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BNM Annual Report 2010: Growth assured amidst headwinds

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Bank Negara Malaysia Annual Report 2010

Introduction

The MARC Economic Research team and vice president of financial institution ratings attended the analyst briefing that was held in conjunction with the release of the Bank Negara Malaysia (BNM) Annual Report 2010 on March 23, 2011. The turnout at the event was very encouraging, with the diverse crowd comprising sell- and buy-side analysts from institutions like research houses and investment banks.

During the question-and-answer session, there was notable interest amongst attendees in BNM's potential response to future inflation dynamics, the latest statutory reserve requirement (SRR) hike, the high household debt situation and the increasing liberalisation of the banking sector. We offer below some of our thoughts on the key takeaways from the presentations made by senior BNM officials.

2011 Growth

BNM is targeting a growth rate of between 5% and 6% this year (2010: 7.2%), with domestic demand likely to be the key pillar that will hold the economy up amidst a slowdown in the external sector. The central tendency appears to be very much in line with our growth projection of 5.3%, as announced in our outlook report released in January this year. Economic performance in 1H2011 is expected to be challenged by the higher base effect in 1H2010 as well as the lower prevailing global demand for electronics. In 2H2011, however, growth is likely to be more favourable, driven by domestic demand with a growth rate of 6.7% in 2011 (2010: 6.3%). Factors like improved labour market conditions, higher disposable income as well as greater access to credit are the main catalysts for private consumption growth. Impetuses such as positive business sentiment and the implementation of key initiatives announced by the government under the Economic Transformation Program (ETP) will propel private investment growth to 9.7% in 2011 (2010: 13.8%).

The present state of the global economy is a convoluted one, with political instability in the Middle East and North Africa (MENA) region and the earthquake, tsunami and nuclear disasters in Japan, all of which have the potential to curb Malaysia's growth in the foreseeable future. However, the positive vibes emanating from the United States (US) could well result in upside risks to export growth (especially if the US unemployment rate continues to decline), while improved access to credit can generate higher personal consumption expenditure (PCE), which will ultimately be beneficial to US growth. Hence, the Malaysian economy should be able to maintain respectable growth this year in light of greater domestic activities as well as a sustained external sector, with gross domestic product (GDP) growth likely to come in at 5.3%.

Table 1: GDP growth

			BNM	MARC
	2009	2010	2011F	2011F
GDP	-1.7%	7.2%	5% - 6%	5.3%
Domestic demand	-0.5%	6.3%	6.7%	5.2%
Consumption	1.2%	5.3%	7.0%	5.4%
-Private	0.7%	6.6%	6.9%	5.8%
-Public	3.1%	0.1%	7.2%	3.9%
Investment	-5.6%	9.4%	6.1%	4.5%
-Private	-17.2%	13.8%	9.7%	8.0%
-Public	8.0%	5.5%	2.7%	1.2%
Real exports	-10.4%	9.8%	2.7%	8.8%
Real imports	-12.3%	14.7%	2.8%	9.4%
Net exports	5.0%	-24.2%	2.3%	3.1%

Sources: BNM & MARC

Global energy and commodity price rises inflate consumer spending concerns

The prevailing high global energy and commodity prices, driven to their current levels by supply disruptions from geopolitical developments (primarily the uprising in the Middle East and North Africa region), weather conditions that have inflicted damage on crops, as well as investors' thirst for better yields in a predominantly low interest rate environment are threatening to unseat inflation expectations as general prices rise.

Certainly, inflationary pressure has been building up in Malaysia, although the consumer price index (CPI) has remained below 3% in terms of yearly growth in recent months. For January 2011, the CPI rose by 2.4% year-on-year (y-o-y), compared with December's 2.2%, largely attributable to significant rises in food & non-alcoholic beverages, transport and healthcare costs. The BNM forecasts that 2011 inflation will increase further and average at between 2.5% and 3.5%, driven primarily by the consequential rises in global energy and commodity prices, as well as potential domestic demand factors that could arise amidst sustained economic expansion resulting from the initiatives being implemented under the government's Economic Transformation Programme (ETP).

As such, we opine that consumer price appreciation going forward would be driven almost equally by demand- and supply-side influences. The higher oil prices would necessitate further subsidy reduction as the government is determined to keep its budget deficits in check. So far, the fuel price adjustment has been gradual and we expect such measures will continue in the months ahead. Issues relating to food prices are also garnering attention today. Domestic food prices are projected to rise as well, as Malaysia's self-sufficiency levels in such essential categories of food as rice, milk and vegetables are glaringly low (71.4%, 4.9% and 41.2% respectively in 2010), resulting in the country's high dependence on food imports to supplement domestic needs. Such supply-side issues can have material impact on rising costs in the country.

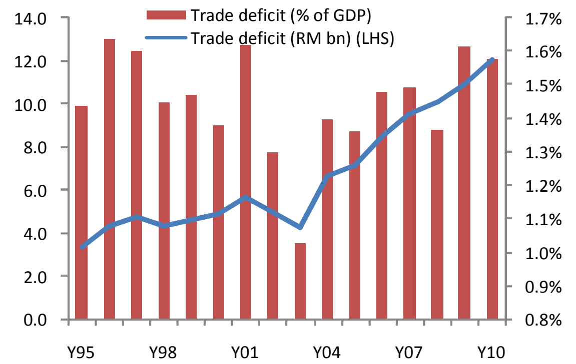
As for demand-led inflation, capacity constraints faced by manufacturers suggest that second-round effects such as wage increases are likely to occur as producers are preoccupied with keeping pace with high product demand, causing nominal wage growth to peak at 19.0% year-on-year (y-o-y) in March 2010. However, wage growth has been moderating since then. In fact, the latest Ministry of Human Resource report reveals that the country's unemployment rate in January 2011 rose to 3.4% from December's 3.2%, implying that a resource slack is very much present in the economy. Therefore, there are mixed feelings as to how demand-pull inflation could evolve in the near term. Going forward, as inflationary pressures continues to build up, we have bumped up our average CPI growth target to 3.3% for 2011.

Monetary policy to remain supportive of growth

Although the issue of inflation will likely take centre stage, BNM appears to be divided over the raising of policy rates in the near term. Inflation originating from significant increases in energy and commodity prices has been addressed by gradually removing subsidies, increasing food production as well as improving distributional efficiencies. However, strong domestic activities have caused demand-led inflation to emerge, as evidenced by the capacity constraints faced by manufacturing businesses (this was reflected in the narrowing of the output gap, which could turn slightly positive this year). In this regard, monetary policy will be implemented against a backdrop of sustained economic growth. The latest move (hiking the SRR) was not seen as a major detractor of the banking system's profitability, given that the cost of funds may take time to adjust, according to BNM's governor. Hence financial intermediation or loans growth should not experience sharp reversals as net interest margins are still reasonably high.

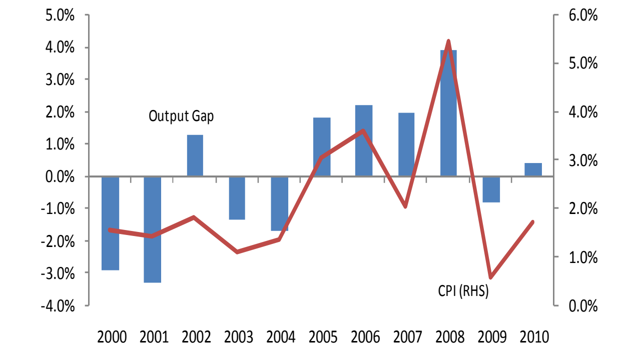
In our view, the immediate focus would be addressing financial imbalances in the economy, especially in light of the rise in the level of household debt which was sustained at 75.9% of GDP in 2010 (2009: 76.0%). The latest move to control credit card usage is the best example of BNM's seriousness in tackling the issue, which, if left unattended, could potentially derail Malaysia's growth prospects and its aspirations of achieving developed-nation status by 2020. In addition, wage increases in the manufacturing sector have been moderating in recent months amidst steady employment creation, implying that demand-pull inflation has shifted into low gear. Nonetheless, our estimates showed that the output gap in 2010 was slightly positive and we expect it to continue in positive territory in 2011. Hence, we retain our call that policy rates will be revised upwards between 25 and 50 basis points in 2H2011 in order to ensure an orderly normalisation process in light of sustained economic growth in 2011.

Chart 1: Malaysia's trade in foodstuff



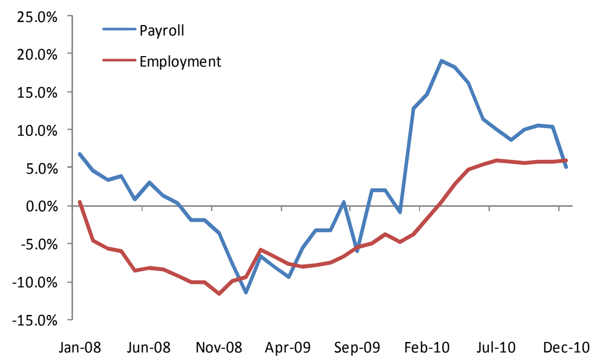
Source: CEIC

Chart 2: Malaysia's output gap vs. CPI



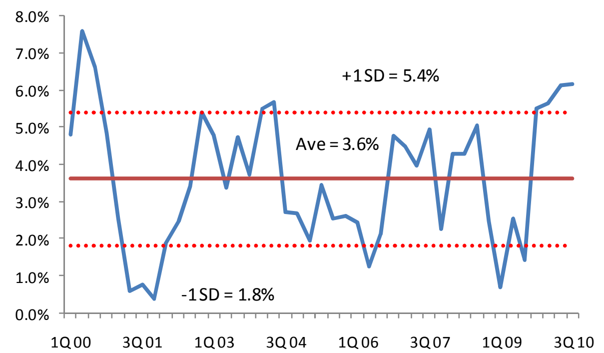
Source: MARC Economic Research

Chart 3: Manufacturing payroll and employment growth



Source: CEIC

Chart 4: House price index (HPI) (y-o-y%)



Source: CEIC

Capital flows not alarming at this juncture

BNM appears unperturbed by the appreciation of the ringgit at this juncture, perceiving such adjustments to be in line with Malaysia's positive economic fundamentals. Apart from that, two-way capital flows remain evident in the balance of payments (BOP) account, with direct investment abroad increasing by 53% in 2010 while the "other investment" category also recorded a sizeable amount of net outflows amounting to RM51.1 billion. These flows managed to offset the large amount of net inflows from portfolio investment of RM44.9 billion in 2010 (2009: -RM1.7 billion). Additionally, the substantial increase in short-term flows has largely been sterilised, imparting stability to domestic monetary conditions.

In light of concerns over risks associated with sudden capital flows, BNM outlined several policy options commonly used by other countries in this region that can be instituted if deemed necessary, including administrative measures like stamp duties and levies, greater flexibility of outflows by the relaxation of import conditions as well as macro-prudential liquidity measures such as new mortgage-lending requirements. BNM also indicated that under the managed float regime, the currency would adjust accordingly to adapt automatically to dynamic global economic conditions Malaysia might find itself facing.

Our understanding is that BNM is quite comfortable with the current position of the ringgit, and thus sees no necessity to take drastic measures to address its appreciating trend. As such, we believe that the ringgit is fairly valued at this juncture with Malaysia's overall BOP at an almost balanced position (or zerorised at -0.4% of GDP in 2010). Additionally, with the real effective exchange rate (REER) at more than 100 points, we believe that the upside potential for the ringgit is rather limited. Against such a backdrop, we see RM3.00 as the immediate resistance level.

Notwithstanding the medium-term outlook, the immediate trend will primarily depend on the RM3.00 level as it serves as a critical resistance against the greenback. If the ringgit manages to break this level, the new trend will unfold and a strong ringgit will likely persist for a longer period as the RM3.00 level against the greenback will become a major support level.

Managing the Rising Household Sector Debt

Malaysian household sector debt maintained its upward momentum in 2010 increasing by 12.5% in 2010 to RM581 billion from the 9.4% increase posted in 2009. However, despite this increase, household debt as a proportion of GDP remained fairly constant at 75.9% of GDP in 2010 (2009: 76.0%). While this level appears still manageable, especially compared to countries like Australia and Korea, the central bank has announced several pre-emptive prudential regulations and other measures to dampen the expansion of household debt levels.

Is Household Sector Debt a Problem?

Despite the escalation in the household sector debt levels, a notable feature has been the relative resilience of the household sector loan portfolio as indicated by a NPL ratio of 2.3% at end-2010. In fact, the household sector's NPL ratio of 2.3% was lower than the banking sector's NPL ratio of 3.1% at end-2010. Supporting the relative resilience of the household sector loan portfolio is the improvement in the employment conditions during 2010, in line with the rebound in economic activity as the unemployment rate declined to 3.2% in 2010 from 3.5% in 2009.

At the same time, however, much comfort cannot be drawn from the low NPL ratio because an escalating debt burden in the household sector would eventually impact its debt repayment ability in the future. We believe, to its credit, the central bank has recognised this problem and taken pre-emptive policy measures.

Apart from the regulated banking sector, households also borrow from entities that are not regulated by the central bank such as cooperative societies and money lenders. As such entities are not regulated, information on household debt within the economy may be somewhat understated.

A Critical Look at Household Debt Levels

While we take note of the recent measures taken by the central bank, we would like to present our views on household sector debt levels.

Firstly, we believe that the continuous escalation in household sector debt cannot be arrested unless there are some fundamental changes in the business strategies of Malaysian banks. Household debt accounted for 55% of the banking sector's loan book in 2010, a very significant increase from 16% in 1998; even in the immediate aftermath of the Asian Financial Crisis. The progressive refocus towards the household sector was a result of a substantial spike in corporate defaults following the Asian crisis.

With the progressive increase in household income and increased acceptance of consumerism, the household sector has been perceived as a safe bet for the banking sector. The more essential mortgages and auto loans, which account for nearly 65% of household sector loans in 2010, are freely complemented by credit cards and consumer loans. While credit underwriting standards have improved, especially since the implementation of Basel II, they have remained relatively basic. In most instances, it has been limited to the verification of the applicant's salary. It is encouraging to note that the central bank has taken note of it and an 'affordability test' is to be introduced to ensure that the bankers do a more through credit risk assessment prior to extending consumer credit.

Secondly, we believe that household deposits with the banking sector are a better indicator than the household sector financial assets. In any case, the macroeconomic-level household-sector financial assets are a less accurate indicator of income inequalities and the resulting variation in the level of financial asset ownership among households. However, considering that the bulk of household sector borrowings are for mortgages and auto financing, the distribution of household sector debt is likely to be more even among the population than the distribution of financial assets. As a result of this inequality, the household sector financial assets to household sector debt ratio of 238% in 2010 (2009: 237%) is of limited use to measure the household sector's underlying financial asset cover.

According to the central bank, household-sector financial assets consist of price-sensitive financial assets such as stocks and unit trusts (33%), deposits (31%), provident fund savings (30%) and endowment savings (6%). However, it should be noted that a substantial majority of borrowers will not be able to access their savings in provident fund accounts until they reach retirement age, while pre-mature redemption of endowment fund proceeds may not be possible or come at a higher cost. Therefore, such funds are not available for immediate usage to tide over a period of loss of income and repay any loan commitments. Therefore, if the illiquid provident fund savings and endowment savings are factored out, the adjusted household sector financial assets to household debt ratio declines to 153% in 2010.

Furthermore, price-sensitive financial assets such as stocks and unit trust contributions are vulnerable to adverse wealth and income shocks. For instance, in 2008, while the household sector’s debt holdings increased by 9.9%, its financial asset holdings decreased by 4.4% amidst unfavourable financial market conditions which depressed the value of financial assets such as stocks and bonds. Although the household sector financial assets have since posted growth rates of 14.9% and 13.1% in 2009 and 2010, their underlying volatility makes them a less stable measure of resilience.

We believe a better benchmark against which the household sector debt should be viewed (albeit one that still is affected by the inequality effect of wealth distribution) is the household deposits with the banking sector. From this perspective, it is clearly evident that Malaysian households are a net debtor to the banking sector, with household sector deposits accounting for 70% of household sector debt in 2010 (2009: 73%).

Thirdly, since 45% of household sector debt is for mortgage financing and another 20% for auto financing, a total of at least 65.0% of the total household sector debt is secured. This has been used to support the argument that eventual loss to banks after a default is deemed to be low. However, collateral would be an eventual source of repayment during default and not an immediate source of repayment. As a result of this focus, the actual debt servicing ability of the household sector, as reflected by its disposable income, has often not been looked at in detail during credit assessments. Although banks practice foreclosure, it has to be the last resort due to the negative socioeconomic consequences attached to it.

Regulatory Policy Options

It is encouraging to note that the central bank has announced measures to address the problem of escalating household-sector debt levels. Some of the recent policy measures announced by the central bank include:

- A maximum loan-to-value ratio (LTV) of 70% for the purchase of the third residential property.
- A higher capital charge of 100% (previously 75%) in the computation of risk weighted assets for mortgages where the LTV is 90% or higher.
- Higher minimum income requirement of RM24,000 per annum for individuals for credit card applications.
- Individuals drawing less than RM36,000 per annum limited to holdings less than two cards.
- Introduction of more stringent credit assessment standards for consumer credit from the third quarter of 2011. It would include an affordability test, where the repayment ability of the borrower would stressed for progressive increases in cost of borrowing of up to 2%. Anecdotal evidence suggests that bankers are focusing more on the underlying collateral, especially for mortgages and auto loans. The proposed guidelines would fill this gap and thereby improve the quality of credit assessments done by the banks.

The low interest rate environment that prevailed during 2009 and most of 2010 was also a major factor for the rise in household loans. In fact, household-sector loans grew at robust rates of 9.8% in 2009 and 13.4% in 2010. In 2009, household-sector loans dominated the credit disbursements by banks, accounting for 68% of total disbursements, while in 2010 it accounted for 58% of total disbursements. Therefore, the central bank’s policy normalisation measures such as the increase in the overnight prime rate (OPR) and the statutory reserve ratio (SRR) would over time result in an increase in the cost of funds for the banks, which in turn would increase the cost borrowing, and to some extent dampen credit growth.

Going forward, the central bank has emphasized that it would be taking more steps to control the growth of household-sector credit. In our view, upwards interest rate adjustments may take the back seat for the moment, as economic growth and prospects, although promising, are still subject to external shocks, especially with regard to a rise in key commodity prices. However, the central bank is likely to further normalise the SRR towards the pre-crisis level of 4% from the 2% that will take effect from April 2011.

The central bank is likely to engage in vigorous moral suasion of banks to control the expansion of household-sector loans. It is very likely that the central bank would also introduce more directed prudential regulations to control the expansion of household debt. In our view, some of the possible directed prudential regulations that could possibly be deployed by the central bank include:

- Stricter LTV ratios on the purchase of a second residential property, perhaps if such purchases are made within a specific time period.
- A further increase in capital charge in the computation of risk weighted assets, perhaps in areas which may be perceived to be at risk of a developing property bubble.
- Maximum portfolio concentration limits for certain classes of lending such as unsecured personal lending and credit card advances.
- Although it appears fairly unlikely at this stage, the central bank, in an extreme scenario, can also restrict loan expansions for those banks that expand at a much faster pace than their peers.

Conclusion

Considering the central bank's emphasis on addressing the escalation of household sector debt, it is unlikely that the level of household sector debt in the economy would evolve into a problem that can destabilise the banking sector. However, the persistent rise in household-sector debt levels is a worrisome problem and it is encouraging to note that the central bank is taking gradual steps to address the issue.

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