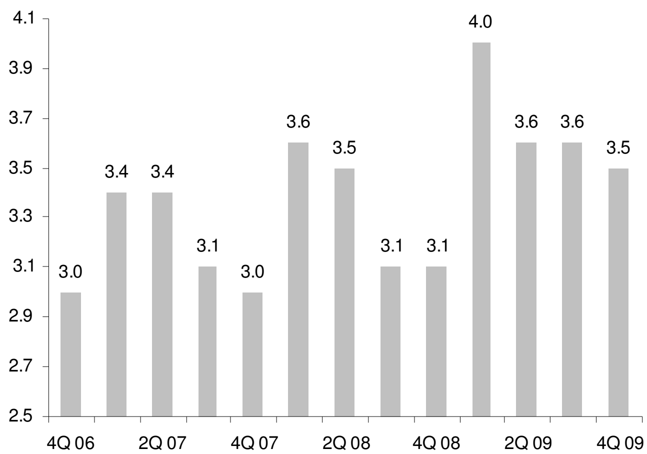
We are aware that this issue will be addressed by the Prime Minister during the impending announcement of the New Economic Model on March 30. While the details of the proposed model are sketchy at present, we feel that the challenge would be the effort to uplift the income of civil servants whose compensation has to eventually be aligned with their productivity. While we acknowledge the fact that productivity in the public sector may continue to improve with the aggressive push towards adopting knowledge-based and value-added activities, we are curious as to how quickly the reward system will be synchronised with these changes. If a holistic approach is not adopted, a new phenomenon may emerge where income levels of this group lag their productivity.

Inflation will remain low but…

The BNM foresees inflation rate to be in the region of 2.0% and 2.5% in 2010, which is in line with our forecast of 2.4%. Although consumer prices will likely rise this year, following a rapid decline in 2H2009, we believe that it will largely be driven by the cost factor. While we have seen a turnaround in wages, we do not feel that it will lead to a spending spree, as this is a part of the normalisation process of the labour market. Thus far, the nominal-wage increase is evident in the manufacturing sector, with the latest print showing a 12.5% gain in January 2010 compared with an 11.5% decline in January 2009.

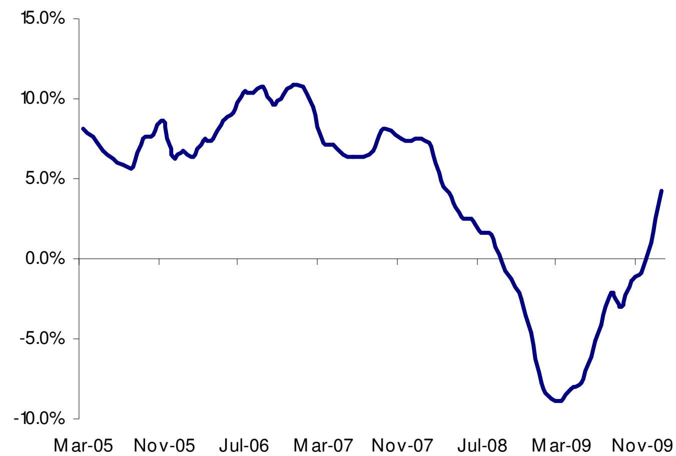
Notwithstanding this, the impact of high prices will be felt by people in the street who are bracing for further upward adjustments in prices of certain goods and services, such as petrol and electricity. With regards to petrol, although the government has announced that the two-tiered fuel subsidy plan, initially scheduled for implementation in May this year, has been put on hold, other means of reducing the subsidy may eventually be imposed as the government is determined to trim the country's budget deficit level to 5.6% of GDP this year. In our opinion, this would include resorting to the "old-fashioned" way of gradually hiking up petrol prices on a staggered basis, which is more practical in terms of implementation. Besides that, an electricity tariff adjustment may also take place as the volatility in prices of gas put pressure on the government to reduce the subsidy through an increase in the electricity tariff. Although there are no firm decisions on this, we are of the view that a persistent rise in commodity prices may lead to an adjustment in the electricity tariff.

Chart 7: Unemployment rate (%)



Source: CEIC

Chart 8: Wages & salaries (3MMA Y-o-Y%)



Sources: CEIC & MARC Economic Research

Capital outflow is not an issue at this juncture

When asked by an economist on the outflows of capital, the BNM stated that the current scenario cannot be termed as "capital flight", as the phrase also implies a loss of confidence in the country's macroeconomic conditions. The outflows of capital, according to the BNM, were attributed more to the direct investments abroad by Malaysian companies which have been taking place in the past few years. In 2009, direct investments abroad remained sizeable at RM30.5 billion, compared with RM50.2 billion in 2008.

We had already pointed this out in one of our publications in the past month. Nonetheless, we understand that the concern is about the amount of outflows categorised as "other investments". A clearer picture of what these investments are will enable us to get a feel of the scale of the phenomenon. Nevertheless, we still hold the view that the currency market is the best indicator of the degree of outflows from Malaysian shores. As indications that the ringgit is under downward pressure are currently lacking, we feel that there is no real concern at this juncture.

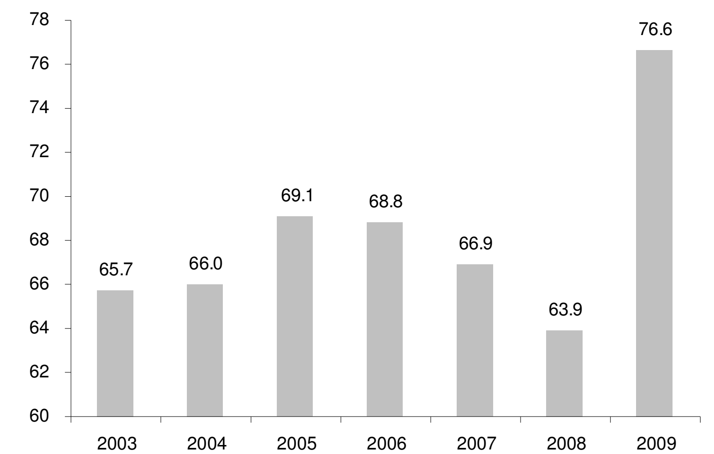
Are there immediate concerns about household debt?

The relative resilience of the Malaysian banking sector and its future prospects undoubtedly hinge on the household sector, which accounted for 55% of banking-sector loans at end-2009. The reorientation of banks' balance sheets towards the household sector, which began in the aftermath of the Asian crisis when household-sector loans were a low 16% of total loans in 1998, resulted in a gradual increase in lending towards the household sector. With business activities and economic confidence remaining low in 2009, the banking sector turned towards the household sector for both growth and revenue. This resulted in household-sector loans growing at a higher rate of 9.9% in 2009, compared with the growth rate of 7.5% for non-household-sector loans. The greater vigour with which the banks pursued the household sector is perhaps better illustrated by the fact that household-sector loans accounted for a steep 68% of all loans granted in 2009 compared with 40% of loans granted in 2008 and 49% of loans granted in 2007.

As long as the banks manage their risk, this development is not likely to be a near-term concern. However, that does not mean all is well. In fact, we believe that over the medium to long term, the increased orientation of banks' balance sheets towards the household sector may become a cause for concern for both the banking sector and the economy.

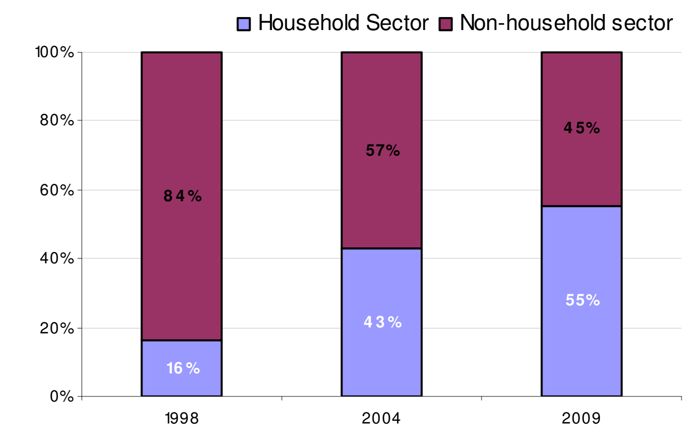
A significant and perhaps to an extent overlooked development is the greater vigour with which banks have been engaging in unsecured lending. Although still small in an absolute sense, the mostly unsecured personal loans grew at a much higher 21.9% in 2009. Furthermore, personal loans and credit cards collectively accounted for 14.9% of household-sector loans in 2009, up from 14.3% in 2008 and 13.0% in 2006. While the household sector has shown a greater appetite to borrow as a result of increased urbanisation, conspicuous consumption and greater psychological willingness to accumulate debt, the banks have in return reciprocated with the supply of credit, and at times even created the demand through marketing strategies. What is most significant is that the increase in household-sector lending took place in a very challenging operating environment for households, which was characterised by large-scale retrenchments, rising individual bankruptcies and higher unemployment.

Chart 9: Household debt-to-GDP ratio (%)



Source: BNM Annual Reports

Chart 10: Loan book composition



Sources: BNM & MARC

Against this backdrop, we maintain a cautious stance on the increasing household-sector exposures. As encouraging as the macroeconomic level data presented by the BNM on the household sector may be, we still believe that there may be possible underestimation of household-sector debt in the economy and overestimation of the household sector's underlying debt-servicing ability.

The precise extent to which household-sector debt may be underestimated is rather hard to gauge due to the lack of supporting data. However, sources outside the banking sector, which are typically not captured in aggregate-level statistics, are a key area of potential underestimation. These potential sources include cooperative societies, merchants offering easy-payment schemes, loans and salary advances directly provided by private-sector employers to their employees, and registered money lenders, not forgetting the numerous illegal money lenders.

That aside, there is also a possible overestimation of household-sector debt-repayment ability. Some of the possible factors that may contribute towards overestimation of the household sector's debt-repayment ability include:

- Significant income inequality and resulting concentration in asset ownership. In fact, the macroeconomic-level household-sector financial assets are a less accurate indicator due to greater variation in financial-asset ownership among the population as a result of income inequalities. However, considering the nature of the household sector's borrowings, the same is not true for household-sector debt, which is likely to be more evenly distributed among the population.

- The vulnerability of the household sector to adverse wealth and income shocks as a result of increased proportion of market-related financial assets. For instance, in 2008, the household sector's financial-asset holdings declined by 4.4%, while its debt holdings increased by 9.9%. Although household-sector financial assets have since rebounded by 14.9% in 2009, these assets remain susceptible to adverse market movements.

- Structural adjustments done during 2008 and 2009 by the authorities to improve the debt-servicing ability of the household sector. These structural changes included the reduction in employee contributions to the Employees Provident Fund by 3%, the reduction in personal income tax by 1% at the lower- and higher-income bands and RM10,000 tax relief for housing-loan interest payments. Even after these adjustments, the BNM has reported that the household sector debt-to-personal-income ratio has increased to 136% in 2009 from 115% in 2008.

- Anecdotal evidence suggests that bankers and even bank regulators are focusing more on the underlying collateral, especially for housing and auto loans. As a result, the actual debt-servicing ability of the household sector, as reflected by its disposable income, has taken a backseat to some extent.

- The recent increases in household-sector loans were also supported by an extremely low-interest-rate environment. Therefore, as and when interest rates normalise, the repayment ability of the household sector is likely to come under some stress.

Considering the rather rapid rate at which household-sector debt is increasing (averaging 9.3% over the last four years) and the underlying sources of such increases, we opine that there may be some medium- to long-term impact on the economy.

First, consumption-oriented personal loans do not necessarily add to productive capacity of the country or economic growth. Thus, the diversion of financial resources towards less-productive activities may not be in the best interest of Malaysia's aspiration of becoming a high-income nation.

Second, while collateral may be available for mortgages and auto loans, in a system-wide crisis when confidence and prices are rapidly depressed, the eventual recoverability through such collateral remains highly questionable.

Third, with an already-widening fiscal deficit, the government's ability to hold up the household sector *en masse* in the event of a crisis is likely to be rather constrained.

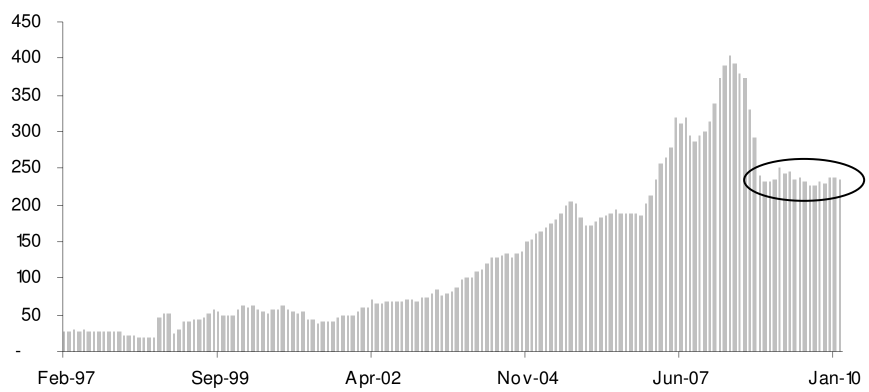
Finally, from the perspective of the banks, they may in fact be boxing themselves further into a narrow consumer-banking space, as result of which their performance and prospects may become even more correlated with the household sector. Although at the bank level risks may be diversified, at a systemic level the expanding household-sector exposure may well sow the seeds for the next crisis.

Monetary policy: What is the neutral rate?

During the briefing, questions on the level of the neutral rate and normalisation of monetary policy were raised and subsequently addressed by the BNM. According to the BNM, the all-time low level of the interest rate may result in financial imbalances which can include financial disintermediation, mispricing of risk, and formation of asset bubbles. On the back of a firmly established economic recovery, the BNM is compelled to normalise its policy rate based on the estimated "neutral rate", a rate which is defined as a dividing mark between one that is considered accommodative, and the other, contractionary. Hence, the BNM opines that increasing the OPR level but maintaining it below the neutral rate will not be detrimental to the economy.

In this light, the first monetary policy statement in January 2010 which indicated that the Monetary Policy Committee *"recognises the need to ensure that the stance of monetary policy is appropriate to prevent the buildup of financial imbalances that could arise from interest rates being too low for a prolonged period of time"* should not have surprised the financial market. In fact, judging by the BNM's earlier explanation to the media that it will not likely change the statutory reserve requirement (SRR) unless there is a buildup in excess liquidity in the system, we feel that the OPR will be the primary tool to be used in the process of monetary normalisation. As such, we are now projecting the OPR to be raised by another 50 basis points this year to 2.75%. Further interest-rate moves in 2H2010 will largely be dependent on high-frequency data. Despite the expected increase, we still believe the present monetary policy setting is supportive of growth, judging by our estimated neutral rate of about 3.50% (using Taylor's Rule). This is on the back of a slight positive output gap and stability in the inflation rate.

Chart 11: Excess liquidity mopped up by the BNM (RM billion)



Source: MARC Economic Research

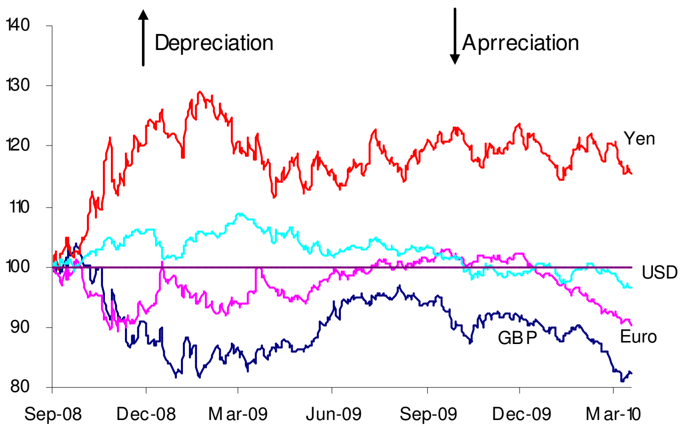
Not much discussion on exchange rate

There were no explicit discussions on the direction of the ringgit during the briefing, which indicates that the exchange rate is not the BNM's main policy tool. Nonetheless, we feel that the expected increase in the momentum of policy-rate normalisation that started on March 4 will be the key factor for the ringgit to remain strong in the medium term. Besides, the BNM is seen to be at the forefront in hiking up rates, compared with the central bank's peers in the Asian region.

Our reading on the ringgit's nominal effective exchange rate (NEER) suggests that the currency is fairly valued at this time. However, we would like to reiterate our medium-term target of RM3.20 – RM3.30 is very much intact as policy-rate normalisation would entail more inflows of capital, while at the same time, the persistent surplus in the current account indicates a higher demand for the ringgit.

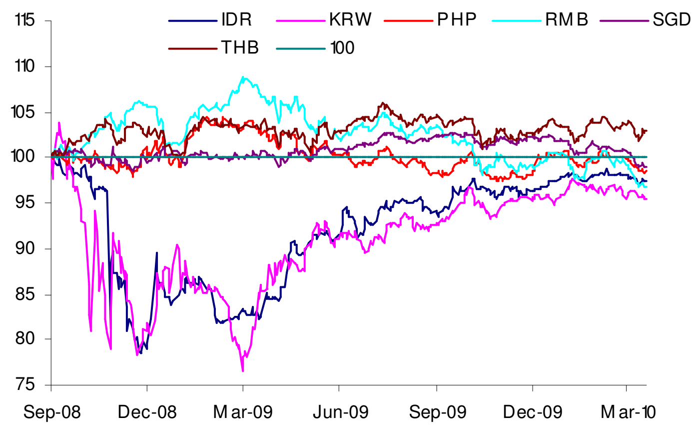
Admittedly, there are caveats to this outlook. First, the prospect of capital outflows associated with a possible correction in the equity market. Technically speaking, the benchmark FBM KLCI faces a strong hurdle at the 1,400 level (the upper band of the long-term regression line) while fundamentally, the market's price-earnings ratio (PER) is not at an attractive level. Second, market reaction to the impending announcement of the New Economic Model will somewhat determine foreigners' attitudes towards investment in Malaysia. Should the new measures fail to excite financial-market investors, the ringgit will likely be affected. Third, as there are now expectations building up for the BNM to further normalise the policy rate, a move perceived as less than aggressive by market players will dampen the sentiment for the ringgit. Finally, should the global economy, for any reason, succumb to a double-dip recession, an open economy like Malaysia will be hit and the desire to hold the ringgit will be reduced.

Chart 12: MYR against advanced countries' currencies (Sep '08 = 100)



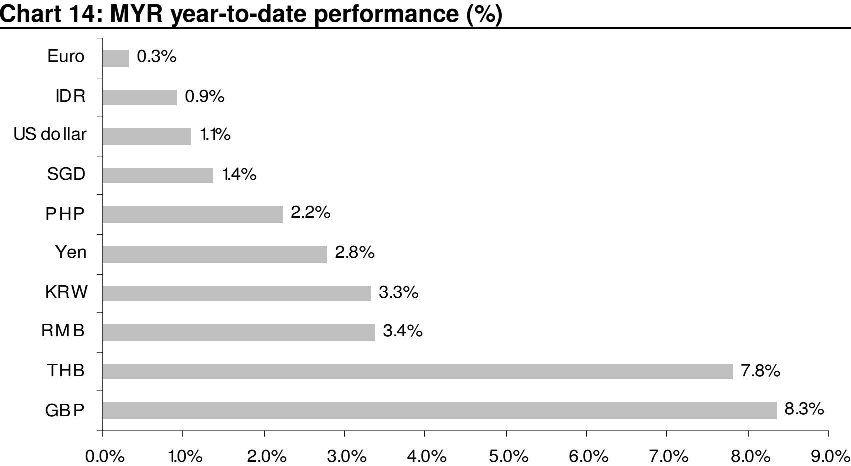
Sources: CEIC & MARC Economic Research

Chart 13: MYR against regional peers' currencies (Sep '08 = 100)



Sources: CEIC & MARC Economic Research

Chart 14: MYR year-to-date performance (%)



Source: CEIC

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Published and Printed by:

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