# Economic Research

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MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

## *The 2011 Bank Negara Malaysia Annual Report*

Vol.: ER/005/2012

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## In a nutshell

► With global economic uncertainties continuing to linger, BNM is targeting a growth rate of between 4%-5% this year (central tendency of 4.5%) after a 5.1% expansion in 2011. Again, domestic demand is expected to remain the key pillar that holds the economy against headwinds from the external sector. In this regard, MARC's GDP growth projection for 2012 is just a shade lower than BNM's projection (2012: 4.4%) while our forecast for 2013 stands at 5%.

► The issue of household debt was elaborated on at length during the briefing with BNM. Overall, the level of household debt continued to edge higher to 76.6% of GDP (2010: 75.8% of GDP). Notwithstanding this, BNM maintains that the overall situation is under control due to several reasons. On our part, we feel that although some macro numbers may look benign (ie NPL for the household sector) much comfort cannot be derived from such statistics because an escalating debt burden in this sector would eventually impact its debt repayment ability in the future.

► Overall, we are heartened that a more concerted effort to address financial imbalances in the economy is being undertaken. The recent introduction of prudent lending measures by BNM – while likely to lead to softer loan growth this year – is a step in the right direction. In fact, we have already indicated in last year's BNM report that lending by non-bank institutions such as cooperatives, MBSB and DFIs should also be closely monitored in order not to cause households to become overextended and create future financial system instability and household hardship.

► Similar to its comments in March last year when BNM commented about the appreciation of the Ringgit, the concerns over the immense amount of capital inflows were downplayed. Our take is that BNM is pretty much comfortable with the current position of the Ringgit and believes that there is no necessity to take drastic measures to address its appreciating trend. There is however another scenario that should not be taken for granted – the possible outflows arising from an upside surprise in the US economy which may prompt investors to scramble for US equities, causing some capital to leave this region. If this happens, Malaysia and Indonesia will likely be the countries that bear the brunt of portfolio re-balancing by international fund managers.

► BNM's overall tone seems to suggest that there is limited downside to interest rates, if there is any. In the past, inflationary pressure originating from significant increases in energy and commodity prices has been addressed through a gradual removal of subsidies, raising food production as well as improving distributional efficiencies. Similar efforts will likely be deployed this time. As such, we will not be surprised if the present level of Overnight Policy Rate (OPR) is maintained throughout the year, at least until a clearer picture of the global economy emerges, with a potential bias towards tightening at the end.

► We feel that BNM will continue to engage in vigorous moral suasion of banks to control the expansion of household sector loans. We still hold to some of the recommendations from our report last year of prudential regulations that could possibly be deployed by the central bank. What needs to be realised is that in waging war against household indebtedness, there are bound to be negative repercussions on certain segments of businesses and consumers. On that score, we do not see the rationale of having a fetish over achieving high headline economic growth without properly addressing financial imbalances in the economy.

## Introduction

The MARC Economic Research team attended the analyst briefing that was held in conjunction with the release of the Bank Negara Malaysia (BNM) Annual Report 2011 yesterday, March 21, 2012. There was a solid turnout at the event with the diverse crowd comprising sell- as well as 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 escalating household debt, fiscal deficits and reserve management. We proffer below some of our thoughts on the key takeaways from the presentations made by senior BNM officials.

## Growth for 2012 and 2013

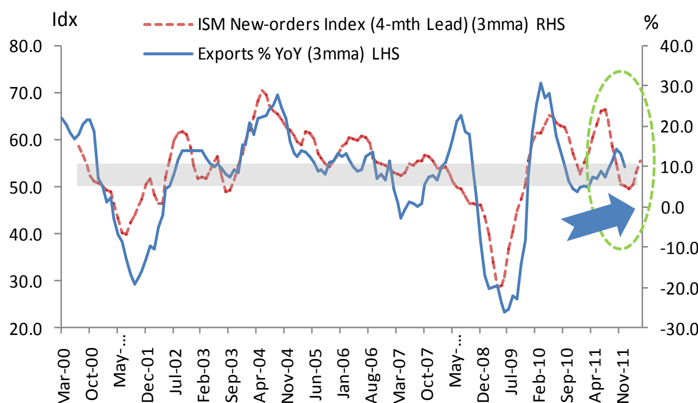
With global economic uncertainties continuing to linger, BNM is targeting a growth rate of between 4%-5% this year (central tendency of 4.5%) after a 5.1% expansion in 2011. Again, domestic demand is expected to remain the key pillar that holds the economy against headwinds from the external sector. In this regard, MARC's GDP growth projection for 2012 is just a shade lower than BNM's projection (2012: 4.4%) while our forecast for 2013 stands at 5%.

Major economic challenges in 1H2012 are very much related to the weakening export sector following a downdraft in regional external trade. In 2H2011, growth was dented by economic turmoil in Europe which sapped demand for Asian exports. In addition, effects from the slump in production following the Japanese earthquake in March 2011 and massive flooding in Thailand beginning July 2011 have contributed to weakening export demand from Malaysia. Not surprisingly, export growth almost screeched to a halt by January 2012, expanding by a mere 0.4% from a double-digit pace of 16.6% and 15.3% in September and October 2011.

Our view on the external trade performance still hinges on the incoming data in the next several months as the recent downturn was exacerbated by the Lunar Year effect as well as the lag effects from Thailand's flood incident. As such, the incoming data will provide a clearer picture of the real trend in Malaysia's export performance.

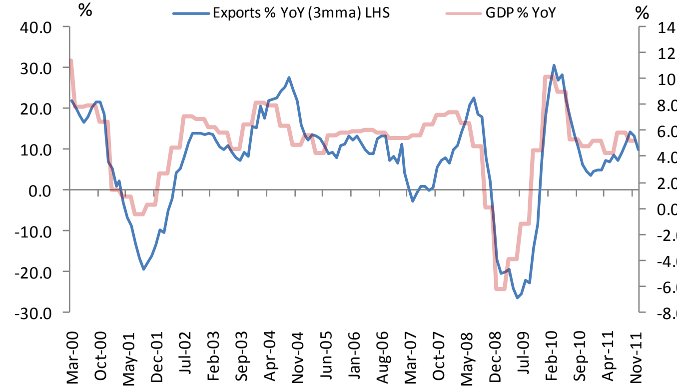
Notwithstanding this, the lingering effect of a moderation in China's growth engine and lackluster demand from other Asian countries will likely point to a much softer export performance going forward. In this regard, our forecast for real export growth of 1.2% in 2012 is almost in line with BNM's projection of a 1.4% expansion.

**Chart 1: Malaysian exports and ISM new orders (4-mth lead)**




*Source: CEIC, MARC Economic Research*

**Chart 2: Malaysian exports and GDP growth**




*Source: CEIC, MARC Economic Research*

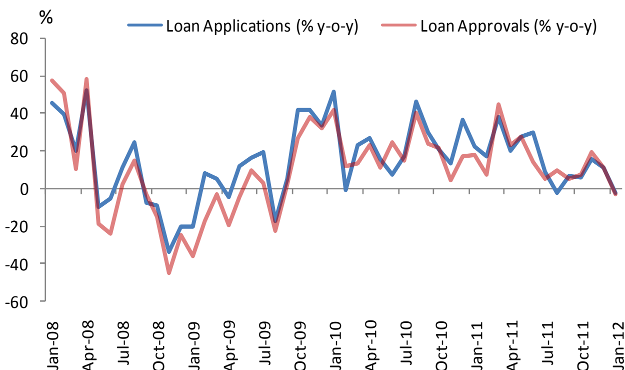
On the flip side, the good news is that the world's largest economy – the United States (US) – is showing persistent strength judging by various high frequency data released in recent months. Equities have recovered strongly and even non-farm payrolls have been flashing signs of a meaningful recovery in the labour market, with unemployment dropping to 8.3% in February 2012 from 9.1% in July 2011.

Such improvements augurs well for an open economy like Malaysia as stronger manufacturing new orders (Institute of Supply Management or ISM new orders) will translate into better export performance (ISM new orders tend to lead Malaysia's exports for approximately 4 months – see chart).

We concur with BNM's view that domestic demand will continue to support growth in the overall economy mainly through private consumption which has been resilient in the past few years. Notwithstanding this, we feel that some downward pressure on private consumption will materialise, though not because of any significant deterioration in labour market conditions (as it did during the Great Recession in 2009). We think the impact of the measures imposed by the central bank to ensure prudent lending practices will weigh on private consumption growth, as well as from the repercussions from a possible increase in pump prices if global oil prices remain stubbornly high in the near future, something that BNM hinted at during the briefing.

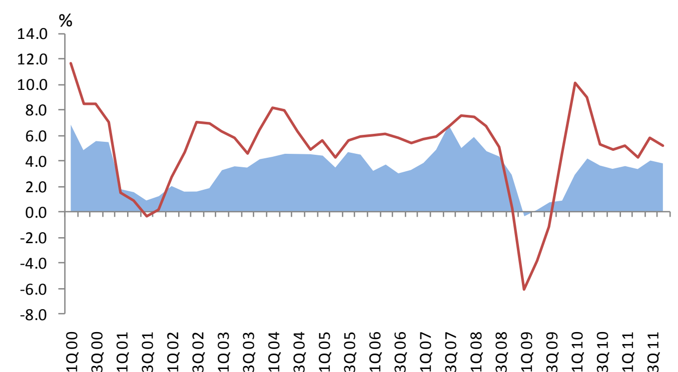
We foresee some weaknesses in loan growth this year, at least judging by leading indicators which have tumbled in recent months (chart). At the same time, upward pressure on oil prices may translate into higher pump prices if the government continues its commitment to reduce the budget deficit to 4.7% this year. As a consequence, consumer sentiment will likely be hit and private consumption will moderate more than expected. Bear in mind that since private consumption has consistently been a major contributor to GDP growth in the past decade, a slowdown in consumer spending would mean softer headline growth numbers for 2012 (chart).

**Chart 3: Loan applications and approvals**




*Source: CEIC, MARC Economic Research*

**Chart 4: Percentage contributions by private consumption and headline GDP**




*Source: CEIC, MARC Economic Research*

While the government is banking on the strength in private investment to support the economy, the upbeat momentum in investment activity will likely be tempered by lingering uncertainties in the advanced countries as well as the rising risk of a significant slowdown in China. As such, the inflows of direct investment may moderate this year from last year's RM 32.9 billion. In the portfolio segment, the risk of outflows may emerge if the upbeat momentum of the US economy finally convinces financial markets about a sooner than expected rate hike prior to 2014 as mentioned by the US Federal Reserve (Fed). In addition, equity valuations in the US especially for the S&P500 are attractive enough to induce more inflows into the US market, which may take some shine off Asian markets and drag their currencies lower in the short term.

Not all is gloom. We sense that global economic recovery is slowly gaining momentum, spearheaded by the strength in the US economy and a European economy that has appeared to bottom out. Hence, we do not subscribe to a scenario of a significant downside in the growth trajectory. Notwithstanding this, a mediocre performance in Malaysia's external trade coupled with a slight moderation in consumer spending in light of stronger oil prices and slower loan growth will threaten the headline economic

growth in 2012. Hence, we maintain our call for Malaysia's GDP growth at 4.4% for this year before rebounding to its long-term trend of 5% in 2013.

**Table 1: GDP – demand side (%)**

| | 2010 | 2011 | BNM 2012F | MoF 2012F | MARC 2012F |
|---|---|---|---|---|---|
| GDP | 7.2 | 5.1 | 4.0-5.0 | 5.0-6.0 | 4.4 |
| Domestic Demand | 6.3 | 8.2 | 6.6 | 7.5 | 7.7 |
| Consumption | 5.2 | 8.9 | 4.9 | 4.5 | 6.2 |
| -Private | 6.5 | 6.9 | 6.2 | 7.1 | 6.3 |
| -Public | 0.5 | 16.8 | 0.2 | 3.0 | 6.2 |
| Investment | 9.8 | 6.0 | 11.9 | 17.0 | 12.3 |
| -Private | 17.7 | 14.4 | 8.3 | 15.9 | 9.1 |
| -Public | 2.8 | -2.4 | 16.2 | 7.0 | 16.0 |
| Real Exports | 9.9 | 3.7 | 1.4 | 2.5 | 1.2 |
| Real Imports | 15.1 | 5.4 | 1.6 | 3.6 | 2.5 |

*Source: CEIC, MARC Economic Research*

## Thorny issue of high household debt

The issue of household debt was elaborated on at length during the briefing with BNM. Overall, the level of household debt continued to edge higher to 76.6% of GDP (2010: 75.8% of GDP) in 2011, albeit at a slower pace than in the prior year (2011: 12.5%; 2010: +13.7%). Notwithstanding this, BNM maintains that the overall situation is under control due to several reasons: (1) growth in household debt has been accompanied by a corresponding expansion in household financial assets (2) strong financial buffers due to a high proportion of liquid and near liquid assets (3) debt servicing capacity of households continues to be supported by favourable income and employment conditions.

On our part, we have elaborated our view on Malaysia's household debt in our report in March last year. To recap, we feel that although some macro numbers may look benign (ie NPL for the household sector) much comfort cannot be derived from such statistics because an escalating debt burden in this sector would eventually impact its debt repayment ability in the future.

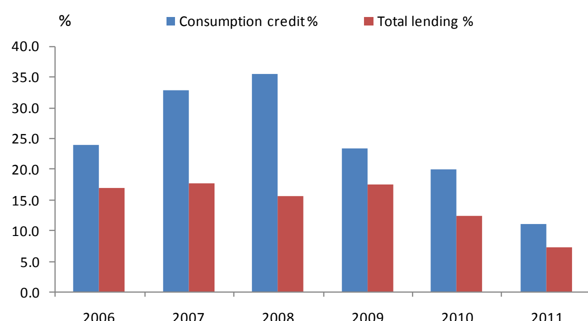
In addition, apart from the regulated banking sector, households also borrow from entities that are not regulated by the central bank such as cooperative societies and money lenders. Statistics from BNM clearly indicate that the pace of lending by non-banking institutions (for example Development Financial Institutions or DFIs such as Bank Pembangunan, Bank Kerjasama Rakyat, Bank Simpanan Nasional etc) has been relatively high in the past few years, averaging 14.5% per annum since 2005 despite moderating to 7.2% in 2011. The growth peaked at 17.6% in 2007. A further breakdown reveals that lending for the segment categorised as 'consumption credit' has grown at a CAGR of 20.3% per annum in the past 7 years. More staggering is the pace of growth in the lending for credit cards segment which recorded a CAGR of 50.4% per annum since 2005.

Judging by these numbers, we feel that one of the more effective ways to contain Malaysia's household debt is by limiting the amount of lending by non-bank institutions in certain categories, particularly consumption credit.

We still hold on to our view that the continuous escalation in household sector debt cannot be arrested unless there are some fundamental changes in the business strategies of Malaysian banks and non-bank financial institutions. With the progressive increases in household income and increased acceptance of consumerism, the household sector has been perceived as a safe-bet for the banking sector. In addition, this strategy was adopted to avoid a substantial spike in corporate defaults that banks experienced during the Asian Financial Crisis in 1998, as well as to accommodate a shift in

corporate borrowing from banks to the capital markets. Currently, household debt still accounts for a hefty 55% of the banking sector's loan book in 2011, up from an estimated 33% in 1998.

**Chart 5: Lending growth by DFIs – total and for consumption credit**




*Source: CEIC*

**Table 2: Growth in lending by DFIs – breakdown of consumption credit**

| | Purchase of motor vehicles | Credit cards |
|---|---|---|
| | % | % |
| 2006 | 43.8 | 54.6 |
| 2007 | 9.6 | 72.0 |
| 2008 | 5.8 | 101.6 |
| 2009 | -5.7 | 83.4 |
| 2010 | -13.3 | 38.3 |
| 2011 | -18.2 | 27.8 |
| CAGR % | 5.3 | 50.4 |

*Source: Financial Stability and Payment Systems Report (various issues)*

On that score, it is encouraging to note that BNM has taken note of the situation and prescribed prudent lending guidelines in November 2011 which took effect in January 2012, to ensure that banks give out loans only to those who are eligible, in order to avoid future distress in the household sector. In addition, BNM's explanation that similar guidelines have also been prescribed to DFIs, cooperatives and MBSB partially relieves our anxiety about over-lending practices by non-banking institutions.

However, aside from the DFIs, these entities remain outside the regulatory purview of BNM and may not necessarily adhere strictly to the credit standards established for the banking sector; nor will they have the and systems or experienced credit personnel to quickly meet the same credit standards. As such we continue to remain concerned over the quality and quantity of loans extended by these institutions, and the resulting vulnerability of households.

Secondly, we maintain our belief that household deposits with the banking sector are a better indicator than household sector financial assets due to income inequalities that cause variations in the level of financial asset ownership among households of different income levels. As a result of this inequality, the household sector financial assets to household sector debt ratio of 230% in 2011 (2010: 238%; 2009: 240%) is of limited use to measure the household sector's underlying financial asset cover.

We have also pointed out in last year's report that even if we consider consumers' financial assets as an important buffer against a deterioration in the household debt situation, we should note that a majority of borrowers will not be able to access their savings in provident fund accounts until they reach retirement age. At the same time, 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. Taking all these into consideration and adjusting the illiquid provident fund savings and endowment savings, the adjusted household sector financial assets to household debt ratio declines to 148% in 2011 (2010: 154%).

It is also noteworthy that price-sensitive financial assets such as stocks and unit trust contributions are vulnerable to adverse wealth and income shocks. For instance in 2008, due to unfavourable financial market conditions which depressed the value of financial assets such as stocks and bonds, the household sector's debt holdings increased by 9.9% while its financial asset holdings decreased by 4.4%. This suggests that the underlying volatility in financial assets makes them a less stable measure of resilience.

There is also an argument that since a big chunk of the household debt is concentrated in the mortgage and auto sector, a total of at least 64% of the total household sector debt is secured. However, we are of the view that collaterals are an eventual source of repayment during default and not an immediate source of repayment. Therefore, 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. Bear in mind that although banks can opt for foreclosure, it is usually considered a last recourse due to the negative

socio-economic consequences attached to it, as well as the typically long time span required before liquidation can be completed.

The differences in asset and debt holdings among households of different income levels are also a concern. While on the one hand, we take comfort from the fact that the majority of borrowings (77%) is mainly by households earning more than RM3000 a month (46.5% for households earning more than RM5000). These households are also more likely to own sufficient financial assets to cover debt obligations. From BNM statistics, it appears leverage ratios in this segment are within a comfortable range of 2.3-3.3 times household income.

On the other hand, the remaining debt has been accrued by households earning less than RM3000, and is a real source of concern, as even illiquid financial assets are lacking and leverage ratios worryingly high at between 4.4-9.6 times incomes. Household debt in this income group comprises 12.7% of total loans, and mainly comprises auto and consumption credit.

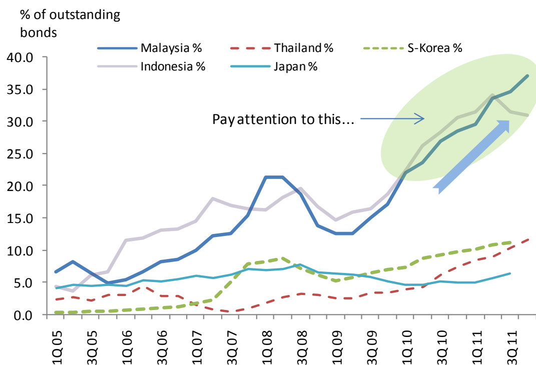
Overall, we are heartened that a more concerted effort to address financial imbalances in the economy is being undertaken especially in light of the rise in the level of outstanding household debt which still grew at a double digit pace of 12.5% in 2011 from 13.7% in 2010.

The recent introduction of prudent lending measures by BNM – while likely to lead to softer loan growth this year – is a step in the right direction. In fact, we have already indicated in last year's BNM report that lending by non-bank institutions such as cooperatives, MBSB and DFIs should also be closely monitored in order not to cause households to become overextended and create future financial system instability and household hardship.

## Capital Flows

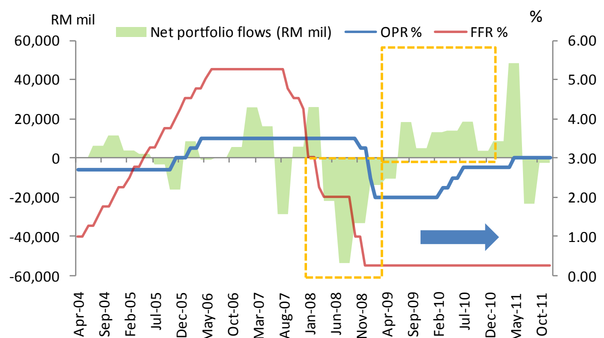
Similar to its comments in March last year when BNM commented about the appreciation of the Ringgit, the concerns over the immense amount of capital inflows were downplayed. This is due to the fact that – according to BNM – two-way capital flows remain evident in the balance of payments (BOP) account, with direct investment abroad increasing by 5.6% in 2011 (2010: 53.8%) while the "other investment" category also recorded net outflows amounting to RM2.4 billion (2010: RM54) billion. In addition, These net inflows from portfolio investment of RM30.3 billion (2010: RM48.5 billion) will likely be offset by a series of outflows when international asset managers start to refocus on the US equity market if the US economy continues to recover.

**Chart 6: Foreign holdings of local bonds as % of local bond outstanding**




*Source: Asian Development Bank*

**Chart 7: Portfolio flows and interest gap between Malaysia and the US**

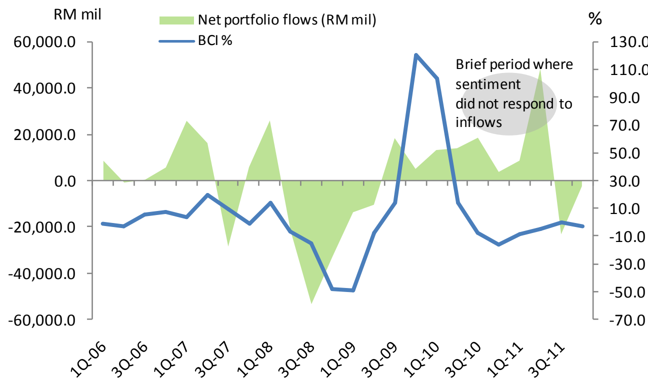



*Source: Financial Stability and Payment Systems Report (various issues)*

Our take is that BNM is pretty much comfortable with the current position of the Ringgit and believes that there is no necessity to take drastic measures to address its appreciating trend. There is however another scenario that should not be taken for granted – the possible outflows arising from an upside surprise in the US economy which may prompt investors to scramble for US equities, causing some capital to leave this region. If this happens, Malaysia and Indonesia will likely be the countries that bear the brunt of portfolio re-balancing by international fund managers. This is due to the fact that both countries have seen massive amount of inflows of capital particularly into government bonds in the past two years. This has bolstered the level of foreign holdings of the bonds in these countries (chart). There is however another possibility. If the bullish sentiment in the US equity market is accompanied by a similar positive trend in the local equity market, a shift in investments from local government bonds to equities will have a neutral effect on the Ringgit.

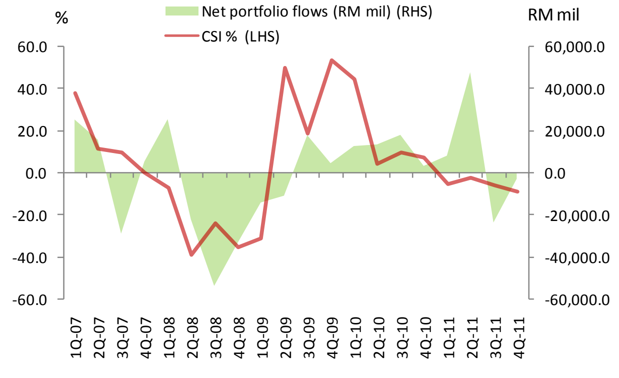
What is important to note is that if the amount of capital outflows overwhelms the inflows, the repercussion on local business conditions should not be underestimated. In fact, past experiences seem to indicate that MIER's business condition index tend to move in tandem with the trend in portfolio flows (chart).

**Chart 8: Portfolio flows and MIER's business conditions index (BSI)**




*Source: CEIC and MARC Economic Research*

**Chart 9: Portfolio flows and MIER's consumer sentiment index (CSI)**




*Source: CEIC and MARC Economic Research*

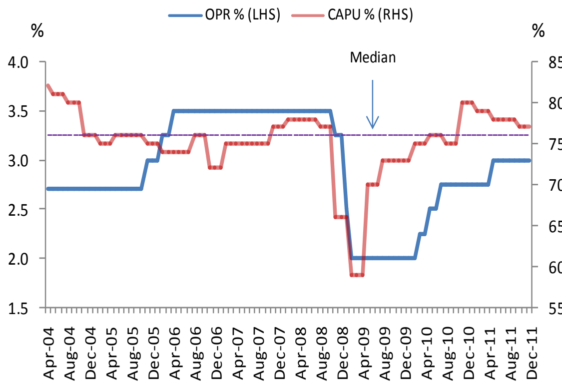
Nevertheless, our view is that the Ringgit over the long term will continue to appreciate, with occasional short term bouts of volatility depending on the balance of capital flows. BNM's international reserves position has been bolstered in recent years, and they have not been shy in mitigating capital outflows with foreign exchange liquidity when it has proven necessary, such as at the end of 2005 and 2008. BNM has also indicated that they have been proactive in diversifying reserves for the past ten years particularly into other Asian currencies, though we believe that the composition is still largely in USD.

## No significant change in monetary policy

BNM's overall tone seems to suggest that there is limited downside to interest rates, if there is any. For one, the central bank has indicated that the present labour market conditions point to an economy operating above potential (an unemployment rate of 4% is considered to be the full employment rate according to BNM). Second, although the inflation rate is expected to be benign this year (between 2.5% to 3%), the potential upside risk emanating from strong oil prices will be closely monitored and will prevent policymakers from moving into an 'ultra accommodative' mode (OPR of less than 3%). BNM's forecasts for the year are partially based on an oil price of between USD100-105 per barrel.

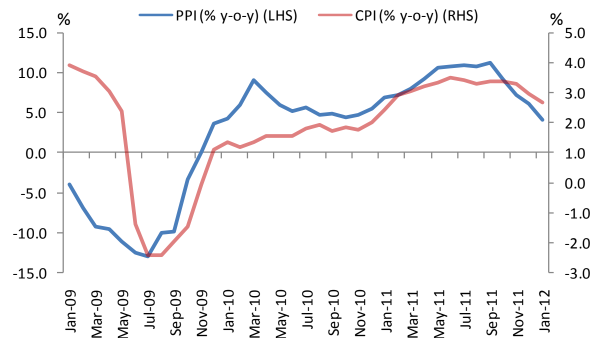
In the past, inflationary pressure originating from significant increases in energy and commodity prices has been addressed through a gradual removal of subsidies, raising food production as well as improving distributional efficiencies. Similar efforts will likely be deployed this time, but the likelihood of a positive output gap this year and demand-led price pressures emerging will gradually increase pressure for a monetary policy response.

**Chart 10: Capacity utilisation and Overnight Policy Rate (OPR)**




*Source:CEIC, MARC Economic Research*

**Chart 11: PPI and CPI inflation**




*Source: DOS*

A decision to trim the policy rate may also prove to be inappropriate at a time when capacity utilisation is above its historical median, again indicating an economy operating above potential and likely to lead to demand side inflationary pressure. The expected increase in public and private investment from the Economic Transformation Programme (ETP), such as the KL MRT project, various large property developments in the Klang Valley and investment in the Iskandar region, may also add to price pressures going into the end of the year. Another difficulty in deciding to trim the policy rate is the fact that it may send a contradictory signal to the market about the central bank's seriousness in addressing Malaysia's household debt problem.

On the flip side, as economic growth trajectory has somewhat tilted to the downside, risk of a hike in the OPR is also limited over the short term. As such, we will not be surprised if the present level of OPR is maintained throughout the year, at least until a clearer picture of the global economy emerges, with a potential bias towards tightening at the end.

## 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. The most significant in our view is the prudent lending guidelines which are expected to be adhered to even by non-banking institutions such as DFIs, cooperatives and MBSB. We see this as a positive move.

We feel that BNM will continue to engage in vigorous moral suasion of banks to control the expansion of household sector loans. We still hold to some of the recommendations from our report last year of prudential regulations that could possibly be deployed by the central bank, which include:

- Stricter loan-to-value (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.

What needs to be realised is that in waging war against household indebtedness, there are bound to be negative repercussions on certain segments of businesses and consumers. In other words, something's got to give, and this may include lower economic growth for a certain period. On that score, we do not see the rationale of having a fetish over achieving high headline economic growth without properly addressing financial imbalances in the economy.

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